REDUCING THE PROFITABILITY OF CORPORATE INSIDER TRADING THROUGH PRETRADING DISCLOSURE

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I. INTRODUCTION

Over the last six decades, the federal government has constructed an extensive system of civil and criminal laws designed to reduce the ability of "corporate insiders"[1] to make profits trading on "inside information."[2] During the 1980s, the government sought to increase the system's effectiveness by increasing penalties and devoting more resources to enforcement. However, both the volume of trading[3] by corporate insiders and the profits these insiders make from "corporate insider trading"[4] have increased dramatically since these measures were put into effect.[5] In fact,

1. In this Article, the terms "corporate insiders" and "insiders" refer to those officers, directors, and shareholders required to file trading reports under Section 16(a) of the Securities Exchange Act of 1934. *See infra* Part III.B.1.

2. The Article uses the term "inside information" to mean information about a corporation that is available only to persons with positions inside the corporation (and their tippees), whether or not that information would be considered legally "material" under the securities laws. For a discussion of the materiality standard, see *infra* Part III.A.3.

3. Unless otherwise indicated, the Article uses the term "trading" to refer to the buying and selling of common stock issued by a corporation with respect to which one is an insider.

4. Except where the context indicates otherwise, the Article uses the terms "corporate insider trading" and "insider trading" to mean the use of inside information by corporate insiders to increase their personal trading profits.

5. *See* H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J. L. & ECON. 149, 172-75 (1992) (reporting that the volume of trading by corporate insiders has increased fourfold

recent studies of insiders' trading suggest that corporate insiders make almost $5 billion per year in insider trading profits.[6]

After surveying the evidence that corporate insiders trade on inside information (and providing an estimate of total corporate insider trading profits), this Article explains why insiders are able to engage in such trading. The Article then puts forward a simple method for reducing insiders' ability to make profits trading on inside information: requiring insiders to disclose publicly their intended trades shortly before submitting orders to their brokers. The Article shows that this pretrading disclosure rule could substantially reduce—and in principle eliminate—corporate insider trading profits. The Article also explains how adopting a pretrading disclosure rule would enable the government to eliminate some of the existing restrictions on insiders' trading and thereby reduce the overall regulatory burden on insiders. The Article concludes by putting forward a second approach to reducing insider trading profits—requiring insiders to conduct all of their trades face-to-face off the exchange—and comparing this "face-to-face" rule and two other rules (a ninety-day notice rule and a no-trade rule) to pretrading disclosure. It finds that these rules would be more effective than pretrading disclosure at reducing insider trading profits, but might impose too high a cost on insiders.

Although several prominent commentators have argued that corporate insider trading is desirable,[7] there has been a strong consensus among the public, Congress, the Securities and Exchange Commission ("SEC"), and most commentators for more than sixty years that corporate insiders should not be permitted to profit freely from their access to inside information. Corporate insider trading is considered undesirable for at least three reasons.

First, insider trading can adversely affect managers' incentives and thereby hurt corporate performance. The prospect of insider trading profits may, for example, induce managers to engage in overly risky projects in order to generate large price swings;[8] discourage managerial effort by

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since 1984 and that "excess returns" per trade (the returns attributable to inside information) have doubled).

6. *See infra* Part II.B.

7. The views of these commentators are discussed *infra* notes 41-57 and accompanying text.

8. *See, e.g.*, Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. L. REV. 309, 332 (the prospect of insider trading profits may encourage managers to engage in overly risky projects). *See also* Mark Bagnoli & Naveen Khanna, *Insider Trading in Financial Signaling Models*, 47 J. FIN. 1905 (1992) (management may have an incentive to act inefficiently to make insider trading profits); Roy A. Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448-89

enabling managers to profit even when they generate bad news;[9] and interfere with internal firm communications by giving managers an incentive to hoard and trade on inside information before revealing it to others.[10]

Second, even if insider trading does not adversely affect managerial incentives, it increases the cost of equity capital.[11] Insider trading profits reduce—dollar-for-dollar—the profits of other stockholders.[12] To the extent that there is insider trading, investors will anticipate lower returns from investing in stock and therefore be willing to pay less for it. Insider trading can also reduce the supply of equity capital by undermining public confidence in the stock market.[13]

(managers permitted to trade on inside information will run company to maximize insider trading opportunities rather than to maximize shareholder value).

9. *See, e.g.*, James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628 (the ability to trade on inside information may discourage managerial effort by permitting managers to profit even when news is bad); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) (same); Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489-90 (1969) (reviewing HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966)) (same).

10. *See, e.g.*, Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1064 (1982) (the ability to trade on inside information could interfere with internal firm communications).

11. *See* Lawrence M. Asubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1023 (1990) (insider trading can inefficiently increase the cost of capital); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 489 (1979) (same).

12. *See* H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 190 (1986). Insider trading profits reduce the profits earned by other investors both directly and indirectly. Insider trading profits reduce other investors' profits directly to the extent that market makers match investors' orders with those of corporate insiders trading on inside information (so that the market makers' net position is unaffected). If an investor sells to a corporate insider buying on favorable inside information, he or she is deprived of the gain that will occur when that information is released. If an investor buys from an insider selling on negative inside information, the loss is transferred from the insider to the investor. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 62-64 (1996).

Insider trading profits reduce other investors' profits indirectly to the extent that corporate insiders trade with market makers in a manner that leaves the net position of public investors unchanged. Although the market makers will, in the first instance, bear the cost of such trading, this cost forces them to increase their bid-ask spread to ensure that the extra profit that the market makers make trading with noninsiders compensates the market makers for the loss that they will suffer when they trade with insiders using inside information. *See* Seyhun, *supra*, at 191. The increase in the bid-ask spread imposes additional transaction costs on all of those buying and selling stock, indirectly reducing public investors' profits.

It should be emphasized that insider trading profits reduce the profits of other investors dollar-for-dollar only if insider trading has no economic effect other than to redistribute returns among the corporation's shareholders. To the extent that insider trading adversely affects a corporation's performance, every dollar of profits made by corporate insiders trading on inside information reduces the profits made by all investors (including insiders) by an even greater amount.

13. As Arthur Levitt, Jr., the former chairman of the American Stock Exchange, observed: "If the investor thinks he's not getting a fair shake, he's not going to invest, and that is going to hurt

Finally, many share the intuition that—regardless of the economic consequences—it is simply unfair for those with inside information to trade with those who cannot obtain such information.[14] This is apparently the view of Congress,[15] the SEC,[16] and many commentators.[17] Corporate insider trading is also seen as a violation of the insiders' fiduciary duty to the corporation's public shareholders (at whose expense insider trading profits are made).[18]

The consensus against corporate insider trading is reflected in a system of rules designed to reduce the profits from such trading.[19] This sys-

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capital investment in the long run." *The Epidemic of Insider Trading*, BUS. WK., Apr. 29, 1985, at 79. *See also* Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading: Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 227 (1985) [hereinafter *Task Force Report, Part I*] ("[P]eople will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed."). The fact that a number of emerging markets have been forced to take steps to reduce insider trading in order to attract investors provides anecdotal evidence in support of this view. *See, e.g.*, Vincent Boland, *Capital Markets Reforms Promised*, FIN. TIMES, May 14, 1997, at 6 (reporting that the Czech government, in response to pressure from investors, plans to set up an agency to regulate the stock market and crack down on insider trading).

14. *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post*-Chiarella *Restatement*, 70 CAL. L. REV. 1, 1-2 (1982).

15. *See infra* note 153 and accompanying text.

16. *See infra* note 106 and accompanying text.

17. *See, e.g., Task Force Report, Part I, supra* note 13, at 227-28 (concluding that the "fair play" basis for the regulation of trading by corporate insiders is still sound). *See generally* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Kim Lane Scheppelle, *It's Just Not Right: The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993).

18. Indeed, the purpose of the first statute to regulate trading by corporate insiders (Section 16(b) of the Securities Exchange Act of 1934, described *infra* Part III.B.1.), which forces insiders to disgorge any profits made from "short-swing" trading, was seen as establishing a minimum fiduciary standard for officers, directors, and large shareholders. According to the draftsman of Section 16(b) of the Securities Exchange Act of 1934 , the statute "is simply an application of an old principle of law that if you are an agent and you profit by inside information concerning the affairs of your principal, your profits go to your principal." *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong. 122 (1934) (statement of Thomas G. Corcoran). A more recent and frequently cited articulation of the view that corporate insiders trading on inside information violate their fiduciary duty to the corporation's other shareholders is found in *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969), where the court held that:

> [a] person who acquires special knowledge or information by virtue of a . . . fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom. This, in turn is merely a corollary of the broader principle, inherent in the nature of the fiduciary relationship, that prohibits a trustee or agent from extracting secret profits from his position of trust.

Id. (citation omitted).

19. Many (but not all) of the rules aimed at reducing corporate insider trading profits are also intended to prevent so-called "market insiders" (lawyers, accountants, investment bankers, and others who periodically have access to inside information) and lower level employee insiders from profiting from their direct or indirect access to inside information. *See, e.g.*, United States v. O'Hagan, 117 S.

tem is based primarily on Rule 10b-5, promulgated by the SEC under Section 10 of the Securities Exchange Act of 1934 ("the Act" or "the 1934 Act"), which requires that any insider with a fiduciary duty to those with whom she would trade must refrain from trading if in the possession of "material" inside information (that is, undisclosed information about a "bombshell event,"[20] such as an impending takeover offer).[21] Corporate insiders also continue to be subject to Section 16(b) of the Act, which prohibits them from profiting from "short-swing" transactions.[22]

Since the early 1980s, Congress and the SEC have taken a tougher stance in enforcing Rule 10b-5. In 1984, Congress passed the Insider Trading Sanctions Act[23] ("ITSA"), which sharply increased the penalties for violating Rule 10b-5 by allowing the SEC to seek a civil penalty of treble damages (three times the profit made or loss avoided) in addition to disgorgement.[24] Shortly thereafter, the SEC began stepping up its efforts to investigate and prosecute those violating the securities laws. Prison sentences, virtually nonexistent before 1980, became commonplace.[25] In 1988, the Insider Trading and Securities Fraud Enforcement Act[26] ("ITSFEA") raised the maximum criminal penalty to $1 million in fines and ten years in prison.[27] ITSFEA also imposed penalties on "controlling persons" for knowingly or recklessly failing to enforce procedures for dis-

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Ct. 759 (1997) (lawyer of firm representing acquirer found liable under Rule 10b-5 for using inside information to trade in the securities of the target company).

However, trading by market insiders and lower level employee insiders is unlikely to be as harmful as corporate insider trading. First, the volume of trading by market insiders and lower level employees is likely to be lower than the volume of trading by corporate insiders. Not only do these other insiders tend to own less stock than higher level managers (and therefore cannot profit as much by selling stock on bad news), but they also have less access to the information necessary to determine whether it would be profitable to trade (except in the relatively uncommon situation where the information acquired by the insider concerns a "bombshell" event, such as an impending takeover offer). Second, trading by these insiders does not distort managerial incentives and therefore cannot adversely affect corporate performance.

For a good description of some of the legal issues raised in the regulation of market insiders, see Reinier Kraakman, *The Legal Theory of Insider Trading Regulation in the United States*, *in* EUROPEAN INSIDER DEALING 40-47 (Klaus J. Hopt & Eddy Wymeersch eds., 1991).

20. The terminology originates with Dennis Carlton and Daniel Fischel. *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 887 (1983).

21. *See infra* Part III.A.1.

22. *See infra* Part III.B.1.

23. 15 U.S.C. § 78u(d)(2) (1984).

24. Prior to 1984, the SEC's civil remedies against an insider who traded on undisclosed material information were limited to requiring disgorgement of any profits from such trading. *See, e.g.*, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

25. *See* Stuart Taylor, Jr., *Sentences Getting Stiffer*, N.Y. TIMES, May 9, 1985, at D4.

26. Pub L. No. 100-704, 102 Stat. 4677 (1988).

27. *See* Barbara Bader Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALBANY L. REV. 893, 895 n.16 (1988).

couraging illegal use of inside information by their employees. This has led many companies to take steps to restrict insiders' trading.[28]

These enforcement measures appear to have had some effect. Following the adoption of ITSA in 1984, corporate insiders have traded less frequently in the month before earnings results are released or a takeover is announced.[29] For example, since the passage of ITSA there has been almost no trading by top executives in the month before a takeover announcement is made.[30]

However, ITSA and ITSFEA appear to have had no effect on the volume of trading by corporate insiders and the total amount of corporate insider trading profits. In fact, both have increased since Congress began its recent crackdown: Since 1984, the volume of trading by corporate insiders has increased fourfold and the average return per trade attributable to inside information has doubled.[31]

Corporate insiders' continuing ability to make insider trading profits reflects limitations inherent in the current regulatory system. Rule 10b-5 cannot easily deter insiders from trading on material inside information in the many cases where there is little likelihood that a violator will be detected and punished.[32] Furthermore, Rule 10b-5 does not prohibit insiders from trading on "sub-material" information (information that does not meet the strict legal standard of materiality).[33] And Section 16(b) and employer-imposed restrictions are unlikely to prevent all of the insider trading that Rule 10b-5 fails to deter or actually permits.[34]

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28. *See infra* Part III.C.

29. *See* Seyhun, *supra* note 5, at 171-73; Nasser Arshadi & Thomas H. Eyssell, *Regulatory Deterrence and Registered Insider Trading: The Case of Tender Offers*, FIN. MGMT., Summer 1991, at 30 n.1. *See generally* Thomas H. Eyssell & James P. Reburn, *The Effects of the Insider Trading Sanctions Act of 1984: The Case of Seasoned Equity Offerings*, 16 J. FIN. RES. 161 (1993) (finding that insiders were less likely to sell shares prior to price-depressing announcements of equity offerings following the passage of ITSA in 1984).

30. *See* Seyhun, *supra* note 5, at 175.

31. *See id.* at 150.

32. *See infra* Part III.A.2.

33. *See infra* Part III.A.3. Rule 10b-5 also does not prohibit insiders from using inside information to postpone trading until the release of that information moves the stock price in a favorable direction. The conventional view is that Rule 10b-5 therefore permits insiders to profit at the expense of public shareholders not only by trading on sub-material information but also by postponing trading based on inside information. One of the contributions of this Article is to show that this view is mistaken. As I explain below, an insider's ability to use inside information to postpone trading until the stock price moves in a favorable direction does not put the insider in a better position than the average public shareholder. *See infra* Part III.A.4.

34. *See infra* Parts III.B, III.C.

Total corporate insider trading profits are substantial. Since the mid-1980s, access to inside information has enabled insiders to beat the market—which rises an average of ten percent per year—by an additional seven percent per year.[35] Based on data indicating that corporate insiders trade $70 billion worth of their own shares each year, I estimate that corporate insiders make almost $5 billion annually trading on inside information.[36]

To be sure, not all of these insider trading profits are generated by illegal trading on material inside information.[37] Much, if not most, of the insider trading profits are made legally by trading on important but sub-material inside information. But from a policy perspective there is little difference between legal and illegal insider trading (except, perhaps, of degree), a point that has been recognized by participants on both sides of the insider trading debate.[38]

To see why this is the case, suppose that Corporation M insiders can profit from their access to inside information only by trading on material inside information and that Corporation S insiders can make insider trading profits only by trading on sub-material information. Suppose, for purposes of illustration, that material information is information whose release would cause the stock price to move X% (and that sub-material information is information whose release would cause the stock price to move Y%, which is less than X%). The profits that M insiders make trading on material inside information and the profits that S insiders make trading on sub-material inside information both reduce the profits earned by public investors in their respective companies. To the extent that they anticipate these diminished profits, investors will be willing to pay less for the stock of both Corporation M and Corporation S. To the extent that insiders' ability to sell on undisclosed bad news reduces, on the margin, their incentive to avoid generating that bad news in the first instance, both M and S insiders face the same type of distorted incentives. Finally, if it is unfair for M insiders to profit from access to inside information at the expense of the public, it is also unfair for S insiders to do so (even if their profit is smaller).

To be sure, M insiders selling on material inside information will avoid more losses than S insiders selling the same amount on sub-material

35. *See* Seyhun, *supra* note 5, at 159.

36. *See infra* Part II.B.

37. The fact that many corporate insiders are caught trading on material inside information indicates that at least some of the almost $5 billion in insider trading profits derives from such trading. *See infra* note 111.

38. *See, e.g.*, Carlton & Fischel, *supra* note 20, at 861; Kraakman, *supra* note 19, at 48.

information. For example, if both sets of insiders sell $100 worth of stock, the sales by M insiders will reduce public shareholders' profits by $X and the sales by S insiders will reduce other shareholders' profits by only $Y. The sales by M insiders will thus have a potentially greater adverse effect on managerial incentives, and arguably will be more unfair, than the sales by S insiders.

But since the bombshell events that generate material inside information are not common, there are likely to be more opportunities for S insiders to trade on sub-material information than there are for M insiders to trade on material information. S insiders might therefore make *more* trading on sub-material inside information than M insiders make trading on material inside information. If so, trading by S insiders on sub-material information could, in the aggregate, lead to a greater increase in the cost of capital, more severe distortions of managerial incentives, and more instances of unfairness than trading by M insiders on material inside information.

In short, trading on sub-material inside information can—perhaps to an even greater degree—generate the same harms as trading on material inside information.[39] As a result, there would be benefits to reducing both the profits that insiders continue to make trading illegally on material in-

39. Notwithstanding the analysis just presented, one might argue that the fact that trading on sub-material inside information remains legal indicates the considered judgment of congressional policymakers that such trading does not raise the same concerns as trading on material inside information. But if congressional policymakers believed that the only form of insider trading that is objectionable is trading on material inside information, they would have by now repealed Section 16(b), which prevents corporate insiders from profiting from any inside information, material or otherwise, if there is a purchase and a sale within six months of each other. The fact that Congress has not abolished Section 16(b) suggests that congressional policymakers believe that Rule 10b-5 does not prohibit all of the forms of insider trading that they find undesirable. *Cf.* Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading: Part II: Reform of Section 16*, 42 BUS. LAW. 1087 (1987) [hereinafter *Task Force Report, Part II*] (recommending that Section 16(b) be retained in part because Section 16(b) prevents the unfair use of inside information in ways not prohibited by Rule 10b-5).

A more plausible explanation for Congress' failure to prohibit trading on sub-material inside information is that Congress understands that it would not be practical (or possible) to do so using either the "disclose or abstain" approach embodied in Rule 10b-5 or the "no-profit" approach of Section 16(b). *See infra* Parts III.A.5, III.B.3. *Cf. Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934: Hearings on H.R. 4344, H.R. 5065, H.R. 5832 Before House Comm. on Interstate and Foreign Commerce*, 77th Cong. 1224 (1941) ("Principally because of the intangible nature of the offense against which the law is directed, the old problem of trying to legislate honesty into man, it has proven impossible satisfactorily to write an exact prohibition." (statement of George Rea, President of the New York Stock Exchange)).

I do not mean to imply that Congress' goal in regulating insiders' trading is to eliminate all insider trading profits. I am simply pointing out that one cannot infer from Rule 10b-5 that Congress believes that it is desirable for insiders to trade on sub-material inside information.

side information and the profits insiders that make trading legally on sub-material inside information. And it would be desirable to reduce these profits if these benefits exceed the costs of doing so, including (1) the cost of enforcing additional regulations (which will be borne by the government) and (2) the costs that the additional regulations will impose on insiders (beyond the cost of reducing their insider trading profits).[40]

This Article puts forward a simple, cost-effective means of reducing the profitability of corporate insider trading: the "pretrading disclosure" rule. Under the pretrading disclosure rule, a corporate insider would be required to disclose publicly her intended trade shortly before submitting an order to her broker (or completing a negotiated trade off the exchange). Market makers, dealers, and public investors (including the substantial number of professional and amateur investors who currently base their investment decisions on reported trades by corporate insiders) would then adjust the price at which they are willing to buy or sell in light of the insider's announcement (taking into account, for example, trading by other insiders of that corporation, previous trading by this particular insider, and any other information that they believe is relevant). As will be explained, pretrading disclosure would substantially reduce corporate insiders' ability as a group to make insider trading profits and should, at least in principle, eliminate those profits. One intuition for this is as follows: Insiders should not, in principle, be able consistently to outperform other shareholders once these other shareholders can perform the same trades as insiders. Pretrading disclosure would also impose only minimal costs on the government and insiders.

As I noted earlier, there are several prominent academic commentators who argue that the entire premise of the currently regulatory system is mistaken: that corporate insiders should be permitted to engage freely in insider trading.[41] These commentators make two main arguments. The first is that, contrary to the prevailing view, insider trading generates desirable incentive effects.[42] The second is that insider trading enables information to be transmitted to the market more quickly, thereby making stock prices more accurate (or "efficient").[43] They also claim that because in-

40. Those who believe that insider trading generates benefits would argue that any reduction in those benefits should be considered an additional cost of reducing insider trading profits. I discuss the possible benefits of insider trading below.

41. *See, e.g.*, HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 30-31 (1966); Carlton & Fischel, *supra* note 20.

42. *See* Carlton & Fischel, *supra* note 20, at 866-72.

43. *See id.* at 867. Other commentators might argue that, even if it is undesirable for corporate insiders to trade on material inside information, there are important price efficiency benefits to allowing them to trade on sub-material information, particularly "soft" information. However, I find this

sider trading profits are a form of compensation, they do not increase the cost of capital or raise fairness concerns any more than the salary compensation for which they should be seen as a substitute.[44] They would probably argue that pretrading disclosure is not only unnecessary but also undesirable.

However, most commentators, including myself, do not find their incentive and price efficiency arguments convincing. Consider first the claim that insider trading provides desirable managerial incentives. Proponents of insider trading argue that managers are generally risk-averse and will tend to be too cautious if they cannot make insider trading profits.[45] In particular, they claim that the prospect of profiting on both good news and bad news can make managers more willing to engage in socially desirable high risk, high return projects that they would otherwise forego.[46] If the project succeeds, they can make substantial profits buying stock before that information is released. If the project fails, they can reduce their losses by selling on the bad news.[47]

Although in theory insider trading can generate desirable as well as undesirable incentives,[48] the empirical data that are available suggest that—on balance—insider trading creates undesirable incentives. First, the fact that insiders sell twice as much stock as they buy,[49] and make almost all of their profits from selling before the release of bad news,[50] suggests that any incentive effect is likely to be negative.[51] Second, there is at least one statistical study finding that increased trading by insiders is associated

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modified price efficiency argument unconvincing for the same reasons that I find the original price efficiency argument unconvincing. *See infra* note 53 and accompanying text.

44. *See* Carlton & Fischel, *supra* note 20, at 881 n.80.

45. *See id.* at 871-72.

46. *See id.*

47. *See id.*

48. *See, e.g.*, Lucian Arye Bebchuk & Chaim Fershtman, *The Effects of Insider Trading on Insiders' Effort in Good and Bad Times*, 9 EUR. J. POL. ECON. 469 (1993) (insider trading may increase managerial productivity in good times but decrease it in bad times); Lucian Arye Bebchuk & Chaim Fershtman, *Insider Trading and the Managerial Choice Among Risky Projects*, 29 J. FIN. & QUANTITATIVE ANALYSIS 1, 13 (1994) [hereinafter Bebchuk & Fershtman, *Managerial Choice*] (insider trading may improve or worsen project choices).

49. *See infra* note 243 and accompanying text.

50. *See infra* note 73.

51. To be sure, the ability to sell on bad news could, in theory, provide an efficiency benefit by encouraging risk averse managers to undertake high risk, high reward projects. *See* Carlton & Fischel, *supra* note 20, at 871-72. But if this type of reward structure were in fact useful, we would expect firms to create arrangements that increase managers' salaries when projects fail. The fact that such arrangements are not observed (and that real-world compensation arrangements increase managers' salaries when projects succeed) suggests that selling on bad news on balance creates undesirable incentive effects.

with lower firm value.[52] To the extent that the volume of insiders' trading is correlated with insider trading profits, this study suggests that, on balance, insider trading profits worsen managerial incentives.

Next, consider the claim that insider trading creates a social benefit by increasing stock price efficiency. Recent work by economists and legal commentators, however, suggests that the "accuracy" of stock prices has little effect on the allocation of capital in the economy and that, therefore, there is little social value to "accurate" stock prices.[53] And even if accurate stock prices were socially desirable, insider trading can improve price efficiency only from the time that the trades are disclosed to the time that the underlying inside information emerges. Since insiders' trades are currently not disclosed until the middle of the following month, and corporations must disclose most material information about the corporation in their quarterly and annual filings with the SEC, the period during which insider trading can make prices more accurate is likely to be rather short. Finally, even if insider trading can communicate information to the market, and all else being equal, make it more efficient, insider trading might have an overall negative effect on price efficiency by giving corporate insiders an incentive to refrain from disclosing information to the market[54] (or even to deliberately provide the market with misleading information) and by discouraging informed outsiders from trading.[55]

The claim that insider trading profits are just another form of compensation (and therefore do not raise the cost of capital any more than other forms of compensation) is also flawed in two respects. First, because the market for managerial compensation is not tightly constrained by competition, insider trading profits do not substitute for other forms of com-

52. *See* Robert T. Masson & Ananth Madhavan, *Insider Trading and the Value of the Firm*, 39 J. INDUS. ECON. 333 (1991) (finding empirically that trading by insiders is associated with lower firm value).

53. *See, e.g.*, Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1016-17 (1992); Lynn Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 646-47 (1988).

54. *See* Easterbrook, *supra* note 8, at 333 (noting that the "prospect of insiders' gain may lead firm to delay the release of information"); Mendelson, *supra* note 9, at 489-90 (same); Schotland, *supra* note 8, at 1448-49 (same).

55. *See* Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993); Naveen Khanna, Steve L. Slezak & Michael Bradley, *Insider Trading, Outside Search & Resource Allocation: Why Firms and Society May Disagree on Insider Trading Restrictions*, 7 REV. FIN. STUD. 575 (1994) (insider trading may increase the cost to liquidity traders without generating more price efficiency because it reduces trading by informed outsiders). For a technical model showing that insider trading may decrease price efficiency, see Michael J. Fishman & Kathleen M. Hagerty, *Insider Trading and the Efficiency of Stock Prices*, 23 RAND J. ECON. 106 (1992).

pensation, but rather augment them.[56] Second, even if these profits did substitute for other forms of compensation, their use would still raise the cost of capital because they are an inefficient way to compensate managers. Insiders must make more than $1 in (gross) insider trading profits to make them as well off as if they had received $1 in salary because of the lottery-like nature of insider trading profits,[57] and because of the transaction costs that must be incurred to make them.

In any event, the purpose of this Article is not to enter into the debate over the desirability of corporate insider trading. Instead, this Article takes as given that it would be desirable to reduce corporate insider trading profits if this can be accomplished at a sufficiently low cost. The main purposes of the Article are (1) to provide a detailed survey of the evidence of corporate insider trading and develop an estimate of total corporate insider trading profits (Part II); (2) to identify the limitations of the existing rules for regulating trading by corporate insiders, namely, Rule 10b-5, Section 16(b), and employer-imposed restrictions on the timing of insiders' trades (and explain why it would not be desirable to build on any of these approaches) (Part III); (3) to put forward the pretrading disclosure rule as a cost-effective means of reducing corporate insider trading profits (and as a replacement for the more burdensome Section 16(b)) (Part IV); (4) to respond to possible objections to the pretrading disclosure rule (Part V); and (5) to compare pretrading disclosure to three other approaches to reducing corporate insider trading profits: (a) the "face-to-face" rule, which would permit corporate insiders only to trade in face-to-face transactions off the exchange; (b) a rule that would require insiders to disclose their intended trades ninety days in advance; and (c) a no-trade rule (Part VI).

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56. There is evidence of considerable slack in the managerial compensation market. Top managers are able to set their own compensation, subject only to such informal constraints as adverse publicity. *See* John A. Byrne, *How High Can CEO Pay Go?*, BUS. WK., Apr. 22, 1996, at 100-22; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 90 J. POL. ECON. 225 (1990) (finding little correlation between managerial pay and corporate performance); Kraakman, *supra* note 19, at 53; Marilyn F. Johnson, Susan Porter & Margaret B. Shackell, Stakeholder Pressure and the Structure of Executive Compensation (May 1997) (unpublished manuscript, on file with author) (finding that negative financial press coverage of a firm's compensation policies has a greater effect on changes in the level of compensation than any other factor). Permitting corporate insiders to profit from their access to inside information is thus unlikely to reduce the compensation that they receive from other sources.

57. Insider trading profits are very speculative—they depend on the insider having access to inside information, the ability to trade at a time when the price of the stock does not reflect its actual value, and adequate available capital. Thus these profits are not as valuable to managers as cash compensation. *See* Bebchuk & Fershtman, *Managerial Choice*, *supra* note 48, at 13 (total compensation paid to insiders must be increased when insider trading is permitted); Easterbrook, *supra* note 8, at 332 (insider trading is an inefficient way to compensate managers).

II. EVIDENCE OF CORPORATE INSIDER TRADING

This Part surveys the evidence indicating that there is widespread corporate insider trading and provides an estimate of total corporate insider trading profits. Section A summarizes the results of studies that examine the timing of corporate insiders' trades in relation to important corporate announcements and significant stock price movements. These studies show that corporate insiders increase their purchases before the release of good news and increase their sales before the release of bad news. Section B presents the results of studies that examine the profits that corporate insiders make on their trades. These studies show that corporate insiders as a group make significant "excess returns" on their trades (that is, they outperform the market), which they could not do without access to information that is not available to other market participants. The excess returns data are then used to formulate an estimate of the profits that corporate insiders as a group make from corporate insider trading. Market participants have long understood that corporate insiders trade on inside information. Section C explains how market participants use information about corporate insiders' trades to make their own trading decisions. Section D considers, and rejects, two alternative explanations for corporate insiders' excess returns and the behavior of public investors: (1) that corporate insiders are superior investors and (2) that corporate insiders outperform the market because market participants, believing (incorrectly) that insiders have access to inside information, bid up the price of stocks that insiders have bought and dump the stocks that insiders have sold.

A. INSIDERS' TRADING BEFORE ANNOUNCEMENTS

Although following the adoption of ITSA there has been less trading by insiders shortly prior to the release of takeover and earnings announcements, there is statistical and other evidence that insiders continue to trade heavily in advance of these and other types of announcements in ways which are consistent with their using inside information. That is, insiders continue to increase their purchases before the release of good news and increase their sales before the release of bad news, suggesting that they are either trading legally on sub-material inside information or trading illegally on material inside information.

One study of publicly traded firms that announced stock repurchases (which tend to increase stock price) between 1982 and 1990 found that purchases by insiders increased sharply in the month before the announce-

ment.[58] Another study, which examined over-the-counter ("OTC") firms between 1985 and 1987, found that there was heavy selling by insiders in the five months before price-depressing announcements of bankruptcy.[59] A third study showed that employee-insiders tended to be heavy buyers of stock before the release of earnings results that were substantially better than analysts' estimates—announcements that usually led to large price increases.[60]

A study of Real Estate Investment Trust ("REIT") insiders[61] indicates that insiders sometimes trade on specific items of information shortly before the information is announced. REITs are publicly traded corporations that manage a portfolio of real estate investments on behalf of their shareholders. Managers of a REIT will often seek a reappraisal of its assets when they believe that the new appraisal will show that the value of those assets has increased. The appraisal results are released with the next quarterly earnings report. Favorable results generally lead to an increase in the stock price, while unfavorable results typically cause the stock price to fall. Among the items of information that are released is the date of the appraisal. It is thus possible to identify the period during which the appraisal results were known to insiders but not to the market and examine insiders' trading during that period.

The study found evidence that REIT insiders increased their purchases *before* the appraisal date (presumably because they expected the appraisal results to come back favorable).[62] Once appraisal results arrived, insiders' trading intensified substantially. If, as was usually the case, the results were positive, there was an even greater increase in insider purchases. In firms with favorable appraisals, the ratio of net insider purchases to total insider transactions rose to 77% (versus 14% during normal

58. *See* Eias Raad & H. K. Wu, *Insider Trading Effects on Stock Returns Around Open-Market Stock Repurchase Announcements: An Empirical Study*, 18 J. FIN. RES. 45, 55-57 (1995).

59. *See* Thomas Gosnell, Arthur J. Keown & John M. Pinkerton, *Bankruptcy and Insider Trading: Differences Between Exchange-Listed and OTC Firms*, 47 J. FIN. 349, 350-53 (1992).

60. *See* Enyang Guo, Nilanjan Sen & Dilip K. Shome, *Analysts' Forecasts: Low-Balling, Market Efficiency, and Insider Trading*, 30 FIN. REV. 529, 538 (1995). The study examined Standard and Poor 400 industrial firms during the period from 1984 to 1992. It found that in the quarters before surprise positive earnings results were released, the buying/selling ratio (ratio of buying transactions to selling transactions) was 50% greater than in the quarters when analysts' estimates were on target. Similar results were obtained looking at the shares-bought/shares-sold ratio. As the authors of the study observe, analysts' estimates are usually based on conversations with management. Managers are believed to have an incentive to "low-ball" earnings estimates in order to look good when higher than expected earnings are announced. This study suggests that the prospect of insider trading profits provides an additional incentive to engage in "low-balling." *See id.* at 529.

61. *See* Aswath Damodaran & Crocker H. Liu, *Insider Trading as a Signal of Private Information*, 6 REV. FIN. STUD. 79 (1993).

62. *See id.* at 116.

periods); the ratio of net insider shares purchased to total insider shares traded rose to 93% (versus 1% in normal periods); and the ratio of net insider purchasing (in dollars) to the total dollar value of insider transactions rose to 87% (versus 3% in normal periods).[63] If, however, the REIT insiders had misjudged and the results came back negative, there was a "dramatic shift" toward selling before the public announcement of the appraisal results. In firms with unfavorable appraisals, the ratio of net insider sales to total insider transactions was 59% (versus -12% in normal periods), the ratio of net insider shares sold to total insider shares traded rose to 99% (versus .5% in normal periods), and the ratio of net insider selling (in dollars) to the total dollar value of insider shares traded rose to 99% (versus .5% in normal periods).[64]

The results of the studies cited here, which show that corporate insiders trade on inside information shortly before it is released, are consistent with the findings of studies examining other time periods;[65] with findings

63. *See id.*

64. *See id.*

65. Studies examining other periods have found that: (1) insiders in New York Stock Exchange ("NYSE") and American Stock Exchange ("ASE") firms between 1967 and 1974 tended to buy stock before the release of earnings forecasts that caused a significant increase in the stock price and to sell stock before the release of earnings forecasts that caused a significant decrease in share price, *see* Stephen H. Penman, *Insider Trading and the Dissemination of Firms' Forecast Information*, 55 J. BUS. 479, 501-02 (1982); (2) insiders in NYSE firms in 1971 traded in advance of significant corporate announcements, *see* Joseph E. Finnerty, *Insiders' Activity and Inside Information: A Multivariate Analysis*, J. FIN. QUANTITATIVE ANALYSIS 205, 213 (1976); (3) in NYSE and ASE firms between 1976 and 1979, there was reduced insider selling and increased insider buying before price-increasing announcements of mergers, large earnings, and dividend increases, *see* John Elliott, Dale Morse & Gordon Richardson, *The Association Between Insider Trading and Information Announcements*, 15 RAND J. ECON. 521, 529 (1984); (4) in publicly traded firms between 1975 and 1982, net insider purchasing rose in the six-month period before the announcements of corporate sell-offs that were received the most favorably by the market, *see* Mark Hirschey & Janis K. Zaima, *Insider Trading, Ownership Structure, and the Market Assessment of Corporate Sell Offs*, 44 J. FIN. 971 (1989); (5) in 265 publicly traded firms that announced the initiation of dividends between 1975 and 1985, insider buying was found to be particularly heavy before those announcements that caused the largest increases in price, *see* Kose John & Larry H.P. Lang, *Insider Trading Around Dividend Announcements: Theory and Evidence*, 46 J. FIN. 1361, 1382-84 (1991); (6) in 179 primary security issues between 1975 and 1982, insiders were found to increase their sales prior to price-decreasing announcements of equity and convertible debt issues, *see* Jonathan M. Karpoff & Daniel Lee, *Insider Trading Before New Issue Announcements*, 1991 J. FIN. MGMT. 18, 25; (7) in NYSE and ASE firms between 1977 and 1988 that announced fixed price repurchase offers, there was an increase in purchasing in the six months prior to the announcement, *see* D. Scott Lee, Wayne H. Mikkelson & M. Megan Partch, *Managers' Trading Around Stock Purchases*, 47 J. FIN. 1947, 1952 (1992); (8) insiders buy heavily before announcing value-increasing liquidations, *see, e.g.*, Thomas H. Eyssell, *Corporate Insiders and the Death of the Firm: Evidence on the Incidence of Insider Trading in Corporate Dissolutions*, 26 FIN. REV. 517 (1991); and (9) insiders sell heavily in the months before an announcement of bankruptcy, *see id.* at 531; H. Nejat Seyhun & Michael Bradley, *Corporate Bankruptcy and Insider Trading*, 70 J. BUS. 189, 214 (1997).

that insiders buy before abnormally large price increases and sell before abnormally large price decreases;[66] and with anecdotal accounts suggesting that corporate insiders trade on inside information before the release of both favorable and unfavorable information.[67] Insiders also increase their trading *after* market-moving corporate announcements in a manner consistent with their using inside information to postpone trades until the price moves in a favorable direction, which provides additional evidence that insiders use inside information to time their trades.[68]

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66. *See* Seyhun, *supra* note 12, at 196.

67. *See, e.g.*, Bridget O'Brian, *Buying by Grand Casino's Top Officials May Signal Change in Stock's Fortunes*, WALL. ST. J., May 7, 1997, at C20 [hereinafter O'Brian, *Buying by Top Officials*] (five officers of Saks Holdings exercised options and sold $3 million of stock six weeks before the stock price fell 30%); Bridget O'Brian, *Ten Insiders Sold Parametric Shares Before Big Decline*, WALL ST. J., Apr. 9, 1997, at C1 (reporting that ten Parametric insiders sold $18 million of shares several months before the stock price fell 40%); Vanessa O'Connell, *Circuit City Officials Sold Stock Before Poor Sales Report*, WALL ST. J., May 8, 1996, at C1 (reporting that nine Circuit City insiders sold $6 million of shares "just as the stock price peaked and shortly before reports of lower-than-expected sales in April").

68. For example, a study of firms listed on the NYSE and the ASE that made annual earnings forecasts between 1967 and 1974 found that insiders substantially increased their selling after good news forecasts (and, to a lesser extent, increased their buying after bad news forecasts). *See* Penman, *supra* note 65, at 492. Another study of exchange-traded firms between 1976 and 1979 found that insiders sold much more than usual after positive earnings announcements and merger announcements. *See* Elliott et al., *supra* note 65, at 525.

Other studies have found that in the months before there is heavy buying or selling by corporate insiders there have often been unusual price movements. These studies find that stock prices experience negative "abnormal returns" prior to heavy buying by insiders and positive abnormal returns prior to heavy selling. (A stock is said to yield "abnormal returns" when the price increases or decreases by an amount greater than expected given its performance over time and the stock's performance relative to that of the larger market.) Because abnormal returns are usually caused by the release of good or bad news (by the corporation or other sources), the abnormal return studies are consistent with insiders delaying their trading until after the release of important information. In a study of OTC firms from 1975 through 1983, for example, Ji-Chai Lin and John Howe found that during the six months prior to "intensive" insider sales months, stock prices experienced positive abnormal returns averaging 13.66% to 17.22% (depending on the methodology employed). *See* Ji-Chai Lin & John S. Howe, *Insider Trading in the OTC Market*, 45 J. FIN. 1273, 1274, 1279 (1990) (A month was considered to be an "intensive" insider selling (buying) month if there were three or more sales (purchases) and no purchases (sales).). For "intensive" insider purchase months, there were abnormal negative returns averaging 2.29% to 3.59% in the previous six months. *See id.* at 1279. In a more recent study of trading by individual bank insiders between 1987 through 1991, it was found that the average negative abnormal return over the forty days prior to insider purchase transactions was 7.65% (abnormal positive returns were not observed prior to sales). *See* Jeff Madura & Kenneth J. Wiant, *Information Content of Bank Insider Trading*, 5 APPLIED FIN. ECON. 219, 222 (1995). The finding that insiders buy after negative abnormal returns and sell after positive abnormal returns is also consistent with anecdotal evidence to that effect. *See, e.g.*, Bridget O'Brian, *Insiders Buy Firms' Shares as Tide Turns*, WALL ST. J., Aug. 14, 1996, at C1 [hereinafter O'Brian, *Insiders*] (reporting that six insiders at Office Depot, Inc. had started buying 122,900 shares the day after the stock fell 24% and that the chairman of Ivax Corporation purchased 290,000 shares after the stock price fell 50%); Bridget O'Brian, *McDonald's Executives Feast on Options, Sell Shares Amid Recent 52-Week High*, WALL ST. J., Apr. 17, 1996, at C1 (reporting that McDonald's executives sold $20 million of shares after two

B. CORPORATE INSIDERS' EXCESS RETURNS

Section A presented evidence that corporate insiders trade heavily before potentially price-moving announcements, suggesting that insiders are trading (either legally or illegally) on important information that is expected to be made public. The timing of corporate insiders' trades thus provides evidence of corporate insider trading. However, much of the trading by corporate insiders does not immediately precede the release of particular news.[69] Thus, studies that measure the profits corporate insiders make from all of their trades can provide additional evidence of corporate insider trading.

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announcements "helped propel McDonald's stock higher"—but before the price subsequently began falling); Vanessa O'Connell, *Some Stock Funds Beat Rivals by Following Insiders' Trades*, WALL ST. J., Jan. 29, 1997, at C1 (reporting that seven insiders purchased shares after company issued a warning that earnings would be below estimates and the price fell more than 20%); Vanessa O'Connell, *Top Executives at Continental Unload Shares*, WALL ST. J., Dec. 4, 1996, at C1 (ten top executives sold $30 million of shares after the price rose 50% in two months, leaving many with no stock except unexercisable options).

The results of these studies are consistent with insiders delaying their trades until the release of inside information moves the price to its proper value. As I explain *infra* Part III.A.4, insiders cannot make profits at the expense of public shareholders by postponing trades until the release of inside information moves the price to its correct level. But to the extent that the market can overreact to the release of good or bad news by publicly traded firms, the trading patterns detected in these studies are also consistent with insiders taking advantage of their access to inside information to profit from the market's overreaction to good or bad news. Consider, for example, a good news announcement that generates positive abnormal returns. Insiders may increase their selling not because they have delayed planned sales until the price has moved to its proper value after the announcement but because the market has overreacted to the release of the good news, giving insiders an opportunity to sell at a temporarily high price.

There is other evidence consistent with the hypothesis that insiders trade on inside information when news (from whatever source) causes the market to overreact: "intensive" insider trading months are not only preceded by abnormal returns but also are followed by abnormal returns in the other direction. For example, an "intensive" insider selling month is not only likely to be preceded by abnormal positive returns but also likely to be followed by abnormal negative returns. Similarly, an "intensive" insider buying month is likely to be preceded by abnormal negative returns and followed by abnormal positive returns. In the Lin and Howe study of OTC firms between 1975 and 1983, for example, it was found that following "intensive" insider sales months, the stock price experienced negative abnormal returns averaging 3.55% to 8.63% for the following twelve months; following intensive insider purchase months, the abnormal change in stock prices over the next twelve months was found to be -1.5% to 8.28%, depending on the methodology used. *See* Lin & Howe, *supra*, at 1279-80. A study during a similar period of all publicly traded firms found that "net" insider buying months were followed by 100-day positive abnormal returns of 3%. Net insider selling was followed by 100-day negative abnormal returns of 1.7%. *See* Seyhun, *supra* note 12, at 196. A month was considered to be a "net" insider selling (buying) month if there were more sales (purchases) than purchases (sales). *See id.* at 194-95.

69. *See* Elliott et al., *supra* note 65, at 535 (in a study of exchange-traded firms between 1975 and 1979, only a small proportion of insider trading appeared to result from the private use of information that was subsequently disclosed); Dan Givoly & Dan Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence*, 58 J. BUS. 69, 85 (1985).

These studies find that corporate insiders as a group consistently earn excess returns trading in their own shares—that is, after adjusting for the specific characteristics of their own companies (for example, volatility, price/earnings ratio, size), corporate insiders (as a group) consistently beat the market.[70] In light of the considerable evidence that there is no group of public investors that is able to systematically outperform the market, the most plausible explanation for this result is that insiders are trading on information that is not available to the rest of the market.[71] Economists and legal commentators on both sides of the insider trading debate therefore agree that insiders are using inside information when trading (and that these excess returns measure the portion of their trading profits that are attributable to the use of inside information).[72]

The most recent study of the excess returns earned by insiders indicates that, although corporate insiders are trading less prior to takeovers and earnings announcements,[73] there has been neither a reduction in the volume of trading by corporate insiders nor a reduction in the excess returns from such trading.[74] The study, which was performed by Professor H. Nejat Seyhun, examined trading by corporate insiders of 9,000 New York Stock Exchange ("NYSE") and American Stock Exchange ("ASE") firms between 1975 and 1989. Seyhun found that these insiders earned excess returns of 3.5% during the twelve months following their trades for the period between 1975 and 1980, rising to 5.1% for the period between 1980 and 1984, and then to 7% for the period between 1984 and 1989.[75]

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70. *See* Seyhun, *supra* note 5, and sources cited *infra* note 75.

71. Two other explanations are considered *infra* Part II.D.

72. *See, e.g.*, Seyhun, *supra* note 5, at 176-77; Carlton & Fischel, *supra* note 20, at 859; Kraakman, *supra* note 19, at 48.

73. *See* Seyhun, *supra* note 5, at 150-51.

74. *See id.* at 159, 169. For earlier empirical studies showing that the adoption of restrictions on insider trading historically has had little effect on the level of insider trading, see Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141, 1148 (1976); Jeffrey F. Jaffe, *The Effect of Regulation on Insider Trading*, 5 BELL J. ECON. & MGMT. SCI. 93, 114-15 (1974). *Cf.* ROBERT C. CLARK, CORPORATE LAW 282 (1986) (observing that pre-1984 restrictions on insider trading were unlikely to have much effect because insiders caught insider trading were required only to disgorge their profits).

75. *See* Seyhun, *supra* note 5, at 158-60 & tbl.2. Seyhun also found that the difference between excess returns for purchases and for sales has increased over time. In the first period, 1975-1980, purchases were associated with abnormal returns of 4.4% and sales with abnormal returns of 3.3%. By the last period, 1984-1989, purchases were not associated with abnormal returns and sales were associated with abnormal returns of 13.8%, suggesting that insiders were not buying on good news but were selling on bad news. *See id.* at 159-62 & tbl.3.

The results reported are consistent with those of previous studies by Seyhun and other researchers looking at similar time periods. *See, e.g.*, Finnerty, *supra* note 74, at 1141 (study of NYSE insiders from 1969 and 1972 found that insiders earned abnormal returns of approximately 4.8% over the year following their trades); Givoly & Palmon, *supra* note 69, at 76-85 (study of insider transactions

(Seyhun measured these excess returns from the beginning of the month following each trade date. His methodology thus underestimates total abnormal returns by not taking into account the abnormal returns that arise between the trading date and the end of that month.)[76] In addition to finding that the profitability of corporate insider trading had doubled during the period of the study, Seyhun also found that there had been a fourfold increase in the number of shares traded by corporate insiders.[77]

The data from Seyhun's study make it possible to estimate total corporate insider trading profits. Seyhun reports that net insider trading—the net number of shares purchased or sold by insiders of each firm—constituted .074% of outstanding shares per month during 1985-1989 (or approximately .9% over the year), *not including sales off the exchange*.[78] The total value of publicly traded shares in the United States is approximately $7.2 trillion. If the annual volume of net trading by insiders is still .9% of total outstanding shares and trading is uncorrelated with firm size, then the amount of trading by insiders each year may be almost $70 billion. If insiders are still earning an average of 7% 12-month excess returns per trade, this would imply that insiders make almost $5 billion each year in insider trading profits.

C. THE BEHAVIOR OF PUBLIC INVESTORS

The studies examining the timing of insiders' trades and the excess returns that insiders make on their trading confirm what most market par-

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in 68 ASE-listed companies between 1973 and 1976 found that insiders earned abnormal returns of 8.6% during the year following their trades, with abnormal returns of 11.53% per year following sales transactions); Jeffrey F. Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410, 426 (1974) (study of insiders in 200 largest NYSE corporations between 1962 and 1968 that experienced net insider buying found that, after transaction costs, insiders were able to make excess returns of five percent over eight months); Lin & Howe, *supra* note 65, at 1278-80 (finding that insiders in OTC firms between 1975 and 1983 earned twelve-month excess returns of 2.46-4.05% on their trades (depending on the methodology used)); Michael S. Rozeff & Mir A. Zaman, *Market Efficiency and Insider Trading: New Evidence*, 61 J. BUS. 25, 39 (1988) (study of NYSE firms during the period 1973-1982 found that insiders earned 6.6% over twelve months after 2% transaction costs using the same methodology as Jaffe, but using a model that takes into account size effect, insiders made 3.2% per year, after transactions costs); Seyhun, *supra* note 12, at 196-99 (study of over 700 publicly held firms between 1975 and 1981 found that insiders earned 4.3% excess returns for purchases and 2.2% excess returns for stock over the 300 days following their trades).

76. However, this 7% figure overstates net profits to the extent that it does not take into account the insiders' transaction costs. For another reason why this figure might overstate insiders' profits, see Harold Demsetz, *Corporate Control, Insider Trading, and Rates of Return*, 76 AEA PAPERS AND PROCEEDINGS 313 (1985) (arguing that the excess profits earned by those insiders who are controlling shareholders should be discounted because of the firm-specific risk these shareholders must bear).

77. *See* Seyhun, *supra* note 5, at 157.

78. *See id.* at 169.

ticipants have long known: that insiders trade on inside information. In this Section, I explain how market participants use publicly available information about insiders' trades to improve their own investment decisions.

As will be explained, Section 16(a) of the 1934 Act requires insiders to report the previous month's trades by the tenth of each month.[79] Reporting services such as the Consensus of Insiders ("COI") Advisory Service, Insider Indicator, The Insiders, Insiders' Chronicle, Invest/Net: Insider Trading Monitor, Vickers On-Line, Transactions & Intentions Report, and Vickers Weekly Insider Report retrieve this information when it arrives at the SEC, analyze it, and distribute the information through on-line services and newsletters to market participants who use the information to determine whether there has been a pattern of trading activity in the previous month that suggests that a company's insiders believe (based on their inside information) that the stock is over- or undervalued.[80] Heavy net buying activity is often taken to indicate that the stock is undervalued; similarly, heavy net selling activity is often taken to mean the opposite. Some market participants take into account other factors, including: (1) the absolute size of the trades;[81] (2) the size of the trades relative to each insider's existing holdings and previous trades;[82] (3) whether previous trades by these insiders and other company insiders seem to predict later price movements;[83] (4) the amount of purchases and sales by insiders of the same corporation in prior months;[84] (5) recent share price history;[85] and

79. *See infra* Part III.B.

80. *See* Wayne Y. Lee & Michael E. Stolt, *Insider Trading: A Poor Guide to Market Timing*, 12 J. PORTFOLIO MGMT. 65, 66 (1986). These services also gather, analyze, and distribute insider trading information from stock exchanges and other sources.

81. *See* Bridget O'Brian & Andy Pasztor, *At Occidental, A High-Octane Stock Purchase*, WALL ST. J., Jan. 22, 1997, at C1 (noting that $24 million purchase by director after stock price had fallen attracted considerable investor attention); Alexandra Peers, *Insiders Reap Big Gains from Big Trades*, WALL ST. J., Sept. 23, 1992, at C1 (market watchers understand that large transactions are more likely to be based on inside information).

82. An insider's trading history is often scrutinized when market participants attempt to decode a recent trade by that insider. *See* Bob Gabele, *Inside, Not Out: Psst! Market Jitters or No, Insiders Are Still Buying Stocks, Big and Small*, BARRON'S, Aug. 5, 1996, at 15-16 (reporting case in which $62,000 purchase of stock by insider was considered to be an attempt to show confidence in the company's stock rather than reflect the insider's true convictions about the firm because six years earlier he had sold $16 million worth of shares); O'Brian, *Insiders*, *supra* note 68, at C13 (observing that a transaction was the insider's first open market purchase).

83. *See* O'Brian, *Buying by Top Officials*, *supra* note 67, at C20 (remarking that prior trades by a particular insider, who sold $32 million worth of stock before it lost 70% of its value in the following year, were well-timed).

84. *See* Gabele, *supra* note 82, at 15.

85. Buying is considered noteworthy when the share price has already moved up or after there has been a sharp drop in the price of the stock. *See* Gabele, *supra* note 82, at 16.

(6) any other information about the corporation or the market generally that traders think is relevant.[86] In fact, some of the simple strategies that are actually used by investors—such as buying a stock when three or more insiders have made purchases within the previous month and none has made a sale—have been shown to yield investors excess returns of 2-5% per year.[87]

D. ALTERNATIVE EXPLANATIONS FOR INSIDERS' EXCESS RETURNS AND THE BEHAVIOR OF PUBLIC INVESTORS

The studies showing that insiders time their trades to precede significant announcements about their firms indicate that insiders use inside information in their trading. There can be little doubt that at least some of the insiders' excess returns are due to insider trading. But there could be other factors contributing to these excess returns. Perhaps insiders are simply superior investors. Or perhaps insiders earn excess returns because

86. Such information would include whether the company is buying its own stock and whether the buying or selling is options related. *See id.* Selling following the exercise of options (which increase an insider's shareholdings) is not considered as much of a bearish signal as sales of existing shares. *See* Bridget O'Brian, *Insiders' Sales Bear Careful Watching*, WALL ST. J., May 29, 1996, at C1.

87. A 1987 study showed that by buying the stocks listed in the COI newsletters published between 1976 and 1983 (each of which listed the 20 stocks that appeared to be most attractive based on insiders' trading over the trailing four months) and holding them for 12 months, readers could earn an excess return of 3-5% (depending on the methodology used). *See generally* Gary A. Benesh & Robert A. Pari, *Performance of Stocks Recommended on the Basis of Insider Trading Activity*, 22 FIN. REV. 145 (1987). A 1988 study using different methodology found that, in the period 1973-1982, by buying the stock of NYSE firms in which three or more insiders had bought and no insiders had sold during the previous month, public investors could have earned excess returns of 3.7% per year. *See* Rozeff & Zaman, *supra* note 75, at 38. Other studies have come to similar conclusions. *See, e.g.*, Jaffe, *supra* note 75, at 427 (outsiders using publicly available information about insider trades could make excess returns of 4.5%); Gerald P. Madden, *The Performance of Common Stocks After Intensive Trading by Insiders*, 14 FIN. REV. 27, 34 (1979) (in a study of NYSE firms between 1974 and 1976, outsiders who relied on intensive selling by insiders to sell stock "significantly" outperformed the market). For anecdotal evidence that information about insiders' trades can be used to increase trading profits, see Vanessa O'Connell, *Some Stock Funds Beat Rivals By Following Insiders' Trades*, WALL ST. J., Jan. 29, 1997, at C1.

However, transaction costs make it difficult for outsiders to earn excess returns by following an active trading strategy based on insiders' trades. *See* Lin & Howe, *supra* note 68, at 1283 (concluding, based on a study of OTC insider trading during 1975-1983, that outsiders could not earn excess returns following insider trades after taking into account transaction costs); Rozeff & Zaman, *supra* note 75, at 38 (after taking into account two-percent transaction costs, outsiders following NYSE insider trades between 1973 and 1982 would have earned virtually no excess returns); Seyhun, *supra* note 12, at 208 (in a study of insider trading between 1975 and 1981, outsiders following insiders' trades when they became available from the SEC could earn 300-day excess returns of only two percent before transaction costs). Therefore, public investors could not earn these excess returns unless they had already decided to trade (and therefore would incur transaction costs in any event) and were using the insider trading data to decide which stocks to buy or sell.

public investors *believe* that insiders have access to inside information (even when they do not) and engage in "copycat" behavior that moves stock prices in the direction "predicted" by the insiders' trading. But, as explained below, neither the superior investor nor the copycat explanation is likely to account for a substantial portion of insiders' excess returns.

1. *The Superior Investors Theory*

In theory, insiders' excess returns could be due to their superior investment abilities. The idea that corporate insiders consistently beat the market because they are better investors is, on its face, an entirely plausible one: Corporate officers, directors, and 10% shareholders may well have more investment skill than the average stock market investor.

However, while it is plausible that insiders are better investors than the average investor, it is unlikely that they are better investors than money managers, who devote all of their time to investing and who have a staff to collect and analyze market information. And money managers—as a group—cannot consistently outperform the market over time.[88] Indeed, only a handful of money managers are able to outperform the market over time, and this handful does so by an average of only a few points per year. This suggests that insiders' investment acumen is unlikely to explain a significant portion of their excess returns.[89]

In addition, a number of studies have shown that those insiders who have access to the most information in the firm tend to make the most insider trading profits. For example, in a study of insiders' trading between 1975 and 1981, officer-directors were found to earn greater excess returns than chairmen of the board and ordinary directors, who in turn were found to earn greater excess returns than ordinary officers.[90] Large, unaffiliated shareholders—the insiders farthest from both the day-to-day operations of the firm and board decisionmaking—generally earn the least excess returns of all corporate insiders.[91] Similar results were reported when trading

88. *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 6 (1980).

89. *See id.* If the superior investor explanation were true, we would expect a steady migration of lower-paid corporate insiders to the money management sector, where managers who can beat the market over time receive very high salaries. That such a pattern is not observed is further evidence that insiders' excess returns are due more to their positional advantage than inherent investment abilities.

90. *See* Seyhun, *supra* note 12, at 204-05.

91. *See* Lin & Howe, *supra* note 68, at 1283 (in study of 1,800 OTC firms between 1975 and 1983, board chairmen, directors, officer-directors, and officers earned greater excess returns than did large unaffiliated shareholders). *See also* Kenneth P. Nunn, Jr., Gerald P. Madden & Michael J. Gombola, *Are Some Insiders More "Inside" Than Others?*, 9 J. PORTFOLIO MGMT. 18 (1983) (study exam-

around particular announcements was studied. For example, "high information" insiders—board chairmen and inside directors—were more likely to trade before price-moving dissolution announcements than "low information" insiders—outside directors, large shareholders, and officers who were not directors.[92] These information-access studies suggest that insiders earn excess returns because of their access to inside information rather than because of their inherent investment acumen.

The finding that insiders of small firms consistently outperform insiders of large firms in their trading[93] also suggests that excess returns are due more to informational advantages than to investment ability. There is no reason to believe that insiders of small firms are more savvy investors than insiders of large firms. However, insiders of small firms do have two informational advantages over those of big firms that could account for their better trading performance. First, insiders of small firms are likely to have a better understanding of their firms' affairs than insiders of larger companies. Second, smaller companies are studied by fewer analysts. The stock price of a small firm is thus likely to deviate more frequently from its fundamental value than the stock price of a large firm, giving insiders of small firms more opportunities to profit from their access to inside information. In short, the available evidence indicates that insiders' excess returns are attributable to their access to inside information rather than their investment skills.

2. *The Copycat Effect Theory*

The abnormal price changes that occur after insiders trade are often not due to the release of specific news about their firms. Instead, it appears that stock prices move in reaction to news of the trading itself.[94] That is, as market participants learn about insiders' trades, they follow them knowing that, on average, insiders have better information about the future direction of their companies' stock prices than does the market. It is generally believed that market participants' response to news of trading by

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ining firms between 1974 and 1978 found that chief executive officers ("CEOs") and directors outperformed shareholders-insiders and vice-presidents on purchases but not on sales).

92. *See* Thomas H. Eyssell, *Corporate Insiders and the Death of the Firm: Evidence on the Incidence of Insider Trading in Corporate Dissolutions*, 26 FIN. REV. 517, 531 (1991).

93. *See* Gosnell et al., *supra* note 59, at 362; Madura & Wiant, *supra* note 68, at 225 (insiders of small banks found to outperform insiders of large banks); Seyhun, *supra* note 12, at 203 (study of insiders' trading in publicly held firms between 1975 and 1981 suggests that insiders in large firms trade on less valuable information than insiders of small firms). *Cf.* Lin & Howe, *supra* note 68, at 1283 (concluding that, among OTC firms examined between 1975 and 1983, there was no evidence that insiders of smaller firms traded on more valuable information).

94. *See* Givoly & Palmon, *supra* note 69, at 86.

insiders is "rational" (in other words, market participants follow insiders' trades because the insiders' trading does convey information about the stocks' underlying value).[95] However, at least one commentator has argued that insiders may make excess returns by deliberately or inadvertently inducing market participants to follow trades that are not based on inside information.[96] According to this theory, insiders' excess returns do not arise because of their access to inside information, but rather because market participants *think* insiders have inside information. That is, when market participants learn of a corporate insider's trade, they believe (incorrectly) that the insider has information indicating that the value of the stock is significantly different from the market price, leading to copycat behavior that moves the price of the stock in the direction favorable to the insider. This price movement is then taken as further evidence that inside information gives corporate insiders the ability to "forecast" future price changes.

To be sure, there will be times when market participants follow insiders' trades that are not based on inside information (just as there will be times when market participants fail to follow trades that are based on inside information). But the unstated premise of the copycat effect explanation is that insiders' trades can consistently fool market participants into moving stock prices away from their fundamental values in a direction favorable to the insiders. If this were the case, insiders could make a steady stream of profits by buying, reporting their purchases, waiting for the price to rise, and then selling, before starting the cycle over again.[97] They would have an incentive to trade frequently and continually reverse the direction of their trading. But this is not observed. On average, firms see only one insider trade per month.[98] In addition, purchases (sales) by one insider are usually followed by purchases (sales) by other insiders of the same firm over a long period of time.[99] Thus, insiders' trading patterns are certainly not consistent with any deliberate attempt to fool the market. In any event, it is believed that market participants would eventually learn

95. *See id.*

96. *See* S.S. Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. LEGIS. 511, 513 (1988).

97. Section 16(b) would prevent an insider employing this strategy from profiting from a high-price sale made within six months of a low-price purchase. *See infra* Part III.B.1. Consequently, the insider would be forced to wait at least six months before selling the shares that she had purchased.

98. *See* Michael S. Rozeff & Louis M. Jacobs, *Reflections on Insider Trading*, 45 FIN. ANALYSIS J. 12, 12 (1989).

99. *See* James H. Lorie & Victor Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J.L. & ECON. 35, 45 (1968).

to ignore trading that does not communicate any real information.[100] So while there may be instances in which the copycat effect occurs, it is unlikely that this effect can explain a meaningful portion of insiders' excess returns.

III. THE LIMITATIONS OF CURRENT APPROACHES TO REGULATING INSIDERS' TRADING

Part II surveyed the empirical evidence of corporate insider trading and presented data indicating that insiders make almost $5 billion each year trading on inside information. This Part identifies the limitations of the current approaches to regulating insiders' trading that enable insiders to make these profits. There are three main ways in which insiders' trading is regulated: (1) the duty to "disclose or abstain" under Rule 10b-5, which was promulgated by the SEC under Section 10(b) of the 1934 Act (Section A); (2) a ban on short-swing profit-taking by corporate insiders under Section 16(b) of the 1934 Act (Section B); and (3) employer-imposed restrictions on the timing of employee-insiders' trades (Section C).[101] Below, I explain why these approaches collectively fail to prevent corporate insider trading in a wide variety of circumstances.[102] In the course of the analysis, I also explain why, contrary to the conventional

100. *See* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 354 (1989) (observing that market participants would stop following the trades of an insider who tried to mislead them); Carlton & Fischel, *supra* note 20, at 892 (same). *Cf.* Gabele, *supra* note 82, at 15 (reporting a case in which an insider's purchase of $62,000 worth of shares was considered a deliberate attempt to signal the market—rather than a reflection of the person's actual beliefs about the stock—because seven years earlier the insider had sold $16 million worth of shares).

101. Other federal rules designed to regulate trading by corporate insiders include Rule 14e-3 under the 1934 Act (imposing a duty to disclose or abstain on a person who receives material nonpublic information about a tender offer that originates with either the offeror or the target) and Section 16(c) of the 1934 Act (forbidding short-selling by insiders). In addition, a variety of federal criminal statutes, such as RICO and the mail and wire fraud statutes, have been invoked to enforce Rule 10b-5. *See* O'Connor, *supra* note 100, at 339-41. There are also state corporate-law restrictions on trading by insiders. *See* Langevoort, *supra* note 14, at 2 n.5 (collecting cases). However, they have largely been supplanted by federal law. *See* CLARK, *supra* note 74, at 265, 306-09.

102. The only other attempt to systematically identify the limitations of current insider trading restrictions of which I am aware is Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention from Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 WASH. L. REV. 307 (1993). Salbu's focus is on how Rule 10b-5 permits corporate insiders to transmit material information to tippees in a variety of ways, while my focus in this Part is on how Rule 10b-5, Section 16(b), and trading windows enable corporate insiders to profit from their access to inside information by trading illegally on material inside information or by trading legally on sub-material information. Also, while Salbu argues that the use of inside information to abstain from trading is just as unfair as trading on inside information, *see* Salbu, *supra*, at 332, I show that the ability to use inside information to abstain from (or postpone) trading does not make an insider better off than the average public shareholder. *See infra* Part III.A.4.

view, Rule 10b-5's failure to prohibit insiders from using inside information to postpone their trades does not make insiders better off than public shareholders as a group and why it would not be desirable to attempt to further reduce insider trading profits by building on any of these approaches. Section D summarizes this analysis.

A. RULE 10B-5 AND ITS LIMITATIONS

1. *The Operation of Rule 10b-5*

The primary mechanism for regulating the trading of corporate insiders is the duty to "disclose or abstain," which arises under Rule 10b-5 of the 1934 Act. Under the duty to disclose or abstain, a person in possession of material[103] nonpublic information must either disclose the information or abstain from trading when the other party to the transaction is entitled to know the information because of a fiduciary duty or other similar relationship of trust and confidence between them.[104] The rule applies to insiders trading in their corporation's shares because they owe a fiduciary duty to public shareholders.[105]

Rule 10b-5, which was promulgated by the SEC in 1942, does not expressly prohibit corporate insiders from trading on inside information. However, its prohibition against "any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security" was interpreted by the SEC in 1961 to impose the duty to disclose or abstain.[106] According to the SEC:

> [T]he obligation [to disclose or abstain] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.[107]

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103. For a discussion of the meaning of "material" see *infra* Part III.A.3.

104. *See* Chiarella v. United States, 445 U.S. 222, 230-31 (1980).

105. Shareholders who own enough stock to exercise control over the corporation are considered to owe fiduciary duties to public shareholders even though their legal relationship with the public is not the same as that of the corporation's employees. *See* DONALD C. LANGEVOORT, INSIDER TRADING REGULATION 72 (1989).

106. In In re *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961), the SEC stated:

> [I]nsiders 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. [If disclosure would be] improper or unrealistic [the insider must] forego the transaction.

107. *Id.* at 912. The duty to disclose or abstain was later adopted by the Second Circuit in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), and was implicitly acknowledged by the Supreme

During the last 15 years, Congress has sharply increased the penalties for violating Rule 10b-5. In 1984, Congress passed ITSA, which gave the SEC the discretion to seek civil penalties in Rule 10b-5 cases of up to three times the profit made or loss avoided (in addition to disgorgement of profits, which was the civil penalty prior to 1984), as well as increased criminal penalties (for natural persons) tenfold from $10,000 to $100,000.[108] In 1988, Congress passed ITSFEA, which increased criminal penalties (for natural persons) from $100,000 to $1 million and raised maximum prison sentences from five to ten years.[109] To facilitate enforcement of Rule 10b-5, ITSFEA also created a bounty system to encourage the reporting of illegal insider trading by others, and imposed penalties on employers and other "controlling persons" that failed to take steps to prevent illegal insider trading.[110]

Below, I explain why Rule 10b-5 fails to deter insiders from trading on material inside information and how Rule 10b-5 permits insiders to make profits trading on sub-material inside information. I also explain that although Rule 10b-5 permits insiders to postpone trading based on inside information, their ability to do so does not give them an advantage over public shareholders as a group. Finally, I argue that it would not be desirable to reduce Rule 10b-5's shortcomings by increasing penalties, by making it easier for the government to impose liability on insiders, or by lowering the materiality standard.

2. *Illegal Trading on Material Inside Information*

As we will see below, Rule 10b-5 permits insiders to trade legally on sub-material inside information. Rule 10b-5 prohibits trading on inside information only when the information meets the strict legal standard of materiality. However, even in these cases, Rule 10b-5 cannot always deter insiders from trading on such information.[111] For although the penalty for

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Court in *Chiarella v. United States*, 445 U.S. 222 (1980), which conditioned the duty on the existence of a fiduciary or other special relationship between the parties.

108. Insider Trading Sanctions Act, 15 U.S.C. § 78u-1(a)(2) (1984).

109. *See* Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78ff(a) (1988); O'Connor, *supra* note 100, at 339.

110. *See* O'Connor, *supra* note 100, at 336-37. One of the steps taken by many corporations to prevent illegal insider trading is the use of trading-window rules designed to limit insiders' ability to trade before important corporate news is announced. *See infra* Part III.C.

111. The evidence that corporate insiders are not always deterred from trading on material inside information is that some are caught having done so. *See, e.g.*, William M. Bulkelely, *Former Executives of Kendall Square Accept Sanctions to Settle SEC Charges*, WALL ST. J., Apr. 30, 1996, at C17 (reporting the SEC's claim that the former president, chief financial officer, and head of sales of Kendall Square Research Corporation had sold stock while in possession of material inside information); *Business Technology: SEC Accord on Comptonia*, N.Y. TIMES, Mar. 30, 1994, at D7 (former chairman

violating Rule 10b-5 can be quite severe, there are many situations in which the probability of apprehension and punishment is very low.[112]

In investigating potential violations of Rule 10b-5, the SEC faces two major problems. First, most potential violations of Rule 10b-5 cannot be investigated.[113] Corporate insiders engage in hundreds of thousands of trades each year. Any of these trades could be motivated by material inside information in violation of Rule 10b-5. However, the SEC has only limited resources, most of which are allocated to reviewing registrations and reports, monitoring the markets, and rulemaking.[114] Thus, it and the stock exchanges (which also monitor for insider trading) are able to investigate only a small fraction of insiders' trades. Indeed, the SEC lacks the resources even to follow up on all of the tips it receives.[115]

Second, it is difficult to prove that a corporate insider has violated Rule 10b-5. The SEC must show that the insider traded on information that he knew was both material and nonpublic.[116] That is, the government must (1) identify the information that the insider traded on; (2) show that the insider traded on that information; (3) demonstrate that the information was material and nonpublic; and (4) prove the insider knew that the information was material and nonpublic. When, as is often the case, there is

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and two other former officers of Comptonia agreed to repay investors about $1.1 million to settle fraud and insider trading charges arising out of the sale of shares at prices inflated by false information); *Gitano Executives Agree to Settlement Over SEC Charges*, WALL ST. J., Dec. 19, 1996, at A6 (four Gitano executives paid $1 million in fines to settle charges that they violated insider trading laws); Floyd Norris, *Company News: Health Data Chief Settles with SEC*, N.Y. TIMES, June 23, 1994, at D4 (chairman and CEO of Shared Medical Systems Corporation required to pay nearly $200,000 to the government after admitting to selling stock after he had learned, but before it was made public, that the company's explosive growth rate was slowing).

112. *See* Henry Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 937 (1985) (noting that the "ability to detect [insider trading] will always be difficult, and when the gains that can be realized from the practice, discounted by the risk of being apprehended, are compared to the potential costs, many people will have the incentive to trade on inside information"). To the extent that a corporate insider trades on information that is essentially undiscoverable—such as his intuition, based on all of the information available to him, that a particular project will not succeed—the probability of apprehension will be zero.

113. Although private persons sometimes have the right to bring suit under Rule 10b-5, they lack the police power and resources available to the SEC. Thus most cases are brought by the SEC. *See* Dooley, *supra* note 88, at 20.

114. *See id.* at 18; Seyhun, *supra* note 5, at 155. *See also* Greg Steinmetz & Cacilie Rohwedder, *SAP Insider Probe Points to Reforms Needed in Germany*, WALL ST. J., May 8, 1997, at A18 (reporting that insider trading investigations account for only 10% of the SEC's activities).

115. *See* O'Connor, *supra* note 100, at 366-67. *See also* Charles Gasparino, *Total of SEC Investigations Is Off Despite Staffing Rise*, WALL ST. J., Jan. 29, 1997, at C1 (reporting that the number of insider trading investigations launched by the SEC has been declining even as it has been adding more staff).

116. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

nobody available to testify about the insider's state of mind,[117] the government must build its case solely on circumstantial evidence.[118]

Because there are thousands of potential cases of illegal insider trading and violations of Rule 10b-5 are difficult to prove, the SEC uses its limited enforcement resources to focus on cases in which a violation of Rule 10b-5 is most likely to have occurred and will be easiest to prove.[119] These are cases where (1) there is an announcement that leads to a sharp movement in the stock price;[120] (2) there is a significant change in a person's holdings shortly before the announcement;[121] and (3) the information contained in the announcement was clearly material (and nonpublic) at the time of the person's trading,[122]—that is, the cases where the illegal use of inside information appears to have been the most blatant. Consequently, most of the insider trading cases brought by the SEC involve trading shortly before earnings or takeover announcements[123]—where the case law makes it clear that such information is material and where there is often strong circumstantial evidence suggesting that the insider was trading on information about the forthcoming announcement.[124]

The SEC's focus on such cases has, to a certain extent, paid off. Following the passage of ITSA in 1984, which sharply increased the penalties for violating Rule 10b-5 and other securities laws, there has been a decrease in trading by insiders prior to announcements of tender offers, merger bids, and earnings announcements.[125] Corporate insiders have also reduced their selling prior to price-depressing announcements of equity offerings.[126] The decrease in such trading by the highest-visibility insiders

117. Most defendants in SEC enforcement actions have not disclosed the inside information to others. *See* Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1668 (1992).

118. *See* Stan Crock, *Proof Eludes SEC in Battling Insider Trades*, WALL ST. J., Aug. 13, 1980, at 31.

119. *See* O'Connor, *supra* note 100, at 368.

120. *See* Dooley, *supra* note 88, at 19.

121. By itself, a large change in insider holdings is likely to be disregarded as a random fluctuation. *See id.*

122. *See* O'Connor, *supra* note 100, at 364.

123. *See* Dooley, *supra* note 88, at 19. Approximately 80% of the insider trading cases brought by the SEC are related to corporate control transactions—tender offers, mergers, etc.—and the remainder involve earnings announcements, bankruptcies, financial fraud, and other news. *See* Meulbroek, *supra* note 117, at 1669.

124. *See* Elliott et al., *supra* note 65, at 523 (noting that, as of 1984, successful litigation had occurred only in cases where there was blatant use of inside information).

125. *See* Arshadi & Eyssell, *supra* note 29, at 38; Seyhun, *supra* note 5, at 173, 175.

126. *See* Eyssell & Reburn, *supra* note 29, at 168.

has been the most pronounced.[127] Indeed, one study found that the highest ranking corporate insiders almost ceased trading altogether one month prior to takeover announcements.[128] These studies demonstrate that insiders have been deterred or prevented from trading on certain types of inside information.

However, the SEC's focus on the most blatant cases means that a corporate insider who trades on material inside information (1) in the absence of a sharp movement in price, or (2) in the absence of a sharp movement in price that shortly follows the trade is unlikely to be detected and even less likely to be punished for violating Rule 10b-5.

Consider the first strategy—trading on material inside information when there is not expected to be a sudden change in the stock price. For example, suppose that in January a CEO is presented with information by her managers that the development of a key product is ahead of schedule, that major customers have indicated that they plan to purchase in much larger quantities than expected, and therefore that profits during the coming year should be twice as great as had been anticipated. Suppose that if this information were released, the stock price would increase by 50% within several days (that is, the information is legally material).[129] However, the information is not disclosed and the CEO purchases shares, tripling her investment in the company. Over the year, the stock price climbs 50% as more good news (higher than expected sales, higher profits, etc.) is released each quarter.

There is no sharp increase in the price of the stock to focus the SEC's attention on her trading. Even if the SEC's attention were to be drawn to the fact the CEO had tripled her shareholdings at the beginning of a twelve-month period in which the stock price rose 50%, the SEC is unlikely to use its limited resources to investigate her trading when there are other cases to be pursued in which the likelihood of prevailing is much greater. Thus, a person in a position similar to that of the CEO in this example—that is, a corporate insider who believes that the material inside

127. *See id.* at 168 (stating that high-information/high-visibility insiders—inside directors and officers—reduced their trading prior to price-depressing announcements of equity offerings by more than other insiders, such as outside directors and large shareholders, following the passage of ITSA in 1984).

128. *See* Seyhun, *supra* note 5, at 175.

129. I am assuming that such information would be considered legally material. If not, then this example illustrates how an insider could legally profit from her access to important but sub-material information. *See infra* Part III.A.3.

information she possesses will be released only gradually—is unlikely to be deterred from violating Rule 10b-5.[130]

Next, consider the strategy of trading on inside information that, when it becomes public, will lead to a sharp increase in price, but which will not be made public for some time. Suppose that the CEO knows that in six months another company will, barring unforeseen circumstances, offer to acquire the CEO's firm at a price substantially above the current market price. The CEO believes that the information is reliable and substantially increases her holdings. The acquirer in fact comes forward six months later and offers to purchase the company at a substantial premium. As a result, the stock price rises sharply, and the CEO makes a significant profit.[131]

The announcement of a takeover and the sharp rise in the price of the stock it generates may draw the attention of regulators. Yet it is unlikely that the regulators will ever connect the announcement to the CEO's purchase six months earlier. Thus, a person in the CEO's position—who can trade on material inside information long before it is released—may well not be deterred from doing so. In fact, there is evidence that insiders often start trading heavily three to six months before significant corporate announcements.[132]

3. *Legal Trading on Sub-Material Inside Information*

Rule 10b-5 prohibits trading on inside information only if the information is "material." In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit held that material facts are those to which a "reasonable man would attach importance in determining [whether to buy or sell shares]."[133] In interpreting the term "material" under a related statute, the Supreme Court

130. Interestingly, the above-market returns earned by corporate insiders are sometimes realized up to 12 months following their trades, suggesting that the information that they trade on is not released all at once, but rather gradually over time. *See* Jerome B. Baesel & Garry R. Stein, *The Value of Information: Inferences From the Profitability of Insider Trading*, 14 J. FIN & QUANTITATIVE ANALYSIS 553, 566 (1979).

131. Of course, Section 16(b) would require that the insider wait a few days before realizing the profit. *See infra* Part III.B.1.

132. *See, e.g.*, Gosnell et al., *supra* note 59, at 350 (reporting that insiders in OTC firms sell stock heavily in the five months before price-depressing bankruptcy announcements); Guo et al., *supra* note 60, at 536-37 (insiders trade heavily in the quarter before a firm releases surprise earnings data); Lee et al., *supra* note 65, at 1960 (insiders buy heavily six months before firms make price-increasing repurchase announcements). Of course, the information on which the insiders were trading in these studies could have been either material or sub-material.

133. 401 F.2d 833, 849 (2d Cir. 1968) (citation omitted).

provided a similar definition.[134] More recently, the Court has indicated that the purpose of the materiality standard is "to filter out essentially useless information that a reasonable investor would not consider significant . . . in making his investment decision."[135]

Since a reasonable investor would presumably consider important or significant any information that could be used to increase his trading profits, this language might suggest that any information that insiders could use to increase their trading profits would be legally material. However, in a more recent case the Supreme Court also held that information does not become legally material merely because an insider can earn profits trading on it.[136] And, in practice lower courts have been reluctant to find information "material" unless it concerns a "bombshell event"[137]—such as the definite existence of a takeover offer—whose announcement causes the stock price to move very sharply in one direction or the other. For example, in *SEC v. Hoover*,[138] an insider of a company that had publicly projected a decline in earnings of 10% sold the stock after learning that the estimate of the decline in earnings had been revised downward to 10-12%. Shortly thereafter the company announced that it expected an earnings decline of 12-15%, causing the price to fall 20%. Although (as this case shows) even a small adjustment in earnings estimates can cause a price change of large magnitude, the court granted summary judgment for the insider on the ground that the SEC could not prove that the information on which the insider was traded was material. In addition, information that is important but whose significance is more difficult to assess (such as information about a possible takeover) is not usually considered material.[139] This includes so-called "soft" information.[140] According to the A.B.A. Task Force on Insider Trading:

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134. *See* TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 449 (1976) (holding that under Rule 14e-9, the general antifraud provisions of the SEC's proxy rules, an omitted fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote"). *See generally* CLARK, *supra* note 74, at § 8.10.4 & n.25.

135. Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) (citation omitted).

136. *See id.* at 240 n.18 (citing Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1231 (1st Cir. 1984)).

137. *See* Carlton & Fischel, *supra* note 20, at 886-87.

138. [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,886 (S.D. Tex. 1995).

139. Lower courts have been reluctant to find information to be material unless it is the type of information that would be considered important by an investor in any context. *See* Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 753-59 (1989).

140. The term "soft information" is sometimes used to describe all future-oriented information, including written projections and estimates (which, under current law, can sometimes be considered legally material). *See id.* at 729-30.

> [Rule 10b-5 permits] the use of softer information of the type that insiders often have but that members of the investing public do not: the ability to make better informed guesses as to the success of new products, the likely results of negotiations, and the real risks of contingencies and the other uncertainties, the underlying facts of which have been publicly disclosed.[141]

Thus, as many commentators have recognized, the threshold of materiality that is used by the courts means that Rule 10b-5 (even if it could be adequately enforced) enables insiders to make profits trading on submaterial information. As Dennis Carlton and Daniel Fischel put it:

> Knowledge 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.[142]

4. *A Note on Using Inside Information to Postpone (or Abstain From) Trading*

As is well known, Rule 10b-5 does not prohibit corporate insiders from using material inside information to decide *not* to trade, or to decide to postpone their trades.[143] For example, suppose that there is one corporate insider, CI, who must sell $1000 worth of either company stock or mutual fund shares, and that she intends to sell the stock.[144] However, before selling the stock CI learns that the company will shortly announce material good news whose release will indicate to the market that the stock, which is currently trading at $10 per share, is actually worth $15 per share. As a result, CI decides either (a) to sell $1000 of mutual fund shares (rather than $1000 worth of stock) or (b) to postpone the sale of the stock until the good news is released. In either case, CI will use inside information to increase her wealth by $500, the loss that she avoids by not selling stock worth $15 per share for only $10 per share. However, in neither case will CI violate Rule 10b-5. In the first case, CI will not be trading in stock of her company. In the second case, CI will be trading only after the material inside information has been released.

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141. *Task Force Report, Part II*, *supra* note 39, at 1092.

142. Carlton & Fischel, *supra* note 20, at 886-87 (citation omitted).

143. *See, e.g.*, Kraakman, *supra* note 19, at 48.

144. The assumption that there is only one insider, which is made to simplify the exposition, is not critical to the analysis that follows.

As this example demonstrates, the ability to use inside information to postpone (or abstain from) trading can make an insider better off than a (hypothetical) similarly situated public shareholder who does not have access to that information. This has led commentators on both sides of the insider trading debate to conclude that Rule 10b-5 allows insiders to make insider trading profits at the expense of public shareholders by postponing (or abstaining from) trading until inside information is released.[145] As one of these commentators has argued:

> In fact, many people who exploit new information do not buy additional stock; rather they simply *do not sell*. . . . A failure to sell cannot be a violation of the SEC's Rule 10b-5, because there has been no securities transaction. . . .
>
> The upshot of all this is that people can make abnormal profits in the stock market simply by knowing when *not* to buy and when *not* to sell. They will not make as much perhaps as if they could trade on the information more efficiently, but nonetheless they will still make supra-competitive returns. And this is a form of insider trading that no one can do anything about. It may also be the dominant method of using inside information.[146]

Surprisingly, this long and widely held view is incorrect. As I explain below, insiders cannot make excess returns by using inside information to postpone trading until the release of news that moves the price in a favorable direction (or by abstaining from trading when the price is unfavorable). In other words, none of the approximately $5 billion in profits that corporate insiders make trading on inside information derives from the use of inside information to postpone or abstain from trading.

To see why this is the case, suppose first that insiders can use inside information only to abstain from trading when they believe that the trade would be on unfavorable terms. Returning to our example, suppose that upon learning that the stock is actually worth $15, CI decides to sell $1000 worth of mutual fund shares rather than sell 100 shares of stock for $10 per share. As a result, she avoids a loss of $500.

Access to inside information has clearly made CI better off than a (hypothetical) public shareholder facing the same choice and, indeed, all of those shareholders who sold at $10 but who would have postponed their

145. *See, e.g.*, Kraakman, *supra* note 19, at 48; Manne, *supra* note 112, at 938; Salbu, *supra* note 102, at 332. An earlier discussion-paper version of this Article also reflected this view. *See* JESSE M. FRIED, TOWARDS REDUCING THE PROFITABILITY OF CORPORATE INSIDER TRADING 25-27 (John M. Olin Center for Law, Economics, and Business at Harvard Law School, Discussion Paper No. 195, 1996).

146. Manne, *supra* note 112, at 938 (citation omitted) (emphasis in original).

sales had they known about the forthcoming good news announcement. However, the inside information does not make CI better off than public shareholders as a group (and therefore the average public shareholder). For while similarly situated public shareholders without access to the same inside information sell stock worth $15 for only $10 per share, their counterparties—other public shareholders—buy stock worth $15 for only $10 per share. In other words, the similarly situated public shareholders' loss is completely offset by other public shareholders' gain. Put differently, public shareholders as a group are not made worse off because they lack CI's inside information. If public shareholders had all been made aware of the good news, the price of the stock would have immediately risen to $15; public sellers would have been better off, but public buyers would have been worse off by an equivalent amount: $5 per share.

To be sure, public shareholders as a group would have been better off if CI, lacking inside information, had sold the stock for $10 per share. Thus, CI's use of inside information to abstain from trading does make public shareholders worse off than they would have been otherwise. But if CI had sold the stock for $10 when it was worth $15, public shareholders would have enjoyed excess returns at CI's expense by buying the stock for less than what it is worth. CI's abstention from trading therefore makes public shareholders worse off only by depriving them of excess returns. Put differently, CI's abstention does not make her better off than public shareholders by enabling her to earn excess returns at their expense; it makes her as well off as public shareholders by allowing her to avoid making sub-market returns.

Having seen that insiders cannot make excess returns using inside information to abstain from trading, let us examine the case in which insiders can use inside information only to postpone trading. Returning to the example, suppose that CI, upon learning of information that indicates that her stock is worth $15 rather than $10, decides to postpone the sale of $1000 worth of stock until the information is released and the price rises to $15. Again, CI uses inside information to increase her wealth by $500. But, unlike in the abstention case considered above, CI does trade the stock.

However, CI's decision to postpone the sale of the stock until after the good news is released and the price accurately reflects the stock's value is simply equivalent to (1) abstaining from selling when the stock is priced too low and (2) selling when the stock's price reflects its actual value. As we just saw, CI cannot make excess returns by abstaining from selling the stock when it is underpriced. Nor can CI make excess returns at

the expense of her counterparty by selling the stock when it is properly priced. It follows that CI cannot make excess returns by postponing her trades until inside information is released and becomes incorporated into the stock price.

To make insider trading profits, insiders must not only trade but also trade at a favorable price. That is, insiders can make excess returns only by selling when the stock is overpriced or buying when the stock is underpriced. Insiders who postpone their trades until inside information is released in order to avoid trading at an unfavorable price thus cannot earn excess returns at the expense of public shareholders.[147]

5. *"Fixing" Rule 10b-5*

In light of Rule 10b-5's failure to prohibit or deter insider trading in a variety of circumstances, one might consider lowering the materiality standard, increasing penalties, and/or lowering the government's burden of proof. Such steps would certainly reduce corporate insider trading profits. First, the higher penalties and lower burden of proof would increase the deterrence of trading that is currently illegal. Second, there would be less trading on inside information that is not currently material but which would be under the lower materiality standard. Third, the higher penalties and the lower burden of proof would tend to chill trading on inside information that would still be considered sub-material under the lower materiality standard (because corporate insiders would face an increased risk of being improperly convicted of violating Rule 10b-5).

However, to the extent that corporate insiders are not chilled from trading, they could still trade legally on information considered sub-material under the new materiality standard. And, unless the SEC's enforcement budget is increased substantially, in many cases insiders will still not be deterred from trading illegally on inside information.[148] Thus insiders would still be able to make insider trading profits.

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147. The fact that insiders are unable to make excess returns at the expense of public shareholders by postponing or abstaining from trading has a number of important implications. First, the use of inside information to postpone or abstain from trading does not distort managerial incentives. In fact, it could actually improve them. By making it more likely that insiders do not sell stock when it is underpriced or buy stock when it is overpriced, the use of inside information enables insiders to benefit fully from increases in the value of the stock. Second, postponing or abstaining from trading does not raise the cost of capital above that which would prevail if insiders had no access to inside information. Third, using inside information to postpone or abstain from trading should not raise the same fairness concerns as using inside information to buy when the stock is underpriced or to sell when the stock is overpriced, both of which make other shareholders worse off than insiders.

148. *See* DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION 8-3 n.3 (1996) (suggesting that changes in penalties are unlikely to increase deterrence of

Furthermore, the cost of expanding Rule 10b-5 in this manner would be quite high. Lowering the materiality standard would lead to increased litigation which, in turn, would impose higher costs on the government as well as on insiders. Lowering the materiality standard and the government's burden of proof would also increase the risk that a corporate insider trading legally would be subject to a severe penalty (or, at the very least, forced to litigate the legality of a trade). This would increase the risk-bearing costs borne by insiders and chill trading not based on inside information. In short, it does not appear desirable to attempt to overcome Rule 10b-5's limitations by increasing penalties or by lowering the burden of proof and the materiality standard.

B. SECTION 16(B) AND ITS LIMITATIONS

Although in many cases Rule 10b-5 will either permit or fail to deter a corporate insider from profiting from inside information, it is not the only restriction faced by corporate insiders. Corporate insiders are also subject to Section 16(b), which limits insiders' ability to profit from trades made within a six-month period (as well as restrictions on trading imposed by their own employer).[149]

1. *The Operation of Section 16(b)*

Section 16(b), which applies to virtually all directors, officers, and 10% beneficial owners[150] of publicly traded companies,[151] prohibits these particular insiders from profiting from a purchase and a sale that take place within any six-month period. The corporation or another shareholder may compel the insider to disgorge any "Section 16(b) profits" to the corporation.[152]

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insider trading because insiders do not believe that they will be caught, but that increasing enforcement resources would increase deterrence).

149. The other provisions of Section 16 require that corporate insiders report their trading to the SEC and prohibit them from engaging in short sales.

150. A 10% beneficial owner is a person who directly or indirectly owns more than 10% of any class of the corporation's shares which is registered under Section 12 of the 1934 Act (other than certain exempted classes of shares). *See* CLARK, *supra* note 74, at § 8.6.1.

151. Section 16(b) applies to directors, officers, and 10% beneficial owners of more than 10% of any class of equity securities of companies whose shares trade on national security exchanges like the NYSE, ASE, Pacific Coast Stock Exchange, and other regional exchanges, as well as corporations with assets in excess of $3 million and a class of equity security held of record by 500 or more persons. *See id.*

152. *See* MARC STEINBERG, SECURITIES LAW 280 (2d ed. 1995). Actions are generally brought by lawyers who monitor insider trading reports looking for possible violations (and who typically receive a percentage of any profits the insider is forced to disgorge). *See* Anup Agrawal & Jeffrey F.

According to Congress, Section 16(b) was enacted to "prevent . . . the unfair use of information which may be obtained by [the statutory insider] by reason of his relationship to the issuer."[153] Congress apparently believed that the possibility of abuse of inside information was greatest in short-swing trading situations (or that short-swing trading was especially likely to be based on inside information).[154] Of course, Section 16(b)'s flat prohibition on short-swing profits means that insiders are also prevented from making short-swing profits based on public information. The rule is therefore overinclusive. However, a flat prohibition on such profits was considered necessary because Congress believed that it would be difficult to prove an insider's motivation for trading.[155]

In an attempt to ensure that an insider does not hide a profitable unfair trade among a series of unprofitable trades, most courts have adopted a "lowest in-highest out" approach to computing profits for purposes of Section 16(b): Highest price sales are matched against the lowest price purchases within any six-month period in order to calculate the insider's Section 16(b) profits.[156] Consequently, the penalty is imposed even if the insider sustains an overall trading loss during the relevant six-month period. To facilitate enforcement of Section 16(b), Section 16(a) requires that statutory insiders report trades in their companies' shares no later than the tenth day of the month following the month in which they made the trades.[157] Below, I explain why Section 16(b) is very limited in its ability

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Jaffe, *Does Section 16b Deter Insider Trading by Target Managers?*, 39 J. FIN. ECON. 295, 296-97 (1995).

153. § 16(b). Section 16(b) is the only provision in the federal securities laws designed explicitly to control the use of inside information by corporate insiders. The other provisions of the federal securities laws that are used to regulate trading by insiders, including Section 10 of the 1934 Act, under which Rule 10b-5 was promulgated, are general antifraud provisions.

154. *See, e.g.*, Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 243 (1976) ("In [Section] 16(b) Congress sought to 'curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.'" (quoting Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972))).

155. *See* O'Connor, *supra* note 100, at 321. According to the testimony of the draftsman of Section 16(b): "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb . . . ." *Stock Exchange Practices: Hearings on S. 56 and 97 Before the Senate Comm. On Banking and Currency*, 73d Cong. (1934) (statement of Thomas G. Corcoran).

156. When there are multiple trades during overlapping six-month periods, the lowest in-highest out approach does not always generate the highest "Section 16(b) profits." *See generally* Andrew Chin, *Accurate Calculation of Short-Swing Profits Under Section 16(b) of the Securities Exchange Act of 1934*, 22 DEL. J. CORP. L. 587 (1997).

157. *See* § 16(a). Section 16(a) requires that a person who is an officer, director, or 10% beneficial owner file a statement on Form 3 with the SEC indicating that they have become a Section 16(a) insider within 10 days of acquiring that status. Except for specified de minimis transactions, any insider who has filed a Form 3 must then file a Form 4 within 10 days of the end of any month in

to reduce insider trading profits and why it would not be desirable to try to enhance Section 16(b)'s effectiveness by extending the no-profit period beyond its current six months.

2. *The Limited Effectiveness of Section 16(b)*

Section 16(b) imposes a penalty on insiders buying on inside information only if (1) the insider sells at a higher price within six months; or (2) the insider has sold at a higher price during the previous six months. Similarly, Section 16(b) imposes a penalty on insiders selling on inside information only if (1) the insider buys at a lower price within the next six months; or (2) the insider has bought shares at a lower price within the last six months. Thus, if the insider has made certain opposite trades in the past six months or expects to make certain opposite trades in the following six months, Section 16(b) can deter trading on inside information.

However, Section 16(b) does not impose a penalty on an insider buying on inside information as long as there has not been (and will not be) a higher-price sale within six months. Likewise, Section 16(b) does not impose a cost when an insider sells on inside information as long as there has not been (and will not be) a lower-price purchase within six months. Thus, Section 16(b)'s overall ability to prevent insiders from profiting from their access to information is rather limited.[158]

3. *Extending Section 16(b): A No-Profit Rule*

Because Section 16(b)'s ability to prevent insider trading is limited, in large part because an insider can avoid the reach of the provision simply by waiting six months before entering into an opposite transaction, it might be natural to consider extending the six-month no-profit period of Section 16(b). Although the period could be extended to any length of time, for purposes of illustration consider a "no-profit" rule that prohibits insiders from profiting from a purchase and a sale during the period that they are insiders. That is, any purchase and any sale an insider makes from the

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which there has been a change in share ownership. Thus, for example, trades made from March 1 through March 31 must be reported to the SEC by April 10.

158. *See, e.g.*, Agrawal & Jaffe, *supra* note 152, at 297; O'Connor, *supra* note 100, at 372-75. *Cf.* Merritt Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2124-25 (1994) (describing how the six-month "swing period" generally reduces insiders' incentives to buy or sell on inside information by forcing them to wait six months before they can rebalance their portfolios).

time she becomes an insider to the day that status ends could be matched to determine if the insider has made Section 16(b) profits.[159]

A no-profit rule would have some attractive features. It would be as easy to enforce as current Section 16(b). The rule would prevent insiders from using inside information to make trading profits buying and then selling shares (or vice versa) during the insider period. In addition, an insider who has information suggesting that his firm's stock is undervalued might be discouraged from buying on that information if he had previously sold shares at a higher price. Likewise, an insider who believes that the stock is overvalued might be discouraged from selling if he had previously purchased shares at a lower price. Consequently, the no-profit rule would almost certainly reduce insider trading profits.

However, there are two significant problems with a no-profit rule. First, it would be completely ineffective in many cases. Insiders who mostly purchase shares—such as insiders of small companies[160]—could buy on inside information as an insider and not sell until after their insider status terminates. On the other hand, insiders who mostly sell shares—such as insiders of larger companies[161]—could sell on inside information during the insider period stock that was acquired before the period (or, in the case of employee-insiders, stock that they receive as executive compensation).

Second, in those cases where the rule is not completely ineffective, it would impose a cost on insiders (beyond that of reducing their insider trading profits).[162] The effect of a no-profit rule would be to impose a tax on purchases (sales) when an opposite trade had previously taken place at a higher (lower) price. This tax would often exceed an insider's profits from inside information (since some, and perhaps most, of the profits generated by the trading would not be due to inside information).[163]

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159. That is, profits would be computed by matching high price sales with low price purchases as is done currently under Section 16(b). The rule might apply to shareholder-insiders the day after they become insiders and not apply on the day that they reduce their shareholdings to 10% or less. Otherwise, shareholder-insiders would be required to disgorge all of the appreciation in their shares during the period that they are insiders.

160. *See* Rozeff & Zaman, *supra* note 75, at 42; Seyhun, *supra* note 12, at 194.

161. *See* Rozeff & Zaman, *supra* note 75, at 42; Seyhun, *supra* note 12, at 194.

162. A no-profit rule would impose no costs on (but would also be completely ineffective with respect to) insiders who consistently bought or consistently sold shares (such as an insider who receives more stock through an executive compensation plan than desired and periodically sells to rebalance her portfolio).

163. To be sure, the no-profit rule could be modified to ease the burden on those insiders who desired to both buy and sell. Profits could be measured cumulatively, rather than on the basis of the highest price sale and lowest price purchase. Alternatively, one might permit insiders to earn "reasonable" profits trading. A "reasonable-profits" rule might, for example, require an insider to

In general, the problem with the no-profit rule is that it focuses on realized trading profits, which do not necessarily bear any relation to the amount an insider makes buying and selling on inside information. In certain cases realized trading profits would be less than insider trading profits and in other cases would exceed them. As a result, the no-profit rule would not prevent certain insiders from earning insider trading profits while imposing significant burdens on others.[164]

C. EMPLOYER REGULATION OF CORPORATE INSIDER TRADING: TRADING WINDOWS

The New York Stock Exchange has suggested for the past two decades that listed companies restrict the times when employee-insiders can trade[165] and many publicly traded companies have done so[166] (perhaps in order to avoid "controlling person" liability under ITSFEA).[167] The most common type of restriction is the use of trading windows, which permit insiders to trade only during certain fixed periods throughout the year.[168] A typical trading-window rule permits corporate insiders to trade during a

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disgorge any profits in excess of that which he would have earned by similar trading in a stock market index (whether those profits are measured on a most-favorable-trade or cumulative basis). Although both approaches would reduce the cost imposed on insiders, to the extent that the insider is able to earn profits from trading, he is able to make insider trading profits. Thus, easing the burden on insiders who desire to buy and sell would also reduce the effectiveness of the rule. Similarly, shortening the no-profit period (so that insiders could sell or buy freely after, say, two years had passed) would reduce the burden on some insiders, but also increase the opportunity for insider trading.

164. In the discussion paper version of this Article, I present and examine three return-limiting rules that would avoid this problem by limiting the total return (both realized *and unrealized*) that insiders can earn from their trading. I conclude, however, that these rules would be difficult to implement. *See* FRIED, *supra* note 145, at 103-13.

165. The New York Stock Exchange has urged listed companies to allow insiders to trade only after the firm has issued its annual report, quarterly results, proxy statement, or prospectus, and the insider has learned from the CEO that there are no important undisclosed developments. New York Stock Exchange Listed Company Manual § 309.00, 4 Fed. Sec. L. Rep. (CCH) ¶ 26,100, at 19,103-104 (1983) [hereinafter NYSE Manual].

166. *See* Leslie Jeng, Insider Trading and the Window of Opportunity (Sept. 11, 1997) (unpublished manuscript, on file with author) (reporting that approximately two out of three publicly traded companies responding to questionnaire about insider trading compliance programs indicated that they impose trading-window restrictions on employees).

167. *See generally* Alan Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180 (1990).

168. Some firms use a "black-out" rule that permits insiders to trade except during certain limited periods throughout the year. Gillette, for example, has adopted a rule that allows employee insiders to trade except during the two weeks before and the one week after the release of earnings results. *See* Jonathan Auerbach, *Gillette Executives Cut Their Holdings*, WALL ST. J., Oct. 9, 1996, at C1. Black-out periods are sufficiently similar to trading windows that there is no need to analyze them separately.

7-30 day period after quarterly earnings reports and other important corporate announcements are released.[169]

Trading windows reduce corporate insider trading profits by hampering insiders' ability to time their trades in order to take advantage of expected price movements. In particular, insiders cannot trade on information that they learn after a window period closes and that becomes public and incorporated into the stock price before the next window period begins. However, the typical trading-window rule might not be very effective at reducing profits from trading on inside information: Insiders can still trade on inside information that has not yet become public. As we saw in Part II, insiders often trade heavily up to six months in advance of significant corporate announcements.[170] This suggests that insiders often have access to important information months before it is announced (and therefore would not be prevented from trading on that information under a typical trading-window rule). In fact, there is anecdotal evidence that insiders of corporations using such windows buy and sell on inside information during trading periods.[171]

Of course, it would be possible to impose a mandatory trading-window rule that is more restrictive.[172] One approach would be to restrict the types of trades in which insiders can engage while the window is open.

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169. *See, e.g.*, Bridget O'Brian, *Insider Selling of a Stock Headed South May Mean Others Should Also Bail Out*, WALL ST. J., July 17, 1996, at C14 (reporting that Micro Warehouse Inc. permits executives to trade only during a nine-day period that begins five days after each quarterly earnings announcement); Joseph B. White & Alexandra Peers, *GM Executives Sold Stock Prior to Sharp Drop in Price*, WALL ST. J., Oct. 2, 1991, at C1 (reporting that top General Motors insiders are allowed to sell shares only during four annual 10-day window periods following the release of earnings results).

170. *See supra* Part II.A.

171. *See, e.g.*, O'Brian, *supra* note 169, at C14 (reporting that Micro Warehouse Inc., which permits executives to trade only during a nine-day period that begins five days after each quarterly earnings announcement, sold $2.4 million of stock in late-April/early-May, a month before an announcement about disappointing second quarter earnings drove the share price down by more than 60%). In addition, many companies are forced to close trading windows when unscheduled announcements are made, suggesting that by themselves the trading windows could not have prevented insiders from trading illegally on material inside information. *See* White & Peers, *supra* note 169, at C1 (reporting that top GM insiders are allowed to sell shares only during four annual 10-day window periods following quarterly earnings announcements); Alexandra Peers, *These Top Executives Sent Hot Signals to Investors*, WALL ST. J., Jan. 22, 1992, at C25 (quoting a GM spokesman as saying that GM insiders were asked not sell shares "early in the year" and in the fourth quarter because of potentially market-moving announcements by the company).

172. Imposing mandatory trading windows similar to the ones used currently is unlikely to be very effective at reducing insider trading profits. First, as explained above, these windows give insiders at least four periods each year during which when they can buy and sell on inside information. Second, there is evidence that a substantial number of publicly traded corporations are already using trading windows. *See supra* note 166 and accompanying text. A mandatory trading-window rule would not reduce the insider trading profits of the insiders of these corporations.

For example, one could permit insiders only to sell shares (in effect, combining a sell-only rule[173] with the standard trading-window rule).[174] A selling-window rule would be more effective than the standard trading-window rule because (1) it would not permit insiders to buy on inside information during the window periods and (2) insiders would have less of an incentive to sell shares on inside information if they believe that in the long-run the stock is a good investment. Such a rule would not impose much more burden on corporate insiders than the trading-window rules used currently.[175]

The main problem with a selling-window rule is that it would still permit insiders to sell on inside information during the trading windows.[176] Since insiders sell twice as much stock as they buy and make almost all of their insider trading profits by selling stock on bad news,[177] a selling-window rule is unlikely to be very effective at reducing insider trading profits. A second problem is that it might prevent large shareholders from accumulating additional stock in the corporation, which could have given them greater incentive to monitor management.[178]

The second approach to making the standard trading-window rule more restrictive would be to reduce the number of trading days by reducing the number of trading windows during the year and/or shortening the length of each window period. Reducing the number of trading days would provide insiders with fewer opportunities to trade on inside infor-

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173. For an analysis of a sell-only rule, see FRIED, *supra* note 145, at 92-96.

174. Since a buy-only rule might impose substantial liquidity costs on insiders, a selling-window rule is likely to be more desirable than a buying-window rule. *See id.*

175. Insiders' inability to buy under a selling-window rule would not impose any liquidity costs on them.

176. One could eliminate this insider trading opportunity by requiring mandatory selling during the selling-window period. For example, insiders could be required to sell a fixed fraction of their shares each window period. Similar schemes have already been suggested. *See* Levmore, *supra* note 9, at 129-32 (describing a "blind-trust" for insiders that would randomly purchase or sell shares each period). *See also* NYSE Manual, *supra* note 165, at ¶ 26,100, at 19,103 (suggesting that a firm concerned about insider trading could employ independent brokers to administer investment programs for employees so that employees could not time their purchases and sales of the company's securities). All three of these arrangements would eliminate insiders' opportunity to trade on inside information. However, they would be more expensive to administer and have the same drawbacks as a no-trade rule, *see* discussion *infra* Part VI.C, namely, that they might discourage entrepreneurs with large stakes in their companies from taking their companies public and large shareholders from accumulating more than 10% of a company's stock.

177. *See* Rozeff & Zaman, *supra* note 75, at 42; Seyhun, *supra* note 12, at 194.

178. *See infra* note 232. However, a selling-window rule would not necessarily lead to reduced employee-insider shareholdings since employee-insiders could be given more stock through their compensation arrangements.

mation (and therefore reduce their insider trading profits).[179] One might be able to reduce significantly the number and the length of trading-window periods without increasing the burden on insiders.[180]

However, at some point restricting the trading windows might begin to impose substantial costs on employee-insiders with large shareholdings and large shareholders. It might thus impose the same (potentially large) costs as a no-trade rule, analyzed *infra* Part VI.C: Namely, it might discourage entrepreneurs with large stakes from taking their firms public and large shareholders from acquiring more than ten percent of a company's stock. And whenever insiders did trade, they could still profit fully from their access to inside information.

D. SUMMARY

In this Part, I have explained why Rule 10b-5, Section 16(b), and trading windows fail to prevent insiders from trading on inside information. I have also explained why expanding Rule 10b-5 or Section 16(b), or imposing mandatory and more restrictive trading windows is likely to be very costly and/or not sufficiently effective at reducing insider trading profits. In the next Part, I consider an entirely different approach to reducing such profits: requiring insiders to announce their intended trades (or privately negotiated transactions) shortly in advance.

IV. THE PRETRADING DISCLOSURE RULE

This Part puts forward and begins analyzing the operation of the pretrading disclosure rule. Section A introduces and describes the rule. Section B demonstrates how the rule could reduce (and, in principle, eliminate) corporate insider trading profits. Section C explains why pretrading disclosure could replace Section 16(b) (but not Rule 10b-5) and thereby reduce the overall regulatory burden on insiders.

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179. *See* Jeng, *supra* note 166 (finding some preliminary evidence suggesting that shorter trading windows reduce insiders' ability to make excess profits from inside information). One could also delay opening the windows for a few weeks after important news is released. Delaying the opening of the windows would reduce insiders' ability to trade on market overreactions to corporate announcements (but increase the amount of undisclosed information on which they could trade).

180. In general, the burden on insiders of a trading-window rule would depend on the size of the window and the number of window periods during the year.

A. OVERVIEW AND OPERATION OF THE PRETRADING DISCLOSURE RULE

Under the pretrading disclosure rule, a corporate insider could not submit an order to buy or sell shares in her company unless she had given notice of the order[181] shortly in advance.[182] If the insider intends to execute a face-to-face transaction off the exchange, she would also be required to announce that transaction shortly before consummating it.[183] In her disclosure to the SEC, the insider could include any other information that she wishes to communicate to the market.[184] The disclosure would be made by filing details of the order on the SEC's Electronic Data Gathering And Retrieval system ("EDGAR"), which can make the information available to the market upon its arrival at the SEC.[185] The rule would apply to insiders who are subject to Section 16(a) reporting requirements. As under Section 16(a), an insider would be required to announce not only his own

181. The insider would be required to disclose to the SEC the exact details of the order she intends to give the broker. Thus, for example, if the insider intends to tell her broker to "buy 100 shares at a price of $10 or better, good-until-canceled," the insider would be required to disclose to the SEC all of those terms. As will be explained, pretrading disclosure would not be effective if insiders could easily "back out" of their intended trades. In the absence of a specificity requirement, insiders could effectively "back out" of their intended trades by submitting orders that are consistent with their announcement but which either involve only nominal amounts of stock or stand little chance of being executed. For example, an insider could announce that he intends to sell stock at a price of $10 or better and then, if he decides to back out of the trade at the last minute, sell only 100 shares. Or an insider could announce that he intends to sell 10,000 shares of stock and then, if he decides to back out of the trade, submit a limit order at a price that will ensure that the order is not executed.

182. One could require notification one, two, or perhaps three days before the trade. The optimal notice period would depend on the speed with which the market can react to the announcement of a trade and the cost that delay would impose on insiders.

183. An insider would also be required to disclose before engaging in any transaction involving options and other derivative instruments (including employee stock options ("ESOs") and stock appreciation rights ("SARs")) that is economically similar to either the purchase or the sale of stock. For example, a corporate insider exercising a SAR the value of which is based on the market price of the stock would be required to announce in advance his intention to exercise the SAR. This announcement might affect the market price of the stock and, therefore, the insider's profits from the exercise of the SAR. The use of SARs and other stock-like instruments is already reached by the same provisions that regulate the trading by insiders in the stock of their own companies. *See* Fox, *supra* note 158, at 2138-90.

184. As will be explained, an insider might find it in her interest to indicate to the market that following the announced trade she does not intend to make any further trades for a specified period.

185. Currently, EDGAR filings are made available immediately to a commercial firm that in turn feeds them to other firms that sell the information to subscribers. *See* Marcia Vickers, *Rich, If Not Famous, in 15 Minutes,* N.Y. TIMES, July 14, 1996, at D7. Investors could obtain the information directly by subscribing to one of these reporting services or via news services such as Reuters, the Associated Press, and Bloomberg, which would disseminate the information in the electronic and print media before the market opens the next morning. The announcement could also be sent to the SEC by fax or overnight delivery so that it can be posted on EDGAR by the appropriate deadline.

trades but also trades in which he has a direct or indirect pecuniary interest, such as trades by members of his immediate family.[186]

Following the disclosure of an intended trade, market participants could adjust the price at which they are willing to trade to reflect the heightened possibility of an abnormal price change that is signaled by the insider's order. To see how the rule might work, consider the following example.

Suppose that on Monday, when ABC stock is trading for $26, an ABC insider announces that, on Wednesday, she will submit an order to her broker to sell 20,000 shares at a price of $25 or higher. Knowing that there is a possibility that the insider is selling now because she believes, based on inside information, that the stock is overvalued, market participants who had been considering trading ABC stock on Tuesday and Wednesday might choose to modify or abandon their planned trades. Market participants who were considering purchasing shares of ABC stock might not go forward with these purchases, or might reduce the price at which they are willing to purchase the stock. Market participants who were considering selling ABC stock might reduce the price at which they are willing to sell it. Market participants who, prior to the insider's announcement, were not considering selling the stock might decide to sell some of their shares. The combined effect of these adjustments would be, everything else being equal, to reduce the price at which those making a market in the stock are willing to buy and sell the stock.[187] When the insider's trade is executed on Wednesday, it is likely to be executed at a lower price than if she had not disclosed the order in advance—to the extent that market participants believe that she is trading on inside information.

In principle, pretrading disclosure should prevent corporate insiders as a group from making excess returns. As I noted in the Introduction, an intuitive way to understand this result is as follows: 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.

The pretrading disclosure requirement would not be difficult to enforce. Section 16(a) already requires insiders to report each trade. The SEC could easily maintain a record of the pretrading announcements that it

186. *See* Rule 16a-1(a)(2), 17 C.F.R. § 240.16a-1(a)(2) (1994). A person who intends to execute a trade in which an insider has a pecuniary interest would therefore be required to inform the insider in advance so that the insider could make her pretrading disclosure.

187. Of course, there will be other news that affects the price at which investors are willing to buy and sell the stock.

receives. Reported trades and announcements could be matched to determine whether any trades had not been preceded by an announcement.[188] An insider who trades without prior announcement could be forced to disgorge any profits (avoided losses) or fined a fraction (or multiple) of the dollar value of the transaction. As under Section 16(b), actions could be brought by private attorneys.[189]

Corporate insiders would not be forced to follow through on their announced trades. However, they would be required to pay a small fine (say, 1-2% of the transaction amount) if they do not submit the announced order to their broker (or complete a privately negotiated trade). Otherwise, corporate insiders would have an incentive to engage in a strategy of deliberately "crying wolf"—repeatedly announcing intended trades but not executing them—in order to render their announcements almost meaningless and thereby disable the adjustment mechanism.[190] To demonstrate that the announced order had been submitted to the broker, the insider would either file a Section 16(a) report showing the completed trade, or if the order expires unfilled, send a copy of the order receipt to the SEC by courier, mail, or fax.[191] To ensure that insiders do not effectively back out of a trade by

188. Under pretrading disclosure, corporate insiders would have a greater incentive to not report completed trades than they do currently. However, the reporting requirement could be enforced through random audits of insiders' personal accounts and by matching tax returns with Section 16(a) filings. An insider might consider resorting to off-shore accounts. But the use of information-sharing agreements with foreign governments and the willingness of foreign institutions to cooperate with the SEC is believed to give the SEC considerable ability to reach trading in foreign accounts. *See* Jeffery Taylor, *Inside Traders Get a Message in Duracell Case*, WALL ST. J., Sept. 19, 1996, at C15.

189. *See supra* note 152 and accompanying text.

190. Two other approaches to preventing the "crying wolf" strategy might be considered. The first, the "safe harbor" approach, would permit an insider to cancel any particular trade, but subject the insider to heavy fines if she fails to follow through on at least a fixed fraction (say, 80% or 90%) of her announced trades (by dollar value) per year. By forcing insiders to follow through on most but not all of their trades, this approach would severely reduce the ability of insiders to disable the adjustment mechanism while reducing the risk that they would be forced to follow through on trades that they decide (at the last minute) are undesirable.

The second approach would be to impose no follow-through requirements and rely on the antifraud provisions to deter insiders from attempting to manipulate the market. However, if it is too difficult to prove fraud, such a rule might not deter the insider from "crying wolf." And if it is too easy to prove fraud, insiders might feel pressured to go through with unfavorable trades to avoid liability. Thus, of these two other approaches, the safe harbor approach would be the most promising.

191. On a good-until-canceled order the insider would be required to announce his intent to cancel the order shortly before canceling (as if it were an order to buy or sell stocks). That is, if an insider is required to announce an intention to submit an order to her broker three days in advance of submitting the order, she would be required to announce an intention to cancel the order three days in advance of doing so, and to send a copy of the cancel order to the SEC. An insider could also cancel a market order in the same manner. In either case, a cancellation order that is not announced on the same day as the intended trade may not cancel the order before the order is executed. For example, if under a three-day pretrading disclosure rule an insider announces on Monday that she will submit a good-until-canceled (or market) order on Thursday and then announces on Tuesday that she intends to

announcing their intention to submit good-for-the-day orders and then submitting them to their brokers immediately before the close of the market, insiders would be required to submit such orders before the opening of the market. If an insider is unable to consummate a privately negotiated transaction that had been announced, the insider would be required to submit a statement explaining his failure to complete the trade.

The idea of pretrading notification is not entirely new. Rule 144 currently requires that certain sales by "affiliates" and holders of "restricted securities" be disclosed to the SEC in advance.[192] And in the mid-1980s, a number of proposals were made to amend Section 16(a) to require same-day disclosure or disclosure a few days in advance of trading.[193] The pur-

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cancel the order, the broker cannot be instructed to cancel the order until Friday, by which time the order might already have been executed.

192. Rule 144, 17 C.F.R. § 230.144 (1994). Rule 144 provides a safe harbor from the registration requirements for holders of restricted securities and persons affiliated with publicly traded corporations (including employees in "control" positions, such as high level officers) seeking to sell more than 500 shares or $10,000 worth of shares. Among Rule 144's requirements are that sales be in limited amounts (during any 90-day period, an insider may sell up to 1% of the company's total outstanding shares, or the average number of shares traded in the most recent four weeks, whichever is greater), and that there be prior or concurrent notification of the sales through the filing of a Form 144 with the SEC and the principal exchange on which the issuer's stock is traded. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION §4.26 (3d ed. 1996).

Rule 144 imposes a pretrading disclosure rule of sorts with respect to sales. Since there are twice as many sales as purchases and most corporate insider trading profits are made selling shares, one might argue that there is essentially already a pretrading disclosure rule in place for most insider trades (and that it is ineffective). But the disclosure requirement under Rule 144 is considerably different from what I propose.

First, the statute does not cover *buying* by control persons. One of the key indicators that insiders are trading on inside information is the existence of "consensus" trading; that is, most of the insider trading is either buying or selling. Since Rule 144 filings do not indicate whether the selling that is reported is greater than or less than the buying, they fail to provide information that is important to market participants when attempting to decode trading by insiders. *Cf.* Alexandra Peers, *Vote on Rules Ending Insider Reporting for Some Executives is Slated by SEC*, WALL ST. J., Jan. 9, 1991, at C19 (reporting that investors and money managers complained about proposals to reduce the number of corporate officers required to file under Section 16(a) because it would become more difficult "to spot telltale clusters of trading activity in which more than one officer or director is buying or selling in a short period of time").

Second, to the extent that the statute does cover selling by control persons, the filing indicates only that the filer *may* sell during the next three months. The filing does not indicate the price at which the insider is willing to sell. The insider may in fact not sell, or even buy. Therefore, the disclosure conveys much less information to the market than the pretrading disclosure rule that I put forward and enables insiders to back out of intended trades, which undermines the adjustment mechanism. *See supra* note 190 and accompanying text.

Third, and perhaps most importantly, to the extent that an insider believes that a Form 144 filing would convey information to market participants, the insider can avoid an adjustment by filing the form concurrently with the trade.

193. *See* Michael Klein, *Outsider Proposes Change in Insider Trading Bill*, LEGAL TIMES, Dec. 12, 1983, at 8 (proposing that Section 16(a) insiders be required to give three- to five-day notice of their specific intentions to trade in the company's stock). A same-day disclosure rule was suggested

poses of these proposals appeared to be to improve price efficiency and to serve the information needs of traders.[194] However, none of these rules or proposed rules was aimed explicitly at reducing corporate insider trading profits.[195]

B. HOW PRETRADING DISCLOSURE REDUCES CORPORATE INSIDER TRADING PROFITS

The theory behind pretrading disclosure is simple: Insiders should not be able to systematically outperform other shareholders if other shareholders have the ability to perform the same trades as the insiders. This Section describes the mechanisms by which pretrading disclosure reduces (and in principle eliminates) corporate insider trading profits. It also presents empirical data suggesting that pretrading disclosure would in fact substantially reduce (although not completely eliminate) corporate insider trading profits. Pretrading disclosure reduces insiders' ability to make insider trading profits both through its effect on the trading decisions of market participants and through its effect on the trading decisions of insiders. Each effect is considered in turn.

Before proceeding, I should note that, for purposes of this Part, I assume that corporate insiders do not engage in strategic behavior designed to circumvent, manipulate, or deliberately undermine the effectiveness of

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by Senator Chafee in 1985. *See Task Force Report, Part II, supra* note 39, at 1102. Without much elaboration, a 1987 American Bar Association report dismissed these same day and prior disclosure proposals as impractical and unnecessarily burdensome and suggested disclosure within two business days following the transaction. *See id.* Since the use of computers, e-mail, and the Internet has become much more widespread over the last decade, it is not clear that those who wrote the report would reach the same conclusion today.

194. *See* Klein, *supra* note 193, at 8. The possibility of requiring pretrading disclosure to enhance price efficiency is also mentioned briefly in Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 632 n.221 (1984). However, as I explain below, pretrading disclosure is likely to reduce insiders' incentive to trade on inside information. Thus, pretrading disclosure is likely to make trading by insiders a less effective means of communicating information to the market. Nevertheless, pretrading disclosure could improve price efficiency by, for example, reducing insiders' incentive to withhold information from the market. *See supra* notes 54-55 and accompanying text.

195. The only proposal I have seen that suggests disclosure as a method of reducing corporate insider trading profits is one that would require insiders to announce their trades 90 days in advance. *See* Samuelson, *supra* note 96, at 522-28. The purpose of Samuelson's proposal is to ensure that any inside information that is available to the insider at the time of announcement emerges and becomes incorporated into the share price by the time the trade is executed (thus depriving the insider of the ability to profit from that information). The mechanism for reducing insider trading profits at the core of Samuelson's proposal is different from the mechanism that would make the pretrading disclosure rule I put forward effective. As will be explained in Part VI.B, a 90-day rule might not be much more effective at reducing corporate insider trading profits than the pretrading disclosure rule that I propose, yet it could impose much greater costs on insiders.

the pretrading disclosure rule. In Part V.A, I will examine various means by which corporate insiders might try to preserve their insider trading profits under pretrading disclosure and explain why none is likely to be effective.

1. *The Effect of Pretrading Disclosure on Market Participants' Trading Decisions*

As Part II.C explained, a significant number of market participants currently use Section 16(a) trading reports to inform their trading decisions. Among the factors that they take into account in "decoding" a particular trade are the size of that trade, the size of the trade relative to the insider's holdings and previous trades, whether the insider's previous trades have correlated with subsequent stock price movements, and recent trades by other company insiders. These market participants tend to increase their purchases whenever insiders' purchases are believed to signal the possibility that the stock is undervalued and increase their sales when insiders' sales are believed to signal the opposite. The price adjustment that results from their trading occurs only after insiders trade. As a result, insiders' trading profits are unaffected by market participants' trading. Under pretrading disclosure, their trading activity would move the price against an insider before the insider trades, forcing him to trade at a worse price, and thereby reducing his trading profits.[196]

To better understand how the trading activities of market participants reduce insider trading profits, it will be helpful to think of market participants as belonging to one of two groups: market participants who would have traded even in the absence of an insider's announcement (and who, therefore, might incur no "marginal transaction cost"[197] or might even save transaction costs by adjusting their trade in response to an announcement) and market participants who would not have traded in the absence of the insider's announcement but who might follow the insider's trade if, after

196. Of course, the adoption of a pretrading disclosure rule would affect the trading patterns of corporate insiders, *see infra* Part IV.B.2, perhaps rendering obsolete the strategies that are currently used. Market participants might therefore need to develop new strategies for profiting from the information signaled by pretrading disclosures.

197. The marginal transaction cost associated with a trade is the additional transaction costs that a person must incur to complete that trade as opposed to the trade that she would otherwise have executed (if any). Suppose, for example, that a person is deciding between selling stock A and selling stock B. Then the marginal transaction cost associated with the sale of stock A is the difference between the transaction cost associated with the sale of stock A and the transaction cost associated with the sale of stock B. If the former is the less than the latter, the marginal transaction cost of selling stock A is negative. If, on the other hand, the person is deciding between selling stock A and not performing any trade, the marginal transaction cost associated with selling stock A is the full transaction cost that must be incurred to sell the stock.

analyzing the insider's announcement and other relevant information, they believe that the particular trade is based on undisclosed information and the expected excess return is higher than the transaction cost involved in doing so. Let us call the first group zero-transaction-cost ("ZTC") traders because they may face no marginal transaction cost (and in fact may face a negative marginal transaction cost) in responding to an insider's announcement.[198] Let us call the second group "non-ZTC" traders because they will face a positive marginal transaction cost if they trade in response to the insider's announcement.

Consider first the trading decisions of ZTC traders. ZTC traders about to trade *against* an insider by buying shares on the day that the insider is selling may abandon their trades or seek a better limit order price. Market participants who find themselves trading *with* the insider may increase the size of their trades or accept a worse price on their limit orders. These adjustments, to the extent that they occur, would force the insider to trade at a less favorable price.

Of course, ZTC traders could not know the motives for the insider's trade. Thus the adjustment in price caused by ZTC traders would never, in any given case, precisely reflect the inside information, if any, behind the insider's trade. Instead, the adjustment would at best reflect the *expected value* of the inside information communicated by the announcement. Nevertheless, the adjustment caused by the reactions of ZTC traders to the announcement should, in principle, eliminate the excess returns that corporate insiders make as a group from inside information, as the following simple example illustrates.

Suppose that in the example above, the ABC insider's announcement that she intends to sell 20,000 shares at $25 or higher could mean either that she has inside information indicating that the stock, currently trading at $26, is overvalued by $2, or that she has no particular inside information suggesting that the stock is overvalued but needs to raise cash. Suppose that based on the insider's previous trading history and other relevant information, ZTC traders believe there is a 75% chance that she is selling to raise cash and a 25% chance that she knows the stock is worth only $24. In that case, ZTC buyers may now be willing to pay only $25.50 for the stock (*$26 - 25% of $2*) and ZTC sellers who otherwise would not have sold for less than $26 may now be willing to sell for $25.50. The insider will thus be able to sell her shares for $25.50 (rather than for $26, the price

198. ZTC traders include market participants who would have incurred a transaction cost trading other stock but who, as a result of the announcement, might instead trade in the stock of the insider's company. *See supra* note 197.

that would have prevailed in the absence of her disclosure). Thus if the ABC insider is selling on inside information indicating that the stock is worth only $24, she will make a profit of $1.50 per share selling on inside information. But if the ABC insider is simply selling to raise cash, she will get 50¢ less for her shares than what they are worth.[199] In neither case will the adjustment reflect precisely the inside information, if any, behind the trade.

However, if the adjustment reflects the average value of the inside information on which the ABC insider trades, over time the insider will not be able to make excess returns. For example, suppose that the stock is $2 overpriced one out of every four times the ABC insider sells stock and that it is priced properly the other three times. Suppose further that the ABC insider sells 20,000 shares each time that she trades. The insider should face a 50¢ per share adjustment (*25% of $2*) each time that she trades, for a total adjustment on each trade of $10,000 (*50¢ x 20,000*). Over the course of four trades the insider will therefore face aggregate total adjustments of $40,000, which is precisely the amount of insider trading profits (*$2 x 20,000*) that she makes (before the adjustment) on the one sale based on inside information.

In practice, many of the ZTC traders trading against the insider will be either uninformed or forced, for one reason or another, to transact at the market price. As a result, the adjustment resulting from ZTC trading, by itself, might not eliminate an insider's excess returns over time. That is, when insiders announce their intention to buy, ZTC trading does not, on average, increase the price sufficiently to reflect the positive abnormal returns that are expected to follow. And when insiders announce their intention to sell, ZTC trading does not, on average, reduce the price sufficiently to reflect expected abnormal negative returns.

However, to the extent that ZTC traders do not eliminate corporate insider trading profits, non-ZTC traders will have an incentive to follow an insider's trade if, after the adjustments resulting from ZTC trading, they still expect the stock to generate abnormal returns greater than their transaction costs. Transaction costs of trading are approximately 2%.[200] Thus, non-ZTC traders will have an incentive to follow the insider's trade only if

199. To be sure, the ABC insider could indicate that she is selling solely to raise cash in her pretrading disclosure to the SEC. However, market participants would understand that, regardless of her reason for selling the stock, she will have an incentive to give the impression that the sale is not information driven in order to minimize the adjustment. Thus, any such announcement is likely to be ignored. Instead, market participants will examine the insider's trading history and other pertinent information in order to assess the likelihood that the sale is information driven.

200. *See supra* note 87.

they believe that they will make excess returns greater than 2%. As a result, either ZTC trading will reduce expected excess returns to less than 2%, or non-ZTC trading will reduce expected excess returns to 2%. In either case, an insider who would be trading in any event (and thus faces a zero marginal transaction cost) would, on average, be able to make excess returns of no more than 2%.

Returning to our example, suppose that after the ABC insider's announcement, trading by ZTC traders does not move the stock price below $26. Thus, the stock is overpriced: A person selling the stock could expect to make excess returns (by avoiding abnormal losses) of 50¢ per share. Suppose further that a non-ZTC trader's marginal transaction cost in selling ABC stock is 40¢ per share (approximately 1.6% of the pre-announcement price). In that case, non-ZTC traders will have an incentive to sell ABC stock until its price declines to $25.90, the price at which it is no longer profitable for these traders to sell the stock. The ABC insider should thus be able to sell her stock for $25.90 per share, making average excess returns of 40¢ per share.

Now suppose that the effect of ZTC trading is to move the stock price to $25.75. The stock is still overpriced, but only by 25¢ per share. If, as we assumed above, non-ZTC traders face a marginal transaction cost of 40¢ per share in selling ABC stock, they will not have an incentive to sell the stock, and the price will remain at $25.75, enabling the insider to make only 25¢ per share in average excess returns. In either case, the insider makes average excess returns less than or equal to the non-ZTC traders' marginal transaction cost.

2. *The Effect of Pretrading Disclosure on Insiders' Trading Decisions*

In examining the effect of pretrading disclosure on market participants' trading decisions, I temporarily abstracted from pretrading disclosures effect on insiders' trading activities. But, as I explain below, adoption of a pretrading disclosure rule will also affect insiders' trading activities in a way that will contribute to the reduction of insider trading profits. The rule will do so in two ways: (1) by causing insiders to structure their trades in ways that reduce insider trading profits, and (2) by reducing the number of times that insiders trade on inside information.[201]

201. Pretrading disclosure will not affect nondiscretionary trades, trades that, for one reason or another, insiders believe they must execute (regardless of the adjustment). For example, an insider might need to purchase additional stock in order to increase the size of her control block or to satisfy board demands that she hold a certain amount of stock, or the insider might feel compelled to sell stock in order to rebalance her portfolio or raise cash. Nevertheless, the insider might still have dis-

Currently, an insider's cost of trading is no different from that of any other market participant. But under pretrading disclosure, an insider trading will face two additional costs: (1) the adjustment to the preannouncement price that will occur as a result of the insider's announcement ("the immediate adjustment"), and (2) the change in (the net present value of) future adjustments that will occur as a result of the insider's trade ("change in future adjustments").

As explained previously, market participants analyzing insiders' trades consider, among other things: (1) an insider's trading history; (2) the size of the trade (in absolute terms, and relative to prior trades and the insider's holdings); and (3) recent trading by other insiders of the firm. The more an insider's previous trades have predicted future stock price movements, the larger the trade, and the more intensive the trading by other insiders, the more likely market participants are to believe that the insider is trading on inside information, and the larger the immediate adjustment will be. The change in future adjustments will depend on (1) the extent to which this trade predicts subsequent price movements, and (2) the extent to which the insider expects to trade in the future. To the extent that the trade predicts subsequent price movements, the insider can expect increased adjustments in the future.[202] However, if the insider does not expect to trade in the future, then she will give no weight to the possibility of future adjustments.

First, consider how pretrading disclosure would affect how insiders structure their trades. For example, consider the situation of an insider who has already decided to sell stock over a three-month period, but has not decided how much to sell, the date(s) of the sale, what she considers to be an acceptable price, and whether to sell the stock in one transaction or two. Currently, the insider would choose the optimal amount of stock to sell and attempt to sell all of it at the best price that she believes that she will be able to get.

Under pretrading disclosure, such a strategy might not maximize her trading profits over time. In particular, she might face a substantial immediate adjustment if she sells a large block of stock in one trade, particu-

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cretion over the timing of the trade and whether it is executed as one trade or two or more smaller trades. *See infra* note 203 and accompanying text.

202. The extent of the increase will depend on the insider's trading record. Suppose that the insider has traded frequently and all of her trades have been followed by the same amount of abnormal returns. Then an additional such trade might increase future adjustments by making market participants more willing to follow her trades. But suppose that the insider has traded frequently and that all of her previous trades have been followed by much higher abnormal returns. In that case, a trade that is followed by lower abnormal returns (or no abnormal returns) might reduce future adjustments.

larly if other insiders have also recently sold (and her trades have historically "predicted" future price movements). To reduce the immediate adjustment, the insider will have an incentive to sell fewer shares than she would sell currently (and, perhaps, break up the trade into two or more smaller transactions). She would also have an incentive not to sell at the same time as other insiders. That is, she would have an incentive to postpone her sale(s) if other insiders had recently sold, or to accelerate her sale(s) so that she sells before others do.

By giving insiders who have already decided to trade an incentive to trade fewer shares, space their trades apart from those of other insiders, and break up their trades into smaller orders, pretrading disclosure reduces insider trading profits by (1) reducing the volume of trading, and (2) making it more difficult for insiders to trade at what they might believe is the best price.[203]

Now, consider the situation in which the insider must decide whether to sell shares in the first instance, given whatever selling strategy (size and timing) she would find optimal. Currently, the insider has an incentive to sell those shares if the expected excess return from the sale exceed the marginal transaction cost. Under pretrading disclosure, the insider has an incentive to trade those shares only if the expected excess returns from the sale (at the pre-announcement price) exceed the marginal transaction cost plus the sum of the immediate and future adjustments. Thus, there will be fewer trades on inside information than there are currently (which will reduce total insider trading profits).[204]

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203. One might argue that an insider trading on inside information could break up her trades or trade separately in order to mislead the market. But, as I explain later, such strategies would not be very effective. *See infra* Part V.A.

204. At first glance, it might appear that pretrading disclosure would cause insiders to trade only on high-value information, which in turn would increase the average excess returns per trade. However, average (pre-adjustment) excess returns could be either higher or lower than they are currently.

To see why this is the case, suppose that insiders currently engage in three types of trades: trades not based on inside information ("no-value trades"); trades based on low-value inside information ("low-value trades"); and trades based on high-value inside information ("high-value trades"). Suppose further that the average excess return from high-value trades is 30%, the average excess return from low-value trades is 10%, and that the average excess return from no-value trades is 0%. Finally, suppose that 50% of all trades are no-value, 25% are low-value, and 25% are high-value. Thus, average excess returns are 10% (*(.25)(.30) + (.25)(.10)*).

Adoption of pretrading disclosure will reduce the volume of each type of trade. Consider first high-value and low-value trades. To the extent that market participants cannot differentiate between these trades at the time that they are announced, they will lead to the same immediate adjustment. As a result, some of the low-value trades will no longer be worthwhile. However, trading on high-value information (rather than low-value information) is likely to lead to larger increases in future adjustments. So while the expected benefit of trading on high-value information is greater, so will be the expected cost. As a result, some of the high-value trades will also no longer be worthwhile. Thus

3. *Assessing the Likely Effectiveness of Pretrading Disclosure*

The effectiveness of pretrading disclosure depends on market participants' ability to incorporate the information signaled by announcements into their trading decisions before insiders' orders are executed. While it is impossible to know in advance how well the market price will adjust to reflect the information communicated by insider announcements, there is empirical data—in the form of studies examining market reactions to the release of Section 16(a) reports—suggesting that pretrading disclosure could reduce insider trading profits to approximately 2%—the marginal transaction cost that an insider would incur trading solely to make excess returns.

As explained in Part II.C, insider trades reported to the SEC are made available to the public through a variety of channels. In a perfectly efficient market—a market in which prices reflect all publicly available information—the information that is conveyed by these reports would be incorporated almost immediately into the stock price. That is, a person trading a month, a week, or even several days after the filings are made public would not be able to use the reports to systematically make excess profits.

In fact, prices do adjust to the news contained in the trading reports on the day that the reports are made public.[205] However, prices do not adjust fully: Stocks that insiders have traded show abnormal price movements not only around the announcement day but for months thereafter. One study, for example, found that stocks traded by insiders showed abnormal returns of 1.9% over the 300 days following announcement dates,[206] indicating that the market did not immediately impound all of the information contained in the announcements.

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there are likely to be both fewer high-value trades and fewer low-value trades under pretrading disclosure. Next, consider no-value trades. To the extent that these trades are discretionary and insiders about to engage in such trades expect an adjustment, there will be fewer such trades as well. However, although many no-value trades are not discretionary and there are many insiders who will not face an adjustment because they historically have not traded on inside information, there are still likely to be many no-value trades under pretrading disclosure.

The average excess returns under pretrading disclosure will depend on the relative frequency of each type of trade. Suppose, for example, that pretrading disclosure reduces low-value trades by 80%, high-value trades by 20%, and no-value trades by 40% (and that the average excess return for each of these trades remains the same). In that case, average excess returns will be approximately 12% *((.05)(.10) + (.20)(.30)/.55)*. If, on the other hand, pretrading disclosure reduces low-value trades by 80%, high-value trades by 40%, and no-value trades by 20%, average excess returns will be approximately 8% *((.05)(.10) + (.15)(.30)/.60)*.

205. *See* Seyhun, *supra* note 12, at 208-10.

206. *See generally* Seyhun, *supra* note 12.

The results of this study suggest that under the pretrading disclosure rule the market would not fully adjust to the information communicated by insiders' announcements. In particular, the study suggests that, on average, the immediate adjustment to insiders' trades may fall 2% short. To the extent that insiders who otherwise would have traded (and therefore face a zero marginal transaction cost) face such an incomplete adjustment, they will be able to earn excess returns averaging 2%.

However, pretrading disclosure is likely to be more effective at reducing insider trading profits than this study might suggest. First, market participants are more likely to give weight to a contemporaneous announcement of an intended trade than to an announcement about a trade that occurred 2-6 weeks previously (even if, in theory, both announcements can be used by market participants to generate the same excess returns). Thus, more market participants—including ZTC traders—are likely to adjust their trades to the information communicated through pretrading disclosure than currently do so with respect to Section 16(a) filings. As a result, the immediate adjustment under pretrading disclosure is likely to be more complete. Second, the insiders who trade on inside information and who would not otherwise have traded will incur a marginal transaction cost of approximately 2%. To the extent that these insiders earn excess returns averaging 2%, those returns will be completely offset by the marginal transaction cost. Third, pretrading disclosure will reduce the incentive to trade on inside information by increasing the cost of doing so.[207] Therefore the volume of insider trading on which insiders earn their excess returns will almost surely decline, further reducing insider trading profits.

C. PRETRADING DISCLOSURE AS A REPLACEMENT FOR SECTION 16(B)

In Sections A and B, I put forward and began analyzing a rule of pretrading disclosure that, I argued, could substantially reduce corporate insider trading profits. In this Section, I explain why adopting the pretrading disclosure rule would make Section 16(b)—which currently imposes considerable costs on insiders—largely redundant.

As we saw earlier, Section 16(b) is relatively ineffective at reducing insider trading profits.[208] At the same time, there are significant costs to Section 16(b). First, Section 16(b) imposes a tax equal to the difference between the purchase and the sale price on corporate insiders who must buy and sell within six months for reasons other than exploiting inside in-

207. *See supra* Part IV.B.2.
208. *See supra* Part III.B.2.

formation.[209] Second, the difficulty of determining whether the various elements of complicated compensation arrangements are considered purchases or sales for purposes of Section 16(b) (in order to avoid accidentally triggering a Section 16(b) penalty) imposes a considerable administrative and legal cost on insiders and their employers.[210] Like all costs imposed on insiders, these costs are borne in part by insiders and in part by other shareholders.[211]

Although Section 16(b) is of limited effectiveness and imposes considerable costs on insiders, it has been retained because it is still believed to serve three useful purposes: (1) it reduces insiders' ability to profit from short-term stock price fluctuations, better enabling them to focus their attention on the long-term performance of the firm; (2) it makes it more difficult for insiders to exploit Rule 10b-5's limitations by unfairly using submaterial inside information; and (3) it reduces insiders' incentives to manipulate the information transmitted by the corporation in order to make short-term trading profits.[212] As a result, the ABA has recommended—and the government apparently has agreed—that Section 16(b) should be retained.[213] However, Section 16(b) reduces insiders' ability to profit from short-term price fluctuations, reduces their ability to profit from submaterial information, and reduces their incentive to manipulate stock prices only to the extent that these activities require a purchase and sale within six months of each other.

Pretrading disclosure would serve these three purposes more effectively. Consider the first purpose of Section 16(b)—preventing insiders from profiting from price fluctuations so that they will concentrate their efforts on managing the corporation. Section 16(b) does not prevent insiders from taking advantage of short-term fluctuations as long as the transaction is not closed within six months. For example, if the price of a stock suddenly drops and insiders believe that the stock is undervalued at the lower price, they can profit by accumulating the stock and selling it more than six months later after the price rebounds. Under pretrading disclo-

209. The possible imposition of a Section 16(b) penalty also discourages large shareholders from coordinating their efforts to monitor and discipline management, lest they collectively be considered a 10% shareholder subject to Section 16(b). *See generally* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 822-23 (1992) (noting that Section 16(b) is one of a number of legal impediments to institutional shareholder activism).

210. *See* Chin, *supra* note 156, at 588 (reporting that "Section 16(b) compliance remains a complex problem for corporate counsel, especially given the continuing popularity of derivative and convertible debt securities in executive compensation plans" (citations omitted)).

211. *See infra* Part V.B.

212. *See Task Force Report, Part II, supra* note 39, at 1092.

213. *See id.*

sure, insiders who buy when the price is temporarily low or sell when it has reached a temporary high will face larger future adjustments which will force them to give back some of the gains, thereby discouraging them from attempting to profit from short-term price fluctuations in the first place. Pretrading disclosure will have this effect whether or not there is a purchase and a sale within a six-month period and even if the insider only buys or only sells.

As explained in Parts III.B.2 and IV.B, pretrading disclosure is also more effective than Section 16(b) at preventing insiders from unfairly using sub-material inside information if there are not two opposite transactions within a six-month period. For similar reasons, Section 16(b) also does not deter insiders from manipulating corporate announcements to make trading profits unless the manipulation scheme requires opposite transactions spaced less than six months apart. For example, Section 16(b) cannot prevent insiders from artificially boosting the price of a stock and selling it at the inflated price as long as there has not been a lower-price purchase in the previous six months. In contrast, pretrading disclosure would make it much more difficult to manipulate stock prices through misleading corporate announcements by alerting market participants to the fact that—notwithstanding the information contained in the announcement—insiders have a contrary assessment of the firm's prospects.

Pretrading disclosure is not only more effective than Section 16(b) at accomplishing these goals, it would also impose less regulatory cost on insiders. Under pretrading disclosure, insiders could make "Section 16(b) profits" without paying a penalty. To be sure, some insiders—those believed to be trading on inside information—would face adjustments on both trades. But on average even those insiders would be forced to give up only their excess returns, not their total profits. Since under pretrading disclosure there is little cost to treating a given transaction—such as the exercise of a stock appreciation right—as a purchase or a sale for purposes of the rule, there would be no need, as there is now under Section 16(b), to incur administrative and legal costs to tailor transactions so that they are not considered to be a sale or a purchase (or, if the transaction must be structured as a purchase or sale, so that there is no other transaction that will generate a Section 16(b) penalty). Instead, any transaction that might be considered a sale or purchase could be simply announced to the SEC.[214]

214. As explained, the pretrading disclosure rule would require advance notification of any transaction that is economically equivalent to the purchase or sale of a stock, including, for example, the exercise of a stock appreciation right under a compensation arrangement. *See supra* note 183.

In short, since pretrading disclosure would impose much less cost than Section 16(b) while achieving Section 16(b)'s goals more effectively, Section 16(b) should be abolished if pretrading disclosure is adopted.[215]

V. POSSIBLE OBJECTIONS TO PRETRADING DISCLOSURE

In Part IV, I put forward and began analyzing the pretrading disclosure rule. I explained how pretrading disclosure could reduce (and in principle eliminate) corporate insider trading profits. I also presented empirical data suggesting that such a rule could in fact substantially reduce these profits. In this Part, I consider possible objections to adoption of a mandatory pretrading disclosure rule: (1) that insiders would be able to circumvent, undermine the effectiveness of, or even exploit the pretrading disclosure rule (Section A); (2) that pretrading disclosure would impose undue costs on employee-insiders and adversely affect corporate performance by reducing insiders' voluntary shareholdings and the number of large shareholders (Section B); (3) that pretrading disclosure would be unfair to insiders who do not trade on inside information (Section C); and (4)

215. Section 16(a) should continue to apply to those subject to the pretrading disclosure rule because post-trade reporting is necessary to enforce it. *See supra* note 191 and accompanying text.

One might wonder whether adoption of a pretrading disclosure rule would also obviate the need for Rule 10b-5 (to the extent that it applies to insiders covered by the pretrading disclosure rule). Rule 10b-5 gives rise to various costs, some of which are substantial. Since Rule 10b-5 liability turns on the insider's intent, enforcing the rule requires considerable investigatory and litigation resources. *See supra* Part III.A. In addition, Rule 10b-5 exposes corporate insiders not trading on material inside information to the risk of becoming subject to a costly SEC investigation. Thus, there would be benefits to making insiders subject to the pretrading disclosure rule exempt from Rule 10b-5 liability. However, Rule 10b-5 could still serve two useful (and related) purposes under a rule of pretrading disclosure.

First, Rule 10b-5 would deter some insiders from trading on material inside information. Under pretrading disclosure, many insiders will be reluctant to trade on material inside information even in the absence of Rule 10b-5 because if they trade on very valuable information they are likely to face larger future adjustments. Thus, Rule 10b-5 will become less important if pretrading disclosure is adopted. However, insiders who expect their insider status to terminate shortly, or for some other reason give little weight to the possibility of future adjustments, will have no incentive to refrain from trading on material inside information in the absence of Rule 10b-5. Rule 10b-5 can thus reduce the ability of such "end game traders" to make profits trading on material inside information.

Second, Rule 10b-5 would reduce the size of the adjustment faced by insiders not trading on inside information. As explained, market participants analyzing the announcement of an intended trade by an insider without a record of predictive trading, who is purchasing or selling only a modest amount of stock and who is not trading contemporaneously with (and in the same direction as) other insiders of her firm, will likely conclude that the insider is probably not trading on inside information of any value. Thus, she is unlikely to face much of an adjustment when she trades. But since there is always some possibility that the insider is in fact trading on inside information, she might face some adjustment. And that adjustment will be larger to the extent that market participants believe that the insider might be trading on material inside information. Since Rule 10b-5 makes it less likely that any particular trade is based on material inside information, all insiders should face smaller adjustments if the rule is retained.

that pretrading disclosure should not be mandatory because it will be adopted voluntarily if it is desirable (Section D).

A. INSIDERS' ABILITY TO CIRCUMVENT, UNDERMINE THE EFFECTIVENESS OF, AND EXPLOIT THE PRETRADING DISCLOSURE RULE

Part IV.B's analysis of the effect of pretrading disclosure on insiders' trading decisions implicitly assumed that insiders would not, in order to preserve their insider trading profits, either (1) attempt to illegally circumvent or manipulate the rule or (2) engage in strategic trading designed to mislead market participants and undermine the effectiveness of the adjustment mechanism. In this Section, I relax that assumption and examine a variety of illegal and legal strategies that insiders might consider using to make insider trading profits under pretrading disclosure. As we will see, insiders' ability to circumvent, undermine, or exploit pretrading disclosure is likely to be extremely limited.

1. *Illegal Circumvention or Manipulation of the Pretrading Disclosure Rule*

There are two illegal strategies that insiders might consider using to preserve (or even increase) their insider trading profits under pretrading disclosure: (1) trading through tippees, and (2) using pretrading announcements to assist in price manipulation. Each of these strategies will be considered in turn.

a. *Illegal use of tippees to circumvent pretrading disclosure*: As explained, the pretrading disclosure rule would require insiders to disclose their own intended trades as well as any other trades in which they have a "direct or indirect pecuniary interest."[216] Therefore, an insider who trades through a tippee in exchange for part of the resulting profits would be required, under the rule, to announce the tippee's trades in advance.[217] Nevertheless, an insider might consider entering into such an arrangement and illegally concealing the tippee's trades from the SEC in order to avoid the adjustments that might occur if the trades are disclosed in advance.

But an insider who is willing to illegally use a tippee already has a strong incentive to do so. To the extent that such an insider has access to inside information, he should be able to profit (either legally or illegally)

216. Rule 16a-1(a)(2), 17 C.F.R. § 240.16a-1(a)(2) (1994).

217. Of course, such an arrangement may still violate other laws, including Rule 10b-5, which would prohibit the tipping of material inside information in exchange for a share of the resulting profits.

by giving a tippee that information in exchange for a share of the resulting profits. The profits from the tipping arrangement would supplement whatever insider trading profits that the insider can make directly through his own trading. Pretrading disclosure would not increase the profits that insiders can make from their existing arrangements with tippees.

To be sure, pretrading disclosure reduces insiders' ability to make insider trading profits through their own trading. Therefore, insiders willing to illegally use tippees would, under the rule, have an incentive to use nondisclosing tippees to perform trades that they would have otherwise executed themselves. For example, an insider who would otherwise have used $100,000 of her own funds to buy stock on positive inside information might, under pretrading disclosure, consider giving that capital to her tippee and have her purchase the stock unannounced.

But this substitution effect is likely to be insignificant. To begin, most insider trading profits are made by insiders selling their own stock on bad news.[218] The sale of an insider's stock, much of which is received directly from her corporation, simply cannot be performed through a tippee's account.[219] In addition, insiders may well be reluctant to give tippees money for stock that the insiders would otherwise have purchased. First, the insider may have little recourse if the tippee decides not to return the money.[220] Second, it might be difficult to reach an agreement with the tippee about how to identify the profits that should be shared, particularly if the information being traded on is sub-material. Since the excess returns generated by the use of such information are likely to be more modest and accrue more gradually than excess returns that can be made from trading on material inside information about bombshell events, they will not be easy to separate from returns due to subsequent news about the stock, or changes in interest rates. In short, adoption of pretrading disclosure is unlikely to increase the use of illegal information-sharing arrangements with tippees.

b. *Illegal use of pretrading announcements to manipulate stock prices*: Under pretrading disclosure, an insider might consider using the

218. *See* Seyhun, *supra* note 12, at 194.

219. An insider could share the bad news with a tippee in exchange for part of the profits that result from the insider's purchases of puts or sales of calls on the stock (to the extent that there is a market in these derivative securities). But the insider and the tippee would have no more incentive or resources to enter into such an arrangement under pretrading disclosure than they do currently.

220. One could reduce this risk by using a family member as a tippee. However, entering into a unreported tipping arrangement with a member of one's family is likely to increase substantially the chance of apprehension, since family members' accounts are probably the first that the SEC investigates when they suspect that an insider is violating the securities laws.

pretrading announcement to deliberately send a false signal to market participants and then trading (or having a tippee trade) in the opposite direction. Any such manipulation scheme would, of course, be illegal.[221]

Currently, insiders willing to engage in illegal market manipulation can make insider trading profits by releasing misleading information bearing on the value of the stock and then trading (or having a tippee trade) at the resulting distorted price. That misleading information might be either "news" or the trades reported by the insiders. For example, insiders might be able to boost stock prices either by (a) announcing good news or (b) purchasing a significant amount of stock and reporting those purchases in their Section 16(a) filings, and then selling (or having tippees sell) an even greater amount of stock.[222]

Pretrading disclosure will generally make it more, not less, difficult for insiders to manipulate prices than currently. Consider the scheme of announcing false good news and then selling the stock at an artificially high price. Under pretrading disclosure, the insider could not sell without first announcing the intended sale. Such an announcement would cause market participants to discount the prior good news announcement and immediately adjust the price downward in light of the new information communicated by the sell order, reducing the insider's profits.[223] In addition, pretrading disclosure will make it all but impossible for insiders to sell stock at an inflated price by purchasing a significant amount of stock and then selling an even greater amount after the price rises. Any increase in price that follows the announcement of the intended purchase will be more than offset by the decrease in price resulting from the announcement of the larger intended sale produces. To be sure, pretrading disclosure would not make it more difficult for insiders to use nonreporting tippees as part of a manipulation scheme. But it would not make their use any eas-

221. *See generally* HAZEN, *supra* note 192, § 12.1.

222. If the sales follow less than six months after the purchases, then Section 16(b) would impose a penalty equal to the difference between the sale and purchase prices, reducing the insiders' profits. However, if within six months the insiders sell more stock than they buy, they can make insider trading profits on their net sales.

223. To avoid the adjustment, the insider might consider not announcing the trade and not reporting it in a Section 16(a) filing. But such a strategy creates two risks. First, since it should be relatively easy to enforce the pretrading announcement requirement and post-trade reporting requirement through random checks of insiders' accounts, *see supra* note 188, violating the pretrading disclosure rule is likely to increase the probability of apprehension. Second, an insider that releases good news and then is found to have hidden a large sale of stock is more likely to be convicted of stock manipulation.

ier.[224] Thus, on balance, pretrading disclosure should reduce the amount of insider manipulation.[225]

2. *Undermining Pretrading Disclosure's Effectiveness Legally Through Strategic Trading and the Use of Limit Orders*

Having seen that insiders are unlikely to use tippees illegally to circumvent pretrading disclosure (and are likely to engage in less stock manipulation than currently), let us now consider insiders' ability to undermine pretrading disclosure's effectiveness through a variety of legal strategies. Below, I analyze four strategies that an insider might consider using to preserve insider trading profits if a pretrading disclosure rule is adopted: (1) establishing a record of "uninformed" trading, so that the market fails to adjust when he does trade on inside information; (2) breaking up large trades into a number of smaller trades, which market participants are less likely to believe result from the use of inside information; (3) placing limit orders designed to mislead market participants about the insider's true assessment of the stock's value; and (4) placing limit orders that ensure that all trades that are executed are expected to generate excess returns. As will be explained, none of these strategies poses a serious threat to pretrading disclosure's effectiveness.

a. *Establishing a record of "uninformed" trading, then trading (legally or illegally) on inside information*: An insider might consider first establishing a reputation as a person who does not trade on inside information, so that the market stops adjusting to his trades, and then trading on inside information. As we will see, the potential costs of such a strategy far outweigh the expected benefits.

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224. Pretrading disclosure might somewhat increase insiders' ability to manipulate stock prices through the use of tippees by giving them a new way to signal misleading news (or reinforce other misleading information that they communicate to the market) through the use of pretrading announcements. However, insiders currently have the ability to announce their trades in advance or shortly after executing them. To the extent that they can already make such announcements without appearing to be attempting to manipulate the stock price, pretrading disclosure would not offer insiders any advantage. In addition, if the pretrading announcement is successful, the insiders face a large adjustment when they execute their trades, forcing them to buy stock at an artificially high price or sell stock at an artificially low price. Thus, the insiders can make a profit from manipulating the price through pretrading announcements only to the extent that tippees buy more stock than they sell at an artificially low price or sell more stock than they buy at an artificially high price.

225. One might argue that if pretrading disclosure is adopted, insiders who would have engaged in manipulation without the use of tippees under the current regime would shift to using tippees and, therefore, that there would be no overall decrease in stock manipulation. But for the reasons explained above, pretrading disclosure is not likely to increase the use of tippees. *See supra* Part V.A.1.a.

Establishing a record of uninformed trading requires making trades that do not generate excess returns. To the extent that an insider would have performed the same volume of trading in any event, there would be no cost to establishing such a record (other than, perhaps, foregoing some insider trading profits). But to the extent that establishing such a record requires the insider to make non-information-based trades that he would not have otherwise made, the insider will incur additional transaction costs that will reduce his profits. As a result, he will make only sub-market returns on these trades, making the strategy costly.

At the same time, the expected benefits of this strategy are likely to be low. There is no assurance that the insider will ever have the opportunity to trade on inside information. Such an opportunity will arise only if four conditions are met simultaneously: (1) the insider has inside information; (2) the inside information indicates that the market price does not reflect the actual value of the company; (3) the insider is not prevented from trading by, for example, fear of Rule 10b-5 liability or the company's own trading restrictions; and (4) if the trade would be a purchase, the insider has sufficient capital. Unless these conditions are simultaneously satisfied, the insider will not have the opportunity to trade on inside information. Moreover, should such an opportunity arise, the potential gain is likely to be limited. First, a large trade would attract the attention of the market because it would mark a departure from the usual pattern of trading. The insider is therefore likely to face a significant immediate adjustment.[226] Second, the abnormal returns that follow the trade will cause market participants to revise their assessment of the information conveyed by the insider's future trading announcements and increase their future adjustments against the insider, forcing the insider to give up much of the gains in the future.[227]

b. *Breaking up a large trade into two or more smaller trades*: The second strategy that an insider might consider using to undermine the effectiveness of pretrading disclosure is breaking up a large trade into two or more less conspicuous small trades in the hope of reducing the immediate adjustment faced by the insider. For example, suppose that

226. To be sure, the insider could minimize the immediate adjustment by not trading much more stock than he had traded on previous occasions. But this would limit the amount of profits that the insider could make from the trade.

227. The insider would not face any future adjustments if this is his last trade. But at the time the insider contemplates embarking on this strategy, he will not know whether the trade on inside information, if it occurs, will be his last trade. Thus, in calculating his expected insider trading profits he will assume that there is some possibility that he will lose some of those profits through increased future adjustments.

corporate insider CI believes that a sale of 20,000 shares would lead to an immediate adjustment of two percent and that a sale of 10,000 shares would lead to an immediate adjustment of one percent. CI might thus consider selling 10,000 shares one day and 10,000 shares several days later, reasoning as follows: After the announcement of an intended sale of 10,000 shares, the price will fall one percent, reducing the proceeds of the sale by one percent of the pre-announcement price. When CI announces that another 10,000 shares are to be sold, market participants will realize that in fact a total of 20,000 shares is being sold and drive the price down another one percent. Thus, CI would face a total of a two percent adjustment on the second 10,000 shares. As a result, it would appear that CI could save one percent of a total of the sale of the first 10,000 shares by splitting up his 20,000 share sale in this manner.[228]

However, if CI decides to sell 10,000 shares on one day and another 10,000 shares several days later, CI will signal that he is trying to deceive market participants by breaking up his trades. Market participants may thus suspect that CI plans to sell another 10,000 shares several days later, and so on. As a result, market participants may overadjust to the insider at the time of the second trade by driving the price down by more than an additional one percent. CI may thus face a larger immediate adjustment than if he had not split up the order.[229] The possibility of large future adjustments may also deter CI from splitting up his order: If CI splits up trades, the next time he trades the market may believe that CI plans to trade even more shares on subsequent days, and overadjust against CI.[230]

c. *Using limit orders to deceive the market*: Next, consider the third strategy that a corporate insider might try using to undermine the effectiveness of pretrading disclosure: submitting limit orders designed to obscure the insider's expectations about the future price of the stock. For example, suppose that corporate insider CI, believing that the price of stock in his corporation will increase from $10 to at least $15 over the next year, seeks to purchase additional stock at a price less than $15. However,

228. Note that CI's net benefit from splitting up the 20,000 share trade into two 10,000 share trades might be somewhat less because, by breaking up the trade, CI could not perform the entire trade at what CI believes to be the best price. *See supra* Part IV.B.2.

229. If CI had not split up the order, he still might have faced an overadjustment on the first day (an adjustment greater than two percent) if market participants had believed (incorrectly) that CI intended to sell even more shares shortly. Thus, as explained earlier, the pretrading disclosure rule would allow corporate insiders to indicate that they will not make any additional trades for a period that they specify. This would ensure that insiders not planning to break up their orders would not face an overadjustment.

230. However, CI could simply announce the next time he trades that the trade will not be followed by any other for a specified period of time.

CI believes that if he puts in a limit order to buy at a price of $15 or better, market participants will realize that he has information suggesting that the price will increase to at least $15. They will thus bid the price towards or above $15 before CI's broker attempts to execute the order, reducing CI's insider trading profits (or preventing him from trading altogether).

CI may thus contemplate placing a limit order at a price of $12 or better in order to convey the impression that CI believes that the stock is not worth more than $12. There would be two possible outcomes of announcing such a limit order. First, the price could rise to above $12 before the limit order is executed, either because market participants believe, based on CI's order, that the stock price will exceed $12,[231] or because of other information that reaches the market. In that case, CI's order will not be executed, and CI will not be able to make any insider trading profits. The lower the limit price on the buy order, the more likely it is that the order will not be executed.

Second, the limit order could be executed at a price below $12. However, in assessing the announcement, market participants will understand that CI has an incentive to attempt to mislead them by setting the limit price too low. They will thus assume that CI may have information suggesting that the stock is worth more than $12. As a result, unless market participants decide that the announcement conveys no information about the value of the stock, the price at which CI purchases the stock in this scenario will be higher than if there had been no announcement. Thus under either outcome the immediate adjustment will reduce the expected excess returns of this strategy. In addition, such a trade—if executed—would establish CI (or will reinforce his reputation) as a person who trades on valuable information. As a result, CI will face larger future adjustments if he trades in the future, whether or not he trades on inside information. Thus, even if the limit-order strategy generates some excess returns, pretrading disclosure will force CI to give back at least part of these gains over time.

d. *Using limit orders to ensure excess returns*: Finally, let us consider the fourth strategy that insiders might use to preserve excess returns—placing limit orders that ensure that every trade that is executed is expected to generate excess returns. As explained, pretrading disclosure reduces insider trading profits in part through the mechanism of future adjustments. That is, the market adjusts to the trades of people who have historically traded on inside information. This increases the cost to an

231. Market participants will understand CI's incentive to lowball the limit order and thus may well believe that the order indicates that the price will significantly exceed $12.

insider of insider trading. Thus, while an insider may make excess returns on certain trades, she will be forced to give back much (if not all) of those gains on subsequent trades that are not based on inside information. However, an insider could ensure that any trade that goes through is expected to yield positive excess profits, even if there is an adjustment, through the use of limit orders set to prices that would, if executed, generate such profits. If the trade is not executed, the insider would not make any excess profits, but would not give back any of those profits either. Thus the insider could continue to earn, on aggregate, excess returns from inside information.

For example, suppose that corporate insider CI believes that the stock of her corporation, currently trading at $25, is in fact worth $30. CI would thus put in a limit order to purchase the stock at a price of $30 or less. If the price moves higher than the limit price and the trade is not executed, CI is not forced to overpay for the stock. If the trade is executed, CI will purchase the stock for less than $30 and thereby earn excess returns. If CI attempts to trade only when she expects to make excess returns, then every time CI trades, she would expect to earn excess returns.

The use of such a strategy is unlikely to undermine pretrading disclosure's effectiveness substantially. First, most insiders will not be able to restrict their trading only to times when they expect to make excess returns. These insiders will be forced to give back much of their insider trading profits when they trade for other reasons. Nevertheless, suppose that there is a subset of insiders for whom all trading is discretionary. Since these insiders will trade only on inside information, market participants will quickly identify them as insiders whose trades are followed by large abnormal returns. As a result, these insiders will face large immediate adjustments when they announce their limit orders. The effect of these large adjustments will be either to force the price outside the range of the limit order, preventing these insiders from trading, or to move the price in a direction that is unfavorable to the insider, reducing these insiders' profits on the limit orders that are executed.

B. THE COST TO CORPORATE INSIDERS AND THE EFFECT ON CORPORATE PERFORMANCE

As I noted in the Introduction, it would not be desirable to reduce corporate insider trading profits if doing so would impose substantial regulatory costs on either the government or corporate insiders. We saw in Part IV that pretrading disclosure would not impose substantial enforce-

ment costs on the government. In this Section I will consider the costs that pretrading disclosure would impose on corporate insiders.

Corporate insiders' trades are not always motivated by inside information. Like other investors, insiders may desire to buy or sell shares because of changes in their wealth, risk preferences, or consumption needs. Placing additional restrictions on insiders' trading could (a) reduce insiders' liquidity, (b) increase their transaction costs, and/or (c) restrict their investment "flexibility"—their ability to increase or decrease their shareholdings (for reasons unrelated to inside information). Everything else being equal, imposing liquidity, transaction, and flexibility costs on insiders is undesirable for two reasons. First, these costs reduce the size of the "pie" that can be shared by insiders and public shareholders. To the extent some or all of the additional cost imposed on employee-insiders requires that they be paid higher compensation, this cost is ultimately borne by all shareholders. Second, imposing these costs on insiders could indirectly hurt corporate performance by (a) reducing the number of large shareholders that are willing to trigger the pretrading disclosure obligation by acquiring more than 10% of a company's stock,[232] and (b) reducing employee insiders' "voluntary shareholdings" (the shares that employee insiders choose to own in addition to those that they might be required to hold by employment contract).[233] As I explain below, however, a rule of pretrading disclosure will impose minimal costs on corporate insiders and will have little effect on corporate performance (and whatever effect it does have may be positive).

1. *The Cost to Corporate Insiders*

Currently, many insiders must wait months to sell their stock because of Section 16(b).[234] Pretrading disclosure's requirement to announce shortly (for example, several days) before trading would thus impose only

232. The presence of large shareholders is generally desirable because they can improve corporate performance by monitoring management more effectively than dispersed public shareholders. *See* Richard J. Zeckhauser & John Pound, *Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance, in* ASYMMETRIC INFORMATION, CORPORATE FINANCE AND INVESTMENT 149, 177-78 (R. Glenn Hubbard ed., 1990) (finding that large shareholders can improve corporate performance).

233. Managerial share ownership may improve performance by aligning employees' interests with those of shareholders. *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, 308 (1976). To the extent that a reduction in voluntary shareholding hurts corporate performance, that cost would be borne by all shareholders.

234. Employee-insiders might be required to wait even longer because of trading-window restrictions. *See supra* Part III.C.

a small marginal flexibility or liquidity cost on insiders.[235] The transaction cost involved in transmitting pretrading announcements to the SEC, which presumably could be handled efficiently by the broker or a law firm,[236] would be minimal. This would be no more burdensome than the current requirement to file a Form 144 (which can also be sent electronically).[237] The relative cost of pretrading disclosure for large shareholders is likely to be extremely low since these shareholders may already incur considerable transactions costs looking for counterparties off the exchange to buy and sell large blocks of stock. Pretrading disclosure is also likely to have little effect on the price at which large shareholders trade for two reasons. First, much of their trading is already done off the exchange with counterparties who know their identities. Second, it is known that large (unaffiliated) shareholders generally have the least access to inside information.[238] Thus, to the extent that they trade on the exchange they are unlikely to face much of an adjustment.

As explained, insiders who fail to submit orders that they have reported to the SEC would be fined a modest amount (say, one or two percent of the value of the transaction) in order to deter insiders from engaging in a strategy of crying wolf.[239] Requiring an insider to submit an order that she had announced several days before, even if the insider's personal circumstances or views have since changed, might appear to put the insider at risk. But an insider's desires are unlikely to change so dramatically over a period of several days that she would wish to cancel an order, especially since the use of a limit order would largely protect the insider from paying what she thinks is too much for a stock or selling it for what she thinks is too little.[240] In any event, the risk to the insider would be limited to the

235. Brokers are willing to lend funds against stock collateral that employee insiders are prevented from selling. *See* Michael S. Malone, *Paper-Rich Software Tycoons Find Ways to Liquidate Wealth*, AUSTIN AMERICAN-STATESMAN, Feb. 19, 1996, at D1 (noting the emergence in major brokerage houses of special departments for restricted-stock equity that allow corporate insiders and employees to borrow against their restricted stock holdings). *See also* Bridget O'Brian, *Help Abounds for Cash-Poor Yet Stock Rich*, WALL ST. J., Apr. 30, 1997, at C1 (same). Thus, there may not be much liquidity cost to preventing corporate insiders from selling even for a much longer period.

236. The software that is available to law offices for filing Section 16(a) reports presumably could be adapted to file pretrading disclosure reports. *Cf. CCH Section 16 Compliance Assistant*, 6 LAW OFF. TECH. REV., June 20, 1997, at 1047, *available in* 1997 WL 9407079 (describing easy-to-use software package capable of electronically filing Section 16 reports to the SEC).

237. Insiders would also be required to submit order receipts for trades that are not executed and copies of cancel orders for trades that are canceled. *See supra* note 192 and accompanying text. This would also impose only minimal transaction costs on insiders.

238. *See supra* note 91 and accompanying text.

239. *See supra* note 190 and accompanying text.

240. A limit order would not offer complete protection because the insider's subjective valuation of the stock might change between the announcement and trade dates. *See infra* Part VI.B.

size of the fine imposed for not following through on the transaction, which would be fairly modest. In short, the pretrading disclosure rule would not impose much cost on insiders (beyond reducing their profits from inside information). And if, as I propose, Section 16(b) is abolished, the net cost to insiders of adopting pretrading disclosure is likely to be negative.[241]

2. *The Effect of Pretrading Disclosure on Corporate Performance*

We have just seen that adopting a pretrading disclosure rule would impose only minimal regulatory costs on both employee- and shareholder-insiders (and might even reduce the cost imposed on insiders if adoption of the rule is coupled with the elimination of Section 16(b)). Because pretrading disclosure is likely to have little effect on shareholder-insiders, it should not deter large shareholders from becoming statutory insiders. However, pretrading disclosure could hurt corporate performance through its effect on the level of employee-insider shareholdings. But, as we will see, the effect of pretrading disclosure on corporate performance through its effect on employee-insider shareholdings could be either positive or negative, and the effect in any event is likely to be insignificant.[242]

First, pretrading disclosure could either increase or decrease corporate insiders' voluntary shareholdings. By slightly increasing the transaction cost of buying and selling shares, pretrading disclosure would slightly reduce insiders' incentive to buy and sell shares. In larger firms, insiders sell approximately twice as much as they buy (the opposite is true in smaller firms).[243] Overall, there appears to be twice as much insider selling as buying.[244] Thus, to the extent that pretrading disclosure reduces trading across the board, it will reduce the amount of selling by more than it reduces the amount of buying, leading to higher overall shareholdings. To be sure, insiders anticipating higher transaction costs of selling might compensate by reducing their initial holdings ex ante, and this might reduce their average voluntary shareholdings (as well as the amount of compensation they seek in the form of stock) over time. This reduction could

241. *See supra* Part IV.C.

242. Even if pretrading disclosure (a) reduces voluntary shareholdings, and (b) this adversely affects corporate performance, everything else being equal, this adverse effect must be weighed against any improvement in managerial incentives that results from the reduction in corporate insider trading.

243. *See* Seyhun, *supra* note 12, at 194; Rozeff & Zaman, *supra* note 75, at 42.

244. *See* Seyhun, *supra* note 12, at 194; Rozeff & Zaman, *supra* note 75, at 42.

outweigh any positive trading effect. Thus, pretrading disclosure could either increase or decrease voluntary shareholdings.[245]

Moreover, even if pretrading disclosure reduces corporate insiders' voluntary shareholdings, corporate performance may not be adversely affected. First, public corporations that are run to maximize value could require that managers own a specific number of shares, or provide compensation based on stock performance in order to provide managers with an incentive to act efficiently.[246] Thus, if adoption of pretrading disclosure would undesirably affect voluntary shareholdings, some corporations could take steps to mitigate or offset those effects. There are also many alternative mechanisms for motivating or monitoring managers (reducing "agency costs") that companies can use, such as debt, large blockholders, and institutional investors.[247] Second, a reduction in managerial shareholdings may in some cases have *desirable* efficiency consequences. Ownership of a significant fraction of a firm's shares could enable management to thwart attempts by other, better management groups to take over the firm.[248] Share ownership can also cause managers to engage in overly risky activities.[249] Indeed, there is considerable evidence that at low levels of managerial share ownership increases in managerial shareholdings improve corporate performance, but at higher levels such increases worsen corporate performance.[250] In short, (1) pretrading disclo-

245. The elimination of Section 16(b) would also have opposite effects on the amount of insiders' voluntary shareholdings. On the one hand, insiders would be more willing to buy stock if they do not face a Section 16(b) penalty when they want to sell the stock. On the other, insiders might sell more stock than they do currently.

246. *See* Carlton & Fischel, *supra* note 20, at 864-65.

247. *See, e.g.*, Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANALYSIS 377 (1996) (describing many alternative "control mechanisms" to reduce managerial agency costs, including debt and large blockholders).

248. *See* Moon H. Song & Ralph A. Walkling, *The Impact of Managerial Ownership on Acquisition Attempts and Target Shareholder Wealth*, 28 J. FIN. & QUANTITATIVE ANALYSIS 439, 456 (1993) (finding that target firms have significantly lower levels of managerial ownership than nontargets). Of course, managers who hold their shares in order to deter or prevent hostile takeovers are unlikely to reduce substantially their holdings (and thereby put their positions in jeopardy) if pretrading disclosure is adopted.

249. *Cf.* Richard A. DeFusco, Robert R. Johnson & Thomas S. Zorn, *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617 (1990) (stock option plans cause managers to take on more risk, transferring value from bondholders to equity holders).

250. *See, e.g.*, Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, FIN. MGMT., Winter 1991, at 101 (finding that corporate performance improves with increases in ownership up to 1%, and then decreases); John J. McConnell & Henri Servaes, *Additional Evidence On Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595, 595 (1990) (finding that corporate value increases with managerial ownership until ownership reaches 40-50%, and then decreases); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293, 311 (1988)

sure is likely to impose little burden on insiders and, therefore, should not significantly affect insiders' voluntary shareholdings; (2) to the extent that pretrading disclosure affects those shareholdings, the effect may be either to increase or decrease them; (3) to the extent that the effect is undesirable, companies that are run to maximize value might neutralize that effect by requiring insiders to hold more (or fewer) shares or employing other methods to reduce agency costs; and (4) to the extent that pretrading disclosure reduces voluntary insider shareholdings and the corporation does not take any other steps, the economic consequences of that change may well be positive.

C. FAIRNESS

As explained in Part I, many share the intuition that it is unfair for insiders to use inside information to make excess trading profits at the expense of public shareholders. Pretrading disclosure might appeal to those holding this view because the rule reduces (and in principle eliminates) corporate insiders' ability to make such profits by eroding their informational advantage over public shareholders. But while pretrading disclosure levels the playing field in favor of public investors, one might argue that it is unfair to certain insiders—those who lack the ability, or opportunity, or inclination to trade on inside information but who might nevertheless face an adjustment.[251] Below I explain why insiders not trading on inside information will face little, if any, adjustment. I also point out that insiders who do not trade on inside information are likely to be better off than they are currently if, as I propose, pretrading disclosure replaces Section 16(b).

Suppose that corporate insider A trades on inside information but that corporate insider B lacks the ability, inclination, or opportunity to do so. Under the current regime, both trade at the market price. Under pretrading disclosure, A is likely to face an adjustment when he trades. But B may also face an adjustment if market participants believe (mistakenly) that B is trading on inside information. Indeed, if the market cannot discern that A is more likely to be trading on inside information than B, then both will face the same adjustment. To the extent that B faces such an adjustment, pretrading disclosure will make her worse off than the average shareholder. However, market participants can and do discriminate among in-

(finding that corporate value increases as board ownership increases to 5%, then falls as ownership rises further to 25%, and continues to rise (but more slowly) as ownership rises above 25%).

251. In practice, every insider will have access to at least some inside information that she will consciously or unconsciously factor into her trading decisions. I thus use the phrase "no inside information" to mean inside information of only minimal value.

siders based on their previous trades and other information.[252] Just as market participants would currently examine the size of A's and B's trades, whether previous trading by either insider had predicted subsequent price movements, and whether other insiders of their firms are also trading in the same direction in order to decide whether (or how) to trade the stock of these insiders' respective companies, they would do so under pretrading disclosure. If, for example, A trades larger blocks of stock than B in order to take advantage of his inside information, and A's trades have in the past been more frequently followed by abnormal price changes than B's trades, market participants will adjust more against A than they will against B. To the extent that market participants adjust against B because they believe (incorrectly) that she trades on inside information, they will incur trading losses. Thus, it is in their interest to learn as quickly as possible that B in fact does not trade on inside information.

To be sure, an insider trading for the first time will not have a trading history indicating that she does not generally trade on inside information. But those with a short trading record could signal to the market that they are not trading on inside information by trading in small blocks of stock, or not selling when other insiders of their firms are selling. After accumulating a record of uncorrelated trades, the market would learn that certain insiders are unlikely to be trading on inside information.

That is not to say that no innocent insider will be made worse off by pretrading disclosure. Market participants will understand that an insider who has never appeared to trade on inside information may be trading on inside information for the first time. Therefore, some insiders who have never traded on inside information (of any value) may face small adjustments when they trade at what would otherwise be the correct price.

But all insider trading restrictions are overinclusive to some extent. For example, even though Rule 10b-5 targets only insiders who trade on material inside information, it may in some cases deter trading by innocent but risk averse insiders who fear that the SEC will mistakenly accuse them of illegal insider trading.[253] However, pretrading disclosure's adjustment mechanism is less overinclusive than Section 16(b), which effectively imposes a 100% tax on short-swing profits whether or not the insider has traded on inside information.[254] Therefore if, as I suggest, Section 16(b) is

252. *See, e.g.*, Bridget O'Brian, *Stock Pickers Love to Watch These Folks*, WALL ST. J., Feb. 5, 1997, at C22 (stock pickers keep lists of particular insiders "whose purchases and sales, over the years, have turned out to be particularly timely"). *See also supra* Part II.C.

253. *See supra* note 215.

254. *See supra* Part III.B.1.

eliminated when pretrading disclosure is adopted, insiders who do not trade on inside information are likely to be better off than they are currently.

D. LEAVING PRETRADING DISCLOSURE TO PRIVATE ORDERING

To make the case for adoption of a mandatory pretrading disclosure rule, one must show not only that such a rule is desirable but that there are potential market-failure problems that might prevent public corporations from adopting pretrading disclosure through private contracting. In the absence of market-failure problems, there is no obvious justification for imposing such a rule on corporations and their shareholders. Indeed, if there are no market-failure problems, the fact that corporations have not adopted pretrading disclosure may well indicate that the rule is not desirable.

In this Section, I explain that there are potential market-failure problems that might prevent corporations from adopting optimal insider trading restriction in general and pretrading disclosure in particular.[255] This has two implications. First, the fact that pretrading disclosure has not been voluntarily adopted does not prove that the rule is undesirable. Second, one who believes that the rule is a good one should favor making it mandatory.[256]

To begin, consider the likelihood of existing companies that have already gone public adopting insider trading restrictions. Managers of such companies may have little to gain by voluntarily restricting their ability to make insider trading profits, thereby reducing their overall compensation.[257] And shareholders might face collective action problems in attempting to force companies to adopt insider trading restrictions.[258]

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255. Much of the discussion on why corporations might not adopt voluntarily optimal insider trading restrictions draws on the work of Judge Frank Easterbrook. *See* Easterbrook, *supra* note 8, at 333-35.

256. I will not address the question of whether corporations and their shareholders should be able to opt out of mandatory pretrading disclosure, either at the public offering stage or through midstream charter amendments. But for an argument that opt-out mechanisms will not always yield desirable results, see Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989) [hereinafter Bebchuk, *Charters*]; LUCIAN ARYE BEBCHUK, FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW (Harvard Law School Program in Law and Economics, Discussion Paper No. 46, 1988).

257. *See supra* note 56.

258. *See* O'Connor, *supra* note 100, at 345 (free-rider and high transaction costs make it difficult for shareholders to contract for trading restrictions with managers).

Next, consider the likelihood of companies going public adopting such restrictions. Entrepreneurs taking their companies public have a stronger incentive to adopt insider trading regulations because—to the extent that such regulations generate efficiency benefits—they are likely to capture some of those benefits in the form of a higher price for their stock. Let us assume that investors can price the benefits of a voluntary insider trading restriction rule and may be willing to pay more for the stock when it is issued.[259] The question is: Would entrepreneurs incorporate such restrictions? There are at least three reasons to believe that companies might not adopt insider trading restriction even if it would be efficient for the government to implement the same restrictions.

First, managers might not be able or willing to enforce insider trading rules against each other. To discover and prosecute violators, those enforcing the rules may need police investigatory powers that are impossible to arrange through private contract. There may also be a need for heavy fines or imprisonment to deter violators, the latter of which also could not be accomplished through private arrangement.[260] And even if a firm's managers had the means to enforce insider trading restrictions, they may lack the incentive to enforce them rigorously against one another. At an extreme, management might, if permitted, use midstream charter amendments to eliminate the arrangement.[261] To the extent that corporations would find it difficult to make a credible commitment that they can and will enforce insider trading rules, shareholders would not be willing to pay more for the stock of companies which had adopted such rules.[262]

Second, even if managers are able and willing to enforce insider trading restrictions, it still might be inefficient for individual corporations to attempt to regulate insider trading. There are tremendous economies of scale in enforcement and jurisprudence.[263] The social benefit of insider trading restrictions might outweigh their social cost if one agency enforces them, but not if each publicly traded corporation must enforce its own set of rules.

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259. If market participants cannot price insider trading restrictions in the corporation's charter, then the entrepreneur might not have an incentive to offer those restrictions, even if they are highly efficient.

260. *See* Easterbrook, *supra* note 8, at 334.

261. *See generally* Bebchuk, *Charters*, *supra* note 256.

262. *See* Easterbrook, *supra* note 8, at 334. *Cf.* Paul E. Fischer, *Optimal Contracting and Insider Trading Restrictions*, 47 J. FIN. 673 (1992) (offering a model showing that informational costs will lead shareholders to assume insider trading is permitted by the firm and thus raise the cost of capital unless insider trading is prohibited by the government).

263. *See* Easterbrook, *supra* note 8, at 334.

Third, even if managers are able and willing to enforce insider trading restrictions and such restrictions would be efficient for an individual corporation to adopt (that is, the social benefit exceeds the social cost), it might not be privately optimal for the corporation to adopt such restrictions (that is, the private benefit may not exceed the private cost) because a corporation adopting insider trading restrictions would not capture all of the benefits of such restrictions. In particular, the firm would not capture all of the benefits of the more efficient pricing that might result.[264] And the first corporation to develop such an arrangement would not capture the efficiency benefit of conferring "learning externalities" on other firms, who could simply copy the arrangement.[265]

The enforcement, economy-of-scale, and externality problems described above provide three sets of reasons why, in general, corporations might not adopt insider trading rules that would be optimal for the government to implement. All of these reasons apply in connection with the private adoption of pretrading disclosure. Private adoption of pretrading disclosure also raises the problem of "network externalities."[266] That is, pretrading disclosure is unlikely to be effective unless it is adopted by a critical number of companies. If only one firm adopts pretrading disclosure, there is not likely to be marketwide interest in the pretrading announcements of its insiders. Commercial reporting services are unlikely to carry these announcements, and, if they do, they are unlikely to give the announcements much prominence. If a service does not issue reports more than once a week, any announcement information it does report is likely to be obsolete by the time the subscriber sees it.[267] And market participants may not find it profitable to develop strategies for decoding the pretrading announcements of one particular firm. As a result, the insiders of the first firm to adopt pretrading disclosure may not face a significant adjustment if they trade on inside information. Those investing in the first firm to adopt pretrading disclosure are thus unlikely to pay any more for its stock, which in turn would deprive the owner of any incentive to offer pre-trading disclosure.

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264. *See* Fishman & Hagerty, *supra* note 55, at 106-13 (shareholders may not opt for restrictions on insiders' trading because they do not internalize all of the benefits of the resulting efficient pricing).

265. *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 726-27 (1997).

266. *See id.* at 726.

267. If all insiders were subject to pretrading disclosure, there would be a significant demand for daily reports of insiders' announcements, which could be delivered by mail, fax, e-mail, or via the Web.

VI. THE FACE-TO-FACE RULE AND TWO OTHER ALTERNATIVES TO PRETRADING DISCLOSURE

In Parts IV and V, I put forward, analyzed, and considered various objections to a pretrading disclosure rule that would reduce corporate insider trading profits by requiring corporate insiders to disclose their intended trades shortly in advance of submitting orders to their brokers (or consummating a private trade). In this Part, I offer another rule designed to reduce insider trading profits—the face-to-face rule—and consider it and two other approaches as alternatives to pretrading disclosure. Under the face-to-face rule, insiders would be allowed to buy and sell stock in privately negotiated face-to-face transactions but prohibited from trading anonymously (for example, on the stock exchange) (Section A). The other two rules I consider are (1) a rule requiring corporate insiders to announce their intended trades much farther in advance (say, ninety days) (Section B); and (2) a no-trade rule (Section C).[268] As will be explained, each of these three rules would be more effective than pretrading disclosure at reducing corporate insider trading profits. However, each of these rules might impose an unacceptably high cost on insiders.

A. THE FACE-TO-FACE RULE

The face-to-face rule would permit corporate insiders to enter into unlimited privately negotiated face-to-face trades, but would forbid them from trading anonymously (on the open market or through automated proprietary trading systems).[269] The principle underlying the face-to-face rule is the same as that underlying pretrading disclosure: Forcing insiders to reveal their identities and intentions to other traders reduces their ability to make excess profits at these other traders' expense.

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268. There are of course other alternative rules. For example, one could require that corporate insiders trade only among themselves. Although this rule would ensure that corporate insiders, as a group, do not make excess returns, it might impose substantial liquidity costs on insiders and discourage large shareholders from becoming statutory insiders. Another alternative would be to require pretrading disclosure for stock sales but not for stock purchases. Such a rule might be attractive if buying on positive inside information is considered desirable but selling on negative inside information is not. For additional alternatives, see FRIED, *supra* note 145 (describing and analyzing various other approaches to reducing corporate insider trading profits, including a buy-only rule, a sell-only rule, and three rules that limit insiders' returns from trading).

269. Many institutional investors currently trade with each other face-to-face (or anonymously through automated proprietary trading systems) off the major exchanges in what is known as the "Fourth Market." *See* WILLIAM A. KLEIN & JOHN C. COFFEE, Jr., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 387-88 (5th ed. 1993).

As will be explained shortly, the face-to-face rule would be effective at reducing insiders' trading profits only if their trading partners are forced to bear the risk of price movements following the face-to-face transactions. To ensure that this occurs, insiders' trading partners would be prohibited from making offsetting trades during a specified holding period following the transaction. That is, during the holding period a trader that had purchased from or sold shares to the corporate insider, could not sell (purchase) shares.[270]

1. *Effectiveness of the Face-to-Face Rule*

As we will see, the face-to-face rule is likely to be more effective than pretrading disclosure at reducing corporate insider trading profits. Suppose, for example, that trader T, who is considering purchasing stock from corporate insider CI, knows that CI might possess negative inside information bearing on the value of the stock that, when released, will cause the price of the stock to drop. For concreteness, assume that T knows that when CI trades there is a 50% possibility that CI is in possession of inside information that, when made public, is expected to reduce the price of the stock by 10% (and that there is a 50% possibility that CI is not in possession of any inside information about the stock).

We would expect T to charge CI a 5% premium (by insisting on a 5% discount to the market price) that, on an expected value basis, would compensate T for the risk that CI is trading on negative inside information and that the price will fall 10% after the transaction. If CI is in fact trading on that inside information, CI will make excess profits of 5% at T's expense. If CI is not trading on inside information, CI will make 5% less from the sale than if he could have traded anonymously on the stock exchange and T will be overcompensated by 5%.[271] Over time, CI would not be able to earn excess profits at T's expense.

It is easy to see that the face-to-face rule reduces the ability of corporate insiders to make insider trading profits in a manner similar to that of pretrading disclosure.[272] However, there are three important differences between pretrading disclosure and the face-to-face rule that, everything

270. To enforce the holding period requirement, a corporate insider or counterparty who trades in violation of the rule could be compelled to disgorge his profits, if any, and pay a fine equal to a specified fraction of the dollar amount of the transaction.

271. One might argue that if CI is not trading on inside information he will simply refuse to sell the stock to T at a 5% discount. But if CI is selling the stock to rebalance her portfolio or raise cash, she might not decline to trade in the face of a slightly unfavorable price.

272. *See supra* Part IV.B.1.

else being equal, would tend to make the latter more effective at reducing insider trading profits.

First, when negotiating face to face off the exchange, insiders are likely to be faced with prices that better reflect the expected excess returns that they will earn from the trade. As explained, the presence of uninformed ZTC traders and the transaction costs faced by non-ZTC traders may prevent the price faced by the insider under pretrading disclosure from fully reflecting her expected excess returns.[273] Off the exchange, a party that has already decided to trade with a corporate insider can, at little additional cost, adjust the price at which it is willing to transact with the insider. Second, the insider's counterparty could arrange contractually to be compensated (or have the transaction reversed) if there is a large unfavorable price change following the transaction. Third, an insider who becomes known for selling shares shortly before unfavorable information is released, or buying shares on positive inside information, may find it difficult to buy or sell shares off the exchange in the future. Insiders may therefore have a reputational incentive not to buy or sell when they anticipate significant price movements in their favor. In fact, there is evidence that when insiders currently trade off-market, the abnormal returns exhibited by the stock following their transactions are much lower than when insiders trade anonymously on the open market.[274] This suggests that there may be costs to insiders from attempting to exploit their access to inside information when trading face to face with private parties, and, as a result, in advance of large anticipated price movements they choose to do their trading anonymously.[275]

The face-to-face rule would be effective at reducing corporate insider trading profits only to the extent that insiders' counterparties have an incentive to protect themselves from (or seek compensation for) the risk of abnormal price movement following their transactions with corporate insiders. And the counterparties would have such an incentive only if they could not eliminate their exposure to that risk following the transaction by simultaneously entering into an offsetting transaction. For example, a person who purchases shares from a corporate insider would not need to charge the insider a risk premium if that buyer could simultaneously hedge by selling the stock short or selling the stock the next day. In essence, the insider's counterparty would simply be acting as a conduit between the

273. *See id.*

274. *See* Seyhun, *supra* note 5, at 156 n.20.

275. Another possible explanation is that the insiders who transact off the exchange tend to be large shareholders (rather than employee-insiders), who in turn tend to trade on less valuable information than employee insiders. *See supra* note 91.

insider and the public market. Thus, to accomplish the desired result of reducing corporate insider trading profits it would be necessary to prohibit insiders' trading partners from making offsetting trades during a prescribed holding period.

In principle, the holding period should be sufficiently long so that the insider's counterparty is forced to bear fully the risk of abnormal price movement following the transaction. One approach would be to make the holding period last for as long as abnormal price movements are likely to occur (say, twelve months). Alternatively, one could make the holding period extend until market participants learn of the insider's trade and incorporate the information signaled by the trade into the stock price (so that the price at which the counterparty could trade at the end of the holding period would reflect the risk of abnormal return signaled by the insider's trade).[276] However, to the extent that the market price does not accurately reflect the information communicated by the insider's trade, this approach would not be as effective as the first.

2. *Costs of the Face-to-Face Rule*

While a face-to-face rule might be more effective than the pretrading disclosure rule, it would be more costly than pretrading disclosure and potentially too costly to be worth adopting. First, enforcing the face-to-face rule would require monitoring the activities of insiders' off-market counterparties to ensure that they respect the holding period requirement. These traders would be required to file statements with the SEC indicating that they had entered into a transaction with an insider and then report all of their transactions for the duration of the holding period. The SEC or private parties would then be required to determine if an impermissible offsetting transaction had taken place during that time. Second, the face-to-face rule would impose greater transaction costs on insiders (particularly employee-insiders) by making it more costly to find trading partners and negotiate each transaction. These costs would depend on the number of traders willing to transact with insiders on terms that reasonably reflect the risk of abnormal price changes following the transactions, which in turn would depend on the length of the required holding period.

In sum, the face-to-face rule is likely to be more effective at reducing insider trading profits than pretrading disclosure because insiders' off-exchange counterparties are more likely to transact under terms that com-

276. If market participants learn of the trade before the insider's trading partner offsets it with an opposite trade, then (in principle) the insider and his trading partner could not make excess profits at other investors' expense.

pensate them for the risk of abnormal price changes following the trades. However, the need to monitor the trading activities of insiders' counterparties, and the burden that the rule would impose on employee-insiders, may make this rule too costly to be worth adopting.

B. REQUIRING MUCH EARLIER DISCLOSURE: A NINETY-DAY NOTICE RULE

The pretrading disclosure rule presented in Part IV gives market participants several days to factor an insider's disclosure of his intended trade into their assessment of the value of the stock. One might believe that market participants could not fully incorporate this information into their assessments of the value of the stock in such a short period of time and, therefore, that insiders would not face the appropriate adjustment.[277] To ensure that insiders face the proper adjustment, one might thus propose that disclosure be made much farther in advance. Below, I compare the effectiveness of a rule requiring much earlier disclosure to the pretrading disclosure rule put forward in Part IV. For concreteness, I consider a rule that would require public notice of an intended trade ninety days in advance.[278] As I explain below, a ninety-day notice rule would lead to more accurate adjustments with respect to any given trade, but it may not cause individual insiders to face a more appropriate aggregate adjustment over time or be more effective at reducing total corporate insider trading profits. It would also be more costly to corporate insiders than the pretrading disclosure rule put forward in Part IV.

1. *The Effectiveness of a Ninety-Day Notice Rule*

The relative effectiveness of a ninety-day notice rule would depend on the ability of market participants to adjust to the information transmitted by the disclosure of an intended trade during the waiting period between the announcement and the submission of the order under the pretrading disclosure rule. If the market is able to absorb the information transmitted by the disclosure within this waiting period, then a ninety-day

277. For purposes of this Section, I assume that the market adjustment to an announcement of an intended trade increases monotonically toward (even if it never reaches) its correct value—the adjustment that would take place in a perfectly efficient market. In other words, the market adjustment may fall short of but will never exceed that value

278. I use a 90-day notice rule to illustrate the general approach of requiring much earlier disclosure because, as noted earlier, *see supra* note 96 and accompanying text, one commentator has advocated the adoption of such a rule. As explained, the purpose of the 90-day notice period is to ensure that the inside information to which corporate insiders have access when they announce their trades will emerge and become incorporated into the stock price before their trades are executed. *See* Samuelson, *supra* note 96, at 513-17.

notice rule will lead to more accurate adjustments with respect to individual trades, but will not affect the total adjustment faced by individual insiders over time or the total adjustment faced by insiders as a group. However, to the extent that market participants are unable to absorb the information transmitted by the disclosure within pretrading disclosure's waiting period, a ninety-day notice rule would lead to more accurate immediate adjustments with respect to individual trades, more accurate adjustments against individual insiders over time, and more accurate adjustments against insiders as a group.

First, consider the case in which, under pretrading disclosure, the market fully absorbs the information communicated by a corporate insider's disclosure during the period before the trade is executed. In such a case, much earlier disclosure would increase the accuracy of adjustment with respect to individual trades because some of the information known to the insider, but not to the market, at the time the insider announces his intention to trade will become public and incorporated into the stock price by the time the insider's trade is actually executed.[279] It should be emphasized, however, that insiders often trade more than five to six months in advance of the release of important information bearing on the value of their stock.[280] To the extent that insiders trade on such information under a ninety-day notice rule, that information would not be reflected in the stock price before they trade.

However, an increase in the accuracy of adjustment with respect to each particular trade would not necessarily affect the total adjustment faced by individual insiders over time or the total adjustment faced by insiders as a group. The total adjustments faced by individual insiders over time and insiders as a group depend only on the *average* adjustment faced by insiders when they trade, not the immediate adjustment preceding each particular trade. If the market quickly absorbs the information transmitted by the disclosure (even though that information is incomplete), the *average* adjustment faced by insiders individually or as a group will not depend on the length of time between the disclosure and the trade.

To see why this is the case, suppose that when corporate insider CI announces that he will sell shares, market participants believe (correctly), after several days of analysis, that there is a 50% probability that there will be abnormal returns of 2% (CI is selling primarily for liquidity reasons) and a 50% probability that there will be twelve-month abnormal negative

279. *See id.* at 519-20.

280. *See, e.g.*, Seyhun & Bradley, *supra* note 65, at 214 (corporate insiders increase their sales of stock in their companies up to five years before a bankruptcy filing).

returns averaging 10% (CI is selling because he has information indicating that the stock is overpriced). And suppose that if market participants have ninety days to consider the announcement before trading, information will emerge that will enable them to determine with certainty whether CI is selling for liquidity reasons or whether CI is selling because the stock is overvalued.

Under the pretrading disclosure rule, the price would be driven down 6% by a perfectly efficient market, reflecting an expected negative abnormal return of 6%. In half the cases, insider CI will earn insider trading profits of 4% (*10% - 6%*), and in the other half he will give those profits back to the market. Under a rule that requires disclosure ninety days in advance, the market would adjust 10% in those cases where the CI is selling because the stock is overpriced by 10%, and 2% in the other cases. On average, insider CI would make the same excess returns under both rules: zero. Since individual investors would, on average, make zero excess returns, it follows that insiders as a group would also make zero excess returns.

Now let us consider the case in which the market does not adjust quickly to the release of information bearing on the value of a stock, but rather adjusts gradually over a week, a month, or even three months. In this case, earlier disclosure will increase the accuracy of adjustment with respect to individual trades because the market has more time to adjust to this information communicated by the announcement. This will be true even if no inside information emerges during the period between announcement and trade. For the same reason, a ninety-day notice rule will increase the total adjustment faced over time by both individual corporate insiders and corporate insiders as a group.[281]

Suppose, for example, that it would take the market two weeks following CI's announcement to estimate that there is a 50% probability of abnormal returns of 2% and a 50% probability that there will be twelve months of abnormal returns of 10% (so that it takes two weeks for the price of the stock to rise by 6%). If CI can trade several days after his announcement, then the price will not yet have increased by the full 6%. In such a case, pretrading disclosure will not, on average, eliminate the insiders' excess returns. Therefore, it will not eliminate the insider trading profits made by insiders as a group. Under a rule that requires announcements ninety days in advance, however, the market will have sufficient

281. To the extent that the market price does not adjust to the information communicated by the announcement during the three-month period between announcement and trade under the 90-day notice rule, the adjustment will still be incomplete.

time to absorb all of the information communicated by the announcement and the insider will face an adjustment of 6%. Thus the ninety-day notice rule will lead to a more accurate adjustment even if no additional information emerges after the insider's announcement. Since the rule would increase the average adjustment faced by individual insiders over time, it will also increase the extent and accuracy of adjustment with respect to insiders as a group.

2. *The Costs of a Ninety-Day Notice Rule*

Although a ninety-day notice rule would lead to more accurate adjustments with respect to individual trades and might be more effective at reducing the insider trading profits that individual insiders make over time as well as the insider trading profits made by corporate insiders as a group, such a rule would also increase the cost to insiders (beyond reducing their insider trading profits). In particular, under a ninety-day notice rule insiders would face higher liquidity and transaction costs.

To the extent that insiders could not borrow against their stock,[282] they would face higher liquidity costs because the rule would not permit an insider to sell shares until ninety days after the insider realizes that he has a need for cash. This could substantially increase the cost of holding stock and force the insider to keep more of his wealth in cash. An insider would face higher transaction costs because the three-month delay between announcement and trade creates what might be called "investment risk"—the possibility that a trade that the insider considers desirable at the time of the announcement turns out to be undesirable because the price and/or the insider's valuation of the stock change during the three-month waiting period. For example, if corporate insider CI desires to sell 10,000 shares of stock at the current price of $10 because she believes the stock is worth approximately that and puts in an order to sell 10,000 shares at the market price ninety days in advance, there is the possibility that when the stock is sold it will be for a price that the insider considers to be too low.[283] This investment risk increases the effective cost of buying and selling shares.[284]

To be sure, CI could partially protect herself from risk by using limit orders specifying the price range in which she is willing to trade. As explained, such limit orders can prevent the insider from buying at a price

282. *See supra* note 235.

283. Even if the stock price has increased since the insider announced the intended order, the insider's subjective valuation of the stock might have increased by an even greater amount.

284. One might ask why the corporate insider would ever object to trading at the market price, which reflects market participants' collective assessment of the value of the stock. But the insider might, based solely on public information, have a different view of the value of the stock.

she considers too high or selling at a price she considers too low. However, limit orders cannot provide complete protection from investment risk under the ninety-day rule. For example, if CI puts in a limit order to sell at a price of $10 or higher because she believes, at the time of the announcement, that the stock is worth at least $10, it is possible that at the time the trade is to be executed at a market price of $12 the corporate insider values the stock at $15 and would prefer the trade not to be executed. Or suppose that at the time the trade is to be executed the stock is trading at $9, but the insider believes (based on public information) that it is worth only $8. The limit order will prevent a trade that the insider considers desirable from going through. As this example shows, limit orders also increase liquidity risk because they may prevent a sale that, ninety days after the announcement, the insider would prefer to take place. In short, the ninety-day notice rule might impose too large a cost on insiders.

C. A NO-TRADE RULE

The pretrading disclosure rule put forward in Part IV and the two alternatives discussed so far—the face-to-face rule offered as an alternative to pretrading disclosure and the ninety-day notice rule—are what I call "information-based" rules. These rules reduce insider trading profits by providing insiders' trading partners with information about the insiders' trades (and, in the case of the ninety-day notice rule, by allowing inside information to emerge before the insider trades). The third alternative to pretrading disclosure—a no-trade rule—would simply bar corporate insiders from trading.[285]

As is well understood, a no-trade rule is the most effective approach to eliminating insider trading profits. Under pretrading disclosure insiders would still be able to profit from inside information to the extent that the market is not completely efficient. Under the no-trade rule, insiders would make no profits whatsoever. Furthermore, the no-trade rule would eliminate 100% of *each* insider's profits from trading on inside information, while the pretrading disclosure rule would at best eliminate 100% of total corporate insider trading profits, forcing some insiders to disgorge more than 100% of their insider trading profits, and forcing others to disgorge less.

However, the no-trade rule would impose a much larger burden on insiders than pretrading disclosure. First and most significantly, a no-trade

285. For a detailed discussion of how a no-trade rule might be implemented, see FRIED, *supra* note 145, at 88-90.

rule would deprive insiders of the ability to raise cash by selling their shares. This in turn could reduce their investment returns by requiring them to keep more cash on hand to meet unexpected consumption needs. Second, a no-trade rule would deprive insiders of the ability to increase or decrease their shareholdings for reasons unrelated to inside information—such as a change in their wealth or risk preferences, or the availability of a particularly attractive opportunity elsewhere—an ability enjoyed by other shareholders.[286]

To be sure, the burden placed on the typical employee-insider might not be that great. As explained earlier, a corporate insider could raise cash by obtaining a broker's loan collateralized by his company's stock.[287] Such loans would substantially decrease the liquidity costs associated with the rule (although not the flexibility costs).

But a no-trade rule could impose substantial costs on two important groups of insiders: entrepreneurs who have taken their firms public but who still have most (or almost all) of their personal wealth tied up in the stock of their firms, and large shareholders. A no-trade rule would prevent entrepreneurs and large shareholders from diversifying their portfolios over time and from liquidating their holdings in order to invest in other ventures.[288] It might therefore discourage owners from taking their companies public in the first instance and large shareholders from acquiring enough stock to be considered statutory insiders (which could reduce the desirable shareholder monitoring of publicly traded firms).[289]

In sum, a no-trade rule would be simple to enforce and would eliminate insider trading profits. However, the costs the rule imposes on insiders (beyond those associated with reducing their profits from trading on inside information) could be unacceptably high.[290]

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286. However, a no-trade rule would not prevent insiders from earning the same return on their stock as public shareholders (in fact, it would ensure that they do so).

287. *See supra* note 235.

288. Like other employee-insiders, entrepreneurs might be able to borrow modest amounts against their stock for consumption purposes. *See id.* However, brokerage houses may not be willing to lend entrepreneurs the large amounts necessary to start a new business.

289. *See* Zeckhauser & Pound, *supra* note 232, at 176.

290. In the discussion paper version of this Article, I examine a "virtual no trade" rule that attempts to achieve the effectiveness of the no trade rule while reducing the burden associated with it by (1) giving corporate insiders unlimited freedom to buy or sell shares, but (2) limiting the total return from their trading to that which they would earn under the no-trade rule described here. I conclude, however, that such an approach could not be practically implemented. *See* FRIED, *supra* note 145.

VII. CONCLUSION

Despite recent efforts by Congress and the SEC to crack down on insider trading, corporate insiders—officers, directors, and large shareholders of publicly traded corporations—continue to make substantial profits trading on inside information. In light of the failure of current restrictions on insider trading to prevent insiders from making insider trading profits, this Article proposes that insiders be required to disclose their intended trades to the market shortly before submitting orders to their brokers (or consummating a trade off the exchange).

Pretrading disclosure would reduce corporate insiders' ability to profit from their access to inside information by forcing insiders to trade at a price that reflects the information, if any, that is communicated by the announcement of their intended trade. The Article showed that, over time, such a rule could be expected to reduce substantially (and, in principle, could eliminate) corporate insider trading profits. The pretrading disclosure rule would be easy to enforce and would not impose much cost on insiders (beyond reducing their insider trading profits). Indeed, since pretrading disclosure would obviate the need for Section 16(b), which imposes a considerable burden on insiders, adopting such a rule as a substitute for Section 16(b) might lead to a net reduction in the regulatory burden imposed on corporate insiders.

After considering a variety of objections to pretrading disclosure and finding none of them to be substantial, the Article put forward an alternative to pretrading disclosure: a face-to-face rule that would require corporate insiders to conduct all of their trades in face-to-face transactions off the exchange. The Article then compared this alternative and two others (a ninety-day notice rule and a no-trade rule) to pretrading disclosure. Although these alternatives would be more effective at reducing corporate insider trading profits than pretrading disclosure, the Article concluded that they might also be too costly.