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INSIDER TRADING VIA THE CORPORATION

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INSIDER TRADING VIA THE CORPORATION

Jesse M. Fried*

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Abstract

When a U.S. firm trades its own shares in the open market, it is subject to much less stringent trade-disclosure rules than an insider of the firm trading in those shares. Insiders owning equity in their firm thus frequently engage in *indirect* insider trading: having the firm buy and sell its own stock at favorable prices. Such indirect insider trading imposes substantial costs on public investors in two ways: by systematically diverting value to insiders and by causing insiders to take steps that destroy economic value. To reduce these costs, I put forward a simple proposal: subject firms to the same trade-disclosure rules imposed on their insiders.

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Insider Trading Via the Corporation

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I. INTRODUCTION

Publicly-traded U.S. firms buy and sell a staggering amount of their own shares in the open market each year. Open-market repurchases (“OMRs”) alone total hundreds of billions of dollars per year; in 2007, they reached \$1 trillion.¹ Firms are also increasingly selling shares in the open market through so-called “at-the-market” issuances (“ATMs”).²

For a U.S. firm trading in its own shares, trade-disclosure requirements are minimal. The firm must report only aggregate monthly trading activity, and not until well into the following quarter.³ Thus, the firm can secretly buy and sell its own shares in the open market for several months, and never disclose the exact details of its trades to shareholders and regulators.

The trade-disclosure requirements imposed on U.S. firms are quite lax relative to those employed in the largest stock markets abroad. For example, the U.K. and Hong Kong require firms trading in their own shares to disclose the details of their trades by the morning of the next business day; Japan requires same-day disclosure.⁴ And in Switzerland, firms commonly repurchase shares through a second, dedicated trading line, thereby making trade-disclosure instantaneous.⁵

The trade-disclosure requirements imposed on U.S. firms are also much less stringent than those imposed on *insiders* of those firms. Since the 1930s, insiders of a U.S. firm have been required to report the specific details of each of their trades.⁶ Before the Sarbanes-Oxley Act of 2002, insiders typically had until the 10th day of the following month to disclose their purchases

¹ See *infra* Part III.A.

² See *infra* Part IV.A.

³ See *infra* Part III.B.3.

⁴ See *infra* Part VI.A.

⁵ *Id.*

⁶ See *infra* Part II.B.2.

and sales.⁷ But the desire for increased transparency led to Congress shortening the deadline; now an insider's trades in firm shares must be reported within two business days.⁸

The strict trade-disclosure rules for insiders reflects a strong, longstanding consensus in the U.S. that a corporation's insiders—its officers, directors, and controlling shareholder—should not be permitted to profit freely from their access to inside information about the firm. It is part of an elaborate set of regulations designed to reduce these insiders' ability to engage in insider trading: reaping profits by buying and selling the firm's shares on inside information.⁹

What U.S. policymakers have failed to grasp is that when insiders are subject to strict trade-disclosure requirements and firms are not, insiders have a strong incentive to exploit the relatively lax trade-disclosure rules applicable to the firm to engage in *indirect* insider trading: having the firm buy and sell its own shares at favorable prices to pump up the value of the insiders' equity. If insiders own (say) 10% of a firm's equity, they will capture approximately \$1 out of every \$10 in insider trading profits generated by the firm's trading in its own shares.

Although the U.S. firms are commonly thought to have relatively diffuse ownership, average insider ownership in publicly-traded firms is in fact surprisingly high, over 20%.¹⁰ For example, in one study of 375 randomly selected publicly-traded firms, directors and

⁷ *Id.*

⁸ *Id.*

⁹ See Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 329-48 (1998) [hereinafter, "Fried, *Reducing the Profitability*"]. I use the term "insider trading" to mean insiders buying or selling shares on inside information, whether that trading is legal or illegal.

¹⁰ See Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382 (2009). And this figure does not include insiders' stock options, which would further increase their effective equity ownership.

officers were found to own an average of 24-32% of a firm's equity (depending on the measurement methodology).¹¹ Larger, better-known firms do tend to have a lower percentage of insider ownership.¹² So while *value-weighted* average insider ownership may be less than 20%, insiders' proportionate claim on cash flow is substantial in many firms.

Not surprisingly, insiders use control of the firm to engage in indirect insider trading.¹³ Insiders acknowledge using repurchases to buy stock they believe to be underpriced and equity issuances to sell stock they believe to be overpriced.¹⁴ There is also a substantial body of empirical work in the finance literature documenting that repurchases and equity issuances are frequently driven by insiders' desire to indirectly buy stock at a low price or sell stock at a high price.¹⁵

Such indirect insider trading is likely to impose considerable costs on public investors in two ways. First, just like ordinary ("direct") insider trading, indirect insider trading secretly redistributes value from public investors to insiders.¹⁶ To be sure, much of the indirect insider trading profits generated by firms are shared with public investors. But on average, public investors lose, and insiders systematically profit—to the tune of several billion dollars per year.¹⁷

Second, similar to direct insider trading, the use of the corporation for insider trading can lead insiders to take steps that waste social resources. For example,

¹¹ *Id.* at 1382–83.

¹² *Id.* at 1378.

¹³ *See infra* Parts III.C. and IV.C.

¹⁴ *Id.*

¹⁵ *Id.* *See also* Malcom Baker & Jeffrey Wurgler, *Market Timing and Capital Structure*, 57 J. FIN. 1, 2 (2002) (reporting that equity market timing—having the firm buy shares at a low price and issue shares at a high price—is an important aspect of actual corporate finance practice).

¹⁶ *See infra* Part V.A.

¹⁷ *Id.*

indirect insider trading can distort capital deployment decisions by re-allocating capital between the shareholders and the firm in a manner that destroys economic value.¹⁸ Thus, indirect insider trading can diminish the value flowing to investors over time by far more than the profits reaped by insiders.

The purpose of this paper is threefold: (1) to demonstrate that insiders have an incentive to (and do in fact) exploit the relatively lax trade-disclosure rules applicable to firms to enrich themselves via indirect insider trading; (2) to describe the costs of such indirect insider trading to public shareholders; and (3) to put forward a proposal that regulators subject firms to the same 2-day disclosure rule applied to their insiders which, I show, will substantially reduce insiders' ability to engage in indirect insider trading.¹⁹

The remainder of the paper is structured as follows: Part II briefly describes the insider-trading regulations applicable to insiders, how firms trade in their own shares on the open market, and the relatively lax insider-trading regulations imposed on these firms. Part III

¹⁸ See *infra* Part V.B.

¹⁹ See *infra* Part VI.A. This paper is part of a larger project of mine examining the corporate governance implications of share repurchases and equity issuances by public firms. Prior work has focused mainly on the use of share repurchases (and deceptive share-repurchase announcements) to enrich executives. See, e.g., Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323 (2005) [hereinafter "Fried, *Informed Trading*"]. This paper extends the earlier analysis by including at-the-market equity issuances, reconceptualizing firms' use of inside information to trade in their own shares as "indirect insider trading," and arguing that the insider-trading regulations imposed on firms trading in their own shares should be aligned with the insider-trading regulations imposed on firm insiders trading in those same shares. While other academics have discussed the legal treatment of firms buying their own shares in the open market, see Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45 (2005), they have not systematically examined the economic costs of indirect insider trading or proposed any regulatory solution to reduce these costs, as I do here.

examines how insiders use share repurchases to engage in indirect insider trading. Part IV explains how equity issuances can be used to engage in indirect insider trading. Part V identifies the cost to public investors of indirect insider trading. Part VI first proposes that firms be subject to the same trade-disclosure rules as insiders and then details the benefits of such an approach. Part VII concludes.

II. DIRECT INSIDER TRADING AND ITS REGULATION

This Part briefly explains how public investors are hurt when insiders trade personally (“directly”) on private information and describes the core insider-trading regulations applicable to insiders in the U.S. Section A discusses the costs imposed by direct insider trading on public investors. Section B describes the main insider-trading regulations applicable to insiders trading personally in their firms’ shares.

A. Costs of Direct Insider Trading

Direct insider trading by those controlling the firm (direct insider trading) imposes costs on public investors in two ways: (1) by systematically diverting value from public shareholders to insiders and (2) by undermining and distorting insiders’ incentives to generate economic value, reducing the size of the pie. As we will see in Part V, these costs also arise as a result of *indirect* insider trading.

1. Diversion of Value

When insiders use private information to time their personal trades, they directly reduce public shareholders’ returns. Each dollar reaped by insiders

comes at public investors' expense.²⁰ In earlier work, I calculated that such trading puts at least several billion dollars into the pockets of insiders each year.²¹ This diversion of value reduces public investors' expected returns and increases firms' cost of capital.²²

One might argue that insider-trading profits are just another form of compensation. In principle, for example, firms reduce other components of executives' and directors' compensation arrangements to offset expected insider-trading profits. Indeed, some commentators have made this very claim.²³

But insider-trading profits are a peculiar type of pay. They are tied to insiders' informational advantage and their ability to control the flow of information to the market, not to their contribution to economic-value creation. Permitting insiders to make such gains is an inefficient way to reward them for performance.²⁴ Indeed, as I explain below, these profits provide insiders

²⁰ 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 directly to the extent that market makers match investors' orders with those of insiders trading on inside information (so that the market makers' net position is unaffected) or indirectly by forcing market makers to increase the bid-ask. See *id.* at 191.

²¹ See Fried, *Reducing the Profitability*, *supra* note 9, at 323.

²² See Lawrence M. Asubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1023 (1990) (analyzing the effect of insider trading on cost of capital). Not surprisingly, the enforcement of insider trading laws tends to reduce firms' cost of capital. See Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 77–78 (2002).

²³ See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 881 n.80 (1983).

²⁴ See, e.g., Lucian Arye Bebchuk & Chaim Fershtman, *Insider Trading and the Managerial Choice Among Risky Projects*, 29 J. FIN. & QUANTITATIVE ANALYSIS 1, 13 (1994) (total compensation paid to insiders must be increased when insider trading is permitted because insider trading profits are uncertain); Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332 (similar).

with incentives to take steps that may destroy economic value.

2. Weakening and Distortion of Incentives

In addition to diverting value directly from public investors, insider trading may reduce the total amount of value to be shared between public investors and insiders. First, it can decrease insiders' motivation to generate value. For example, permitting insiders to sell on bad news reduces the financial payoff differential between good and poor performance, thereby undermining insiders' incentive to increase value.²⁵

Second, insider trading can create perverse incentives. For example, insiders who are free to unload large amounts of shares may seek to raise short-term stock prices by running the firm in a way that improves short-term results at the expense of economic value.²⁶ Insiders may also have incentives to choose less transparent (but less valuable) projects because the lack of transparency enables insiders to profit more from insider trading.²⁷

²⁵ Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 655 (2005).

²⁶ See Fried, *Reducing the Profitability*, *supra* note 9, at 362 (explaining how executives' ability to profit from short-term stock-price fluctuations can reduce long-term value). See also Mark Bagnoli & Naveen Khanna, *Insider Trading in Financial Signaling Models*, 47 J. FIN. 1905, 1908–09 (1992) (explaining why management may have an incentive to act inefficiently to make insider trading profits).

²⁷ See Oren Bar-Gill & Lucian Arye Bebchuk, *The Costs of Permitting Managers to Sell Shares 2* (unpublished manuscript, Oct. 2003), available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/03.Bar-Gill.Bebchuk.cost-permitting.pdf (presenting a formal model showing why managers who are free to unload their stock on private information have an incentive to make information unobservable to the market). For a contrary view that insider trading improves incentives, see Carlton & Fischel, *supra* note 23, at 866–72, and for a critique of this contrary view, see Fried, *Reducing the Profitability*, *supra* note 9, at 314–15.

B. Regulation

The main regulations governing insiders' trading in their own firms' shares are Rule 10b-5, which prohibits trading on certain kinds of information, and Section 16(a), which requires insiders to disclose their trades.²⁸

1. Rule 10b-5 and its Limits

Rule 10b-5, promulgated by the Securities and Exchange Commission ("SEC") under Section 10 of the Securities Exchange Act of 1934 ("the Act"),²⁹ requires

Carlton and Fischel also claim that insider trading enables information to be transmitted to the market more quickly, thereby making stock prices more accurate (or "efficient"). See Carlton and Fischel, *supra* note 23, at 867. But the ability to engage in insider trading may cause insiders to withhold information from the market, making markets less efficient. See, e.g., Easterbrook, *supra* note 24, at 333 (noting that the "prospect of insiders' gain may lead firm to delay the release of information"); Naveen Khanna et al., *Insider Trading, Outside Search & Resource Allocation: Why Firms and Society May Disagree on Insider Trading Restrictions*, 7 REV. FIN. STUD. 575, 576 (1994) (insider trading may increase the cost to liquidity traders without generating more price efficiency because it reduces trading by informed outsiders); Michael J. Fishman & Kathleen M. Hagerty, *Insider trading and the efficiency of stock prices*, 23 RAND J. ECON. 106, 106-07 (1992) (providing a technical model explaining how insider trading can decrease price efficiency). In this paper, I will assume that insider trading (direct or indirect) has no net negative or positive effect on price efficiency.

²⁸ Insiders are also subject Section 16(b) of the Securities Exchange Act of 1934, which prohibits executives, officers, and persons owning more than 10% of a firm's shares from making what are commonly referred to as "short-swing profits." See 15 U.S.C. § 78p(b) (2000). An insider makes a short-swing profit if she buys and sells stock within a six-month period and the purchase price is lower than the sale price. Because Section 16(b) does not play in an important role in reducing insiders' ability to profit from inside information, Fried, *Reducing the Profitability*, *supra* note 9, at 341-43, I do not discuss it in the text. But it is worth noting here that Section 16(b) does not apply to indirect purchases made by insiders through share repurchases or indirect sales made by insiders through equity issuances. Thus, Section 16(b) gives insiders another reason to engage in indirect insider trading.

²⁹ 17 C.F.R. § 240.10b-5(b) (2006).

that certain persons possessing “material” nonpublic information disclose that information or abstain from trading. According to the U.S. Supreme Court, the rule applies to a firm’s insiders—its officers and directors.³⁰ Rule 10b-5 would also be expected to apply to a controlling shareholder.³¹

While Rule 10b-5 substantially reduces the amount of direct insider trading, it cannot prevent insiders from trading on valuable inside information because (1) not all valuable information is considered “material” and (2) the difficulties of enforcement lead to under-deterrence.

First, Rule 10b-5 applies only when insiders trade on information that is considered “material.”³² According to the courts, “material facts” are those to which a “reasonable man would attach importance . . . in determining whether to buy or sell shares.”³³ While this definition would appear to suggest that any valuable information is material, the Supreme Court has held that information does not become material merely because someone can earn profits trading on it.³⁴ For example, internal projections and other forms of “soft” information are not considered legally material even though they may be important and of great interest to investors.³⁵ And lower courts have been reluctant to find

³⁰ See *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

³¹ See Fried, *Reducing the Profitability*, *supra* note 9, at 330 n.105.

³² See, e.g., § 240.10b-5(b).

³³ See *Sec. & Exch. Comm’n v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965)). In interpreting the term “material” under a related statute, the Supreme Court provided a similar definition. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that under Rule 14a-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”).

³⁴ *Basic Inc. v. Levinson*, 485 U.S. 224, 241 n.18 (1988).

³⁵ See Mitu Gulati, *When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 682 (1999) (reporting that SEC’s position do not oblige companies to disclose forecasts); ROBERT CLARK, CORPORATE LAW

information material unless the announcement of that information would cause the stock price to move sharply.³⁶ As a result, insiders can profit legally by trading on many types of valuable sub-material information.³⁷

The second limitation of Rule 10b-5 is that a prohibition on trading on “material” nonpublic information may not always *deter* such trading. The SEC has limited resources, most of which cannot be allocated to investigating the hundreds of thousands of trades conducted by insiders each year.³⁸ The probability of detection, successful investigation, and sanction is often very low, even though the trade-disclosure rules imposed on insiders are relatively strict. The fact that insiders are often found to have violated Rule 10b-5 indicates that deterrence is far from perfect.³⁹

507–08 (1986) (noting that managers may have access to bits of information that are not important enough individually to be considered legally material but that in aggregate are very valuable); Donald Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1335 (1999) (“Insiders at almost all times have the advantage of superior insight and a sense of which way things are going even if they do not possess a fact that a court would call material and nonpublic.”)

³⁶ See Fried, *Reducing the Profitability*, *supra* note 9, at 335–36.

³⁷ One might argue that the high bar for “materiality” reflects a judgment that there is no cost to investors when insiders trade on certain kinds of private information. But from an economic perspective, there is little difference between trading on material information and sub-material information, as participants on both sides of the insider trading debate have recognized. See, e.g., Carlton & Fischel, *supra* note 23, at 861; Reinier Kraakman, *The Legal Theory of Insider Trading Regulation in the United States*, in EUROPEAN INSIDER DEALING 40, 48 (Klaus J. Hopt & Eddy Wymeersch eds., 1991). A more likely explanation for the adoption of a high materiality bar is that the litigation and transaction costs of subjecting insiders—who always possess inside information—to a low bar would exceed the benefits of reducing their ability to engage in insider trading.

³⁸ See Fried, *Reducing the Profitability*, *supra* note 9, at 331–35.

³⁹ In 2007, former Countrywide CEO Angelo Mozilo reported over 82 trades pursuant to Section 16(a). See, e.g., Countrywide Fin. Corp., Statement of Changes in Beneficial Ownership of Securities (Form 4)

2. Section 16(a)'s Trade-Disclosure Rule

Because Rule 10b-5 by itself cannot prevent insiders from trading on valuable inside information, it is complemented by a trade-disclosure rule: Section 16(a) of the Act. Section 16(a) requires top executives, directors, and any person owning more than 10% of the shares of a publicly-traded firm (a “10% shareholder”) to report the details of each purchase and sale of the firm’s shares after the transaction.⁴⁰

Before 2002, Section 16(a) required insiders to report most of their trades by the tenth day of the following month, enabling them to wait as many as forty days before reporting these trades.⁴¹ After the Enron meltdown and other corporate governance scandals in which executives secretly sold shares on inside information, Congress amended Section 16(a) via the Sarbanes-Oxley Act of 2002 to require executives to report every trade to the SEC by the end of the second business day following the transaction.⁴²

Section 16(a) complements Rule 10b-5 in two important ways. First, by requiring insiders to report the details of each trade, Section 16(a) increases the

(Jan. 5, 2007) (on file with author); Countrywide Fin. Corp., Statement of Changes in Beneficial Ownership of Securities (Form 4) (July 25, 2007) (on file with author). Mozilo later agreed to pay \$45 million to settle SEC insider trading charges that implicated his 2007 trades. *See* Press Release, U.S. Securities and Exchange Commission, Former Countrywide CEO Angelo Mozilo to Pay SEC’s Largest-Ever Financial Penalty Against a Public Company’s Senior Executive (Oct. 15, 2010), *available at* <http://www.sec.gov/news/press/2010/2010-197.htm>.

⁴⁰ Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (2000).

⁴¹ *Id.*

⁴² Sarbanes-Oxley Act of 2002 § 403(a), 15 U.S.C. § 78p(a)(2)(C) (Supp. II 2002).

likelihood that a trade on material inside information in violation of Rule 10b-5 will be investigated and the offending insider sanctioned. The increased probability of sanction strengthens Rule 10b-5's deterrence effect, reducing the likelihood that an insider will trade on material inside information.

Second, whether an insider trades on material or sub-material information, a Section 16(a) report alerts public investors within two days of the trade to the possibility that the insider has private information, indicating that the stock is mispriced. Investors may use this information to adjust the price at which they are willing to buy or sell shares. This price adjustment, in turn, reduces the insider's ability to use inside information to profit on subsequent, post-disclosure transactions, thereby diminishing his insider-trading profits.

To be sure, insiders can still profit from their access to inside information notwithstanding Section 16(a).⁴³ The point is that absent Section 16(a)'s trade-disclosure requirement, insiders' profits from trading on inside information would be far greater.

III. INSIDER BUYING VIA THE CORPORATION

Having seen how insiders are subject to various insider-trading rules, including Section 16(a)'s 2-day disclosure rule, we will now see why insiders have an incentive to use open-market repurchases ("OMRs") to engage in indirect insider trading. Section A of this Part

⁴³ Cf. Lauren Cohen et al., *Decoding Inside Information*, 67 J. FIN. 1009, 1024 (2012) (finding that "opportunistic" corporate insiders make abnormal returns on their trades even though during the sample period, which spanned 2002, the median trade was reported within three days). In unreported results, the authors do find that corporate insiders' ability to generate abnormal trades declined (but did not disappear) after 2002, when the 2-day disclosure rule for Section 16(a) was adopted (email dated 5/24/12 from Professor Christopher Malloy to the author).

describes the growing use of OMRs to distribute cash to shareholders. Section B describes the insider-trading regulation of OMRs and explains why it is more lax than the insider-trading regulation imposed on insiders themselves. Section C shows that insiders have an incentive to exploit this lax regulation to cause their firms to buy stock at a cheap price. Section D provides considerable evidence that insiders frequently do just that.

A. Open Market Repurchases (OMRs)

Publicly-traded U.S. firms generate hundreds of billions of dollars in earnings annually.⁴⁴ Each year, boards must decide how much of their retained earnings should be distributed to shareholders rather than left in the firm. Boards must also decide the form that such distribution should take: dividends, repurchases, or a combination of both.⁴⁵

Repurchases can provide a number of benefits relative to dividends. In particular, repurchases (1) are generally more tax efficient; (2) more flexible; (3) enable the firm to acquire shares for employee stock-option plans; and (4) can increase liquidity.⁴⁶ Not surprisingly, share repurchases have become increasingly common and are now the dominant form of cash payout.⁴⁷ Over 90% of U.S. public firms that

⁴⁴ See Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases, and the Substitution Hypothesis*, 57 J. FIN. 1649, 1655 tbl.1 (2002) (reporting annual aggregate earnings of U.S. firms from 1972 through 2000).

⁴⁵ See generally Douglas J. Skinner, *The Evolving Relation Between Earnings, Dividends, and Stock Repurchases*, 87 J. FIN. ECON. 582 (2008) (comparing the percentages of firms that pay dividends, firms that repurchase shares, and firms that do both).

⁴⁶ Reasons for the popularity of repurchases are explored and analyzed in Fried, *Informed Trading*, *supra* note x, at 1346-1350.

⁴⁷ See Skinner, *supra* note x, at 584.

distribute cash engage in repurchases.⁴⁸ In 2007, S&P 500 firms distributed almost \$600 billion through repurchases.⁴⁹ Market-wide repurchases reportedly reached \$1 trillion.⁵⁰ The overwhelming majority of repurchases take the form of an “open market repurchase” (“OMR”), in which the firm buys its own stock on the market through a broker.⁵¹

B. Regulation of OMRs

We now turn to the insider-trading regulations applicable to firms conducting OMRs. They include (1) an announcement requirement; (2) Rule 10b-5’s ban on repurchasing shares on “material” nonpublic information; and (3) post-repurchase disclosure requirements.⁵²

⁴⁸ See Gustavo Grullon & David L. Ikenberry, *What Do We Know About Stock Repurchases?*, J. APPLIED CORP. FIN., Spring 2000, at 31, 33–34 (reporting that in the 1990s additional cash flows were channeled into share repurchases instead of dividends); Skinner, *supra* note 45, at 583 (explaining that in 2005 only 7% of firms paid dividends and did not distribute any cash through repurchases).

⁴⁹ Press Release, Standard & Poor’s, S&P 500 Buybacks Set Record of \$589 Billion in 2007 (Apr. 7, 2008), available at http://www2.standardandpoors.com/spf/pdf/index/040708_SP500_BUYBACK_PR.pdf.

⁵⁰ Paul A. Griffin & Ning Zhu, *Accounting Rules? Stock Buybacks and Stock Options: Additional Evidence*, 6 J. CONTEMP. ACCT. & ECON. 1, 1 (2010).

⁵¹ See Monica L. Banyl et al., *Errors in Estimating Share Repurchases*, 14 J. CORP. FIN. 460, 460 (2008). Most other repurchases take the form of a “repurchase tender offer” (“RTO”), in which the firm offers to buy back its own stock directly from shareholders, usually at a premium over the market price. RTOs can also be used for insider trading via the corporation. See Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 421 (2000).

⁵² Firms trading in their own shares are also subject to the anti-manipulation provisions of Section 9(a)(2) of the Act, including the Rule 10b-18 safe harbor for firms repurchasing shares. Because these rules do not reduce a corporation’s ability to trade on inside information, see Fried, *Informed Trading*, *supra* note x, at 1341–42, I will not discuss them here.

1. Announcement Requirement

Before buying back shares in an OMR, a firm must first announce its board's establishment of an open-market buyback program.⁵³ But such announcements can be, and typically are, quite vague.⁵⁴ A firm is not required to indicate the number (or dollar amount) of shares to be repurchased. Nor must the firm indicate the expiration date of its buyback program; the announcement is "good for" an indefinite period of time. Even if a firm voluntarily indicates a repurchase target, it will state that actual repurchases will depend on market conditions. As a result, firms do not commit—and are not obligated—to buy back any stock.⁵⁵ In fact, one study found that almost 30% of firms announcing repurchases do not buy back a single share within four years of the repurchase announcement.⁵⁶

2. Rule 10b-5

As discussed in Part II.B., Rule 10b-5 requires that certain persons (including a firm's insiders) who possess material nonpublic information disclose the information or abstain from trading. The SEC takes the position that Rule 10b-5 also applies to a firm buying its

⁵³ See Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Stock Repurchases*, 6 BERKELEY BUS. L.J. 96, 96 (2009).

⁵⁴ See Murali Jagannathan et al., *Financial Flexibility and the Choice Between Dividends and Stock Repurchases*, 57 J. FIN. ECON. 355, 358–60 (1999); Clifford P. Stephens & Michael S. Weisbach, *Actual Share Repurchases in Open Market Repurchase Programs*, 53 J. FIN. 313, 317 (1998).

⁵⁵ David L. Ikenberry & Theo Vermaelen, *The Option to Repurchase Stock*, 25 FIN. MGMT. 9, 10 (1996).

⁵⁶ See Utpal Bhattacharya & Amy Dittmar, *Costless vs. Costly Signaling: Theory and Evidence* (working paper, 2008), at 15.(available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=250049).

own shares.⁵⁷ Although the doctrinal basis for this view is not completely firm,⁵⁸ I will assume that a firm, like its insiders, is prohibited by Rule 10b-5 from buying its own shares while in possession of material inside information.⁵⁹

However, as we saw in Part II.B., even if Rule 10b-5 were to apply to a firm repurchasing shares, it cannot, by itself, prevent trading on *valuable* inside information.⁶⁰ First, the high materiality threshold used by the courts allows trading on many types of valuable but sub-material information. Second, a prohibition on trading on “material” nonpublic information may not always deter such trading because of detection and enforcement problems. As noted earlier, detecting a violation of Rule 10b-5 is difficult even in the case of insiders reporting their trades under Section 16(a).⁶¹ It is even more difficult to detect a violation by firms repurchasing their shares given the very lax trade-disclosure rules imposed on firms, to which we now turn.

3. Repurchase-Disclosure Rules

Firms buying their own shares on the open market are not subject to Section 16(a)’s 2-day disclosure requirement, which covers only firm insiders.⁶² Indeed, before 2003, a firm did not have to make any disclosure regarding repurchases.⁶³ But since 2003, the SEC has required a firm to report, after the end of each quarter,

⁵⁷ See Loewenstein & Wang, *supra* note x, at 70–72 (2005).

⁵⁸ *Id.* at 46, 47–53.

⁵⁹ To the extent that Rule 10b-5 is interpreted to permit a firm to repurchase its shares on material inside information, the problem of indirect insider trading described in this paper would, obviously, be even more severe.

⁶⁰ See *supra* Part II.B.1.

⁶¹ See *id.*

⁶² See *supra* Part II.B.2.

⁶³ See Fried, *Informed Trading*, *supra* note x, at 1341.

the number of shares repurchased in each month of that quarter and the average price paid for each share.⁶⁴

It is easy to see that the SEC's 2003 trade-disclosure rules for firms repurchasing their own shares are much more lax than those applied to insiders in two respects. First, individual transaction details need not be disclosed. This makes it difficult to determine whether a particular trade was illegal because the firm was in possession of material inside information at the time. As a result, trades on material inside information are more likely to occur.

Second, while insiders must provide trade disclosures within two days, firms repurchasing their shares can wait months to report their transactions. As a result, investors cannot use the information communicated by the repurchase disclosures to adjust their valuation of the stock until long after the information is stale. The firm thus has months to trade secretly on inside information without facing any adjustment in the stock price arising from disclosure of these trades.

C. Insiders' Incentive to Engage in Bargain Repurchases

Having seen that a firm buying its own shares in the market is subject to more lax trade-disclosure requirements than an insider trading those shares, we will now see that insiders have an incentive to use repurchases to engage in indirect insider trading.

Our focus will be on a bargain repurchase—a buyback conducted when those controlling the firm believe the stock price is less than the stock's actual value. A bargain repurchase transfers value from selling

⁶⁴ See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,961 (Nov. 17, 2003) (amending 17 C.F.R. pts. 228, 229, 240, 249, 270, 274), available at <http://www.sec.gov/rules/final/33-8335.htm>.

shareholders to non-selling shareholders pro rata.⁶⁵ Thus, to the extent insiders own shares in the firm (and decline to sell their shares at a cheap price), they will benefit from a bargain repurchase.

Insiders of U.S. firms announcing repurchases tend to own a substantial fraction of the firms' shares before the repurchase—an average of 15% to 20%⁶⁶—which is roughly the same as average insider ownership across all firms.⁶⁷ Thus, when insiders know that stock prices are low, they have a strong incentive to conduct a bargain-price repurchase to transfer value from selling shareholders to themselves and other non-selling shareholders.

To see how a bargain-price repurchase transfers value to insiders and other non-selling shareholders, consider ABC Corporation (“ABC”). Suppose that ABC currently has 6 shares outstanding and that it will be liquidated later, at Liquidation Date. Five shares are held by public shareholders; 1 share is held by Insider. Assume that ABC does not issue any dividends (or sell any equity) before Liquidation Date.

There are two scenarios:

⁶⁵ See Fried, *Informed Trading*, *supra* note x, at 1344–47; Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1120–21 (2011) [hereinafter, “Fried, *Share Repurchases*”]. When a firm buys stock at a price below its actual value, the precise distributional effects depend on whether the selling shareholders would have otherwise sold their shares to new investors for the same price. If so, the selling shareholders cannot be said to “lose” any value as a result of the bargain repurchase. Instead, the bargain repurchase deprives would-be new investors of a gain. For simplicity, however, I will assume that it is the selling shareholders that lose money as the result of the bargain repurchase. This assumption does not affect the analysis.

⁶⁶ See William J. McNally, *Open Market Stock Repurchase Signaling*, 28 FIN. MGMT. 55, 59 (1999); Nikos Vafeas, *Determinants of the Choice between Alternative Share Repurchase Methods*, 12 J. ACCT. AUDITING & FIN. 101, 112–13 (1997). These figures do not include insiders' stock options, which effectively increase their proportional ownership of the firm's equity.

⁶⁷ See Holderness, *supra* note 10, at 1382.

No-Transaction Scenario: If ABC does not repurchase any of its equity prior to Liquidation Date, it will distribute \$60 to the holders of its 6 shares at Liquidation Date. The no-transaction value of each of ABC's 6 shares at Liquidation Date is thus \$10.

Repurchase Scenario: Now suppose that ABC can conduct a repurchase, before Liquidation Date, when the stock trades at \$5 (\$5 less than its actual value of \$10), buying back a single share at that price. Assume that the \$5 spent on the repurchase reduces ABC's Liquidation-Date value from \$60 to \$55 (no economic value is created or destroyed by the repurchase).

Insider does not sell because he is aware the stock is underpriced; the repurchased share is thus acquired from a public shareholder. At Liquidation Date, the value of each of ABC's 5 remaining shares, including the one owned by Insider, is thus \$11.

By assumption, the economic value created by the firm in both scenarios is the same. In the No-Transaction Scenario, \$60 flows to all the shareholders at Liquidation Date. In the Repurchase Scenario, \$5 flows to one shareholder during the repurchase and \$55 flows to the remaining shareholders at Liquidation Date.⁶⁸ In both cases, there is \$60 of economic value flowing to shareholders.

But the bargain repurchase shifts value from public shareholders as a group to Insider. In the No-Transaction Scenario, Insider gets \$10 and public shareholders get \$50. In the Repurchase Scenario, Insider gets \$11 and public shareholders get \$49 (\$44 + \$5). Thus, Insider reaps an extra \$1 even though no economic value is created by the repurchase. The results are summarized in Table 1 below.

⁶⁸ All examples ignore the time value of money (or alternatively, assume it is zero). This assumption, made purely for convenience, does not affect the analysis.

Table 1: Value-Shifting Effect of Bargain Repurchase

	Total Value	Public			Insider
		All	Non-Selling Public	Selling Public	
No Buyback	\$60	\$50	\$50 (5x\$10)	n/a	\$10
Buyback	\$60	\$49	\$44 (4x \$11)	\$5 (1x\$5)	\$11

D. Evidence of Bargain Repurchases

Having seen that insiders have an incentive to engage in bargain repurchases, we now turn to the considerable evidence that they actually do engage in such indirect insider trading. This evidence includes: (1) insiders' own statements and behavior, and (2) stock-price movements following repurchases.

1. Executives' Own Statements and Behavior

Insiders admit that they frequently use repurchases to indirectly buy cheap stock. According to economists who conducted a major 2005 survey of executives regarding firms' payout policies, "[t]he most popular response for all repurchase questions on the entire survey is that firms repurchase when their stock is a good value, relative to its true value: 86.4% of all firms agree or strongly agree with this supposition."⁶⁹ The authors reported that "executives tell us that they accelerate (or initiate) share repurchases when their

⁶⁹ Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483, 514 (2005).

company's stock price is low.”⁷⁰

Until the SEC began requiring limited disclosure of OMR transactions in 2003, it was difficult for economists to confirm that insiders of U.S. firms use inside information to time actual repurchase transactions. But a relatively recent study using post-2003 data found that firms systematically buy stock at low prices within each quarter, often transferring large amounts of value to non-selling shareholders.⁷¹ In one firm, 7.76% of the firm's total market capitalization was shifted from selling to non-selling shareholders in this manner.⁷²

2. Post-Repurchase Stock Returns

Stock-price movements following repurchases also suggest that many repurchases are driven by the desire to engage in indirect insider trading. Researchers have repeatedly found that companies *announcing* (but not necessarily *conducting*) OMRs experience on average cumulative abnormal (market-adjusted) returns of approximately 25% over the next four years.⁷³ This suggests that firms announcing OMRs were, on average, 20% undervalued at the time of the OMR announcement.

⁷⁰ *Id.*

⁷¹ See Amadeo De Cesari et al., *The Effects of Ownership and Liquidity on the Timing of Repurchase Transactions*, 18 J. CORP. FIN. 1023, __ (2012).

⁷² *Id.* at __. This study also finds that insiders' tendency to engage in bargain repurchases increases with insider equity ownership. *Id.*, at

—.⁷³ See, e.g., Konan Chan et al., *Economic Sources of Gain in Stock Repurchases*, 39 J. FIN. & QUANT. ANALYSIS 461, 463 (2004) (finding that shares of firms announcing repurchases earn abnormal returns of 6.7% in the first year following the announcement and 23.6% over the subsequent four years); see also Urs Peyer & Theo Vermaelen, *The Nature and Persistence of Buyback Anomalies*, 22 REV. FIN. STUD. 1693, 1701 (2009) (finding, in a large sample of firms announcing OMRs, a 24.25% cumulative market-adjusted return over 48 months following OMR announcements).

As noted earlier, many firms announcing OMRs do not actually buy back any stock.⁷⁴ First, insiders might announce a repurchase program that they have no plan to actually conduct simply to boost the stock price so they can unload their own shares at a higher price.⁷⁵ Indeed, a recent paper finds evidence of such “false signaling.”⁷⁶ Second, insiders may announce an OMR to give themselves an option to acquire stock at a cheap price. If the stock price does not subsequently turn out to be low relative to its actual value, the insiders will not repurchase stock. Third, a firm may announce a repurchase for a purpose other than insider trading, such as to acquire stock for employee stock-option programs.

We would thus expect firms that announce OMRs and then repurchase shares to be more undervalued than the average firm announcing OMRs. Indeed, one study found that “value” firms (firms with a high book-to-market ratio) that had announced repurchases *and* subsequently repurchased more than 4% of their shares in the year following the repurchase announcement, experienced four-year post-announcement abnormal returns of 57%; in contrast, firms that did not subsequently repurchase any shares experienced zero post-announcement abnormal returns.⁷⁷ These post-repurchase returns provide further strong evidence (along with insiders’ own statements and behavior) that

⁷⁴ See *supra* Part III.B.1.

⁷⁵ See Fried, *Informed Trading*, *supra* note x, at 1351–56 (developing the argument that executives can use repurchase announcements for false signaling and providing anecdotal accounts of such false signaling).

⁷⁶ See Konan Chan et al., *Share Repurchases as a Potential Tool to Mislead Investors*, 16 J. CORP. FIN. 137, 139 (2010) (finding evidence consistent with the notion of executives of poorly performing firms making share repurchase announcements without an intention to repurchase shares).

⁷⁷ See Konan Chan et al., *Do Managers Time the Market? Evidence from Open-Market Share Repurchases*, 31 J. BANKING & FIN. 2673, 2676, 2686–88 (2007).

insiders often use repurchases to indirectly buy underpriced stock.

One might wonder why, if OMRs are used to buy stock at a low price, OMR announcements do not cause the stock price to increase substantially and thereby make it difficult for insiders to engage in indirect insider trading. But remember that OMR announcements may be made merely as a false signal to boost the stock price.⁷⁸ And other OMR announcements may be made by firms intending to engage in an OMR for non insider-trading reasons, such as to acquire shares for employee stock-option program. To the extent that OMR announcements occur even when the stock is not underpriced, the market will not react strongly to any given firm's OMR announcement. In fact, in the 1990s, OMR announcements were associated with short-term abnormal price increases averaging only 2%.⁷⁹ The more muted the market's response to a repurchase announcement, the greater the profits insiders can reap by repurchasing underpriced stock.⁸⁰

⁷⁸ See Chan et al., *supra* note 76, at 139.

⁷⁹ See Peyer & Vermaelen, *supra* note 73, at 1697 (finding that, in a sample of OMR announcements from 1991–2001, there were average abnormal stock-price reactions of 2.39% in the three days around the announcement). Not surprisingly, the market reacts more strongly to OMR announcements when insiders own more stock and the likelihood of indirect insider trading is higher. See Elias Raad & H.K. Wu, *Insider Trading Effects on Stock Returns Around Open-Market Stock Repurchase Announcements: An Empirical Study*, 18 J. FIN. RES. 45, 57 (1995).

⁸⁰ The use of OMRs to engage in indirect insider trading would be expected, everything else equal, to increase the bid-ask spread. While a lack of adequate disclosure of U.S. firm trades makes it difficult to study the effect of OMRs on the bid-ask spread as they are being undertaken, studies of OMRs in foreign markets with better disclosure find that the bid-ask spread widens when firms repurchase their shares in the market. See Paul Brockman & Dennis Y. Chung, *Managerial Timing and Corporate Liquidity: Evidence from Actual Share Repurchases*, 61 J. FIN. ECON. 417, 418 (2001) (Hong Kong); Edith Ginglinger & Jacques Hamon, *Actual share repurchases, timing and liquidity*, 31 J. BANK & FIN. 915, 929–33 (2007) (France).

IV. INSIDER SELLING VIA THE CORPORATION

We saw in Part III that insiders may use OMRs to engage in indirect insider buying via the firm. This Part discusses the use of at-the-market issuances (“ATMs”) to engage in indirect insider selling via the firm. Just as insiders use OMRs to buy underpriced stock through their firms, they can use ATMs to sell overpriced shares through their firms. Section A describes the growing use of ATMs. Section B discusses the relatively lax insider-trading regulation applicable to firms conducting ATMs. Section C explains why insiders have an incentive to exploit these relatively lax regulations to engage in indirect insider trading.

A. At-the-Market Issuances (ATMs)

We saw in Part III that firms frequently repurchase shares. The typical publicly traded firm also issues considerable amounts of shares between the time it goes public and the time it ceases trading. During the period 1993–2002, an average of 66.5% of large firms made *net* stock issues (issuances less repurchases) each year during that period.⁸¹ Strikingly, these net stock issues averaged 7.5% of assets, which is on the same order of magnitude as net debt issuances.⁸²

Seasoned equity offerings (“SEOs”), in which a firm sells stock to investors for cash, are an important form of equity issuances.⁸³ Until recently, most SEOs were what might be called “traditional”: the firm arranges to

⁸¹ See Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549, 551 (2005).

⁸² *Id.* at 551.

⁸³ Other types of issuances include issuances of stock to employees exercising options and the issuance of stock to shareholders of target firms in exchange for the target’s assets.

sell a specified number of shares all at once, at a fixed price, through an underwriter. When the market learns of a traditional SEO, the stock price typically falls, perhaps because it signals that the stock is likely to be overvalued.⁸⁴

In part due to traditional SEOs' adverse effect on the stock price, firms have increasingly switched to so-called "at-the-market" SEOs ("ATMs"). In an ATM, shares are sold directly (and quietly) in the market through a sales agent.⁸⁵ A firm need not, and typically does not, announce these sales as they are occurring (much as firms do not announce OMR transactions as they are occurring).

Indeed, ATMs are marketed as a way to firms to issue shares quickly when the price appears favorable without alerting the market to the issuance and causing the stock price to fall.⁸⁶ As several securities lawyers put it, an ATM enables "the issuer [to] opportunistically take advantage of stock price movements."⁸⁷

B. Regulation of ATMs

We now turn to consider the insider-trading regulations applicable to firms conducting ATMs, which are analogous to the insider-trading regulations applicable to firms conducting OMRs. They include (1) a pre-transaction filing requirement; (2) a ban on issuing shares on "material" nonpublic information; and (3) post-issuance disclosure requirements.

⁸⁴ See, e.g., Tim Loughran & Jay R. Ritter, *The New Issues Puzzle*, 50 J. FIN. 23, 25, 47 (1995).

⁸⁵ For a discussion of these offerings and their requirements, see James D. Small III et al., *The resurgence of United States at-the-market equity offerings to raise capital in volatile equity markets*, 4 CAP. MKTS. L.J. 290, 291 (2009) (describing requirements for ATM offerings).

⁸⁶ *Id.*

⁸⁷ *Id.*

1. Filing Requirement

Before conducting an ATM, the firm must have an effective shelf registration statement and certain other disclosures on file with the SEC.⁸⁸ In these disclosures, the firm must indicate the maximum number of shares to be sold or the maximum aggregate gross proceeds from such sales, and the sales agent.⁸⁹ However, like an OMR announcement, the filing of these disclosures does not compel the firm to enter into a single transaction. Thus, like an OMR announcement, an ATM filing gives a firm the option, but not the obligation, to trade in its shares on the open market.

2. No Trading on Material Inside Information

Various provisions of the federal securities laws explicitly require a firm selling its own shares to disclose “material” nonpublic information.⁹⁰ Thus, while there may be ambiguity over whether a firm repurchasing its shares must disclose material nonpublic information,⁹¹ the requirement for a firm selling its shares is clear.

But, as we saw in the case of OMRs, a prohibition on a firm trading on material inside information cannot, by itself, prevent it from exploiting valuable inside information.⁹² First, the high threshold for “materiality” used by the courts allows trading on many types of valuable but sub-material information. Second, a prohibition on trading on “material” nonpublic information may not always deter such trading because of detection and enforcement problems, which are exacerbated by ineffective trade-disclosure rules. As we

⁸⁸ See *id.* at 295–96.

⁸⁹ See *id.* at 296.

⁹⁰ See WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 46–47 (2010).

⁹¹ See *supra* Part III.A.

⁹² See *supra* Parts II.B.1; III.B.2.

will see immediately below, the trade-disclosure rules applicable to firms conducting ATMs are, if anything, even more lax than those applicable to firms conducting OMRs.

3. Trade-Disclosure Rules for ATMs

Like firms conducting OMRs, firms conducting ATMs do not have to disclose any information about these transactions until after the end of the quarter.⁹³ But while firms conducting OMRs must disclose the number of shares repurchased in each month of the preceding quarter and the average price paid for each share,⁹⁴ no such breakdown is required for ATMs; the firm need only report the total number of shares issued during the quarter and the proceeds.⁹⁵

As in the case of OMR trade-disclosure rules, ATM trade-disclosure rules are much more lax than those applied to insiders themselves, in two ways. First, the information provided does not include the dates and prices of individual trades. This makes it difficult to determine whether particular trades were illegal because the firm was in possession of material inside information at the time. As a result, trades on material inside information are more likely to occur.

Second, while insiders must provide trade disclosures within two days, firms buying or selling their shares can wait up to three months to report their transactions. As a result, investors cannot use the information communicated by the firm's trades to adjust their valuation of the stock until long after the information is stale. The firm thus has up to three months to trade secretly on inside information without facing any adjustment in the price arising from disclosure of its trades.

⁹³ See Small et al., *supra* note 85, at 302.

⁹⁴ See *supra* Part III.B.3.

⁹⁵ See Small et al., *supra* note 85, at 302.

C. Insiders' Incentive to Engage in Inflated-Price ATMs

Having seen that a firm selling its own shares in the market is subject to more lax trade-disclosure requirements than an insider trading those shares, we will now see that insiders have an incentive to use equity issuances to engage in indirect insider trading.

Our focus will be on inflated-price issuance—an issuance conducted when the stock price exceeds the stock's actual (pre-transaction) value. An inflated-price equity issuance transfers value from buying shareholders to non-buying shareholders pro rata. Thus, insiders conducting an inflated-price issuance who decline to buy more shares benefit to the extent they own shares in the firm. As noted earlier, average inside ownership in U.S. firms is 20%.⁹⁶ In a firm where insiders own 20% of the equity before the issuance, they will capture 20% of the value transferred to non-buying shareholders.

To see how an inflated-price equity issuance transfers value to insiders (and, incidentally, to other non-buying shareholders), consider again ABC Corporation ("ABC"). Suppose that ABC currently has 5 shares outstanding and is liquidated later, at Liquidation Date. Four shares are held by public shareholders; 1 share is held by Insider. Assume that ABC does not issue any dividends (or repurchase any equity) before Liquidation Date.

There are two scenarios:

No-Transaction Scenario: If ABC does not issue any equity prior to Liquidation Date, it will distribute \$50 to the holders of its 5 shares at Liquidation Date. The no-transaction value of each of ABC's 5 shares at Liquidation Date is thus \$10.

⁹⁶ See Holderness, *supra* note 10, at 1382.

Equity-Issuance Scenario: Now suppose that ABC can conduct an equity issuance before Liquidation Date when the stock trades at \$16 (\$6 more than its pre-transaction value of \$10), selling a single share at that price. Assume that the \$16 received for the share increases ABC's Liquidation-Date value from \$50 to \$66 (no economic value is created or destroyed by the equity-issuance).

Insider refrains from purchasing the new share, knowing that it is overvalued. At Liquidation Date, the value of each of ABC's 6 shares, including that owned by Insider, is thus \$11.

By assumption, the economic value created by the firm in both scenarios is the same. In the No-Transaction Scenario, \$50 flows to all the shareholders at Liquidation Date. In the Equity-Issuance Scenario, \$16 flows from shareholders during the issuance and \$66 flows back to shareholders at Liquidation Date. In both cases, there is \$50 of economic value to be allocated to shareholders.

But the equity issuance shifts value from public shareholders as a group to Insider. In the No-Transaction Scenario, Insider gets \$10 and public shareholders get \$40. In the Equity-Issuance Scenario, Insider gets \$11 and public shareholders get \$39 (\$55 - \$16). Thus, Insider reaps an extra \$1 even though no economic value is created by the equity issuance. The results are summarized in Table 2 below.

Table 2: Value-Shifting Effect of Inflated-Price Issuance

	Total Value	Public			Insider
		All	Non-Buying Public	Buying Public	
No Issuance	\$50	\$40	\$40 (4 x 10)	n/a	\$10
Issuance	\$50	\$39	\$44 (4x \$11)	-\$5 (1x-\$5)	\$11

In anonymous surveys, executives acknowledge that they issue shares when they believe the stock price is “high.”⁹⁷ And a large body of studies find that insiders tend to conduct traditional SEOs when the stock is overpriced.⁹⁸ A recent study finds that conducting overpriced SEOs enables insiders to substantially boost the value flowing to themselves and other non-buying shareholders.⁹⁹ In short, there is considerable evidence that insiders deliberately use equity issuances to transfer value from buying shareholders.

⁹⁷ See John R. Graham & Campbell R. Harvey, *The theory and practice of corporate finance: Evidence from the field*, 60 J. FIN. ECON. 187, 216 tbl.8 (2001) (reporting results of survey of 392 CFO about their decision-making around capital structure).

⁹⁸ See, e.g., Loughran & Ritter, *supra* note 84, at 47 (examining 3,702 seasoned equity offerings between 1970 and 1980 and finding evidence consistent with firms announcing stock issuances when the stock is grossly overvalued, the market failing to revalue the stock appropriately, and the stock remaining overvalued when the issuance occurs); Jeffrey Pontiff & Artemiza Woodgate, *Share Issuance and Cross-sectional Returns*, 63 J. FIN. 921, 943–44 (2008) (finding evidence of post-SEO stock underperformance in a recent sample of U.S. SEOs).

⁹⁹ See Ilona Babenko et al., *Agency Implications of Equity Market Timing 5* (working paper, 2012), available at <http://apps.olin.wustl.edu/firs/pdf/2012/2667.pdf> (reporting that for firms timing SEOs the average additional three-year return created for long-term shareholders was 3.21%).

Because ATMs are relatively new, there does not appear to have been a study examining whether insiders use private information to choose the time at which the equity is sold. But the fact that ATMs are explicitly described as a way to exploit favorable market conditions suggests that ATMs are being used to sell stock at a higher price than would otherwise be available if the issuance was disclosed.¹⁰⁰

V. COSTS TO PUBLIC INVESTORS

As Part II detailed, when insiders directly engage in insider trading, public investors are hurt in two ways: (1) value is systematically diverted from public investors to insiders; and (2) the overall pie shrinks because insiders' incentives to generate value are weakened and distorted.

As this Part explains, indirect insider trading also hurts public investors in these two ways. Section A explains how indirect insider trading, like direct insider trading, systematically transfers value from public shareholders to insiders. Section B explains how indirect insider trading causes insiders to act in ways that destroy economic value.

A. Value Diversion

Insiders systematically divert value from public investors through both bargain repurchases and inflated-price equity issuances. In prior work, I used publicly available data to (crudely) estimate that insiders make between \$6 and \$7.5 billion in profits annually on bargain repurchases alone, the same order of magnitude

¹⁰⁰ See, e.g., Small et al., *supra* note 85, at 290 (describing ATMs as a way for firms to “sell equity securities...on an opportunistic basis while minimizing disruptions to their stock prices”).

as profits reaped from direct insider trading.¹⁰¹ While the actual amount diverted may be greater or less than this estimated amount, it is likely that bargain repurchases and inflated-price ATMs together yield insiders several billion dollars per year.

As Part II.A. explained, academics who favor insider trading argue that direct insider-trading profits are a reasonable form of compensation.¹⁰² Similarly, insiders' ability to profit from indirect insider trading might be defended as a form of compensation for those controlling the firm—executives, directors, and large shareholders.

But indirect insider-trading profits, like direct insider-trading profits, are a very strange form of compensation. Gains from direct or indirect insider trading are a function of access to inside information, not the creation of economic value. Indeed, as I will explain shortly, indirect insider trading (like direct insider trading) can be expected to reduce the value flowing to all shareholders over time by causing insiders to take steps that destroy economic value.

To be sure, a distinction can be drawn between direct and indirect insider-trading profits. In particular, while the former are captured only by insiders, the latter are shared pro-rata with certain public shareholders: those who do not sell when the firm conducts a bargain repurchase, and those who do not buy when the firm conducts an inflated-price issuance. Thus, insiders gain from indirect insider trading only if certain public shareholders also benefit.

Indeed, indirect insider trading actually increases a firm's long-term stock price. When the firm buys shares at a low price, it increases the value of non-selling investors' stock. When the firm sells shares at a high

¹⁰¹ See Fried, *Informed Trading*, *supra* note x, at 1357–60 (deriving estimate of insiders' profits from bargain repurchases and explaining limitations of the methodology).

¹⁰² See, e.g., Carlton & Fischel, *supra* note 23, at 857 n.80.

price, it increases the value of non-buying investors' stock.

One might ask, then, why indirect insider-trading gains are different from other types of value that those controlling the firm generate for public shareholders—such as additional profits from increasing revenues or reducing expenses. Don't the firm's insider-trading profits also increase "shareholder value"?

But indirect insider-trading profits, unlike these other profits, come entirely at the expense of public shareholders who happen to be trading against the firm. A bargain repurchase might, for example, pay insiders \$2 for taking \$10 from public shareholders selling today to give \$8 to public shareholders who will sell their shares in the future. Public shareholders in aggregate are not served by such an arrangement; they are made worse off.

To see why direct and indirect insider trading have the same distributional effects from the perspective of public investors as a whole, it might be helpful to consider again ABC Corporation ("ABC"). Suppose that, at the beginning and end of the year, Insider of ABC owns 20% of ABC's equity. Assume that Insider's personal trading does not affect the per-share value of ABC. Consider two scenarios.

Scenario 1: Insider buys and sells X shares on inside information during the course of the year, generating (direct) insider-trading profits of \$2. Because there is no effect on ABC's value, the only effect of Insider's use of private information is to shift \$2 from public investors trading in ABC's shares to Insider.

Scenario 2: Insider uses private information to have ABC buy and sell 5X of its own shares. Assume that ABC buys and sells the same number of shares (so that Insider's proportional interest remains at 20% at the end of the year) and that those ABC shareholders not buying or selling shares during the year capture an extra \$10 as a result of this trading. ABC's per-share value increases.

Insider captures \$2, and the remaining \$8 goes to public shareholders holding their shares of ABC.¹⁰³

These two Scenarios are reflected in Table 3 below.

Table 3: Insider-Trading Scenarios

Scenario	Insider	Public			ABC Share Value
		All	ABC's Non-Trading Public Sh's	ABC's Trading Public Sh's	
(1) Insider Makes \$2 Trading Directly	+\$2	-\$2	\$0	-\$2	Same
(2) Insider Has ABC Make \$10 Trading Profits	+\$2	-\$2	+\$8	-\$10	Higher

Although Scenario 2 leads to a higher share value for ABC than Scenario 1 because it is ABC rather than Insider that engages in insider trading, from the perspective of public shareholders in aggregate there is no difference. In both Scenarios, Insider diverts \$2 from public investors buying or selling ABC's shares; on average, public shareholders are worse off by \$2.

B. Destruction of Value

Indirect insider trading, like direct insider trading, can also lead those controlling the corporation to engage in activities that destroy economic value. Two types of

¹⁰³ Note that Scenario 2 has similar distributional effects to a scenario in which Insider first generates \$10 in direct insider trading profits and then donates the \$10 to ABC, capturing \$2 for itself and sharing \$8 with certain public shareholders.

distortions are described below: (1) stock-price manipulation; and (2) capital misdeployment.

1. Stock-Price Manipulation

When insiders cause a firm to buy shares at a low price or sell shares at a high price, they have an incentive to manipulate the stock price to increase the value flowing to them, even if some economic value must be destroyed in the process. Such value-destroying manipulation further hurts public shareholders as a group.

There is considerable evidence that insiders manipulate prices before and during repurchases, actively driving earnings and the stock price down to increase the amount of value transferred to themselves and other non-selling shareholders.¹⁰⁴ Such earnings manipulation is more aggressive when the CEO's equity ownership is higher, providing additional evidence that insiders conduct repurchases to indirectly buy stock at a cheap price.¹⁰⁵

Similarly, insiders manipulate stock prices upward around equity offerings to increase the amount transferred from investors buying stock to non-buying shareholders.¹⁰⁶ This manipulation is often effected through real earnings management in which insiders' sacrifice a firm's long-term cash flow to report higher earnings.¹⁰⁷

¹⁰⁴ See Guojin Gong, Henock Louis & Amy X. Sun, *Earnings Management and Firm Performance Following Open-Market Repurchases*, 63 J. FIN. 947, 983 (2008) (reporting that firms adjust accruals to decrease their reported earnings before stock repurchases).

¹⁰⁵ *Id.*

¹⁰⁶ See, e.g., Siew Hong Teoh et al., *Earnings Management and the Underperformance of Seasoned Equity Offerings*, 50 J. FIN. ECON. 63, 64–65 (1998) (reporting that seasoned equity issuers raise reported earnings by altering discretionary accruals and that this manipulation lowers post-offering returns).

¹⁰⁷ See Daniel A. Cohen & Paul Zarowin, *Accrual-Based and Real Earnings Management Activities Around Seasoned Equity Offerings*,

2. *Capital Misdeployment*

Insiders engaging in indirect insider trading may also have an incentive to destroy value by misdeploying a firm's capital. Below, I highlight one way in which bargain repurchases can destroy value: by diverting cash from value-increasing projects.¹⁰⁸

To understand the potentially value-destroying effect of a bargain repurchase, consider again ABC Corporation ("ABC"). As before, ABC currently has 6 shares outstanding and is liquidated later, at Liquidation Date. Five shares are held by public shareholders; 1 share is held by Insider. Assume that ABC does not issue any dividends (or sell any equity) before Liquidation Date.

There are two scenarios:

No-Transaction Scenario: As before, if ABC does not repurchase any of its equity prior to Liquidation Date, it will distribute \$60 to the holders of its 6 shares at Liquidation Date. The no-transaction value of each of ABC's 6 shares at Liquidation Date is thus \$10.

Repurchase Scenario: As before, suppose that ABC can conduct a repurchase before Liquidation Date when the stock trades at \$5 (\$5 less than its actual value of \$10), buying back a single share at that price.

Now assume that had the \$5 not been spent on the repurchase, it would have instead been invested in a project that yielded a 50% return. Under this assumption, the repurchase reduces ABC's Liquidation Date value not by \$5 but by \$7.50; the \$5 would have

50 J. ACCT. & ECON. 2, 11 (2010) (finding use of both accrual-based and real earnings management in a sample of 1,511 SEOs between 1987 and 2006).

¹⁰⁸ The use of repurchases for indirect insider trading can also destroy value by (1) leading to excessive cash holding in anticipation of future bargain-repurchase opportunities, and (2) causing a firm to use repurchases when dividends would be a more efficient distribution mechanism). See Fried, *Informed Trading*, *supra* note x, at 1364–70.

been invested in a project that yielded a 50% return. As a result, \$2.50 of economic value is lost.

Insider does not sell because it is aware the stock is underpriced; the share is thus purchased from a public shareholder. At Liquidation Date, the value of each of ABC’s 5 remaining shares, including that owned by Insider, is thus \$10.50.

By assumption, the repurchase destroys \$2.50 of economic value. In the No-Transaction Scenario, \$60 flows to all the shareholders at Liquidation Date. In the Repurchase Scenario, \$5 flows to shareholders during the repurchase and \$52.50 flows to shareholders at Liquidation Date, for a total of \$57.50.

But the bargain repurchase enriches Insider by shifting value from public shareholders to Insider. In the No-Transaction Scenario, Insider gets \$10 and public shareholders get \$50. In the Repurchase Scenario, Insider gets \$10.50 and public shareholders get \$47 (\$42 + \$5). Thus, Insider reaps an extra \$0.50 even though no economic value is created by the repurchase. The results are summarized in Table 4 below.

Table 4: Value-Destroying Bargain Repurchase

	Total Value	Public			Insider
		All	Non-Selling Public	Selling Public	
No Buyback	\$60	\$50	\$50 (5 x \$10)	n/a	\$10
Buyback	\$57.50	\$47	\$42 (4x\$10.5)	\$5 (1x\$5)	\$10.50

To be sure, if capital markets functioned perfectly, ABC could borrow \$5 so that it could both buy back one share for \$5 *and* pursue the profitable project. But various market imperfections may make it difficult for

ABC to both engage in the bargain repurchase and pursue all of its desirable projects.¹⁰⁹

Intriguingly, empirical studies suggest that firms that increase repurchases cut back on potentially desirable investment. A recent study found that repurchases, especially those that appear to be driven by insider stock ownership, have a significantly negative effect on a firm's short-term investments and research and development.¹¹⁰ The study found that, holding everything else equal, doubling repurchases led to an 8% reduction in R&D. An earlier study reached similar conclusions.¹¹¹ While these studies, by themselves, do not demonstrate that insiders destroy value to engage in bargain repurchase, they do suggest that repurchases may well divert cash from potentially productive activities inside the firm.¹¹²

Finally, it is worth noting that this particular type of distortion—capital misallocation—is unique to indirect insider trading. While insiders can engage in direct insider trading without altering the firm's capital structure, indirect insider trading cannot be effected unless cash moves into or out of the corporation,

¹⁰⁹ Market imperfections that could prevent a firm from simultaneously exploiting desirable investment opportunities and buying back cheap stock include (1) information asymmetry between financiers and the firm and (2) debt-covenant renegotiation costs. See Fried, *Share Repurchases*, *supra* note 65, at 1125–26.

¹¹⁰ See Alok Bhargava, *Executive compensation, share repurchases and investment expenditures: econometric evidence from US firms*, REV. QUANTITATIVE FIN. & ACCT., Online First, Oct. 14, 2011, at 1.

¹¹¹ See Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises*, 40 J. ACCT. RES. 359, 359 (2002) (finding evidence that firms that repurchase shares to satisfy option exercises exhibit subsequent poor performance because the repurchases divert cash from productive investments).

¹¹² It is worth noting that insiders' use of a dividend to distribute cash would not give rise to the same type of capital-misallocation problem. Because the dividend is pro rata, it would ensure that insiders and public shareholders are in the same boat. Thus, a dividend that reduced public shareholders' payout would also reduce insiders' payout.

potentially affecting the value-creating activities of the firm.

VI. TOWARD REDUCING INDIRECT INSIDER TRADING

In Parts III and IV, we saw that firms trading in their own shares are subject to looser trade-disclosure rules than their own insiders, and that insiders can exploit these relatively lax rules to engage in indirect insider trading. Such indirect insider trading can impose costs on public shareholders by systematically transferring value to insiders and by causing insiders to sacrifice economic value to boost their insider-trading profits.

This Part puts forward a proposal to reduce these costs. Under this proposal, a firm, like its insiders, would be required to disclose details of trades in its own stock within two days. Section A describes the proposed “2-day rule.” Section B explains how such a 2-day rule will reduce the costs associated with indirect insider trading and increase public shareholders’ returns.

A. The Proposed 2-Day Rule

We have seen that Section 16(a) of the 1934 Act currently requires insiders to provide detailed information about any trade in their firm’s shares within two business days.¹¹³ Firms trading in their own shares, by contrast, need only disclose trades only after the end of the quarter, and in much less detail.¹¹⁴ These lax trade-reporting rules make it easier for insiders to trade indirectly on inside information, imposing potentially large costs on public shareholders.

These costs would be reduced if a firm were subject to the same trade-disclosure requirements as its insiders. In particular, a corporation should be required to

¹¹³ See *supra* Part II.B.2.

¹¹⁴ See *supra* Part III.B.3.

disclose each trade in its own shares within two business days of the transaction (a “2-day rule”). Such disclosure would improve transparency and provide public investors with a timely, accurate, and comprehensive picture of insiders’ trading, both direct and indirect.

Importantly, this 2-day rule should also cover *indirect* trading by a firm in its own shares. That is, the rule should apply to trades in a firm’s shares made by the firm’s direct or indirect subsidiaries. Otherwise, a firm could evade the 2-day rule by trading indirectly through its subsidiaries, much as insiders currently avoid Section 16(a)’s 2-day disclosure requirement by trading indirectly through their firms.¹¹⁵

The proposed 2-day rule would not be unduly burdensome for firms, just as Section 16(a) has not been so for insiders. Indeed, the largest stock markets outside the U.S. already require even more timely disclosure by firms of trades in their own shares. For example, in the U.K. and Hong Kong, publicly-traded firms must report all share repurchases to the stock exchange before trading opens the next business day.¹¹⁶ Japan requires same-day disclosure.¹¹⁷ And in Switzerland, a firm trading in its own shares commonly does so through a separate trading line, which are instantaneously

¹¹⁵ For similar reasons, the proposed 2-day rule should cover transactions in options or other derivatives that are economically similar to purchases or sales of the firm’s stock.

¹¹⁶ See Hua Zhang, *Share price performance following actual share repurchases*, 29 J. BANKING & FIN. 1887, 1890 (2005) (describing Hong Kong trade-reporting rules for repurchasing firms); Paul Brockman & Dennis Y. Chung, *Managerial timing and corporate liquidity: evidence from actual share repurchases*, 61 J. FIN. ECON. 417, 421 (2001) (same); United Kingdom Listing Authority Listing Rule 12.4.6 (2012) (describing the U.K.’s requirement for repurchase trades to be reported no later than 7:30am the following business day), available at <http://fsahandbook.info/FSA/html/handbook/LR/12/4>.

¹¹⁷ See Jaemin Kim et al., *Survey on Open Market Repurchase Regulations: Cross-country Examination*, 9 CORP. FIN. REV. 29, 32 (2005).

disclosed to all market participants.¹¹⁸ If firms in Hong Kong, Japan, and the U.K can disclose open-market transactions by the end of the trading day or by the next morning, U.S. firms should be able to disclose their trades within two days without too much difficulty.

B. Benefits of the 2-Day Rule

The 2-day rule would boost public shareholder returns both by reducing the diversion of value to insiders and the destruction of economic value arising as a byproduct of indirect insider trading.

1. Reduced Diversion of Value to Insiders

The 2-day rule will reduce the value diverted to insiders by illegal and legal indirect insider trading.

a. Reduced Illegal Insider-Trading Profits

As we saw in Part III, it is illegal for a firm to trade in its own shares on the open market when in possession of material inside information.¹¹⁹ But enforcing this prohibition is not easy. It is especially difficult when, as now, firms are not required to disclose the details of individual transactions in their own shares.

The 2-day rule will require firms trading their own shares to provide details of each day's trades. Specific information about daily trades will make it easier for regulators to investigate potentially illegal trades by the corporation and, where appropriate, sanction the firm. Better enforcement can be expected to increase deterrence, thereby reducing the amount of value

¹¹⁸ See Dennis Y. Chung et al., *Repurchasing Shares on a Second Trading Line*, 11 REV. FIN. 253, 255 (2007).

¹¹⁹ See *supra* Part III.B.2.

diverted by insiders through illegal insider trading by the firm.

To be sure, some might believe that firms never trade in their own shares when in possession of material inside information. But it would be difficult to support this position without having specific information about the trades firms make in their own shares. In jurisdictions such as Hong Kong and the U.K., such information has long been available to regulators and shareholders. In the U.S., unfortunately, it is not.

b. Reduced Legal Insider-Trading Profits

The 2-day rule will also reduce the amount of value diverted to insiders via legal insider trading by their firms, in two ways. First, it will reduce the value diverted to insiders for any given volume of information-driven firm trading. Second, it will reduce the volume of information-driven firm trading.

(i). Reduced Profits Per Trade

Suppose that insiders engage in indirect insider trading by having their firm buy or sell \$X of its own shares on inside information over a week-long period. Under the proposed rule, the firm must begin disclosing the trading within two days of the first trade. If market participants believe that the firm is attempting to buy (or sell) stock at a favorable price, they will adjust their valuations of the stock.¹²⁰ This adjustment will cause the stock price to move against the firm. As a result, the firm will execute its trades after the second day on less favorable terms. Insiders will therefore capture less

¹²⁰ For a discussion of how market participants currently analyze and respond to Section 16(a) trade disclosures by insiders, *see* Fried, *Reducing the Profitability*, *supra* note 9, at 324. Market participants could be expected to apply the same methodology to decoding firm trades.

value through a firm's legal insider trading than they currently can.¹²¹

To be sure, market participants will not know the exact motives for a particular repurchase or equity issuance. As a result, the price adjustment following trade disclosures by the firm will never precisely reflect the inside information (if any) behind the transactions. Instead, the adjustment can capture at most the expected value of the inside information communicated by the disclosures. Over time, however, these price adjustments can be expected to substantially reduce insiders' profits from indirect insider trading—even if the volume of indirect insider trading is unaffected by the 2-day rule.¹²²

(ii). Reduced Trade Volume

The 2-day rule will also reduce insiders' indirect insider-trading profits by reducing the volume of bargain-repurchases and inflated-price ATMs. Anticipating that the market will adjust to trade disclosures, thereby reducing indirect insider-trading profits, insiders will be more reluctant to conduct certain bargain repurchases and inflated-price equity issuances—those where the expected adjustment is likely to wipe out most of the expected indirect insider-trading profit. As a result, the 2-day rule is likely to reduce not only the profits associated with any given information-based trade but also the volume of such trades.

¹²¹ Most of the insider-trading profits currently generated by OMRs appear to come from firms choosing the right months to buy back shares, not the right days within any given month. *See* De Cesari et al., *supra* note 71, at __. This suggests that a 2-day disclosure rule will substantially reduce OMR insider-trading profits.

¹²² Instructively, the change in the disclosure deadline for Section 16(a) (from the 10th day of the following month, to two business days) following the trade) was accompanied by a decline in insiders' per-trade profits. *See supra* note 43.

2. Less Value Destruction

The use of the firm for indirect insider trading can lead insiders to destroy economic value by manipulating the stock price or distributing cash that would generate greater social returns inside the firm.¹²³ By reducing insiders' expected indirect profits from bargain repurchases and inflated-price equity issuances, the 2-day rule will also reduce the likelihood that insiders will engage in either type of value-destroying activity. The resulting increase in value will accrue in part to public shareholders, further increasing their returns.

3. A Step in the Right Direction

We have seen that other jurisdictions, such as the U.K., require even more timely disclosure by firms of trades in their own shares.¹²⁴ This raises the question of whether the 2-day rule is optimal. Would even earlier disclosure be better? The answer is: yes.

The 2-day rule will still enable insiders to engage in some indirect insider trading, just as Section 16(a) permits insiders to engage in some direct insider trading.¹²⁵ First, firms can trade secretly for two days before announcing such trades. During those two days, there will not be any adjustment in the stock price to reflect the fact that the firm is trading. Second, to the extent the market does not immediately adjust to the information communicated by a trade disclosure, but rather does so only over time, a firm can continue to trade profitably on inside information even after the market begins adjusting to the information provided by its trade disclosures.

¹²³ See *supra* Part V.B.

¹²⁴ See *supra* Part VI.A.

¹²⁵ Cf. Cohen et al., *supra* note 43, at 1024.

Because of the limitations of a 2-day rule, a 1-day or same-day rule for both firms *and* insiders would be even better. Insiders would have less time to trade secretly, directly or indirectly. And stock prices would have more time to impound the information signaled by trade disclosures, reducing insider-trading profits on subsequent trades.

Indeed, I have proposed that both insiders and firms be required to disclose their planned trades in advance.¹²⁶ Such a pre-trading disclosure rule, I have shown, would substantially reduce the costs associated with direct and indirect insider trading.¹²⁷ Thus, I do not claim that the 2-day rule proposed here is ideal. Rather, I see adoption of such a rule as an easy (but important) step toward improving transparency in the capital markets and reducing indirect insider trading and its costs.¹²⁸

VII. CONCLUSION

Publicly-held U.S. firms trading their own shares are subject to much less stringent trade-disclosure rules than are their own insiders when insiders trade these same shares. Insiders must report the specific details of

¹²⁶ See Fried, *Reducing the Profitability*, *supra* note 9, at 349–53 (proposing a pre-trade disclosure rule for corporate insiders); *Informed Trading*, *supra* note x, at 1375–76 (proposing a pre-trade disclosure rule for firms conducting OMRs).

¹²⁷ See Fried, *Reducing the Profitability*, *supra* note 9, at 353–64; Fried, *Informed Trading*, *supra* note x, at 1376–82.

¹²⁸ In other work, I show that one could completely eliminate insiders' ability to profit from insider trading and indirect insider trading through appropriately structured compensation arrangements. See Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 468–74 (2008) (describing an equity arrangement that would eliminate insiders' ability to make insider trading profits by taking control of the timing of sales out of their hands); Fried, *Share Repurchases*, *supra* note 65, at 1136–40 (describing an equity arrangement that would eliminate insiders' ability to make indirect insider trading profits by adjusting their equity position whenever the firm buys or sells its own shares).

each trade within two business days. Firms, by contrast, need report only aggregate monthly or quarterly trading activity, and not until after the end of the quarter.

Not surprisingly, insiders exploit these relatively lax rules to engage in indirect insider trading. There is overwhelming evidence that insiders use private information to have firms secretly buy and sell their own shares at favorable prices. The volume of such indirect insider trading likely totals tens or hundreds of billions of dollars per year.

Such indirect insider trading can impose substantial costs on public investors. It systematically diverts value to insiders, who, in the average U.S. firm, own 20% of the firm's equity. Indirect insider trading can also lead insiders to engage in value-wasting stock-price manipulation and misallocate the firm's capital.

To reduce these costs, I have put forward a simple proposal: subject firms to the same 2-day trade-disclosure rules as their insiders. Other developed stock markets, such as Hong Kong and the U.K, already impose 1-day trade-disclosure rules for firms. There is no reason to deny investors in the U.S. market the benefits of a similar degree of transparency.