INSIDER TRADING IN A GLOBALIZING MARKET: WHO SHOULD REGULATE WHAT?

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I

INTRODUCTION

Trading by an insider on the basis of material non-public corporate information violates the securities laws of the United States and of many, but not all, other countries. As the market for securities becomes increasingly global, the question of whose rules should apply to any particular transaction will arise with increasing frequency. This article addresses that question.

Each country's regime concerning insider trading—which transactions, if any, to ban, and how to do so—has largely evolved through consideration of transactions that are entirely domestic in character and impact. In these transactions, the issuer's state of incorporation and principal place of business, the nationality and residence of the insider and of the other party to the transaction, the location of each when placing the order, and the locations of the exchange on which the transaction is effected and of any other exchanges on which the security is listed, have all been of the same country. Globalization, however, means that an increasing number of securities transactions have one or more such dimensions that differ in nationality from the nationality of the other dimensions. Each country associated with such a transnational transaction must decide whether to try to apply its regime to the transaction and whether to resist attempts by other countries to do so. These decisions will have an important impact on behavior in the globalizing securities market, and hence on global economic welfare, because countries' regimes differ in significant ways: in whether or not they ban insider trading and, where they do, in the scope of such ban, the vigor and methods with which they pursue suspected violators, and in the civil and criminal consequences of violating the ban.¹

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1. See, for example, Harvey L. Pitt & David B. Hardison, *Games Without Frontiers: Trends in the International Response to Insider Trading*, 55 L & Contemp Probs 199 (Autumn 1992) (survey of insider trading laws of Australia, France, Germany, Japan, Mexico, and the Netherlands).

This article offers a framework for considering the different possible decisions countries can make concerning the reach of their policy relating to insider trading. The ultimate question is what, in terms of commonly held goals, are the effects of these decisions? The fundamental tool of analysis is modern finance theory.

Part II of this article examines the problem from the point of view of an individual country. It addresses the question of which, out of all of the transnational transactions that have some connection to the country, are the most important on which to impose its policy preferences. Commentators and legal policymakers have suggested a variety of rationales as to why insider trading is undesirable, which rationales, in a purely domestic context, can be used indiscriminately in support of the country's prohibition. The same is true of rationales that have been suggested as to why insider trading is desirable, and should not be prohibited. But each rationale has different implications in terms of on which transnational transactions a country should impose its policies. Thus, for any country to make sensible decisions concerning the reach of its rules, it must engage in a critical reevaluation of why it regulates (or does not regulate) insider trading in the first place.

Three hypothetical transnational transactions also illustrate in a more concrete context the points developed in Part II concerning the rationales as to why insider trading should or should not be banned. The hypotheticals consider which of these transnational transactions a country adhering to each particular rationale would wish to reach with its regime.

Part III of this article examines the problem from the global point of view. Although the market for securities is becoming increasingly global, the regulation of insider trading can, as a practical matter, be expected to be undertaken by governments at the national level for some time to come. Part III asks which countries ought to regulate which transactions if the goal is to maximize global economic welfare. In addressing this question, the analysis makes two assumptions: (1) there may be differences among issuers as to what, if any, is the optimal amount of regulation of insider trading in their stock, and (2) even if there are no important differences of this type, and the optimal regime is the same for all issuers, we do not know with certainty what that optimal regime is. Part III concludes that each country should apply its regime to all transactions, transnational or domestic, involving issuers of its nationality. It should not apply its regime to transactions in the shares of foreign issuers, even when they are effected on the regulating country's market and involve its residents as buyers or sellers.

Part III takes the problem to be how, given the assumptions set out above, to allocate decisionmaking within a decentralized structure in order to maximize global economic welfare. In large measure, Part III bypasses analyses based on international law jurisdiction to prescribe jurisprudence and choice of law jurisprudence. Because both of these subjects go to the authoritativeness of any given allocation of decisionmaking, they are obviously important, and I intend to say more about them in the future. The

subject addressed in this article, however, should be central to anyone undertaking these other inquiries on the allocation of decisionmaking in transnational settings, since such analyses would be empty exercises in formalism absent a focus on the real social effects of the various possible allocations. Also, even a quick look shows that the allocation that this article ultimately proposes would be congenial to adherents of major schools of thought in both jurisdiction to prescribe² and choice of law.³

2. Under what might be termed the "American" view of jurisdiction to prescribe, association with a transaction in any one or more of the dimensions of nationality listed above is sufficient to give a country a *prima facie* right to regulate. This can be seen, for example, by a review of §§ 402, 403, and 416 of the Restatement (Third) of Foreign Relations Law of the United States (1987) ("Restatement"), which is considered an authoritative statement of the general U.S. view of international law.

Section 402 of the Restatement states that a state has *prima facie* jurisdiction to prescribe conduct (1) that takes place within its territory (for example, the placing of an order by an insider), (2) conduct outside its territory that has a substantial effect within its territory (for examples, the losses incurred by one of the state's residents as the result of an order executed abroad by an insider who is a resident of another country, a change in prices in a regulating country's market as a result of such an order, and the execution in the regulating country of an order made outside of the regulating country by such an insider), and (3) conduct outside its territory undertaken by a national of the regulating state (an insider who is a national of the regulating state placing an order abroad).

Section 403 of the Restatement prohibits exercise of jurisdiction to prescribe on any of these bases if (1) such exercise is unreasonable (an evaluation of which can, in part, be made by consideration of a stated list of factors) or (2) it is reasonable, but another state has a conflicting prescription and the other state's interest in exercising jurisdiction is clearly greater.

Section 416 of the Restatement applies these general principles to issues of the application of U.S. securities laws. It lists situations in which exercise of jurisdiction to prescribe is, in essence, *per se* reasonable, and lists a set of factors (such as substantial effects on a U.S. securities market and the residency of the persons sought to be protected by the rule) to determine reasonableness for situations outside that list.

It would seem impossible to conduct properly the required reasonableness inquiry called for in § 403 and the second part of § 416 without engaging in the kind of economic analysis of the effects of the conduct in question undertaken in this article. See note 67 for a discussion of the only transnational transaction reached by my proposal that is likely to be controversial under any widely accepted theory of jurisdiction to prescribe: the prohibition of a purchase, on a foreign exchange, of shares of an issuer from the regulating country by an insider possessing material nonpublic corporate information, where both the insider and the seller are residents of the foreign country.

3. The issues addressed in this article do not, as a formal matter, involve choice of law. Except possibly in an implied private right of action case, the analyses below do not address a court trying to decide which of two countries' laws to apply to a situation where both *prima facie* appear applicable. Rather, at issue will be a rule, the violation of which results in governmental sanctions. The involved parties are concerned with the decision of any one of a variety of actors—a legislature, an administrative agency in its rule-making function, an administrative agency in its prosecutorial function, and a court interpreting a statute or rule—as to whether the rule, which the actor clearly thinks should apply if all the elements of the situation were domestic, should apply as well when some of the elements are foreign. The consequence of deciding that it does not is that the country's courts have nothing more to do with the matter, not that they apply instead some foreign regulatory regime and mete out the appropriate sanctions.

Despite these differences, however, the kind of reasoning that goes into choice of law analysis can be helpful in determining the authoritativeness of the affirmative decision of any of the actors addressed here to extend the reach to situations with foreign elements. See note 75.

II

THE NATIONAL PERSPECTIVE: FIVE RATIONALES CONCERNING
INSIDER TRADING

A review of the commentary and authoritative discussion concerning insider trading suggests that the prevailing rationales as to why insider trading should or should not be banned can be grouped into five basic categories: (1) the desire for corporate insiders to be fair to those with whom they deal; (2) the desire for such insiders to be fair to traders in the issuer's shares generally; (3) the effect of insider trading on public perceptions of fairness; (4) the effect of insider trading on share price accuracy; and (5) the effect of insider trading on firm performance. As will be developed below, the first two categories concern issues of distribution: the effect of insider trading on the split of the underlying income stream of corporations between managers and shareholders. The critical reviews of these rationales suggest that neither ultimately forms a sound basis for making insider trading policy. The other three categories relate largely to issues of efficiency, or, in other words, the effect of insider trading on the size of this underlying income stream. The critical reviews of these rationales suggest that they form a sounder basis for making policy.

The five categories will initially be discussed in the context of a simple, hypothetical transaction involving insider trading with no transnational transactions:

On February 1, the president of Americo becomes aware, through information provided by company geologists, that Americo has discovered a major ore body that will greatly add to the profits of the company. Americo's top executives keep the discovery a close secret until March 15, while the company acquires mineral rights in the land involved. It is obvious to anyone in possession of the information that, when the discovery is announced, the price of Americo shares will soar. On March 13 and 14, the president places orders for an aggregate of 20,000 shares, which he is able to buy at \$105, about five dollars higher than the price at which it has been trading recently. With the benefit of hindsight, it will appear that the president's orders are the cause of the price increasing from \$100 to \$105. Five hundred of the shares acquired by the president are sold on the exchange by Ms. Smith. Mr. Jones also sells 500 shares on March 13. His shares go into the hands of some third party, but he would not have sold if the price had only been \$100. Ms. Green considers buying some Americo shares on March 13, and would have done so if the price were \$100, but decides that at \$105 the price is too high. The discovery is publicly announced on March 15, and the share price immediately rises to \$150. Americo is a Delaware corporation, with its headquarters, principal place of business, and substantially all of its assets in the United States. Almost all of its

employees (including the president) are U.S. nationals residing in the United States. Its shares are listed only on the New York Stock Exchange, where the president's order is placed, and almost all of its shares are owned by U.S. residents. Smith, Jones, and Green are all U.S. nationals residing in the United States. Thus the president's purchase is an entirely domestic transaction, and a classic violation of the U.S. rules against insider trading.⁴

A. Fairness with Whom You Deal

1. *The Nature of the Rationale.* The first and most traditional rationale as to why insider trading is undesirable rests on concepts of honor and fair behavior. The insider's involvement with the corporation is said to create a special relationship between him and the shareholders. Because of this relationship, when the insider deals with a shareholder, he must treat her more fairly than when he deals with other people.⁵ To meet this higher standard of fairness, the insider possessing material information not available to the shareholder with whom he is dealing must disclose the information to the shareholder. Thus, in the hypothetical, Americo's president should have revealed the ore discovery to Smith and the other persons from whom he acquired the shares.

The key feature of this rationale is the critical role each party's status plays. In the case of any traded commodity, where one party to a transaction possesses information about the commodity's future value that is not available to the other party, there is an increase both in the likelihood that the better-informed party will be advantaged by entering into the transaction, and in the likelihood that the lesser-informed party will be disadvantaged by entering into it. But the "fairness with whom you deal" rationale does not support a condemnation of all such transactions. For the rationale to apply, the first party must be an insider of the corporation from which the information

4. These facts, of course, bear a significant resemblance to *SEC v Texas Gulf Sulphur Co.*, 401 F2d 833 (2d Cir 1968), the classic case in which the purchases by corporate officers on the basis of an undisclosed copper discovery were found to violate § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

As will be the case throughout this article, unless the context indicates otherwise, this discussion assumes that the nonpublic information used by the insider is positive so that it motivates him to make a purchase.

5. A prominent articulation of this rationale can be found in Justice Powell's majority opinion in *Chiarella v United States*, 445 US 222 (1980). The Court held that "mere possession of nonpublic market information" does not give rise to a duty under Rule 10b-5 to disclose or refrain from trading. *Id* at 235. Corporate insiders in possession of such information do have such a duty, however, because they "have an obligation to place the shareholder's welfare before their own." *Id* at 230. See also *Goodwin v. Agassiz*, 186 NE 659, 661 (Mass 1933) (finding no duty to disclose in connection with a purchase effected on an impersonal stock exchange, but saying in dicta that a director has "a peculiar obligation to observe every requirement of fair dealing when directly buying or selling its stock," and that "directors cannot rightly be allowed to indulge with impunity in practices which do violence to prevailing standards of upright businessmen," and so may have a common law duty to disclose when they seek-out a purchaser or seller); Donald C. Langevoort, *Insider Trading Regulation* 12 (Clark Boardman, 1989) ("an executive's self-interest should be subordinate to the interests of the shareholders"); Arnold S. Jacobs, *Litigation and Practice Under Rule 10b-5*, § 66.02[a][iii] at 3-478 (Clark Boardman, 1988).

derives, and the other party must be either an existing shareholder or a person who becomes a shareholder by reason of the trade (in other words, the commodity she is selling or buying must be a security of the corporation). Thus, a trade in a corporation's shares by an outsider who receives such information by accident is not covered;⁶ nor is a trade by an insider possessing such information if the commodity in question is land rather than securities.

2. *Implied Reach to Transnational Transactions.* Consideration of what is and what is not condemned by the "fairness with whom you deal" rationale suggests something about the policies that underlie it and, in turn, the sensible reach of the insider trading ban of a country embracing this rationale. To start, why is there no condemnation of trades where the person possessing the corporate information is an "outsider" who acquires it by accident? Why do insiders have some special obligation to act more fairly? It is not because the gains to the insider are greater than they would be to an outsider using the same information. It is not that the possible losses to the other party are greater than they would be if the trade were with an outsider possessing the same information. And it is not that the other party has different expectations if she trades with an outsider rather than an insider; on an organized stock exchange, the other party is very unlikely to know with whom she is dealing. Rather, the disparity of treatment between insiders and outsiders must represent a wish to reinforce the other strictures on self-interested behavior that constitute the insider's fiduciary duties, duties that are normally defined by the laws of the firm's state of incorporation.⁷ In other words, it is feared that allowing insiders to trade on nonpublic corporate information would lead to a generally "bad attitude" that could affect the manner in which insiders deal with shareholders and the corporation in other regards. This is presumably just as great a concern when the insider deals with persons residing abroad as when he deals with persons residing in the regulating country.

The "fairness with whom you deal" rationale, however, derives from more than simply the concern for reinforcing restraints on self-interested behavior by insiders. Agency law prohibits all trades by an insider, whether in securities or anything else, based on nonpublic information obtained from his

6. *Chiarella*, 445 US at 235. The situation where the outsider uses information received by accident should be distinguished from the situation where (1) he receives the information from someone with whom he has a preexisting relationship that, because of some contractual or fiduciary duty arising out of that relationship, makes its use wrongful (the "misappropriation theory" articulated by Justice Burger in his dissent in *Chiarella*, 445 US at 239-45, and subsequently adopted in a number of federal circuits, see for example *United States v Newman*, 664 F2d 12 (2d Cir 1981), *aff'd* after remand, 772 F2d 729 (2d Cir 1981), and (2) he receives the information directly or indirectly because of a tip by an insider (and, in accordance with Justice Powell's theory articulated in the majority opinion in *Dirks v SEC*, 463 US 646 (1983), is therefore a "participant after the fact" in the insider's breach of the insider's fiduciary duty not to tip, which is owed to the issuer's shareholders).

7. See note 26.

corporation.⁸ But that is a protection for the *corporation*, which can waive its rights if it so chooses, not a protection for the other party. Thus, if an insider trades in land, based on inside corporate information, agency law is not concerned with the effect on the other party. The rationale's emphasis on the relationship between the parties suggests that when it is securities that the insiders are trading, the outsiders are particularly vulnerable to suffering losses and are thus more in need of protection.⁹ Residents of the regulating country presumably need this protection just as much, whether they trade in the shares of a foreign issuer or a domestic one.

Thus, a country banning insider trading on the basis of the "fairness with whom you deal" rationale would want to apply its regime to two groups of transnational transactions. First, the concern with reinforcing other strictures on self-interested behavior would argue for applying its regime to all those transactions involving an insider of a firm incorporated under its laws, even when the other party—the outsider—resides in another country and the trade is executed on a foreign exchange. As discussed, a trade with a person residing abroad undermines these strictures as much as does a trade with a person residing at home. Second, the country would want to apply its regime to all transactions in which the other party—the outsider—resides in the regulating country, whatever the issuer's country of incorporation, because the special vulnerability outsiders face when trading securities is just as great with a foreign issuer as with a domestic one.

3. *Critique of the Rationale.* Closer scrutiny reveals problems with this rationale, however, and hence with using it as a guide to determine the appropriate reach of a ban on insider trading. A trade by an insider on the basis of nonpublic corporate information may not work any unfairness at all on the other party. This problem, sometimes referred to as the "causation anomaly," is most easily understood in the context of the hypothetical.¹⁰ Under the "fairness with whom you deal" rationale, nothing would have been unfair about Americo's president failing to disclose the information, as long as he did not place an order for shares. The condemned activity is the failure to disclose *coupled with* an order for shares. Though Americo's president did place an order to buy 20,000 shares, Smith might have sold her shares even if the president had not placed the order. If that were the case, Americo's president would not have caused Smith any harm by engaging in the

8. See, for example, *City of Chicago ex rel Cohen v Keane*, 357 NE2d 452 (Ill 1976) (purchase of land based on information concerning what areas would be sites of urban renewal projects); see generally Restatement (Second) of Agency § 388 comment c (1958).

9. This perception of greater vulnerability might be because, in any given period of time, insiders will become aware of more pieces of information that will lead to a substantial reevaluation of the future value of the firm's stock than of ones that will lead to a substantial reevaluation of most other market-traded commodities. The size and liquidity of the market for many corporations' securities also create an opportunity for the insider to make a larger investment based on the information and, in exploiting it more fully, to hurt more outsiders.

10. See William K. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S Cal L Rev 1217, 1241-45 (1981); *Fridrich v. Bradford*, 542 F2d 307 (6th Cir 1976).

condemned activity. Actually, on the facts, he would have helped Smith somewhat. Because of the president's order, Smith would have received five dollars more per share than she otherwise would have.

B. Fairness to Traders Generally

A second rationale as to why insider trading is undesirable is that it is potentially unfair to all those who trade in the issuer's shares, whether or not they actually deal with the insider.¹¹ This represents a more sophisticated approach to the distributional issues involved in insider trading than does the first rationale. It also puts the first rationale's foil, the causation anomaly, in better perspective.

1. *The Nature of the Rationale.* The story told above, where both Americo's president and Smith benefit from the inside trade, does not prove that insider trading, in fact, ushers in the best of all possible worlds. In the end, because of the trade, the president owns 20,000 more shares of stock, which subsequently increase in price, than he otherwise would have and, as a group, outside shareholders own 20,000 fewer such shares.¹² As a practice, insider trading would appear to effect a transfer of wealth from outside shareholders to insiders, \$1 million in the case of the hypothetical. Even if Smith would have sold her shares anyway, and thus the trade is not a "but for" cause of harm to her, the shares acquired by the president must come from *somewhere*. Two groups of persons are actually harmed. One group, represented in the hypothetical by Jones, consists of the persons pulled into the market who sell in response to the rise in price that resulted from the president's order; that is, those who would not have sold at \$100 but do sell at \$105. These shares may go to third parties who would have bought regardless of the president's order, but the fact that they are available to satisfy the third parties' orders means that shares like those of Smith are available to satisfy the president's order. The second group, represented in the hypothetical by Green, consists of the persons pushed away from buying in the market by the rise in price; that is, those who would have bought at \$100 but do not buy at \$105. The failure of this second group to buy frees-up shares that would have been sold anyway, and makes them available as well to fill the president's order.¹³

11. A good articulation of this theory can be found in Judge Timber's opinion in *Shapiro v Merrill Lynch*, in which he said the following:

We hold that defendants owed a duty—for the breach of which they may be held liable in this private action for damages—not only to the purchasers of the actual shares sold by defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in the possession of defendants.

495 F2d 228, 237 (2d Cir 1974).

12. Professor Wang refers to this as the "Law of Conservation of Securities." For a more extended discussion, see Wang, 54 S Cal L Rev at 1234-35 (cited in note 10). Professor Cox has argued that as an empirical matter the amount of damage involved here is likely to be small. James D. Cox, *Insider Trading and Contracting: A Critical Response to the Chicago School*, 1986 Duke L.J. 628, 635.

13. Implicit in this description is a model of investor behavior that assumes an upward sloping supply curve (or downward sloping demand curve) for the securities of any particular issuer. Many

2. *Implied Reach to Transnational Transactions.* To start, this rationale, like “fairness with whom you deal,” does not condemn trades where the party possessing the corporate information is an outsider acquiring it by accident. Again, by the same logic as presented before, distinguishing between insiders and outsiders must represent a wish to reinforce other strictures on self-interested behavior.¹⁴ And again, this is presumably as great a concern when the insider deals with persons residing abroad as when he deals with persons residing in the regulating country.

The determination of who needs protection from insider trades, however, proceeds along different lines than under the “fairness with whom you deal” rationale. If a significant number of persons residing in the regulating country trade in an issuer’s shares, any time an insider trades, there are bound to be some residents belonging to each of those two groups of persons who are actually hurt. This will be true whether the issuer is foreign or domestic. And it will not matter if the insider placed his order on some exchange outside the regulating country, and none of the shares acquired by the insider came from the regulating country’s residents.

Thus, a country banning insider trading on the basis of the “fairness to traders generally” rationale would want to apply its regime to a somewhat larger set of transnational transactions. First, as just noted, the concern with reinforcing other strictures on self-interested behavior would again argue for applying its regime to all those transactions involving an insider of a firm incorporated under its laws, wherever the outside party resides, and wherever the order has been executed. Second, the concern with the special vulnerability of outsiders when they purchase securities would argue for applying the regulating country’s regime to all those insider trades, whatever the issuer’s nationality, where a significant number of the regulating country’s residents regularly trade in the issuer’s shares. At a minimum, this suggests applying the regime to all inside trades in the shares of any issuer whose shares are listed on an exchange located in the regulating country, even if the trade is executed abroad, and the parties to it and the issuer are foreign. With stock exchanges linked by arbitrage, sellers and potential buyers who place their orders on an exchange in the regulating country are as likely to be among those pulled into or pushed out of the market by the insider’s trade as are those placing orders on the exchange where the insider’s trade is executed, and hence are as likely to be among those actually harmed by it.

finance economists would assert instead that the supply curve is essentially horizontal. See note 39. While I disagree with that assertion, it does not matter for purposes of this discussion. The president ended up with 20,000 more shares, which means that there are 20,000 fewer shares in the hands of the public. Whatever the precise nature of the mechanism, there are only three ways this could happen: someone sold who would not have but for the president’s order; the specialists in the stock have reduced their inventory by 20,000 shares (really just a special version of the first way); or someone did not buy who but for the president’s purchase would have bought.

14. See part IIA2.

3. *Critique of the Rationale.* This second rationale describes more accurately than the first the distributional consequences of an insider trade. It too, however, is troublesome as a basis for a country to ban insider trading because, like the first, it views the distributional effects of an insider trade from an ex post, rather than the more appropriate ex ante perspective. Hence, this second rationale is also an unsound guide to determine the appropriate reach of a country's ban on insider trading.

The second rationale's perspective is ex post because it looks back no further than the moment of the inside trade. Using a "but-for" theory of causation, it simply asks whom the trade makes better and worse off. From this perspective, it is clear that the insider is aided and certain outside shareholders are hurt. Because there is no apparent justification for this transfer of wealth, the trade is labelled "unfair." Generalizing this idea, to permit the practice of insider trading would appear to effect an overall undeserved transfer of wealth from outsiders to insiders, giving the insiders a larger slice of the income stream generated by corporations than if the practice were not allowed.

An ex ante analysis of the distributional effects of insider trading produces a very different result. The focus is on the expectations of the outsiders at the time they initially purchase their shares and the price they pay. The time of purchase is when outsiders make the decision that places them in a position to be affected by the practice. Consider those investors who buy or sell on the basis of personal beliefs concerning the probability distribution of future security returns.¹⁵ These are the investors whose actions determine the price. If insider trading is allowed, each such investor, when she considers buying a share, makes an estimate of the expected trading profits (discounted to present value) over the rest of the life of the firm that insiders will capture as a result of trading on inside information and adjusts what she is willing to pay

15. A significant portion of investors—perhaps most—choose their portfolios randomly, simply seeking diversification and trusting in market prices as the best predictors of future returns. These passive investors—persons who randomly add to their portfolio when they have money to invest, and subtract from it randomly when they need cash—can never be hurt by the insider's purchase because they would have sold whether he had purchased or not. The rest, however, choose their portfolios on the basis of their own beliefs, comparing their valuations of available securities with market price. They have the potential, at least in the ex post sense, of being hurt by insider trades.

for the shares accordingly.¹⁶ As a result the market price of the shares will be appropriately discounted.¹⁷

Thus, it is not unfair for an investor to suffer harm from an inside trade; she took a gamble at the time of purchase that this would occur, and she was compensated for the possibility by an appropriate discount in the purchase price.¹⁸ Even at the individual level, this appears to be the more appropriate perspective, since most investors are at least somewhat diversified and are buying and selling in the market over a considerable portion of their lifetimes.

16. On a per-share basis, this estimate will equal the net expected reduction (discounted to present value) that the holders of the share will suffer because of disadvantageously timed purchases and sales that would not have occurred but for the insiders' trades. Knowing that one or both of her transactions in the share—her purchase now and her subsequent sale at the time she disposes of it—may be such disadvantageously timed transactions, and knowing that the purchaser at the time of her sale will also be making such an estimate, she will adjust what she would be willing to pay for the share so that the expected return on its purchase will still be competitive.

The amount of an issuer's shareholder distribution each year in the future is uncertain. The investor, however, forms views concerning its probability distribution. Suppose that the investor, based on the publicly available information concerning an issuer, decides that the expected value of the issuer's dividend for each year in the future in perpetuity will be \$11. She discounts this stream of expected dividends at 10%, reflecting what she could earn on investments with comparable risk. Thus the discounted present value of this income stream is \$110. The issuer has one million shares outstanding.

If there is no possibility of insider trading, the investor would be willing to pay \$110 for the share. If insider trading is allowed, however, she would not be willing to pay this much. Suppose that she estimates that over the rest of the life of the firm insiders will make \$10 million or \$10 per share (after discounting to present value) in trading profits (the actual profit made by making purchases just before announcements of good news and the losses avoided by making sales just before the announcements of bad news). The investor will only be willing to pay \$100 for the share.

Three factors go into her calculation. First, she may already have incurred a trading loss with the very act of purchase. The company may soon announce bad news that would lead her to reduce her projection of future shareholder distributions, and she may have been one of the persons induced into purchasing at this inopportune moment by insider sales pushing the market price down to what appears an attractive level. Second, when she disposes of the share she may miss out on a gain, the possibility of which had been part of her \$110 valuation. Her estimate included the possibilities that cash flow would be better or worse than the expected \$11 per year. With insider trading allowed, she will suffer from any bad news developing between the moments of her purchase and sale, the possibility of which is part of her evaluation that dividends may possibly be less than \$11. But she will not be assured that she will enjoy any good news developing in that period, the possibility of which is part of her evaluation that the dividends may possibly be greater than eleven dollars. This is because good news may result in insiders entering the market before disclosure, pushing market prices up to what appears to be an attractive level, and inducing her to sell at an inopportune moment. Finally, she knows that even if neither her purchase nor her sale is subject to these problems, the person who buys the share from her faces the same risks and, as a result, will not be willing to pay for the shares the then-discounted present value of expected dividends.

It should be noted that she might purchase at a time that bad news has not yet been disclosed or sell at a time that good news has not been announced, but the purchase or sale may not be one induced by the trading of insiders. The existence of these possibilities are canceled out by the opposite equally likely possibilities: a purchase at a time that good news has not yet been announced and a sale at a time that bad news has not yet been announced.

17. There are good reasons to believe that the resulting discount in market price represents an unbiased forecast of the amount of trading profits that insiders would gain and outsiders would lose as a result of permitting insider trading. See Part IID.

18. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Protection of Information*, 1981 S Ct Rev 309, 325 (if the possibility of insider trading exists, "shareholders will respond by bidding less for the stock in the first place."); Cox, 1986 Duke L J at 638 (cited in note 12) ("Insider trading does not hurt investors because they can self-insure against abusive insider-trading practices by discounting all stocks by the average risk for all firms.") (citation omitted); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J Legal Studies 801 (1980).

In aggregate, the ex post losses they suffer should therefore approximate their ex ante compensation. More importantly, the ex ante analysis shows as clearly incorrect the generalization suggested by the ex post analysis that the practice of insider trading would work an overall transfer of wealth from outsiders to insiders.¹⁹ Because the price will be discounted in anticipation of the trades, the practice will not affect the distribution of wealth between outsiders and insiders, and it suggests that "fairness" is an empty concept in the context of insider trading.²⁰

C. Public Perception of Fairness

1. *The Nature of the Rationale.* The next rationale concerning the desirability of insider trading suggests that insider trading creates a *public perception* that investors will be unfairly hurt by it and that this perception is important even if financial economists are correct that, in fact, investors will not be hurt. Such a perception creates two problems. First, a widespread perception that a major social institution operates unfairly makes people feel badly, even if the perception results in no change in behavior.²¹ Second, such a perception, by undermining investor confidence in the market, can in fact change behavior. Many investors may feel that trading in the market for corporate equities is a game not worth playing, and will drop out of it altogether.²²

If insider trading in fact causes investors to drop out, it creates an inefficiency. The perception of unfairness serves as a barrier that prevents a number of persons from sharing in the economy's aggregate amount of

19. It is not only that outsiders would not lose. Insiders would not gain. See Part IIE2 for a discussion of why the expected profits from the ability to engage in insider trading would tend to be counterbalanced by lower executive salaries.

20. Not all commentators agree with this concept of fairness. Some object, for example, that it is based on a hypothetical average shareholder rather than on an actual shareholder; actual shareholders may not be diversified, or may, due to individual motivations or expectations, value the shares differently than the market rate. Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 Temple L.Q. 47, 64-68 (1987). There is no way of resolving the debate except to point out that it would be hard to find any practice in society that ex post leaves every single person affected by the practice at least as well off as if the practice were not followed.

It has also been suggested that "there is little evidence to suggest that any such discounting occurs at all." Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 Wis L. Rev 573, 630 (citation omitted). This is a kind of phenomenon, however, where it would be hard to show empirically either its existence or nonexistence. But widely accepted financial models that in other contexts are supported by empirical evidence suggest that discounting would occur. See Part IID1.

21. Education may be a better alternative to banning a practice that the public perceives as unfair but in fact is not. Whether education is better depends in part on how inexpensive and effective it is and whether the practice has substantial social benefits, such as the significant enhancement of economic efficiency.

22. One small piece of empirical evidence concerning the volume of trading is at least consistent with this proposition. See *Amsterdam Exchange Cracks Down on Insider Trading, Volume Explodes*, Securities Week 5 (April 7, 1986) (as the Amsterdam Stock Exchange announced new measures to fight insider trading, volume jumped from \$7.2 billion in February, 1986, to a record \$10.5 billion in March, 1986). It is, of course, possible that the increase in volume does not represent an increase in the number of participants, but rather an increase in the rate by which existing investors trade, turning over their portfolios, once their fear of insider trading has been reduced. Even this can be termed an increase in participation of sorts, however, since, like an increased number of investors, it increases liquidity.

undiversifiable market risk who otherwise, for an adequate premium, would be willing to do so.²³ Narrower participation also reduces liquidity.²⁴ Both effects result in some combination of higher capital costs and lower investor welfare.

Narrower participation may also have undesirable political effects. Impediments to financing through publicly issued securities increase the dependence of issuers on large institutional investors, and enhance the power that the institutional investors wield in society.²⁵

2. *Implied Reach to Transnational Transactions.* To determine the appropriate reach of a country's insider trading ban based on this third rationale, one must start by introducing a notion of the "nationality" of an issuer, a notion that will be used throughout the rest of this article. An issuer will be considered a national of a given country when the largest portion of its shares is held by residents of that country, and the largest portion of its operations is conducted there²⁶ (hence that country is the residence of the suppliers of the largest portion of the issuer's other factors of production). The bulk of the

23. For the general proposition that an increase in the number of people sharing an undiversifiable risk increases efficiency, see Steven Shavell, *Economic Analysis of Accident Law* 201 (Harvard U Press, 1987); Merritt B. Fox, *Corporate Successors under Strict Liability: A General Economic Theory and the Case of CERCLA*, 26 Wake Forest L Rev 183, 188-92 (1991).

24. The importance of liquidity is demonstrated by commentary concerning the disadvantages of private placement financing. See Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 355 (McGraw Hill, 1991) (noting also that investors must be compensated for holding illiquid assets, and that the typical differential between public and private placements may be about .50%); Elvin F. Donaldson, John K. Pfahl & Peter L. Mullins, *Corporate Finance* 504 (Ronald Press Co., 1975).

25. The extreme case would be the power wielded by the large banks in Germany and Japan before World War II. The breakup of the power of these banks by the occupying forces after the War was clearly motivated in part by the feeling that the banks had contributed to the authoritarian nature of the pre-War societies. See, for example, Andrew Roth, *Dilemma in Japan* 71-98 (Little Brown, 1945).

A contemporary theme in U.S. corporate law scholarship is that over-regulation may have made U.S. institutional investors too powerless rather than too powerful. See, for example, Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum L Rev 10 (1991); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich L Rev 520 (1990). This, however, is not a call for a move away from publicly owned corporations, but rather for reforms within that structure that would permit a number of institutional investors, each owning a few percent of a corporation, to act together as some kind of counterweight to the power of management. See also John C. Coffee Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum L Rev 1277 (1991).

26. U.S. lawyers are accustomed to thinking of a corporation's nationality in terms of the place of its incorporation. This thinking reflects the importance in U.S. law of the "internal affairs" doctrine. Most issues relating to the internal affairs of a corporation, including "validity of stock issues and of corporate bylaws, the selection of directors and management, [and] the declaration of assessments and dividends," are governed by the law of the place of incorporation. Eugene F. Scoles & Peter Hay, *Conflict of Laws* §§ 23.2, 23.5 at 913, 920 (West, 1992).

There are other ways of looking at the question, however. Consider, for example, the real seat doctrine, *siège réel*, followed by most of the European Community's civil law countries, under which the law of the place of management governs all aspects of the corporation's existence, whether or not it is the same as the place of incorporation. See Andreas Reindl, *Companies in the European Community: Are the Choice-of-Law Rules Ready for 1992?*, 11 Mich J Intl L 1270, 1272-75 (1990). In international law, the importance of the nationality of significant numbers of shareholders, when different from the place of incorporation, has also been recognized where a state does damage to a corporation incorporated under its own laws. Restatement (Third) of the Foreign Relation Law of the United States, § 213 comment d, § 713 comment e (1987); Richard B. Lillich & Gordon A. Christenson, *International Claims: Their Preparation and Presentation* 15-20 (Syracuse U Press, 1962) (concerning U.S.

world's economic activity is still undertaken by enterprises (including many labelled "multinational") sufficiently associated with a single nation to possess this type of national identity.²⁷

A country basing a ban on insider trading exclusively on its effect on public perceptions of fairness will be concerned both with purely domestic transactions and certain kinds of transnational securities transactions. The concern, however, will not extend to as many kinds of transnational transactions as it does in the case of a country basing its ban on either of the first two rationales. Instead, it will be limited to transnational transactions involving issuers of the regulating country's nationality, and the intensity of the concern will depend on why investors believe insider trading is unfair. Higher capital costs harm the entrepreneurs of a new issuer and the existing shareholders of an established issuer. Higher capital costs will also generally hurt the suppliers of the issuer's other factors of production. For an issuer of a given nationality, its entrepreneur is likely to be of the same nationality as are most of its shareholders and other factors of production. Thus, the regulating country will be primarily concerned with perceptions of unfairness in the trading of issuers of its own nationality.

Unlike the first two rationales, the third rationale does not form a strong basis for a country to extend an insider trading ban to transactions in the shares of foreign issuers, even where the insider places his order on one of the regulating country's exchanges and the trade is with one of the regulating country's residents. This is because the third rationale does not have a true investor protection focus; rather, it focuses on the harm that the practice of insider trading causes to issuers as a class and to the moral fabric of society.²⁸

The intensity with which the regulating country is concerned with transnational transactions in shares of its issuers depends on why insider trading is perceived to lead to unfairness. Assume first that the perception is that the risk of harm from insider trading is the risk that the outsider might unwittingly deal with an insider at a time when the insider possesses material nonpublic information.²⁹ In that case the regulating country would want to extend its ban to preclude the use of inside information by insiders of its issuers in trades with foreigners on foreign exchanges. Failure to do so would discourage foreign investors from trading in the shares of the country's

practice). But see *Case concerning the Barcelona Traction, Light and Power Company, Limited (New Application: 1962) (Belgium v Spain)*, 1970 ICJ 4.

27. In 1989, profits from foreign operations of U.S. corporations amounted to only about one-sixth of all corporate profits. See NIPA Table 6.18B, 71 *Surv Current Bus* No 10 at 13 (Oct 1991). Overseas assets of even U.S. corporations designated as "multinational" were only about one-fifth of their total assets, see Jeffrey H. Lowe & Raymond J. Mataloni, Jr., *U.S. Direct Investment Abroad: 1989 Benchmark Survey Results*, 71 *Surv Current Bus* No 10 at 29 (Oct 1991) (data from Table 1).

28. Of course, one could argue that the failure to include these transactions within the ban will lead to social demoralization, since the country's exchanges would be perceived to be a place where unfair transactions could occur. But the case is not strong, given that investors would be on notice that trading in the shares of foreign issuers would involve this risk, that there are a multitude of domestic stocks available in which to trade without the risk, and that the practice involves behavior by foreign persons (the insiders) concerning their operation of a foreign corporation.

29. This perception parallels the first rationale for banning insider trading.

domestic transactions and all transnational transactions in shares of issuers of its nationality. Again, the regulating country will not be concerned with any transaction in shares of an issuer of any other nationality, even when the other party—the outsider—is one of the regulating country's residents, or when the transaction is effected on one of its exchanges.

1. *The Uncertain Discount for Insider Trading.* Remember that if insider trading is allowed, some investors at least, when considering whether to buy shares of an issuer, will estimate the expected trading profits (discounted to present value) over the life of the firm that insiders will capture as a result of trading on inside information.³¹ While such investors may be working with incomplete information concerning the levels of insider trading likely to occur in the shares of available issuers, no reason exists to believe that the inferences that each draws from this information will be systematically biased, that is, result in his consistently over- or underestimating the amount that ultimately occurs.³² As a consequence, just because insider trading is allowed and investors are uncertain of how much to expect in the future, there is no reason to expect the market prices of such issuers' shares are biased,³³ that is,

31. See note 16.

32. In a world in which insider trading is legal, an issuer's management, of course, may still not be forthcoming about its proclivity to engage in the practice or its particularly well-informed view as to the likelihood of opportunities to do so over the remaining life of the issuer. And it may not promise to keep in place mechanisms to detect accurately and report publicly the insider trading that does occur. The investor, however, can draw inferences from the fact that management chooses not to say more about its proclivities and opportunities, or if it instead puts such mechanisms in place and promises to maintain them.

The proposition here is that even where management has not commented on a matter, the speculator on average guesses correctly. The idea behind the proposition is that each speculator's expectations concerning a share's future returns are based on the particular bits of information within his possession. Nothing structural in the process that determines the information received by the speculator would lead him to underestimate or overestimate the value of a share's future returns; thus there is no reason to believe *ex ante* that the flow of bits of information that each speculator receives will bias that individual's expectations concerning future return. The actual bits received may lead to an underestimate or overestimate of value in any particular assessment but, just as in sampling, which direction the estimate errs is purely a matter of chance. For an elaboration of the view of how investors form their subjective probability distributions concerning the future returns of securities, see Merritt B. Fox, *Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy* 75 (Columbia U Press, 1987).

33. A variety of theories exist regarding price formation in markets where investors have heterogeneous views concerning the probability distribution of the future values of the available securities. See, for example, John Lintner, *The Aggregation of Investor's Diverse Judgments and Preferences in a Purely Competitive Securities Market*, 4 J Fin and Quantitative Anal 347 (1969) (prices reflect a weighted average of the views of all investors); Sanford J. Grossman, *On the Efficiency of Competitive Stock Markets Where Traders Have Diverse Information*, 31 J Finance 573 (1976) and Sanford J. Grossman, *Further Results on the Informational Efficiency of Competitive Stock Markets*, 18 J Econ Theory (1978) (final equilibrium market prices reflect the most accurate possible prediction of future value given all information possessed by any one or more investors as a result of each investor "reading" the information possessed by the others through observation of the movement of market prices toward equilibrium); Robert E. Verrecchia, *On the Theory of Information Efficiency*, 1 J Acct & Econ 77 (1979) and Robert E. Verrecchia, *Consensus Beliefs, Information Acquisition, and Market Information Efficiency*, 70 Am Econ Rev 874 (1980) (prices average the views of investors in such a way that they are more accurate than the forecasts of any individual investor); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J Pol Econ 110, 112 (1965) and Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1165 (1981)

differ *on average* from their “actual values” (the future streams of income—dividends and other distributions—accruing to their holder, discounted to present value³⁴). Empirical literature testing the efficient market hypothesis, although involving the ability of the market to process a different type of information and testing immediate price reaction against longer-term prices (rather than against actual value), is consistent with the proposition that the market reaction to the possibility of insider trading would also be unbiased.³⁵

While the prospect of insider trading will not bias share prices, it will render them less accurate. Lack of bias and accuracy are two different things. A share price can be unbiased—no more likely to be above than below the share’s actual value—but still have a low expected accuracy in the sense that there is a significant likelihood that it will deviate substantially one way or the other from the actual value.³⁶ The possibility that insiders will trade in some uncertain future amount simply adds another consideration in estimating what future return an investor may expect from purchasing a share, and increases the chance that the overall estimate will be well off the mark.³⁷

(any investor possessing a new bit of information will trade to his profit on it until the price moves to the point when there are no more profits to be made because the information is fully reflected in price). Whatever theory one embraces, however, if the view of each individual investor is unbiased in the sense that the term is used here, whatever the relative roles of different investors in determining price, the price will be similarly unbiased.

34. This definition of actual value requires an *ex post* view to be operative. A real world investor at any given date, equipped only with the incomplete information available to her at that time, must guess what a share’s actual value is as of that date. For an elaboration of this concept and its relationship to market price, see Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 Va L Rev 1005, 1010-14 (1984).

35. A large body of financial economics literature evaluates the market reaction to the public announcement of various types of events affecting particular issuers. For a review, see Kenneth D. Garbade, *Securities Markets* 249-59 (1982). An “event study” involves a large number of issuers, each of which has at one time or another experienced the announcement of a particular type of event (a stock split, for example). The typical study demonstrates that the shares of the affected firms as a group experience statistically significant abnormal returns at the time of the announcement and, starting almost immediately thereafter, normal returns for the duration of the study, which is sometimes as long as several years. Thus, while some issuers’ share prices rise in the period following the announcement (compared to the market as a whole), and others fall, the average change is near zero. Assuming that longer term prices are themselves an unbiased measure of actual value, the results of the studies are thus consistent with the concept that the market’s evaluation of the significance of the event for the actual value of each issuer’s shares, while it may have sometimes have been too high and sometimes too low, was unbiased.

36. To put this concept of expected accuracy in statistical terms, consider price to be a random variable generated by a distribution function with a mean equal to actual value (reflecting the fact that the price is unbiased). A good measure of the price’s expected accuracy would then be the variance of the distribution—the expected value of the square of the deviation from actual value. The smaller the variance, the greater the price’s expected accuracy.

37. This is true even when the extent of insider trading is independent of all the future events of less-than-certain probability that could affect firm income. A very simplified analogy can be drawn to a fair coin toss experiment, where each flip is the determinant of whether a different independent event occurs. A head represents a positive outcome (the occurrence of the event if it is positive and the nonoccurrence if it is negative) that affects the value of the share and a tail a negative outcome. All events have the same magnitude of effect on the ultimate value of holding one of the firm’s shares. The effect on price of each of these possible events (ignoring risk aversion and the time value of money) will be exactly half the effect on value if the event ultimately occurs. The variance—the measure of the expected divergence between current price and actual value, and hence of price inaccuracy—is proportional to the number such events or coin flips. Adding insider trading in an

2. *Speed of Price Adjustment to New Information.* Permitting insider trading will also have mixed effects on the speed with which share prices adjust to new information developed within the firm. This can be demonstrated by elaborating the hypothetical above involving the discovery of a major ore body by Americo executives:

Americo has an interest in keeping the information secret while it acquires options to purchase the mineral rights in the land, options that would be far more expensive if the sellers knew the information the company geologists had labored to discover. But secrecy has disadvantages. During the six-week period following the discovery, while the information is undisclosed, Americo's share price of about \$100 is grossly inaccurate, as it is well below the \$150 price that the market, once it has become informed, will ultimately indicate is its best estimate of actual value.

Permitting insider trading can help resolve this dilemma because insider trades will help move the share price toward \$150 without requiring disclosure of the mineral ore find.³⁸ In the hypothetical, the extra demand created by the president's purchase pushes the price up five dollars to \$105.³⁹ A more complex model of securities pricing would predict that this increase would be just the first wave. As professionals observe the orders and price movement, they will speculate that someone is in possession of positive information, and bid the price up further.⁴⁰

amount that cannot be determined with certainty (less trading would be the event that is the positive outcome) is simply another event that adds to expected price inaccuracy.

38. This idea was first suggested by Henry G. Manne. Henry G. Manne, *Insider Trading and the Stock Market* 79 (Free Press, 1966).

39. Many financial economists argue that an increase in demand will not by itself cause an increase in price because the supply curve of the security is essentially horizontal. The theory behind this argument is based on the Capital Asset Pricing Model. The idea here is that the security is priced entirely on the basis of its Beta (the measure of the relationship of its risk to that of the market as a whole), and since there is a large number of securities with approximately the same Beta, the supply of such shares is almost infinite. Under this theory only information moves prices.

The problem with this theory is that it does not explain exactly how information, when it is not instantaneously distributed to all participants, moves the price. It must depend on the action of speculative investors (which may include specialists in the stock). I have argued elsewhere that portfolio choice theory suggests that each speculative investor has a downward-sloping demand curve (and hence an upward-sloping supply curve) for a given security because the more that is acquired based on information that is not yet fully reflected in price, the more undiversified the investor becomes. Merritt B. Fox, *Finance and Industrial Performance* at 36-43 (cited in note 32). See also Lynn A. Stout, *Are Takeover Premiums Really Premiums: Market Price, Fair Value, and Corporate Law*, 99 Yale L.J. 1235, 1239-58 (1990).

The issue is difficult to sort out empirically because the placement of a large order of securities in and of itself contains information (see note 40). Myron Scholes found that the price-depressing effect of a substantial secondary offering of securities was not proportional to the size of the offering, and concluded that this was evidence that the supply curve was horizontal. Myron S. Scholes, *The Market for Securities, Substitution versus Price Pressure and the Effects of Information on Share Prices*, J. Business 179-211 (1972). On the other hand, the very existence of "dutch auctions," in which corporations that self-tender for their stock get bids at different prices, strongly suggests that different investors value the stock differently.

40. This is what Gilson and Kraakman refer to as "derivatively informed trading." Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va L. Rev. 554, 564 (1984).

Permitting insider trading, while reducing the magnitude of the divergence between price and value, may at the same time prolong it. Until the information becomes known, at least by the professional investment community, it will not be fully reflected in price despite insider trading.⁴¹ In the hypothetical example, the choice of March 15 as the date of public announcement may represent a delay of a couple of days to give the president time to make his inside trades.⁴² The delay in another situation could be much more significant. If the president and other insiders all intend to trade, and want to avoid placing too many buy orders on any one day (so that professional investors will not start drawing inferences from the pattern of trading), the delay will be much longer. Also, much of the news developed within a corporation will not injure the corporation if it is immediately released. For this information, permitting insider trading simply delays release without any corresponding benefits.⁴³

3. *Effects of Share Price Accuracy.* This article has established some kind of relationship between insider trading and share price accuracy. But, without an understanding of the effects of more versus less accurate share prices, a regulating country cannot determine whether it wants to base an insider trading policy on that relationship and, if so, to which transnational transactions it should apply its regime.

a. *Investor welfare, assuming no effect on real resource allocation.* Investors are typically described as concerned with expected return and risk. Assume for a moment that insider trading will have no effect on the allocation and use of real resources and hence on the size of the aggregate income stream generated by a country's corporations. Since neither uncertainty over the appropriate discount to compensate outsiders for insider gains at their expense, nor a generally slower speed of price adjustment to new information developed within the firm will bias share prices, expected return will not be affected by the presence or absence of insider trading. Risk is more complicated. If the price of an issuer's shares has lower expected accuracy, it will display more volatility over time because, on average, it has further to go in its movement toward actual value.⁴⁴ Thus, investors holding shares of just

41. Id at 572.

42. Out of fear that his share purchases might ignite rumors that would affect the sale price of the mineral rights that Americo is seeking, the president might delay the share purchases until all of the mineral rights options had been obtained.

43. It can be argued, however, that the fact that the corporation would suffer no injury from immediate release does not guarantee that the corporation will in fact immediately release it. Management might have other reasons to keep it secret, and do so for a considerable period of time. In that event, permitting insider trading might nevertheless actually accelerate disclosure; the insiders will want to trade on the information as soon as possible, and, once they have traded, they will be strongly motivated to announce the news so that they can lock in their profits through reverse transactions.

44. If an investor holds the share for the life of the firm, she will ultimately receive the actual value of the share, that is, the aggregate shareholder distributions paid out over the rest of the life of the firm, discounted to present value. Greater expected share price inaccuracy means a greater

one issuer will be harmed by the added volatility resulting from insider trading. But shareholders who hold a portfolio divided among a number of stocks will not be harmed because the added risks from insider trading are primarily firm-specific, and thus will be diversified away.⁴⁵

b. *Allocation of real resources.* Contrary to the assumption above, inaccurate share prices generally do affect the manner in which resources are allocated, and hence reduce investor welfare generally by reducing the size of the aggregate corporate income stream. Inaccurate share prices damage economic efficiency in at least three ways. First, inaccurate share prices reduce the likelihood that resources will be allocated to implement the most promising real investment projects available in the economy. This is most obvious in the case of new firms considering issuing equity to finance their initial proposed projects: if firm B's project is superior to firm A's, but firm A's shares are overpriced and firm B's underpriced, A's entrepreneur may be induced to proceed while B's may be unable to obtain sufficient financing to implement hers. Inaccurate prices also cause misallocation among projects being considered by established firms. Most finance economists believe that if an established firm acts to maximize share value, share price will enter into its calculation of its cost of capital. This will be true however the project might be financed.⁴⁶ Too high a share price will result in an artificially low cost of capital calculation, and can lead to the implementation of a project less promising than ones that other firms reject; too low a share price can have the opposite effect.

Second, inaccurate pricing decreases the feasibility of share price-based compensation, with its positive incentives for management to make share value maximizing decisions. Managers are risk-averse, and their job

expected deviation—plus or minus—between share price and actual value, between what the holder pays and what she receives.

If an investor holds a share for less than the life of the firm, what she ultimately receives is a combination of the aggregate shareholder distributions until she sells and the share price at the time she sells. That combination, discounted to present value, will be closer to actual value than is the purchase price (whatever its level of expected inaccuracy) because (1) the shareholder distributions received during the holding period are in fact part of the actual value calculation, and (2) the market price later in time will be closer to the value of the remaining distributions because it will include the additional information that becomes available about the world as the future unfolds. Thus, again greater share price inaccuracy will lead to a greater expected deviation—one way or the other—between what the investor pays and what she receives.

45. Barbara A. Banoff, *Registration Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 Va L Rev 135, 182-183 (1984); Fox, 70 Va L Rev at 1012-14 (cited in note 34).

It is possible that uncertainty about the extent of future insider trading in the shares of individual issuers could contain a significant market-wide element. The market might under- or overestimate the extent of insider trading as a general managerial practice, as well as under- or overestimate the particular tendencies of the management of any given firm to trade more or less than the average. If that were the case, part of the uncertainty about how much insider trading the managers of any one issuer will undertake cannot be diversified away. Insider trading would then add to the risk of investing in the market as a whole and hurt the welfare of all investors. However, feedback on the extent of insider trading as a general managerial practice is likely to be clearer than that on individual firm managements, so this uncertainty is likely to diminish over time.

46. For an expanded discussion of the effect of share price accuracy on allocation of resources for real investment, see Fox, 70 Va L Rev 1005 (cited in note 34).

compensation is too big a portion of their total income to be able to diversify away much of the risk associated with that compensation. Share price inaccuracy leads to greater volatility over time because the share price has further to go in its movement toward actual value. Thus, the more inaccurate are share prices, the less attractive managers find a share price-based compensation package with a given expected return in comparison to the alternative of straight salary of the same amount.

Finally, inaccurate prices undermine the market for corporate control. Less accurate prices make the investment involved in the acquisition of a target riskier; the discounted cash flows ultimately generated by the acquired assets are more likely to deviate significantly one way or the other from what must be paid for them. An acquisition investment is often sufficiently large relative to, and sufficiently similar in kind to, the assets of the acquiror that a substantial portion of the added risk from this less accurate price will not be diversified away when the cash flows from the assets of the two companies are combined. Managers of acquiring firms, like managers generally, are risk-averse. Typically their level of income and wealth is tied to the earnings of their firm. As a result, with less accurate prices, they will insist on a greater level of target firm mismanagement (that is, a greater potential for improved performance) before they will find a takeover worthwhile.⁴⁷ In this way, inaccurate prices undermine the effectiveness of both the mechanism by which incompetent management is replaced and the threat that makes competent management work in shareholders' best interest.⁴⁸

c. *The peculiarities of insider trading-induced price inaccuracy and inefficiency.* The discussion so far has concerned the general effect of share price accuracy on investors and on real resource allocation, whatever the factor increasing or decreasing that accuracy. But the regulating country is specifically concerned with changes in share price accuracy caused by insider trading. And these changes have characteristic features.

(1) *Uncertainty about the appropriate discount.* It seems incontrovertible that uncertainty about the appropriate discount where insider trading is permitted will reduce price accuracy over both the short and long term, since feedback on the amount of insider trading that actually occurs over time is ambiguous.⁴⁹ This inevitably will result in the three kinds of efficiency losses

47. Even where the potential acquiror's management knows (or is fairly certain of) the facts that are not reflected in price, inaccurate prices hurt the functioning of the market for corporate control. Inaccurate prices increase the chance that poorly run firms are priced above actual value and, as a result, are not as profitable acquisitions for the better managers, who would otherwise be induced to take them over. Thus, fewer such firms will be taken over.

48. How important these three kinds of damage are to the regulating country—and hence their relevance to its choice of insider trading regime—depends significantly on the country's institutional corporate governance structures. It would appear, for example, that the damage would be greater in the United States and Great Britain, where the mechanisms that are damaged play a large role, than in Japan or Germany, where they do not.

49. See, for example, Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 Fordham L Rev 309, 314 (1989) (no reliable estimates of amount of

discussed immediately above.⁵⁰ Thus, this phenomenon should be given serious weight in the overall decision whether or not to ban insider trading.⁵¹

(2) *Speed of adjustment* The effects of insider trading on the speed of price adjustment do not deserve similar weight. As noted above, the effects work in both directions, and the net result—whether insider trading increases or decreases the speed of adjustment—is open to debate. Even if the net result is positive, it is likely to add little to overall efficiency. A failure of share prices to react immediately to changes in what the best existing information says about share value is simply not essential for the efficiency mechanisms described above to function reasonably well.

Consider first the choice of the most promising proposed real investment projects. No public market will exist for shares of new firms desiring to undertake new projects; thus, no share price adjustments to new information can be accelerated by insider trading. The management of established firms desiring to undertake new projects can adjust the share prices they use in calculating cost of capital to account for nonpublic information that is not reflected in price. Thus, rapid price adjustment to reflect this information is not necessary for this calculation to be accurate.

Furthermore, where public sales of equity are actually used to raise the funds, other regulations are likely to assure that the information is reflected in price. In the United States, for example, section 11 of the Securities Act of 1933 imposes strict liability on issuers, and strict liability, subject to a due diligence defense, on directors, high executives, and underwriters, for material omissions in the registration statement.⁵² This renders the speed of adjustment prior to the offering irrelevant because, at the time of the offering, it is very unlikely that there will be any negative material nonpublic information in the hands of management. Because of these regulations, positive information that is best kept temporarily undisclosed (like Americo's ore discovery) may require a delay in the sale of equity, but, given other

insider trading exist); *MacNeil/Lehrer News Hour* (PBS television broadcast, May 22, 1986) (interview of Gary Lynch, head of enforcement for the SEC: "It's impossible to estimate the amount of fraud that goes on."). These problems do not prevent observers from trying to guess, however. See Fred R. Bleakley, *Wall St. Worries Over Insider Leaks*, *NY Times* D1 col 4 (Jan 25, 1985) (some bankers and traders estimated that the amount of insider trading profits in takeover stocks alone over a four year period at "significantly more" than \$100 million); *Trading Pattern Enabled SEC to Break Levine Insider Case, Lynch Tells Panel*, 18 *Sec Reg & L Rep* (BNA) 889 (1986) (SEC Chairman John S.R. Shad estimated fraudulent securities transactions, of which insider trading is but one of many activities, at a "tiny fraction" of one percent of the \$50 billion of daily trades).

50. See Part IID3b.

51. It is possible, of course, that the diminution in the three kinds of efficiency losses that can be effected by the ban is smaller in total than the cost of its administration. If that can be shown, uncertainty about the extent of the appropriate discount is not a sufficient justification, by itself, to impose the ban. There is also the possibility that countervailing benefits exist from permitting insider trading, either in terms of speed of price adjustment or incentives that make firms more production-efficient. If there are, these benefits would also have to be factored into the equation. The discussion below, however, suggests on a priori grounds that the speed of adjustment benefits, if any, are small, and that the production efficiency incentives are negative.

52. 15 USCS § 77k (Law Co-op, 1991).

available methods of raising interim funds, this should not represent a real problem to the firm.

Moderate delays in price adjustment will also not seriously add to the riskiness of share price-based compensation. When managers are awarded such compensation, the directors, and often also the managers, know if undisclosed information exists that would lead to a discrepancy between current price and value, and can calculate the expected value of the package as accurately as if the information were already impounded in price.⁵³ The role of speed of adjustment at the time the managers convert their stock price-based compensation into cash is more complex. Where a manager actually owns shares, speed of adjustment is not too important because he can control the time of sale.⁵⁴ Where stock options, stock appreciation rights, or other schemes are involved, slower price adjustment may add to the riskiness of payout because the moment of realization may in part or in whole be controlled by some formula implemented either at the initiative of the firm or, in the United States at least, to avoid a return of profits under section 16(b) of the Securities Exchange Act of 1934.⁵⁵

Moderate delays in price adjustment also would not significantly affect the market for corporate control because by the time the acquiror becomes unconditionally bound to buy at a given price, there is unlikely to be undisclosed information that otherwise might have been reflected in the price at which shares trade. Control transactions typically take months between initiation and the moment at which the acquiror is unconditionally bound. By that point, material information nonpublic at the time of initiation will usually have been made public by the ordinary processes of corporate disclosure. Furthermore, in friendly deals, the acquiror can perform a due diligence investigation of the target. In hostile deals, the management of a target company normally is forced, as part of the defense, to make affirmative statements about the firm. Such statements are likely to trigger a legal

53. Even where an incumbent manager is not aware of the undisclosed information, he will learn about it quickly, and will know that the directors knew about it at the time of the award. So, unless the package must have a certain expected value or the manager will leave immediately, the delay will be of no consequence. This is because, where the manager is not at the edge of quitting, the functions of a larger package are to shape the manager's longer-term attitudes toward staying with the firm and to act as a spur to more junior managers.

The delay in speed of adjustment will matter in the case of a package offered to a new person whom the board is trying to attract, since she will not come unless the package is sufficiently attractive to her. Her knowledge that share price adjustment is slow will render a package that appears to have a given expected return less attractive to her because it possesses greater inherent risk.

54. Where a discrepancy exists between price and value because of undisclosed positive information, he will prefer to, and usually can, wait until the time of disclosure. Where there is a discrepancy because of undisclosed negative information, he will be forced to wait if there is a ban on insider trading. Either way, a ban does not add to the riskiness of his payoff even if the ban delays price adjustment; he will normally trade at a time after the adjustment has been made.

55. 15 USC § 78 (1988).

obligation to reveal much of the target's undisclosed information to render the affirmative statements made not misleading.⁵⁶

4. *Implications for the Reach of National Prohibitions.* The preceding discussion assumes a purely domestic economy. What happens when we introduce into this model foreign direct investment and transnational portfolio investment? If both were sufficiently extensive, the concept of a national economy would become empty, and attempts at national regulation an exercise in frustration. But we are yet far from that point. As discussed above, the bulk of economic activity is still undertaken by issuers sufficiently associated with one nation to be considered its national. Thus, it is the share price accuracy of that nation's issuers that will largely determine how closely the investment projects actually implemented in that country correspond to the list of proposed projects that would have ultimately produced the highest returns. It is also the share price accuracy of that nation's issuers that largely determines how well the implemented projects are managed.

Moreover, if the shares of issuers of the regulating country's nationality have more accurate prices, the primary beneficiaries from the better choice of projects and better management will be the regulating country's residents. Residents of the regulating country are likely to have been the founding entrepreneurs of the companies, to hold the largest portion of their shares, and to supply the largest portion of their other factors of production. The increased cash flow generated by the resulting better choice of projects and better management will be divided between these entrepreneurs and the initial public shareholders of these firms.⁵⁷ The suppliers of the other factors

56. Both § 14(e) of the Securities Exchange Act of 1934 (which relates to statements made in connection with tender offers) and Rule 10b-5 prohibit omission "to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." No duty exists for a target company to make statements in response to a hostile tender offer; however, once it does so, "it assumes the responsibility of disclosing relevant information." *Berman v Gerber Products Co.*, 454 F Supp 1310, 1325 (WD Mich 1978). A similar responsibility exists under Rule 10b-5 when statements are made. See *Basic Inc. v Levinson*, 485 US 224, 238 (1988) (corporations need not trade to be held liable; any material statement that is "false or incomplete" may justify liability under Rule 10b-5); *SEC v Texas Gulf Sulphur Co.*, 401 F2d 833, 862 (1968) (Rule 10b-5 is violated when statements are made "in a manner reasonably calculated to influence the investing public, . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes."); Jacobs, *Litigation and Practice* § 88.04[b] at 4-18 (cited in note 5).

57. If world capital markets were perfectly integrated and perfectly competitive, just one global risk-adjusted rate of return would exist. Investors in the regulating country would not receive a higher rate of expected return, even if their country made better choices among its proposed projects and they concentrated their investments in issuers of their nationality; they would receive only the global expected rate of return. In that perfectly integrated and competitive world, entrepreneurs in the regulating country would receive all the gains from the better choices and better management, through better terms at the time they take their firms public. In fact, the world's capital markets do not appear completely integrated. Kenneth French & James Poterba, *Investor Diversification and International Equity Markets*, 81 Am Econ Rev Papers & Proceedings 222 (1991); Merritt B. Fox, *Regulating Securities Disclosure in a Globalizing Market* 24-30 (paper presented at The University of Michigan Law and Economics Workshop on April 16, 1992) (unabridged draft). Thus, a portion of the gains from better choices and better management would benefit the initial public shareholders.

of production probably also realize higher returns from better project choice and management.⁵⁸

This suggests that the regulating country will be concerned with the share price accuracy of the issuers of its nationality. If the regulating country concludes that insider trading impairs price accuracy, it would want its ban to extend beyond purely domestic transactions in these shares. The prospect of transactions by insiders using inside information where the other party to the transaction is a foreign resident and the transaction is effected on a foreign exchange has just as great a negative impact on share price accuracy as does the prospect of a purely domestic insider transaction.⁵⁹

Should the regulating country embracing the "price accuracy" rationale for prohibiting insider trading extend the reach of the ban to trades by insiders of foreign, as well as domestic, issuers, at least where the trades are effected on the regulating country's stock exchange, and where the other party is one of its residents? An allocation of resources argument for doing so is unpersuasive. Residents of the regulating country do not have a substantial stake in how well projects are chosen and managed in other countries.

However, insider trading-induced price inaccuracy also increases the risk associated with holding shares of a single issuer, and causes welfare losses for investors who in fact hold just one or a few securities.⁶⁰ On the surface, increased risk would appear to be a better justification to extend the reach to trades by the insiders of foreign issuers. Upon examination, however, it too is unpersuasive, except where the regulating country's ban essentially represents a cooperative substitute enforcement mechanism for the foreign country's attempt to ban worldwide insider trading in its issuers' stock. A ban by the regulating country alone on trades effected on its stock exchanges would not significantly reduce the price inaccuracy effect of insider trading. Banning it in the regulating country would simply move the trading elsewhere.

The regulating country could itself attempt to enforce a worldwide ban on insider trading in the stock of the foreign issuer. But it does not seem appropriate to do so simply because some of the regulating country's

58. I have analyzed elsewhere in detail why this is likely to be the case. Better capital allocation can be analogized to innovation because it increases the amount that can be produced from a fixed stock of factors of production. If the better capital allocation is like capital-saving or factor-neutral innovation, the absolute return to labor (the surrogate for all other factors of production) is bound to increase. Even if it is like labor-saving innovation, empirical evidence concerning the prevailing elasticities of substitution in the developed nations of the world suggest that the absolute share to labor would still increase. Fox, *Regulating Securities Disclosure in a Globalizing Market* at 60-74 (cited in note 57).

59. There is formal symmetry to this line of reasoning if the regulating country decides that unfettered insider trading aids price accuracy. It would want insiders to be able to trade in the shares of its issuers anywhere. The intensity of this desire, however, is not symmetrical to the situation where the regulating country decides that insider trading is harmful. Where insider trading is desired, the inability to trade on foreign exchanges is only a minor inconvenience. Where insider trading is not desired, the ability of an insider to trade on a foreign exchange can be a major breach in the defense.

60. See Part IID3a.

investors might benefit. The issuer's country, where far more of the persons who will enjoy any benefits from the ban, apparently either does not believe a ban beneficial or does not believe it is worth the cost. Furthermore, the justification for the regulating country to regulate the foreign issuer is particularly weak. The regulating country's investors as a group are not blocked by the added risk from the opportunity of investing in an unusually high expected return stock (if in fact that is the case). They simply should protect themselves by only investing in the stock as part of a well diversified portfolio.

E. Firm Performance

The final category of rationales as to why insider trading should or should not be banned is that the availability of the practice affects managerial behavior such that, depending on the rationale, firm performance is decreased or increased.

1. *Direct Incentives.* In the mid-1960s, Henry Manne started a still-unresolved debate by arguing that to permit insider trading would help align the interests of shareholders and management by providing incentives for managers to be "entrepreneurial."⁶¹ Managers would labor to create events that represent "good news" because they would know of their creations first, and be able to trade on that information to their profit. Thus in our hypothetical, Americo might never have discovered the mineral ore deposit if the president, attracted by the lure of the profits that he ultimately did receive, had not devised a business strategy emphasizing exploration.

The first criticism of Manne's idea is that since insiders can profit from trading on negative as well as positive information, the availability of insider trading creates as much incentive to run the company into the ground as to take it to the sky. It is a "gain neutral" practice. While one may argue that other pressures are likely to cause managers to choose the sky over the ground,⁶² the criticism shows that the important incentive created by permitting insider trading would not be to make better business decisions, but to make riskier ones. This incentive might be simply a healthy antidote to the natural tendency of managers to be more risk-averse than is in the shareholders' best interest, but it might also represent an overdose that leads

61. The function of the entrepreneur is to innovate. To achieve this goal, according to Manne, the method of compensation should allow the individual to reap the benefits of his contribution, while not requiring a large, long-term investment. Clearly this cannot simply be budgeted, as value of the innovation cannot be accurately estimated in advance. Manne also dismisses salary as the sole compensation for the entrepreneur because it does not account for the value of the contribution. Similarly, a bonus plan must be calculated on an annual basis, while the innovation's true value may not be apparent for a number of years. The only compensation scheme that fulfills all of these requirements, according to Manne, would be to allow insider trading, through which the entrepreneur could himself value his contribution, and reap that reward. See Manne, *Insider Trading* at 131-43 (cited in note 38).

62. See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan L Rev 857, 872-75 (1983).

managers to make decisions that are highly risky, even if they have a lower expected return than those that are less risky.

A second criticism of the entrepreneurial incentive idea is that even if the direction of the incentives created by insider trading is positive, the persons actually responsible for creating the positive events are likely to receive only a small portion of the total trading profits made on the news. Thus, as an incentive device, most of what outside shareholders give up because of insiders' trading profits is wasted.

2. *Quality of Compensation Package.* It might be argued that even if only a small percentage of the trading profits go to those who actually create the news, the remainder is not wasted because it constitutes an alternative form of compensation that is as attractive as straight salary. This is simply not true. Permitting insiders to trade on inside information involves an inefficient allocation of risk between management and shareholders. Consider two compensation packages: one is straight salary with no right to inside trade, and the other is a combination of a lower salary and the right to engage in insider trading. The salary is set in the second package so that both packages have an equal expected value, and hence an equal expected cost to shareholders. Shareholders will have no preference between the two packages because, given their ability to diversify, they are risk-neutral with respect to these sorts of risks.⁶³

Managers, however, are risk-averse with respect to possible variation in their job compensation. Since job compensation forms a large portion of their total income, any risks associated with it cannot be diversified away. Thus, managers will find the package with insider trading, which has various possible levels of actual payout, inferior to the straight salary package, which is risk free. Stating this concept in another way, for a package including insider trading to be equally effective in attracting and retaining managers, it must possess a greater expected value, and hence a greater expected cost to shareholders, than a straight salary package.

3. *Organizational Effects.* One might also argue that the criticism that only a small portion of the insider trading gains are likely to go to the managers actually responsible for creating the positive events giving rise to the gains fails to recognize that corporate management makes decisions as a team and that insider trading can reward the team as a whole. But again that argument raises another serious problem with permitting insider trading in the first

63. The first package involves more risk to shareholders since they receive the residual of the firm's cash flow after payment of the fixed salary, and thus bear the brunt of any downswing and enjoy all of any upswing. The second package, by permitting insider trading on positive information, involves the insiders taking less (because the straight salary is less) in the event of future states of the world that result in, or suggest, a cash flow that is lower than or equal to what is expected at the time the compensation package is set, but insiders sharing in the gain from certain future states of the world that result in or suggest a greater cash flow. These are the states of nature about which insiders would receive advance notice. The events about which insiders would tend to have advance notice are likely to be firm-specific, and thus the associated risk can be diversified away.

place. The problem is the effect that insider trading will have on the manner in which the members of the managerial team relate to each other, and hence on the team's organizational performance. Robert Haft, for example, has demonstrated that the ability to engage in insider trading creates an incentive for team members at each level to delay and, perhaps, to distort information as they pass it up the corporate ladder.⁶⁴ This not only directly injures internal communication but, when combined with the competition to trade early in order to reap the greatest profits, is likely to breed distrust among team members. Even in the unlikely event that the team could develop mechanisms that divided the potential gains from insider trading in some organized manner, the institutionalization of the practice would be likely to represent an unhealthy distraction from the real job of team members: to manage the firm in a manner that uses current assets as profitably as is possible, and that searches effectively for the most promising new projects.

4. *Implications for Transnational Reach.* The overall impact of the arguments raised in objection to Manne's claim that insider trading creates a useful incentive for managers to be more entrepreneurial is that it in fact may be harmful to firm performance. A country embracing this dimmer view must decide to which transnational transactions, if any, it should apply its ban. The answer again must be all transnational transactions involving issuers of its nationality.⁶⁵ As indicated above, the analysis is the same as with the price accuracy rationale for the ban.⁶⁶ Trades by insiders using nonpublic information, whether involving purely domestic or transnational transactions, are equally damaging to firm performance. Improving the performance of firms of the regulating country's nationality will benefit primarily the country's own residents, since they constitute most of these firms' entrepreneurs, outside investors, and suppliers of other factors of production. Banning trades by insiders of issuers of other countries, even when effected on the regulating country's exchange and with one of its residents, will not, absent a worldwide ban on such trades, significantly reduce the incidence of such trades, and hence improve the performance of such issuers.

F. Illustrative Hypotheticals

The five rationales explored in this Part each justify a U.S. ban on the president's purchases in the purely domestic American hypothetical. The question is whether, under each of these rationales, the U.S. ban should apply as well to such purchases in transnational transactions. Three hypotheticals illustrate.

64. Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich L Rev 1051 (1982).

65. A country embracing Manne's view would, as in the price accuracy example, desire a regime that promoted unfettered insider trading in the shares of its issuers. At least as a formal matter, it also would desire its regime to apply globally for its issuers. As a practical matter, application of its regime only domestically would probably be sufficient to meet its goals. See note 59.

66. See Part IID4.

The facts of the first hypothetical are the same as those of the Americo hypothetical with the following changes:

The corporation, Deutschco, is incorporated in Germany, and has its headquarters and the bulk of its operations in that country. Its shares are listed on both the Frankfurt exchange and the New York Stock Exchange ("NYSE"). On an average day, about ninety percent of the trading volume in Deutschco shares occurs on the Frankfurt exchange and about ten percent on the NYSE. About ten percent of Deutschco's outstanding shares are owned by U.S. residents, almost all of whom buy and sell their shares on the NYSE. The president, a German national and resident, places his orders on the Frankfurt exchange. Five hundred of the shares acquired by the president are sold on the Frankfurt exchange to him by Mr. Schmidt, a German national and resident. As in the Americo hypothetical, Mr. Jones, a U.S. national and resident, sells 500 Deutschco shares on March 13 on the NYSE.

If the United States relies solely on the "fairness with whom you deal" rationale for its ban on insider trading, it should not apply the ban to the president's purchases. The issuer is a German, not a U.S., corporation, and thus applying the ban here is not needed as a reinforcement of other strictures protecting U.S. corporations from self-interested behavior by their insiders. No or very few U.S. investors are likely to have sold Deutschco shares on March 13 and 14 on the Frankfurt exchange, the place where all the shares acquired by the president were sold. The persons with whom the president deals are akin to Mr. Schmidt, not Mr. Smith. Thus, no significant number of U.S. residents were treated "unfairly" by the president, as that term is understood under this rationale.

In contrast, if the United States relies solely on the "fairness to the traders generally" rationale, it should apply the ban. Again, because Deutschco is not a U.S. corporation, there is no need to apply the ban simply to reinforce other strictures protecting U.S. corporations from self-interested behavior by their insiders. But ten percent of Deutschco shareholders are U.S. residents. Each is as likely to be lured into selling by the president's purchase as to be lured into selling shares they hold of a U.S. firm where an insider buys under similar circumstances. Hence they are in equal need of protection. For example, Mr. Jones is injured as a result of the president's actions (for the same reasons that he is injured in the Americo hypothetical), even though he sells on the NYSE and the president purchases on the Frankfurt exchange. But for the president's purchase, the price would have been \$100, and he would not have sold and lost out on the subsequent large increase in price.

If the United States relies solely on the "public perception of fairness" justification, it should not apply the ban to the president's purchases. The issuer whose shares are being traded in what the public perceives to be an unfair fashion is a German, not a U.S., national. German firms will suffer a narrowing of participation in the trading of their shares and the resulting

increase in cost of capital. The persons harmed by increased capital costs—entrepreneurs contemplating new issues, shareholders of existing firms, and suppliers of factors of production—will therefore be concentrated among German residents. Furthermore, any social demoralization that results from this type of transaction will occur in Germany, since that is not only the nationality of the issuer and the insider doing the trading, but it is also where the transaction occurs and where the other parties largely reside.

Finally, if the United States relies on either the “share price accuracy” or the “firm performance” rationales for banning insider trading, it again should not apply the ban to the president’s purchases. The beneficiaries of the better choice of new projects and more productive use of existing assets that would result from banning insider trading of issuers of German nationality would, according to each of these rationales, be concentrated among German residents. A unilateral attempt by the United States to improve the performance of German corporations, where the government representing a much larger percentage of their shareholders has decided it is unjustifiable to do so, would, as we have seen, be difficult to justify. This is particularly true considering that any loss from choice of poorer projects and bad utilization of existing assets will be reflected in price, and so U.S. investors will receive a market rate of a return even without the ban.

The facts of the second hypothetical are again the same as those of the Americo hypothetical with the following changes:

The Corporation, Usco, like Americo, is a U.S. corporation with its headquarters and the bulk of its operations in the United States. But the Usco’s shares are listed on the Frankfurt exchange as well as the NYSE. On an average day, about ten percent of the trading volume in Usco shares occurs on the Frankfurt exchange and about ninety percent on the NYSE. About ninety percent of Usco’s outstanding shares are owned by U.S. residents, almost all of whom buy and sell their shares on the NYSE. Usco’s president, although a U.S. national and resident, places his orders on the Frankfurt exchange. As with the Deutschco hypothetical, 500 of the shares acquired by the president are sold on the Frankfurt exchange to the president by Mr. Schmidt, a German national and resident. As in the Americo hypothetical, Mr. Jones, a U.S. national and resident, sells 500 Usco shares on March 13 on the NYSE at \$105, shares he would not have sold had the price been \$100.

Each of the five rationales for the U.S. ban on purely domestic trades by insiders based on nonpublic information imply that it should be extended to the Usco transaction as well. Application under the “fairness with whom you deal” rationale is needed to reinforce other strictures against self-interested behavior on the part of insiders of U.S. issuers. Application is called for under the “fairness to traders generally” rationale because U.S. investors like Mr. Jones are just as likely to be drawn into the market and actually hurt when an insider trades on a foreign exchange as when the insider trades on a

domestic exchange. The “public perception of fairness” rationale calls for application because otherwise, at a minimum, participation by foreigners in the trading of issuers of U.S. nationality will be narrowed, and the cost of capital of these issuers consequently increased.

The “price accuracy” and “firm performance” rationales also support application of the U.S. ban to the Usco president’s trade on the Frankfurt exchange. The possibility of this type of trade abroad in a U.S. issuer is as damaging to price accuracy as if it occurred on a U.S. exchange, and hence is as harmful to the best choice of new investment projects in the United States and to the best utilization of existing projects. The direct incentive effects on the managers of Usco are the same whether they are able to trade on inside information on a U.S. or a foreign exchange.

The third hypothetical is the mirror image of the Usco hypothetical. According to the analysis discussed above, therefore, if Germany bans insider trading in purely domestic transactions on the basis of any of the five rationales, it should apply its ban to the following hypothetical transaction as well. The facts are the same as those of the Americo hypothetical with the following changes:

The corporation, Frankco, is, like Deutschco, incorporated in Germany, with its headquarters and the bulk of its operations in that country. The shares of Frankco are listed on the Frankfurt exchange and the NYSE. On an average day about ninety percent of the trading volume in Frankco shares occurs on the Frankfurt exchange and about ten percent on the NYSE. About ten percent of Frankco’s outstanding shares are owned by U.S. residents, almost all of whom buy and sell their shares on the NYSE. The president, a German national and resident, places his orders on the NYSE. Five hundred of the shares acquired by the president are sold on the NYSE to him by Ms. Smith, a U.S. national and resident. Mr. Jones, another U.S. national and resident, sells 500 Frankco shares on March 13 on the NYSE at \$105, shares he also would not have sold if the price were \$100. Mr. Stein, a German national and resident, sells 500 Deutschco shares on March 13 on the Frankfurt exchange for the Deutschemark equivalent of \$105, shares he would not have sold if the price were equivalent to \$100.

The “fairness with whom you deal” and “fairness to traders generally” rationales each support application of the U.S. ban to the president’s transaction. The president dealt with Ms. Smith and many other U.S. residents in a manner that, under the first rationale, is considered unfair. And the president’s actions caused harm in a manner that the second rationale deems unfair to Mr. Jones and many other U.S. residents.

The “market confidence” rationale does not support application of the U.S. ban, since it is German issuers that will suffer from narrower participation in the market for their shares if this type of behavior goes undeterred. Nor are U.S. residents likely to be demoralized by the existence

of such trades in shares of German issuers, even if they are effected on a U.S. exchange.

The "price accuracy" and "firm performance" rationales do not support application, since Germans would be the primary beneficiaries of any improvement in choice of new projects and better utilization of existing projects that might result from banning insider trading. Also, a unilateral ban by the United States on insider transactions in the shares of German issuers effected on U.S. exchanges would be ineffective in increasing price accuracy or better managerial incentives because, absent a worldwide ban by Germany, the transactions would simply move elsewhere.

III

THE GLOBAL PERSPECTIVE

The regulation of insider trading has traditionally been undertaken by government at the national level, and is likely to continue to be so for some time. Part II of this article examined the problem of whose regime should be applied to what transnational transactions from the point of view of the interests of an individual regulating country. This article now examines the same question from the point of view of maximizing global economic welfare. This is obviously an important normative exercise. It is also an important exercise in positive analysis. Individual states decide which transactions to regulate in an interactive world that forces them to consider more than their own narrow interests. Their legislative and judicial officials have incentives to identify and seek-out the approach to regulatory reach that, if followed by all states, will yield the most global gain to divide.

The recommended approach is easy to state. Each country should apply its insider trading regime to all transactions in shares of issuers of its nationality, wherever the transactions are effected and whatever is the residence of the parties. It should not apply its regime to transactions in shares of issuers of any other country, even if the transactions are effected in the regulating country and between its own residents.

Two extreme examples illustrate the parameters of this approach: (1) the United States *should* find a purchase on the Frankfurt exchange of General Motors shares by an insider possessing material nonpublic corporate information to be a violation of its laws, even where both the insider and the seller are German residents,⁶⁷ and (2) it *should not* find a purchase on the New York Stock Exchange of Sony stock by an insider possessing comparable information to be a violation of U.S. laws, even where both the insider and the

67. This is the only transnational transaction reached by this proposal that is likely to be controversial under any widely accepted theory of jurisdiction to prescribe. See note 2. In terms of an economic analysis of such a transaction, the only basis for U.S. jurisdiction would be the effect on either U.S. investors in the stock or U.S. issuers generally (which of these would apply depends on the rationale behind the prohibition).

Since Judge Learned Hand's opinion in *United States v Alcoa*, 148 F2d 416 (2d Cir 1945), concerning the application of the Sherman Act to a cartel among foreigners abroad that affected prices in the United States, the "effects" basis for jurisdiction to prescribe has been a standard part

seller are U.S. residents. This is a striking conclusion. Application of U.S. law to the transaction on the Frankfurt exchange sounds highly intrusive, as it regulates dealings between two Germans undertaken entirely in Germany. Refraining from applying U.S. law to the transaction on the New York Stock Exchange runs contrary to the deep "investor protection" traditions of our securities laws. As developed below, however, the reasons supporting adoption of the recommended approach are strong. One can feel much more comfortable with it after experiencing a change in mindset, from thinking of insider trading regulation as a type of securities law, to thinking of it as a type of corporate law. It is then much more natural that the law of the issuer's nationality govern the transactions even when the place and persons involved are of a different country.

A. *The Interests of Each Individual Country as a Guide for Global Welfare*

The rule of regulatory reach that best serves the interests of any individual country that adopts it will, if adopted by all countries, maximize global welfare as well if we make the simplifying assumption that, applying this rule of reach, the regulating country's choice of insider trading regime has no effect on any other country. In such a situation, global welfare is simply the aggregation of the individual countries' welfare. Although the situation here is not as simple as this assumption, it is sufficiently close to allow consideration of the interests of individual countries to be the starting point of the analysis.

Part II identified for each rationale the transnational transactions involving insider trading which a country has an important interest in regulating. As noted below, that analysis and the recommended approach identify the same set of transactions as the ones that the regulating country should reach under its regime. Under our simplifying assumption it is easy to demonstrate that the recommended approach is also the rule of regulatory reach that maximizes global economic welfare.

of the U.S. view of the subject. It has engendered controversy abroad, however, particularly in Europe.

There are, however, a number of reasons to believe that a U.S. prohibition of this kind of transaction would not violate international law. First, the classical view, as exemplified in the *Lotus* case (*France v Turkey*, PCIJ Ser A No 10 (1927)), has been in essence that a state automatically has a prima facie case of jurisdiction when the sanction behind the regulation involves the exercise of power in its own territory. The party challenging this jurisdiction has the burden of showing the existence of international law to the contrary. Second, the Europeans, in applying the Community's own antitrust laws, appear to have more recently used a very similar basis themselves. (See Case 89/85 *Ahlstrom Osakeyhtiö v Commission*, Common Mkt Rep (CCH) ¶ 14,491 (1988) (the "wood pulp" decision). Finally, one can argue that the insider trading prohibition being considered in this hypothetical has more connection with the United States than the mere price effects found in the *Alcoa* case. The insider trading prohibition represents a restriction on who at any particular time can own shares of a U.S. issuer. That restriction is designed to assure a particular distribution of the gains from corporate activity between insiders and outside shareholders that is akin to the corporate law regulation of non-arms length transactions and non-pro rata dividends. I have discussed elsewhere at greater length the first two reasons, as well as more generally the evolution of the effects test in U.S. and European antitrust cases. Fox, *Regulating Securities Disclosure in a Globalizing Market* at 84-97 (cited in note 57).

The first two rationales discussed in Part II—fairness with whom you deal and fairness to traders generally—do not on their face support the recommended approach. They each suggest that the regulating country has important interests in a wider range of transactions than is reached under the recommended approach. Specifically, they include certain transactions in the shares of foreign issuers. The “fairness with whom you deal” rationale implies a need to regulate all transactions in foreign issuer shares, where the party transacting with the insider is a resident of the regulating country. The “fairness to traders generally” rationale implies the need to regulate all transactions in shares of a foreign issuer, whomever the parties are, where the issuer’s shares are regularly traded by residents of the regulating country. An unpacking of these rationales, however, reveals that each stands for two distinct policies, one reasonably sound and one fundamentally unsound. In each case, only the unsound policy calls for a broader reach than that demanded by the approach recommended here.

The reasonably sound policy shared by the two rationales is the need to prohibit insider trading to reinforce other strictures against self-interested behavior by corporate insiders. While a legitimate debate can occur as to how important a relationship exists among various types of self-interested behavior, it is impossible to argue that the concern is illogical or contrary to proven fact. The regulatory reach implied by this policy, standing alone, is again identical to the recommended approach. When an insider of an issuer of the regulating country is allowed to trade on nonpublic information, any resulting increase in her tendency to ignore strictures on other forms of self-interested behavior will be equally great wherever the trade is effected and whatever the residence of the other party. The regulating country, however, does not have an important interest when an insider of an issuer of another nationality trades because it is that other country that defines the strictures on the insider’s self-interested behavior that might be undermined by the trading.

The second policy behind the “fairness with whom you deal” rationale is the need to prevent harm to the other party. This policy is fundamentally unsound because the causation anomaly demonstrates⁶⁸ that the other party is no more likely to be harmed than anyone else considering buying or selling the shares at about the same time. The second policy behind the “fairness to traders generally” rationale is the need to prevent harm to persons among that larger group of contemporaneous traders. Although an ex post analysis shows that some persons among this larger group are in fact harmed, this policy too is fundamentally unsound. An ex ante analysis is more appropriate and shows⁶⁹ that the harm suffered by these persons is not unfair. A discounted purchase price compensated them in advance for the possibility of the harm. Since the second policies behind the two rationales are each fundamentally unsound, it should be of no great concern that they call for

68. See text accompanying note 11.

69. See Part IIB3.

reaching a broader range of transactions than does the recommended approach.

The other three categories of rationales discussed in Part II—perception of fairness, price accuracy, and firm performance—identify as involving important interests of the regulating country exactly the same transactions as those on which the recommended approach suggests the country should impose its regime.

Assume for a moment an all-or-nothing world in which a regulating country has no interests in any transactions other than those in which it has important interests. Under the Part II analysis, a country has important interests in all transactions in the shares of its issuers and in no others. Thus transactions would be divided among countries in a mutually exclusive manner. If a country were to follow the recommended approach, the decision of the regulating country as to the content of its insider trading regime would have no effect on any other country, because no other country would have an interest in any of the transactions to which the regime would be applied. We have therefore met the conditions necessary for the rule of regulatory reach that maximizes the national interests of each individual country to be that which maximizes global welfare as well.

B. Recognizing Multiple State Interests in the Same Transaction

Because of international capital flows, it is inaccurate to assume that no country other than an issuer's own country has any interest in the insider trading regime applied to transactions in the issuer's shares. Consideration of these interests, however, does not ultimately alter the conclusion that the recommended approach will maximize global welfare. For any given transaction, the question reduces to a determination of which country, among the multiple countries that have an interest, will regulate it in the fashion that most enhances global welfare. For a number of reasons, the country that will do so still generally turns out to be the country of the issuer's nationality. Consideration of other countries' interests, however, does suggest where the application of an additional country's regulatory scheme is least harmful, and where, on the contrary, the allocation of authority recommended here must not only be exclusive, but be supported by the cooperation of other countries.

1. *The Interests of Other Countries in Transactions in Shares of an Issuer of a Given Nationality.* The existence of transnational portfolio investment means that all of an issuer's shares will not necessarily be held by residents of its nationality. As a consequence, the persons having a stake in which proposed real investment projects of a given country, Country A, are implemented, and how they are managed, will extend beyond A's own residents. Thus, residents of other countries will have a stake in the insider trading regime that governs

transactions in the shares of issuers of country A's nationality.⁷⁰ The extent and intensity of the stakes of the residents of any other single country are likely to pale in comparison to that of Country A's residents, however.

If world capital markets were perfectly integrated and perfectly competitive, there would exist one global risk-adjusted expected rate of return. Better project choice and management in Country A would simply raise slightly the global expected rate of return on *all* investments.⁷¹ Thus, every purchaser around the world of a new issue of securities of any issuer, whatever its nationality, would have a stake, albeit small, in A's choice of insider trading regime. The main beneficiaries of the better project choice and management would be entrepreneurs proposing new projects in Country A and the existing shareholders of existing A issuers. In each case, they could receive more favorable terms for the sale of their shares if choice and management of projects in A improve. To the extent that the world's capital markets are not perfectly integrated, part of the gains that would otherwise have gone to entrepreneurs or shareholders of already-existing firms would flow instead to investors purchasing new issues of stock of issuers in A. In all cases, suppliers of other factors of production to projects in A would tend to benefit.

Thus, the benefits of better choice and management of A's projects are to some extent diffused evenly throughout the globe. To the extent that they are not, they are enjoyed by groups (entrepreneurs proposing new projects in A, existing shareholders in existing issuers in A, purchasers of new issues of stock of issuers in A, and suppliers of other factors of production) in which residents of A will usually clearly outnumber the residents of any other single country.⁷²

The existence of direct foreign investment means that all of a country's real investment projects are not necessarily implemented and managed by issuers of its nationality. As a consequence, persons in that country, Country B, have some stake in the cost of capital, price accuracy, and quality of the management of foreign issuers, and hence in the insider trading regime applied to transactions in their shares. Again, however, the aggregate investment of foreign issuers of any given nationality in projects in their home country is likely to be much greater than in projects in B. Thus, the aggregate stake of residents of B in how transactions in the shares of issuers of any single foreign country is likely to be small in comparison to the stake of residents of that country.

70. The analysis that follows applies equally to the stake that persons outside country A would have to the cost of capital experienced by A issuers. The effects of insider trading on the cost of capital is a principal concern behind the perception of fairness rationale. See Part IIC1.

71. Even a major improvement in project choice and management in A would result only in a slight increase in the world rate of return as long as Country A is not a large portion of the total global economy.

72. The same is true of any harm to investors that suffer damage from insider trading because of the increase in the riskiness of holding country A issuers' shares in a less than fully diversified portfolio. See Part IID4a.

2. *The Choice of the Appropriate Exclusive Regime.* Start with the proposition for a moment that just one country should regulate any given transnational securities transaction. The existence of interests in the transaction of countries other than the country of the issuer violates the simplifying assumption used in demonstrating how an approach to regulatory reach that maximizes the interests of each individual country also maximizes global welfare. However, the recommended approach is, for a number of reasons, still the best one.

To start, as discussed in Part II, differences may exist among issuers in terms of what amount, if any, of regulation of insider trading is optimal. These differences arise from differences among countries in the institutional structures of corporate governance that prevail with respect to issuers of their nationality. An issuer's own government is the most competent judge of what insider trading regime best fits the typical governance structure in its country. The recommended approach places the decision in the hands of the government best able to choose.

Second, also as discussed in Part II, even if no important such differences exist, and the optimal regime is the same for issuers of all nationalities, there is considerable debate as to the optimal regime. Some commentators find insider trading to be harmful, while others find it to be beneficial. Even among those who find it harmful, there is disagreement as to the extent of its harm, and hence the costs worth incurring to fight it. Those costs are a function of, among other things, the scope of the ban and the civil and criminal consequences for violating it. We simply do not know the answers to these questions with certainty. The recommended approach allocates decisionmaking in a fashion that provides for the best feedback, so the system can learn and move toward the optimal regime. The decisionmakers in this case are national governments. Different governments decide the regime for different sets of transactions. The recommended approach, by the transactions it assigns to each government, concentrates the effects of the regime that the government chooses—whether those effects turn out to be good or bad—on the residents of the country the government represents.

Finally, the recommended approach enjoys a number of operational advantages. It is likely to minimize conflict between countries because only one country is assigned authority to regulate a given transaction. It is relatively easy to apply in the sense that it will be clear what the nationality of most issuers is, and hence which country is assigned regulatory authority.⁷³ This not only assists in the reduction of conflict between countries, it also puts both the market and the potentially affected parties on clear notice which law governs, reducing the need to consume legal services to find out. The

73. The only cases where this will be difficult currently are the relatively few genuinely multinational companies where the largest percentage of share ownership, the largest portion of their assets, and the corporate headquarters are not all within the same country.

The process of application could be rendered more simple by adopting a presumption that an issuer is a national of the country of incorporation (or alternatively of the place of its headquarters), assuming that it also has significant other contacts there (significant share ownership, assets, etc.).

recommended approach is more likely to be effective and to cost less to administer since most insiders will share the same nationality and residence with their issuers. Compared to a regime that would reach the insiders of foreign issuers, under the recommended approach, the regulating country and others suing pursuant to its laws are more likely to be able to exercise personal jurisdiction over violators, and will find investigation and discovery easier. Effectiveness is an important value in and of itself because it reinforces the legitimacy of the overall regime.

3. *Tolerable and Intolerable Deviations from the Recommended Approach.* Consider two deviations from the recommended approach, each of which is easy to imagine given current practices of regulatory reach. For both, assume a Country C, which has a relatively strict regime banning insider trading, and a Country D, which effectively allows insider trading.

The first deviation is where Country C detects that insiders of issuers of Country D are trading in shares of their issuers on C's exchanges, and decides to end the practice by applying its regime to these trades. This move will be largely ineffective. The overall level of insider trading in shares of issuers in D will not be significantly deterred because the only effect of C's decision will be to impose on the insiders the inconvenience of moving their trades elsewhere. With the same overall level of trading, investors in C will be equally injured ex post. Similarly, any deleterious effects that C believes the trading has on the choice and management of projects in D, and hence on the value of shares of issuers in D held by residents of C, will not be reduced. But this very ineffectiveness means that C's decision is a relatively innocent deviation from the recommended approach because it does little to undermine the regime of D, the more appropriate country to decide how to regulate the transactions in question.⁷⁴

The second deviation is where Country C detects that insiders of its issuers are trading their shares on D's exchanges. Suppose this practice goes unchecked, either because C is concerned that imposing its regime on these transactions will offend D or because D is totally unhelpful and takes whatever steps it can to frustrate any effort by C to stop the trading. This is a major deviation from the recommended approach because D can become the place to which all the insider trading in shares of issuers in C will move. C's ban on insider trades in its own issuer's shares would therefore be rendered largely ineffective. D, the less appropriate country to decide how these transactions should be regulated, has effectively made that determination.⁷⁵

74. Country C could, of course, try to ban insider trading in stocks of issuers in D wherever they were traded in the world. It is very unlikely that it would be able to enforce such a ban, however. In the unlikely event that it could, it would be effectively implementing its goals. This would be a serious deviation from the recommended approach because C would then be the country that determined how these transactions should be regulated.

75. The discussion in this section shows that the proposed approach involves an allocation of decisionmaking that would be authoritative according to reasoning highly analogous to choice of law theories of scholars such as William Baxter and Larry Kramer. Each of these theories, to at least some extent, involves a governmental interest method for identifying "true conflicts" of law: for the

IV

CONCLUSION

This article has addressed the question of who should regulate insider trading in transactions in this increasingly globalizing economy. Except in those instances where the policy underlying them is fundamentally unsound, an analysis of the various rationales as to why insider trading should or should not be banned all point to the same striking conclusion. A regulating country has a high degree of interest in imposing its insider trading regime on transactions in the shares of issuers of its nationality, wherever they occur and whomever they involve. The regulating country has, at most, a much lower degree of interest in imposing its regime on any other transactions, even if they occur on its exchanges and between its residents. This also, upon examination, turns out to be the best approach to regulatory reach in terms of maximizing global economic welfare.

This approach to regulatory reach is the best available for the medium-term future. It obviously represents a significant departure from the current emphasis on the place of the transaction and the country in which the outsider resides, an emphasis driven by concerns of investor protection. It is likely, however, that national governments will move in the direction recommended

potentially applicable law of each state it asks whether the purpose of the law, when applied in a purely domestic context, will also be served by application when there are elements of the situation involving another state. And, where a true conflict exists, each theory provides a method of choice between the laws based on some kind of hypothetical bargain between the states as co-equal sovereigns. William F. Baxter, *Choice of Law and the Federal System*, 16 Stan L Rev 1 (1963); Larry Kramer, *Rethinking Choice of Law*, 90 Colum L Rev 277 (1990).

Assume that all countries understand the unsoundness of the bases for prohibiting insider trading identified as unsound in Part II (or alternatively assume that, as a matter of choice of law methodology, one should not find a governmental interest where the rationale suggesting the interest does not make sense according to what one believes to be the best scientific understanding of the underlying social process being regulated). The existence of transnational portfolio investment and transnational direct investment means that more than one country has an interest in whether any given insider trade occurs, and hence a situation akin to a "true conflict" exists. The issuer's country, however, always has the largest interest. That is the country to which the proposed approach assigns regulation of the transaction. Thus, the proposed approach is exactly the allocation of decisionmaking that one would expect states to agree upon, since what each state gains from the agreement (keeping other states from regulating the transactions where its interest is greatest) is larger than what it is giving up (the ability to regulate where its interest is less). The argument that this is the rule to which states would agree is strengthened by the fact that it is the one that best serves the "multistate policies" of predictability and ease of administration. It is also strengthened by the fact that it is the rule that can be expected to maximize global economic welfare, and hence give states the most to divide in any bargain.

The discussion in Part IIIB3 concerning acceptable and unacceptable deviations shows, however, that it may not be necessary to assume that all countries correctly understand what are unsound bases for prohibiting insider trading (or should be treated as though they do). Consider a less restrictive rule of decision allocation: each state may prohibit or not, as it wishes, insider transactions in both shares of its own issuers and, where the transaction would occur in the regulating country, shares of foreign issuers, but no state should impose regulations (for example, a "blocking" statute) that affirmatively undermine the ability of any other state to prohibit insider trading in the other state's issuers. This would be a rule that would be agreeable to states that believe that prohibition protects the outside party to an insider transaction (the unsound basis to the first rationale), as well as by the states that are persuaded by the analysis here. It does not create any significant obstacles for the latter group to pursue welfare-maximizing regulatory policies in accordance with the approach I recommend.

as it becomes more and more difficult to identify where a transaction actually takes place, and as policymakers' understanding of modern financial economics increases.

In the longer-term future, increases in transnational portfolio investment and transnational direct investment may render the recommended approach unworkable. An increasingly larger proportion of the world's production will be undertaken by issuers with no clear national center of gravity. Arrival at this point of unworkability, rather than indicating the need for a new principle to determine the reach of national regulation, will signal that the entire system of national-level regulation of corporate law and insider trading will have become obsolete.