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THE EFFECT OF INSIDER TRADING RULES ON THE INTERNAL EFFICIENCY OF THE LARGE CORPORATION†

Robert J. Haft*

“Insiders” — directors, officers, and employees of a corporation — cannot use material nonpublic information about the corporation when trading in the organized securities markets. They must either disclose the information or abstain from trading their corporation’s stock.1

Professor Kenneth Scott recently summarized the three primary justifications for this rule.2 First, the “Fair Play” rationale posits that taking advantage of inside information that is unavailable to other parties is inherently inequitable. This “one-on-one” perspective asserts that insiders unfairly obtain benefits from and damage the public investor on the other side of the trade. A variation of the Fair Play rationale speaks of the “integrity of the securities markets”: If the public believes that the game is unfair and chooses not to play, the markets will suffer and the efficient allocation of capital will be impeded.3 Second, the “Informed Market” rationale asserts

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In the only Supreme Court case defining “materiality” (and there, for the purposes of the federal proxy rules), various formulations were used on the same page:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.


3. Id. at 804-09. Professor Scott states that the fair play and the integrity of the market rationales stem from the idea that traders in the markets should have relatively equal access to material information. Since the insider has unequal access, his trading is unfair.

Some commentators, prominent among them Henry Manne, have objected that the only
that prohibiting insider trading "removes an incentive to delay the release of corporate information so that insiders may first take a trading profit." The rule thus "facilitates the flow of information to the market, so that it may better perform its functions of security evaluation and capital allocation." Third, the "Business Property" theory adopts the view that the insider trading ban "affords protection to the property rights of the firm in inside information...." A seminal case held the rule applicable to "information intended to be available only for a corporate purpose and not for the personal benefit of anyone."
Academics have hotly debated these justifications for years, and none of the three has achieved universal acclaim. This Article suggests another perspective: Prohibiting insider trading may enhance business decision-making in large corporations. With the exception of proponents of the Business Property view, analysts have focused on how an insider trading rule affects the national securities markets and traders in those markets. The internal governance of the large corporation is a different matter, one deserving separate consideration.

I. CORPORATE DECISIONS BASED ON INFORMATION RECEIVED AT THE LOWER LEVELS AND PASSED UPWARD

Whether business decisions will be correct depends directly on the accuracy, quality, and timeliness of the information on which they are based. In large corporations, this information may pass through as many as fifteen hierarchical levels from bottom to top. Organizational and communications scholars have confirmed the obvious: merely because the information is transmitted so many times, the message becomes distorted. They have also found that the per-


Professor Michael P. Dooley, in a recent and significant article, analyzes and roundly criticizes the justifications for the present prohibition. Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1 (1980). He asserts that "the principal objection to insider trading . . . ultimately rests on a view of insider trading as indulging one's self-interest to the point of dishonesty." Id. at 39. He then subjects this objection to an economic "agency cost" analysis and later concludes that the objection is meritless.

9. See Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1138 (1977). The discussion in Part I of this Article is premised on the existence of a large and complex organization and is thus limited to the large corporation with many hierarchical levels. Part II, which focuses on the small group of top-level corporate decision-makers, may well be applicable to large and medium-sized corporations.

Some information relevant to business decisions may originate at the top of the corporation. See notes 25-26 infra and accompanying text. Such information usually relates to prospective tender offers or acquisitions, events that are far less common than top-level allocations of corporate resources, long-term and strategic planning, marketing, product development, and financing. These important but less spectacular decisions require information that proceeds from lower levels to the top-level decision-makers.

10. See id. at 1138.
sonal biases and self-interest of each sender-subordinate and each receiver-superior in the hierarchy exacerbate this obstacle to high-quality business decisions.\(^\text{11}\)

Although decision-makers recognize this distortion of information, they cannot completely counteract it. Superiors may reduce distortion by counter-biasing or discounting the content of the message by the self-interest that they perceive the sender to have in the message.\(^\text{12}\) Distortion may also be reduced to the extent that the sender and receiver "trust" each other.\(^\text{13}\) But the most common response to information distortion in complex organizations is to force decision-making downward to specialists or to a unit closer to the relevant information.\(^\text{14}\) Downward delegation in complex organizations is efficient because the unit closest to the scene is the most knowledgeable, its reaction time is short, and its reaction mode is highly programmed.

Now, let us introduce a rule permitting securities trading by corporate employees, officers, and directors based on the material non-public information that they receive in the course of their employment. This rule would likely impair corporate decision-making at all hierarchical levels.\(^\text{15}\) Subordinates would stall the upward

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14. The complex organization solves many problems involving uncertainty by forcing decision-making downward to the specialists or unit closest to the scene. Each unit deals with the slice of the complex environment that the corporation has assigned to it and programs everything else out. The specialists "hedge" by making a decision with foreseeable short-term consequences. This permits fine-tuning from time to time based on continuous feedback. They make decisions only when a problem arises, and their responses are usually highly programmed. The need to act quickly requires the lowest practicable organizational level to make the decision. See E. Lawler \& J. Rhode, Information and Control in Organizations 192-93 (1976); Van de Ven, A Panel Study on the Effects of Task Uncertainty, Interdependence, and Size on Unit Decision-Making, 8 Org. \& Ad. Sci. 237, 239, 244 (1977).

15. This idea was first suggested in 1970 by Professor Oliver Williamson, the noted econo-
flow of critical information to maximize their opportunities for financial gain. They would purchase stock when they received “good” information — indicating favorable firm prospects — and sell when they discovered “bad” information before transmitting the information to other insiders who would drive the market price higher by their purchases or lower by their sales. When the information is later publicly disseminated, the insiders would sell on the good news or, if the news is bad, buy to “cover” their prior short-sales, or do nothing if their prior sales were only of stock that they owned at the time.

While the initial purchases or sales might occasion little delay — short-sellers on “bad” information and purchasers on “good” information have an incentive to transmit information upward quickly — profit-maximizing insiders, before transmitting information upward, might attempt to arrange loans to purchase or sell a greater amount of stock than their available resources would otherwise permit. Insiders might also convey the information to select corporate outsiders to whom they owe favors or from whom they expect future benefits. Even if the delay at each hierarchical level were slight, the aggregate delay in upward transmission to the top decision-making levels might be substantial. Assuming that higher level officials make the important decisions, informational delay within the organization will also increase with the importance of the decision and its likely impact on stock, as will the delay in releasing the information to the public.

These incentives for delay and internal competition for insider

mist, as part of his critique of Professor Henry G. Manne’s book in favor of insider trading. On this point, Williamson stated:

It is not obvious that the information hoarding which insider trading would seem to require would also have ideal properties from the standpoint of the firm. The conflict is between the necessity to provide “impacted” information (so as to prevent the disclosure of significant developments to free riders) and the demands for effective information exchange within a complex, hierarchical organization. Can an information system be designed for the unitary form organization that avoids the free-ride problem without impairing coordination and inducing subgoal pursuit of a debilitating sort? This seems doubtful.

O. WILLIAMSON, supra note 8, at 95.

16. “Short-selling” (on bad information) involves the sale of stock not owned by the seller. The stock is borrowed by the seller from the brokerage firm through which the seller transacts the short-sale. Later, when the market price falls, the short-seller “covers” the short-sale by purchasing stock in the market at the lower price and delivering that stock to the broker. The short-seller thus profits by the difference between the higher short-sale price and lower covering price. Section 16(c) of the Securities Exchange Act of 1934 prohibits short-selling by any director or officer (or beneficial owner of more than 10% of the stock) of the corporation. Thus, profit maximization at the highest corporate levels in the case of bad information would be limited by the number of shares owned by those insiders.

17. See note 19 infra and accompanying text.
trading profits would increase the normal distortion in the upward transmission of information. And the usual organizational countermeasures to informational distortion would likely fail. Superiors would not know how nor in which direction to counter-bias or discount information because they could not accurately perceive the subordinate’s self-interest. Subordinates with incentives to delay or compete may understate information or mislead superiors, while others seeking quick profits may exaggerate the information to bring about a rise in the stock price (or a fall if the information is “bad”).

An increase in competition among hierarchical levels, moreover, would reduce “trust” between senders and receivers. And the relevant superior might choose not to delegate decision-making downward even when delegation is the most efficient solution to information distortion. The superior would have to weigh the personal benefit of less work resulting from that delegation against the trading and informational opportunities delegation forecloses. All things being equal, otherwise efficient downward delegation in the complex organization would decrease.

Organizational efficiency is usually also promoted by the cohesiveness of the unit to which decision-making is delegated. Add the potential for trading profits to the unit’s previously efficient “program”18 for dealing with the complex environment, and the unit’s efficiency may diminish. And, as Part II will demonstrate, if the members of the unit choose to capture such profits individually rather than cooperatively, work groups will become less cohesive and the quality of their decisions will fall.

The power to decide also implies the power to manipulate business decisions with an eye to potential trading profits. Although the deciders could not manipulate often without being exposed for their misdeeds and possibly fired, a few manipulations per level multiplied by the number of decision-making levels might substantially injure the firm. The opportunity to manipulate, moreover, might weigh against the superior’s otherwise efficient downward delegation and thus further reduce the quality of corporate decision-making.

There are substantial constraints on this scenario of lessened efficiency and exacerbated informational distortion. Insiders cannot unreasonably delay or grossly distort information in the authoritarian and hierarchical organization that is the modern large corporation. Their costs would be too high: loss of employment or reduced compensation. The delayers and distorters also could not adversely af-

18. See note 14 supra.
fect the organization “too much,” or else they might eliminate their opportunity to profit in the future.

The potential of hierarchical levels to hoard information to maximize profits is also limited by the need of lower level purchasers and short-sellers to transmit the information upward for more highly profiled and publicly visible action by the higher levels. These visible actions will allow the lower level employees to realize gains in the public markets by their offsetting sales or purchases after public disclosure more quickly and without the uncertain investment risks of delay. Whether the balance of considerations would lead to quicker and more accurate upward transmission of information is the crux of the issue. The answer may depend on particular circumstances — the trading position taken and potential profits — and on the nature of the particular information. While one can credibly argue that with a free trading rule good news would move up faster (but with more “puffing”) than it does today, I believe that on balance permitting insider trading would increase delay and distortion and thus impair decision-making that depends on timely and accurate information from below.

When the higher levels do obtain the information, they will also trade. But this may take its toll on the organizational morale below because ultimately the higher echelons can use inside corporate information more effectively and profitably. Lower level insiders will recognize that each succeeding level upward possesses greater financial resources and over-all knowledge of corporate activities than the last. They will thus know that the next level upward stands to profit more and can react more effectively to the bits of information that the lower level receives.

What are some of the counter-arguments to the reduced organizational efficiency scenario? First, there is no direct empirical evidence to support it, either in the pre-prohibition experiences of American corporations or in the experiences of corporations in countries with no prohibition. This must be conceded. But a partial answer is that data were never collected through the sieve that this Article suggests. The present illegality of insider trading makes it unlikely that any meaningful empirical evidence can be obtained today

19. If the nonpublic material information was bad (i.e., unfavorable to the firm’s prospects) and the insider sold only the stock that he then owned, there would be no countervailing need to transmit the information upward for publicly visible action by the higher levels. In the case of a short-sale by the insider, see note 16 supra, this countervailing need would exist.

20. See Schotland, supra note 8, at 1452.
in the United States or in countries, such as Canada or Great Britain, with roughly similar cultures that also prohibit insider trading.

Second, those corporations that insider trading may potentially damage can voluntarily prohibit the practice. But who would move particular corporations toward an insider trading ban? Would the board of directors and chief executive voluntarily eliminate their own potentially immense profits under a *laissez faire* rule when they demanded contractual provisions prohibiting insider trading from others? This seems doubtful. If they demanded such provisions from employees but did not themselves agree to the trading restrictions, resentment and cynicism would brew below, and the restrictions would be counter-productive.

It requires strong faith in the efficiency of the free market to argue that the stock market or other markets might then punish the nonsigning directors and top officers or the corporation itself and eventually lead to the ouster, through a shareholder vote or takeover, of those “errant” agents who continue to favor free trading for themselves. Lower earnings or other economic benchmarks of poor performance would presumably signal to the market the internal inefficiency caused by insider trading. But the market would not usually be in a position to attribute the lower earnings to increased informational distortion or delay because of many possible alternative explanations. Nor would the key managers, with their bias toward insider trading profits, subjectively attribute the inefficiency to less than optimal business decisions caused by increased informational distortion or delay.

Third, with insider trading by all employees, the higher echelons arguably would learn about significant corporate events, through the movement of the company’s stock price, sooner and with less distortion than they do today, given the present and pervasive up-

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21. Professor Manne would undoubtedly concur with this suggestion. He has stated: At no point in my entire book do I express the belief that corporations should be required to tolerate insider trading. . . . [I]f through legal means a corporation properly indicates that its rule is no insider trading, that should be the business of that corporation and its shareholders and the courts if a violation is alleged. Manne, supra note 8, at 581 (emphasis in original) (footnote omitted). Corporations would be required to disclose publicly “whether or not insiders will be allowed to use information in the stock market or under what conditions this will be allowed.”

22. This discussion assumes that every corporation would be required to disclose publicly whether and on what conditions it prohibits or allows insider trading. Requiring every insider to report publicly his actual trading by a public filing would make additional information available to the market. See Securities Exchange Act of 1934, § 16(a), 15 U.S.C. § 78p(a) (1976) (requiring such a filing in the case of all trades by officers and directors). And if, in the case of comparable corporations, some permitted insider trading, while others prohibited it, the market (or its more sophisticated participants) might then be in a position to make accurate attributions concerning informational distortion or delay.
ward informational blockages. This position is a slight variation on the efficient market argument that permitting insiders to trade on material nonpublic information would tend to move the market in the correct direction. The argument might hold in the intra-organizational context only in the unlikely event that all of the following occur: (1) the lower levels are financially able to trade in relatively large amounts so that the stock price may "signal" the upper levels; (2) the upper levels actually monitor the stock price and volume; and (3) the upper levels, on the basis of accurate information, are able to exclude each of the following other plausible explanations for the price movements: (a) outside sources are incorrectly interpreting information previously obtained from the company and its insiders; (b) outside sources are incorrectly adopting rumors circulating in the market; and (c) the lower levels are incorrectly interpreting the overall effect of tidbits of information.

Fourth, one might argue that under a laissez faire trading rule the upper levels would become better informed and less subject to informational blockages because of their real incentives to dip down into the hierarchy for critical information. The higher levels would then trade accurately in large amounts and correctly signal the market as to corporate developments. The argument is another efficient market variation, with the added bonus of increased organizational efficiency. These informational benefits to the organization and the market may some day be convincingly demonstrated so as to overcome the decreased organizational efficiency argument, but I doubt that this will occur.

Fifth, the decreased organizational efficiency argument assumes the frequent flow at most hierarchical levels of "material" information; to the extent that this is not so, the posited injury to the organization is reduced. All levels receive far more mundane information than information that is spectacular. Only rarely are low-level employees at the right spot at the right time to learn of a prospective major earnings decline or dividend cut. And a GM machinist could not confidently base a short-sale on his or a co-worker's bad fit of a screw into one car's template.

Insider trading opportunities, however, do not usually depend on

23. See Freeman v. Decio, 584 F.2d 186, 190 (7th Cir. 1978) (concluding that "even when confronted with the possibility of a trade-off between fairness and economic efficiency, most authorities appear to find that the balance tips in favor of discouraging insider trading" (footnote omitted)); Manne, supra note 8, at 565-75; Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260 (1968); Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031, 1073 (1977).
information that is material on its own. As Professor James Lorie, the eminent economist, has stated: "With respect to the analysis of securities, information is anything that changes the investor's subjective probability distribution with respect to future market prices or returns." 24 Securities analysts profit today under Lorie's observation by fitting tidbits of nonmaterial information legally provided to them by insiders into the "mosaic" of publicly available information. Insiders at most hierarchical levels can probably fit their tidbits into the mosaic of other nonpublic information that they acquire, so that the totality would be in many cases "material." Furthermore, an insider who believes that particular information is "material" when it is not, or is material only if other related information can be acquired, will have the same incentives to delay and distort the information as insiders who actually possess material information. Thus, the decreased organizational efficiency argument does not wholly rely on the upward flow of "material" information.

II. DECISION-MAKING AT THE TOP LEVEL

Most of the recent insider trading "scandals" involved nonpublic information initially received at the highest levels in the corporation. The information has often related to prospective tender offers, mergers, or acquisitions. 25 In these situations, if insider trading were freely permitted such trading would "signal" the stock market that a particular company will be the target of a tender offer or an acquisition proposal because the bidder or acquirer's directors and chief executive would purchase target stock in large amounts and drive the price up. If the bidder forewarned the target of its tender offer, the target board and chief executive, assuming that they were willing to "do business" with the prospective bidder, would also purchase target stock. Market efficiency in such a situation would be enhanced by insider trading. 26

But an emphasis on the less spectacular aspects of corporate life and top-level decision-making may be more significant. Most chief executive or board decisions involve not tender offers or acquisitions,


26. The bidder corporation, however, may be harmed because it may have to raise its planned offering price to reflect the increase in the target's stock price caused by the insider purchases prior to the public announcement.
but major allocations of corporate resources, long-term and strategic planning, markets, products, and financing.

Would a rule permitting insider trading affect this decision-making at the top level? Part I of this Article argued that top level decisions that are highly dependent on timely receipt of accurate information from below would likely suffer because of the increased delay and distortion in the upward transmission of the information. But even assuming that *laissez faire* insider trading would not result in informational blockage or that this blockage could be counteracted, we must still consider the impact of permitting top-level insider trading on the quality of decision-making at the apex of the largest American corporations.

Until recently, management dominated the boards of directors of these corporations. As lower-rank officers and business associates of the corporation, directors on the old board were generally beholden to one "director," the chief executive. In contrast, the new board now typically has a majority of directors who are "independent" of management. It has emerged as a peer group — a collegial body of equals, with the chief executive as the *prima inter pares* — and as such is uniquely positioned to make business decisions of the highest quality.27 The evidence from the behavioral sciences indicates that, all other things being equal, the new board will make higher quality decisions than both other *ad hoc* decision-making groups in the corporation and individuals, including the chief executive. And, all other things being equal, to the extent that the new board becomes cohesive (which seems likely), the quality of its decisions will improve. Although the evidence to date is somewhat conflicting, the new board is effectively beginning to assert greater power over the course and direction of affairs in these corporations. If the behavioral science findings hold, this trend is encouraging: to the extent that the new board engages in decision-making, the corporation will be better off.

If we introduce a free insider trading rule into this cohesive peer group and assume that information is distortion-free and timely, will we impair the quality of decision-making? The answer might well depend on whether the directors competed with each other for trading profits or agreed to cooperate and share the profits. Empirical findings drawn from the behavioral sciences, most notably social

psychology, confirm our intuitions: competition among directors would adversely affect their decision-making.

Competition among directors for trading profits would create distrust in the group. As studies of business and other decision-making groups have confirmed,28 trust among the members of a group is an essential precondition to quality decision-making. Distrustful group members conceal or distort relevant information and disguise ideas and conclusions to provide information that is low in accuracy, comprehensiveness, and timeliness. The distortion that they introduce compounds the complexity and uncertainty inherent in every major business decision, increasing the probability that underlying problems will go undetected or avoided and making solutions more difficult to identify. Such a group will seize an expedient solution to end its problem task. Conversely, high-trust groups provide relevant, accurate, and timely information. Their members are also less likely to misinterpret the intentions and behavior of others. Trust among group members thus promotes identification and examination of underlying problems and generates solutions that are more likely to be appropriate, creative, and long-range.

Closely related to distrust among group members is “opportunistic” behavior by members of peer groups. Professor Oliver E. Williamson, the noted economist, argues that such behavior impairs the group’s effectiveness. One of the three chief abuses that he notes is “joining the peer group in order to acquire knowhow and to learn trade secrets, thereafter to set up a rival organization . . . . Disincentives must be devised to discourage members from joining for the strategic purpose of acquiring learning-by-doing advantages, and then resigning.”29 Members of insider trading peer groups will obtain greater profits by remaining in the group than by resigning. Nevertheless, Williamson’s observation that opportunism detracts from the group’s effectiveness would still appear to hold.

Would the directors compete with each other for trading profits or would they cooperate and agree to share their profits and losses? If they competed inter se, suspicion would prevail, undermining cohesiveness among group members and the quality of business decisions by the peer group at the corporate apex. If the directors (or a majority of them) opted for a “take the money and run” solution, they might attempt to maximize individual profits by competing over the short term — until the shareholders or the market discovered the

28. See note 13 supra.
29. O. WILLIAMSON, supra note 11, at 47-48.
Each director would be strongly tempted to dip down into the hierarchy to discover the latest and best information on which to profit. In the process, a director might make alliances and side deals with those below whom the director considered best for personal purposes. Competition might thus turn management information systems designed for corporate purposes into stock market ticker tapes. The market would arguably become more "efficient," but it is doubtful that the corporation would become so.

Since low trust and opportunistic behavior appear to be detrimental to group effectiveness, and given the huge profit potential of insider trading by directors, the directors might agree to cooperate as a group rather than compete as individuals for these profits. Such cooperation, which could be formalized by a contract among the directors to share profits (and losses), might well maintain group trust and, through group-monitoring, reduce or eliminate individual opportunism. The director's incentive to do so would be strong because of the direct relationships among board effectiveness, continuance in office, and profit maintenance. The independent directors would then carefully "monitor" the chief executive's "performance," with far greater incentives to do so than the present "directors-as-monitors" model contemplates.30

A legal rule imposing fiduciary duties on directors inter se could then ensure the efficiency gains that this cooperative scenario might provide by requiring insider trading to be cooperative. Relations among directors would then resemble those among partners in a general partnership.31 However, such a scenario would destroy the equality among directors underlying the findings of peer group superiority in decision-making.32 Even if we assume that the board members would share their trading profits, the chief executive would likely receive a greater partnership share than the others because of his critical position in the information chain. Certain other directors might be in a position to bargain for higher shares as well. With

30. The "directors-as-monitors" model was first proposed by Professor Melvin A. Eisenberg. See M. EISENBERG, THE STRUCTURE OF THE MODERN CORPORATION 165-66 (1977). It has since been adopted by most legal and business commentators.

31. For a discussion of fiduciary duties among partners, see Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. REV. 738, 759-61, 771-72, 793-94 (1978); Dooley, supra note 8, at 64-65; Scott, supra note 2, at 815.

32. Yet another argument for permitting insider trading might be that it would increase the quality of board decision-making because independent directors would work harder than they do today. The huge profit potentials of such a rule would create strong incentives for talented individuals to come to the board and perform well. This "entrepreneurial reward" prong of Professor Manne's thesis has been well answered by others. See note 8 supra.
senior, middle and junior partners, the new board would return to
the old process of hierarchical decision-making and could no longer
claim peer group decision-making superiority. And, given the large
personal stakes that directors would have in corporate affairs, corpo-
rations would lose the anticipated benefits of the recent governance
changes. Specifically, the “independent” directors would become
management directors rather than “monitors” and “discipliners” of
management performance. That the market alone did not appear to
monitor adequately was the *raison d'être* for installing a majority of
independent directors in our very largest corporations; a rule permit-
ting insider trading would undermine that gain.

### III. **TIPPEES OF CORPORATE INSIDERS**

How far can liability be extended to persons outside the organi-
zation who receive material nonpublic information from insiders?
The Fair Play, Informed Markets, and Business Property rationales
can be logically extended to such “tippees” of corporate directors,
officers, and employees. The Internal Efficiency rationale may also
justify tippee liability.

The typical outside recipients of material nonpublic information
are organizations, such as investment and commercial banking firms,
that have regular and on-going relationships with the corporation.
The corporation transmits and the banking firms receive this infor-
mation with legitimate business purposes in mind and understand
implicitly that the information will remain confidential. Undoubt-
edly, an insider may casually tip a friend on the golf course, but the
effect of such tips is more random and of less magnitude than the
regular and legitimate flow of corporate information to those power-
ful economic organizations, the large investment and commercial
bankers.

These bankers, like law firms, accounting firms, and financial
printing firms, are “agents” — in the economic sense — of the corpo-

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33. The Fair Play rationale focuses on the inequality of information possessed by the par-
ticular persons on each side of a particular trade. Both the insider and the tippee of an insider
take advantage of the nonpublic information knowing that it is unavailable to the person on
the other side of the trade. *See* text at note 3 *supra*. The Informed Market rationale empha-
sizes the rapid flow of corporate information to the overall market (not to particular traders).
Whether the insider or the insider's tippee is presently withholding the information from the
market to obtain trading profits is unimportant because the information is still not flowing into
the market. *See* text at notes 4-5 *supra*. The Business Property rationale treats the information
simply as the property of the corporation. *See* text at notes 6-7 *supra*. The stolen property or
its equivalent can be recovered from either or both the thief (the insider) or the recipient (the
tippee). The corporation’s property rights are vindicated in either case.
ration. If the agency organization profits by trading on the information, its indulgence will be "signaled" to the corporate principal and to others, to its likely detriment. Agency organizations, however, rarely breach their obligations to keep the confidences secret after a conscious organizational decision to do so. More often, the cause of the agent's breach lies with individuals or subunits in the agent's own organization. These individuals or subunits are usually acting detrimentally to the agent's organization.

*United States v. Newman,* a recent decision, provides the paradigm fact pattern. The defendant's alleged coconspirators, who held key positions at two prominent investment banking firms, allegedly conveyed confidential information to the defendant concerning prospective tender offers received by their firms as agents of the bidders. The defendant, together with two confederates, then purchased shares of the target companies. When the proposed takeovers became known to the public and the target's stock predictably increased in value, the conspirators sold out and divided the profits. The Court of Appeals for the Second Circuit sustained the legal sufficiency of the federal securities law counts on the ground that the coconspirators misappropriated valuable nonpublic information entrusted to them by their employers, the investment banking firms. The damage to the investment firms could have been substantial because the conspirators' actions signaled the firms' potential unrelia-

bility to the corporate market. As the Court of Appeals stated: "By sullying the reputations of [the coconspirators'] employers as safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money." The same potential damage to law, accounting, and financial printing firms

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34. In the strict legal sense, commercial banks are not "agents" of the borrower corpora-
tions. See Note, Regulating the Use of Confidential Information in Tender Offer Financing: A Common Law Solution, 55 N.Y.U. L. Rev. 838, 856-59 (1981). However, the Note's analysis fails to account for the fact that corporations deposit funds in the banks from which they borrow, and a legal agency relationship is created in favor of a depositor with the bank's "qualified obligation not to reveal confidential information relating to that depositor's account." *Id.* at 859.


36. [Current] FED. SEC. L. REP. (CCH) ¶ 98,332, at 92,050.

37. [Current] FED. SEC. L. REP. (CCH) ¶ 98,332, at 92,052. The Court sustained the mail fraud counts in the indictment on the same misappropriation theory coupled with the breach of the employees' fiduciary duties by material misrepresentations to the employer and material nondisclosures of their buying activities (which they were specifically required to report). [Current] FED. SEC. L. REP. (CCH) ¶ 98,332, at 92,053-54.
representing corporate clients would be inflicted by errant lawyers, accountants, or "make-up" employees.

The tippee thus appears to have "damaged" both the agent's organization and the business corporation from which the information emanated. The client corporation might assert claims against the agent institution and the latter's disloyal employee, and the agent's stockholders or partners might sue the guilty individual or subunit of the organization in a derivative action. If we allow such claims, are we too far afield from the objective of preventing organizational damage to the business corporation from which the information emanated? The answer should be in the negative, if we candidly admit that the primary purpose of insider trading liability is deterrence rather than compensation. The risk that the disloyal individuals will pay twice for their conduct will serve that purpose. Extending liability to tippees might also remove further incentives for the insider to delay or distort the upward transmission of information within the corporation. The objectives of the Internal Efficiency rationale are accurate and timely internal transmission of information.

38. The claim by the client corporation is supported by traditional state agency law. An agent is required to account to the principal for any profit gained through the use of confidential information, even if the principal was not harmed. See Restatement (Second) of Agency § 338, Comment e (1958). The claim by the corporation (the "principal") can be asserted against both the agent organization (the legal "agent") and its disloyal employee (a legal "subagent"). See W. Sell, Agency 17 (1975).

39. The focus of this Article is on insider trading on the national securities markets, not on face-to-face transactions between the insider and another. In the anonymous market, the insider says or does nothing except to call his broker to buy or sell. The person on the other side of the trade is there fortuitously through his broker. This "public trader" would have traded anyway, and most likely at or near the same price. That public trader, as well as all other public traders thereafter, traded at the prices they did, not because of the insider's trade but because of the nondisclosure of material information that, if disclosed, would have affected the prices of all trades. Had the insider not traded at all, all the trading that occurred likely would have occurred anyway, and at the same (or very similar) prices. See note 3 supra; Dooley, supra note 8, at 33. But see Mendelson, supra note 8, at 485-86; Wang, supra note 8, at 1234-40. And neither the nontrading insider nor the company would have incurred liability to any traders because rule 10b-5 does not mandate disclosure of material nonpublic information. The obligation of the insider to "disclose or abstain" from trading on material nonpublic information reduces to a ban on insider trading. Thus, the idea of "compensating" the public trader on the other side of the trade with the insider, or the public traders who transacted "contemporaneously" with the insider, or who transacted from that time until disclosure to the public of the material information does not comport with the realities of the anonymous securities markets. The Internal Efficiency rationale could provide a basis for compensatory damages, but the amount of damages sustained by the corporation in a particular case would be difficult to establish.

Thus, if an insider who trades on material nonpublic information is held to be liable, the primary basis must be deterrence, not compensation. The New York Court of Appeals in Diamond v. Oreamuno, 24 N.Y.2d 494, 503, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (1969), enunciated this policy with respect to insider trading: "Only by sanctioning such a cause of action will there be any effective method to prevent the type of abuse of corporate office complained of in this case."
and high quality decisions; whether the insider or the insider's tippee causes the adverse effects is irrelevant.

IV. LEGAL IMPLICATIONS OF THE INTERNAL EFFICIENCY RATIONALE

The argument that a free insider trading rule would adversely affect the corporation's efficiency and decision-making has legal implications that this Part of the Article considers. First, the proposition goes beyond the Business Property rationale by providing a basis for asserting injury to the corporation in every case of insider trading. As Professor Scott observes, the Business Property rationale "implies that the injured party is the company." He concludes that this rationale cannot be extended to all cases because not every personal use of confidential corporate information has the potential to injure the corporation. His "impression is that application [of the insider trading ban] to protect investments in socially valuable discoveries is justifiable, but beyond that the case becomes increasingly dubious." Scott includes as socially valuable discoveries "new mineral deposits and companies that could be made more productive and profitable." However, the Internal Efficiency rationale that this Article suggests applies to all cases of insider trading based on material nonpublic information because of the internal distortions that such trading would likely cause. Since any exceptions to a rule prohibiting insider trading may undermine corporate efficiency and the quality of decision-making, liability under the rationale would be more expansive.

Second, because the Internal Efficiency rationale: (a) focuses exclusively on the internal affairs of the corporation; and (b) asserts that the corporation is injured, its federal concerns are almost nonexistent and its state concerns are strong. The national securities markets and the trading public have been traditional federal concerns at least since 1934, when Congress passed the Securities Exchange Act. The Act contains the two principal provisions relevant to insider trading, sections 10(b) and 16(b). Rule 10b-5, promulgated under section 10(b), is the source of the present "disclose or abstain" rule, which in effect prohibits insiders from trading on the basis of material nonpublic information. Both the Fair Play and Informed Mar-

40. Scott, supra note 2, at 805.
41. Id. at 818.
42. Id. at 815.
ket rationales focus upon the national securities markets and the trading public. Either rationale, if accepted, provides a basis for federal enforcement under rule 10b-5. The Business Property and Internal Efficiency rationales focus on the corporation's interests, a concern that is rather far removed from the national securities markets. And, as the Supreme Court has reminded us, the internal affairs of the corporation are matters "traditionally relegated to state law, in an area basically the concern of the States . . . ." The co-existence of state and federal remedies, therefore, may depend on which rationales the courts accept.

Third, because the Internal Efficiency rationale posits that the corporate entity is injured, the applicable civil legal enforcement device is a shareholder's derivative suit against the inside traders, with the recovery going to the corporation. The derivative suit is also appropriate because deterrence — the primary goal of derivative suits — and compensation — a secondary goal — precisely parallel the relative purposes of a rule prohibiting insider trading. But a federal derivative suit based on the Internal Efficiency rationale would not be available because of the limitation of suits under rule 10b-5 to purchasers or sellers of securities.47

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47. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Ratner, Federal and State Roles in the Regulation of Insider Trading, 31 BUS. LAW. 947, 957, 960 (1976). In Blue Chip, the Court held that only a purchaser or seller (of securities) has standing to bring a private action for damages under rule 10b-5 (the rule). Since the corporation is usually not a purchaser or seller with respect to the insider's trades on the securities market, it has no standing to sue the insider. See, e.g., Davidge v. White, 377 F. Supp. 1084 (S.D.N.Y. 1974). It necessarily follows that a stockholder's derivative suit on behalf of the corporation for insider trading under the rule is foreclosed by Blue Chip.

Blue Chip reaffirmed the long-standing Birnbaum purchaser-seller requirement formulated by the Second Circuit in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). The Birnbaum rule was subject to some exceptions, including pri-
Fourth, because detection may be extremely difficult, the most realistic method to deter insider trading might be to provide for corporate recovery of double or treble the amount of the insider’s profit or loss avoidance. This would require a new statute in most states.

48 See W. CARY & M. EISENBERG, CORPORATIONS 728-29 (5th ed. unabr. 1980) (difficulty of detecting insider trading). Professor Dooley argues that enforcement of the insider trading prohibition has been ineffective and costly, and the sanctions arbitrary. See Dooley, supra note 8, at 19-20, 24-25, 68, 73. He ultimately concludes that retention of “[t]he existing system . . . is indefensible.” Id. at 72. But when he focuses solely on enforcement of the
unless the state courts allowed punitive damages. A corporate recovery of the profit under state law coupled with an individual suit or class action under rule 10b-5 for the same amount based on viable Fair Play or Informed Market rationales might effectively hold out the threat of a double recovery. Indeed, this may be the present law applicable to New York corporations. In *Diamond v. Oreamuno*, the New York Court of Appeals upheld a derivative suit under state law for insider trading, with the corporate recovery measured by the profit (or loss avoidance) that the insiders realized. In a federal action under rule 10b-5 today, the insiders can be required for deterrence purposes to disgorge their profits into a court fund against which public traders might claim. Despite the New York court's desire to avoid a double recovery, the existence of parallel, but nonexclusive, federal and state claims for insider trading may well strike the proper deterrent balance and also satisfy, in a broad sense, the independent “compensatory” claims of the corpo-

prohibition, he concludes that a “a fine system based on a multiple of trading profits probably would be most effective.” *Id.* (footnote omitted).


50. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). *Diamond* has not been adopted in any other state. In *Schein v. Chasen*, 313 So. 2d 739, 746 (Fla. 1975), the Florida Supreme Court refused to adopt the *Diamond* rationale. “[A]ctual damage to the corporation must be alleged in the complaint to substantiate a stockholders’ derivative action.” In *Freeman v. Decio*, 584 F.2d 186, 196 (7th Cir. 1978), the court stated that the Indiana courts would most likely refuse to adopt *Diamond*. It characterized *Diamond* as a decision that “can best be understood as an example of judicial securities regulation.” 584 F.2d at 196 (footnote omitted). Further, the *Decio* court considered any asserted harm to corporate goodwill as speculative. Such harm was a basis for the *Diamond* decision. In *Diamond*, the court stated:

[Despite the lack of any specific allegation of damage, it may well be inferred that the defendants' actions might have caused some harm to the enterprise. . . . When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.]

24 N.Y.2d at 499, 248 N.E.2d at 912, 301 N.Y.S.2d at 81-82. This Article argues that whatever external effects insider trading has on the corporation or the securities markets, it will adversely affect the internal efficiency of the corporation.

The leading incorporation state of Delaware, in a decision predating *Diamond*, has ruled that a corporation could recover the insider trading profit of an employee who purchased stock with inside knowledge that the corporation would engage in a stock buy-in program on the open market. The employee sold his stock at a profit after the corporation's purchases foreseeably drove up the stock price. *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 246-47, 70 A.2d 5, 8 (1949). It is an open question whether the Delaware courts would adopt *Diamond* in the typical insider trading case, where the corporation does not buy or sell its stock close to the time of the insider's trades.


rate entity and of the traders in the national securities markets. The courts could also add criminal prosecution under certain state statutes to the deterrence formula.53

CONCLUSION

Intellectual ferment about insider trading is on the rise once again. The reasons are clear: The considerations are complex and the relevant empirical evidence sparse. An additional perspective should be added to the complex mix: What are the effects, if any, of various insider trading rules on decision-making and efficiency in the large corporation? The Internal Efficiency rationale suggests that allowing insider trading would have adverse effects of a pervasive and systemic nature upon internal decision-making and efficiency.

If this rationale were accepted as the sole basis for prohibiting insider trading, which this Article has not urged, then the legal consequence might be to commit enforcement to state derivative suits. However, if the Fair Play (or “integrity of the markets”) or Informed Market rationale is accepted as sufficient support for the present federal rule, the Internal Efficiency rationale can be viewed as icing on the federal cake or as a new basis for a separate and additional derivative claim under state law, with deterrence as the goal. In any event, the end purpose of the instant effort is to fuel analysis and empiricism on the rationale that this Article has offered.

53. Many states have enacted laws containing anti-fraud provisions modeled on Rule 10b-5. . . . A number have adopted Section 101 of the Uniform Securities Act, which is substantially identical with 10b-5, and also Section 410, which provides for express liability. (Section 410(h) is designed to assure that no civil cause of action may be implied from § 101). Some states prescribe civil liability for violation of § 101 equal to that implied under Rule 10b-5, or may afford the possibility of implying a civil remedy. See Shermer v. Baker, 2 Wash. App. 845, 472 P.2d 589 (1970).
W. CARY & M. EISENBERG, supra note 48, at 718. Section 101 would provide the basis for a state criminal prosecution, provided the state courts were willing to read the section as proscribing insider trading based on material nonpublic information, as the federal courts have done under rule 10b-5. Similarly, courts in certain states could provide an implied civil remedy for insider trading under the particular version of the Uniform Securities Act adopted in those states. Id. at 1333-34.

Obviously, federal criminal prosecution under rule 10b-5 would promote deterrence. Chiarella v. United States, 445 U.S. 222 (1980), exemplifies a relatively strong disposition of the Department of Justice towards prosecution, particularly because the defendant was a low-level employee in a financial printing firm. Although the Supreme Court reversed the conviction, the government thereafter indicted a coconspirator whose investment banking firms were entrusted by bidders with information concerning the future targets of tender offers, and the Second Circuit sustained the sufficiencies of the indictment. United States v. Newman, [Current] FED. SEC. L. REP. (CCH) ¶ 98, 332 (2d Cir. Oct. 30, 1981).