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Avoiding Wasteful Competition: Why Trading on Inside Information Should Be Illegal

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Avoiding Wasteful Competition

WHY TRADING ON INSIDE INFORMATION SHOULD BE ILLEGAL

Michael D. Guttentag†

INTRODUCTION

This article offers a new and compelling reason to make all trading based on inside information illegal.

The value realized by trading on inside information is unusual in two respects. First, inside information is produced at little or no incremental cost and is nevertheless quite valuable. Second, profits made from trading on inside information come largely at the expense of others. When the value of something exceeds the cost to produce it, a race to capture the resulting surplus is both hard to avoid and wasteful. Similarly, resources spent to take something of value from someone else are wasted from a social welfare perspective. Thus, both at its source and in its use, inside information invites wasteful competition. A law prohibiting all trading on inside information is the best way to avoid this wasteful competition.

The analysis of the links between wasteful competition and an outright ban on insider trading begins, as many arguments involving economic activity do, with Adam Smith. Adam Smith observes in *The Wealth of Nations*: "[w]e don't expect our dinner from the benevolence of the butcher, brewer, or baker but from their regard for their own interest."[1] Smith's statement captures perhaps the most important insight from the study of

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[1] ADAM SMITH, THE WEALTH OF NATIONS, bk. I, Chapter II, 7 (Johnathan Bennet ed. 2017) (1776).

microeconomics: Under the right conditions, competition and the pursuit of self-interest can lead to the efficient use of resources.[2]

Smith's insight identifies an important ingredient in many of the successes of capitalism. In a market economy, competition can provide an engine for growth and shared prosperity. When the price charged for an activity reflects fully the costs and benefits of that activity, people will only choose to undertake activities that are welfare enhancing. Personal choice and increased social welfare align.

Two of the ways in which this ideal model might fail in practice are widely acknowledged. First, prices can deviate from the true social costs and benefits of an activity because of externalities. Arthur C. Pigou famously explained that forcing prices to incorporate all relevant costs and benefits could address this market failure.[3] The second widely recognized way in which the link between pursuit of self-interest and increased social welfare might fail is if there is not enough competition. This is a problem antitrust law is designed to address, and the reason the Federal Trade Commission explicitly targets business practices that reduce or limit competition.[4]

A third way in which the pursuit of self-interest fails to produce welfare-enhancing outcomes in a market economy receives less attention. There can be *too much* competition. Competition itself can waste resources, because the winners in a competition have little reason to take into account the costs incurred by those they have vanquished. The private gains from

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[2] This insight dovetails for many with a naïve Darwinism that views human behavior as innately self-interested. If pursuit of self-interest is innate, the naïve Darwinism argument continues, then we are fortunate to have markets that provide a way to channel energies innately dedicated to pursuit of self-interest toward actions that enhance social welfare. This is a view of human nature, by the way, that Smith's own writings on moral philosophy do not embrace. *See, e.g.*, ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 3 (George Bell & Sons, eds. 1892) (1759). Nor is the idea that human nature is exclusively self-interested currently accepted as a reasonable starting assumption by most. *See, e.g.*, ELLIOTT SOBER & DAVID SLOAN WILSON, UNTO OTHERS: THE EVOLUTION AND PSYCHOLOGY OF UNSELFISH BEHAVIOR 8-9 (1998); Joseph Henrich & Michael Muthukkrishna, *The Origins and Psychology of Human Cooperation*, 2021 ANN. REV. PSYCHOL. 207, 209.

[3] ARTHUR C. PIGOU, THE ECONOMICS OF WELFARE 196, 172–203 (1920) (introducing the idea of a "Pigouvian tax" that could be added or subtracted from the price of a good so that the price paid included social costs or benefits). Ronald Coase offered an alternative way to solve the problem of mispricing. Coase observed that where property rights are well defined and there are few transaction costs, the affected parties can agree among themselves on how to optimally use resources. R. H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 2–5 (1960).

[4] *Anticompetitive Practices*, FED. TRADE COMM'N: ENFORCEMENT, https://www.ftc.gov/enforcement/anticompetitive-practices [https://perma.cc/UCZ9-KCAK] ("The FTC generally pursues anticompetitive conduct as violations of Section 5 of the Federal Trade Commission Act . . . .").

competition will, therefore, often exceed societal benefits.[5] Gordon Tullock observes: "This illustrates a very old point in economics. Competition is not always a good thing."[6]

Two situations where this problem of too much competition can arise are especially relevant to the analysis of insider trading policy. First, the problem of too much competition can arise when the value of a good exceeds the cost to produce that good. In such a situation, there will be a surplus, and the race to be the first to capture the resulting surplus is both hard to avoid and likely to waste resources.[7] Richard Posner provides a simple but powerful hypothetical example of this kind of wasteful competition in the context of a race to rescue valuable goods lost at sea.[8] In Posner's example, goods lost at sea are worth $1,000, and the cost to recover the goods is $250. Posner observes that if each potential rescuer has an equal chance of success, it would be logical for four ships to enter the race to find the wreck (because ¼ times $1,000 equals $250, the cost to undertake a rescue effort). However, if only one ship undertook the rescue, there would be a $750 gain (the difference between the $1,000 value of the wreck and the $250 cost of salvage). Posner's example shows how "an expected gain [can be] translated into costs through competitive efforts."[9]

Posner's example of the potential for waste in rescuing valuable goods lost at sea also illustrates how legal rules can help to avoid a wasteful competition problem. The admiralty law rule of salvage dictates that a salvor is entitled to less than the full value

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[5] Economic analysis of this dynamic is provided in Dale T. Mortensen, *Property Rights and Efficiency in Mating, Racing, and Related Games*, 72 AM. ECON. REV. 968 (1982); *see also* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 291 (2004) (providing an economic model of this problem). As a side note, there may also be psychological costs of competition. *See* Dan Simon et al., *The Adversarial Mindset in Psychology, Public Policy & Law*. (Am. Psychol. Ass'n ed. 2020) (on file with publisher).

[6] Gordon Tullock, *Rent Seeking as a Negative Sum Game*, *in James M. Buchanan et al., Toward a Theory of the Rent-Seeking Society* 31 (1980).

[7] This phenomenon is described as rent dissipation by some. *See, e.g.*, Mark F. Grady & Jay I. Alexander, *Patent Law and Rent Dissipation*, 78 VA. L. REV. 305, 306–07 (1992); Dean Lueck, *The Rule of First Possession and the Design of the Law*, 38 J.L. & ECON. 393, 394 (1995). Discussing this problem in the context of a property rule granting ownership to those who are first to possess, Terry Anderson and Peter Hill observe:

> Some law and economics scholars contend that the rent dissipation resulting from open access can be mitigated by common-law rules of first possession such as those that apply to abandoned property, adverse possession, oil and gas, and spoils of war. The race to be first, however, also consumes valuable resources and can diminish the gain from privatization and possibly dissipate it completely.

Terry L. Anderson & Peter J. Hill, *Cowboys and Contracts*, 31 J. LEGAL STUD. S489, S490 (2002).

[8] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 45 (8th ed. 2011).

[9] *Id.* at 45 n.4.

of goods rescued at sea.[10] Posner observes that a rule reducing the payout to the salvor has the effect of reducing waste by lowering the incentive salvors have to be the first to capture the surplus. Posner nicely concludes that "the *denial* of a property right can be as much an economizing device as the creation of one."[11]

The second situation where there is a problem of too much competition that is especially relevant to the analysis of insider trading policy arises when one party's gains come at the expense of another. Resources spent to take something of value from someone else (or when playing a zero-sum game in the language of game theory) are likely to be wasted from a social welfare perspective.[12] Again, this is a problem that the law can address. Tullock, for example, argues that theft is outlawed in almost all societies to avoid precisely this type of wasteful competition:

> [L]arge resources may be invested in attempting to make or prevent transfers. These largely offsetting commitments of resources are totally wasted from the standpoint of society as a whole. This lesson has been learned by almost all societies that have adopted a collective method of reducing this sort of income transfer. This collective procedure [is] laws against theft and police and courts to enforce them . . . .[13]

The discussion thus far reviews how competition, while welfare-enhancing in many situations, can waste resources under two conditions: (1) when competing for a surplus, and (2) when competing for a prize of fixed value. Importantly, and not previously highlighted, inside information at both its source and in its use involves situations in which unfettered competition is likely to waste resources.

Inside information is likely to trigger wasteful competition at its source because inside information is produced at little or no incremental cost and is nevertheless quite

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[10] The law of salvage, which dates back to antiquity, provides that "persons by whose voluntary assistance a ship at sea or her cargo or both have been saved" receives, if and only if the rescue is successful, an amount somewhat greater than the cost of rescue, but not necessarily the total value of the cargo rescued. If there is value remaining after the salver has been compensated, that surplus goes to the original owner of the property. 3A BENEDICT ON ADMIRALTY §§ 2, 235–44 (Martin J. Norris ed., 7th ed. 1997) (citations omitted); GRANT GILMORE & CHARLES L. BLACK, JR., THE LAW OF ADMIRALTY 559–74 (2nd ed. 1975). For a discussion of the precedents in antiquity for this rule, see 3A BENEDICT ON ADMIRALTY *supra* note 10, at § 1.

[11] *See* POSNER, *supra* note 8, at 47.

[12] In game theory and economic theory, a zero-sum game is a mathematical representation of a situation in which each participant's gain or loss of utility is exactly balanced by the losses or gains of the utility of the other participants. DOUGLAS BAIRD & ROBERT GERTNER, GAME THEORY AND THE LAW 317 (1994).

[13] Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 230 (1967).

valuable.[14] Something of value that can be produced at little or no cost creates a surplus, and the existence of a surplus invites wasteful competition, just as when a ship with valuable merchandise on board is lost at sea. Inside information is also likely to trigger wasteful competition when used for a trading advantage in securities markets.[15] Profits generated by trading on inside information come almost exclusively at the expense of others, and competition in this kind of a zero-sum game inevitably wastes resources.

The observation that insider trading invites wasteful competition both at its source and in its use provides a new and compelling reason to prohibit all trading based on inside information. Three policy ramifications follow from this insight. First and foremost, the analysis here shows that it is a mistake to limit an insider trading prohibition to situations where there is evidence inside information is acquired in a deceptive or wrongful manner. This means that we need to change insider trading law in the United States. The legality of trading on inside information currently hinges on whether the information involved was wrongfully obtained.[16] Conditioning of the insider trading prohibition on how the inside information is obtained is necessary because the insider trading prohibition in the United States is based on federal common law determinations of how to apply antifraud statutes to insider trading transactions.[17] Making insider trading liability contingent on how information is obtained creates many doctrinal challenges, such determining when someone who trades on a tip is acting in a sufficiently deceptive manner to justify imposing criminal liability.[18]

If the harm caused by insider trading is wasteful competition, then an insider trading prohibition should not be limited to situations in which information is wrongfully obtained. The better approach is to enact a simple prohibition based on the nature and source of the information rather than on the extent of wrongdoing in the method by which the information is acquired or used.In the two most recent sessions

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[14] *See infra* Section II.B.

[15] *See infra* Section II.C.

[16] *See, e.g.*, Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 439 (2013).

[17] With respect to the federal common law nature of the insider trading prohibition, see United States v. Whitman, 904 F. Supp. 2d 363, 369 (S.D.N.Y. 2012) ("*Dirks*, and indeed all the Supreme Court cases dealing with insider trading, have implicitly assumed that the relevant fiduciary duty is a matter of federal common law . . . ."); Adam C. Pritchard, *Justice Lewis F. Powell, Jr. and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 930 (2003) ("Powell saw Rule 10b-5's jurisprudence as a species of 'federal common law.'").

[18] *See infra* Section V.B.

of Congress the House of Representatives passed legislation to regulate insider trading (in December 2019 the Insider Trading Prohibition Act of 2019 (ITPA of 2019) and in May 2021 the Insider Trading Prohibition Act (ITPA of 2021)) suggesting the time may be now for federal legislation implementing an insider trading prohibition in the United States.[19] While the ITPA of 2019 and the ITPA of 2021 are welcome efforts to place the crime of insider trading on a statutory foundation, both bills continue the practice of only prohibiting trading based on *wrongfully* acquired information. Instead, legislation that bans all trading when in possession of inside information should be enacted.[20]

A second policy implication of the analysis here has to do with the so-called "personal benefit" test established by the Supreme Court in the case of *Dirks v. SEC*.[21] The Court in *Dirks* held that a tip provided by an insider will only trigger insider trading liability if "the insider personally will benefit, directly or indirectly, from his disclosure."[22] Elsewhere I have argued that federal securities statutes do not support the judicial creation of a personal benefit test.[23] Here I observe that the effect of the personal benefit test is to reduce the scope of the insider trading prohibition in a way that does nothing to ameliorate the wasteful competition problems created by inside information. The findings here, therefore, provide a policy rationale in support of the Second Circuit's holding in 2019 in *U.S. v. Blaszczak* that a tipper should face liability for insider trading even absent proof that the tipper received a personal benefit from providing the tip.[24]

A third policy implication of the analysis here has to do with the longstanding debate about whether to prohibit insider trading when someone is in possession of material nonpublic information, or to only prohibit insider trading when someone can be shown to actually use the material nonpublic information for trading purposes.[25] If the problem an insider trading prohibition is designed to address is wasteful competition, the law should disallow trading whenever someone is in *possession*

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[19] The ITPA of 2019 was passed by the House with a vote of 410 yeas and 10 nays on December 5, 2019. 116 CONG. REC. H9271–H9279 (2019). The ITPA of 2021 was passed by the House under a suspension of the rules on May 18, 2021.

[20] *See infra* Section V.A.

[21] Dirks v. SEC, 463 U.S. 646, 663 (1982).

[22] *Id.* at 662.

[23] Michael D. Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519, 524–25 (2017) [hereinafter, Guttentag, *Selective Disclosure*].

[24] United States v. Blaszczak, 947 F.3d 19, 37 (2d Cir. 2019). *See infra* Section V.B.

[25] This is the so-called "possession/use" or "awareness/use" debate. STEPHEN M. BAINBRIDGE, INSIDER TRADING: LAW AND POLICY 71–79 (2014); Andrew Verstein, *Mixed Motive Insider Trading*, 106 IOWA L. REV. 1253, 1258 (2021) [hereinafter, Verstein, *Mixed Motive Insider Trading*].

of inside information. Prohibiting trading only when inside information is used is both more permissive and a more expensive rule to implement. If the goal is to avoid wasteful competition, there is no offsetting benefit from incurring the expense of this additional test to determine whether the insider both possessed and used the inside information.[26]

Before proceeding to the full analysis, there are two additional questions worth addressing in this Introduction. First, why has such a straightforward justification for prohibiting insider trading received so little attention in the vast scholarship on insider trading?[27] Second, why does the government need to intervene when the parties involved have an incentive to work among themselves to avoid wasteful competition?

The answer to the first question, why the topic of wasteful competition has received so little attention, is that this oversight is symptomatic of a larger problem. The economic analysis of legal rules almost always starts with the presumption that unfettered competition is a good thing. As a result, the question of how legal rules can reduce wasteful competition and encourage efficient sharing is underexplored as a general matter.[28]

More specifically, those applying each of the three paradigms relied upon to analyze insider trading policy—efficiency analysis, fairness analysis, and property analysis—have almost completely ignored the problem of too much competition. Efficiency analysis views law as a tool to maximize social welfare and provides a useful lens for analyzing a wasteful competition problem.[29] However, as in other domains, those using efficiency analysis to evaluate insider trading policy have failed to address the costs of wasteful competition.[30] Fairness analysis evaluates when the terms of a transaction comport with ethical notions of fair dealing.[31] Those who use fairness analysis to evaluate insider trading law mistakenly ignore the ethical concerns raised by

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[26] *See infra* Section V.C.

[27] The amount of scholarly discourse on insider trading is quite extraordinary. Among the treatises dedicated to the subject, see generally RALPH C. FERRARA, DONNA M. NAGY, & HERBERT THOMAS, FERRARA ON INSIDER TRADING AND THE WALL (2020); DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION (2019); WILLIAM K. S. WANG & MARC L. STEINBERG, INSIDER TRADING (2012).

[28] *See generally* Michael D. Guttentag, *Law and Surplus: Opportunities Missed*, 2019 UTAH L. REV. 607 (2019) [hereinafter, Guttentag, *Opportunities Missed*] (explaining why legal scholars have mistakenly ignored the important role that law can play in assuring that surplus resources are shared fairly and efficiently).

[29] *See infra* Section III.A.

[30] For limited exceptions where those carrying out efficiency analysis do consider wasteful competition, see *infra* Sections III.A.2.a.–b.

[31] *See infra* Section III.B.

situations involving wasteful competition.[32] Finally, those who use property analysis to evaluate insider trading law have ignored the admonition of Posner that sometimes the denial of a property right is the best approach from an economic efficiency perspective.[33] In summary, for a host of reasons detailed below, scholarship on insider trading has failed to address the central economic problem created by insider trading, the problem of wasteful competition.[34]

The second additional question I want to address in this Introduction is why the government, and not private parties, might be best situated to address the wasteful competition problems created by trading on inside information. What prevents firms from simply agreeing among themselves on the best way to minimize wasteful competition for inside information? There are several reasons discussed below why private ordering arrangements struggle to address the potential for waste arising out of competition to acquire and use inside information.[35] Most importantly, efforts to exploit inside information affect a wide swath of market participants. The disparate nature of the parties involved makes private ordering solutions impractical.[36]

The first Part of this article provides an illustrative hypothetical example of a situation involving a two-sided wasteful competition problem.[37] The second Part of this article defines inside information, and explains why inside information so defined invites wasteful competition both in its acquisition and in its use.[38] The third Part of this article explains why scholarship on insider trading has either ignored or marginalized the importance of the wasteful nature of the competition to acquire and use inside information.[39] The fourth Part of this article: (1) reviews how legal rules can be used to address wasteful competition problems generally,[40] and (2) explains why an insider trading prohibition is the most effective way to combat the two-sided wasteful competition problem created by inside information and also addresses three potential challenges to this conclusion.[41] The final Part of this article provides three policy prescriptions if one accepts that avoiding wasteful competition is the best reason to prohibit insider trading. The recommendations are:

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[32] For evidence of the importance of ethical concerns related to wasteful competition, see *infra* notes 247–250 and accompanying text.

[33] *See infra* Section III.C; *see also supra* note 11 and accompanying text.

[34] *See infra* Part III.

[35] *See infra* notes 212–227 and accompanying text.

[36] *See infra* notes 212–227 and accompanying text.

[37] *See infra* Part I.

[38] *See infra* Part II.

[39] *See infra* Part III.

[40] *See infra* Section IV.A.

[41] *See infra* Section IV.B.

(1) that federal insider trading legislation should be enacted that prohibits all trading on inside information regardless of whether the information is wrongfully acquired, (2) courts should not require proof that a tipper received a personal benefit to find tippers and tippees culpable, and (3) the mere possession of inside information should be sufficient to trigger a trading prohibition.[42]

I. AN ILLUSTRATIVE EXAMPLE OF A PROHIBITION DESIGNED TO AVOID WASTEFUL COMPETITION

The central claim in this article is that trading on inside information should be prohibited because such a prohibition is the best way to reduce wasteful competition that would otherwise result from efforts to acquire and use inside information for securities trading purposes. To make this claim more tractable, this Part offers an illustrative hypothetical example of a situation where there is wasteful competition both at the source and in the use of a product. This example is provided to show how a legal rule can address the problem of wasteful competition and to highlight how a traditional cost-benefit style analysis can easily miss the problem of wasteful competition.

This illustrative example begins with the introduction of a currency into a simple economy.[43] The currency consists of Conch shells. Conch shells are used as a currency because there is a valuable commodity, wheat, that is difficult to use as a means of exchange. The use of Conch shells as a currency in this economy proceeds as follows. All available Conch shells are gathered up and placed in a central repository. Then, buckets of wheat are exchanged for Conch shells at a preset rate. At any point in time a Conch shell can be redeemed for wheat at the central repository. Conch shells are assumed to have no value other than as a medium of exchange for wheat.

I next introduce the term a "two-sided wasteful competition problem" to describe a situation where a good triggers wasteful competition both in its acquisition and in its use and illustrate how a two-sided wasteful competition problem could arise in this simple economy. Assume Dash happens to come across a previously undiscovered Conch shell. Finding this Conch shell is a byproduct of Dash's other activities. For Dash, the discovery of this Conch shell constitutes a surplus because Dash now has something of

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[42] *See infra* Part V.

[43] I use this setting because it is simple, and not to reflect actual practices with respect to currencies in primitive societies. For a discussion of such practices, see George Dalton, *Primitive Money*, 67 AMER. ANTHROPOLOGIST 44 (1965).

value that he found at little or no cost.[44] The presence of a surplus invites wasteful competition, and has the potential to create one side of the wasteful competition problem in this illustrative example in the following way.[45] Others might invest resources to race ahead of Dash to be the first one to find the Conch shell. While there are private incentives to invest resources in this race to find Conch shells, there is no social welfare benefit if someone else finds the Conch shell before Dash happens to find it.

The second side of the wasteful competition problem in this illustrative example arises when Dash attempts to exchange the newly found Conch shell for wheat. In exchanging the Conch shell for wheat, Dash transfers resources, in this case wheat, from others to himself. While it is true that Dash's exchange of his newly found Conch shell for wheat is not necessarily problematic from a social welfare perspective if the only consequence is to change who gets to consume wheat, any investment of resources in efforts to gain access to the wheat supplies by use of Dash's "counterfeit" Conch shell or any investment of resources in efforts to prevent the transfer of wheat to those who did not originally contribute to the wheat reserves is socially wasteful. The arms race triggered by efforts to exchange "counterfeit" Conch shells for wheat creates the second side of the wasteful competition problem that can arise in this illustrative example. Thus, this illustrative example shows a situation where both at its source, in racing to find the Conch shell, and in its use, in exchanging the "counterfeit" Conch shells for wheat, resources may be wasted even thought all parties involved are acting rationally and the system is at equilibrium.[46]

It would, however, be a misnomer to call the competition to find Conch shells or to exchange them for wheat in this illustrative example "wasteful" if such competition is unavoidable. This

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[44] The definition of a surplus used here is the amount by which benefits are received in excess of costs. Examples of definitions based on this meaning include "an excess of receipts over disbursements," *Surplus*, WEBSTER'S NEW COLLEGIATE DICTIONARY (1973), or "an excess of production or supply over demand." GOOGLE, https://www.google.com/search?q=surplus+definition&ie=utf-8&oe=utf-8&client=firefox-b-1 [https://perma.cc/XH44-PAB4]. For a more in-depth discussion of the surplus terminology, see Guttentag, *Opportunities Missed*, *supra* note 28, at 623 n.79.

[45] For further discussion of the connection between surplus and wasteful competition, see Guttentag, *Opportunities Missed*, *supra* note 28, at 616–22.

[46] Ian Ayres and Stephen Choi make a similar observation and explain how, using stock price valuations as an example, reaching an equilibrium does not mean assets are being utilized efficiently. They observe that "[t]he mere fact, however, that investor information research is self-limiting does not guarantee that social welfare is at a maximum under the laissez-faire approach . . . ." Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 345 (2002).

competition is wasteful only if there is a less wasteful alternative approach available. A law that prohibits the exchange of "counterfeit" Conch shells for wheat could provide just such a low-cost alternative. Setting aside questions of enforceability, such a prohibition would reduce both the incentive to invest resources in efforts to find Conch shells and the incentive to invest resources in efforts to exchange "counterfeit" Conch shells for wheat. Such a law provides an example of how "the *denial* of a property right can be as much an economizing device as the creation of one."[47]

This illustrative example can also be used to show how a traditional listing of the costs and benefits of an activity can miss the problems created by wasteful competition. One could imagine what a traditional cost/benefit analysis of the search for Conch shells in this simple economy would look like. First, one would identify various costs that might arise in the search for new Conch shells, such as mining costs. Then one would identify benefits from finding a new Conch shell, which would consist here of the value of a Conch shell as a medium of exchange for wheat. There might also be externalities one could identify. Perhaps valuable minerals are more easily uncovered by other people who are following the Conch shell searchers. This would constitute a positive externality. On the other hand, those searching for Conch shells may leave behind a landscape marred by ugly potholes, creating a negative externality.

An efficiency-minded regulator might look at these various costs, benefits, and externalities and reach two conclusions. First, in an ideal world and, following Pigou, it might seem preferable if those seeking to acquire and exchange Conch shells were forced to internalize the costs and benefits of their activities.[48] Second, in the absence of a mechanism to force the Conch shell searchers to internalize the various externalities, the regulator might try to measure the magnitude and direction of the externalities in order to determine if regulatory intervention is justified. Observe that this entire discussion of costs, benefits, externalities, and considerations of regulatory intervention, misses the central problem, wasteful competition, raised by this illustrative example.

The problem with the traditional cost/benefit analysis presented above is that the analysis implicitly relied on the assumption that the value realized by undertaking an activity is

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[47] *See* POSNER, *supra* note 8, at 47.

[48] *See generally* PIGOU, *supra* note 3, at 172–203 (explaining how bounties and taxes can be used to address a problem that arises when there is a divergence between the private benefits realized from undertaking an activity and the social benefits from undertaking that activity).

an accurate measure of the social value of this activity. However, when the activity involves engaging in competition for a surplus or when one's success comes at the expense of others this assumption is incorrect. Multiple parties searching for the same supply of Conch shells will waste resources just as efforts to use the newly found Conch shells in exchange for wheat will waste resources. Even if a system is in equilibrium, resources may be wasted for reasons that are easily missed by a discussion of the various costs and benefits that the activities directly or indirectly appear to implicate.[49]

The discussion below will make the case that inside information is much like the Conch shells in this illustrative example. As with Conch shells in this example, efforts to acquire and use inside information will trigger not one, but two wasteful arms races. The first is a race to gain access to inside information before others. The second is a race to trade using that information in public securities markets. Finding a way to avoid investing resources in both forms of wasteful competition should be the central focus of insider trading policy.

II. WHY INSIDER TRADING INVITES WASTEFUL COMPETITION

This Part provides evidence in support of the claim that inside information, both at its source and in its use, invites wasteful competition. The first Section of this Part sets out a definition of inside information for the purposes of this claim. The next Section explains why efforts to acquire inside information are likely to result in wasteful competition. The final Section explains why efforts to use inside information are likely to result in wasteful competition.

A. Defining Inside Information

The term "inside information" can be defined in many ways. For the purposes of this article, the definition of inside information provided by Merritt Fox, Lawrence Glosten, and Gabriel Rauterberg best captures the salient features of inside information. According to Fox, Glosten, and Rauterberg, inside information consists of material "nonpublic information obtained from inside an issuer or another entity."[50]

The first part of this definition, that inside information is material and nonpublic, is not controversial. The standard used to

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[49] *See infra* Part V.

[50] Merritt B. Fox, Lawrence R. Glosten, & Gabriel V. Rauterberg, *Informed Trading and Its Regulation*, 43 J. CORP. L. 817, 821 (2018).

determine if information is material is well-established. In *TSC Industries v. Northway,* the Supreme Court defined information as material for the purposes of the Securities and Exchange Act "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote [on a particular matter]."[51] In *Basic Inc. v. Levinson*, the Supreme Court applied the *TSC Industries* materiality standard to a lawsuit brought under section 10b-5 of the Securities and Exchange Act, explaining that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information" in making an investment decision.[52] With respect to the non-public component of the definition, defining inside information as consisting only of information that is nonpublic is a logical way to focus on information that is likely to provide a trading advantage to someone who possesses it. As discussed more fully below, information that is already publicly available is unlikely to be valuable for trading purposes.[53]

The final definitional issue relates to how best to distinguish inside information from other types of material nonpublic information. There are three criteria that might be used: (1) the content of the information, (2) the precision of the information, or (3) the source of the information. There are examples of each of these three approaches in the various regimes that regulate insider trading. For example, the rule in the United States that prohibits trading based on information about a forthcoming tender offer, Rule 14e-3, implements what is primarily a content-based determination.[54] If the information

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[51] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (interpreting the materiality standard in the context of a proxy statement).

[52] Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988). For an excellent discussion, see BAINBRIDGE, *supra* note 25, at 66–68; *see also* Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 170 n.185 (2004) [hereinafter, Guttentag, *Imposing Disclosure Requirements*].

[53] *See infra* note 148 and accompanying text.

[54] SEC Rule on Transactions in securities on the basis of material, nonpublic information in the context of tender offers 17 C.F.R. § 240.14e–3(a) [hereinafter SEC Rule] ("(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information *relating to such tender offer* which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: (1)[t]he offering person, (2) [t]he issuer of the securities sought or to be sought by such tender offer, or (3) [a]ny officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.").

one has is about a forthcoming tender offer as defined in the rule, then trading based on that information is prohibited.[55]

An example of a definition of inside information that depends primarily on the precision of the information comes from the Market Abuse Directive (MAD) adopted by the European Union (EU), which prohibits trading using inside information.[56] The relevant MAD provision defines "inside information" as:

> information *of a precise nature*, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.[57]

The MAD provisions go on to provide some detail as to when information "shall be deemed to be of a precise nature."[58] Under the MAD provisions, information is precise:

> if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred . . . where it is specific enough to enable a conclusion to be drawn as to the possible effect . . . on the prices of the financial instruments.[59]

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[55] This observation is a bit of an oversimplification because there is also a source component in that the rule also requires knowledge about the likely source of the information. *See* SEC Rule, *supra* note 54.

[56] Regulation (EU) 596/2014 of the European Parliament and of the Council of 16 April 2014 on Market Abuse (Market Abuse Regulation) and Repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC, and 2004/72/EC, 2014 O.J. (L 173/1), ch. 2, art. 7 [hereinafter EU Regulation 596/2014]. For an overview of European insider trading law, see Katja Langenbucher, *Insider Trading in European Law*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 429 (Stephen M. Bainbridge ed. 2013); *see also* JOHN P. ANDERSON, INSIDER TRADING: LAW, ETHICS, AND REFORM 6, 122–24 (2018).

[57] *See* EU Regulation 596/2014, *supra* note 56, ch. 2, art. 7, 1(a) (emphasis added). In addition to the precision requirement, the EU rule also looks to some degree to the source of the material nonpublic information to determine if information is inside information. The EU provisions apply to "any person who possesses inside information as a result of: (a) being a member of the administrative, management or supervisory bodies of the issuer . . . (c) having access to the information through the exercise of an employment, profession or duties; or (d) being involved in criminal activities." *Id.* at ch. 2, art. 8(4). There is also a fairly sweeping catch-all stating that: "[t]his Article also applies to any person who possesses inside information under circumstances other than those referred to . . . where that person knows or ought to know that it is inside information." *Id.*

[58] *Id.* at ch.2, art. 7(2).

[59] *Id.* There was a carve-out that removed from the definition of inside information the information gathered by value-oriented investors to decide whether to invest in a firm based on publicly available information. The rule stated that "[r]esearch and estimates developed from publicly available data should not be regarded as inside information." Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse) 2003 O.J. (L 96) 31. However, that carve-out was removed on Feb. 7, 2016 pursuant to 32014R0596.

An example of the third approach, a definition based on the source of the information, is provided by the Fox, Glosten, and Rauterberg definition of inside information. The Fox, Glosten, and Rauterberg definition looks primarily to the source of the material nonpublic information, namely if the information is "obtained from inside an issuer or another entity,"[60] to determine whether the information constitutes inside information. I argue below why a definition of inside information based primarily on the source the information might be a better tool to avoid wasteful competition than a definition similar to the content-focused type of definition used in Rule 14e-3 or the precision-based type of definition in the MAD provisions adopted by the EU.[61]

B. Sources of Inside Information and Waste

Inside information, defined as material "nonpublic information obtained from inside an issuer or another entity,"[62] invites wasteful competition at its sources because there is often a gap between the value that can be realized by trading with foreknowledge and the incremental cost of producing this foreknowledge. When the value of something exceeds its production cost, as is typically the case with inside information, there is likely to be a wasteful race to be the first to capture it.[63]

Many of those who work within a firm have access to information that can be used to trade profitably in securities markets. Employees, for example, may know something as mundane as how well a particular product is selling or something as crucial as whether the results of a clinical trial provide evidence that the company's treatment for a serious medical condition is safe and effective. If an investor, in this case the employee, has knowledge about future events before other investors, then that investor can determine when securities are trading above or below the insider's more informed estimate of the firm's future cash flows.[64]

The existence of this type of valuable inside information is well-recognized.[65] The crucial additional observation here is that the incremental cost of producing such information is likely to be quite low. As suggested by the example provided just above

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[60] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 821.

[61] *See infra* Section V.A.

[62] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 821.

[63] There is an additional risk that managers might engage in new activities primarily to create the kind of valuable foreknowledge that can be traded on for profit. I thank Elizabeth Pollman for this helpful observation.

[64] *See, e.g.*, Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561, 562 (1971) (describing foreknowledge).

[65] *See infra* note 81 and accompanying text.

of clinical trial results, information that is valuable for securities trading purposes is often produced as a byproduct of other activities. Clinical trial results are generated as part of an effort to evaluate the efficacy of a new treatment. However, the trading value of the information comes from the extent to which public disclosure will alter securities prices, not the incremental cost of gathering the information.

When something of value can be created at little or no cost, a surplus results.[66] The existence of a surplus invites wasteful competition because competition for surplus (or rent-seeking in the terminology economists prefer) is both hard to prevent and inherently wasteful.[67] The nature of the wasteful competition that could result from efforts to access these windfalls inside the firm is nicely chronicled by Robert Haft.[68] Haft describes, for example, how the "incentives for delay and internal competition for insider trading profits would increase the normal distortion in the upward transmission of information."[69]

A simple example may be helpful. Let us suppose that Angel works at Company A and is asked by coworkers about the business model of a small public company, Company B, in a related industry. Angel correctly surmises that Company A wants to purchase Company B. Based on this information, Angel buys Company B stock. As Angel expected, Company A makes a bid for Company B, and the stock price of Company B rises dramatically. Angel sells the Company B shares at a hefty profit.[70]

In this example, Angel did not have to spend any money or other resources to gain access to what proved to be valuable material nonpublic information. For Angel the information about Company B's future share price arrives like manna from heaven. Nor does Company A expend resources to provide this

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[66] This was Posner's insight in the numerical example of the rescue of a valuable ship lost at sea and his explanation of the economic rationale behind the admiralty law rule of salvage. *See supra* notes 8–11 and accompanying text.

[67] There is some ambiguity in what economists mean by the term rent-seeking, as I have discussed elsewhere. *See* Guttentag, *Opportunities Missed*, *supra* note 28, at 619–22.

[68] Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1051–56 (1982).

[69] *Id.* at 1055–56.

[70] This is similar to the situation described in Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 197–98 (1991). According to research by Michael Perino, this type of insider trading infraction, where a person gathers and trades on material nonpublic information about another firm from their position within their own firm, is the most common basis for an insider trading enforcement action. MICHAEL A. PERINO, REAL INSIDER TRADING 47–48 (2019).

Determining whether Angel's trading is illegal under current insider trading law in the United States requires an application of the misappropriation theory of insider trading, which forbids trading using information misappropriated from the source of the information. This determination, therefore, depends on whether Angel's trading in Company B shares was sanctioned by Company A. *See infra* note 254 and accompanying text.

information to Angel. In fact, Company A receives a benefit from sharing the information about Company B with Angel, because Angel provides Company A new information about Company B.

That valuable material nonpublic information may be produced by firms at little or no cost is a feature of inside information that many scholars studying insider trading readily acknowledge. Fox, Glosten, and Rauterberg observe that "most material information from within an issuer is the synergistic byproduct of the operations of the underlying business."[71] Ian Ayres and Stephen Choi go so far as to define a term, "non-trading information," specifically to describe valuable material nonpublic information that is produced as a byproduct of other activities within the firm.[72]

There is, however, one point of confusion that has obfuscated the surplus nature of inside information at its source for some scholars. When presented with the observation that access to inside information appears to provide a windfall to a lucky few insiders, Henry Manne and other critics of an insider trading prohibition offer an explanation for why access to inside information may not constitute a windfall for these employees. These scholars argue that access to inside information can be a component of the compensation provided to employees.[73] According to this line of argument, if access to inside information is a substitute for other forms of compensation, then the value from access to inside information realized by employees would not be a windfall.

Using the facts of the hypothetical above to illustrate this point, suppose that Company A chooses to reduce Angel's salary to reflect the gain Angel is able to realize by trading in Company B shares. It is correct that reducing Angel's salary to offset the gains Angel realizes from trading in Company B shares may eliminate Angel's windfall. However, treating access to inside information as a component of compensation does not alter the surplus nature of the value realized by using inside information for a trading advantage. Offsetting Angel's gain from access to inside information with a reduction in Angel's salary simply shifts the beneficiary of the windfall created by the low incremental cost of

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[71] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 859.

[72] *See* Ayres & Choi, *supra* note 46, at 342 ("Outside information pertinent to the valuation of the traded firm, in turn, may be separated into two categories: information that would have been created without regard to trading profit (termed 'non-trading information') . . . ."). Henry Manne similarly acknowledged that "many significant pieces of information are windfalls to the individuals who first learn them." HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 56 (1966).

[73] Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) (arguing "why allowing [insider trading] may be an efficient way to compensate corporate managers"); *see also* MANNE, *supra* note 72, at 131–45.

creating valuable inside information from Angel to Company A. If access to inside information is used as a component of compensation, then the windfall nature of inside information is not eliminated but simply shifted from the employee to the firm.

Inside information is surplus at its source because few incremental resources need to be expended to produce this information, not because access to inside information can provide an unexpected windfall to a few employees.

C. Uses of Inside Information and Waste

The discussion above focuses on how the low-cost production of inside information creates a surplus.[74] The discussion now shifts to showing why the use of inside information to trade securities involves a zero-sum game wherein gains by those in possession of inside information come primarily at the expense of others.

There are three elements to the claim that the value in use of inside information involves a transfer of value from others rather than the creation of new value. The first element is the assertion that the ability to trade on inside information is valuable. The second element is the assertion that this value is realized at someone else's expense. The third element of the claim is an explanation as to why people allow this transfer of value to occur, or, in other words, why would anyone continue to enter into trades when they are more likely to lose than to win.

1. Value of Inside Information

The first part of explaining why trading on inside information constitutes the transfer of value rather than the creation of value involves reviewing why trading on inside information generates returns that exceed those realized by other investors. Explaining why inside information is valuable requires a review of work by financial economists on market efficiency. Financial economists have studied the relationship between information and stock prices in depth and have considered in detail three different hypotheses about the relationship between information and stock prices. Each of these three hypotheses is described as a version of the Efficient Capital Market Hypothesis (ECMH).[75]

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[74] *See supra* Section II.B.

[75] *See generally* Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994) (summarizing the history of the ECMH and the random walk

The first hypothesis about the relationship between information and stock prices is the "weak" ECMH. The weak ECMH hypothesizes that historical information about securities price movements is already incorporated into current stock prices.[76] The consensus among financial economists is that the weak ECMH holds true in well-functioning securities markets.[77] As a result, having access to information about historical price movements does not provide an investor with the basis for a sustainable trading advantage.

The second hypothesis proffered by financial economists about the relationship between information and stock prices is known as the "semi-strong" ECMH. The semi-strong ECMH hypothesizes that all publicly available information, such as the publicly reported earnings of a company, is rapidly incorporated into stock prices.[78] Despite some evidence to the contrary and disagreement about precisely how rapidly public information is incorporated into stock prices, the consensus among financial economists is that the semi-strong ECMH is also an accurate characterization of well-functioning securities markets.[79] As a result, having access to information that is already publicly available does not provide an investor with the basis for a sustainable trading advantage.

The third hypothesis with respect to the relationship between information and stock prices is the "strong" ECMH. The strong ECMH hypothesizes that all information, whether public or private, is rapidly incorporated into stock prices.[80] If the strong version of the ECMH is an accurate description of well-functioning securities markets, then inside information would be of little value. This information would already be incorporated into stock prices and those with access to inside information could not systematically trade profitably based on that access. The consensus among financial economists is that the available evidence does not support the strong ECMH. In fact, some of the best evidence for rejecting the strong ECMH is the ability of insiders to trade profitably using inside information.[81]

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model of public capital market behavior); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (reviewing economics literature on the ECMH).

[76] *See* Fama, *supra* note 75, at 388.

[77] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555 n.25 (1984).

[78] *See* Fama, *supra* note 75, at 388.

[79] Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 911–12 n.11 (1989).

[80] *See* Fama, *supra* note 75, at 388.

[81] *See* Fischel, *supra* note 79, at 911–12 n.11.

2. Source of Value of Inside Information

The evidence suggests that those in possession of inside information can generate returns that exceed those realized by other investors.[82] The next question to consider in explaining why the use of inside information invites wasteful competition is where these excess returns come from. There are two possible answers. First, insiders might profit because their activities increase the value of the firm. Second, insiders might profit at the expense of others.

Manne rejects the idea that gains realized from insider trading must come at the expense of others. Manne writes that: "The insider's gain is not made at the expense of anyone. The occasionally voiced objection to insider trading—that someone must be losing the specific money the insider makes—is not true in any relevant sense."[83] However, Manne provides no evidence to support this claim. Instead, Manne and others rely on two observations to suggest that profits from insider trading do not come at the expense of others.

One observation that might support this claim is that employee access to inside information can be used to lower the amount the firm needs to pay in other forms of compensation.[84] However, this observation is only relevant to the question of which party benefits from access to the excess returns that can be generated by trading on access to inside information and not to the question of how that value is created.[85] In the scenario where inside information is used as a form of executive compensation, it is simply the firm rather than the employee who benefits from the value realized by trading on this information.[86]

Another observation offered to argue that trading on inside information does not simply transfer value from less informed investors is that there are benefits provided by insider trading, such as improved share price accuracy.[87] Improving share price accuracy can benefit both the firm and the economy as a whole. The open issue is the empirical question of how the magnitude of this benefit—the improvements in share price accuracy—compares to the amount of the value realized by

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[82] *See supra* Section II.C.1.

[83] *See* MANNE, *supra* note 72, at 61.

[84] *See supra* note 73 and accompanying text.

[85] *See supra* note 73 and accompanying text.

[86] Only if insider trading is an efficient way to compensate employees (the evidence is to the contrary) will this compensation technique provide at least some explanation for the value that can be realized by trading on inside information. For a discussion of the relative efficiency or inefficiency of insider trading as a means of compensation, see *infra* notes 118–121 and accompanying text.

[87] *See infra* note 118–119 and accompanying text.

trading on inside information. We know that trading on inside information can produce substantial amounts of profit.[88] It seems implausible that these substantial profits are entirely the result of improvements in share price accuracy.

The mechanism by which trading on inside information might transfer value from other investors is, on the other hand, quite straightforward to understand. As Jack Treynor, writing under the nom de plume Walter Bagehot, observes, "[e]very time one investor benefits from a trade, after all, another loses."[89] Trading on inside information is almost certainly not the magical value creation machine that Manne claims it to be. The consensus view now is that profits realized by trading on material nonpublic information come at the expense of others. Ayres and Choi write "the trading benefit that informed traders receive from their information advantage will exactly equal the trading loss to uninformed investors."[90] Fox, Glosten, and Rauterberg similarly conclude that "trading is a zero-sum game."[91] William Wang provides a detailed scenario-based explanation as to why "each act of inside trading does in fact harm other individuals."[92]

The related question as to who loses out to insiders is a much-debated topic. Possible losers include market makers, others who trade in the firm's securities at the same time insiders are trading, or the firms themselves when raising capital in public securities markets.[93] Fox, Glosten, & Rauterberg, for example, argue that other investors will not price securities in a way that provides them a below-market return, so the fact that informed traders can capture value means that firms raising capital will receive less than they otherwise would if they could sell securities only to investors who would never trade on inside information.[94]

If trading on inside information involves a zero-sum game, as the evidence suggests, then resources invested in competitive efforts to trade on this information are wasted from a social welfare perspective.

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[88] *See infra* Section IV.B.

[89] Walter Bagehot, *The Only Game in Town*, 27 FIN. ANALYSTS J. 12, 12 (1971).

[90] *See* Ayres & Choi, *supra* note 46, at 330.

[91] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 849.

[92] William K.S. Wang, *Trading on Material Non-Public Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1234–35 (1981).

[93] For a discussion of market makers, see *infra* note 96 and accompanying text.

[94] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 840.

3. Trading with Those in Possession of Inside Information

The observation above, that those who trade on inside information benefit at the expense of others, raises a follow-on question worthy of further consideration.[95] Why would investors ever willingly choose to trade with those who have access to inside information?

This question is addressed by those who study market makers. A market maker is a professional liquidity supplier whose business is "to stand ready to buy or sell shares at [their] quoted prices (respectively a 'bid' price to buy and an 'offer' or 'ask' price to sell)."[96] Because market makers purchase and sell securities from all parties, market makers would appear to be those most likely to be harmed by trading with better informed counter-parties. The question then becomes why would market makers ever trade with those in possession of material nonpublic information. The answer to this question must be that it is less expensive to occasionally trade with better informed parties than to try and ferret out which traders are trading at an informational advantage. If avoiding those trading with inside information were simple to do, then insider trading would not generate excess returns. Market makers instead choose to offset their losses to informed traders by setting a higher bid-ask spread. The bid-ask spread presumably provides market makers adequate compensation for providing liquidity despite the fact that some purchasers or sellers are working at an informational advantage.[97]

In summary, inside information invites wasteful competition in two respects. First, inside information costs little to produce yet can be quite valuable.[98] This creates a surplus that can be dissipated through competition. Second, the value of inside information comes almost exclusively from a transfer of wealth from others.[99] Resources invested in competing for a fixed prize are wasted. The next Part of

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[95] *See supra* Section II.C.2.

[96] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 827–28; *see also* Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

[97] Treynor explains:

> [T]he market maker can be viewed as a conduit through which money flows from liquidity-motivated transactors to transactors with special information . . . .[What the market maker] loses in trading against the spread must be large enough to provide insiders with their profits, and hopefully leave something for the market makers beside.

See Bagehot, *supra* note 89, at 14.

[98] *See supra* Section II.B.

[99] *See supra* Section II.C.

this article considers why existing scholarship on inside information ignores or minimizes such an important observation about the nature of trading on inside information.

III. WHY SCHOLARSHIP ON INSIDER TRADING POLICY IGNORES THE WASTEFUL COMPETITION PROBLEM

The discussion above explains why the acquisition and use of inside information invites wasteful competition.[100] This observation may appear so obvious that, given the rich history of insider trading scholarship, such an observation would not be particularly helpful in advancing our understanding of insider trading policy. The discussion in this Part explains how such an important insight was ignored entirely or treated as a matter of secondary importance in prior scholarship on insider trading.

Scholars studying insider trading policy have primarily relied on one of three methodological approaches: (1) efficiency analysis, (2) fairness analysis, and (3) property analysis. Efficiency analysis considers how legal rules can ensure that assets are utilized efficiently throughout the economy.[101] Fairness analysis evaluates when the terms of a transaction comport with ethical notions of fair dealing.[102] Property analysis is based on the idea that granting clear property rights is usually the best way to insure that assets are exploited efficiently.[103] None of these analytic approaches, at least as currently applied to insider trading policy analysis, is particularly helpful in highlighting how legal rules can address the two-sided wasteful competition problem created by inside information.[104]

A. Efficiency Analysis

Efficiency analysis considers how legal rules can ensure that assets are utilized efficiently throughout the economy. Efficiency analysis is the dominant method of evaluating the regulation of securities markets generally and of insider trading policies in particular. However, those who carry out efficiency analysis rarely consider situations in which competition itself is a significant economic problem.[105] One consequence of this oversight is that the efficiency analysis of insider trading policy

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[100] *See supra* Sections II.B.–C.

[101] *See infra* Section III.A.

[102] *See infra* Section III.B.

[103] *See infra* Section III.C.

[104] For the definition of a two-sided wasteful competition problem, see *supra* note 43 and accompanying text.

[105] *See* Guttentag, *Opportunities Missed*, *supra* note 28, at 611.

has rarely grappled with the wasteful competition problem created by trading on inside information. The few scholars studying the efficiency of insider trading policy who have engaged with the wasteful competition problem created by inside information, such as Jonathan Macey, offer empirically unsupported justifications for avoiding the obvious conclusion that a ban on insider trading is likely to be the most efficient way to address this wasteful competition problem.[106]

1. Efficiency Analysis Generally

Two tenets underpin the efficiency analysis of legal rules. The first tenet is the First Fundamental Theorem of Welfare Economics. The First Fundamental Theorem of Welfare Economics holds that prices for goods will reflect the social marginal cost of using those goods when certain assumptions are valid.[107] When prices reflect costs, those who choose to consume goods will only do so when the benefits they realize either equal or exceed the social cost of those goods. Legal scholars who undertake efficiency analysis infer from the First Fundamental Theorem of Welfare Economics that if the goal of legal intervention is to ensure that assets are allocated efficiently, then well-functioning markets with accurate prices provide a particularly attractive means of achieving this objective.

The second tenet of the efficiency analysis of law is that efficiency considerations should be paramount when deciding how to regulate market transactions. The claim is not that enhancing economic efficiency should be the only goal of all legal rules. Instead, the argument is that to the extent there are other goals to be achieved by the legal regulation of social activity, such as the goal of redistributing wealth or protecting peoples' rights, regulating market transactions is not a good way to achieve these other goals. For example, tax policy rather than market regulation should be the preferred method to achieve wealth redistribution.[108]

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[106] *See infra* Section III.A.2.

[107] GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 50 (3d ed. 2013) ("The First Fundamental Theorem of Welfare Economics [is that] the competitive equilibrium, where supply equals demand, maximizes social efficiency."); Eric S. Maskin, *The Economics of Kenneth J. Arrow: A Selective Review*, 11 ANN. REV. ECON 1, 13 (2019) ("[L]et us define an allocation to be Pareto optimal if there exists no other allocation that every consumer finds at least as preferable as the original allocation and some consumer finds strictly preferable. The First Welfare Theorem (FWT) then asserts that a competitive equilibrium allocation is Pareto optimal . . . .").

[108] *See, e.g.*, RICHARD MUSGRAVE, THE THEORY OF PUBLIC FINANCE 18 (1959); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEG. STUD. 667, 667–68 (1994); Steven Shavell, *A Note on*

Putting these two tenets together leads to a straightforward recommendation as to when to use legal rules to regulate market activity. If markets are the best way to allocate assets efficiently, and achieving efficient outcomes is the appropriate objective for the legal regulation of market transactions, then only a market failure can justify regulating a market transaction. In the absence of a market failure, markets will allocate assets efficiently—the desired outcome in the context of market regulation.

This approach also suggests an additional constraint on legal intervention in market transactions. If efficiency is to be the criteria for lawmaking in the domain of market transactions, then it would only make sense to undertake a legal intervention when the benefits of intervention are likely to exceed the costs. This means that even after identifying a market failure, one must also carry out a cost-benefit analysis of any proposed legal intervention to make sure the cure is not more expensive than the problem one is attempting to address. A market failure is a necessary but not sufficient justification for legal intervention.

It is helpful in describing the efficiency analysis of legal rules to provide some content as to when and how markets might fail. Legal scholars have identified several kinds of market failures that justify legal intervention, including those caused by externalities,[109] information asymmetries,[110] behavioral failings,[111] public goods,[112] and natural monopolies.[113] Each of these market failures raises a separate set of complex issues about if, when, or how legal intervention might increase efficiency.

The issues raised by the presence of externalities show how the analysis of a legal intervention designed to enhance efficiency might be carried out. Externalities arise when the price of a good

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Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation?, 71 AM. ECON. REV. 414, 414 (1981) Rory Van Loo, *Consumer Law as Tax Alternative*, 96 N.C. L. REV. 101, 103 (2019) (reviewing "the longstanding scholarly paradigm that taxes are the best mechanism for redistribution because they are the most efficient option").

[109] *See infra* notes 114 to 116 and accompanying text.

[110] A market failure arising from information asymmetries was formally modeled by George Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism of Social Cost*, 84 QUART. J. ECON. 488, 490 (1970).

[111] Pernicious sellers can take advantage of predictable imperfections and biases when people make purchase decisions. The result is behavioral exploitation. The prototypical example of behavioral exploitation occurs when a seller charges higher prices by taking advantage of differences between a buyer's "decision utility," which determines the choices people make, and that same buyer's "experienced utility," which reflects the actual benefits people receive from their choices. *See, e.g.*, Daniel Kahneman et al., *Back to Bentham? Explorations of Experienced Utility*, 112 QUART. J. ECON. 375, 375 (1997); Sendhil Mullainathan et al., *A Reduced-Form Approach to Behavioral Public Finance*, 4 ANN. REV. ECON. 511, 516 (2012).

[112] *See* MUSGRAVE, *supra* note 108, at 43–44.

[113] *Id.* at 44–45.

or service does not reflect the full social cost or benefit of using that good.[114] However, the presence of an externality does not automatically justify legal intervention for several reasons. First, the social costs arising from the mispricing caused by the externality may not be sufficiently large to justify the costs of legal intervention. Second, even if the costs of mispricing are significant, private ordering, which refers to private negotiations between the affected parties, might prove more efficacious than legal intervention.[115] For example, rather than have a regulator attempt to calculate when a loud factory should be shut down, it may be more efficacious to grant the right to quiet to the factory's neighbors. Granting rights in this manner could make it easier for the neighbors and the factory owner to establish the optimal noise level on their own.[116] To justify legal intervention, it must then be true both that the cost of the intervention is less than the harm averted, and that there are no lower-cost private mechanisms available for addressing the problem.

The challenge in determining the best legal solution to an externality problem is but one example of scholarship that considers the costs and benefits of different types of legal intervention into market transactions from an efficiency perspective.

2. Relationship to the Wasteful Competition Problem

There are many examples of arguments for or against regulating insider trading based on efficiency considerations. These arguments usually begin by identifying various costs and benefits of either prohibiting or allowing insider trading.

One provocative aspect of the seminal writings of Manne on insider trading was that Manne identified potential benefits if insider trading were permitted.[117] There were two benefits of permitting insider trading that Manne initially highlighted. First, Manne argued that allowing insider trading would not only improve share price accuracy, but would do so in a particularly helpful manner.[118] Those trading on inside

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[114] *See generally* PIGOU, *supra* note 3, at 172–203 (explaining how bounties and taxes can be used to address a problem that arises when there is a divergence between the private benefits realized from undertaking an activity and the social benefits from undertaking that activity).

[115] *See* Coase, *supra* note 3, at 17.

[116] *See, e.g.*, GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970).

[117] *See* MANNE, *supra* note 72, at 88–102, 138–43; *see also* Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565–76 (1970).

[118] *See* MANNE, *supra* note 72, at 88–102; *see also* John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 14 (2014) ("Most commentators have come to accept that insider trading pushes stock prices in the

information are able to communicate information to the market about the future value of share prices because their purchases or sales suggest the existence of good or bad news that is not publicly disclosed. Through this process, share prices can become more accurate without the firm having to disclose underlying and potentially proprietary information.[119]

Second, Manne argued that allowing insider trading provides a particularly effective way to compensate corporate executives. Manne wrote "insider trading constitutes the most appropriate device for compensating entrepreneurs in large corporations."[120] However, other scholars subsequently identified several problems with using the ability to trade on inside information as a form of executive compensation. For example, Dennis Carlton and Daniel Fischel observe that "insider trading creates perverse incentives by allowing corporate managers to profit on bad news as well as good, encourages managers to invest in risky projects, impedes corporate decisionmaking, and tempts managers to delay public disclosure of valuable information."[121]

Scholars writing in the efficiency tradition identify three major costs that might result from permitting insider trading. First, to maintain profitable operations when faced with some counterparties that are better informed, market makers will need to increase the spread they charge on all transactions.[122] A larger spread increases the cost of purchasing and selling securities, and potentially the cost to the firm of raising new capital.[123] Second, if

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'correct' direction . . . ."); *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 852–53; Andrew Verstein, *Insider Trading: Are Insolvent Firms Different?*, 13 BROOK. J. CORP. FIN. & COM. L. 53, 64–65 (2018) [hereinafter, Verstein, *Are Insolvent Firms Different?*].

[119] *See* BAINBRIDGE, *supra* note 25, at 179 ("Manne essentially argued that insider trading is an effective compromise between the need for preserving incentives to produce information and the need for maintaining accurate securities prices.").

[120] *See* MANNE, *supra* note 72, at 182*; see also* Fox, Glosten, & Rauterberg, *supra* note 50, at 853–55; Verstein, *Are Insolvent Firms Different?*, *supra* note 118, at 64.

[121] *See* Carlton & Fischel, *supra* note 73, at 858; *see also* Ayres & Choi, *supra* note 46, at 333 ("Insiders of the traded firm may choose to delay disclosure of confidential projects within the traded firm to enhance their ability to engage in insider trading."); Verstein, *Are Insolvent Firms Different?*, *supra* note 118, at 63.

Eventually Manne came to acknowledge that many of the concerns expressed by others with using inside information as a form of compensation were valid. Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 170–71 (2005) ("My second 'positive' argument for insider trading, that it could perform well as a part of an executive compensation package, has been the more forcefully attacked, and it is perhaps less robust than I and other proponents had originally assumed.").

[122] *See supra* note 97 and accompanying text.

[123] *See* Anderson, *supra* note 118, at 11 ("The increased spread therefore operates as a 'tax' on all investors."); Carlton & Fischel, *supra* note 73, at 858 ("Still others have claimed that insider trading allows insiders to divert part of the firm's earnings that would otherwise go to shareholders and therefore raises the firm's cost of capital."); Fox, Glosten, & Rauterberg, *supra* note 50, at 850; Verstein, *Are Insolvent Firms Different?*, *supra* note 118, at 64–65. *But see* Stanislav Dolgopolov, *Insider Trading, Informed Trading, and Market*

insider trading is permitted, the firm's managers may make business and disclosure decisions guided more by their desire to profit from inside information than by their desire to increase the value of the firm.[124] Third, allowing insider trading might discourage would-be investors from purchasing securities generally because of their fear that securities markets are rigged against investors who are not insiders.[125]

Scholars have varying views about how the costs and benefits of permitting or prohibiting insider trading discussed above compare. In 1980, Michael Dooley concluded that these costs and benefits roughly offset, writing that "insider trading has little or no effect on the allocational efficiency of the market."[126] More recently, John Anderson reached a similar conclusion, writing that "weak empirical evidence makes it difficult to ultimately quantify the net economic impact of insider trading with any certainty."[127] Fox, Glosten, and Rauterberg reach a different conclusion and write that allowing insider trading "makes the economy less, not more, efficient."[128]

However, simply identifying and then comparing the costs and benefits of an activity does not provide a justification for legal intervention.[129] Determining whether legal intervention is advisable from the traditional efficiency perspective requires three steps: identifying a market failure, evaluating whether there is a cost-effective legal solution to rectifying that market failure, and comparing legal intervention to solutions that facilitate private ordering.[130]

Of the main costs and benefits of permitting insider trading listed above, two stand out as especially likely to also involve a market failure. The first is a cost arising from a general decline in investor confidence.[131] If permitting insider trading in the shares of

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Making: Liquidity of Securities Markets in the Zero-Sum Game, 3 WM. & MARY BUS. L. REV. 1, 5 (2012) ("Overall, there is little evidence that insider trading has posed a significant concern for equity market makers . . . .").

[124] *See supra* note 117 and accompanying text; *see also* Fox, Glosten, & Rauterberg, *supra* note 50, at 852.

[125] *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."); *see also* Anderson, *supra* note 118, at 9 ("The promotion of investor confidence in the markets is among the most often-cited policy goals served by the criminalization of insider trading.").

[126] Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 36 (1980).

[127] *See* ANDERSON, *supra* note 56, at 6; *see also* Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L. J. 353, 357 (1988) ("The comparative costs and benefits have not been quantified.").

[128] *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 848.

[129] *See supra* note 108 and accompanying text.

[130] *See supra* note 108 and accompanying text.

[131] *See supra* note 125 and accompanying text.

one firm discourages investors from purchasing the securities of other firms, this would constitute a negative externality caused by an individual firm's decision to allow insider trading. However, evidence of this kind of negative spillover effect on willingness to invest in the market overall is equivocal.[132]

The second potential source of a market failure is a benefit that may be provided to other firms and the economy overall if share price accuracy is improved. Merritt Fox and Marcel Kahan, among others, argue that more accurate share prices create positive externalities.[133] Even if Fox and Kahan are correct about these benefits, there is little evidence that the magnitude of these benefits are significant.[134]

Moreover, the possibility or even likelihood of a positive or negative externality is not sufficient to justify legal intervention. There also needs to be evidence that the benefits of legal intervention are likely to exceed the costs.[135] Fisch logically concludes: "[u]nless the effect of the legalization of insider trading on investor confidence or management behavior can be quantified, it is impossible to determine whether such effects justify retaining the existing prohibition."[136] Similarly, based on the lack of compelling evidence of a measurable and correctable market failure, Anderson concludes that "the economic analysis of Manne, Jonathan Macey, Dennis Carlton and Daniel Fischel, Todd Henderson, and others have been successful in showing that the current insider trading enforcement regime is highly inefficient."[137]

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[132] In 1991, Jill Fisch summarized the situation as follows: "[t]his analysis, while interesting on a theoretical level, has not generated any clear consensus, probably because of the absence of empirical data." *See* Fisch, *supra* note 70, at 220. Her conclusion is still valid today.

[133] Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2562–69 (1997); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 981–87 (1992)*; see also* Guttentag, *Imposing Disclosure Requirements*, *supra* note 52, at 135. *But see*, Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 616–18 (1988) (arguing that efficient stock markets do not have a significant effect on economic productivity).

[134] *See infra* Section IV.B.1.

[135] *See supra* note 108 and accompanying text.

[136] *See* Fisch, *supra* note 70, at 220.

[137] *See* ANDERSON, *supra* note 56, at 200. Rejecting market failure arguments for a federal insider trading prohibition is not the same as arguing that whoever happens to gain access to inside information should be allowed to trade using this information. One could reject the need for a federal rule prohibiting trading based on inside information and still accept that if someone makes a contractual or fiduciary commitment to refrain from using certain information for stock trading purposes, then those commitments should be legally enforceable.

Nor do scholars who reach the conclusion that an externality problem does not justify an insider trading prohibition entirely dispel with the possibility that there might be some potential economic benefits from federal enforcement of an insider trading prohibition. One benefit of federal regulation they identify is the potential for economies of scale in federal enforcement. *See, e.g.*, David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1450–51 (1986).

The efficiency analysis of insider trading policy detailed thus far does not include any discussion of the problem of wasteful competition. However, there are a few efficiency-minded scholars whose work on insider trading at least hints at the importance of wasteful competition in the analysis of insider trading policy. The work of these scholars can be separated into two categories: waste acknowledgers and waste fatalists.[138]

The waste acknowledgers recognize that certain aspects of the use of inside information invite wasteful competition, but fail to fully explore the ramifications of this insight for insider trading policy.[139] The waste fatalists, on the other hand, recognize either explicitly or implicitly that the amount of wasteful competition to find and exploit inside information may be significant, but assume that these costs are unavoidable.[140]

a. Waste Acknowledgers

A disparate group of scholars suggest either directly or indirectly that at least some aspects of efforts to acquire and use inside information are socially wasteful. I call such scholars waste acknowledgers. As an example, Eric Kades, in an article on the legal regulation of windfalls generally, observes that inside information can have the characteristics of a windfall.[141] Kades writes that "insider trading can result in unearned windfalls, and hence regulation is clearly desirable."[142] While Kades recognizes the windfall nature of inside information, the argument he offers linking the existence of a windfall to the need for regulatory intervention is quite different than the analysis presented here. Kades argument for a regulatory intervention is based on an insurance rationale. He writes: "[f]orbidding insider trading spreads gains more broadly and hence is yet another form of reverse insurance."[143]

Some of the economic analysis of insider trading presented by Fox, Glosten, and Rauterberg might also be read as acknowledging the potential for waste in the effort to redistribute the costs imposed by those trading with inside information. Fox, Glosten, and Rauterberg include in the costs they identify as resulting from insider trading "the impact of the

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138 Some arguments cross over and do not fall exclusively into one of these two categories.
139 *See infra* Section III.A.2.a.
140 *See infra* Section III.A.2.b.
141 Eric Kades, *Windfalls*, 108 YALE L.J. 1489, 1554–57 (1999).
142 *Id.* at 1555.
143 *Id.*

[informed] trading on the real resources that society devotes to trading in and operating equity markets."[144]

However, acknowledging the possibility that insider trading involves a zero-sum game in which competition wastes resources falls far short of reaching policy conclusions based on these concerns. Bainbridge aptly observes:

> [s]ome contend that insider trading results in outside investors—as a class—being injured because they reap a smaller share of the gains from new information . . . . To justify a ban on insider trading, you need a basis for asserting that it is inappropriate, undesirable, or immoral for those gains to be reaped by insiders.[145]

Unlike previous scholarship, this article provides the kind of complete argument that Bainbridge correctly recognizes is necessary to link wasteful competition to insider trading policy.

b. Waste Fatalists

A second group of scholars, the waste fatalists, go one step further than the waste acknowledgers. These scholars acknowledge that competition for inside information is likely to trigger an arms race that may waste significant resources from a social welfare perspective. However, these scholars then jump to the conclusion that such competition is unavoidable. Carlton and Fischel, for example, argue:

> … [T]he only effect a ban on insider trading might have is that those with better access to information, such as brokers, would reap some of the gains from inside information. While this may be inefficient because brokers can become informed only at a higher cost, the informed-uninformed trader problem remains. Smart brokers, in other words, cause the same problem as smart insiders.[146]

In this view, the race for foreknowledge is unavoidable, and the best policy response is to allow those with low-cost early access to the information to trade before others can enter the race.

One can use terminology from economics to describe the argument of the waste fatalists. The waste fatalists are making a claim about information-gathering substitutes for insider trading. In the strongest form, the waste fatalist claim is that there are other information gathering activities that may be more expensive than letting insiders trade on inside information, but these other

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144 *See* Fox, Glosten, & Rauterberg, *supra* note 50, at 833. Whether Fox, Glosten, and Rauterberg are just referring to the costs of establishing a market maker or a broader range of costs is unclear.

145 *See* BAINBRIDGE, *supra* note 25, at 197–98.

146 *See* Carlton & Fischel, *supra* note 73, at 880.

information gathering activities are otherwise perfect substitutes for the information gathering capabilities of insiders.[147] According to this analysis, the race for inside information can be thrown off course but never ultimately slowed down.

If the waste fatalists are correct that there is no way to reduce wasteful competition for foreknowledge and all that an insider trading prohibition will do is shift information gathering activities to those who will gather the same information but at a higher cost then the argument presented here for an insider trading ban designed to reduce wasteful competition is unpersuasive. It makes no sense to invest resources in efforts to reduce wasteful competition if such efforts are doomed to fail.

The claim of the waste fatalists that there is no way to reduce wasteful competition for foreknowledge is an empirical one; however, they do not provide evidence to support this conclusion. In fact, numerous studies find that laws restricting insider trading and related restrictions on the selective disclosure of material nonpublic information do have significant and measurable effects on the amount of information incorporated into securities prices. These findings are inconsistent with the claim of the waste fatalists that efforts to prevent the rapid flow of inside information into market prices cannot succeed.

One noteworthy study suggesting that an insider trading ban can be effective in reducing the extent to which private information is incorporated into securities prices is a study by Utpal Bhattacharya and Hazem Daouk. Bhattacharya and Daouk analyze whether there is an effect on the cost to firms of raising capital when a country enacts and begins enforcing laws that limit insider trading.[148] Bhattacharya and Daouk find a statistically significant decline in the cost of capital for firms after insider trading regulations are enacted and enforced.[149] This finding suggests that insider trading prohibitions do reduce concerns about trading at an informational disadvantage to those trading with inside information. If there were readily available information-gathering substitutes for insiders, then concerns about trading at

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[147] Jonathan Macey makes an additional observation about the cost to the firm if information gathering activities are carried out by those outside the firm rather than by firm insiders. Macey writes that "if insider trading is banned, neither the firm's insiders nor its public shareholders but market professionals will capitalize on the firm's good fortune." JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 15 (1991). According to Macey, when the winner of the race to be the first to exploit new information is the market professional the firm will lose out.

[148] Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 76 (2002).

[149] *Id.* at 97.

an informational disadvantage and the resulting premiums charged would not be affected by an insider trading ban.

Evidence of the potential efficacy of rules regulating the use of inside information for trading purposes is also provided by research on the effects of rules reducing the firm's ability to engage in the selective disclosure of material non-public information. For example, a study by Ronald Anderson and colleagues on the effects of the enactment of Regulation FD, a rule restricting the selective disclosure of information by public companies, found that enactment of Regulation FD significantly reduced securities price informativeness.[150] This finding provides further evidence that restrictions on informed trading are not readily substituted for by the information gathering activities of others outside the firm. The key waste fatalist assumption, that those outside the firm can easily access the same amount of information as those trading with inside information, is inconsistent with the available evidence.

In summary, efficiency analysis is a logical tool to use to evaluate legal measures designed to reduce the waste associated with efforts to acquire and exploit inside information. However, most of the efficiency analysis of insider trading policy tends toward the kind of traditional cost/benefit and externalities analysis that assumes away any kind of wasteful competition problem.[151] As a result, the wasteful competition problems created by efforts to acquire and exploit inside information are either ignored entirely or analyzed in a perfunctory manner by those undertaking efficiency analysis of insider trading policy.

B. Fairness Analysis

An alternative analytic approach among scholars studying insider trading is to look to fairness concerns to determine when trading based on material nonpublic information should be outlawed. Fairness analysis starts from the premise that standards of fair play should dictate to at least some degree the types of market transactions that are permissible. Reliance on fairness justifications for the legal regulation of market transactions has declined steadily over the past centuries;

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[150] Ronald C. Anderson et al., *The Efficacy of Regulatory Intervention: Evidence from the Distribution of Informed Option Trading*, 37 J. BANKING & FIN. 4337, 4337 (2013) ("we provide evidence on the efficacy of security regulation in limiting informed trading"). For an overview of Regulation FD, see Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 112, 112–14 (Stephen M. Bainbridge ed. 2013); *see also* 17 C.F.R. § 243.100.

[151] *See supra* note 49 and accompanying text.

however, in the context of an insider trading prohibition, appeals to fairness remain robust.[152]

Unfortunately, the fairness analysis of insider trading policy to date has focused almost exclusively on the propriety of taking advantage of information asymmetries in market transactions and has not addressed how to avoid wasteful competition in a fair and efficient manner. This oversight limits the usefulness of the current scholarship on fairness and insider trading when trying to determine the appropriate scope of an insider trading prohibition designed to avoid wasteful competition.

1. Fairness Analysis Generally

Evaluating the extent to which marketplace transactions should be constrained by the law because of considerations of fairness has a history dating back millennia.[153] Christian doctrine, for example, holds that there is a just price at which market transactions should take place.[154] The debate about the extent to which fairness concerns should guide the regulation of market transactions is ongoing.

In the context of contract law, for example, scholars such as Margaret Radin argue for the inclusion of fairness and other noneconomic concerns in designing legal rules, while other scholars reject the idea that equitable considerations should be used to determine the rules of contract law.[155] Scholars rejecting the inclusion of fairness concerns in the design of contract law argue that fairness concerns are relics of past beliefs about the law that should no longer be welcome elements of contract law doctrine.[156]

Fairness concerns are also addressed by scholars who focus their analytic work on identifying how legal rules can

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[152] *See, e.g.*, Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 728–30 (1988); Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119, 121 (2002); Louis Loss, *The Fiduciary Concept as Applied to Trading by Corporate "Insider" in the United States*, 33 MOD. L. REV. 34, 36–37 (1970); Robert W. McGee, *Analyzing Insider Trading from the Perspectives of Utilitarian Ethics and Rights Theory*, 91 J. BUS. ETHICS 65 (2009); Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 L. & CONTEMP. PROB. 123, 125 (1993); Roy A. Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1426–29 (1967); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 381 (1999); Patricia H. Werhane, *The Ethics of Insider Trading*, 8 J. BUS. ETHICS 841, 841 (1989).

[153] *See, e.g.*, ANDERSON, *supra* note 56, at 143–60 (reviewing the history starting with Roman times of trying to determine when information asymmetry should trigger a disclosure obligation).

[154] William Boyd, *Just Price, Public Utility, and the Long History of Economic Regulation in America*, 35 YALE J. REG. 721, 729–36 (2018).

[155] *Compare* MARGARET JANE RADIN, BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW (2013) *with* Jody P. Kraus & Robert E. Scott, *The Case Against Equity in American Contract Law*, 93 S. CAL. L. REV. 1323 (2020).

[156] *See* Kraus & Scott, *supra* note 155.

address efficiency concerns. Law and economics scholars such as Louis Kaplow and Steven Shavell argue that preferences for "fair treatment" in market transactions should be included among the preferences that determine market outcomes.[157] Kaplow and Shavell write: "individuals have a taste for a notion of fairness, just as they may have a taste for art, nature, or fine wine . . . .In such cases, satisfying the principle of fairness enhances the individual's well-being, just as would satisfying his preference for wine."[158] However, for Kaplow and Shavell these kinds of fairness considerations do not provide an independent justification for legal intervention into market transactions. Their argument is that in the absence of a market failure, firms acting on their own can and do modify policies in order to address fairness concerns.[159]

2. Relationship to the Wasteful Competition Problem

Many have argued that fairness concerns justify putting in place an insider trading prohibition. For example, Alan Strudler and Eric Orts develop a theory of what constitutes fair behavior in securities markets in order to explain why insider trading should be prohibited. They write:

> We propose a general theory of insider trading that uses moral concepts to specify duties of disclosure owed by those who trade with each other in public securities markets . . . . Our analysis provides a more precise understanding of what exactly is unfair about trading on inside information. We rely on the standard deontological view that what makes an act morally justifiable is the respect it expresses for the autonomy, rights, and dignity of those persons affected by it, and not merely the social welfare or the utility that the act produces.[160]

As is true of many of the sophisticated defenses of an insider trading prohibition on fairness grounds, Strudler and Orts are explicit in grounding their analysis of the fairness of insider trading in a deontological approach to moral theory.

Survey evidence suggests that fairness concerns are, in fact, triggered by incidents of insider trading.[161] However, the

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[157] LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 21 (2002). There is much research showing that people do tend to have strongly held views about their right to be treated fairly. *See, e.g.*, Ernst Fehr & Simon Gachter, *Cooperation and Punishment in Public Goods Experiments*, 90 AM. ECON. REV. 980, 984 (2000).

[158] *See* KAPLOW & SHAVELL, *supra* note 157, at 21.

[159] *Id.*

[160] *See* Strudler & Orts, *supra* note 152, at 380–81.

[161] While research on attitudes toward insider trading do show that there are aspects of insider trading that individuals generally find morally troubling, the details of how and why insider trading raises moral concerns are complex, contradictory, and difficult to unbundle. *See, e.g.*, John P. Anderson, Jeremy L. Kidd, & George A Mocsary, *Public Perceptions of Insider*

precise reason why trading based on inside information might be unfair is not self-evident. For example, the ability to trade on inside information could be part of a firm's compensation package.[162] If a firm sanctions trading on inside information by its employees then it would appear to be no more unfair for those managers to trade on inside information than for them to collect their salary, at least from the firm's perspective.

Another difficulty in specifying what is unfair about insider trading is the plausible argument that the fairness of a transaction should be determined by the terms of engagement the parties involved mutually agree to and not by some third party standard of what constitutes a fair transaction.[163] If one party is willing to risk trading with those who might have access to inside information, then based on this standard, there would not appear to be anything unfair about a transaction where the other party does, in fact, have access to inside information. The purported unfairness of trading on inside information is further complicated by the fact that withholding information when negotiating with an adverse party is not generally deemed to be morally wrong.[164]

Macey nicely summarizes the state of fairness concerns as a justification for outlawing insider trading as follows: "[i]nitially the [insider trading prohibition] was thought to be grounded on notions of 'fairness' and 'equity.' These justifications were vague and ill formed and did not provide a coherent basis for imposing legal sanctions."[165] In a similar vein, Stephen Bainbridge observes: "[t]he difficulty, of course, is that fairness and equality are high-sounding but essentially content-less words."[166]

A related fairness justification for prohibiting insider trading is based on considerations of equality of access to information. The idea here is that what matters from a fairness perspective is that all parties have relatively equal access to underlying information. This notion of fairness as a reason to forbid at least some insider trading is suggested in the 1961 administrative opinion *In the Matter of Cady, Roberts & Company*, authored by William Cary, Chairman of the SEC at the time.[167]

Trading, 51 SETON HALL L. REV. 1035 (2021); Stuart P. Green & Matthew B. Kugler, *When is it Wrong to Trade on Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 453 (2011).

[162] *See supra* notes 120–121 and accompanying text.

[163] *See* MANNE, *supra* note 72, at 12–15.

[164] In fact, the majority view is that there is no affirmative obligation to disclose information in market transactions with third parties in the absence of a special relationship. *See* ANDERSON, *supra* note 56, at 14–16.

[165] *See* Macey, *supra* note 147, at 10.

[166] *See* BAINBRIDGE, *supra* note 25, at 175.

[167] *See* Cady, Roberts & Co., 40 S.E.C. 907, Exchange Act Release No. 6668, 1961 WL 60638 at *4 (Nov. 8, 1961).

Cary wrote in that opinion of "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[168]

Victor Brudney, following on Cary, offers equality of access as the foundational fairness test for determining whether trading based on material nonpublic information should be allowed.[169] Brudney writes:

> The unfairness is not a function merely of possessing more information—outsiders may possess more information than other outsiders by reason of their diligence or zeal—but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access.[170]

Brudney's intuition is that if all parties start with relatively equal access to information *ex ante*, then any *ex post* informational advantages are ethically acceptable to exploit. While equality of access may provide an intuitive fairness justification for prohibiting at least some insider trading, Brudney and others never develop a clear argument that explains precisely when or why unequal access should trigger an insider trading prohibition.[171]

The analytic work linking fairness concerns to a ban on insider trading is, at best, incomplete. Moreover, there is nothing in this scholarship that provides insight into how or why the law should engage with the problem of wasteful competition triggered by efforts to acquire and exploit inside information.

C. Property Analysis

Another analytic approach scholars studying insider trading policy rely on starts from the premise that inside information is best understood as property belonging to the firm whose activities created the information.[172] According to this line of analysis, treating inside information as firm property is the best way to ensure that optimal amounts of inside information

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[168] *Id.*

[169] Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979).

[170] *Id.*

[171] For a more detailed critique of problems with using an unerodable advantage test for determining when trading based on such information should be prohibited, see Ayres & Choi, *supra* note 46, at 319 ("This Article comes to bury the concept of unerodable advantage as the basis for regulating informationally driven trades.").

[172] *See, e.g.*, BAINBRIDGE, *supra* note 25, at 204; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 263 (1991); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1592 (1999); Fisch, *supra* note 70, at 190; Macey, *supra* note 147, at 51.

are produced and used. The guiding insight is that when property rights are clearly established, assets are more likely to be utilized in the most productive manner feasible.[173] However, those who apply a property perspective to analyze insider trading policy do not grapple with either the wasteful nature of competition for certain kinds of property or the implications of this insight for determining whether to grant any party a property right in inside information.

1. Property Analysis Generally

Property law is too vast a field of study to summarize in a few paragraphs. Instead I review here a few key insights from property law that will prove helpful in critiquing current thinking about an insider trading prohibition viewed from a property perspective.

Property is a creation of the law generally associated with the right to exclusive use.[174] There are various ethical, efficiency, and behavioral justifications offered for granting exclusive rights to own and use property. One prominent justification derives from the political philosophy of John Locke.[175] Locke argues that property ownership originates when humans comingle their personal labor with otherwise abundant natural resources.[176] Another more efficiency-oriented justification for property argues that granting an exclusive right to use ensures that the owner of a piece of property can make decisions that take into account the full consequences of one's actions.[177]

A classic counterfactual considers what would happen if, for example, all property was commonly owned. The result might be a massive "tragedy of the commons," where individuals overconsume common resources, because those taking from the commons do not internalize the full costs of their takings.[178] Efficiency analysis of property rules also recognizes there may be circumstances where granting too many property rights can create inefficiencies because of the challenges of carrying out collective action among many

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[173] *See* Coase, *supra* note 3, at 44.

[174] *See, e.g.*, BARLOW BURKE & JOSEPH SNOE, PROPERTY 5 (5th ed. 2016) ("Property permits one person to exclude another from using a thing; to use it personally to gain rents, profits, or income from it; to sell it; or to give it by will to one relative and not another.").

[175] JOHN LOCKE, THE SECOND TREATISE OF GOVERNMENT § 27 (1690).

[176] *Id.* ("Though the earth and all inferior creatures be common to all men, yet every man has a 'property' in his own 'person'. This nobody has any right to but himself . . . . Whatsoever, then, he removes out of the state that Nature hath provided and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property . . . at least where there is enough, and as good left in common for others.").

[177] *See, e.g.*, POSNER, *supra* note 8, at 40–41.

[178] *See, e.g.*, Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244 (1968).

owners.[179] From an evolutionary perspective, property can be understood as an outgrowth of our innate preference for exclusive control of the things that influence our well-being.[180]

2. Relationship to the Wasteful Competition Problem

Proponents of the view that inside information is best analyzed as firm property include Bainbridge, Macey, and Kenneth Scott.[181] Bainbridge observes: "[t]here are striking doctrinal parallels, moreover, between insider trading and these other types of property rights in information."[182] More specifically, Bainbridge explains, "the rationale for prohibiting insider trading is the same as that for prohibiting patent infringement or theft of trade secrets; i.e., protecting the economic incentives to produce socially valuable information."[183]

One assumption underlying this property rights view of inside information is that a property right in inside information needs to reside somewhere. Bainbridge writes: "There is no avoiding the necessity of assigning a property interest in the information to either the corporation or the insider."[184] Bringing attention to the relationships between wasteful competition and trading on inside information suggests an alternative to treating inside information as property of either the firm or the insider. The grant of a property right to any party can exacerbate a wasteful competition problem. Arguments for treating inside information as corporate property have not grappled with Posner's observation that "the *denial* of a property right can be as much an economizing device as the creation of one."[185] There is a third possibility with

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[179] *See* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 624 (1998).

[180] Jeffrey Evans Stake, *The Property 'Instinct*,' 359 PHIL. TRANSACTIONS: BIOLOGICAL SCI. 1763 (2004).

[181] *See* BAINBRIDGE, *supra* note 25; Macey, *supra* note 147, at 30; Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 814–15 (1980); *see also* Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 94 (1987).

[182] *See* BAINBRIDGE, *supra* note 25, at 202.

[183] *Id.* at 202–03. Bainbridge does acknowledge that "[a]s with other property rights, the law therefore should simply assume (*although the assumption will sometimes be wrong*) that assigning the property right to agent-produced information to the firm maximizes the social incentives for the production of valuable new information." *Id.* at 204 (emphasis added); *See also* EASTERBROOK & FISCHEL, *supra* note 172, at 263 ("The Coase Theorem implies that firms and insiders have strong incentives to allocate the property right in valuable information to the highest valuing user.").

[184] *See* BAINBRIDGE, *supra* note 25, at 203. Proponents of the property view do acknowledge that there is a mismatch between insider trading law as enacted and what the law would be if the property view were fully adopted. Thus, Bainbridge writes: "This argument does not provide as compelling a justification for the insider trading prohibition as it does for the patent system." *Id.*

[185] *See* POSNER, *supra* note 8, at 47.

respect to the question of who gets a property right to inside information and that answer is no one, the answer endorsed here. Removing property rights can eliminate the private incentive to invest in competition when competition wastes resources.

In summary, a vast literature on the question of whether to prohibit insider trading relies on one of three paradigms to evaluate insider trading law: efficiency analysis, fairness analysis, and property analysis. None of these approaches as currently applied offers an insightful analysis of the central proposition developed here, namely that insider trading should be outlawed to discourage wasteful competition to acquire and exploit inside information.

IV. PROHIBITING INSIDER TRADING TO AVOID WASTEFUL COMPETITION

The first Part of this article provides an illustrative example of a situation involving a two-sided wasteful competition problem.[186] The second Part of this article defines inside information and explains why inside information so defined invites wasteful competition both in its acquisition and in its use.[187] The third Part of this article shows how scholarship on insider trading has either ignored or marginalized the importance of the wasteful nature of the competition to acquire and use inside information.[188] This Part: (1) reviews how legal rules can be used to address wasteful competition problems generally,[189] and (2) explains why an insider trading prohibition is the most effective way to address the two-sided wasteful competition problem created by inside information, in part by considering and rejecting three potential challenges to this conclusion.[190]

A. Law and Avoiding Wasteful Competition Generally

This section reviews how legal rules can be applied directly and indirectly to reduce wasteful competition. Perhaps the best-known example of how a legal rule can reduce wasteful competition comes from Posner as discussed in the Introduction.[191] Posner argues that the admiralty law rule of salvage is an example of precisely such a law. In Posner's analysis, rewards to the party who

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[186] *See supra* Part I.
[187] *See supra* Part II.
[188] *See supra* Part III.
[189] *See infra* Section IV.A.
[190] *See infra* Section IV.B.
[191] *See supra* note 11 and accompanying text.

salves a wreck are reduced to avoid a wasteful race to be the first to rescue valuable goods lost at sea.[192]

There are other examples of legal rules that appear to be designed specifically to reduce wasteful competition. One example from property law involves the rule of capture for whales. Carol Rose observes that: "the courts expended a considerable amount of mental energy in finding signs of 'possession' that were comprehensible to whalers from their own customs and that at the same time came early enough in the chase to allow the parties to *avoid wasted efforts* and the ensuing mutual recriminations."[193] Intellectual property, and more specifically patent law, is another area where efforts to reduce wasteful competition appear to inform the law's design. Posner observes that: "[n]othing might seem more remote from sunken treasure than patented inventions, and yet the economic problem created by patents is remarkably like that of abandoned property. Ideas are in a sense created but in another sense found."[194]

Legal measures can also reduce wasteful competition in indirect ways. For example, a law that requires firms to prominently post their prices, such as a California law that requires gasoline stations to display in large type how much they charge for a gallon of gas, prevents firms from selectively charging customers different prices for the same product.[195] Charging customers different prices can devolve into a wasteful arms race between buyers and sellers.[196] In the absence of prominently posted prices, gas station owners may invest resources trying to figure out which customers are willing to pay more and those customers may, in turn, invest resources in evasive measures to try to avoid paying more than other customers.[197] A rule requiring prices to be posted prominently reduces this wasteful haggling.

There are also ways in which tax policy can be used as a means to indirectly address the potentially wasteful aspects of unfettered competition in certain arenas. For example, some argue that much of the trading activity on Wall Street is the result of efforts to use informational advantages to trade

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[192] *See supra* note 11 and accompanying text.

[193] Carol M. Rose, *Possession as the Origin of Property*, 52 U. CHI. L. REV. 73, 83 (1985) (emphasis added). More specifically, and looking beyond formal legal rules, Robert Ellickson explains how the fast-fish, loose-fish rule was used to determine possession of the less agile Right whale, whereas the iron-holds-the-whale rule was used to determine ownership of the more difficult to control and capture sperm whale. ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 197–99 (1991).

[194] *See* POSNER, *supra* note 8, at 47; *see also* Grady & Alexander, *supra* note 7.

[195] *See* CAL. BUS. & PROF. CODE §§ 13531–32 (requiring that each numeral in the price be "not less than six inches in height and of uniform size and color" and that the price information "be clearly visible from each street of the intersection").

[196] *See* Guttentag, *Opportunities Missed*, *supra* note 28, at 629–31.

[197] *Id.* at 639–40.

profitably with those who have less information, and that these efforts constitute socially wasteful competition, since the rewards of winning the competition far exceed the societal gains.[198] To address this concern there is a long-gestating proposal that a small tax be imposed on every securities market transaction.[199] Such a tax would reduce the returns from trading securities with the potential benefit that fewer resources would be invested in wasteful competition.

Economists have also grappled with the question of how to identify and reduce wasteful competition. In "The Private and Social Value of Information and the Reward to Inventive Activity," Jack Hirshleifer develops a simple model to illustrate how access to foreknowledge can provide significant private gains but yield no societal benefits.[200] The work of Tullock and others studying rent seeking draws attention to the wasteful nature of competition for access to the government's ability to grant tariff and other protections from market competition.[201] These scholars argue that avoiding these costs is a justification for limiting the creation of government sanctioned monopolies.[202] Eric Budish, Peter Cramton, and John Shim analyze how the design of a securities trading system can reduce wasteful competition.[203] Budish, Cramton, and Shim model the race to be the first to access market price information in securities markets and conclude that "the high-frequency trading arms race is a symptom of a basic flaw in the design of modern financial exchanges."[204] Budish, Cramton, and Shim propose a redesign so that "trade requests received during the same interval are treated as having arrived at the same (discrete) time" as a way to avoid a wasteful arms race to be first to access market price information in securities markets.[205]

The study of the ways in which legal rules can address a wasteful competition problem is in its infancy. Yet even now there

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[198] *See, e.g.*, Jared Bernstein, *The Case for a Tax on Financial Transactions*, N.Y. TIMES (July 22, 2015), https://www.nytimes.com/2015/07/22/opinion/the-case-for-a-tax-on-financial-transactions.html [https://perma.cc/D2CK-ASPU].

[199] *See, e.g.*, Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax*, 3 J. FIN. SERVS. RES. 261, 263 (1989).

[200] *See* Hirshleifer, *supra* note 64, at 563–66.

[201] For a discussion of the rent-seeking literature, see Guttentag, *Opportunities Missed*, *supra* note 28, at 616–22.

[202] *See, e.g.*, Tullock, *supra* note 13, at 228–32.

[203] Eric Budish et al., *The High-Frequency Trading Arms Race: Frequent Batch Auctions as a Market Design Response*, 130 Q. J. ECON. 1547, 1549, 1552–53 (2015).

[204] *Id.* at 1549.

[205] *Id.*

is clear evidence that legal rules can and do play an important role in reducing wasteful competition in certain sectors of the economy.

B. Law, Avoiding Wasteful Competition, and Insider Trading

Legal rules can be used to reduce costs that might otherwise result from wasteful competition.[206] Since the likelihood of wasteful competition is a defining feature of inside information both at its source and in its use, it is not difficult to make a prima facia case for prohibiting insider trading based on this concern. The logic for such a claim follows from Posner's observation that "the *denial* of a property right can be as much an economizing device as the creation of one."[207] Prohibiting insider trading can both reduce resources spent in a race to be the first to acquire inside information and reduce resources spent in the arms race that might otherwise develop between those trying to trade on inside information and those trying to avoid trading with those with inside information.

The burden should rightfully be placed on proponents of allowing insider trading to explain why we should legalize such a wasteful social activity. I next consider and reject three affirmative justifications for allowing insider trading to proceed in light of the wasteful competition problem inherent in trading on this information.

The first affirmative justification one might offer for allowing insider trading is that the potential waste resulting from the battle to acquire and use inside information is worth incurring because of the offsetting benefits that allowing trading based on inside information would provide.

The debate on the efficiency effects of allowing or prohibiting insider trading above concluded that it is difficult to determine whether the benefits of allowing insider trading exceed the costs.[208] In carrying out that analysis the costs arising from wasteful competition were not included in the calculation. Once we add in the fact that allowing insider trading inevitably wastes significant resources as a result of wasteful competition, the cost-benefit analysis points clearly toward the efficacy of banning insider trading. Without compelling evidence of significant benefits from insider trading, the correct presumption, once we recognize that allowing insider trading

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[206] *See supra* Section IV.A.

[207] *See* POSNER, *supra* note 8, at 47.

[208] *See supra* notes 123–137 and accompanying text.

wastes significant resources as a result of wasteful competition, is that insider trading should be prohibited.

The second possible affirmative justification for allowing insider trading in spite of significant wasteful competition costs is that private parties will choose to prohibit insider trading on their own without the costs arising out of federal intervention if an insider trading prohibition truly is welfare-enhancing.[209] There is much to like about this argument. Where there is a surplus, competitors have an incentive to agree among themselves as to how to divvy up resources in ways that avoid wasteful competition. As Oliver Williamson observes, "[a]lthough this haggling is jointly (and socially) unproductive, it constitutes a source of private pecuniary gain. Being, nevertheless, a joint profit drain, an incentive to avoid these costs, if somehow this could be arranged, is set up."[210]

To analyze the feasibility of private ordering solutions to the wasteful competition problems created by inside information, the potential for wasteful competition at the source and in the use of inside information need to be considered separately. The fact that inside information at its source is a surplus byproduct of other activities raises the possibility of wasteful competition to secure and use this information for trading purposes.[211] Because the locus where inside information is created can be relatively well defined, and there are pre-existing relationships between the various parties who could have access to the inside information, there is at least the reasonable possibility that wasteful competition at the source of inside information could be avoided through private ordering arrangements.

There are, however, obstacles that limit the ability of firms to control the use of inside information produced within the firm. One set of obstacles arise out of agency costs.[212] Individual employees have an incentive to find ways to acquire and use inside information even when the firm prefers all such efforts be avoided, and the reality is that insider trading can be quite difficult for the firm to detect, particularly if carried out by lower-level

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[209] A private ordering solution to the problem of wasteful competition for inside information would also be preferable to a federal mandate given the heterogeneity of the parties involved. *See, e.g.*, Ayres & Choi, *supra* note 46, at 359 ("Firms with different types of investors and market capitalization, moreover, may prefer varying levels of informed outsider trading.").

[210] OLIVER E. WILLIAMSON, ANTITRUST ECONOMICS: MERGERS, CONTRACTING, AND STRATEGIC BEHAVIOR 28 (1987).

[211] *See supra* Section II.B.

[212] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

employees.[213] The costs of agents' efforts to gain access to inside information within the firm also may be subtle. As discussed above, Haft conjectures, for example, that "[e]ach 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."[214] Similarly, Macey observes: "corporate officers and directors do not always act in shareholders' interests. If firms were allowed to allocate insider trading rights for themselves, the divergence of interests between shareholders and managers could manifest itself by allocating too many rights to certain powerful insiders."[215]

Allowing insider trading could also trigger more of an arms race between those attempting to exploit inside information in trading markets and those attempting to avoid trading with those who are better informed.[216] This source of wasteful competition, arising out of efforts to use inside information for trading advantage, would appear to be quite difficult to avoid through private ordering, because this arms race is unlikely to fall within the gambit of a small well-connected group of winners and losers.[217] As Ayres and Choi observe: "The class of potential informed traders, while not all-encompassing, might literally run into the thousands."[218] It is also difficult to identify who precisely is harmed when someone trades using inside information. Successful private ordering arrangements between those benefiting from access to inside information and those harmed by such trading would appear to be difficult to sustain.[219]

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[213] Michael D. Guttentag, *"Huh?" Insider Trading: The Chris Collins Story*, 15 TENN. J. L. & POLICY 95, 112 (2020) (explaining how "[g]ains from insider trading can be camouflaged as fortuitous stock trades without the need for some future reconciliation").

[214] *See* Haft, *supra* note 68, at 1063.

[215] JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 5 (1991).

[216] *See supra* Section II.C.

[217] *See* Ayres & Choi, *supra* note 46, at 321 ("Just like a polluter who fails to internalize the social impact of its pollution, the outsider trader is not well placed to decide whether informed trading enhances social welfare."); *see also supra* note 93 and accompanying text.

[218] *See* Ayres & Choi, *supra* note 46, at 371.

[219] Ayres and Choi do propose a regime to address the private ordering challenge with respect to the use of inside information for trading advantage. Ayres & Choi argue that the right to exclude informed trading by outsiders should be held by the firm whose securities are being trading. Their recommendation is to shift "the property right to engage in informed trades to the traded firm." *Id.* at 401. The recommendation here for government action implicitly rejects the feasibility or attractiveness of implementing their private ordering scheme, which appears to rely on the assumption that those trading on inside information can be identified and quarantined. If their scheme were feasible, there would not be excess returns achieved by those trading on inside information, since they would be sorted out. At a minimum, the Ayers and Choi scheme is substantially more complex than the proposal here to simply prohibit all trading on inside information.

Consider the hypothetical case of insider trading provided above involving Angel, Company A, and Company B.[220] In that hypothetical, Angel is an employee of Company A and in that capacity receives information about Company B. From the perspective of Company A, regardless of whether the value of the inside information remains with Angel or is transferred to Company A shareholders, the opportunity to trade profitably in Company B shares is a windfall. There is no reason that Company A, in establishing an insider trading policy, would recognize the costs imposed on those outside the firm, whoever they may be, because of trading based on that information.[221] Wasteful competition triggered by trading based on inside information is not a problem that private actors are well-situated to address.

The third potential affirmative justification for allowing insider trading in spite of the wasteful competition costs is that while it may be true that in an ideal world all trading on inside information should be prohibited to avoid wasteful competition, in practice it is too difficult to craft an insider trading prohibition that prevents wasteful competition while also allowing for welfare-enhancing securities research to flourish. Justice Powell's argument requiring evidence of a personal benefit in order to find a tipper guilty of insider trading in the *Dirks* opinion is based to some degree on this policy concern. Powell writes in *Dirks* that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts."[222]

There are two rebuttals to the concern that allowing insider trading is a necessary evil to sustain well-functioning securities markets. First, we have much evidence that the challenge of designing a legal regime that distinguishes between trading on inside information and trading on information legitimately gathered to value securities is not insurmountable, and that a system prohibiting all trading on inside information can feasibly be designed and implemented. In fact, there are many regimes that already make the kinds of distinctions recommended here between inside information and information deemed to be legitimately gathered for securities trading purposes. For example, the prohibition against trading based on an imminent tender offer is such a prohibition.[223] In the EU, trading on certain inside

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[220] *See supra* note 70 and accompanying text.

[221] This is one of the central insights discussed in Ayres & Choi, *supra* note 46.

[222] Dirks v. SEC, 463 U.S. 646, 658 (1983).

[223] *See supra* notes 54–55 and accompanying text.

information is also prohibited regardless of whether the information was acquired wrongfully.[224]

The insider trading prohibitions in the EU do not appear to have wreaked havoc on securities markets there. In fact, if anything, the regime called for in this article in which all trading on inside information is forbidden is more straightforward and less complex to implement than the current regime in the United States. In the United States currently, the legality of trading when in possession of inside information hinges on an analysis of how the information involved was obtained and whether that process involved deceptive or wrongful conduct.[225] Making this determination requires uncovering the lineage of the information advantage and the conduct that contributed to that lineage. This kind of excavation of lineage is not necessary to implement the prohibition proposed in this article.

A second reason to question concerns about the difficulty of designing a regime that can distinguish between trading on inside information and trading based on other types of informational advantage is that these concerns assume that there is a compelling reason to protect current levels of "legitimate" information gathering activities. This appears to be the reason for Justice Powell's concern about implementing a rule that "could have an inhibiting influence on the role of market analysts."[226] In fact, the market for information about securities prices is distorted by several major market failures. On the one hand, there may be an "overproduction of information by investors attempting to 'beat the market.'"[227] On the other hand, there may be an underproduction of information about securities prices, because there are positive spillover effects from more accurate share prices that those collecting the information are unable to capture the value of.[228] There is no way to know if limiting the insider trading prohibition to information that is wrongfully acquired, the current regime in the United States, leads to too much or too little information gathering.[229] Rejecting a new and broader insider trading prohibition because of the need to maintain a given level of independent securities research does not stand on a strong evidentiary foundation.

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[224] *See supra* notes 56–59 and accompanying text.

[225] *See, e.g.*, Langevoort, *supra* note 16, at 10.

[226] *Dirks*, 463 U.S. at 658.

[227] *See* Guttentag, *Imposing Disclosure Requirements*, *supra* note 52, at 138.

[228] *See supra* note 133 and accompanying text.

[229] *See* Guttentag, *Imposing Disclosure Requirements*, *supra* note 52, at 138 ("It may be that without any regulatory intervention, the overproduction of information by investors attempting to 'beat the market' is just enough to offset the underproduction of information that results from the public goods nature of this information.").

The reasonable solution to the two-sided wasteful competition problem created by inside information is to prohibit all trading based on inside information. The party best positioned to weigh the relevant evidence and enforce such a ban is a centralized regulator. Private arrangements cannot easily be made between all the affected parties to generate socially optimal results, while a federally imposed prohibition is quite feasible to put in place.

Three additional questions raised by the claim that all trading based on inside information should be prohibited to avoid wasteful competition deserve at least a preliminary consideration here. These three questions are: (1) what specific evidence can be gathered to estimate the actual magnitude of the wasteful competition problems created if trading while in possession of inside information is permitted, (2) would a more precise social welfare analysis of a rule prohibiting all trading based on inside information lead to conclusions similar to those presented here, and (3) how does the justification presented here for making all trading based on inside information illegal inform the question of whether insider trading should be criminalized. I will sketch out preliminary responses to these important questions below and leave a fuller analysis for another day.

1. Magnitude of the Inside Information Wasteful Competition Problem

The central claim of this article is that avoiding wasteful competition justifies a sweeping federal prohibition on all trading based on inside information. One assumption implicit in reaching this conclusion is that the magnitude of the wasteful competition problems that might be triggered by allowing insider trading is so substantial that legalizing any degree of insider trading would not only be problematic, but problematic at a significant scale. Thus far, I have not quantified what the magnitude of these wasteful competition problems are likely to be and why.

I offer here a preliminary argument as to why the magnitude of wasteful competition triggered by permitting some or all of those in possession of inside information to trade is likely to be substantial. Recall in Posner's hypothetical example of how resources might be wasted in a race to be first to recover goods lost at sea Posner compared two amounts: the value of the rescued goods ($1,000 in his example) and the cost to rescue the goods ($250 in his example).[230] This led Posner to estimate the potential waste at $750 based on the assumption that the entire

[230] *See supra* notes 8–10 and accompanying text.

difference between the value of the goods and the cost of recovery (the surplus) could be consumed through wasteful competition.

We can carry out a similar calculation to provide a rough estimate as to the potential magnitude of the costs of wasteful competition that could arise from the competition to gather and exploit inside information.[231] First, following the logic above that inside information is generally produced as a byproduct of other activities, a reasonable first approximation is that the cost of producing inside information is zero.[232]

The more difficult value to estimate is how much inside information might be worth if there were no precautions taken against its use.[233] If we ignore the opportunity to profit from insider trading in any market except the United States equity markets, this would place the pool of potential returns from which insider traders could earn a disproportionate share in the range of several trillion dollars a year based on the following calculation.[234] The value of the United States traded equity market is approximately $34 trillion dollars and the historical annual return on public equities is around 7 percent. This implies an estimated return on investment of approximately $2.5 trillion per year.[235]

If returns on public equities traded in the United States are in the range of trillions of dollars for the reasons suggested above, the next questions are how much of this return can be captured by those with foreknowledge and how much foreknowledge would access to inside information provide. Perhaps those with foreknowledge can only capture a modest share of these returns, or perhaps foreknowledge is crucial to garnering a significant share of returns, so a range of between 1 percent and 25 percent of the total

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[231] Of course, the amount of resources expended to capture a prize need not equal the value of the prize available for a number of reasons. *See, e.g.*, KAI A. KONRAD, STRATEGY AND DYNAMICS IN CONTESTS (2009); Luis C. Corchón, *The Theory of Contests: A Survey*, 11 REV. ECON. DESIGN 69, 81–84 (2007).

[232] *See supra* note 65 and accompanying text.

[233] With respect to the specific details of what might constitute the costs of precautions, analysis of the social costs associated with defensive measures that might be taken to prevent losses to informed investors is not well-developed. There is research that considers how market makers can shift the cost of transacting with informed traders to other market participants. *See, e.g.*, Golsten & Milgrom, *supra* note 96, at 71. However, these models focus primarily on cost shifting and do not delve into the question of whether, at what cost, and to what extent firms invest resources in trying to determine whether they are trading with informed investors.

[234] Insider trading could certainly provide alluring prizes outside of the United States equity markets. *See, e.g.*, Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447 (2016) [hereinafter, Verstein, *Insider Trading in Commodities Markets*].

[235] *See* Ron Surz, *U.S. Stock Market is Biggest & Most Expensive in World, But U.S. Economy is Not the Most Productive*, NASDAQ (Apr. 2, 2018), https://www.nasdaq.com/articles/us-stock-market-biggest-most-expensive-world-us-economy-not-most-productive-2018-04-02.

returns available is at least plausible.[236] Next, inside information might provide valuable foreknowledge with respect to between 1 percent and 10 percent of the total returns available from the use of foreknowledge. The implication of these very preliminary estimates is that the wealth at stake that might entice wasteful competition to acquire and use inside information could range from hundreds of millions dollars each year to tens of billions dollars each year.[237]

Estimating more precisely the magnitude of wasteful competition around the collection and use of inside information in the absence of an insider trading prohibition or as compared to a prohibition that is only triggered by the wrongful use of inside information would be an important next step in further buttressing the central claim of this article.[238]

2. Social Welfare Analysis

The full analysis of any proposed regulatory intervention should include a consideration of both the efficiency and equity effects of the proposed regulation.[239] Allowing individuals to trade on inside information might help to redistribute resources in socially desirable ways even if insider trading also wastes resources. A more analytically rigorous evaluation than the one offered here would include a full consideration of the redistributional effects of insider trading policy choices.

The rough approximation of a social welfare analysis provided here looks to see if there are likely to be meaningful differences between winners and losers depending on whether

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[236] *See* Scott, *supra* note 181, at 807, reports that "[t]he level of excess returns found [using the reports filed with the SEC or exchanges] has been on average from 2 percent to 8 percent."

[237] The low end would be $2.5 trillion x 1 percent x 1 percent, or $250 million. The high end would be $2.5 trillion x 25 percent x 10 percent, or $62.5 billion. By comparison Budish et al., *supra* note 203, at 1553, estimate that the prize at stake in one arbitrage they study in depth is $75 million. They then observe: "[a]lthough we hesitate to put a precise estimate on the total size of the prize in the speed race, commonsense extrapolation from our . . . estimates suggests that the sums are substantial." *Id.*

[238] In addition to the framework presented in the text, there are many alternative ways to estimate the trading value of inside information, including looking at the value realized ex post by those who appear to have traded on inside information, or by looking at the magnitude of daily trading volumes to estimate the size of the opportunity to trade profitably with inside information. It is also true that the current regime in the United States is far from fully permissive of all insider trading. So an accurate measure of the gains available from implementing the recommendation in the article may be better compared to the current regime in which at least some forms of insider trading are prohibited.

[239] More specifically the analysis of policy is best carried by means of applying a social welfare function. A social welfare function "conceptualizes the status quo and each policy alternative as a pattern of *well-being* across the population of concern." Matthew D. Adler, *A Better Calculus for Regulators: From Cost-Benefit Analysis to the Social Welfare Function*, 2 (Duke Univ. Philosophy & Pub. Policy, Working Paper Feb. 2017); *see also* MATTHEW D. ADLER, WELL-BEING AND FAIR DISTRIBUTION: BEYOND COST-BENEFIT ANALYSIS (2012).

insider trading is or is not prohibited. On the one hand, two groups could benefit from access to inside information in the absence of an insider trading prohibition. The first group would be employees at public companies and employees at firms that interact with public companies on a regular basis, such as investment banks, accounting firms, and law firms. Neither public company employees nor employees at professional service firms appear to be especially needy. The second group of potential beneficiaries in the absence of an insider trading prohibition might be the firms whose activities generate the inside information. At least in theory, these firms could capture the value of the inside information they produce by reducing compensation to offset gains their employees realize from insider trading.[240] The beneficiaries in this case would be the shareholders of the firm generating the inside information rather than the employees who first gain access to and trade on this information. Again, there does not appear to be anything especially needy about this cohort of shareholders.[241]

On the other hand, if the use of inside information for trading purposes is prohibited then the most likely beneficiaries would be those who hold public securities or have an interest in firms that raise capital in public securities markets.[242] Holders of public securities and capital raisers are also affluent groups.[243] On first impression, there do not appear to be distributional effects that should cause concern about adopting the most efficient solution to the wasteful competition problems created by insider trading, a ban on all trading based on inside information.

3. Criminalization

An additional policy debate about insider trading is whether those who trade on inside information should be subject to both civil and criminal penalties. In the United States you can, and many do, go to jail for insider trading.[244] The discussion thus far about the benefits of outlawing all trading based on inside information as the

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[240] *See supra* notes 73 and accompanying text.

[241] If anything, from a wealth inequality perspective, such a distribution may be worse, because some inside information may be generated by private firms, and ownership of private firms may be even more skewed toward the well-off than the ownership of public securities generally.

[242] *See supra* Section II.C.2.

[243] *See, e.g.*, Patricia Cohen, *We All Have a Stake in the Stock Market, Right? Guess Again*, N.Y. TIMES (Feb. 8, 2018), https://www.nytimes.com/2018/02/08/business/economy/stocks-economy.html [https://perma.cc/PBE4-D2SG] ("A whopping 84 percent of all stocks owned by Americans belong to the wealthiest 10 percent of households.").

[244] *See* U.S. SEC. AND EXCHANGE COMM'N, DIV. OF ENF'T, 2019 ANNUAL REPORT, https://www.sec.gov/enforcement-annual-report-2019.pdf [https://perma.cc/NZ6J-LNNV] (insider trading prosecutions and enforcement actions reported by the S.E.C. Fiscal Year 2019).

best way to address a two-sided wasteful competition problem says nothing about criminalization. A logical question is what the implications are for criminalizing insider trading if the reason to prohibit insider trading is to avoid wasteful competition.[245]

Let me sketch out here what the case for criminalizing insider trading based on the policy analysis above might look like, while acknowledging that the topic deserves a more extensive treatment than is provided here. I start from the simplistic assumption that criminalizing an offense requires more than just an argument that certain conduct is more efficient than other conduct. One basis for making a distinction between civil and criminal liability might be, as Paul Robinson describes it, that "[c]riminal liability signals moral condemnation of the offender, while civil liability does not."[246]

Starting from the assumption that criminalizing an offense makes the most sense when the behavior in question triggers moral condemnation, the relevant question becomes whether the choice to engage in wasteful competition triggers feelings of moral condemnation. A preliminary answer to this question comes from other situations where people engage in competition that appears to be wasteful. One example of such a situation that might reveal whether moral feelings are triggered by engaging in wasteful competition are the reactions people have when others cut in line.

Cutting in line reallocates waiting time from those who cut in line to those who do not cut and now have a longer wait without providing any obvious efficiency gains. The practice of cutting in line is an example of wasteful competition. Several studies have found that people have strong feelings of disapproval toward those who cut in line, including work by Marie Helweg-Larsen and Barbara LoMonaco,[247] Richard Larson,[248] Stanley Milgram and colleagues,[249] and Felix Oberholzer-Gee.[250] These findings suggest there is a strong moral antipathy toward those who engage in competition to further their own interests solely at the expense of others. This kind of moral approbation suggests that the

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[245] Adam Pritchard asked precisely this question at a presentation of an earlier version of this project.

[246] Paul H. Robinson, *The Criminal-Civil Distinction and the Utility of Desert*, 76 B.U. L. REV. 201, 206 (1996). Robinson, by the way, rejects this view of the appropriate basis for the civil/criminal distinction as too simplistic.

[247] Marie Helweg-Larsen & Barbara L. LoMonaco, *Queuing Among U2 Fans: Reactions to Social Norm Violations*, 38 J. APPLIED SOC. PSCYHOL. 2378, 2384–85, 2389–92 (2008).

[248] Richard C. Larson, *Perspective on Queues: Social Justice and the Psychology of Queueing*, 35 OPERATIONS RES. 895, 897 (1987).

[249] Stanley Milgram et al., *Response to Intrusion Into Waiting Lines*, 51 J. PERSONALITY & SOC. PSCYHOL. 683 (1986).

[250] Felix Oberholzer-Gee, *A Market for Time Fairness and Efficiency in Waiting Lines*, 59 KYKLOS 427, 429–31 (2006).

implementation of a policy with the objective of avoiding wasteful competition may justify both civil and criminal penalties. A more elaborate consideration of the moral distaste for wasteful competition and its relation to the criminalization of insider trading is beyond the scope of this article.

V. POLICY IMPLICATIONS OF AN INSIDER TRADING PROHIBITION DESIGNED TO AVOID WASTEFUL COMPETITION

The analysis above shows why inside information invites wasteful competition both at its source and in its use and argues that the best way to avoid this wasteful competition is to outlaw all trading based on inside information.[251] Three specific policy recommendations follow from this conclusion. First, federal legislation should be enacted that bans all trading based on inside information and not just trading based on wrongfully acquired information. Second, there is no reason to require proof that a tipper received a personal benefit to prosecute someone for either tipping inside information or for trading based on inside information received from a tipper. Third, the possession of inside information should be enough to trigger an insider trading prohibition.

A. Federal Legislation

In this Section I consider the implications for federal legislation, and, more specifically, the ITPA if one accepts that avoiding wasteful competition is a sound justification for prohibiting insider trading. As mentioned in the Introduction, the House of Representatives in December of 2019 and again in May 2021 passed insider trading legislation with bipartisan support.[252] Both of these pieces of legislation represent a welcome effort to place the crime of insider trading on a statutory foundation, which is preferable to prosecuting crimes based on a federal common law prohibition.

However, both the ITPA of 2019 and the ITPA of 2021 condition insider trading liability on whether material nonpublic information is wrongfully acquired and not on the nature of the information itself. For example, the ITPA of 2019 states that:

> [i]t shall be unlawful for any person, directly or indirectly, to purchase [or] sell . . . while aware of material, nonpublic information relating to such security . . . if such person knows, or recklessly disregards, that

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[251] *See supra* Parts II & IV.

[252] *See* 116 CONG. REC. H9271–H9279, *supra* note 19.

> such *information has been obtained wrongfully*, or that such purchase or sale would constitute a *wrongful use of such information*.[253]

Observe that only the use of information wrongfully acquired violates the law. This kind of "wrongful" acquisition test is familiar to students and scholars studying insider trading law in the United States. Limiting insider trading liability to situations involving wrongfully acquired information is, for example, the basis for the misappropriation theory of insider trading.[254]

While providing a statutory foundation for insider trading liability is a laudatory undertaking, there is an important policy question that enacting the ITPA of 2021 or any other federal insider trading legislation should not skip over. The effort to improve on the federal common law of insider trading offers an opportunity to carry out a more fundamental reevaluation of insider trading policy. An insider trading prohibition need not be conditioned on whether information is acquired wrongfully. For example, the MAD provision in the EU

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[253] Insider Trading Prohibition Act of 2019, H.R.2534, 116th Cong. § 16A(a) (emphasis added). This choice to prohibit trading on material nonpublic information to situations where information is wrongfully obtained raises several questions. One question is whether any wrongful acquisition of material nonpublic information would trigger a prohibition on trading, or if only certain types of wrongful conduct should trigger the insider trading prohibition. The ITPA of 2019 and the ITPA of 2021 provide an exclusive list of the specific kinds of wrongful acquisition of information that would trigger insider trading liability. The lists of the wrongful conduct that can trigger insider trading liability include theft, bribery, misrepresentation, espionage, violation of federal laws protecting computer data, intellectual property, or privacy, conversion, misappropriation, other unauthorized and deceptive taking of such information, and various types of breaches of fiduciary or other relationships. *Id.* at (c)(1). Donna Nagy and I have argued that the "selective disclosure of material nonpublic information" in violation of Regulation FD should be sufficiently wrongful to trigger the insider trading prohibition. *See* Guttentag, *Selective Disclosure*, *supra* note 23, 521–25; Donna M. Nagy, *Beyond* Dirks*: Gratuitous Tipping and Insider Trading*, 42 J. CORP. LAW 22, 26–28 (2016). John Anderson has responded that our claims represent an unjustified "creative expansion" of when wrongful conduct should trigger insider trading liability. *See* ANDERSON, *supra* note 56, at 83–87. Unfortunately, neither version of the ITPA resolves this important policy question.

An alternative approach would avoid providing an exclusive list of the kinds of wrongful conduct that could trigger insider trading liability. This alternative approach is recommended in a report issued by a task force convened by Preet Bharara, the former United States Attorney for the Southern District of New York. That task force recommended that an insider trading statute "should clearly and expressly prohibit trading in securities based on any such 'wrongfully obtained' material nonpublic information." DEP'T OF JUSTICE, THE BHARARA TASK FORCE ON INSIDER TRADING 15 (2020), https://static1.squarespace.com/static/5e1f2462d354fa5f5bac2699/t/5e2a1e9d12e0c33aefc41303/1579818654541/Report+of+the+Bharara+Task+Force+on+Insider+Trading.pdf [https://perma.cc/XA7T-6XV7]. The Bharara Task Force includes a proposal as to how to categorize wrongful conduct that includes "(a) deception, fraud, or misrepresentation, (b) breaches of duties of trust or confidence or breach of an agreement to keep information confidential, express or implied, (c) theft, misappropriation, or embezzlement, or (d) unauthorized access to electronic devices, documents, or information." *Id.* at 18.

[254] The misappropriation theory of insider trading "holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." United States v. O'Hagan, 521 U.S. 642, 652 (1997).

conditions liability not on the wrongfulness of the acquisition of information but on the precision and source of the information.[255]

If I am correct that avoiding wasteful competition is the best reason to prohibit insider trading, this has a clear implication for whether to condition insider trading liability on whether information is wrongly acquired. The problems of wasteful competition for inside information arise regardless of whether information is rightfully or wrongfully acquired. Insider trading sanctioned by a firm can also trigger a wasteful arms race. The zero-sum game triggered by efforts to exploit informational advantages in trading markets arises whenever it is difficult for the transacting parties to easily discern who is better informed, and this is a problem whether the person trading on inside information wrongfully acquired the information or not.

The better approach to addressing the wasteful competition problem created by inside information is to look to the nature of the information involved to determine whether trading should be prohibited. The nature of the information can provide guidance as to whether the information is likely to be produced as a byproduct of other activities and to trigger an arms race to trade on value relevant information. Information generated as a byproduct of other activities within the firm is more likely to generate a surplus and therefore is also more likely to invite wasteful competition. Rather than prohibit trading based on wrongfully acquired information, trading should be prohibited based on the source of the information without requiring a determination of whether the information was wrongfully acquired.[256] There are two systems already in place that provide a model of this better approach. The first example of the better approach is the insider trading prohibition adopted by the European Union (EU). The EU prohibition determines who may not trade based on whether they have certain types of precise information about future events in their possession.[257] A second example of the better approach is an insider trading prohibition in the United States. In the United States trading when in possession of information relating to an upcoming tender offer is prohibited without the additional requirement that the information be wrongfully obtained.[258]

The ITPA of 2021 may be an improvement over relying on federal common law to prohibit and criminalize insider

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[255] *See supra* notes 56–59 and accompanying text.
[256] *See supra* Section IV.
[257] *See supra* notes 56–59 and accompanying text.
[258] *See supra* notes 54–55 and accompanying text.

trading. However, an insider trading statute should address the most significant problem created by trading on inside information, the two-sided wasteful competition problem. To achieve this objective, such a statute should home in on the source of the information, not on whether the information is wrongfully acquired.

B. Tipper/Tippee Liability

Insider trading is often carried out by a small group of co-conspirators rather than by an individual acting alone.[259] Frequently, the person who receives inside information from within an organization does not trade on that information, but rather passes information on to others who are the ones who ultimately trade based on that information. Those who pass on the inside information are referred to as tippers, and those who receive the inside information are tippees.

The question of whether tippers and tippees should face liability under the current federal common law fraud-based regime that governs insider trading in the United States raises a host of difficult doctrinal questions.[260] This is because there is "no obvious common law precedent [that] suggests how to determine when the selective disclosure of material nonpublic information constitutes a deceptive practice."[261]

The current test for liability of a tipper for insider trading comes from the 1983 Supreme Court decision in *SEC v. Dirks*.[262] The rule established by the Supreme Court in *Dirks* is that the tipper and tippee face liability for insider trading only when the tipper receives a "personal[] . . . benefit" from providing the tip and the tippee knows or should have known of the tipper's

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[259] *See, e.g.*, Michael D. Guttentag et al., *Brandeis' Policeman: Results from a Laboratory Experiment on How to Prevent Corporate Fraud*, 5 J. EMPIRICAL LEGAL STUD. 239, 245 (2008).

[260] *See, e.g.*, Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 182–83 (2005/2006); Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 268 (2003); Fisch, *supra* note 70, at 213–14; Guttentag, *Selective Disclosure*, *supra* note 23, at 519; Jonathan R. Macey, *Beyond the Personal Benefit Test: The Economics of Tipping by Insiders*, 2 U. PA J.L. & PUB. AFF. 25, 27 (2017); Nagy, *supra* note 253; Harvey L. Pitt & Karl A Groskaufmanis, *Family Ties, Tippees and the Chestman Decision: Time for a Principled Definition of Insider Trading*, 4 No. 7 INSIGHTS 7 (1990); Jeffrey Plotkin, *The Tipper Benefit Test Under the Misappropriation Theory*, 230 N.Y. L.J., no. 3, 2003; A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 859 (2015); Craig W. Davis, Comment, *Misappropriators, Tippees and the Intent-to-Benefit Rule: What Can We Learn from* Cady, Roberts, 35 SETON HALL L. REV. 263, 266–67 (2004); Allison M. Vissichelli, Note, *Intent to Reconcile:* S.E.C. v. Obus*, The Second Circuit's Edification of the Tippee Scienter Standard*, 62 AM. U. L. REV. 763, 767 (2013).

[261] *See* Guttentag, *Selective Disclosure*, *supra* note 23, at 523–24.

[262] *See generally* Dirks v. SEC, 463 U.S. 646 (1983).

personal benefit.[263] There are many reasons to criticize this test.[264] There is also ongoing tension between the circuits and even within the Second Circuit about how exactly to apply the personal benefit test established in *Dirks*. In 2014, in the case of *United States v. Newman*, the Second Circuit dismissed a case against defendants Anthony Chiasson and Tod Newman and held that to convict a tippee of insider trading there must be evidence of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain [to the tipper] of a pecuniary or similarly valuable nature."[265]

Shortly after the *Newman* case was decided, an opinion in the Ninth Circuit in *United States v. Salman* also addressed the question of what must be established to prove that the tipper received a personal benefit for providing the tip. In the *Salman* case, investment banker Maher Kara repeatedly passed confidential information garnered through his position at Citigroup to his brother, Michael Kara, who, in turn, passed the information along to Bassam Salman, who traded using this information.[266] The Ninth Circuit *Salman* opinion found that the tipper, Maher Kara, had received the requisite personal benefit and emphasized the statement in *Dirks* that the "exploitation of nonpublic information also exist[s] when an insider makes a gift of confidential information to a trading relative or friend."[267] The Supreme Court subsequently affirmed the Ninth Circuit *Salman* opinion and explicitly rejected the *Newman* panel's statement of the personal benefit test.[268]

Meanwhile, in December of 2019 the Second Circuit Court of Appeals in *United States v. Blaszczak* affirmed an insider trading conviction without even requiring proof that the tipper received a personal benefit from providing the tip.[269]

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[263] *Id.* at 662.

[264] *See, e.g.*, Guttentag, *Selective Disclosure*, *supra* note 23, at 523–24.

[265] *Id.* at 537–38 (alteration in original).

[266] United States v. Salman, 792 F.3d 1087, 1088–89 (9th Cir. 2015).

[267] *Id.* at 1092 (emphasis omitted) (quoting *Dirks*, 463 U.S. at 664).

[268] Salman v. United States, 137 S. Ct. 420, 428 (2016). More recently in *United States v. Martoma* a Second Circuit panel first held "that the logic of *Salman* abrogated *Newman*'s 'meaningfully close personal relationship' requirement," but then reissued their opinion based on the grounds that Dr. Gilman had been handsomely paid for his consultations, meeting the 'pecuniary gain' requirement for the personal benefit. United States v. Martoma (Martoma I), 869 F.3d 58, 61 (2d Cir. 2017), *amended and superseded by* United States v. Martoma (Martoma II), 894 F.3d 64 (2d Cir. 2018). For a discussion of these cases, see Karen E. Woody, *The New Insider Trading*, 52 ARIZ. ST. L. REV. 594, 612–14 (2020)*; see also* Donald Langevoort, *Watching Insider Trading Law Wobble:* Obus, Newman, Salman *and the Two* Martomas*, and a* Blaszczak 6–8 (2019), https://scholarship.law.georgetown.edu/facpub/2209 [https://perma.cc/YFB8-EUK3].

[269] United States v. Blaszczak, 947 F.3d 19, 45 (2d Cir. 2019). The prosecution brought charges under several different federal statutes, including Title 15 which contains

Blaszczak involved a situation where an employee at the Centers for Medicare & Medicaid Services, a federal agency, provided a tip consisting of material nonpublic information to Blaszczak.[270] Blaszczak was a "political intelligence" consultant for hedge funds, and he passed along the information to employees at a hedge fund.[271] The hedge fund made profitable trades based on that information.[272] The Second Circuit applied Section 1348 of the Securities and Commodities Fraud statute adopted as part of the 2002 Sarbanes-Oxley Act without requiring proof that the tipper receive a personal benefit from providing the tip.[273] This holding raises the policy question as to whether there should be circumstances under which providing a tip without any personal benefit should be prosecuted.

The analysis in this article can address that policy question. If the insider trading prohibition is designed to avoid wasteful competition and not based upon the goal of preventing the use of wrongfully acquired information when trading in securities markets, then there is no reason to condition insider trading liability on whether a tipper receives a personal benefit. The Court in *Dirks* introduced the personal benefit test to develop a means for determining whether information was provided to an outsider for a wrongful purpose.[274] There is no need for a test to distinguish between different situations where inside information is secretly passed on to those outside of the firm if the goal is to reduce wasteful competition. Any tipping is likely to trigger wasteful competition regardless of the rationale for passing along the tip. The process of passing along information from one person to another would only add to the costs associated with the contest to be the first to uncover and use inside information.

Therefore, the holding in *Blaszczak* that removes the personal benefit test from an insider trading case involving tipping can be justified based on policy considerations.

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the Section 10(b) prohibition that is the usual basis for prosecuting insider trading cases. Charges were also brought under Title 18, which contains Sections 1343 and 1348. *Id.* at 29. Section 1348 "proscribes a 'scheme or artifice . . . to obtain, by means of false or fraudulent pretenses . . . any money or property in connection with the purchase or sale of' securities." *Id.* at 31 n.1 (omissions in original).

[270] *Id.* at 26.

[271] *Id.*

[272] *Id.*

[273] *Id.*

[274] *See, e.g.*, Guttentag, *Selective Disclosure*, *supra* note 23, at 533–37.

C. "Possession" Versus "Use" Liability

A third policy implication of the analysis here relates to the longstanding debate about whether to prohibit trading whenever someone is in possession of material nonpublic information or to only prohibit trading when someone can be shown to actually use the material nonpublic information they possess for trading purposes.[275]

There is a split among the federal circuits as to whether the insider trading prohibition extends to all situations in which one is in possession of inside information or only to situations where it can be shown that someone actually uses the inside information in their possession as a basis for making a securities trade. The Second Circuit opinion in *U.S. v. Teicher* bans insider trading when in possession of material nonpublic information.[276] The court in that opinion writes "that one who trades while knowingly *possessing* material inside information has an informational advantage over other traders."[277] In contrast, the Eleventh Circuit in *S.E.C. v. Adler* held that one could rebut the presumption that possession of inside information triggered an insider trading violation by "adducing evidence that there was no causal connection between the information and the trade—i.e., that the information was not used."[278]

In 2000, the SEC adopted Rule 10b5-1 to address this circuit split by providing a well-defined safe-harbor for when those in possession of material nonpublic information could safely trade.[279] There is, however, some concern that executives have figured out ways to manipulate the provisions of Rule 10b5-1 and continue to use material nonpublic information to trade profitably in their firm's shares.[280]

In an important recent article, Andrew Verstein suggests that a reasonable resolution of the possession/use debate is available if we apply the normative principle that "[t]raders should not on average be richer or poorer as a result of proscribed inside information."[281] Proceeding from this premise,

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[275] This is the so-called "possession/use" or "awareness/use." *See* BAINBRIDGE, *supra* note 25, at 72–79; Verstein, *Mixed Motive Insider Trading*, *supra* note 25, at 1258.

[276] United States v. Teicher, 987 F.2d 112, 121 (2d Cir.1993).

[277] *Id.* at 120 (emphasis added).

[278] S.E.C. v. Adler, 147 F.3d 1325, 1337 (11th Cir. 1998).

[279] Selective Disclosure and Insider Trading, 17 C.F.R. §§ 240, 243, 249 (2020).

[280] *See, e.g.*, Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224, 226–27, 235–37 (2009). Alternatively, insiders may use the timing of charitable contributions of stock to realize tax benefits from their access to inside information. Sureyya Avci et al., *Insider Giving*, 71 DUKE L.J. at 1, 3 (forthcoming 2021).

[281] *See* Verstein, *Mixed Motive Insider Trading*, *supra* note 25, at 1257–58.

Verstein concludes that "a *primary motive* test, under which a trader is liable if and only if her primary reason for trading was unlawful" is the best rule.[282] If one accepts Verstein's normative assumption about how to resolve the possession versus use debate then Verstein's argument for the primary motive test is compelling. However, the analysis here shows that there is a policy rationale for prohibiting insider trading that Verstein does not consider. The analysis here shows that the insider trading prohibition should be grounded in the desire to reduce wasteful competition. This insight provides a new lens through which to evaluate the merits of each side in the circuit split about whether to condition insider trading liability on the possession or use of inside information.

If the problem an insider trading prohibition is designed to address is wasteful competition, the law should disallow trading whenever someone is in *possession* of inside information. Conditioning an insider trading prohibition on the use and not just the possession of inside information is the more expensive rule to implement. Applying the "use" standard might require showing that inside information was not just possessed but also "used" for trading purposes. If the goal is to avoid wasteful competition, there is no offsetting benefit from incurring the possible expense of this additional test to determine the scope of the insider trading prohibition.

Permitting those who can only be shown to be in possession of inside information to trade but cannot be shown to have used that information for trading does nothing to ameliorate the wasteful competition problems created by inside information. In fact, any conditional test that is likely to expand the ability to trade on inside information should be disfavored, because the greater the scope of permissible insider trading the greater the wasteful competition problem that results from allowing trading on inside information is likely to be.

Based on the policy analysis here, a rule prohibiting trading when in possession of inside information is preferable to one which conditions the prohibition on whether the information is actually relied upon for trading purposes.

CONCLUSION

Allowing people to trade on inside information invites wasteful competition. Recognizing and analyzing the scope and magnitude of this problem reinvigorates the case for prohibiting

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[282] *Id.* at 1258.

insider trading and provides new guidance as to the optimal composition of such a prohibition. The time has come for the United States to replace the current insider trading regime, which conditions the insider trading prohibition on whether the information is wrongfully acquired, with an insider trading prohibition that bans all trading when in possession of inside information regardless of how the information was acquired.