THE HIDDEN CONTRADICTION WITHIN INSIDER TRADING REGULATION

Michelle N. Comeau*

Regulation of insider trading in the United States centers around two types of rules. The first and most publicized is the set of rules prohibiting "illegal" insider trading—trades based on material, nonpublic information. These laws are designed to increase investor confidence in the stock market by making the market seem fair and honest. However, the roughly 475,000 insider trades executed each year consistently net higher returns than the trades of ordinary investors. And the vast majority are simply ignored by the Securities and Exchange Commission, either because the trades were made for reasons other than the insider's confidential knowledge, or because the government simply could not prove otherwise. Nevertheless, the second set of rules mandates that each of these trades be posted within two days on the Securities and Exchange Commission's website, where they are quickly made available for perusal by the investing public. This Comment proposes that mandatory disclosure, by flaunting the ubiquity of these profitable trades to ordinary investors, most likely works against the stated goal of bolstering investor confidence. Instead, the author proposes a more persuasive justification for mandatory disclosure rules—promoting market efficiency.

* Senior Editor, UCLA Law Review, Volume 53. J.D. 2006, UCLA School of Law; B.A. 2000, Dartmouth College. For his comments and criticism in the development of this piece, I thank Professor Lynn LoPucki. For their efforts in the production of this Comment, I thank the *UCLA Law Review* staff, especially Elizabeth Oh, Pei Pei Tan, Sergio Vazquez, and Ryan White. Finally, for unflagging support and guidance, I thank Peggy Comeau, Bob Comeau, Bob Ellig, and William Schoen.

INTRODUCTION

There is a hidden contradiction within insider trading regulation between prohibitory and disclosure rules. These rules, created by Congress, the Securities and Exchange Commission (SEC), and the judiciary, regulate the 475,000 such trades that occur each year[1] as insiders buy or sell the stock of their companies using their own money.[2] A subset of the trades is considered illegal because they were made while the trader possessed material, nonpublic information,[3] based on the theory that this is a form of fraud committed against the person with whom the trade is executed.[4] The SEC is empowered to bring civil or administrative enforcement proceedings against the insider who trades illegally.[5] However, the large majority of insider trades provoke no action from the SEC, either because they are made for reasons other than knowledge of material, nonpublic information or because the SEC lacks the ability to detect the illegal aspect of the trade. Nevertheless, these trades remain subject to regulation. Specifically, insiders must report details of all trades in their own stock within two business days of the trade. The SEC immediately makes the fact of the trade available to the public by posting it on its own website,[6] and search engines such as Yahoo! in turn post the information to their web pages on the corresponding stock.[7] The SEC thus quickly enables noninsiders to utilize the information in making investment decisions.

Congress, the SEC, and the judiciary have each stated that the goal of insider trading regulation is to promote investor confidence—the certitude of

1. For a calculation of this number, see *infra* note 89.
2. Insider trading also includes misappropriation—that is, trading in or passing information regarding the stock of a company you do not work for but about which you have "secret" information. Because this Comment addresses a disclosure requirement that applies only to firm insiders, it will discuss only "classical" insider trading.
3. *See* 17 C.F.R. § 240.10b-5 (2005) (Rule 10b-5).
4. *See In re* Cady, Roberts, & Co., 40 S.E.C. 907, 912 (1961).
5. The Securities and Exchange Commission (SEC) does not prosecute insider trading criminally. However, it is responsible for detecting violations and for working with the Department of Justice to coordinate criminal prosecutions. *See* Anish Vashista et al., *Twentieth Survey of White Collar Crime: Securities Fraud*, 42 AM. CRIM. L. REV. 877, 881 (2005) (discussing the process).
6. Current filings can be found through the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) at U.S. Sec. & Exch. Comm'n, Latest EDGAR Filings, http://www.sec.gov/cgi-bin/browse-edgar?action=getcurrent (last visited May 4, 2006).
7. *See, e.g.*, Yahoo Finance, Quotes & Info, Microsoft Corp., http://finance.yahoo.com/q/it?s=msft (last visited May 4, 2006).

investors at large that the market is fair. But making information on insider trades broadly available to the public likely does not increase investors' confidence that they are getting a fair shake in the stock market; instead it shows only that insiders are constantly buying ahead of gains and selling ahead of losses, and are almost certainly making more money than noninsiders.[8] Thus, at this point the investor confidence rationale falters.

Remarkably, no scholar to date has directly attacked the relevance of the investor confidence rationale to the mandatory disclosure rules for insider trading. Some have offered other justifications for mandatory disclosure of insider trades; however, none are fully persuasive.

Congress first mandated an insider trading disclosure requirement in the Securities Exchange Act of 1934 (1934 Act).[9] Section 16(a) of the 1934 Act mandates disclosure of all insider trades, while section 16(b) prohibits "short-swing profits."[10] At least two academics have taken the position that section 16(a) simply provides the vehicle for enforcement of section 16(b).[11] In this view, the SEC must collect information on insider trades in order to catch insiders attempting to make short-swing profits.[12] However, this rationale is a poor fit with the actual statute. Under section 16(a), the SEC is mandated not simply to collect the information, but to make it available to the public as well.[13] Public release of this information does not improve—and cannot be justified as merely a support mechanism for—the SEC's ability to monitor short-swing profits.

Moreover, in 2002 Congress made an affirmative change to the public distribution provision of the statute by mandating that the information be filed online and posted immediately by the SEC.[14] If disclosure of trades was required only to permit the identification and capture of short-swing profits, then delay in disseminating the information would be unimportant. If,

---

8. *See* discussion *infra* Part I.B and accompanying notes.

9. Securities Exchange Act of 1934 (1934 Act), ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).

10. Short-swing profits are gains from a sale made within six months of a stock's purchase. *See id.* § 16(b), 48 Stat. at 896 (codified as amended at 15 U.S.C. § 78p(b) (2000)).

11. *See* Michael H. Dessent, *Weapons to Fight Insider Trading in the 21st Century: A Call for the Repeal of Section 16(b)*, 33 AKRON L. REV. 481, 488, 495–96 (2000) (discussing the "[a]ppropriate [r]ole of § 16(a)"); Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183, 187–88 (1992) (discussing reading sections 16(a) and 16(b) together as an integrated regulatory scheme).

12. *See* Dessent, *supra* note 11, at 488, 495–96.

13. Securities Exchange Act of 1934 § 16(a), 48 Stat. at 896 (codified as amended at 15 U.S.C. § 78p(a) (2000)).

14. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 403, 116 Stat. 745, 788 (codified as amended at 15 U.S.C. § 78p(a) (Supp. II 2002) (amending 15 U.S.C. § 78p(a) (2000))).

however, disclosure was designed to serve some broader purpose associated with alerting the public to the fact of insider trades, then the delay in reporting would be very important. Congress's actions confirm the latter theory; thus, the mandatory disclosure requirement must serve some greater purpose and cannot by justified merely by its usefulness to the SEC's monitoring function.

Alternatively, Professor Steve Thel has posited that the original mandatory reporting requirement was designed to provide investors with insight into top management's view of a company, as evidenced by the size of managers' personal stakes.[15] Presumably, where managers are significantly invested, they will work harder and may hold a high opinion of the company's future.[16] This position is somewhat convincing: As discussed in Part I.B below, the viewpoint of insiders does relate to a company's future prospects. However, this rationale does not fit the actual disclosure requirement comfortably either. Under Thel's theory, investors need to know only how much is owned rather than the details of the transaction itself.[17] A statute that supported this would likely require reporting at regular intervals, such as quarterly or yearly. Yet, the current disclosure requirements are transaction-based, reporting on buys and sells, rather than how much stock is owned. Further, as discussed below, the value of collecting and disseminating information on insiders lies more in following their buys and sells than in their overall stake, as suggested by Thel. Thus, Thel's theory of the purpose of section 16(a) fails to persuade because it does not justify the reporting requirements as they are actually constructed.

The Sarbanes-Oxley Act of 2002[18] changed the insider trading disclosure requirement by shortening the reporting deadline from forty days to two days. Scholarship on the accelerated disclosure is relatively thin; indeed, some scholars do not consider the provision worth discussing at all.[19] However, at

15. Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 421–23 (1991) (arguing that requiring managers and directors to disclose their equity stake encourages them to hold stock, and noting that prior to the passage of section 16(a) stockholders had a difficult time determining managers' and directors' financial interest in their companies).

16. *See id.* at 422.

17. *See id.* at 421 (arguing that section 16(a) makes management keep disclosure of its positions current).

18. Sarbanes-Oxley Act of 2002, § 403, 116 Stat. at 788 (codified as amended at 15 U.S.C. § 78p(a) (Supp. II 2002) (amending 15 U.S.C. § 78p(a) (2000))).

19. One scholar called section 403 a "tinkering" provision. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 965 n.221 (2003) (mentioning the accelerated disclosure provision in a brief footnote to his summary of the Act's efforts to move toward "real-time" disclosure). Another referred to the provision as "window dressing." André Douglas Pond Cummings, *"Ain't No Glory In Pain": How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the*

least one commentator did find the provision important, arguing that the shortened timeframe would "eliminate the potential for 'insiders' to gain any substantial unfair advantage" because investors could receive and react to insider signals within only two days, thereby removing the insiders' profit margin.[20] This reasoning is plainly wrong. As discussed in Part I.B below, insiders' ability to profit lies in the fact that they purchase or sell prior to noninsiders, not in the amount of time that passes between their insider trade and the revelation of the company's news to the public. For example, suppose an insider buys stock because of her (informed) belief that certain patents will be approved. The insider will realize the gain via an increased share price when the fortuitous event or circumstance comes to pass (and likely also when noninsiders buy to copy the insider), regardless of whether her purchase precedes a noninsider's purchase by two days or forty.[21] Learning helpful information earlier only provides an advantage vis-à-vis those who learn the information later, or never learn it at all. It does not provide an advantage vis-à-vis the insider because her purchase has already been made, and she locked in the value of her information at that time. Thus, the disclosure requirement cannot be justified as an effort to rein in the gains of insiders.

In sum, while some scholars have attempted to show various independent purposes for the mandatory disclosure rules, none of these explanations is persuasive. Moreover, no one has yet disputed Congress's, the SEC's or the courts' connection of these rules with the stated goal of boosting investor confidence in the stock market.

This Comment contends that there is a contradiction within insider trading regulation between the stated goal of promoting investor confidence and the actual effects of the reporting rules. It argues that the reporting rules cannot be justified under the investor confidence theory and instead reflect an unstated goal of promoting market efficiency. Part I demonstrates that insider trading regulation, including mandatory disclosure rules, is heavily grounded in the goals of fairness and investor confidence. It outlines the

Collapse of the United States Capital Markets, 83 NEB. L. REV. 979, 1061 (2005) (arguing that, overall, the Sarbanes-Oxley Act offers little or no additional investor protection).

20. Sarah Y. Rifaat, Comment, *It's Payback Time, or Is It?: An Argument to Apply Universal Heightened Standards to All Employee Stock-Based Individual Account Programs in the Post-Enron Era and Why Sarbanes-Oxley's Preventive Measures Do Not Adequately Protect Employee Investor Interests*, 32 PEPP. L. REV. 671, 719 (2005).

21. The timing of disclosure could make a difference in a case in which there is an "event" underlying the purchase, and the event occurs prior to a noninsider's learning of the insider's purchase. Because the event had passed, the outsider may not copy the insider, and the insider's gain would be smaller. However, these circumstances would not assist the theory advanced above; the accelerated reporting required under Sarbanes-Oxley would probably *benefit* the insider because the event would be unlikely to occur before the fact of the insider's trade was made public.

three primary pieces of legislation governing insider trading regulation: the Securities Act of 1933 (1933 Act), the 1934 Act, and the Sarbanes-Oxley Act of 2002, and shows that Congress, the SEC, and the courts have each justified insider trading regulation as promoting investor confidence in the market. Part I then applies this goal to the mandatory disclosure requirements for insider transactions and argues that publicizing this information does not increase investor confidence in the market or otherwise make the market fairer.

Part II proposes that these regulations actually serve an alternative, unstated goal of market efficiency. Market efficiency is associated with the ability of a market's stock prices to fully reflect all available information. Unlike an investor confidence rationale, a market-efficiency rationale supposes a large group of rational investors who are not interested in whether insider trading is just or unjust. Instead, given a relevant piece of information about a stock, they will rapidly incorporate that information into the stock's price. The disclosure requirements promote market efficiency by providing a necessary component: timely, relevant information about a stock's value. Part II then suggests several reasons why promoting market efficiency, while a persuasive justification for disclosure of insider trades, remains an unstated justification.

I. "INVESTOR CONFIDENCE" AS THE DOMINANT BUT UNPERSUASIVE JUSTIFICATION OF INSIDER TRADING REGULATION

Insider trading regulation defines insiders as corporate officers or directors, or shareholders owning at least 10 percent of a company.[22] Under current law, insiders may not trade in the stock of that company if the trade is based on material, nonpublic information.[23] The paradigmatic example of such a trade is the officer who buys his mining company's stock shortly after the company purchases an exceptionally promising new mine, but before informing the public of the mine's existence.[24]

"Investor confidence" refers to the general conviction, held by individual investors as a group, that they trust the stock market enough to purchase securities. Investor confidence in "the market" encompasses several degrees of trust—from investors' personal trust in the intermediaries who

22. Sarbanes-Oxley Act of 2002 § 403, 116 Stat. at 788 (codified as amended at 15 U.S.C. § 78p(a) (Supp. II 2002) (amending 15 U.S.C. § 78p(a) (2000))).
23. *See* 17 C.F.R. § 240.10b-5 (2005).
24. These were loosely the facts of *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971).

advise them and handle their money, to institutional trust that market mechanisms will operate as promised.[25] Investor confidence is also related to a secondary set of beliefs that investors are protected by a regulatory system that ensures the integrity of capital markets above and beyond investors' own ability to monitor them.[26]

How is insider trading related to investor confidence? The SEC regulates insider trading in two important ways. First, under the SEC's interpretation of federal securities laws, it is inherently unfair to the noninsider trading party for the insider to take advantage of the special information that she has, knowing that it is unavailable to the other party.[27] In fact, the SEC has argued successfully that that this constitutes fraud committed by the insider on the noninsider.[28] If such fraud was allowed, investors would be aware that it occurred but would have no way to know when an insider was the trading partner in a given transaction (because the trades are anonymous). Therefore, they would be discouraged from investing because they would know that they could not "win" against superior information.[29] Thus, in order to shore up the confidence of average investors, they must be convinced that insiders are not permitted to make such trades.[30]

25. *See* Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 415–20 (2002) (discussing the various aspects of trust that "investor confidence" incorporates).

26. *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 468 (2003) (discussing how the regulatory system is seen by investors as the "cop on the beat"); *see also* Stout, *supra* note 25, at 420 (noting that even if investors do not trust individual actors in the market, "they must at least trust the system").

27. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). The SEC and later courts used this unfairness rationale as the basis to construct a "duty" that the insider owed to the outsider, such that the insider breached his duty by trading on the information without disclosing it. Moreover, the breach of duty is considered "deception," as required to constitute a violation of sections 10(b) of the 1934 Act and Rule 10-b5.

28. *See id.* at 915–16 (finding fraud where a broker-dealer firm sold shares of another company after learning from a firm associate, who was also a director of the other company, that the company planned to reduce its dividend); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 842–43, 848 (2d Cir. 1968) (finding fraud by insiders against noninsiders where trading was based on confidential information, even where legitimate corporate objectives prevented insiders from disclosing information).

29. *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 41 (1980) (noting that investors cannot identify companies whose insiders trade on confidential information because opportunities for insider trading are distributed randomly throughout the market); Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 157–63 (1993) (arguing that allowing insider trading would lead ordinary investors to leave the market because they would perceive that they lacked any roughly calculable chance to win).

30. This theory is not without its critics. *See generally* B. MARK SMITH, TOWARD RATIONAL EXUBERANCE 266 (2001); Stephen M. Bainbridge, *Insider Trading: An Overview*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 772, 786 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000) (arguing that insider trading should not affect investor confidence because noninsiders are not injured by it, and noting that the U.S. stock market has experienced only increased

Second, the SEC regulates insider trading by mandating that insiders report inside trades within two business days of their execution, regardless of their ultimate status as "legal" or "illegal." This information is made available on the SEC website the same day the trade is reported.[31] Part I.B shows that this regulation cannot be justified by pointing to investor confidence; these disclosures likely serve only to show that insiders continue to trade actively in their own stocks and seem to enjoy a clear advantage over ordinary investors, despite SEC "protection" of such investors. Nevertheless, investor confidence has been invoked as the rationale behind every rule related to insider trading.

A. The Uniform Goal of Investor Confidence in Insider Trading Regulation

Congress, the SEC, and the judiciary each have contributed to the modern landscape of insider trading regulation, tying it explicitly and exclusively to the goal of promoting investor confidence. Congress first relied on this policy when crafting insider trading regulation in the early 1930s, and did so again in 2002. The SEC has pointed consistently to investor confidence as the justification for its continual push to expand insider trading law. Finally, the courts, in interpreting insider trading law, have indicated that investor confidence is the primary justification for regulating insider trading.

1. Congress

Corporate malfeasance was common and varied prior to the stock market crash of 1929.[32] Investment bankers released false or no information to the public regarding revenues and costs when an investment's prospects were poor, or withheld promising prospects from the public in favor of a small group of preferred investors.[33] Company insiders often used the public's lack

trading volume since the highly publicized insider trading scandals of the 1980s). Nevertheless, the theory powerfully influences insider trading policy.

31. *See* U.S. Sec. & Exch. Comm'n, Latest EDGAR Filings, http://www.sec.gov/cgi-bin/browse-edgar?action=getcurrent (last visited May 4, 2006). If the filing is received after 5:30 p.m. it is available the following day. *Id.*

32. *See* FERDINAND PECORA, WALL STREET UNDER OATH 27, 206, 258 (Augustus M. Kelley ed., 1968) (1939) (describing schemes, relayed in congressional hearings by 1930s Wall Street financiers, such as cut-rate sales of stock to "preferred investors," pyramid schemes marketed as investments to the public, and stock pools); Elisabeth Keller & Gregory A. Gehlmann, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 331–36 (1988) (describing various types of fraud).

33. *See* PECORA, *supra* note 32, at 27; *see, e.g.*, *id.* at 96–104 (discussing issuance of bonds without disclosure of high default risk); Laylin K. James, *The Securities Act of 1933*, 32 MICH. L.

of information to their personal advantage by placing their own money on the winning side of a transaction.[34] It was widely believed that these behaviors contributed to the 1929 stock market crash, and as soon as Franklin D. Roosevelt took office he instructed Congress to exercise more control over the securities markets.[35] In response, Congress enacted the 1933 and 1934 Acts.[36]

The purpose of these Acts was to restore public faith in U.S. securities markets. The U.S. Supreme Court has noted that, in addition to providing for disclosure related to public offerings, the 1933 Act "was designed . . . to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."[37] Similarly, the 1934 Act "was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."[38] Congress intended for the reporting requirements to deter fraud by making it difficult for a company to manipulate the public's perception of the company's financial state.[39] Moreover, standardizing the content and timing of what was to be reported more readily allowed investors to interpret financial information distributed by a company. For example, the Acts mandated regular disclosure of financial reports (at least annually) and set forth informational requirements for a registration statement to be prepared whenever a company planned to issue stock.[40]

Supporters made clear during floor debates that the Acts' purpose was to deter fraud and thereby promote investor confidence and fairness. Senator

---

REV. 624, 627–29 (1934) (describing stock offerings in companies that did not exist and falsification of entire balance sheets and earnings statements).

34. *See, e.g.*, PECORA, *supra* note 32, at 105–06 (discussing insider manipulation of Anaconda Copper); *id.* at 110–12 (discussing insider manipulation of National City Bank); *id.* at 270–82 (discussing insider manipulation of American Commercial Alcohol Company).

35. One of President Franklin D. Roosevelt's first acts was to send a message to Congress urging the enactment of federal securities legislation. *See* S. REP. NO. 73-47, at 6–7 (1933); H.R. REP. NO. 73-85, at 1–2 (1933).

36. Securities Act of 1933 (1933 Act), ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)); *see* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN L. REV. 385, 407–24 (1990) (discussing the 1934 Act's fundamental purpose).

37. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (citations omitted).

38. *Id.*

39. *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS 228–29 (3d ed. 1989).

40. Securities Act of 1933 §§ 6–7, 48 Stat. at 78–79 (codified as amended at 15 U.S.C. §§ 77f–77g (2000)) (regarding registration); Securities Exchange Act of 1934 § 13(a), 48 Stat. at 894 (codified as amended 15 U.S.C. § 78m(a) (2000)).

Duncan Fletcher, the 1934 Act's sponsor and Chairman of the Senate Committee on Banking and Currency, explained bluntly:

> Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America. Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of outside investors.[41]

Congress was concerned specifically with price manipulation of a company's stock by its insiders.[42] At that time, insiders were known to manipulate the stock of their companies through "stock pools," formed with other wealthy investors.[43] They would buy large lots of a stock in order to artificially raise the price of the stock and attract interest from investors "watching the tape across the country."[44] If the public responded by buying, the pool would sell the stock back within a short timeframe at the higher price.[45] Alternately, they would sell to artificially lower the price, and then buy back the stock.[46] These profits were known as short-swing profits.[47]

According to Senator Fletcher, part of the protection afforded outside investors by the 1934 Act would be "to deprive corporate directors, corporate officers, and other corporate insiders of the opportunity to play the stocks of their companies against the interests of the stockholders of their companies."[48] The 1934 Act dealt with this type of stock manipulation in two ways. First, it

---

41. 78 CONG. REC. 2270, 2271 (1934) (statement of Sen. Fletcher), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 765 (1975) (Blackmun, J., dissenting).

42. *See* Dooley, *supra* note 29, at 56–57. Dooley argues that Congress was not concerned with insider trading as we know it today. *See id.* (noting the lack of congressional discussion regarding inside information and showing that section 16, which did address the use of insider information, addressed only stock manipulation for short-swing profits). However, others have argued that at least some members of Congress did have the manipulation of confidential information in mind, although the 1933 and 1934 Acts did not explicitly address this. *See, e.g.*, Keller & Gehlmann, *supra* note 32, at 350–51 (citing remarks of Rep. Lea).

43. *See* JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, at 79 (1979); GEORGE L. LEFFLER & LORING C. FARWELL, THE STOCK MARKET 459 (3d ed. 1963).

44. GALBRAITH, *supra* note 43, at 79.

45. *See id.*; *see also* LEFFLER & FARWELL, *supra* note 43, at 459 (providing a colorful description of the stock pool method).

46. *See* GALBRAITH, *supra* note 43, at 79.

47. *See* Dooley, *supra* note 29, at 56–57. See PECORA, *supra* note 32, at 264–66, for a description of wash sales and matched sales, two other manipulative mechanisms commonly employed by stock pools.

48. *See supra* note 41.

prohibited insiders from realizing short-swing profits by selling within six months of purchase (or vice versa).[49] Second, it implemented a broad monitoring scheme that applied to every transaction by insiders. The Act required insiders to disclose to the SEC and the public their ownership of stock in the company, and to report any changes in ownership.[50] The insiders had until the tenth business day after the month of the trade to make the report to the SEC (up to forty days in total) and the SEC would then make the reported information available to the public.[51] Congressional statements indicate a belief that the public-disclosure requirement would directly reduce the amount of manipulation that took place.[52] Reporting thus supported the larger scheme of bolstering investor confidence.

The 1934 Act also contained a small provision, section 10(b), that prohibited manipulation or deception in connection with the purchase or sale of securities.[53] This would later form the basis for the modern prohibition of "illegal" insider trading. Finally, to oversee and enforce the federal securities laws, Congress created the SEC through the 1934 Act.[54] The function of the SEC is to "protect investors and maintain the integrity of the securities markets."[55]

The reporting mechanism implemented by the 1934 Act remained untouched until 2002. As a part of a broad measure to increase disclosure requirements of public companies, Congress amended the statute governing

49. Securities Exchange Act of 1934, ch. 404, § 16(b), 48 Stat. 881, 896 (codified as amended at 15 U.S.C. § 78p(b) (2000)).

50. *Id.*

51. *Id.*

52. H.R. REP. NO. 73-1383, at 13 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 18, at 13 (J.S. Ellenberger & E. Mahar eds., 1973) (deeming the full public disclosure required by section 16(a) "the most potent weapon against the abuse of inside information"). According to two scholars, Congress viewed publicity as a deterrent, reasoning that "people are likely to refrain from improper acts . . . if they know such acts will be exposed to public scrutiny." Janet G. Feldman & Richard L. Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 CASE W. RES. L. REV. 1054, 1065 (1966).

53. Securities Exchange Act of 1934 § 10(b), 48 Stat. at 891 (codified as amended 15 U.S.C. § 78j(b) (2000)). For a comprehensive history of this portion of the 1934 Act, see Thel, *supra* note 36, at 424-61 (reviewing the congressional development of and debate over section 10(b) and suggesting that the provision was designed to confer extensive control to the SEC, although that purpose has not been realized).

54. Securities Exchange Act of 1934 § 4(a), 48 Stat. at 885 (codified as amended at 15 U.S.C. § 78d(a) (2000)). Congress also provided for potential private rights of action and criminal liability. *Id.* § 18, 48 Stat. at 897 (codified as amended at 15 U.S.C. § 78r (2000)) (providing liability for misleading statements); *id.* § 32, 48 Stat. at 904 (codified as amended at 15 U.S.C. § 78ff (2000)) (providing penalties).

55. U.S. Sec. & Exch. Comm'n, The Investor's Advocate, http://www.sec.gov/about/whatwedo.shtml (last visited May 4, 2006).

insider trading and passed the Sarbanes-Oxley Act, which narrows substantially the window of time that insiders have to disclose their trades. The Sarbanes-Oxley Act was implemented in the wake of extremely public corporate governance scandals that broke between 2000 and 2002, most notably the collapse of Enron in November 2001.[56] Similar to the 1933 and 1934 Acts, Sarbanes-Oxley was unquestionably motivated by a desire to impress upon the public that the government would "do something" about the shady practices of corporate executives.[57] The events had contributed to a sudden, sharp decline in stock prices,[58] as well as to a decline in consumer confidence in the honesty of American businesses.[59] In response to the public's "radical" mood change with respect to corporate governance, a bill that previously had "no chance of enactment" was passed hastily and virtually unanimously by Congress, and signed by the president with much fanfare the same day it was presented to him.[60]

The Sarbanes-Oxley Act's stated purpose is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws."[61] During debates, the Act's supporters focused on the need to promote investor confidence in the wake of the corporate governance scandals. For example, Senator Paul Sarbanes, one of the bill's sponsors, said that the bill was urgently needed "to address the incredible loss of investor confidence that is now taking place."[62] To illustrate his point he quoted

56. See Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 3–40 (2003), for a detailed account of the period.

57. *Id.* at 4–5.

58. For example, Priceline.com stock fell from $162 to $1.12. *See, e.g.*, Steven Syre & Charles Stein, *Net Findings: Travel Works, Groceries Don't*, BOSTON GLOBE, July 11, 2001, at C6. Yahoo!'s stock price fell 92 percent. *See Year in Life of Richard Li*, SOUTH CHINA MORNING POST, Aug. 17, 2001, at A1. Cisco Systems' stock value was reduced by $148 billion. *See* Floyd Norris, *After Two-Year Drop in Markets, Calendar Turns on Note of Hope*, N.Y. TIMES, Jan. 1, 2002, at A1. Overall, Nasdaq stocks lost 70 percent of their value in 2000. *See* Vincent Boland, *Nasdaq Changes 15 Stocks*, FIN. TIMES (London), Dec. 16, 2002, at 26. Some have estimated that market value lost in the subsequent market reverse totaled $8.5 trillion. *See, e.g.*, *Cutting Interest Rates Won't Halt Deflation*, POST-DISPATCH, Nov. 5, 2002, at B6.

59. *See* Galina Davidoff, *National Juror Perception Survey Warns That People of Different Color Have One Thing in Common: Distrust Toward Corporations*, DIVERSITY & THE BAR, Feb. 2003, *available at* http://www.mcca.com/site/data/magazine/coverstory/jurorperception0203.shtml. This study, conducted in 2002, indicated that 76 percent of respondents believed that the current system of corporate governance promoted corruption, 78 percent believed that companies would destroy documents to avoid trouble, and 85 percent believed that large corporations hide the truth about the dangers of their products. *Id.*

60. Hamilton, *supra* note 56, at 45–47.

61. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745 ("An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.").

62. *See* 148 CONG. REC. 6327, 6329 (2002) (statement of Sen. Sarbanes).

several "ordinary citizen" investors, who each claimed they were no longer confident that the market was fair.[63] Senators Michael Enzi, Harry Reid, and Christopher Dodd each similarly discussed the "collapse in confidence" driving the passage of this legislation.[64]

Shortening the insider trading reporting deadline to two business days was written into a short provision of the Act.[65] This provision also mandated that the report be filed electronically and that the SEC make the information available to the public within one business day of receiving the information.[66] This was the only portion of the Act that dealt with insider trading, and it received no floor debate or explanation.[67] However, the section was grouped within a provision that "enhanced financial disclosures" made by public companies.[68] Senator Sarbanes indicated generally that the enhanced disclosure requirements of the Act would promote investor confidence.[69]

Thus, from the first set of federal securities regulations to the present, protection of investors against fraud and increasing investor confidence in the markets has figured prominently in Congress's adoption of fundamental securities legislation in general and insider trading regulations in particular.

63. *See id.*

64. *See* 148 CONG. REC. 6327, 6339 (2002) (statement of Sen. Enzi), 6341 (statement of Sen. Reid), 6342 (statement of Sen. Dodd).

65. Sarbanes-Oxley Act of 2002 § 403, 116 Stat. at 788 (codified as amended at 15 U.S.C. § 78p(a) (Supp. II 2002) (amending 15 U.S.C. § 78p(a) (2000))).

66. *See id.*

67. *See* 148 CONG. REC. 1205, 1217, 4683, 4838, 5393, 5462, 6327, 6436, 6524, 6603, 6683, 6734, 7350 (2002). Subsequent SEC comments regarding the goal of the accelerated-disclosure provision indicated that it would, in a timely manner, make the information broadly available to the public for free via the SEC website. Harvey L. Pitt, Chairman, U.S. Sec. & Exch. Comm'n, SEC Remarks at the Commission Open Meeting (Dec. 18, 2002), *available at* http://www.sec.gov/news/speech/spch121802hlp.htm. Former SEC Chairman Harvey Pitt noted, "many investors believe that these reports provide useful information regarding management's views on the performance or prospects of a company." *See id.* The current SEC Chairman, William Donaldson, has similarly emphasized the importance of moving the transaction information to the Internet in order to make it available to as many people as possible. *See* William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 Before the Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2003) (summarizing the accelerated disclosure change), *available at* http://banking.senate.gov/_files/wmdndsn.pdf. Overall, this provision received relatively little notice on its own, either in the literature or by the SEC.

68. *See* Sarbanes-Oxley Act of 2002 §§ 401–409, 116 Stat. at 785–91 (codified as amended at 15 U.S.C. §§ 78m, 78p, 7261–66 (Supp. II 2002)) (Section 403 is part of Title IV of the Act, which covers "enhanced financial disclosure.").

69. 148 CONG. REC. 6327, 6329–30 (2002) (statement of Sen. Sarbanes).

2. The SEC and the Judiciary

In 1943, in response to reports of an insider spreading false information about his company in order to artificially depress the price, the SEC promulgated Rule 10b-5, which prohibits omission of a material fact in connection with the purchase or sale of any security.[70] According to the Commission's official press release, the rule was passed to combat fraud.[71] The SEC first ruled that 10b-5 prohibited insider trading in *In re Cady, Roberts & Co.*[72] This hearing disciplined a broker who had sold stock in a company—of which he was a fiduciary—prior to public disclosure of material, negative information about the company.[73]

The SEC has traditionally been a strong advocate of insider trading restrictions and regulations. It has argued consistently to the courts that insider trading is unfair and destructive of investor confidence.[74] In fact, some claim that the SEC's zeal to protect investor confidence has encouraged it to pursue cases where there is a serious lack of proof.[75]

The SEC's views have not been adopted wholesale by the courts. However, during the six decades that it has policed insider trading, the SEC has used the investor confidence rationale to persuade courts to expand their understanding of what constitutes insider trading. The judiciary has adopted investor confidence and the prevention of fraud as the preeminent justifications for insider trading regulations, although the Supreme Court has declined to rely on investor confidence to impose broad liability on virtually all insider trading, as urged by the SEC.

---

70. 17 C.F.R. § 240.10b-5 (2005). *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton V. Freeman) (former SEC Commissioner recounting the discussions and events leading to passage of Rule 10b-5), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting).

71. Securities Exchange Act of 1934 Release No. 3230, 7 Fed. Reg. 3804 (May 21, 1942).

72. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 909–10 (1961).

73. *Id.*

74. *See* Spencer Derek Klein, Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988) (detailing the SEC's interpretation of the relationship between insider trading enforcement and investor confidence); *see also* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971); Schoenbaum v. Firstbrook, 405 F.2d 215, 219–20 (2d Cir. 1968). *See generally In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

75. *See, e.g.*, Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 CAL. L. REV. 1421, 1461–67 (1991) (discussing Carpenter v. United States, 484 U.S. 19 (1987), and United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc)). According to Eads, "the government's ardor to stop the use of material, nonpublic inside information comes from a belief that the faith of the investing public in the securities markets can best be protected by severely limiting the use of inside information." *Id.* at 1458 n.179.

For example, in the first major court case affirming the use of Rule 10b-5, the Second Circuit Court of Appeals initially adopted a limited version of the investor confidence rationale to justify punishing inside traders. In *Texas Gulf Sulphur Co. v. SEC*,[76] Texas Gulf Sulphur, a mining company, discovered a large deposit of ore, and several insiders purchased stock in the company based on this information before the company made public the details of the discovery.[77] Both the district and circuit courts found nearly all of the insiders liable for illegal trading,[78] and subsequently ordered them to remit the profits back to Texas Gulf Sulphur itself.[79] The Second Circuit justified this remedy by arguing that the fraud of insider trading would lead primarily to a loss of investor confidence in Texas Gulf Sulphur (therefore, the company itself was the injured party).[80]

Conversely, where the courts have declined to find liability, they often have invoked the justification of investor confidence indirectly by finding that the alleged wrongdoer did not owe a duty to her trading partner, and thus no fraud was committed.[81] Notably, the Supreme Court has declined to adopt the broadest implications of the investor confidence rationale, holding in *Ernst & Ernst v. Hochfelder*[82] that the goal of investor protection does not justify fault due to only negligent conduct,[83] and finding in *Chiarella v. United States*[84] that parity of information is not an appropriate guide for the enforcement of insider trading laws.[85]

---

76. 446 F.2d 1301 (2d Cir. 1971).

77. SEC v. Texas Gulf Sulphur Co., 258 F. Supp 262, 267–74 (S.D.N.Y. 1966), *rev'd in part*, 401 F.2d 833 (2d Cir. 1968)).

78. *Tex. Gulf Sulphur Co.*, 258 F. Supp. at 296; *Tex. Gulf Sulphur Co.*, 401 F.2d at 842–43.

79. SEC v. Tex. Gulf Sulphur Co., 312 F. Supp 77, 90–93 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 1301 (2d Cir. 1971).

80. *Tex. Gulf Sulphur Co.*, 446 F.2d at 1308.

81. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980) (finding defendant had no duty to the public to refrain from trading on information gained by virtue of his job as a financial printer). Similarly, in cases based on a misappropriation theory (where the trader was not an insider), the Court has declined to find liability where the trader had no duty to an insider. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983).

82. 425 U.S. 185 (1976).

83. *Id.* at 198–201.

84. 445 U.S. 222, 233 (1980).

85. Parity-of-information theory asserts that all market participants are entitled to trade with relatively equal information. Therefore, it would confer a duty on anyone in possession of material, nonpublic information to either disclose it or refrain from trading. This theory—the initial stance of the SEC—would have led to stricter rules against insider trading. *See* Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 BROOK. L. REV. 149, 154–55 (1993) (discussing acceptance of parity-of-information theory in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), and the theory's rejection by the Supreme Court in *Chiarella v. United States*, 445 U.S. 222, 233 (1980)).

B. Failure of the Investor Confidence Rationale

Although promoting investor confidence reasonably justifies the portion of insider trading law that prohibits trading based on material, nonpublic information, it does not cohesively justify the entire body of regulations governing insider trading. Specifically, as this subpart shows, the requirement of reporting insider trades to the public does not further investor confidence in the stock market in any meaningful way. Instead, it merely highlights the informational asymmetry between insiders and noninsiders. To the extent that an investor monitors this information, the high number of insider trades combined with evidence that they are abnormally profitable to the insiders involved makes their disclosure likely to deflate investor confidence.

The mandatory disclosure system, by design, allows the public to quickly and easily access details on insider trades. Per the SEC rules, the insider must report the trade on the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR), by completing a "form 4" over the Internet.[86] Upon receipt of the insider trading information, the SEC makes the trade details available on the same business day that the form 4 is filed, or on the following day if it is received after the close of business. The EDGAR site is open to the public and is relatively user friendly. Visitors can look up information by company, by date, by form type, or can just browse the latest filings. In addition, several secondary online financial information providers quickly capture and offer the information, free of charge, in a highly accessible way. For example, Yahoo!, MSN, and AOL (three popular web portals) each import EDGAR form 4 information and report the trades shortly after they appear on EDGAR.[87]

The most striking thing about the insider trading disclosures posted on EDGAR is the sheer volume. In fact, nearly half of all forms filed with the SEC report insider trade transactions.[88] In 2005, approximately 475,000 insider trades were reported electronically—about 1975 insider trades per business day.[89] Moreover, these are unusually successful trades. In examining

86. U.S. Sec. & Exch. Comm'n, EDGAR OnlineForms Login, https://www.onlineforms.edgarfiling.sec.gov (last visited May 4, 2006).

87. Spot testing of various filings showed that AOL reported EDGAR inside trading filings within one to three days. Yahoo! reported trades consistently two days after EDGAR, and MSN reported EDGAR filings with a lag of three days.

88. In 2005, 45 percent of the forms filed on EDGAR were form 4s. I performed a series of queries on the SEC website to yield this number. The data is on file with the author.

89. I performed a search on the SEC website to yield this number. From the EDGAR search tool, available at U.S. Sec. & Exch. Comm'n, Search Historical SEC EDGAR Archives, http://www.sec.gov/cgi-bin/srch-edgar, I entered "form-type=4" and selected 2005 for the starting and ending years. The results yielded 474,221 form 4s filed in 2005. The results are available at http://www.sec.gov/cgi-bin/srch-edgar?text=form-type+%3D+4&first=2005&last=2005 (last visited

the trades, studies have repeatedly shown that insiders are a savvy group, consistently reaping significantly higher returns in trades of their own stock than noninsiders.[90] Indeed, one study reported that insiders' returns in their own stocks exceeded noninsiders' returns by 4.5 percent.[91] Recognizing this disparity, several online businesses offer to help noninsiders mimic insiders in order to achieve the same gains. These businesses sell information regarding insider trades to average investors on the premise that insiders' ability to predict the future movement of their stocks may be profitably copied.[92]

Ordinary investors, whom Professor Lynn Stout terms "the heart and soul of the modern market,"[93] own nearly 50 percent of U.S. equities.[94] The overwhelming majority of these investors are not corporate insiders and are therefore unable to participate in the insider trades that they observe. The conclusion of such an investor, who views the large amount of insider trades and learns of the abnormally high returns enjoyed by insiders, is probably not a sense of increased confidence in the integrity of the stock market. Instead,

May 4, 2006). A similar search for 2004 yielded 476,186 form 4 filings. The results are available at http://www.sec.gov/cgi-bin/srch-edgar?text=form-type+%3D+4&first=2004&last=2004 (last visited May 4, 2006).

90. *See, e.g.*, H. NEJAT SEYHUN, INVESTMENT INTELLIGENCE FROM INSIDER TRADING 63 (1998) (finding that insider buys outperformed the market by 4.5 percent and insider sells underperformed the market by 2.7 percent, concluding that "insiders earn significant profits from trading in their own firms"); Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141, 1147–48 (1976) (finding abnormal returns for insiders); Leslie A. Jeng et al., *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. ECON. & STAT. 453, 453–55 (2003) (finding that the portfolio of insider "buys" earned abnormal returns of forty basis points per month between 1975 and 1996); H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J.L. & ECON. 149, 172–75 (1992) (reporting that between 1984 and 1992, the volume of trading by corporate insiders increased fourfold and "excess returns" per trade—that is, the returns attributable to inside information—have doubled). However, research results are not entirely uniform. At least one study has disagreed with the findings above. *See* Ji-Chai Lin & John S. Howe, *Insider Trading in the OTC Market*, 45 J. FIN. 1273, 1273, 1281 (1990) (finding that high transaction costs eliminate insiders' abnormal returns).

91. SEYHUN, *supra* note 90, at 63.

92. *See, e.g.*, Insider-Transactions.com, How to Profit from Insider Data, http://www.insider-transactions.com/web/Benefits.asp (last visited May 4, 2006) ("Time and again, insider transactions have predicted the future price of stocks."); InsideMove.com, Strategy/FAQ, http://www.insidemove.com/strategy.htm (last visited May 4, 2006) ("When corporate officers are willing to put out their own money to buy company stock, we have to assume they have in-depth knowledge about the company's future . . . anything from mergers, buyouts, new product launches etc."); InsiderScore, Why InsiderScore?, https://www.insiderscore.com/why.php (last visited May 4, 2006) (claiming that insider "buys" outperformed the market by 8.9 percent). The general theory seems to be the maxim, "if you can't beat 'em, join 'em."

93. Stout, *supra* note 25, at 430.

94. N.Y. STOCK EXCH. NYSE FACT BOOK FOR THE YEAR 2001, at 61 (2002) (noting that U.S. institutional investors hold a total of 46.7 percent of outstanding U.S. equities); *see also id.* at 57 (showing, for all adult shareholders, a median portfolio value of $28,000 and a mean portfolio value of $148,500).

it is likely a realization that many insiders continue to trade profitably based on material, nonpublic information despite prohibitions and SEC policing.[95] Thus, the mandatory reporting rules in today's system most likely do not increase investors' confidence in the market.[96]

Reporting requirements would look very different if investor confidence was the actual motivation for these rules. Specifically, disclosure would be mandated either prior to the trade or simultaneous with the trade, not *after* the trade. For example, imagine if the government required that insiders be assigned a separate class of shares.[97] An insider seeking a lot of 1000 "I-shares" would likely have to pay a slightly higher price than the prevailing price for other share classes because buyers would be rightly wary that they were trading against a party with superior information. Removing the insider's anonymity thus would substantially mitigate her trading advantage.

Conceptually, a simultaneous disclosure model has precedent in Regulation Fair Disclosure (Regulation FD).[98] Prior to Regulation FD, senior management routinely met privately with investment analysts and selectively disclosed relevant information, such as advance warnings of earnings results, only to investment analysts.[99] Regulation FD requires publicly traded companies to immediately disseminate to the public information disclosed to securities-market professionals.[100] This serves the dual purposes of preventing

95. In his article critiquing current insider trading disclosure regulations, Professor Jesse Fried explains why substantial illegal insider trading persists despite laws prohibiting it. Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pre-Trading Disclosure* 71 S. CAL. L. REV. 303, 331–37 (1998) (discussing the SEC's limited resources to pursue insider trading investigations and the difficulty of proving the elements of illegal insider trading). Commentators note that insider trading on nonpublic information that is not legally "material" but is still highly relevant to a company's prospects, such as knowledge of a top manager's lack of focus due to family problems, can give insiders substantial excess returns. *See id.* at 337.

96. One could argue, against my theory, that reporting furthers investor confidence by increasing the chances that those engaged in improper insider trading will be caught because the public is exposed to the trades and might turn in the insiders. However, this argument is not persuasive because none of the information provided via EDGAR gives the public enough information to enforce the insider trading laws. It is difficult to imagine that the average investor, simply by looking at a form 4, or even by noticing a particular pattern of trades, would have any way of knowing whether a particular insider trade was based on inside information rather than a legal basis. Moreover, insider trading in the wake of obvious events such as mergers and earnings announcements is generally as perceptible to the SEC as to the public at large. *See id.* at 333–34.

97. The broker or clearinghouse would have to ensure that the share classification converted appropriately once the shares changed hands.

98. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

99. *See id.*

100. For an example of how the process of selective disclosure typically worked, see Jason Michael Craft, *What's All the Commotion?: An Examination of the Securities and Exchange*

analysts from taking advantage of priority access to information that may bear on a stock's price, and making analysts' buy or sell recommendations more honest by making the underlying information known to all.[101] This "real time" disclosure is said to "level the playing field" between analysts and the public.[102] Similarly, by disclosing the identity of an insider during a transaction, the noninsider would be able to decide for herself whether the trade at the proposed terms seemed fair given this revelation.

Although Regulation FD does not (and could not) eliminate the analysts' inherent advantage of being able to better interpret information, the average investor should in theory be able to adjust her trading strategy for this disadvantage because she is aware of it. For example, an initial public offering announcement may alert an investor that the company's stock price should rise. However, if the price does not begin to rise immediately, the investor may take this as an indicator that analysts' interpretations of the announcement differ from her own, and may hesitate before buying (or selling). Similarly, although the mere fact that the person on the other end of a transaction is an insider will not place the average investor on par with the experience or knowledge of the insider, the noninsider is at least on notice that she likely is betting against superior information. Thus, knowing when an insider is on the other end of a transaction largely removes the component of deception that figures so prominently in prohibitions against insider trading.[103]

If investor confidence were the actual motivation for these rules, disclosure might alternatively be mandated prior to the trade. Professor Jesse Fried has outlined an example of how such a system might work.[104] On the assumption that promoting investor confidence is a primary goal of securities regulation, Fried argues that the current regulatory system does not fully support the goal because it continues to allow insiders to profit from illegal trading.[105] He asserts that insiders' ability to consistently beat the market with respect to their stocks proves that they necessarily are trading on inside

---

Commission's Regulation FD, 14 DEPAUL BUS. L.J. 119, 124–25 (2001) (describing selective disclosure in the context of an initial public offering).

101. For an example of analyst and company misconduct, see Caroline F. Hayday, Note, *Shedding Light on Wall Street: Why Reg. FD Is Appropriate in the Information Age*, 81 B.U. L. REV. 843, 847 (2001).

102. Robert N. Sobol, *Regulation FD: Mandates on Managing Disclosure*, LEGAL INTELLIGENCER, June 13, 2001, at 1.

103. See *supra* Part I and text accompanying notes 27–30 for a discussion of the importance of deception in the trading prohibitions.

104. Fried, *supra* note 95, at 348. For a similar idea, see S.S. Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. ON LEGIS. 511, 523–24 (1988) (suggesting that insiders should report ninety days prior to the trade).

105. Fried, *supra* note 95, at 308–13.

information.[106] However, because the SEC often cannot accurately link the trade to a single specific event, it cannot prove the strict legal standard of materiality with respect to most trades.[107] Thus, insiders are able to violate the spirit of the law and go unpunished.[108] He contends that to truly stop illegal insider trading, insiders should be required to disclose that they plan to trade ahead of time.[109] Under this system, the insider would disclose the exact details of the trade to the SEC via an electronic filing one to three days before the trade.[110] That would allow the market to respond to the insider's "signal" ahead of time—tending to lower the price ahead of a planned insider sale and tending to raise the price ahead of a planned insider buy.[111] By operating to reduce the insider's excess returns, this system would thereby ensure that most insider trades truly were legal (that is, based on the liquidity needs of the insider) rather than based on material, nonpublic information.[112] This strong parity-of-information model would bolster investors' confidence in their own ability to compete in the market.

Ultimately, as illustrated by Regulation FD and Fried's model, if promoting investor confidence truly were the primary goal, insiders would be required to report their trades prior or simultaneous to execution. Because the current reporting scheme resembles neither of these options, it must be based on some other goal.

II. MARKET EFFICIENCY

A better model for understanding the insider trading disclosure requirements is as a means of promoting market efficiency. This objective has occasionally been adopted by the SEC with respect to other types of securities regulations. With respect to insider trading, however, neither the SEC nor other policymakers have articulated market efficiency as a goal.[113] This may be because promoting market efficiency is consistent with easing restrictions

106. *Id.* at 325–29 (discrediting other explanations such as the superior-investors theory and the copycat-effect theory).
107. *Id.* at 331–37.
108. *Id.*
109. *Id.* at 348, 364, 382.
110. The filing would be made on EDGAR. *Id.* at 349. Details would include the price, the number of shares, and the terms of purchase or sale. *Id.* at 349 nn.181–82.
111. For an example of market adjustment in response to an advance signal, see *id.* at 350.
112. *See id.* at 354–59.
113. *See supra* Part I.A (demonstrating that investor confidence is the sole stated rationale for insider trading laws and regulations).

on insider trading, which contradicts the government's consistent policy favoring strong insider trading prohibitions.

A. What Is Market Efficiency, Why Does It Matter, and How Is It Enhanced by Insider Trading Disclosure?

In its purest form, market efficiency is simply a positive description of how a capital market may adapt to information. If a capital market is efficient, stock prices should fully reflect all available information.[114] Furthermore, the price of shares should immediately adjust to new information that is relevant to a stock's value. The value of maintaining an efficient market lies in the market's ability to properly allocate investment resources. That is, firms raising capital by selling shares of stock in an efficient market should expect to receive exactly the fair value of the shares that they sell.[115] In other words, "valuable financing opportunities that arise from fooling investors are unavailable in efficient capital markets."[116] The cost of capital is then said to be at equilibrium.[117]

Market efficiency in general is supported by requiring disclosure of relevant information because a stock price can accommodate only publicly known information.[118] By increasing the amount of information available to the public, the price becomes more accurate, and the market becomes more transparent. Requiring disclosure that an insider has traded increases efficiency by revealing the insider's "signal" regarding the state of her company to other investors. This information is quickly (or instantly) absorbed into the stock's price. Therefore, mandatory reporting of insider trading

114. *See* STEPHEN A. ROSS ET AL., CORPORATE FINANCE 319–20 (5th ed. 1999); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

115. The fair value is the present value of future earning streams, accounting for nondiversifiable risk.

116. ROSS ET AL., *supra* note 114, at 319.

117. *See id.*

118. Scholarly refinements have set forth three forms of market efficiency under the efficient market hypothesis, each of which represents a different claim about the market's ability to reflect new information. Under the "weak-form" theory of market efficiency, current stock prices reflect all information regarding past price shifts. *See* ROSS ET AL., *supra* note 114, at 319–20; Fama, *supra* note 114, *passim* (developing distinction). Under the "semistrong-form" theory, current prices are said to reflect all publicly available information. *See* ROSS ET AL., *supra* note 114, at 319–20. Finally, under the strong-form theory, current stock prices reflect all existing information, both public and nonpublic. *See id.*

The argument advanced in this Comment assumes that the market displays weak-form efficiency or semistrong-form efficiency, not strong-form efficiency. The ability of insiders to earn abnormal returns on insider trading is evidence that the U.S. securities market is not strong-form efficient because insiders appear to gain an advantage from nonpublic information. *See infra* Part II.B; *see also* ROSS ET AL., *supra* note 114, at 335.

activity, by regulating the release of relevant information, furthers the macro-economic ideal of efficiency.[119]

Similarly, timely disclosure of an event contributes to market efficiency because information is most relevant when it is close in time to the event. In the case of a report of insider trading, the signal sent out by the trade is meaningful so long as the news itself is meaningful. As time between the trade and disclosure elapses, the significance of the disclosure diminishes. Delay of relevant information may affect allocation of resources. For example, delaying bad news may allow the company's share price to remain artificially high and allow the company to borrow money at a lower cost of funds than is actually appropriate given the company's financial state.[120] Consequently, in the case of insider trading, shifting the disclosure deadline from forty days to two days increases market efficiency.

Finally, it is important to note that stock prices that fully reflect all available information are beneficial even where the company does not intend to raise capital at that time. For example, the stock price may impact corporate investment decisions by influencing the projects that managers choose to take on.[121] Moreover, to the extent that stock price changes indicate the company's performance, accurate stock prices allow for better monitoring of management's effectiveness.[122]

B. Precedent for a Market Efficiency Justification of Securities Regulation

Although neither Congress nor the SEC has linked insider trading regulation to the principles of market efficiency, use of these principles is not without precedent in securities regulation. For example, legislative reports surrounding the passage of the 1933 and 1934 Acts indicate that Congress expected certain mandatory disclosures to lead to accurate pricing of

119. This is, of course, only a theoretical ideal. For a discussion of the evolution of the efficient market hypothesis, see 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).

120. *See* Wally Suphap, *Getting It Right Versus Getting It Quick: The Quality-Timeliness Tradeoff in Corporate Disclosure*, 2003 COLUM. BUS. L. REV. 661, 672–73 (discussing this scenario).

121. This is because, generally speaking, the company's decision to take on an internal project will depend on the project's expected rate of return to the company, which in turn depends on the company's risk relative to the market. *See* ROSS ET AL., *supra* note 114, at 291–301 (explaining the calculations involved in capital budgeting). This risk, denominated "beta," measures the responsiveness of a security to movements in the overall stock market. *Id.* at 257. *But cf. id.* at 303–07 (explaining that some project risk may need to be measured differently than overall firm risk). If a stock's price is inaccurate, this measure of responsiveness will be off as well. *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1041 (1992). Consequently, projects may appear more or less profitable than they actually are.

122. *See* Bainbridge, *supra* note 30, at 778.

securities, which is one of the primary results of market efficiency.[123] At that time, the disclosures referred primarily to the corporation's financial condition, rather than insider trading information.[124] Nevertheless, it was well understood that the regular release of relevant information allowed investors to buy and sell stock on an informed basis.

After the development of a formal theory of efficient markets in the late 1970s and early 1980s, the SEC appointed an advisory committee to study the need for mandatory disclosure (assuming U.S. markets were "efficient" under the theory).[125] At the recommendation of the committee, the SEC promulgated two disclosure rules "in reliance on the efficient market theory."[126] In 1982, the SEC adopted a three-tiered system of Securities Act disclosure, which allowed the largest companies to use a shortened registration form for filing equity offerings.[127] In the proposing release, the SEC stated the "Commission's belief that the market operates efficiently for [the qualifying] companies, *i.e.*, that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for by the market place."[128] The shelf registration rule, which permits some issuers to register securities offerings but then delay ("shelve") their distribution to a later date, was similarly justified on efficiency grounds.[129] However, since the 1980s, the SEC has moved away from relying explicitly on the efficient market hypothesis in any affirmative rulemaking activity, probably because to the

123. *See* H.R. REP. NO. 73-1383, at 11 (1934). As the House Report indicated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.

Id.

124. *See* H.R. REP. NO. 73-85, at 3, 10 (1933).

125. *See* STAFF OF H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS., REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC (Comm. Print 1977).

126. Adoption of Integrated Disclosure System, 47 Fed. Reg. 11,380, 11,382 (Mar. 16, 1982).

127. *See* 17 C.F.R. § 239.13(b)(1) (1991).

128. Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, 46 Fed. Reg. 41,902, 41,904 (Aug. 18, 1981). *But see* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 876 (1992) (questioning the SEC's claim that this rule truly rests on market efficiency principles).

129. 17 C.F.R. § 230.415 (2004) (Rule 415); *see also* Langevoort, *supra* note 128, at 883 ("A noisy view of the securities markets . . . suggests that there will be times when the prevailing price is excessively high as a result of investor overreaction to positive signals . . . . [W]ithout some assumption about efficiency, [the rule] would simply be inviting the issue with a shelf registration to take advantage of it.").

extent that the SEC presumes that the market is already efficient, this theory generally supports restraint in imposing regulations.[130]

The SEC has not fully moved away from the efficiency model though, as it has adopted the position that certain rules "promote" efficiency by contributing to the timely setting of accurate stock prices. For example, the SEC has defended stock index futures trading as contributing to pricing efficiency.[131] Similarly, in justifying the need to accelerate periodic reports, the SEC has stated that the purpose of accelerated filing deadlines is "to promote greater timeliness and accessibility of this information so that investors can

130. *See* Langevoort, *supra* note 128, at 888 (speculating that the SEC was using the efficient market theory opportunistically to gain traction among its regulatory peers at a time when the theory enjoyed a large following); Laura S. Unger, Commissioner, U.S. Sec. & Exch. Comm'n, Regulation of U.S. Equity Markets: Implications for Innovation, Competition, & Efficiency, Remarks at the Baruch Conference (Mar. 17, 1999) (regulation of an efficient market may require the SEC to refrain from imposing regulation or to roll back regulation), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch260.htm.

Although the efficient market hypothesis has been a central proposition in finance for over thirty years, economists and others continue to hotly debate the extent to which the U.S. market is "efficient." First, nearly everyone agrees that perfect informational efficiency does not exist. Informational efficiency is the ability of the market to quickly reflect new information, and perfect informational efficiency implies that the market would adjust instantly to new information. *See generally* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980). A perfectly informationally efficient market is a self-defeating proposition because there would be no financial incentive for *anyone* to trade on information, so a price shift could not happen.

More fundamental critiques of the efficient market hypothesis focus on investor behavior. Based on psychological evidence that investors are not rational actors and institutional evidence that arbitrage is limited by risk aversion, short horizons, and agency problems, critics argue that the U.S. market is not efficient. *See generally* ANDREI SCHLEIFER, MARKET INEFFICIENCY: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000) (claiming that efficient market hypothesis fails to explain actual market behavior and proposing new models based on behavioral finance). Others argue similarly that because many investors make buy and sell decisions based on intangibles other than a stock's risk and expected return (the sole variables in the predominant stock pricing model), a stock's price simply does not reflect the stock's fundamental value. *See, e.g.*, Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 IOWA J. CORP. L. 635, 641–44, 660 (2003) (proposing flaws in the predominant pricing model's requirement of homogenous expectations and challenging the efficient market hypothesis assumption that "human beings are rational actors with stable preferences" who are "never misled by emotion and who never make mistakes").

However, others argue just as strongly that market efficiency survives these challenges. For example, Eugene Fama contends that the pricing anomalies due to investor behavior, which supposedly prove that the market is inefficient, are fundamentally random results. *See* Eugene F. Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998) (demonstrating that apparent overreaction of stock prices to information is about as common as underreaction, that post-event continuation of pre-event abnormal returns is about as frequent as post-event reversal, and that the anomalies are "fragile," tending to disappear depending on how they are measured). Fama maintains that in the current market, chance will generate returns greater or less than zero, but the expected value of abnormal returns as a whole is still zero. *Id.* at 284. In any event, one can certainly agree that releasing relevant, timely information promotes market efficiency regardless of one's opinion of the market's current level of efficiency.

131. U.S. SEC. & EXCH. COMM'N., THE OCTOBER 1987 MARKET BREAK: A REPORT BY THE DIVISION OF MARKET REGULATION 3–5 (1988).

more easily make informed investment and voting decisions. Informed investor decisions generally promote market efficiency and capital formation."[132] Thus, market efficiency has been used by the SEC to justify disclosure regulation.

C. Why the Goal of Market Efficiency Is Unstated

Why is investor confidence the only stated goal of insider trading regulation? Primarily, this is likely because the two purposes are somewhat in conflict. As the primary enforcement agency for Congress's securities laws, the SEC strives to present a strong anti-insider trading message. This position is well documented in the SEC's court arguments, which consistently attempt to expand the judicial definition of the people and activities that are covered by insider trading.[133] Indeed, the SEC's originally proposed rules regarding insider trading relied on a parity-of-information justification, which would have eliminated significantly more insider trading.[134] When such theories were rejected by the courts, the SEC responded by "developing new theories to circumvent the restrictions those decisions imposed on the agency's insider trading enforcement efforts."[135] Today, the SEC's policy is to keep the scope of prohibited conduct as broad as possible, in order to avoid setting out a "roadmap to fraud."[136]

The SEC sends a strong message against insider trading in other ways, as well. It consciously uses its enforcement actions to attract public attention to the problem of insider trading and the agency's stance against it.[137] The SEC

132. Acceleration of Periodic Report Filing Dates and Disclosure Concerning Web Site Access to Reports, 67 Fed. Reg. 38,480, 58,500 (Sept. 16, 2002) (codified at 17 C.F.R. pts. 210, 229, 240, 249).

133. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968); *In re* Dirks, Exchange Act Release No. 17,480, 21 SEC Docket 1401, 1407 (Jan. 22, 1981), *rev'd*, 463 U.S. 646 (1983); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). See also the promulgation of Rule 14e-3 after *Dirks*'s reversal, which explicitly applied the disclose-or-abstain rule to tender offers. 17 C.F.R. § 240.14e-3 (2005) (upheld on challenge in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc)).

134. *See supra* note 85.

135. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 206 (1990) (discussing how the SEC developed the misappropriation theory "on an *ad hoc* basis, and in the absence of any legislative predicate for it," in response to defeats in court).

136. Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 180–81 & n.7 (1991).

137. *See* Pitt & Shapiro, *supra* note 135, at 155–56 (discussing the SEC's maintenance of a "vigorous, highly-visible, and largely successful enforcement profile," and noting that, due to the enforcement strategy, praise for the agency's effectiveness has often "shared the limelight" with accusations that the agency substitutes publicized enforcement for "meaningful, orderly, and fair regulatory processes"); *see also* James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 751 (2003) (noting that case priority is given based on "the message delivered to the industry and public about the reach of [the] SEC's enforcement efforts . . . and [the] SEC's visibility in certain areas such as insider trading").

website advertises a "bounty" that it will pay for successful tips on insider trades.[138] Finally, the SEC has stated that it believes that prevention of insider trading is absolutely necessary to its overarching goal of achieving continuous disclosure.[139]

On the other hand, many law and economics scholars have argued that market efficiency as a goal is consistent with the idea of easing restrictions on insider trading.[140] Recall that a stock's intrinsic value is supposed to reflect the sum of the company's future earnings streams (discounted for nondiversifiable risk). Whenever an event that is relevant to the stock price cannot be made public immediately, a disparity arises between the stock's market price, which reflects publicly known information, and its intrinsic value.[141] Permitting insider trading allows insiders to send a signal to the market through their trades without actually releasing the confidential information.[142] This allows the market price to adapt to the new information,[143] minimizing resource-allocation inefficiency in the time between the event's occurrence and the company's public announcement.[144]

For example, if a mining company were to discover a site with a rich new source of minerals, the company's intrinsic value would immediately rise upon this discovery based on the anticipated increase in the company's future earnings. The company would begin to buy up the land around the discovery site. But to prevent sellers from raising the price of the land substantially, the company must keep the discovery confidential. This introduces inefficiency into the market because the fact of the discovery would not be reflected in the price of the company's stock, and the company's cost of capital would be

138. U.S. Sec. & Exch. Comm'n, Insider Trading: Information on Bounties, http://www.sec.gov/divisions/enforce/insider.htm (last visited May 4, 2006).

139. *See* Karmel, *supra* note 85, at 169–71 (author is a former SEC Commissioner).

140. *See, e.g.*, HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 80–90 (1966); Bainbridge, *supra* note 30, at 778–79.

141. *See* Bainbridge, *supra* note 30, at 778. This discussion assumes weak-form or semistrong-form efficiency. Under strong-form efficiency, stock prices would account for all information, both public and nonpublic; thus no regulation would be needed. *See supra* note 118. As discussed above, most economists consider strong-form efficiency an "overstatement" of the market's current state, particularly because it fails to account for the profitability of inside information. *See, e.g.*, BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 196 (2003); ROSS ET AL., *supra* note 114, at 335. Thus, to be incorporated into a stock's price under the weak or semistrong form, relevant information must be publicly known.

142. *See* Bainbridge, *supra* note 30, at 778.

143. The speed at which the information would be incorporated into the stock price depends on the size of the insider trades, the ability of those watching the insiders to read the insider buy as a positive signal for the company (rather than an idiosyncratic purchase), and the economic (and other) constraints on the arbitrageurs.

144. *See* Bainbridge, *supra* note 30, at 778.

too high. If insiders were allowed to trade in the company's stock, they would certainly buy. The stock's price would rise closer to the "correct" price, and any capital budgeting or funds raised during that period would more nearly reflect the true value of the stock's future earnings stream. Therefore, allowing insiders to trade would mitigate the inefficiency created by the company's decision to keep the discovery of the mine confidential.[145]

However, in a case with similar facts, the SEC strongly argued that the insiders should not be permitted to trade based on information that was not yet public.[146] The Court agreed, reasoning that allowing the insiders to trade on this information gave them an unfair advantage over the investors who had sold stock to the insiders, and that the unfair advantage constituted fraud on those parties.[147] The SEC argued that in order to avoid deterring investors from making trades in the future, the insiders should be punished for trading based on the information.[148] The SEC has consistently presented this same argument whenever an insider has introduced relevant but nonpublic information into a stock price through purchase or sale. Thus, easing restrictions on insider trading is inconsistent with the SEC's strong stance against insider trading, and may be one reason why market efficiency is not an enumerated goal of insider trading disclosure.

Another reason that this goal might be unstated is that investor protection has a great deal of populist appeal, while the promotion of efficient markets appears—in the words of former SEC Commissioner Laura Unger—"at best . . . coldly technocratic, and at worst, anti-populist—we're siding with Wall Street against Main Street."[149] This sentiment carries even more weight considering that insider trading is a crime. Punishing a person for insider trading is appropriate only to the extent that inside traders can be considered to

145. For a similar example, see MANNE, *supra* note 140, at 80–90. Naturally, this reasoning would fail if the fact of the insider trade effectively conveyed the same information as if the company had opted for disclosure. In this example, if landowners around the mine tracked that company's insider trades, they might be able to deduce that the mining company had made a discovery in their area. The landowners would then immediately raise the price of the land for sale, which would seem to defeat the company's purpose in keeping the information confidential in the first place. However, that scenario supposes a fairly astute group of stock-watching landowners. It is much more likely that increases in the stock price would stem from the initial insider purchases followed by trades made by arbitrageurs, who are in the business of stock trading (not real estate), and who would decide to buy based on the fact of the insider trade rather than any of their own research into the likely future prospects of the mining company. (From the landowners' perspective, the most likely clue that something big was happening would be immediate observations of the large land purchases being made around them, not inside trading in the mining company's stock.)

146. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 276 (S.D.N.Y. 1966), *aff'd*, 446 F.2d 1301 (2d Cir. 1971).

147. *Tex. Gulf Sulphur Co.*, 258 F. Supp. at 278–80.

148. *Id.*

149. Unger, *supra* note 130, at 1–2.

have "wronged" someone. Many scholars have argued that insider trading is already on shaky ground in that area,[150] and the introduction of an efficiency justification seems unlikely to garner any support for regulations, especially when "it is a lot more difficult to articulate the benefits of promoting fair and efficient markets [than] investor protection."[151]

A final theory is that the government is trying to achieve the best of both worlds. Visible and aggressive enforcement actions signal that insider trading will not be tolerated, thereby giving investors the impression that the market is fair and that they are not likely to be defrauded while making trades. At the same time, by providing for prompt (but still after-the-fact) disclosure of the entire body of insider trades, the SEC may hope to achieve the efficient price adjustments associated with insiders capitalizing on private information.[152]

CONCLUSION

Mandatory reporting and public disclosure of insider trades cannot be justified by the stated theories of increasing fairness and investor confidence. After-the-fact disclosure of insider trades likely does nothing to promote investor confidence; it simply advertises to the world at large the high volume of such trades that occur daily. Other proposed justifications for such a rule are equally unconvincing. Supporting market efficiency provides a persuasive—though previously unstated—justification for regulation of insider trading.

150. *See generally* Bainbridge, *supra* note 30.

151. Unger, *supra* note 130, at 2.

152. Some have argued that there is a causal relationship between efficiency and investor confidence—that is, that mandatory disclosure indirectly increases investor confidence by "assur[ing] investors that capital markets will be efficient." *See, e.g.*, E. Richie Reyes, *Current Public Law and Policy Issues: Can America Escape the Cloud of Corporate Corruption With the Sarbanes-Oxley Act of 2002?*, 24 HAMLINE J. PUB. L. & POL'Y 147, 149 (2002); *see also* Unger, *supra* note 130, at 2 ("[W]e need investors to have a market and a certain kind of market to have investors."). While the two goals probably do affect each other to a certain extent, market efficiency does not necessarily lead to investor confidence. Professor Lynn Stout has argued that market inefficiency will not deter investors from the trading markets. *See* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988). She contends that investors' concerns lie strictly with the return and risk that their investments yield. *Id.* at 700. If the investor is able to profit between the time she buys and the time she sells, then the stock price's accuracy relative to its intrinsic value is relatively unimportant. *See id.* Thus, under this reasoning the goal of investor confidence is independent from market efficiency.