Insider Trading: Easterbrook and Fischel and Easterbrook vs. Fischel

*Jonathan R. Macey**

This Article examines the perspective on insider trading in Frank Easterbrook and Daniel Fischel's classic work, The Economic Structure of Corporate Law*, comparing it with the perspectives the authors have taken in other work on the topic in which the Book's authors did not coauthor with each other. While Easterbrook and Fischel have similar conceptions about the meaning of "fairness" in securities regulation and corporate law, their differing assumptions about the efficacy of the contracting process within the corporation explain their disagreements about what insider trading law should look like.*

Both Easterbrook and Fischel correctly view material inside information as a form of property right. And they correctly identify the firm that generates or "invents" the information as the owner of that property right. Similarly, both Easterbrook and Fischel are consistently sympathetic to the concept that insider trading should be the subject of intra-firm contracting.

Unlike Easterbrook, Fischel predicts that intra-firm contracts regarding insider trading would be highly permissive if public companies were allowed to enter into such contracts. This seems unlikely. Companies go to great lengths to keep certain kinds of information secret, and they routinely fire employees who trade on material nonpublic information.

Finally, Easterbrook & Fischel's contract-based analysis serves to elucidate the core problem in current insider trading litigation, which is how to deal with tippee liability, in which an insider intentionally "tips" or provides material nonpublic information to an outsider while knowing that the outsider either planned to trade on the information or was highly likely to trade on the information.

The Easterbrook and Fischel analysis forces those evaluating the legality of this tip to consider whether the tip provided any benefit to the corporation whose information was tipped. For example, it might be the case that, absent tipping, a company would be unable to attract coverage by stock market analysts, whose coverage can improve the liquidity and the value of the companies whose shares are being traded. In such cases it would be consistent with Easterbrook and Fischel's contractual perspective for companies to permit the disclosure by insiders to tippees as a quid pro quo for those tippees' willingness to provide a continuous two-sided market in the shares of the company.

INTRODUCTION 364
I. THE ECONOMIC STRUCTURE OF CORPORATE LAW AND INSIDER TRADING .365

* Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law, Yale Law School. The author is grateful to Joshua Macey for his valuable comments.

A. Property Rights 365
B. Implementing a Property Rights Regime 368
C. Fairness 371
II. EASTERBROOK'S AGENCY COST APPROACH TO INSIDER TRADING 377
A. Inside Information and Property Rights: Easterbrook v. *Chiarella* 377
B. Fairness in Insider Trading 383
C. Easterbrook and His "Real Concerns About Insider Trading" 384
III. FISCHEL'S COASEAN APPROACH TO INSIDER TRADING 385
CONCLUDING OBSERVATIONS 390

INTRODUCTION

Coauthoring can be a tricky business. This is particularly true where the coauthors already have staked out strong and distinct positions on a highly salient subject such as insider trading.

This Article examines the perspective on insider trading in Frank Easterbrook and Daniel Fischel's classic work, *The Economic Structure of Corporate Law*,[1] comparing it with the perspectives they have taken in other work on the topic in which the Book's authors did not coauthor with each other,[2] and offering a critique of these various perspectives.

Easterbrook and Fischel are admirably transparent in *The Economic Structure of Corporate Law* that, in their previous writings on insider trading, they "have reached conclusions that differ in emphasis about its likely effects."[3] And they also are transparent about the fact that *The Economic Structure of Corporate Law* does not offer a resolution to these differences.[4] In fact, the Book does not really explain what these differences are.

A careful review of both the differing approaches and the unified approach taken by Easterbrook and Fischel can advance our understanding of insider trading policy and explain why there is

---

1 FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

2 *See* Frank H. Easterbrook, *Insider Trading as an Agency Problem*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127 (1984); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981) [hereinafter Easterbrook, *Insider Trading, Secret Agents*].

3 EASTERBROOK & FISCHEL, *supra* note 1, at 253.

4 *Id.*

so little consensus about how to regulate this vexing practice. In a nutshell, while Easterbrook and Fischel have similar conceptions about the meaning of "fairness" in securities regulation and corporate law, their differing assumptions about the efficacy of the contracting process within the corporation explain their disagreements about what insider trading law should look like.

Part I of this Article reprises the approach to trading on inside information taken in *The Economic Structure of Corporate Law*. Parts II and III explain the differences in insider trading regulation taken by Easterbrook and Fischel, respectively. Part IV explains why the approach to insider trading taken by Fischel is more consistent with the contractarian approach to corporate law generally taken in *The Economic Structure of Corporate Law*. Finally, Part V offers an analysis of the concept of fairness as understood by Easterbrook and Fischel and explains why this conception is somewhat incomplete because it does not link the concept of fairness with the concept of market efficiency. A conclusion follows.

I. THE ECONOMIC STRUCTURE OF CORPORATE LAW AND INSIDER TRADING

The key and enduring insight of the chapter on insider trading is that the way to think about insider trading is to start with a property rights approach in which one's first task is to "identify property rights in information."[5] Insiders are free to trade if they own the relevant information on which their trading is based.

A. Property Rights

Put simply, the way that one steals material nonpublic information about a company is to trade on it. The existence of material nonpublic information indicates that current share prices are inaccurate. Insider trading occurs when those in possession of material nonpublic information are able to trade on such information before the share prices of the assets whose values are affected by the information have adjusted to reflect the information. Once share prices have adjusted to their correct levels the information arbitrage opportunity created by the existence of the material nonpublic information disappears.

The property rights approach to insider trading is deeply Lockean. One acquires ownership rights in information by

---

[5] *Id.* at 254.

discovering it and rightfully taking it out of the state of nature. This can be done either by discovering the information or by creating it. Thus, the key to implementing a sensible law of insider trading is to develop a framework for determining when it is fair and appropriate to remove something from the state of nature and use it by trading on it. When information already has been removed from the state of nature and belongs to somebody else, trading on it is theft

As Locke put it so famously:

> 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. The labour of his body and the work of his hands we may say are properly his. 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. It being by him removed from the common state nature placed it in, it hath by this labour something annexed to it that excludes the common right of other men. For this labour being the unquestionable property of the labourer, no man but he can have a right to what that is once joined to, at least where there is enough and as good left in common for others.[6]

In a nutshell, then, insider trading regulations reflect, whether the people making and enforcing the regulations know it or not, an effort to assign and protect property rights in information. As Easterbrook and Fischel succinctly explain it: "[t]rading by managers (or others) in possession of valuable information is appropriate if the insiders own the information."[7]

In a whirlwind tour of the major insider trading cases of the time, Easterbrook and Fischel first identify *Chiarella v. United States*,[8] a case involving a financial printer, and the first criminal insider trading prosecution. As Easterbrook and Fischel rightly point out, "Chiarella broke his promise to his employer's customer, effectively stealing information—but it was information the client had every right to use for his own benefit without telling investors."[9] In other words, the client, having created the material

---

[6] JOHN LOCKE, SECOND TREATISE OF CIVIL GOVERNMENT AND A LETTER CONCERNING TOLERATION 15 (1690).

[7] EASTERBROOK & FISCHEL, *supra* note 1, at 254.

[8] Chiarella v. United States, 445 U.S. 222 (1980).

[9] EASTERBROOK & FISCHEL, *supra* note 1, at 255.

nonpublic information had the right to trade on it, while the defendant Chiarella did not. While not explicitly endorsed as the law in the case itself, this approach has come to be known under the apt term "the misappropriation theory."

Then, turning to *Dirks v. SEC*,[10] in a single sentence, Easterbrook and Fischel interpret their property rights approach to insider trading in the context of a stock market analyst who "nosed out a fraud at a widely held firm (Equity Funding) and alerted his clients to sell."[11] The most important line in the chapter on insider trading follows a paragraph later, "Dirks nosed out the scam, and the right to reveal the news to his clients compensated him for his efforts."[12] The treatment of insider trading is profoundly Lockean, and in my view, reflects the most intellectually sound approach to insider trading issues.

Easterbrook and Fischel elucidate the major insider trading issue of the day, which is how to handle tipping by insiders to professional stock market analysts. Under Easterbrook and Fischel's approach to insider trading, which I heartily endorse, corporations own the information about themselves that they create. As such, corporations are free to use that information as they see fit in order to advance the interests of the corporation and its shareholders. One way that corporations should be able to use material nonpublic information is by providing it to securities analysts for valid reasons such as to motivate analyst coverage of the corporation and thereby promote efficient capital market pricing as well as share price liquidity.

This was the issue facing the Second Circuit in the important case of *U.S. v. Newman*,[13] where the issue was the legality of tipping by corporate insiders at Dell and another company to securities analysts. In *Newman*, the corporate insiders gave tips to analysts who were casual acquaintances of theirs.[14] The analysts then passed the tips along to hedge fund traders.[15] The defendants established that it was common for insiders at Dell to disclose "confidential quarterly financial information arguably similar to the inside information disclosed by [the Dell defendants] to establish relationships with financial firms who might be in a position to buy Dell's stock."[16]

[10] 463 U.S. 646 (1983).
[11] EASTERBROOK & FISCHEL, *supra* note 1, at 255.
[12] *Id.*
[13] United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
[14] *Id.* at 452–54.
[15] *Id.*
[16] *Id.* at 455.

As I have observed previously about *Newman*:

> The Supreme Court in *Dirks* and the Second Circuit in *Newman* explicitly recognized that analysts and other researchers play a vital role in maintaining properly functioning and efficient capital markets and that there are valid reasons, consistent with the interests of shareholders, why corporate insiders should disclose material, nonpublic information to stock market analysts and other capital market participants in advance of its general release to the public.[17]

Further:

> [C]orporate insiders promote a variety of legitimate corporate purposes by leaking information to securities analysts. . . . [T]he defendants established that it was common for insiders at Dell to disclose "confidential quarterly financial information arguably similar to the inside information disclosed by [the Dell defendants] to establish relationships with financial firms who might be in a position to buy Dell's stock."[18]

The *Newman* opinion remains controversial, but that is only because scholars and judges have not properly applied the teachings of Easterbrook and Fischel in Chapter 10 of *The Economic Structure of Corporate Law*. As Easterbrook and Fischel observe, "[t]rading by insiders (for this purpose, managers and those who receive news from managers) may provide firms with a valuable mechanism for communicating information to market participants. Allowing insiders to trade may also create incentives to maximize the value of the firm to the benefit of insiders and outside shareholders alike."[19] Unfortunately, this is a lesson that regulators refuse to learn.

B. Implementing a Property Rights Regime

Of course, not all trading by insiders is beneficial to the firm. This is true for a variety of reasons. Whenever lawyers, accountants, financial printers, and others provide services for firms, they do so under a strict contractual prohibition on trading or

---

[17] Jonathan Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE 64, 68–69 (2016) (alteration in original) (quoting *Dirks v. SEC*, 463 U.S. 646 (1983)) ("Imposing 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 . . . .").

[18] *Id.* at 66 (citing *Newman*, 773 F.3d at 454–55).

[19] EASTERBROOK & FISCHEL, *supra* note 1, at 256.

disclosing the information that they receive in the course of their work. Those who trade on information obtained while in a position of trust and confidence "are stealing assets of the firm as surely as if they reach into the till for cash exceeding their salaries."[20]

As Easterbrook and Fischel observe, real harm is done by people like Vincent Chiarella, the financial printer who got information about imminent takeover bids and bought shares in the target companies.[21] Chiarella, according to Easterbrook and Fischel, "appropriated value from the bidders."[22] As Easterbrook observes, the extent of the harm caused by pilfering information from a public company depends on the extent to which the trading harms the firm. In the context of an acquisition, the harm can come in two forms. First, the insider's purchase can drive up the price of the target firm's shares thereby increasing the cost of the acquisition, or worse, ruining the deal entirely by making the acquisition financially unattractive to the bidder.[23] Second, the insider trading can alert the target that there is an impending bid, giving them precious time to prepare, and reducing the bidder's "probability of success."[24]

Easterbrook and Fischel, however, do not explore a couple of important implications of their analysis. First, while Easterbrook and Fischel acknowledge that "the extent of the harm (to the corporation) depends on the extent to which (the insider's) trading increased the cost of the acquisition,"[25] they do not analyze the very real possibility that in some cases there will be no discernible harm to the company. Suppose, for example, that an insider like Vincent Chiarella clandestinely buys a relatively small number of shares and his purchases go unnoticed in the market, and have no effect on the share price of the target company. Is it appropriate to punish the insider in these circumstances because, under Easterbrook and Fischel's analysis, there has been no harm? One would think, and Easterbrook and Fischel might not necessarily disagree, that there should be punishment even in cases in which the insider or quasi-insider trading on nonpublic information is successful in hiding their activities due to the clear violation of

---

[20] *Id.* at 259.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 260.
[24] *Id.*
[25] *Id.* at 259–60.

contract. Such sanctions would be an important deterrent to other would-be insider traders.

Second, Easterbrook and Fischel do not explicitly say that a company might, at least in theory, explicitly agree to allow trading on inside information by their advisers as a rational alternative to paying fees to such advisers. Here the Easterbrook and Fischel position presumably is clear. Because inside information is (intellectual) property, the company has the right to alienate the property right entirely or to enter into a sharing arrangement with third parties or employees pursuant to which both the company and those with insider information can trade.

Interestingly, we never observe contracts of this type, though perhaps that is because it is in the interest of both the corporation and the insider to keep such information secret. Easterbrook and Fischel posit a possible explanation for this. They posit that because insiders are risk-averse, and because, from insiders' point of view, being compensated with inside information instead of salary is the equivalent of being compensated with lottery tickets, "both shareholders and managers gain by curtailing insider trading."[26]

Moreover, the costs of insider trading to a firm can be enormous. In the context of takeovers, there is a risk that insider trading could raise acquisition costs by hundreds of millions of dollars or even kill deals valued in the billions. Thus, Easterbrook and Fischel recognize that firms likely will wish to bar or heavily regulate insider trading—even when such trading probably can be done entirely in secret and without affecting markets—because it can create perverse incentives.[27] In particular, "the opportunity to gain from trading may induce managers to increase the volatility of the firm's stock prices so that they will have more opportunities to make profitable trades. They may do this by choosing risky investment projects that are not in the interests of the shareholders because risky projects induce share price volatility, and the more volatile a firm's share prices, the more opportunities there are for insiders to engage in trading.[28]

Other problems with allowing insiders to trade are that insiders might want to create news, including bad news, in order to generate trading opportunities,[29] and that "insider trading creates incentives for insiders to disseminate false information about

[26] *Id.* at 260–61.
[27] *Id.* at 260.
[28] *Id.*
[29] *Id.*

the firm so that they can profit by buying and selling mispriced securities."[30]

Thus, Easterbrook and Fischel take a property rights approach to insider trading, but their bottom line appears to be that while firms should be allowed to grant rights to engage in insider trading to insiders and third parties, no rational firm would choose to do so.

C. Fairness

Easterbrook and Fischel move outside of the contours of the firm to discuss the issue of whether insider trading is fair. They do so because public debate, rather than focusing on insider trading from the perspective of property rights, is overwhelmingly concerned with fairness. Specifically, "[m]anagers trading is said to be 'unfair' because managers receive the gains in lieu of the shareholders, who 'deserve' them."[31]

Easterbrook and Fischel rightly reject the fuzzy-headed approach to insider trading that focuses on fairness rather than on property rights and contracts.[32] They reject it out of hand, succinctly observing that if the benefits to shareholders of allowing insider trading outweigh the costs then it simply "is not 'unfair' to investors to use a device (insider trading) that makes them wealthier!"[33]

Unfortunately, Easterbrook and Fischel do not explain what fairness actually is. The fair price for non-insiders when they transact in securities is the efficient market price. This point was made in 1988, three years prior to the publication of *The Economic Structure of Corporate Law* in *Basic Inc. v. Levinson*,[34] a case scarcely mentioned in the book and then only in the context of damages.[35]

The relative lack of focus on *Basic Inc. v. Levinson* is somewhat important in light of the enormous relevance of the case in

[30] *Id.* Of course, since people in general, including insiders, can disseminate false information about any firm, and not just the firms they work for, there is no reason to think that this particular problem, which involves market manipulation, is limited to insiders.

[31] *Id.* at 261.

[32] And, of course, I agree with Easterbrook and Fischel. *See* Jonathan Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

[33] EASTERBROOK & FISCHEL, *supra* note 1, at 261.

[34] Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[35] EASTERBROOK & FISCHEL, *supra* note 1, at 344.

defining the illusive concept of fairness in corporate and securities law.

The holding of *Basic Inc. v. Levinson*[36] is so mesmerizing that it is easy to lose sight of the colorful fact pattern that generated the case in the first place. Basic Incorporated (Basic) was a publicly traded company that made chemical refractories for the steel industry.[37] Another company, Combustion Engineering, Inc., which made alumina-based refractories, long had expressed an interest in buying Basic, but had been deterred by antitrust concerns.[38]

Over time the regulatory environment in antitrust loosened up and, in 1976, Combustion Engineering became intensely focused on acquiring Basic, developing a general strategic plan that gave a central role to the acquisition of Basic.[39]

Not surprisingly, in light of Combustion Engineering's longstanding interest in acquiring Basic, rumors about a possible takeover had been floating around the markets for some time.[40] These rumors posed a significant problem for Basic's management team because, as is often the case in mergers, for the acquirer it was vitally important to maintain the confidentiality of the merger negotiations. If word got out about a proposed merger, shares of Basic likely would skyrocket. This, in turn, would put the deal itself in jeopardy by raising, perhaps dramatically, the cost of the acquisition. As Geoff Miller and I previously have observed:

> Combustion Engineering had been involved in discussions with Basic for over ten years prior to the consummation of the merger on December 19, 1978. The protracted nature of these negotiations suggests that both firms had invested a considerable amount of managerial time, money, and other resources exploring a possible merger. These circumstances make clear why Combustion had a strong desire to keep its negotiations with Basic confidential. News that merger negotiations were in progress would signal to other investors that Basic was an attractive merger prospect, allowing them to "free ride" on Combustion's investment in information about Basic. The simple *identity* of valuable takeover

36 Basic Inc., 485 U.S. at 224.

37 *Id.* at 226.

38 *Id.*

39 *Id.* at 226–27.

40 *Id.* at 227 n.4.

> targets is information that lends itself to free riding. This is because the identification of a firm such as Basic as a likely takeover target "signals to other investors that undervalued assets have been located. Because the subsequent bidders have incurred no costs to acquire information, they can offer more to target-firm shareholders, forcing the initial bidder to increase her offer or lose the opportunity to acquire the target firm."[41]

Put simply, the management of Basic owed fiduciary duties to their own shareholders, and these fiduciary duties required that they keep the information about the company's negotiations with Combustion Engineering secret at almost all costs. Basic had a simple strategy for maintaining the confidentiality of its merger negotiations with Combustion Engineering in the midst of the rumors swirling around the companies' negotiations during the months preceding the announcement of the merger. That strategy was to lie. On three occasions Basic made public statements denying that it was engaged in merger negotiations during the months that preceded the announcement of the merger in December.[42]

Plaintiffs were a class of Basic shareholders who sold their shares during the period between Basic's first false denial of merger negotiations on October 21, 1987 and before the December 18, 1978 trading halt in Basic stock that preceded the formal announcement of the merger.[43]

The plaintiffs' tactical problem was that the plaintiffs had to satisfy the legal requirement that they show reliance. Plaintiffs could not show that they relied on the public statements denying the merger negotiations. And even if they could demonstrate reliance, class certification would be jeopardized because each and every plaintiff would have to show that they heard and relied upon one of the false statements.

Basic Inc. v. Levinson confirmed a trend among lower courts to accept the "fraud-on-the-market" theory, which provides a wholesale mechanism for satisfying the securities laws' reliance requirement. Rather than relying on a particular misstatement, plaintiffs can satisfy the reliance requirement by showing that they relied on the market price of the security they traded. But in

---

[41] Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1069 (1990) (footnote omitted) (citation omitted).

[42] *Basic Inc.*, 485 U.S. at 227 n.4.

[43] *Id.* at 227–28.

order to rely on market prices plaintiffs must show that the securities in question traded in an efficient market.[44]

An interesting, important, and unexamined angle on the Court's opinion in *Basic* is that the Court treated securities markets participants' trading in an efficient market to be a right and not a privilege.[45] Plaintiffs seeking to satisfy the reliance requirement do not have to know that they actually were relying on securities prices, or even that they knew the price at which they were trading when they placed an order to buy or sell at the "market price."[46] Rather, investors have a right to rely on the market's ability to price some but not all securities, i.e., those securities that happen to trade in efficient markets.[47]

The Court's approach to satisfying the reliance requirement raised the question of what, precisely, the Court meant when it said that securities markets were efficient. Simply put, the Court punted on the details of what it meant when it said that securities markets were efficient. While accepting the "fraud on the market" theory and its rebuttable presumption of reliance on securities prices, the Court, for whatever reason, pronounced in a footnote that "we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price."[48] Lawyers unschooled in corporate finance were left to struggle a bit about this.

For corporate finance mavens, however, there was no doubt that the Court, whether it realized it or not, was adopting the semi-strong version of the efficient capital markets hypothesis (ECMH).

By way of background, the ECMH is actually three competing hypotheses about market efficiency: weak form efficiency, semi-strong form efficiency, and strong form efficiency.[49] The weak form of the ECMH posits that a stock's price is independent of past price performance; whatever information is inherent in the historic progression of a

[44] *Id.* at 241–42.

[45] *See id.* at 243–45.

[46] *Id.* at 247–50.

[47] *See id.*

[48] *Id.* at 248 n.28.

[49] Eugene F. Fama's famous 1970 review article introduced this important taxonomy. *See Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970); *see also* ROBERT CHARLES CLARK, CORPORATE LAW 281 n.2 (1986); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555–56 (1984).

stock's price is reflected in the current price. Thus, "an investor cannot enhance his/her ability to select stocks by knowing the history of successive prices and the results of analyzing them in all possible ways."[50]

The all-important semi-strong form of the ECMH is a bit more ambitious. This form of the ECMH claims "that current prices fully reflect public knowledge . . . and that efforts to acquire and analyze this knowledge cannot be expected to produce superior investment results."[51]

Finally, "the strong form takes the market idea to its limit and asserts that both public and private information are fully reflected in the price of a stock. Thus, no investor should be able to outperform the market systematically, because the market incorporates all possible information into the stock price. Under this theory, even inside traders cannot outperform investors as a group."[52]

As Geoff Miller and I previously have observed:

> It is clear that the Supreme Court implicitly applied the semi-strong form of the ECMH in *Basic*. Plaintiff shareholders claimed in *Basic* that three misleading public statements about potential merger prospects depressed the value of their stock relative to its "true" value. In holding for the plaintiffs, the Court unambiguously rejected the strong form of the ECMH: if the market were strong-form efficient, Basic's share price would have adjusted to reflect *all* relevant information, including the fact that the statements issued by Basic were false. In other words, the strong form of the ECMH and the fraud-on-the-market theory are fundamentally incompatible. Critical to the strong form of the ECMH is the assumption that the stock market cannot be fooled because it always accurately reflects all corporate information relevant to the pricing of a security.[53]

Thus *Basic Inc. v. Levinson* stands for the proposition that as long as securities prices reflect all publicly available information, investors are presumed to be relying on market prices, and not on public disclosures, or on their own research into securities prices,

---

[50] JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES & EVIDENCE 56 (2d ed. 1985). The weak form of the ECMH is also known as the "random walk" theory because it implies that successive price movements of a security are independent of each other, and therefore security prices follow a random walk. *Id.* at 56–57.

[51] *Id.*

[52] Macey & Miller, *supra* note 42, at 1077–78.

[53] *Id.* at 1078 (citation omitted) (footnote omitted).

or on advice from stockbrokers or investment advisers. The implications of this view of capital markets are profound and go considerably beyond the realm of reliance. Specifically, the implication is that investors who get the (efficient) market price when buying or selling securities are being treated fairly.

Thus *Basic* fills in an important gap in Easterbrook and Fischel's analysis of insider trading by providing a definition of the illusive concept of fairness. The fair price is the efficient price. Put simply, fairness is the concept that investors get what they pay in efficient markets by buying or selling securities at prices that reflect all available information about that financial asset.

The problem with insider trading, then, remains Lockean in nature. When insiders trade, they deprive other market participants of the opportunity to profit legitimately on nonpublic information. In essence, remaining faithful to the property rights approach to insider trading that Easterbrook and Fischel appropriately embrace, one must recognize the fact that there are property rights not only in information that is in the state of nature, but also that there might be property rights in the right to search for information that properly belongs in the state of nature.

Thus, just as it is illegal for a person to cordon off (and thus remove) land that exists in the state of nature, so too should it be illegal for a fiduciary improperly to remove information from the state of nature that its owners, the shareholders of the firm that created it, believe should remain in the state of nature. Put more concretely, investors rely on a market structure in which share prices are semi-strong efficient. Insider trading imposes costs on those market professionals who search for and "mine" for arbitrage profits by expending resources to discover information and transforming that information into an effective trading strategy that pushes prices to their efficient levels. From a public policy perspective, insider trading is harmful and inefficient because it deprives market professionals of important incentives to engage in costly search for mispriced securities.

Put simply, from the perspective of market efficiency, insider trading drives share prices to their correct levels, but it does so at a heavy price. Not only does such trading often involve theft of a company's own property rights in the information, but it also undermines the incentives of market professionals to engage in the costly process of discovering information. Thus, ironically, insider trading can undermine market efficiency and thereby undermine the very notion of fairness as efficient asset pricing.

However, when all is said and done, it remains the case that, under the framework in Chapter 10, it is the owner of the inside information who should decide if and how it is deployed.

II. EASTERBROOK'S AGENCY COST APPROACH TO INSIDER TRADING

Easterbrook's 1981 article, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, reflects a different approach to insider trading regulation. First, from a property rights perspective, Easterbrook claims that, while "[m]ost things are owned by someone. . . . [i]nformation, in contrast, usually is unowned; at least it is not subject to the same rules of property law that govern apples and steel mills. It is difficult too, for someone who possesses information to appropriate the benefits of knowledge."[54]

Easterbrook is right, of course, in his observation that that most things are owned by someone, but he is wrong, in my view, to say that information is unowned. If information were unowned by anyone, then anyone could claim it and there would be no justification for insider trading regulation. In short, most things are owned by someone, and information is no different. From the secret formula for Coca-Cola to the software that runs the world, to the information about how to build the best batteries for electric cars, information is, and must be, owned and protected. The economy simply would not function if this were not the case.

A more generous reading of this passage focuses on the idea that information can be owned, but that "it is not subject to the same rules of property laws that govern apples and steel mills."[55] But even here I largely disagree with the idea that different rules apply to information pertaining to share prices than to other forms of intellectual property.

A. Inside Information and Property Rights: Easterbrook v. *Chiarella*

If I own an apple or a steel mill, I can decide to use these things exclusively myself or I can decide to sell them or to give them away or to share them with someone else. The same is true for material nonpublic information. In fact, *The Economic Structure of Corporate Law* makes it clear that insider information is property that can be owned and alienated. Easterbrook and

---

54 Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 309.

55 *Id.*

Fischel maintain that the better approach to analyzing insider trading is to "identify property rights in information. Trading by managers (or others) in possession of valuable information is appropriate" if the traders own that information.[56]

Thus, there is a stark contrast between the approach to material nonpublic information taken in *The Economic Structure of Corporate Law*, which treats such information as property, and the approach taken in *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, which treats such information as something whose status as property is muddled. Indeed, in Easterbrook and Fischel's joint work on insider trading in *The Economic Structure of Corporate Law*, the issue is not whether inside information is property. Clearly it is. Rather, for Easterbrook and Fischel, the hard question is "whether, in the absence of explicit contracts, managers should be deemed to own valuable information obtained during their tenure."[57]

A major cornerstone of the law of insider trading is the misappropriation theory, which, of course, is solidly based on the assumption that inside information is a property right. The misappropriation theory, which the Supreme Court explicitly endorsed in *U.S. v. O'Hagan*,[58] posits that a person commits a civil and criminal offense and violates Section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5 when "he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[59] The information is property that belongs to the principal. As Justice Ginsburg succinctly put it, the information is "the principal's information."[60]

It appears that Easterbrook's main point is not about whether inside information is a property right, because clearly it is. Rather, the main point appears to be that property rights in insider information are difficult to identify and enforce. Indeed, Easterbrook soon reverts to a property rights framework:

> Legal recognition of property rights in intangible thoughts is old. Article I, section 8, clause 8 of the Constitution gives Congress power "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the Exclusive Right to their respective Writings and

[56] EASTERBROOK & FISCHEL, *supra* note 1, at 254.
[57] *Id.*
[58] United States v. O'Hagan, 521 U.S. 642 (1997).
[59] *Id.* at 652.
[60] *Id.*

> Discoveries." The patent, copyright, and trademark statutes will establish property rights. The Supreme Court has held that states may recognize still broader rights in intangible property. . . . Several of the older cases may be read to say that one who creates or first finds information has a right to prevent anyone else from using the knowledge for profit. The principle, if it still exists, confers a property right of sorts on the creators of some kinds of information.[61]

Thus, it seems that what Easterbrook is saying here, albeit obliquely, is that material nonpublic information that will affect share prices is a property right, but that there is no explicit legal regime for *enforcing* that right. It is not clear that that is correct. The Supreme Court has, in its well-known footnote 9 to its opinion in *United States v. O'Hagan,* outlined a mechanism by which the owner of insider information can enforce its property rights.

The challenge to enforceability is that the relevant statutes require that defendants engage in deception in order to be liable for insider trading. There is no deception however, "when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from," the owner of the information.[62] However, in such cases, where disclosure obviates the deception element of the crime of stealing inside information, "once a disloyal agent discloses his imminent breach of duty, his principal may seek appropriate equitable relief under state law."[63]

Thus, I disagree with Easterbrook's assertion in *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information* that inside information is a form of property right that is "neither expressly addressed by statute nor covered by the common law of intellectual property."[64] In fact, in the very Supreme Court insider trading case upon which Easterbrook focuses, *Chiarella v. United States*, the Court strongly suggests that insider trading law in the U.S. is nothing other than a framework for enforcing property rights in information.[65] And, as with property rights generally, the analysis centers around contract.[66]

61 Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 310 (citations omitted) (footnote omitted).

62 *O'Hagan*, 521 U.S. at 694 n.9.

63 *Id.*

64 Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 312.

65 *See* Chiarella v. United States, 445 U.S. 222, 222–37 (1980).

66 *See id.*

As Easterbrook and Fischel make clear in *The Economic Structure of Corporate Law*, Vincent Chiarella, the financial printer who engaged in insider trading by stealing information from the companies that had hired his employer, Pandick Press, was "effectively stealing information."[67] On the other hand, the client companies that had hired Pandick Press had created the information. As such, as noted above, the information belonged to Pandick Press's clients, and these clients "had every right to use the information for (their) own benefit without telling investors."[68]

As Easterbrook rightfully points out in *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, in *Chiarella* the SEC pursued a theory of liability, which the Court of Appeals adopted, that eschewed the property rights approach in favor of a vague theory that focused on an unarticulated notion of fairness and equality of information.[69] Under this theory, "anyone with regular access to financial information not generally available to the public is forbidden to trade without disclosing that information."[70]

At the Supreme Court, the government switched gears and took a decidedly property rights approach when the Court granted certiorari. As Easterbrook succinctly puts it, on appeal the Solicitor General argued that:

> Chiarella committed fraud not only because he had privileged access to information but also because that information was the property of the printer's customers. The Solicitor General's brief contended that unauthorized use of information by employees and agents "can disturb market prices and prematurely reveal acquisition plans, contrary to the interests of the acquiring companies." In other words, Chiarella had defrauded the acquiring firms, not the people whose stock he purchased.[71]

Chiarella got off on a technicality. The Court rejected the SEC's "fairness" and "parity of information theory."[72] However, the Supreme Court did not reject the property rights approach taken by the government on appeal. Rather the Court said that, while this approach appeared to be valid, the property rights

67 EASTERBROOK & FISCHEL, *supra* note 1, at 255.
68 *Id.*
69 Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 314–15.
70 *Id.*
71 *Id.* at 315 (citation omitted).
72 *See* Chiarella v. United States, 445 U.S. 222, 235–37 (1980).

theory was not actually presented to the jury as a theory of liability, and so it could not retroactively be used to convict the defendant.[73]

The problem with Easterbrook's analysis is that it does not fully comprehend the extent to which the Court in *Chiarella* (notwithstanding the reversal of the defendant's conviction) interpreted the law of insider trading to embrace the property rights approach that has come to characterize the law of insider trading in the US.

Put simply, history shows that the ban on insider trading did reach Chiarella's conduct because the Solicitor General's theory ultimately was accepted by the Court in *U.S. v. O'Hagan*. By indicating that *Chiarella* was wrongly decided, Easterbrook's analysis did not anticipate future events, which ultimately validated the property rights approach to insider trading.

Easterbrook correctly observes that the SEC "has not been deterred by *Chiarella* from continuing to assert that people who (in the SEC's view) ought not to trade assumed duties not to do so."[74] But he seems to be mistaken in his view that the SEC's position "is not wholly at odds with Justice Powell's opinion" in *Chiarella*.[75] The approach taken by the SEC is based on the theory that insider trading is unfair because it violates a generalized duty that insiders have to the market in general and to their trading counter-parties in particular. In stark contrast, the approach taken by Justice Powell in *Chiarella* is that prohibitions on insider trading are in place in order to protect property rights in information that are violated when an insider is in a relationship of trust and confidence with the rightful owner of the information.

The criticism of Easterbrook is not entirely fair for two reasons. First, the opinion is not by any means a model of clarity, and Easterbrook is right that Justice Powell's opinion "is not internally consistent."[76] Easterbrook also is correct in his view that the opinion sort of mixes and matches rhetoric from the SEC about the need to achieve some nebulous idea of fairness and the need to protect property rights in information.

Easterbrook's core criticism of *Chiarella* is that the opinion lacks a theory of when insider trading is wrongful and when it is permissible:

---

[73] *See id.*

[74] Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 321–22.

[75] *Id.* at 322.

[76] *Id.*

> The Court's treatment of the "duty" requirement is perfectly circular. A trader has a duty when he assumes it; he assumes a duty when he trades knowing that others, in like circumstances, have been required to disclose; a fiduciary relationship (which itself may be imposed by a court) is one source of duty but not the only one. To say that someone has a duty, therefore, is to summarize—but not to support—a conclusion reached by other means that someone ought not to trade. The obligation not to trade rests on a concealed premise, perhaps on the Court's judgment about the costs and benefits of insider trading. And this brings us back to the central problem in *Chiarella:* the Court articulated no concept of why insider trading is wrongful, of who suffers as a result, or of what costs should be borne to stamp out the practice.[77]

However, Easterbrook's view that the majority opinion in *Chiarella* lacks a theory is subject to challenge. The Court makes several important points and embraces a theory of insider trading that can be interpreted as being entirely consistent with a fully coherent articulation of a law of insider trading based on a theory of property rights in information.[78] As developed in subsequent cases that built on the seminal analysis in *Chiarella*, the Court's observation that insider trading regulation is predicated on breaches of fiduciary duty that occur when somebody trades or tips in contravention of a preexisting duty of trust and confidence is an excellent way of grounding insider trading law in a property rights analysis.

The point that Easterbrook seems to miss, which leads to his rather uncharitable reading of *Chiarella*, is that the case actually reflects a strong property rights approach to insider trading. Specifically, *Chiarella* opens the path to the current law of insider trading. Under extant case law, insider trading laws are broken when a person trades in violation of a fiduciary duty. A fiduciary duty is defined in this context as a preexisting relationship of trust and confidence. The key point is that there cannot be a relationship of trust and confidence that creates a duty to disclose or refrain from trading except in cases where the person or company to whom the fiduciary duty is owed is the owner of the information in question.

Put simply, one cannot owe a fiduciary duty to keep information secret to somebody who does not have clear property

[77] *Id.*

[78] For a fuller development of this point, see Macey, *supra* note 33.

rights in the information. Thus, it is not fair to say that *Chiarella* lacks a theory. In fact, the theory is this: The ownership of property rights in information creates a legal duty for those in a relationship of trust and confidence with the owner of the information that prevents them from stealing the property (information) of the owner. Vincent Chiarella, in his capacity as a printer, was in a relationship of trust and confidence with the owner of the information he was preparing for publication. By stealing this information and using it for his own purposes, Chiarella breached his duty, causing harm to the owner of the information. The fact that Chiarella was acquitted on the technicality that this theory was not presented to the jury does not make the theory any less valid.

B. Fairness in Insider Trading

Turning now to the concept of fairness in insider trading, Easterbrook makes a major contribution to the literature that is not reflected in the literature and has gone regrettably underappreciated. First, Easterbrook intuits the important point that fairness in insider trading is the ability to trade at the "right" price, which in this essay I defined as the efficient price, which is the price that reflects all information that the company that owns the information either is legally required to disclose or chooses to disclose even though not legally required to do so.[79]

As Easterbrook observes, in a major contribution to our understanding of insider trading theory, "[i]n a sense, the price at which Chiarella bought his stock was 'wrong.' It did not reflect all of the information about the corporations. Had the market known of the impending offers, people would have offered more for the stocks."[80] Easterbrook's contribution is that he establishes that the responsibility for monitoring and managing share prices did not lie with the defendant Chiarella, but with the owner of the information:

> If there is some ethical obligation to make the trading price "right," it naturally rests on the firm whose stock is being traded. The firm has some obligations (of uncertain dimension) to its shareholders. It certainly has obligations more extensive than those of Chiarella and other strangers. Yet it seems to be accepted that corporations need not disclose the

---

[79] *See* Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 326.

[80] *Id.*

information necessary to enable the prices of their shares to become "right."[81]

C. Easterbrook and His "Real Concerns About Insider Trading"

There are of course some real concerns about a legal regime that would allow unfettered insider trading to go unpunished. Simply put, companies should be able to control the information they generate about themselves and other companies to the full extent permitted by law. Capital market regulations that allowed a Vincent Chiarella to freely purchase shares in a target company based on information that a bidder spent enormous resources to discover and analyze would be highly inefficient because it would provide strong disincentives for bidders to create socially valuable information in the first place.

There are other problems with allowing unfettered insider trading. As Easterbrook catalogues, such trading could provide perverse incentives for insiders to focus too much on trading and too little on their jobs. It can lead to insiders pursuing projects not because they are valuable to the firm, but rather because they create stock price volatility that generates opportunities for insider trading profits. Insider trading opportunities also could create incentives for managers to delay the release of important information to their shareholders and to the markets in order to have time to generate insider trading profits prior to such release.[82]

According to Easterbrook, these "considerations suggest that granting insiders property rights in their knowledge about the firm is not necessarily beneficial."[83] Thus Easterbrook supports the prohibition of insider trading "under some circumstances."[84] The harder question, however, is whether intra-firm contracting or government regulation is the best mechanism for supporting the regulation of insider trading.

Easterbrook comes down tentatively on the side of public enforcement because he believes, oddly, that public enforcement is more efficient than private enforcement, which he deems "inefficient."[85] His conclusion is tentative because the issue ultimately is an empirical one, and he acknowledges that he "may be singing

---

[81] *Id.*
[82] *Id.* at 332–33.
[83] *Id.* at 333.
[84] *Id.* at 334.
[85] *Id.*

a different tune tomorrow"[86] (or on the date of the conference associated with this Article!) But here his views seem conclusory and at odds with the position later taken in *The Economic Structure of Corporate Law*, which reflects a more optimistic view of potential for private contracting as a mechanism for addressing the challenges posed by insider trading.

Later, Easterbrook doubles down on his agency cost analysis. As Alexandre Padilla observed in the *Quarterly Journal of Austrian Economics*, Easterbrook argues that:

> [L]etting firms allow their insiders to trade on inside information gives rise to agency problems that shareholders would be unable to resolve. No firm should be authorized to allow insider trading because shareholders are not able to control the activity of their insiders (Easterbrook 1981 and 1985). This is closely related to the Berle and Means argument that modern corporations are characterized by the separation of ownership and control. In other words, the owners have lost the control of the corporation and are unable to control the activity of the management (Berle and Means 1932).[87]

III. FISCHEL'S COASEAN APPROACH TO INSIDER TRADING

A path-breaking article with Chicago colleague Dennis Carlton takes a more decisively *laissez-faire* approach to insider trading than one observes in Fischel's joint work with Easterbrook. The piece, *The Regulation of Insider Trading*,[88] makes significant criticisms of extant corporate law.

The starting point of this piece is the observation that corporate and securities law did not traditionally elect to regulate or to prohibit the practice. Carlton and Fischel explicitly argue that the debate on insider trading is really a debate about who, as a matter of contract, should be allocated property rights in valuable information by the firm managers or investors.[89] The authors argue that various considerations, most notably private interests, will lead the parties to privately agree on the optimal allocation of such rights.[90]

The discussion of incentive and information effects in Part II suggests that there may be gains to shareholders from allocating

---

86 *Id.* at 338.

87 Alexandre Padilla, *Can Agency Theory Justify the Regulation of Insider Trading?*, 5 Q.J. AUSTRIAN ECON. 3, 3 (2002).

88 Carlton & Fischel, *supra* note 2.

89 *Id.* at 861.

90 *See id.* at 864–65.

property rights in valuable information to managers rather than investors. Carlton and Fischel argue that because such gains exist, it makes sense that one does not observe pervasive regulation on insider trading in private law, common law, and by various local and international jurisdictions.[91]

The authors draw support for their argument that the contracting process likely would result in the allocation of property rights in insider information to insiders from the lack of regulation prohibiting such allocations.[92] While insider trading is among the most heavily regulated areas in modern securities regulation, it was not regulated very heavily at common law. The authors' theory is based on the reasonable assumption that while common law rules tend towards efficiency, statutes are far more likely to reflect legislative capture by special interest groups, and thus reflect inefficient policy choices consistent with the public choice model.[93]

The Carlton and Fischel defense of insider trading is sweeping. Pointing out that terms and conditions of managerial employment such as salaries, bonuses, stock options, and office size are matters of private negotiation between companies and their managers, and that these and other terms and conditions of managerial employment are considered to be outside the bounds of government regulation, the authors query why rights to engage in insider trading are not left to the private contracting process.[94]

The authors explicitly reject the argument that insider trading "is unfair, constitutes theft, destroys investors' confidence, or compensates inefficiently."[95] As a matter of simple logic, it is somewhat anomalous that managers routinely pay themselves munificent salaries and take significant nonpecuniary benefits and perks but cannot engage in insider trading. Moreover, from an efficient capital markets perspective, as long as investors understand that the possibility of insider trading exists, both share prices and managerial compensation will be higher if the efficient allocation of trading rights is achieved but such prices will be lower if the allocation is inefficient.

Carlton and Fischel systematically reject all of the traditional arguments made in favor of regulating insider trading. A

---

[91] *See id.* at 862–63.

[92] *See id.* at 865–66.

[93] For a discussion of interest groups' influence of legislation, *see* MANCUR OLSON, THE RISE AND DECLINE OF NATIONS (1982).

[94] *See* Carlton & Fischel, *supra* note 2, at 865–66.

[95] *Id.* at 862.

standard argument for prohibiting insider trading is that companies have to encourage managers to own shares to align their interests with those of the shareholders. Once managers own shares, however, it is not possible to separate proper from improper trading activity. Thus, share ownership by managers coupled with firms' inability to guard against insider trading on their own means that the only viable policy response is to categorically forbid such trading. In response to this argument, Carlton and Fischel contend that it does not take into account the fact that "firms need not be able to enforce contracts prohibiting insider trading perfectly to benefit from entering into such contracts, if such contracts were in the interest of investors."[96] The authors argue that the apparent absence of widespread use of contracts prohibiting insider trading cannot be explained by the fact that it is difficult to obtain perfect enforcement, but rather by the fact that such contracts are inefficient.[97]

Carlton and Fischel also point out that the argument that insider trading should be prohibited because managers' share ownership must be regulated wrongly assumes that managers must own shares in the first place in order for managers to be induced to work in the best interests of shareholders.[98] Carlton and Fischel argue that firms are free to base managers' compensation on share performance, *even if managers do not own shares*, simply by giving them cash payouts on the basis of positive share price performance.[99] Thus, managers could be prohibited from owning shares, or they could be permitted to own shares but not trade them, if such contracts were efficient.

Firms, however, generally do not utilize these other methods of prohibiting insider trading, suggesting that the absence of such provisions is because they are inefficient, not because they are unenforceable.[100]

Under Carlton and Fischel's analysis, regulatory sanctions for insider trading could only be justified if it were clear that the parties themselves had attempted to deter insider trading by contract, and that the government therefore had a comparative advantage in enforcing such contracts.[101] Otherwise, government action likely displaces efficient private arrangements with

96 *Id.* at 864.
97 *Id.*
98 *Id.*
99 *Id.* at 864–65.
100 *Id.* at 865.
101 *See id.*

inefficient regulatory solutions, much in the same way that government regulation of salaries, bonuses, office size, leisure time, etc. would be inefficient.[102] Thus, according to Carlton and Fischel no justification exists for precluding firms from contracting around a regulatory prohibition of insider trading.

In other words—contrary to the approach taken in his joint work with Easterbrook—in his joint work with Carlton, Fischel makes a full-throated defense of insider trading. Insider trading may present a more viable solution. They defend insider trading on the grounds that insider trading allows a manager to alter her compensation package in light of new knowledge, thereby avoiding continual renegotiation. They argue that allowing insider trading incentivizes managers to acquire new information in the first place, because they profit from it every time they trade.[103] They argue that insider trading helps firms distinguish between good and bad managers because it rewards managers who create valuable information and are willing to take risks.[104]

Carlton and Fischel reject the argument that insider trading should be regulated because allowing managers to trade will lead to short-selling on the basis of negative non-public information. They argue instead that "allowing managers to profit by a decrease in the value of the firm may increase their incentive to *increase* the value of the firm" because managers are concerned about the value of their human capital, and thus they're usually risk-averse.[105] If insider trading is allowed, though, managers may be induced to take up projects with a high expected return, which are riskier if short-selling is prohibited.[106]

Carlton and Fischel go on to consider various objections to their *laissez-faire* approach to insider trading and reject them seriatim. For example, they consider the argument that allowing insiders to profit on bad information makes them indifferent to increasing or decreasing the firm's value.[107] Instead, Carlton and Fischel argue that prohibiting insider trading is too blunt a weapon to address this perverse incentive effect.[108] They also argue that managers often work in teams, and therefore the ability of one manager to pursue bad opportunities will be constrained

[102] *See id.* at 865–66.
[103] *Id.* at 870–71.
[104] *Id.* at 871.
[105] *Id.* at 872.
[106] *Id.*
[107] *Id.* at 873.
[108] *Id.* at 873–74.

because other managers will attempt to maximize firm value since their compensation is linked to maximizing firm value.[109]

In response to the argument made by Leftwich, Verrecchia, and Easterbrook that insiders who trade have an incentive to choose risky (high variance) investments, Carlton and Fischel argue that such an incentive is not necessarily bad.[110] Stock options have the same effect on incentives, but no one thinks that granting stock options to insiders is an inefficient method of compensation. Rather, Carlton and Fischel argue that incentive devices, such as insider trading and stock options, counter the managerial proclivity to be risk-averse, which may be beneficial to shareholders.[111]

In further tension with Easterbrook, Carlton and Fischel argue that the argument made by Easterbrook and Professor Kenneth Scott—that insider trading akin to compensation via lottery tickets and, as such, is an inefficient system of compensation which should be eliminated—is wrong.[112] Instead, Carlton and Fischel posit that this argument ignores the value of providing managers with contingent claims on the firm's income stream as a solution to the principal-agent problem.[113]

In another version of the argument that insider trading is an inefficient compensation mechanism, Professor Stephen Ross argues that the market for managerial services is not competitive, and thus managers are able to obtain contracts that permit insider trading even when such contracts are inefficient.[114] Ross further argues that insider trading allows managers to receive higher compensation than they would if markets were competitive.[115] Rejecting this argument, Carlton and Fischel argue that there is no evidence that supports the premise that labor markets are uncompetitive. Carlton and Fischel even argue that there is no evidence to support the claim that access to information is always (or even usually) merely luckily random.[116] In other words,

---

109 *Id.*

110 *Id.* at 875–76.

111 *Id.*

112 *Id.* at 876 (first citing Easterbrook, *Insider Trading, Secret Agents*, *supra* note 2, at 332; then citing Kenneth E. Scott, *Insider Trading: Rule 10b–5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 808 (1980)).

113 *Id.* at 876–77.

114 *Id.* at 877 (citing Stephen Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 184, 193 (Franklin Edwards ed. 1979)).

115 *Id.*

116 *Id.* at 878.

they argue that insider traders deserve the returns that they obtain by trading on nonpublic information.

Carlton and Fischel also argue that there is little empirical support for the argument that insider trading creates inefficiencies because it causes delays in the disclosure of important information.[117] They double down by arguing that delaying disclosure may be beneficial in some instances, such as in cases in which valuable information is kept from competitors.[118] Moreover, Carlton and Fischel draw an interesting distinction between trading and disclosure of inside information, arguing that information can be the basis for trading even when the information is not disclosed, at least not immediately.[119]

Finally, with regard to the contention that insider trading is unfair or immoral, Carlton and Fischel argue that, if they are right in their claim that insider trading is a desirable compensation scheme (like salaries, options, bonuses, etc.), allowing the practice benefits not only insiders but outsiders as well.[120] Paying managers through various forms of compensation, including insider trading, creates incentives for maximizing firm value.[121]

Further in support of their argument that a free, unconstrained contracting process within corporations would not generate prohibitions on insider trading, Carlton and Fischel note that neither common law nor state law place significant restrictions on insider trading.[122] They also note that there is no evidence that firms have tried to purge insider trading on their own.[123]

Concluding Observations

Both Easterbrook and Fischel are committed Coaseans. They correctly view material inside information as a form of property right. And they correctly identify the firm that generates or "invents" the information as the owner of that property right. Similarly, both Easterbrook and Fischel are consistently sympathetic to the concept that insider trading should be the subject of intrafirm contracting.

---

117 *Id.* at 879.
118 *Id.* at 879.
119 *Id.*
120 *Id.* at 881–82.
121 *Id.*
122 *Id.* at 882–83.
123 *Id.* at 894.

Carlton and Fischel go much further than Easterbrook and Fischel in the sense that, in his writing with Carlton, Fischel makes predictions about what the intra-firm contracts regarding insider trading would look like if public companies were allowed to enter into such contracts.

Carlton and Fischel's argument is very broad. They appear to take the position that all firms would permit insider trading on all issues if permitted to contract over the issue. This seems highly unlikely. Companies go to great lengths to keep certain kinds of information secret, and they routinely fire employees who trade on material nonpublic information. A couple of examples illustrate the point.

It is hard to imagine an investment bank allowing its traders to trade on the basis of material nonpublic information related to the bank's own trading strategy. Imagine that an investment bank, on the basis of its own costly research, developed the hypothesis that a particular stock was undervalued and committed to a strategy of buying shares in the company that issued the stock. Insider trading in advance of the investment bank completing its own trading strategy inevitably would jeopardize the bank's plans because the insider trading would drive up the costs of the issuer's shares and erode or destroy the potential profits from implementing such a strategy.

The same point would seem to apply to any information that a company expended resources to develop or obtain. Suppose, for example, that a corporation planned a tender offer at a 30 percent premium for its own shares, or for the shares of another company. In either context, insider trading in the shares that the company planned to buy likely would increase as a result of such purchases, making the acquisition of those shares more costly. It is impossible to imagine that a company would allow insiders to trade in advance of information about upcoming transactions after incurring substantial risk and costs in developing such information.

It seems more likely that a firm might allow insider trading on information that was not the result of an investment by a company, but rather was the byproduct of ordinary corporate activity. Suppose for example that a company is involved in high-stakes litigation. Suppose further that the litigation settles on terms that are favorable to the company. In this hypothetical, there is a window of opportunity for insider trading between the point in time when the settlement is reached and the point in time when the settlement is announced.

The question is whether any rational, responsible fiduciary would allow insider trading in this context. I am dubious. The problem with insider trading in this context is that it creates perverse incentives to manage the litigation in ways that maximize the opportunities for trading. For example, an insider might prefer to resolve the case by settlement rather than by jury verdict simply to maximize the opportunities for insider trading. Monitoring this sort of behavior would be an exceedingly difficult task for companies. It is doubtful that companies would allow insider trading in advance of litigation settlements.

Another rich source of material nonpublic information that can be used as grist for insider trading is companies' quarterly earnings reports. There likely are some people who have advance knowledge of the information contained in quarterly earnings reports whose actions do not affect such information. Yet, even in this context, it is far from clear that a firm would allow trading on this sort of information. It is hard to see what the benefit would be for the corporation. It is even more difficult to see how trading rights in such information could be allocated among employees in a manner that would be perceived as fair or efficient. Perhaps firms could work all of this out for themselves, but no company has shown any inclination to do so.

The core problem in current insider trading litigation is the challenge of how to deal with tippee liability. This has been the key issue in the three most important insider trading cases of late: *U.S. v. Newman*,[124] *U.S. v. Martoma*,[125] and *Salman v U.S.*[126] In all of these cases an insider intentionally "tipped" or provided material nonpublic information to an outsider while knowing that the outsider either planned to trade on the information or was highly likely to trade on the information.

The Easterbrook and Fischel analysis forces those evaluating the legality of this tip to consider whether the tip provided any benefit to the corporation whose information was tipped. For example, it might be the case that, absent tipping, a company would be able to attract coverage by stock market analysts, whose coverage can improve the liquidity and the value of the companies whose shares are being traded.[127] In such cases it would be perfectly consistent with Easterbrook and Fischel's contractual

124 *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

125 *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017).

126 *Salman v. United States*, 137 S. Ct. 420 (2016).

127 *See* Armando Gomes et al., *SEC Regulation Fair Disclosure, Information, and the Cost of Capital*, 13 J. CORP. FIN. 300, 301–02 (2007).

perspective for companies to permit the disclosure by insiders to tippees as a quid pro quo for those tippees' willingness to provide a continuous two-sided market in the shares of the company. Moreover, in this context, proceeding against the insiders who tipped for the benefit of the company would be misguided. As I have pointed out before, another context in which insider trading should be permitted is where the inside information that is being passed along relates to illegal activity within the firm:

> Suppose, for example, that an insider is working in a company mired in fraud and illegal activities. Unable to get the authorities or press interested or involved, [an] insider passes along his concerns to a securities analyst who does his own investigation, verifies the fraud, and, putting his money where his mouth is, sells stock in the fraudulent firm. This simultaneously drives the company's share price down and notifies the market that something is amiss in the company. The SEC would brand the trader in this hypothetical a fraudster and seek to sanction her. It might even ask the Department of Justice to bring criminal charges against the trader and or the person who provided the tip to the trader.[128]

On the other hand, as discussed above, where there is no discernible corporate or other benefit from disclosing material nonpublic information, and certainly where such disclosure would harm the corporation, insider trading should be prohibited. But still, it is significant that there are clear cases where trading on the basis of material nonpublic information should be allowed because it provides significant information, either to the company to which the information pertains or to the general public.

Trading on the basis of inside information that benefits the public should only be permitted when such trading is consistent with the property interests of the source of the information. Thus, it is inappropriate either to tip or to trade on the basis of insider information about legitimate corporate activities such as takeovers or earnings information unless there is a clear corporate benefit from such trading and tipping. On the other hand, it is unreasonable to consider information about fraudulent corporate activities to be legitimate information that a company has the right to keep confidential. Insiders who tip such information are tantamount to whistleblowers whose trading helps to "get the

128 Macey, *supra* note 17, at 66 (citation omitted).

word out about fraud" in situations in which nobody is paying attention to such fraud.[129]

To summarize, in this section of the Article, I have identified three contexts in which insider trading occurs. Specifically, insider trading occurs when:

1. Information is generated for the purpose of trading, such as information that the company is going to repurchase its own shares or make a purchase of shares in another company;
2. Information is generated as the byproduct of legitimate corporate activity, such as the information contained in earnings reports;
3. Information is generated as the byproduct of illegitimate corporate activity such as fraud.

Insider trading is wholly inappropriate in the first case because no rational company would permit trading that undermines the company's own trading strategy. This is because such trading strategies are costly to develop and risky to implement, so that permitting insider trading on the basis of such information about such strategies involves theft of a company's intellectual property rights.

In the second scenario, insider trading might or might not be appropriate depending on the context and circumstances under which such trading takes place. The issue, from a contractarian point of view, is whether and to what extent the corporation and its shareholders benefit from any insider trading that might occur on the basis of information that is generated in the ordinary course of a corporation's business. For example, where there are benefits from insider trading in the form of improving the liquidity of a firm's shares by attracting an analyst following or attracting market makers, the benefits from insider trading may be greater than the costs.

Finally, there is insider trading that pertains to illegal activities within a firm. Here insider trading is desirable. Companies have no legitimate basis for keeping illegal activities confidential, and trading on the basis of such information provides a credible mechanism for releasing such information.

The analysis by Easterbrook and Fischel has enduring value. It provides answers to questions that still vex courts. Hopefully this Symposium will bring new attention to this important work

[129] *See* Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899 (2007).

from judges and scholars who could sorely use guidance in this troubling field.