CHAPTER – 2
TO PROHIBIT, OR NOT TO PROHIBIT – THE POLICY
DEBATE OVER THE INSIDER TRADING
PROHIBITION

As mentioned in Chapter 1, it is the policy level controversy regarding the very need for as well as the precise rationale behind prohibiting insider trading that has translated into a multiplicity of legal doctrines underlying the insider trading prohibition. Therefore, it is imperative to take a closer look at the arguments offered in favour of as well as against the legalization of insider trading. While some of those arguments were briefly reviewed in Chapter 1, this Chapter is devoted to a more detailed discussion and analysis of those issues.

2.1 ARGUMENTS FOR LEGALIZATION OF INSIDER TRADING

At the first level, the debate focuses on the very desirability of the insider trading prohibition. In this respect, there is a minority (but influential) school of thought that argues that trading on a company’s securities by the insiders actually serves certain socially and economically useful purposes, and thus should not be prohibited.

2.1.1 Henry G. Manne

The most prominent scholar advocating legalization of insider trading is Henry Manne. He presented an early defense of insider trading in his book “Insider Trading and the Stock Market”.¹ He returned to this issue in an article written in 1985.² In this article, he refines and clarifies his earlier stand, without much substantive modification of his earlier views. Therefore, this later article would be a convenient and suitable starting point for analyzing the arguments presented in favour of legalization of insider trading.

Manne claims that since the publication of his 1966 book, a growing number of economic and legal scholars have become inclined to take a less emotional view of the topic and are willing to subject the topic to rigorous academic analysis. He presents three major arguments in favour of insider trading – insider trading does not injure anybody, it makes the stock market more efficient and it is an effective executive compensation scheme.

**Insider Trading Has No Victims**

Manne argues that insider trading has no victims. In case of other market abuses such as financial misstatement or Ponzi Schemes, the investors clearly rely (either directly or indirectly through the price discovery mechanism of the market) on the misstatements or omissions. In contrast, in the case of insider trading, the counterparty is neither induced by nor relies on any misstatement by the inside trader. Indeed, the counterparty comes to the market and decides to buy or sell the securities for wholly exogenous reasons, independent of the presence or absence of insider traders in the market. Manne is sensitive to the potential argument that such insider nonetheless violates a fiduciary duty she owes the current / potential shareholders. However, according to him, this begs the question as to why insider trading is a violation of a fiduciary duty in the first place, in the absence of any injury to the shareholders. Of course, this argument does not, per se, establish the legitimacy of insider trading. However, it shifts the burden of proof to the other side of the debate. Scholars who advocate the prohibition of insider trading must now explain who are the harmed parties as a result of insider trading and what is the exact harm suffered by them.

**Insider Trading Promotes Market Efficiency**

Manne also presents two positive arguments in favour of insider trading. According to him, insider trading actually promotes securities market efficiency. The markets are said to be efficient when the securities prices incorporate all the available information. An efficient securities market is socially and economically valuable as it enables optimal allocation of capital in the economy. However, in practice, a company would

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3 *Id.*
4 *Id.* at 933-934.
5 *Id.* at 934.
6 *Id.* at 935.
not be always be able or willing to disclose the entire information to the market immediately so as to protect its corporate interests. For example, a company that develops a new AIDS drug would like to keep the information secret, say till the drug trials conclusively establish the efficacy of the drug. Thus for a reasonable period of time, this new information would not get incorporated in the price of the company’s securities. However, if insiders who are privy to this information are allowed to trade on its basis, this information would indirectly get incorporated into the price, driving the price towards its efficient value. Thus, insider trading may be seen as an effective mechanism by which the companies can withhold actual disclosure of sensitive confidential information, while at the same time allowing the market prices to converge to the efficient value of a company’s shares (through trades done by people privy to inside information).

This argument also shows that the counterparties to the insider traders, or other outside traders who sell the shares are actually benefitted as a result of insider trading. Suppose Company A develops a new drug. Before this development, the price of the company’s shares was Rs. 100. Once the new development reaches the market, say the price would rise to Rs. 110. In the absence of any insider trading, the price would stay at Rs. 100 for a certain period of time (till the company makes an announcement of the development). This would deprive the outside sellers of the true value of the shares. With insider trading, the price would move up at least partially and settle closer to its efficient price (say Rs. 104). Thus, outside sellers who sell to the insiders or even to other outsiders would get a more favourable price. Thus, even though inside traders have surely benefitted, it is not at the expense of their counterparties or other outside traders taking an opposite position. In other words, insider trading is not a zero sum game.

As mentioned earlier, the term “insider trading” is not defined anywhere in the United States law. The insider trading prohibition there is judge made, in the form of a variety of Court evolved doctrines. The equal access to information was one of the earliest legal doctrine enunciated by the United States Courts.  

counterparty before entering into a securities trade. In this context, any participant who wishes to trade must either disclose to the counterparty, any material non-public information she has access to, or abstain from trading (the disclose or abstain rule). Thus, any trade based on non-disclosure amounts to deception on the counterparty.

However, the aforesaid efficiency based argument in favour of permitting insider trading seems to pose a serious challenge to predication the insider trading prohibition on the equal access doctrine.

First, as the argument establishes, the insider’s trades actually enables the counterparty to make her trade at a more favourable price as compared to the price she would receive in the absence of any insider trading (the insider always has the perfectly legal option to abstain from trading). In our earlier example, the outside seller in the absence of insider trading would have received Rs. 100, when the efficient price was Rs. 110. With insider trading, she received a higher price. Thus, it is hard to see the counterparty as a victim, as is entailed by the equal access to information doctrine.

Second, this analysis seems to show that prima facie, there is a tradeoff between equal access to information on the one hand and efficiency considerations on the other. A critical assessment of the equal access doctrine is taken up in Chapter 5. The seeming inconsistency between ensuring market efficiency through the incorporation of new information in the price of securities and the insider trading prohibition is considered in detail in Chapter 6.

**Insider Trading as Executive Compensation**

The other argument by Manne is in terms of justifying insider trading as an effective executive compensation scheme. He notes an observation made by Joseph Schumpeter that the large company by its nature does not encourage or reward entrepreneurship. Indeed, there is a tendency towards bureaucratization of large companies. This stifles innovation. But encouraging innovation is essential if a company has to create value for its shareholders. Manne’s argument is that allowing

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8 Manne, *supra* note 2, at 936.
insider trading can be a solution to this problem. On this view, legalizing insider trading may encourage executives to innovate and enhance corporate value. Executives can reap the benefits of their innovation by buying company shares before the information regarding their innovations and their positive effects on corporate value becomes public, and sell it once the publicly disclosed information is reflected in the share price.

However, unlike the earlier argument regarding the possible salutary effect of insider trading on market efficiency which is plausible at least if taken at face value, this argument does not seem to be persuasive for a number of reasons.

First, Kripke\(^9\) notes the “attribution problem” in this context. It is not easy to allocate corporate success between different causes – the distinction between pure luck and genuine entrepreneurial initiative by an executive or a group of executives. Even if that could somehow be done, determining the amount of optimal reward would still be challenging.

Second, leaving aside the problem mentioned above, it would be difficult to ensure that only those executives who are innovators would be able to reap the benefits by way of insider trading, that too proportionate to their contribution to the enhanced value. Typically, in a modern organization, information flows through multiple levels, and many more employees unrelated to the innovation often come into possession of such information. Therefore, this problem is real and particularly acute.

Third, insider trading in the real world often occurs not in the context of what Carlton and Fischel term “the bombshell events”\(^10\) such as a new product development or the company winning a major lawsuit against it. In such cases, the enhancement in the corporate value may at least plausibly be attributed to the product development team or the legal team respectively. Quite often, such trading occurs in the context of inside information which is not generated as a result of any innovation by the information generator. To take one example, the Chief Financial Officer (CFO) of a company


would know that the quarterly profits of the company are far above the market estimates. There is no plausible reason to attribute the same to the CFO. In that context, it is hard to see why the CFO should be entitled to use this information to her advantage by engaging in insider trading activity.

To sum up, Manne advocates an absolute, *per se*, legalization of insider trading by stressing that insider trading is a victimless activity and also has positive effects on the securities markets and the company itself.

### 2.1.2 William J. Carney – No Harm Argument

Carney\(^{11}\) supports Manne in his “no insider trading prohibition” argument. He forcefully argues that no coherent theory of significant investor harm has been developed by either the SEC or the Courts. The case law is confused beyond coherent explanation.\(^{12}\)

He argues that the theories of investor harm due to insider trading are because of a confused notion of “causation” of investor loss. He defines causation to mean that which is required for an event to occur. In the modern impersonal market, neither side knows the identity of the parties on the other side of the trade. He concludes that most trading decisions are reached on bases entirely separate from the presence or absence of insider trading. Thus, the presence of inside traders did not result in the outsiders’ trading. Any loss to investors (who are on the other side of the insider trader) cannot be caused by the insiders’ trading. The loss of an investor is caused by revelation of truthful information, which she lacked at the time of trading, and which causes the market to revalue the particular issuer's shares. Thus, treating insider trading as the cause of investor losses confuses events and their consequences.\(^{13}\) This argument is essentially a reformulation and clarification of Manne’s argument regarding reliance. In the context of insider trading, there is no inducement held out by the insider, nor is there any reliance by the outsider with respect to the presence of insider traders in the market, or any representation made by them.

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\(^{12}\) *Id.* at 864.

\(^{13}\) *Id.*
Carney\textsuperscript{14} admits that there may be one situation where insider trading may be said to have genuinely “caused” the outsider to trade. For example, this may happen where insider trading on a positive (yet to be published) information causes an increase in the price of the company’s shares. This increased price may give an indirect signal to outside investors regarding the occurrence of a positive development. This would trigger trading by the outsiders. In this case, insider trading is clearly the “cause” of outsider trading. He argues that since the insiders trade anonymously (due to legal prohibitions against insider trading), such “signaling effects” of insider trading are generally weak. Consequently, his “no causation” hypothesis largely holds.

There is one case where the changes in price definitely trigger the trade. This happens in the context of a preset trade order. One such instance is in the case of a limit order. An investor may buy a security for Rs. 10 and set a limit sell order at Rs. 12. If the price reaches Rs. 12, the sell order is automatically executed, so as to lock in the target rate of appreciation (in this case 20%). Carney’s response\textsuperscript{15} to this argument is that if at all insider trading moves prices, it does so in the correct direction. Once the company announces the hitherto non-public information, the price will anyway move in that direction. In other words, the limit order would anyway get executed. Insider trading merely speeds up the process and does not cause it.

As noted above, this argument does not necessarily establish the legitimacy of insider trading. Rather, it seems to rule out “harm to the counterparty” as a basis for the insider trading prohibition. Consequently, it also poses a serious challenge to conceptualizing insider trading prohibition as an equal access to information issue wherein both parties to the transaction must have equal access to information.

Other scholars have attempted to move away from this absolute position against the insider trading prohibition and to engage in a nuanced analysis of the benefits and harms of insider trading. They claim that particular instances of insider trading may be beneficial or harmful depending on their underlying context. Thus, instead of an absolute prohibition or legalization of insider trading, the legal regime should be

\textsuperscript{14} Id. at 886-87.
\textsuperscript{15} Id. at 890-91.
finetuned, so that insider trading is prohibited only in instances where its harmful effects outweigh the benefits.

2.1.3 Dennis W. Carlton & Daniel R. Fischel – An Opt-out Regime

Carlton and Fischel\textsuperscript{16} advocate a market based solution to the issue. They endorse Manne’s view that insider trading is generally beneficial. At the same time, they accept that it may not benefit all companies in all circumstances. They advocate a regime wherein prohibition of insider trading is the default rule, but companies are permitted to opt out of this rule wherever they perceive insider trading to be in corporate interest. For example, a company (bidder) may be in the process of launching a takeover bid for another company (target). The target company’s independent directors have determined that the takeover is in the interest of its shareholders. A few employees of the target learn about this, and start acquiring the company shares. This would drive up the price of the target company shares and make the takeover more expensive for the bidder. It may even frustrate the takeover plan. In this case, it is clear that it is against the interests of the target for its employees to engage in insider trading. In such a case, the default rule (prohibition) would protect the target from such harmful insider trading. However, if the target company is interested in fending off the takeover attempt, it should be free to opt out of the default rule and permit its employees and other investors to trade on this information.

This proposal is more nuanced than the “always permissible” regime that Manne advocates, as it accepts that at least in certain instances, permitting insider trading may not be desirable. However, this too is susceptible to the agency problem well known in corporate and securities law. The modern company is characterized by separation of ownership and management.\textsuperscript{17} The shareholders are the owners and the residual claimants in the company’s assets and cash flows, but the managers are responsible for running the company. As such, maximizing shareholder value is a fundamental objective (if not the only one) that the managers should pursue. In this sense, the managers are the agents of the shareholders. The agency problem here is that they may seek to promote their own interest at the expense of shareholder value. This opens up an opportunity for managerial self-dealing. Thus, such opt-out from the

\textsuperscript{16} Carlton & Fischel, supra note 10, at 866.
\textsuperscript{17} A. A. Berle & G. C. Means, The Modern Corporation and Private Property (2d ed. 1967).
insider trading prohibition may happen not necessarily where it is in the best interests of the company, but in the interests of the management.

Thus, it seems that such a virtually open ended opt-out rule may not necessarily benefit the company and its shareholders. On the other side, it may potentially give rise to its own serious corporate governance issues.

2.1.4 Dennis S. Corgill – Insider Trading and Signaling Effects

Corgill\textsuperscript{18} agrees with Manne’s thesis that insider trading has positive effects in terms of market efficiency. He refers to market efficiency in terms of the ability of current market prices to provide signals that quickly and accurately convey all available material information.

Given this, he argues that in general, the implication is that insider trading needs no regulation. However, at times, the market may not be able to decode the precise reason behind trading by the insiders. In other words, the market may not be able to figure out whether insider trading is the result of a significant development or is due to other reason – such as an immediate liquidity need of the insider. Corgill terms this a case of market failure that justifies some form of insider trading regulation. In other words, if the market could know for sure that insider buying and the consequent rise in the price of the company securities is due to a positive corporate development, this would itself trigger further outsider trading. This, in turn, would imply that the non-public information gets indirectly incorporated in the price at a much faster rate, improving efficiency, due to the combined effect of insider and (triggered) outside trading.

To address this market failure, Corgill\textsuperscript{19} advocates a regime wherein the issuer of securities would determine whether it is in the issuer's competitive interests to allow insiders to disclose material information through price signals. If the issuer decides to bestow the insider trading privilege as a form of compensation, the designated insiders can trade in the company’s securities, with near simultaneous disclosure of


\textsuperscript{19} Id. at 414.
the underlying information. This would help investors distinguish between trading based on non-public information and noisy trading.

However, this regime would imply that insiders have very short windows to trade on inside information, as the underlying information would have to be disclosed near simultaneously with the first trade, reducing the efficacy of insider trading as a compensation scheme. Once the first insider trades, a simultaneous disclosure would be made. The market then would quickly incorporate this information in the price, eroding the insider advantage for other insider traders, and even for subsequent trades by the same insider.

Also, the requirement of a simultaneous disclosure of the underlying information would imply that the instances where the company may permit insider trading would be extremely rare, as the companies would be reluctant to permit an early disclosure of sensitive information. Therefore in practice, this regime may effectively collapse into one with an absolute prohibition on insider trading.

2.1.5 David D. Haddock & Jonathan R. Macey - A Coasian Model of Insider Trading

Some scholars have attempted to apply the insights gained from the study of other relevant social science disciplines to address this issue. Haddock and Macey20 present a model of insider trading regulation based on the Coasian Theory in economics. Coase’s famous observation in economics states that in the absence of any transaction costs, it is immaterial how the rights in a particular property are initially allocated. Regardless of the initial allocation, the contracting parties or the stakeholders, through bargaining, will reach a Pareto optimal allocation of those rights. A Pareto optimal allocation is a state of allocation of resources in which it is impossible to make any one individual better off without making at least one individual worse off. Haddock and Macey connect this to the problem of insider trading regulation by arguing that the debate over insider trading is essentially one of allocation of property rights in corporate information. Legalization of insider trading implies allocating those rights

to the insiders. On the other hand, prohibition of insider trading amounts to allocating those rights to the company itself.

Thus, they envisage a regime wherein the various stakeholders such as the shareholders and the company managers are able to negotiate and bargain among themselves as to the allocation of property rights in corporate information.\textsuperscript{21} If the ultimate allocation is with the company itself, such a company would prohibit insider trading by its executives. If the final allocation rests with the executives, such a company would permit its executives to engage in insider trading. The Coase Theorem implies that the ultimate allocation would be Pareto optimal.

Based on their analysis, Haddock and Macey conclude that whether a particular company may or may not prohibit insider trading would depend on two factors - whether the executives are risk averse and who stands next in line after the executives as the second best processors of information.\textsuperscript{22}

If the executives are risk averse, they themselves would give up the privilege of insider trading (as the returns from the same are uncertain) and settle for a stable and higher compensation package instead. Next, if the shareholder group contains an unusually large number of investors who are particularly knowledgeable about the company, they would prefer to prohibit insider trading. If insider trading is prohibited, they would be the next best group to exploit their informational advantages, and reap the entire gains from their informed trading.

In other words, Haddock and Macey also advocate an opt-out regime for the companies. On their view, the insider trading prohibition is not only unnecessary, but it acts as an impediment for the shareholders and the executives from freely reaching the most optimal bargain. In this context, they point to the lack of demand for any ban on insider trading from the companies.\textsuperscript{23}

\textsuperscript{21} Id. at 1467.
\textsuperscript{22} Id. at 1468.
\textsuperscript{23} Id. at 1466.
Again, this proposal is susceptible to the same objections as raised against the opt-out proposal by Carlton and Fischel. In particular, it is important to remember that the Coase Theorem applies only under the assumption of a complete absence of transaction costs. However, as noted earlier, the modern company is characterized by the separation of ownership and management. The management of the company is in the hands of the professional executives. Big institutional investors such as mutual funds, pension funds and insurance companies have the expertise and wherewithal to monitor the company. On the other hand, retail investors lack the necessary resources to monitor these companies. This creates significant information asymmetries between the executives and the shareholders on the one hand, and between the institutional shareholders and the retail shareholders on the other. This suggests that there could be significant transaction costs for these shareholders for obtaining and processing the necessary information. This would violate the basic “no transaction costs” assumption. Thus, any bargaining process between the stakeholders for the allocation of property rights may not reach a Pareto optimal outcome.

2.1.6 Henry G. Manne Returns – Insider Trading Improves Corporate Governance

A series of corporate accounting scandals rocked the United States and indeed the entire world in the early twenty first century. Enron, WorldCom and a number of other corporations were found to have indulged in accounting fraud and manipulation which apparently went undetected for several years. When the scandals exploded, the investors suffered losses as a result of a severe drop in the prices of these companies’ shares. This phenomenon breathed a new life into the ongoing policy debate regarding the insider trading prohibition.

In 2005, Henry Manne offered a new perspective on the possible benefits of insider trading.\(^\text{24}\) In this article, he reiterates his earlier claim that insider trading makes the markets more efficient, it acts as an effective executive compensation scheme and the activity has no identifiable victims.

However, the new argument here is that insider trading can be an effective tool for ensuring better corporate governance. He begins his analysis by noting that prior to the SEC getting involved in the enforcement of the insider trading prohibition, very few companies in the United States had any rule against insider trading. Further, there is no significant or convincing evidence that any company or its spokespersons or large shareholders ever pushed for public regulation of insider trading when it was surely widely known that it was going on. With a reference to a famous Sherlock Holmes story, he terms it the mystery of “the dog that did not bark”. His line of argument here is that this complete lack of initiative on the part of corporate actors to lobby for a prohibition on insider trading implies that these actors do not perceive insider trading to be harmful, or even perceive it to be beneficial.

Manne attempts to give a solution of this mystery by drawing on the work of the economist Friedrich Hayek. Hayek worked on the economic role of information in society. Hayek says that the most important task of an economic system is not the efficient allocation of goods and services. If the necessary knowledge of relative values were available, those calculations would in theory not be so difficult. According to Hayek, the problem faced by a centralized socialist planner are more practical. In real life, the required information is available in dispersed, fragmented form with various entities and individuals. The organization and management of these bits of information is, according to Hayek the most challenging task for a central economic planner. In contrast, in the context of decentralized competition, this problem does not arise. In a decentralized system, the decisions are left to the individual actors directly involved in the process.

Manne then applies the insights from Hayek’s work to the problem of insider trading prohibition. Top executives of any company would need accurate and continuous information to run the company. They obtain this information from a variety of internal sources / documents - accounting and statistical data and written and oral reports from subordinates. They also obtain information from their legal advisors, auditors and other specialists. A fair part of this information would be irrelevant,

25 Id. at 174.
26 Id. at 167.
27 Id. at 177.
biased or even plain wrong. Moreover, Manne argues that by definition, any information obtained otherwise through firsthand experience is bound to be delayed and therefore stale. However, unlike in case of economic planning, completely decentralized decision making is not a feasible alternative for running a company.\textsuperscript{28} Thus, \textit{prima facie}, a company executive must live with the possibility that the information she receives is stale, biased or both.

Manne’s response to this problem is allowing insider trading. He argues that in the corporate setting, insider trading is functionally equivalent to decentralized decision making. To take one example, assume the top management of Company A is considering acquiring Company B. A small task force of the executives of Company A has presented a rosy scenario of the synergies that will result from the acquisition. In reality, informed and knowledgeable executives within the company know that the transaction is value destructive. Manne’s argument here is that if insider trading is freely permitted, people in the know would start selling the shares of Company A. Now if the price of Company A’s shares start falling precipitously, it may be an indirect signal that the proposed acquisition is not as valuable as it is made out to be. But this conclusion would be valid only if the shares are being sold by someone who knows more about the acquisition than the top management.

Similarly, assume that a group of employees learns of an accounting fraud in a company. If they are allowed to trade on this, the share prices may decline substantially and alert the top management, investors and even regulators to a potential problem. This might lead to an investigation and an early discovery of fraud.\textsuperscript{29}

On this view, allowing insider trading is a way the employees can send a timely, unbiased alert to the top management. Insider trading can be a substitute for whistle blowing. It may even be more efficient as here the whistle blowers (insider traders trading on bad news) remain anonymous and can avoid personal embarrassment and recriminations. The profits that they earn (or the losses that they avoid) on such insider trading is simply their reward for whistle blowing!

\textsuperscript{28} \textit{Id.} at 178.  
\textsuperscript{29} \textit{Id.} at 180.
2.1.7 Kristoffel Grechenig – Insider Trading on Negative Information

Grechenig further develops this argument. He argues that making a distinction between insider trading on good and bad information also makes sense from an efficiency perspective. The insiders will be eager to convey any good information to the top management and the market for monetary and reputational reasons. They would be equally be reluctant to convey any bad information. Allowing insider trading on bad information solves this problem as the information that is not directly disclosed would indirectly get incorporated into the share prices, and alert top management and the market.

Grechenig further argues that such a distinction is already recognized in the current insider trading law in the United States, albeit only implicitly. To support this assertion, he refers to the US Supreme Court opinion in Dirks v SEC. Raymond L. Dirks was a professional investment analyst who provided investment advice to many institutional clients. He was tipped by a former officer of a company named Equity Funding of America regarding a massive fraud inside the company. Based on the tip, Dirks did his own investigation and passed on the information to SEC and the Wall Street Journal. He also informed several of his clients who sold their shares in the company before any public disclosure of fraud. They were thus able to avoid substantial losses.

SEC charged Dirks with insider trading and censured him. The case reached the Supreme Court. At that point of time, the US Supreme Court had adopted the classical doctrine of insider trading prohibition with an add-on doctrine of tipper – tipee liability. According to this doctrine, a tipee who gets material, non-public information from an insider and trades on the basis of that is guilty of violating the insider trading prohibition if two conditions are fulfilled. The insider tipper must have breached her fiduciary duty in passing on the information and the tipee must have known or has had reason to believe that the tipper was so breaching her duty. In Dirks, the Court held that, in tipping cases, the tip involves a fiduciary breach “if the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain,

there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.” 32 Since the Court concluded that there was no personal benefit to Dirk’s tipper, there was no fiduciary breach on his part, and no derivative breach by Dirks. The Court explicitly stated that “the central role that [Dirks] played in uncovering the fraud at Equity Funding . . . is an important one. Dirks’ careful investigation brought to light a massive fraud . . . . But for Dirks’ efforts, the fraud might well have gone undetected longer.” 33

Grechnig interprets this opinion in terms of an implicit recognition by the Court that insider trading on positive news is illegal while insider trading on negative information is legal. But the Court framed its analysis in terms of whether a fiduciary duty is violated, which in turn depends upon whether there was an element of personal benefit for the tipper or not. Grechnig seems to assume that this personal benefit requirement will always line up with positive information, while the no benefit situation will be coextensive with negative information.

However, this assumption seems to be problematic. The Court makes it clear that the personal benefit does not mean only immediate pecuniary gain but also covers other things such as a reputational benefit that will translate into future earnings. The personal benefit may be direct or indirect. 34 An insider may pass on negative information to an institutional investor in exchange for money and the investor may sell company shares based on this information. Such tipping and trading is clearly prohibited under Dirks, notwithstanding the fact that the impugned information is negative information. This is because the tip was for a direct personal gain and therefore a breach of fiduciary duty by the insider, and the investor knew that the information was disclosed in breach of such duty. In addition, Dirks also held that a gift of the confidential information by the insider to a friend or relative also would constitute a breach of duty, regardless of whether the information was positive or negative. This case is discussed in greater detail in Chapter 3.

32 Dirks, 463 at 661-62.
33 Dirks, 463 at 659 n.18.
34 Dirks, 463 at 663-64.
Thus Grechnig’s thesis that the US Supreme Court implicitly accepted the positive / negative information distinction in the insider trading context does not seem to be correct. Rather, in order to ascertain the legality of tipping trading on negative information in a particular instance, one must investigate the precise motivation of the tipper in the first place. The benefit requirement (or gift element) enunciated by the Court and the nature of information (positive / negative) are conceptually distinct.

There is a more fundamental problem with permitting insider trading on negative information. This may enable people responsible for the fraud to benefit out of it, through insider trading! One response to this could be to restrict trading by those who are not responsible for the fraud. This solution suffers from the attribution problem mentioned earlier. At least in the short run (and sometimes even in the long run), it may not always be possible to attribute the fraud to a particular group of employees.

Bainbridge\(^\text{35}\) notes another problem with this proposal. Allowing insiders to trade on bad news is equivalent to granting them a put option on the corporate value. A put option enables the holder to profit from any upward movement in the value of the underlying, while protecting her from any downside. If the project undertaken by a managerial team succeeds, the team members would gain through enhanced monetary compensation and other intangible benefits such as enhanced reputation and greater bargaining power in the labour market. If the project fails, they can sell the company’s shares before the news of the failure reaches the market. This would help them reduce any monetary and non-monetary loss they might suffer within the company (no pay hike, reduced chances of promotion, damage to reputation). They may even profit from shorting their shares.

Bainbridge also notes that mangers may follow policies that make the stock price more volatile, as a volatile market creates more opportunities for profitable insider trading. The mangers can simply buy at the lower end and sell at the upper end. They may select risky projects because if the project succeeds, they capture a portion of the

gain. If the project flops, the shareholders bear the loss, but the managers again gain through insider trading.

Thus, allowing insider trading on negative information can create perverse incentives for the managers and have perverse consequences for the company.

This completes our discussion of the major arguments advanced in academic literature for complete or partial legalization of insider trading. On the other hand, a number of arguments have been advanced to make out a case for the prohibition of insider trading, and indeed its strict enforcement. However, there is a fair amount of disagreement over the precise rationale behind prohibiting insider trading. We will now turn to the analysis and evaluation of those arguments.

2.2 ARGUMENTS AGAINST LEGALIZATION OF INSIDER TRADING

2.2.1 Roy A. Schotland – Moral and Economic Arguments

Immediately after Manne presented his defense of insider trading in 1966, Schotland published an article attempting to refute Manne’s arguments. In this article, Schotland explains what, according to him, is wrong with insider trading.

He claims that Manne’s defense of insider trading based on economic considerations is full of flaws, which invalidate the entire thesis. Secondly, even if we ignore these flaws, he reminds us that while enacting the Securities Exchange Act of 1934 (SEA), the United States Congress has clearly expressed its overriding concern for fairness. SEA mentions “fair dealing” and “fair and orderly market” in several of its Sections. Similarly, protection of investors is a primary goal of the Act.

Thus, he argues that Manne relies on purely economic analysis and completely banishes any moral and legal considerations from his arguments. Even if unbridled...

37 Id. at 1438.
insider trading results in economic gains, we may still want to prohibit it if it helps us achieve certain noneconomic goals such as fairness, just rewards and integrity.®

However, this argument seems to be a case of question begging, as discussed earlier. In order to establish that insider trading is immoral in the first place, one would have to specify the nature of harm caused by insider trading. If it does not harm anybody, in what sense can it be termed immoral? Similarly, one would need to argue in what way insider trading adversely impacts the fairness or integrity of the securities market. If one simply starts with the a priori assumption that insider trading is immoral, unfair and against the market integrity, the question answers itself!

Further, Schotland criticizes Manne for casting the question in terms of black and white - either insider trading should be freely permitted or it should be totally banned. Having miscast the issue, Manne then improperly shifts the burden of proof on those who advocate the prohibition on insider trading. According to Schotland, since the insider trading prohibition was well established under US law by that time, the burden of proof is actually on those who seek a change in the legal position.®

As discussed earlier, while Manne was an absolutist in his position on insider trading, later scholars have attempted to engage in a nuanced analysis of the issue and identify conditions under which insider trading may be beneficial and therefore should be permitted. Thus, this particular criticism by Schotland seems to have been addressed by these later scholars, if not Manne himself.

Schotland further argues that Manne’s argument is erroneous, even as a matter of economics. He offers the argument that insider trading hurts the long term investor.® Assume an investor bought a company’s shares ten years back at Rs. 10. Now the market price is Rs. 100. However, there is some positive, as-yet-undisclosed information which, once announced, would drive up the price to Rs. 110. The investor had a long term view on the company and waited patiently for ten years to cash in her returns. Now if she sells before the announcement of the positive information, she has

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38 Id. at 1438-39.
39 Id. at 1439.
40 Id. at 1448.
been deprived of that extra Rs. 10 “hidden” in the undisclosed information. He also supplements this analysis with a further appeal to the fairness argument. He claims that it is the long term investor who has the greatest expectation that the securities market is fair.41

However, this analysis does not appear to be persuasive. The only way to ensure that the long term investor always gets the right price (Rs. 110 here) is to compel the companies to make an instant disclosure of all market-moving information. But the law does not stipulate that, as in many cases, there are sound commercial reasons for the companies to keep some information confidential for at least some time. Meanwhile, if the insiders abstain from trading, the price would surely stay at Rs. 100 anyway. In fact, if insider trading is permitted, the price would move up at least partially (say Rs. 104), so the long term investor is still better off, as compared to the position she would be in, without any insider trading. This also answers the fairness objection raised above. Apart from any inchoate, subjective notion of fairness that the long term investor may hold, there is no clear sense in which insider trading has resulted in an unfair outcome for her.

Schotland also offers other economic justifications for prohibiting insider trading. These justifications are in terms of the perverse incentives that opportunities for insider trading may create. First, he argues that allowing insider trading makes improper delay of disclosure more likely.42 This would defeat the very purpose of enacting securities law, whose major cornerstone is a prompt (subject to confidentiality concerns) and accurate disclosure to the market.

Second, allowing insider trading also increases the possibility of unlawful manipulation by the insiders to create good or bad news tailored to their imminent trading plans.43

Finally, Schotland also notes the moral hazard problem implicit in insider trading on bad news.44 Moral hazard45 can be defined as dishonesty or character defects in an

41 *Id.* at 1451.
42 *Id.* at 1448.
43 *Id.* at 1449.
individual that increases the frequency or severity of the loss. In the context of insider trading, since insider traders can profit from an adverse development, they may have the tendency to take decisions that destroy corporate value.

Considered from another angle, if insiders can trade on bad news and earn profits out of that, it is equivalent to giving them extra compensation for a managerial failure. There is no justification for allowing this and indeed a strong justification for prohibiting this practice.

These economic justifications for prohibiting insider trading – preventing improper delay of disclosure by the companies, minimizing the incentives for manipulation and addressing the moral hazard problem – indeed seem to be persuasive. However, it must be noted that all these arguments steer the issue away from the usual fairness considerations and alleged direct harm to the counterparty. Rather, the first two arguments cast the issue in terms of the possible indirect harm to the entire market. The third consideration addresses the harm to the company itself. Allowing insider trading on bad news is an improper form of managerial compensation, with its attendant moral hazard problem. This consideration focuses solely on the harm caused by insider trading to the company itself.

2.2.2 Donald Arthur Winslow & Seth C. Anderson – A Sporting Response

Winslow and Anderson draw an analogy with professional sport to drive home the significance of the moral hazard issue.\(^\text{46}\) In the context of horse racing, the jockey is prohibited from betting on the outcome of the race she is participating in. If she is allowed to bet against her own mount, she might be tempted to throw away the race.\(^\text{47}\) This is an exact parallel to the insiders trading on bad news about their company. Of course, in case of a horse race, the outsiders are allowed to bet on the outcome – which is probably the whole point behind organizing the race!

\(^{44}\) Id. at 1453.

\(^{45}\) GEORGE E. REJDA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 5 (10th ed. 2008).


\(^{47}\) Id. at 297-98.
But Winslow and Anderson go a step further and argue that the insider trading prohibition should be more general, applying to insiders as well as outsiders (if they come in possession of non-public information regarding a company). In this respect, they liken the prohibition to that found in baseball, instead of a more limited proscription such as that found in horse racing. They argue for it so as to preserve the appearance of propriety and address other similar concerns. But here their argument seems to run up against the same question begging objection. It would be first be necessary to answer the question why insider trading is improper (or appears to be so) and also to articulate the precise concerns raised by insider trading.

Therefore, their argument seems to provide support for a very limited proposition – insider trading should be prohibited only by insiders. Actually, it is arguable that it should apply to a small subset of insiders – those in decision making positions (since only such insiders are in a position to “throw” the game) and that too with the limited purpose of minimizing the moral hazard problem.

2.2.3 Robert J. Haft – Insider Trading Harms Internal Corporate Efficiency

Haft approaches the “harm to the company” problem from another perspective. He frames the issue in terms of the harm that insider trading may cause to the efficient working of the large organizations.48 He observes that the correctness of business decisions depends directly on the accuracy, quality, and timeliness of the information on which they are based. Further, in large companies, the information must necessarily pass through several levels of hierarchy. As such, the information as it passes upward is vulnerable to distortion. The personal biases and self-interests of the employees further exacerbate the problem.49

The top management may seek to counteract this effect by carefully filtering any information that comes to them, for any possible biases or distortion. This, however, may not be always possible.50

49 Id. at 1053-54.
50 Id. at 1054.
According to Haft, the most common response to information distortion in large organizations is to delegate decision making downward – to the specialists or to the employees closer to the relevant information. Haft argues that delegation is the most efficient way of addressing the information distortion problem in large organizations. This is because the unit closest to the scene is the most knowledgeable, its reaction time is short, and its reaction mode is highly programmed.\(^\text{51}\)

Haft argues that if insiders are permitted to trade on the basis of inside information, it would stall the flow of free information within the organization. The insiders will buy the company’s shares before transmitting upward any good news about the company, and sell before transmitting upward any bad news. Further, profit maximizing insiders may even try to arrange for borrowed funds (in order to buy securities) or securities (in order to short these) so that they can maximize their trading profits. Such borrowing would carry little risk, since the insiders by definition are trading on the basis of inside information. They may even tip their friends and relatives. This would cause a substantial delay in the transmission of information at one level. In the context of a large organization, the combined delay at several levels would even be longer and may prove fatal from the viewpoint of timely and effective decision making.\(^\text{52}\)

Interestingly, this conclusion directly contradicts Manne’s argument considered earlier\(^\text{53}\) that permitting insider trading can actually be a substitute for whistle-blowing mechanism, and enhance the quality and accuracy of information flow to the top management and even the market.

Haft notes another problem with permitting insider trading.\(^\text{54}\) He notes that any significant positive development is usually a product of team work. If insider trading is permitted as an effective form of compensation, identifying the contribution of each member is essential. However, in practice, the members of the team may form alliances and strike side deals\(^\text{55}\) to capture the maximum possible insider profits. This

\(^{51}\) Id.  
\(^{52}\) Id. at 1055.  
\(^{53}\) Manne, supra note 24.  
\(^{54}\) Haft, supra note 48, at 1056.  
\(^{55}\) Id. at 1063.
would adversely impact the cohesiveness of the team, again impacting the internal efficiency of the organization.

Haft concludes that his argument establishes that insider trading injures the company in every case.\(^{56}\) This line of argument focuses exclusively on the adverse effect of insider trading on the internal affairs of the company and treats the company itself as the injured party. Therefore, Haft concludes that the prohibition of insider trading properly belongs to corporate law (which in the United States is under the states’ jurisdiction). The federal securities law should have no role to play here.\(^{57}\)

Of course, in India, this concern is not relevant. The Indian Parliament has the necessary legislative competence to enact laws on both subjects. Article 246(1) of the Constitution of India\(^ {58}\) read with Entries 44,\(^ {59}\) 48\(^ {60}\) of and 97\(^ {61}\) of List I (Union List) in the Seventh Schedule confer on Parliament the exclusive power to enact laws with respect to both corporate and securities law. Further, as a practical matter, there is no sharp division of enforcement powers related to corporate and securities law either. While Section 195 of the Companies Act, 2013 contains a prohibition against insider trading, the powers to enforce the prohibition have been delegated to SEBI in the context of listed companies or the companies which intend to get their securities listed on a stock exchange.\(^ {62}\)

However, there is a more substantive issue implicated here. As Haft points out, if insider trading merely adversely impacts the internal efficiency of the companies, then the proper remedy here is a shareholder’s derivative suit against the inside trader, with the recovery going to the company.\(^ {63}\) In that case, the severe civil\(^ {64}\) and criminal\(^ {65}\)

\(^{56}\) Id. at 1067.
\(^{57}\) Id.
\(^{58}\) 246. Subject-matter of laws made by Parliament and by the Legislatures of States.—(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the “Union List”).
\(^{59}\) 44. Incorporation, regulation and winding up of corporations, whether trading or not, with objects not confined to one State, but not including universities.
\(^{60}\) 48. Stock exchanges and futures markets.
\(^{61}\) This Entry empowers the Parliament to make laws with respect to any of the matters not enumerated either in List II (State List) or List III (Concurrent List) of the Seventh Schedule.
\(^{62}\) Section 458(1) of the Companies Act, 2013.
\(^{63}\) Haft, supra note 48, at 1068.
penalties provided for insider trading under SEBI Act, 1992 seem to be totally inapposite.

Further, in such a case, the amount of recovery should be limited to the extent of financial loss suffered by the company on account of the delay of transmission of information and the resultant loss in corporate efficiency. The amount of profits made / losses avoided by the insider trader through her trading become irrelevant.

Moreover, if the insider is able to demonstrate that there was no delay in information transmission, there should be no right of recovery. For example, an employee on learning some positive news about the company, may execute a trade through her online trading account, and immediately pass on the information. In such a case, it is hard to see what efficiency loss the company has suffered, as a result of a few minutes’ delay in the transmission of information.

Therefore, Haft offers a powerful reason for regulating insider trading. But his arguments clearly do not support much of the current insider trading prohibition regime, with its strict liability provisions and severe penalties. Rather, his position implies a regime wherein insider trading is treated as an internal corporate issue – the subject matter of a private suit between the insider and the company (or derivatively the shareholders). The company (or derivatively the shareholders) could seek compensation from the inside trader for the efficiency harm suffered by the company, contingent on the company actually being in a position to establish the harm.

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64 15G. Penalty for insider trading.- If any insider who,- (i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or (ii) communicates any unpublished price- sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or (iii) counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price-sensitive information, shall be liable to a penalty of twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher.

65 24. Offences (1) Without prejudice to any award of penalty by the adjudicating officer under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules or regulations made thereunder, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.

(2) If any person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any of his directions or orders, he shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.
2.2.4 William K.S. Wang – Insider Trading Not a Victimless Crime

Wang66 questions the assumption that insider trading is a victimless activity. As the title of his article suggests, he draws a parallel with the fraud in the sale of a used car to explain his point. He begins his analysis by making a distinction between the sale of a used car with the solitary defect and that with the generic defect. Suppose a person owns a particular model (in Wang’s example a 1998 Cadillac). She discovers a defect in the particular car that she owns. Still, she sells her car to a car dealer and sells it at the going price (for good quality 1998 Cadillacs) for $25,000. She does not reveal the defect in that particular car, or even lies about it. The dealer never discovers the defect. The dealer, in turn, resells the car to another buyer.67

It is only this particular 1998 Cadillac which is defective. If the original seller had not sold her defective car to the dealer, the dealer would not have been able to resell it to the other buyer. Wang concludes that the victim of this transaction is the ultimate buyer.68 Thus, in case of the solitary defect example, the ultimate counterparty to the chain of transactions is clearly the victim. Wang argues that this situation is akin to a face-to-face securities transaction. One party may have non-public negative information regarding a security. It may sell the security to a buyer in a face to face transaction without disclosing, or even lying about the negative information (defect) regarding the security. In this case, it can be clearly seen that the buyer is the victim.69

Wang then turns to the generic defect example, which according to him is analogous to anonymous stock market insider trading. In this case, the person who owns a 1998 Cadillac learns the material, non-public information that all 1998 Cadillacs have a major defect. She again sells her car to a car dealer at the going price of $25,000. The dealer in turn sells it to another buyer. Now the news regarding the generic defect becomes public, and the market price of all 1998 Cadillacs falls to $10,000.

Wang’s conclusion here is that the ultimate buyer is not the victim of this sale. She was in the market looking for a 1998 Cadillac. She could have purchased it from

67 Id. at 31.
68 Id. at 32.
69 Id. at 30-31.
another seller (who possibly did not even know about the generic defect) and anyway got stuck with a defective car. Thus, she is no way worse off simply because she happened to buy it (indirectly) from a seller who knew about the defect.\footnote{Id. at 32.}

This analysis provides one more argument that in the context of anonymous stock market trading, the counterparty to the insider trader is not the victim. The counterparty would have anyway bought the security from another trader (who was possibly ignorant of the non-public information) at the same price. Calling the counterparty the victim simply because her trade happened to be matched with that of the insider trader is purely fortuitous.

However, Wang argues that from this one cannot conclude that each act of insider trading has no specific victims. Continuing with the generic defect example, after the seller sold her car to the dealer, the dealer may have lowered the price at which she was willing to buy and sell that particular model, in order to clear the extra inventory. That lower price itself may induce a person to buy a car from the dealer, in which case the dealer’s inventory is back to the original level. On the other side, the lower price may dissuade a potential seller from selling her car to the dealer. However, if the reduced price neither induces a person to buy nor does it dissuade a person from selling, the dealer would be stuck with that extra inventory, as a result of the original transaction. Wang concludes that even in this case, there is only one victim - either the dissuaded seller or the induced buyer or the dealer. In practice, it is difficult to ascertain whether there was any such buyer / seller and if so, who they are. Therefore, in practice it may be difficult to figure out the identity of the victim in a specific case.\footnote{Id. at 34-35.}

There are three points that can be made with respect to this analysis. First, Wang makes the questionable assumption that a marginal change in the price of a car would induce buyers or dissuade sellers from entering into transactions.

More important, the analogy with a used car may not be apt. In the context of securities trading, the market may actually interpret a decline in price as a signal that

\footnote{Id. at 32.}
\footnote{Id. at 34-35.}
an adverse development has occurred. This may dissuade potential buyers from entering the market. Similarly, a price rise may well alert the market to the existence of non-public, positive information, which in turn may attract buyers. To the extent insider trading has any signaling effects, these drive the trading behavior in the correct direction. Such dissuaded (or induced) buyers would actually be beneficiaries of insider trading, contrary to the used car example.

Finally, by definition Wang’s analysis only covers insider trading on negative information (defect). As such, this analogy cannot be employed to analyze insider trading on positive information.

2.2.5 George W. Dent – Disastrous Effects of Insider Trading

Dent subjects insider trading to the most severe criticism by claiming that legalized insider trading would be a disaster.\(^{72}\) He uses counterfactual analysis to explain his point. He assumes that insider trading is legalized and explores the consequences of such legalization.

If insider trading is legalized, the insiders would freely seek outside borrowing for their financing. Since they trade on non-public information, their trading is less risky and so outsiders will be more willing to finance them. The insiders can even launch an Insider Trading Equity Fund (ITEF) and sell units in the same to the outside investors. Such a fund would be able to consistently beat the market.\(^{73}\)

In the alternative, insiders could sell their information. An investment company could create a public Tipee Trading Fund (TTF) and pay insiders for information on which the fund would then trade. This would save insiders the time and expense of trading through their own accounts.\(^{74}\) Also, such a fund would be able to offer a higher return to investors due to trading on non-public information and savings on research costs (research is simply not necessary!).

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\(^{73}\) *Id.* at 252-53.

\(^{74}\) *Id.* at 255.
Dent argues that such legalized, pervasive insider trading would have harmful effects on the stock market. To compensate for the gains siphoned off by insiders, the outsiders will increase their bid-ask spread. They would lower the price at which they are willing to buy and increase the price at which they are willing to sell. This would interfere with the process of discovery of accurate prices. Insider trading would also reduce market depth and liquidity as outsiders would be less willing to participate in such a market. He says that stricter insider trading bans are associated with wider stock ownership, better stock price accuracy, and deeper market liquidity. 75

Dent concludes that legalized insider trading would mean that public trading in stocks would essentially cease. There would be no stock market; there would be no publicly traded companies. Ironically, legalizing insider trading would lead to the extinction of public stock markets and of insider trading itself. 76 Such extinction of public markets, of course, would mean less liquidity for the investors. The cost of raising finance for the companies may go up, as investors would demand a discount for the lack of liquidity. This would also have serious consequences for the capital formation process in the economy.

2.2.6 James D. Cox – Insider Trading and the Dog That Did Not Bark
Cox 77 looks at the puzzle of the dog that did not bark that was discussed earlier. 78 He says that the lack of initiative from the corporate sector to prohibit insider trading does not necessarily mean that it does not harm the companies. He argues that the managers enjoy a natural bargaining advantage over the remote owners (the shareholders). 79 He also notes the well known collective action problem in this context. Each shareholder will receive only a small benefit proportionate to her shareholding, while the cost of bargaining with the managers will be high. Therefore, no shareholder has the necessary incentive to conduct the bargaining process in order to prohibit trading by company insiders. 80 In his view, this is the reason why no

75 Id. at 262.
76 Id. at 263-64.
78 See supra note 26 and accompanying text.
79 Cox, supra note 77, at 657.
80 Id. at 656.
company takes an initiative in prohibiting insider trading, in spite of its adverse effects on corporate functioning.

2.2.7 Jesse M. Fried - Insider Trading via the Corporation

Fried argues that insider trading has the effect of diverting value away from public shareholders. He estimates that that such trading puts at least several billions of dollars into the pockets of insiders each year. This diversion of value reduces public investors’ expected returns and increases firms’ cost of capital. 81

He also notes that opportunities for insider trading may weaken and distort the managerial incentives. In this context, he mentions the moral hazard problem discussed earlier wherein managers can benefit from destruction of firm value. Second, insiders may run the company in such a way so as to improve the short-term performance of the company at the expense of long-term economic value. 82

His argument is that the current insider trading prohibition on insider trading in the US is incomplete. A significant shareholder who holds, say 20% shares in the company can indirectly trade on insider information. She can do so by getting the company to buy back its shares when these are undervalued, through Open Market Repurchases (OMRs) and to sell its shares when these are overvalued, through At the Market (ATM) issuances wherein a company may quietly, over a period of time sell its shares through the stock market without disclosing its identity. According to him, this indirect insider trading has the same adverse consequences as direct insider trading. The only difference is that the indirect trader would retain only a proportionate (in our example 20%) gain. His proposal is to subject trading by a company on its own shares to a strict disclosure regime, so as to reduce the potential for and profitability of such trading. 83

While his argument may be valid in the US context, this may not currently be a big concern in India. In India, the buyback of shares by the companies was first permitted

82 Id. at 807.
83 Id. at 839.
in 1998. It is governed by a comprehensive and strict regulatory regime. Further, the companies are required to extinguish the shares within seven days of the last date of completion of buy-back. Thus, the concept of treasury stock whereby a company buys back its shares and keeps them for reissue at a later date does not exist in India. Similarly, a listed company selling its newly issued shares through ATM route is currently not recognized in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

2.3 CHAPTER SUMMARY AND CONCLUSION

The question whether insider trading must be prohibited and if so, under what conditions is one that continues to be debated in the literature.

It has been argued that one benefit of permitting insider trading is that it can work as an effective executive compensation scheme. On closer examination, however, the argument does not stand scrutiny. The proposal has serious downsides in terms of the attribution problem, moral hazard, perverse managerial incentives and corporate governance issues.

Another argument in favour of permitting insider trading is that it drives the securities prices closer to their efficient value and improves the capital allocation process in the economy. *Prima facie*, this argument seems to have merit, and requires careful consideration. Thus, any policy and doctrinal foundation for the insider trading prohibition has to squarely deal with it. This issue is taken up in Chapter 6.

However, one important point that the argument brings out is that the counterparty to the insider trader is not the injured party. In fact, she may actually benefit by being able to execute the trade closer at a more favourable price.

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84 Section 77A of the Companies Act, 1956 and SEBI (Buy Back of Securities) Regulations, 1998.
85 Section 68 of the Companies Act, 2013.
86 Section 68 (7) of the Companies Act, 2013.
It has also been argued that insider trading can act as an effective substitute for whistle blowing. However, it may give rise to perverse incentives for the insiders. This may enable the people responsible for the fraud (or in general, any corporate value destructive decision) to benefit out of it through insider trading on such information. It may allow them to benefit from any positive news (by way of higher salary, better career opportunities) while at the same time protecting them against any downside (through insider trading on negative information) and induce them to follow policies that increase the volatility in company share price.

One argument that is advanced in favour of prohibiting insider trading is that it is unfair. However, the proponents of this view have not been able to articulate a clear sense as how and to whom it is unfair. Another family of argument focuses on the harm caused to the company itself such as the moral hazard problem and the loss of corporate efficiency. However, these arguments do not seem to support much of the current insider trading regime with its strict liability and severe civil and criminal penalties. Rather, the prohibition of insider trading becomes an internal corporate governance issue – much like the Related Party Transactions (RPTs).

Finally, yet another line of argument focuses on the harm to the entire market and the economy – insider trading would increase bid-ask spreads, reduce market depth and liquidity, raise the cost of capital for companies and impede the process of capital formation in the economy. This argument definitely locates the insider trading prohibition as part of securities law, as the above mentioned harms directly implicate the interests of the investors and the development of the securities market – the core mandate of securities market regulation.

As is to be expected, this policy level controversy regarding the need for and rationale behind prohibiting insider trading has translated into a multiplicity of legal doctrines underlying the insider trading prohibition. In the next chapter, we turn to a detailed discussion of the evolution of those doctrines in the US. The discussion in this Chapter regarding the policy debate will be relevant in an assessment of those doctrines in Chapter 5 as well as in the course of discussing the proposal for an appropriate policy and doctrinal foundation for the insider trading prohibition in Chapter 6.