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Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox

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Selective Disclosure by Issuers, Its Legality and Ex Ante Harm:

Some Observations in Response to Professor Fox

WILLIAM K.S. WANG*

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I. INTRODUCTION

My friend and law school classmate, Professor Merritt Fox, recently published an excellent article, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*.¹ Professor Fox's article has three objectives:

* Professor, University of California, Hastings College of Law. B.A. Amherst College; J.D. Yale Law School. I would like to thank Professors Steve Bainbridge, Steve Choi, Lynn Stout, and Fred Tung for their valuable comments on my manuscript. I also greatly appreciate the help of my research assistant, Linda Sekigahama.

1. Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*, 41 VA. J. INT'L L. 653 (2001).

(1) to analyze whether Regulation FD's prohibition of selective disclosure should apply to foreign issuers listed in the United States,²

(2) to explore the implications of the SEC's exemption of foreign issuers from Regulation FD on the Commission's fairness justification for applying Regulation FD to domestic issuers and the fairness justification for other requirements of federal securities regulation,³ and

(3) to describe a future study comparing the two sets of issuers listed in the United States—domestic and foreign—before and after the imposition of Regulation FD on U.S. issuers; the study will use the tools of empirical financial economics to test whether selective disclosure increases or decreases the amount of meaningful information reflected in share prices.⁴ The study assumes that before the effective date of Regulation FD both foreign and domestic issuers were able to engage in selective disclosure; after the effective date, only foreign issuers were able to do so.⁵

Part II of my Article contends that, both before and after the adoption of Regulation FD, an issuer that selectively discloses material nonpublic information may violate SEC Rule 10b-5.⁶ Because my view is contrary to the conventional wisdom,⁷ however, my argument may not affect the validity of Professor Fox's proposed study.

Part III of my piece concerns only Professor Fox's first objective: analyzing whether Regulation FD's prohibition of selective disclosure should apply to foreign issuers listed in America.⁸ To address this issue, Professor Fox poses two questions: "What are the harms and/or benefits

2. *Id.* at 656, 665-84.

When adopting Regulation FD the SEC decided to exempt foreign issuers "at this time." Selective Disclosure and Insider Trading, SEC Release Nos. 33-7881, 34-43154, IC-24599, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,676, 83,691, 83,689, Part II.B.5, text accompanying note 75 (Aug. 15, 2000), available at <http://www.sec.gov/rules/final/33-7881.htm> [hereinafter *Adopting Release*]. See Fox, *supra* note 1, at 655 & n.5.

3. Fox, *supra* note 1, at 658, 684-88.

4. *Id.* at 658, 688-91.

5. *Id.* at 690. The study must also assume that foreign law does not constrain selective disclosure by foreign issuers listed in the United States. For numerous citations to sources discussing the insider trading law of other countries, see WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 14.3 & n.39 (1996 & Supp. 2002) [hereinafter INSIDER TRADING].

6. 17 C.F.R. § 240.10b-5 (2001). For a general discussion of Rule 10b-5, see INSIDER TRADING, *supra* note 5, § 4.

7. See *infra* notes 15-16 and accompanying text.

8. See Fox, *supra* note 1, at 656, 665-84.

that selective disclosure can generate? Are U.S. residents among the persons in the world who experience these effects when a foreign issuer listed in the United States engages in the practice?"⁹

Professor Fox concedes that, if, based on fairness considerations, the answer to the second question is yes, that would justify the SEC's forbidding selective disclosure by foreign issuers listed in this country.¹⁰ Professor Fox also concedes that, based on fairness considerations, selective disclosure by foreign issuers harms U.S. residents *ex post*.¹¹ Nevertheless, he argues that, when appropriately viewed *ex ante*, U.S. residents are *not* unfairly harmed.¹² Part III of this piece contends that selective disclosure by foreign issuers listed in the United States harms U.S. residents both *ex ante* and *ex post*.

Part IV of my piece digresses on another question discussed by Professor Fox: whether the insider trading resulting from selective disclosure results in more accurate prices and improvement in capital allocation.¹³ I briefly give some reasons why such insider trading may not necessarily have these benefits.

Part V is my summary and conclusion.

II. SELECTIVE DISCLOSURE BY ISSUERS MAY VIOLATE RULE 10B-5

Part I of Professor Fox's Article describes the prior history of attempts to regulate selective disclosure.¹⁴ He concludes: "This history appears to have led to the general belief that selective disclosure [by issuers] was legal."¹⁵ Although this statement may be an accurate description,¹⁶ I disagree with the conventional wisdom.

9. *Id.*

10. *Id.* at 656-57, 668-69, 678-84.

11. *See id.* at 665-68.

12. *See id.* at 669-73. Professor Fox also analyzes the effects of selective disclosure by foreign issuers based on efficiency considerations. *See id.* at 656-57, 673-84. He concludes:

[The efficiency impact] will be felt primarily by residents of the issuer's home country, not by U.S. investors. Foreign officials are also more likely to be able to assess accurately the magnitude of the particular [efficiency] costs and benefits of selective disclosure by their issuers. Thus, foreign, not U.S., officials should make the determination as to whether foreign issuers should be prohibited from engaging in selective disclosure.

Id. at 657. *See id.* at 678-84.

13. *See id.* at 660 & n.21, 673-78.

14. *See id.* at 658-62.

15. *Id.* at 663 (footnote omitted).

16. For sources indicating that a corporation that tips for its own benefit does not violate Rule 10b-5, see sources cited in INSIDER TRADING, *supra* note 5, § 5.2.3.3(b) n.83.

For an argument to the contrary, see Bruce A. Hiler, *Dealing with Securities Analysts; Recent Guidance*, 28 SEC. REG. L.J. 180, 182 (2000) ("*Dirks* has been viewed as providing an exception for communications with analysts from normal insider trading principles, but in fact its personal

The corporation has a “classical relationship” with its own shareholders.¹⁷ It cannot trade its own shares based on material, nonpublic information.¹⁸

If corporate trading would violate Rule 10b-5, corporate tipping for an improper “personal benefit” should also be illegal.¹⁹ *Dirks v. SEC*²⁰

benefit test applies to any communications by officials or employees of an issuer who have inside information.”); *id.* at 183 (“The Commission’s general concern over selective disclosure had led to a narrow view of *Dirks*, which counsels extreme caution when attempting to apply *Dirks* to any particular situation.”); *id.* at 191 (“Such conduct [issuer discussion of material nonpublic information with analysts] is risky under insider trading principles in light of the Commission’s recent expressions of concern about selected [sic] disclosure to analysts and the vagaries of the *Dirks* ‘personal benefit’ test, as evidenced by the *Stevens* case.”).

17. See INSIDER TRADING, *supra* note 5, § 5.2.3.3(a). For discussion of the “classical relationship” theory, see *id.*, § 5.2; William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 46-49 (2000).

18. See *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203 (1st Cir. 1996) (dictum) (“Courts, including this one, have treated a corporation trading in its own securities as an ‘insider’ for purposes of the ‘disclose or abstain’ rule.”) (citing *McCormick v. Fund Am. Cos., Inc.*, 26 F.3d 869 (9th Cir. 1994)); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963); *Green v. Hamilton Int’l Corp.*, 437 F. Supp. 723, 728-29 (S.D.N.Y. 1977); *McCormick*, 26 F.3d at 876 (case involved a face to face transaction; opinion broadly stated: “Numerous authorities have held or otherwise stated that the corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them”); *Tse v. Ventana Medical Sys., Inc.*, 1998 WL 743668, at *8 (D. Del. Sept. 23, 1998) (“In the instant action, the acquiring corporation traded in its own securities . . . [b]y asking plaintiffs to become equity shareholders in the acquiring corporation [through a merger] [The] plaintiffs’ complaint adequately states a claim based on defendants’ duty to disclose material information.”) (citing *Voit v. Wonderware Corp.*, 977 F. Supp. 363 (E.D. Pa. 1997)); *Voit*, 977 F. Supp. at 369 (refusal to dismiss plaintiff’s claims against an issuer for insider trading when using its allegedly overvalued shares to acquire another corporation); *Simon v. Am. Power Conversion Corp.*, 945 F. Supp. 416, 425 (D.R.I. 1996) (dictum) (quoting *Shaw*); INSIDER TRADING, *supra* note 5, § 5.2.3.3(a); 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3505 (3d ed. 1991) (“When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose.”); 8 LOSS & SELIGMAN, *supra*, at 3584-85 (“The term *insider* traditionally has been held to include . . . issuers when repurchasing their own stock.”); Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 984 n.31 (1992) (“persons . . . under a duty not to use material non-public information to obtain trading gains include . . . the corporation itself”); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1052 (1990) (“Even after *Dirks*, it has been assumed without serious question that issuers themselves cannot purchase their own securities while possessing undisclosed material information.”); Daniel J. Winnike, *Rule 10b-5’s Effect on Employer Stock Repurchases and Option Cancellations on Termination of Employment*, 19 SEC. REG. L.J. 227, 237-38 (1991) (“[T]here is little doubt that the relationship between a corporation and its shareholders engenders the type of trust and confidence to which the U.S. Supreme Court referred [in *Chiarella v. United States*, 445 U.S. 222 (1980)].”).

19. See INSIDER TRADING, *supra* note 5, § 5.2.3.3(b). See also Hiler, *supra* note 16, at 182, 183, 191 (excerpts quoted *supra* note 16). Cf. Langevoort, *supra* note 18, at 1053 (“The notion of personal benefit might thereupon grow to include all corporate “gifts” of information—any situation where officials of the issuer consciously prefer the interests of one group of shareholders to another.”) (footnote omitted).

held that, under the “classical relationship” theory, an insider/tipper is liable when “the insider personally will benefit, directly, or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.”²¹

To explain the “personal benefit” test, the Supreme Court quoted from an article by Professor Victor Brudney: “The theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself”²² The opinion continued: “there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient.”²³

Suppose an issuer sells material nonpublic information to an analyst for cash. This may be an improper “personal benefit” to the corporate issuer.²⁴

A corporation, as an entity, may obtain reciprocal benefits by tipping analysts.²⁵ This may also be an improper “personal benefit.”²⁶

Dirks also stated that, when an insider tips a relative or friend who trades, “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”²⁷ A corporation’s tip for an improper “personal benefit” is similar to the company’s trading on material nonpublic information and giving the profits to the tippee with the expectation of some reciprocal benefit. *If* the corporation is

20. 463 U.S. 646 (1983).

21. *Id.* at 662. For discussion of the *Dirks* “personal benefit” test, see INSIDER TRADING, *supra* note 5, § 5.2.8; Wang, *supra* note 17, at 53-54. For discussion of the “classical relationship” theory, see INSIDER TRADING, *supra* note 5, § 5.2; Wang, *supra* note 17, at 46-49.

22. *Dirks*, 463 U.S. at 663-64 (quoting Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 348 (1979)).

23. *Dirks*, 463 U.S. at 664.

24. *See id.* at 663 (“whether the insider receives a direct or indirect personal benefit from the [selective] disclosure, such as a pecuniary gain”); *supra* text accompanying note 22 (quoting excerpt from *Dirks*, in turn quoting from an article by Professor Victor Brudney that refers to “selling the information to its recipient for cash”). *Cf.* Langevoort, *supra* note 18, at 1052 (suggesting that most courts would struggle to find some way of imposing liability on a corporation that openly chose to sell its inside information for cash to the highest bidder); Simon M. Lorne, *What’s So Good About Selective Disclosure?*, INSIGHTS, Sept. 1999, at 2, 3 (“Might a public company dole information out to favored suppliers, in the expectation that they will reciprocate with lower supply costs? Might it provide such information to executives in lieu of bonuses? Why not sell it to the highest bidder at private auction?”).

25. *See* INSIDER TRADING, *supra* note 5, § 5.2.3.3(b) & nn.85a, 92j, 92s-92t, 92x-92y, § 5.2.3.7 n.147. *See also* Fox, *supra* note 1, at 677-78.

26. *See* INSIDER TRADING, *supra* note 5, § 5.2.3.3(b), nn.87-88 and accompanying text; Wang, *supra* note 17, at 56. *See also* Hiler, *supra* note 16, at 182-83, 191.

27. *Dirks*, 463 U.S. at 664.

liable for tipping, its tippees may also be liable as participants after the fact.²⁸

As Professor Fox notes,²⁹ the Court's language in *Dirks v. SEC*³⁰ may suggest a reluctance to regulate analysts' use of material nonpublic information because analysts help to preserve a "healthy market."³¹ This language does not negate issuer liability for selective disclosure. First, a concern for analysts would not necessarily apply to other types of issuer tippees, such as institutional or major investors. Second, and more importantly, the excerpt about analysts is dictum.³² As a matter of policy, some commentators have questioned the extent to which analysts should receive special treatment under the insider trading rules.³³

In contrast to the dictum about analysts, the holding of *Dirks*, noted earlier,³⁴ is that, under the "classical relationship" theory, an insider/tipper is not liable unless "the insider personally will benefit, directly, or indirectly, from his disclosure."³⁵

An attempt to finesse the question of issuer liability is to allege that the officer acting on the company's behalf is personally liable because he or she tipped for some *individual* benefit. The SEC took this

28. See INSIDER TRADING, *supra* note 5, § 5.2.3.3(b). For a general discussion of the tippee's participation after the fact in the tipper's violation under the "classical relationship" theory, see *Dirks*, 463 U.S. at 659-61; INSIDER TRADING, *supra* note 5, §§ 5.3.1, 5.3.2.

29. See Fox, *supra* note 1, at 660-62.

30. 463 U.S. 646 (1983).

31. See *id.* at 657-58 & nn.16-18.

32. See *id.* For a discussion of this dictum, see INSIDER TRADING, *supra* note 5, §§ 5.2.3.3(b) n.87, 5.2.3.6 n.139.

33. See Langevoort, *supra* note 18 (discussing and questioning the argument for special treatment); Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1120-24 (1985) (pre-*Dirks* analysis critical of special latitude for analysts); Peter L. Cholakos, Comment, *Company Disclosure of Earnings Projections: Should Individual Investors Be Allowed into the "Ball Park"?*, 39 SANTA CLARA L. REV. 819, 855-65 (1999). But see Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127, 140-46 (1984) (arguing against applying insider trading laws to analysts because of their role as informational intermediaries with accompanying social benefits). See generally INSIDER TRADING, *supra* note 5, § 2.2.2 (discussing whether insider trading enhances stock market efficiency and analysts' role in enhancing such efficiency).

34. See *supra* note 21 and accompanying text.

35. *Dirks*, 463 U.S. at 662. See Hiler, *supra* note 16, at 182 ("*Dirks* has been viewed as providing an exception for communications with analysts from normal insider trading principles, but in fact its personal benefit test applies to any communications by officials or employees of an issuer who have inside information"). For discussion of the *Dirks* "personal benefit" test, see INSIDER TRADING, *supra* note 5, § 5.2.8; Wang, *supra* note 17, at 53-54. For discussion of the "classical relationship" theory, see INSIDER TRADING, *supra* note 5, § 5.2; Wang, *supra* note 17, at 46-49.

approach in *SEC v. Stevens*,³⁶ a case that resulted in a consent decree.

Professor Fox notes: "Research does not reveal any subsequent case in which the SEC tried to utilize this theory again to pursue anyone engaging in selective disclosure or acting on it."³⁷ Nevertheless, during its discussion of issuer liability for selective disclosure, the release accompanying the adoption of Regulation FD cited *Stevens* and said: "[L]iability for 'tipping' and insider trading under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the *Dirks* 'personal benefit' test."³⁸

While discussing the exemption of foreign issuers from Regulation FD, the Commission warned:

[W]hile Regulation FD will not apply, foreign issuers in their disclosure practices remain subject to liability for conduct that violates, and meets the jurisdictional requirements of, the antifraud provisions of the federal securities laws.³⁹

Furthermore, even if the Commission does not do so, *private* plaintiffs may bring civil actions against issuers for selective disclosure based on the "personal benefit" to either the issuer or the officer giving the tip.⁴⁰ Admittedly, the Private Securities Litigation Reform Act has

36. *SEC v. Stevens*, Litig. Rel. No. 12813, 48 S.E.C. Docket 739, 1991 SEC LEXIS 451 (S.D.N.Y. Mar. 19, 1991) (considering SEC allegation that the defendant CEO/Chairman of issuer tipped analysts for personal benefit, but not alleging that the defendant was acting on behalf of issuer to obtain benefit). For discussion of *Stevens*, see INSIDER TRADING, *supra* note 5, § 5.2.3.3(b) & n.89.

37. Fox, *supra* note 1, at 662.

38. *Adopting Release*, *supra* note 2, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,691 & n.87.

While Mr. Richard D. Walker was Director of Enforcement at the SEC, he said the following:

Traditional insider trading liability will also be available where an official of an issuer . . . makes a selective disclosure . . . to an analyst . . . and . . . receives in return a benefit—either a pecuniary benefit or a benefit to his or her reputation.

Richard D. Walker, *Speech by SEC Staff: Regulation FD: An Enforcement Perspective* (Nov. 1, 2000), available at <http://www.sec.gov/news/speech/spch415.htm>.

39. *Adopting Release*, *supra* note 2, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,689, text accompanying note 77 (footnote omitted) (Aug. 15, 2000).

On the other hand, the Adopting Release noted that, although tipping and insider trading is subject to severe punishment, "the status of issuer selective disclosure has been considerably less clear." *Id.* at 83,677, text at note 7 (footnote omitted). For a brief discussion of this part of the Adopting Release, see INSIDER TRADING, *supra* note 5, § 5.2.3.3(b) & n.83. Undoubtedly, this uncertainty regarding Rule 10b-5 liability prompted the Commission to adopt Regulation FD.

40. For examples of post-*Dirks* private actions against an issuer for selective disclosure, see *Blanchard v. Edgemark Fin. Corp.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,439, at 92,006-07 (N.D. Ill. 1999) (denying defendants' motion to dismiss); *Energy Factors Inc. v. Nuevo Energy Co.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,883, at 93,607-11 (S.D.N.Y. 1992) (without mentioning *Dirks*, refusing to dismiss a complaint alleging that the issuer tipped broker-dealer Southcoast Capital Corporation); *State Teachers Retirement Bd. v. Fluor Corp.*, 576 F. Supp. 1116, 1121 (S.D.N.Y. 1983) (denying the issuer's motion for summary judgment;

made such suits more difficult.⁴¹

III. BOTH EX POST AND EX ANTE, THE INSIDER TRADING RESULTING FROM SELECTIVE DISCLOSURE HARMS INDIVIDUALS AND DECREASES STOCK MARKET LIQUIDITY

As mentioned in the Introduction,⁴² Professor Fox's article has three

plaintiff alleged that the issuer tipped Manufacturers Hanover Trust Co.). For discussion of these cases, see INSIDER TRADING, *supra* note 5, § 5.2.3.3(b) & nn.92a-92n.

SG Cowen Sec. Corp. v. United States Dist. Court for the Northern Dist. of California, 189 F.3d 909 (9th Cir. 1999), addressed the issue of discovery in a private class action alleging that an issuer violated federal securities law by engaging in selective disclosure to an analyst. For additional discussion of this case, see INSIDER TRADING, *supra* note 5, § 6.2 & nn.35-36.

Section 20A of the Securities Exchange Act of 1934 grants contemporaneous traders an express private cause of action against insider traders and tippers who violate federal securities law. See 15 U.S.C. § 78t-1. For discussion of Section 20A, see INSIDER TRADING, *supra* note 5, § 6.2.

41. See INSIDER TRADING, *supra* note 5, § 6.2 & nn.11-49.

The Private Securities Litigation Reform Act of 1995 imposes a particularized pleading standard regarding the state of mind of the defendant in private actions for damages under the Exchange Act. Securities Exchange Act of 1934 § 21D(b)(2). For discussion of this provision, see INSIDER TRADING, *supra* note 5, § 4.4.1 n.5, § 4.4.2 n.9 and the cases and sources cited therein.

For an example of an opinion dismissing a complaint against an alleged insider trader for failure to comply with the specificity requirements of the Private Securities Litigation Reform Act of 1995, see *TFM Investment Group v. Bauer*, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,687, at 93,257, 93,258-59 (E.D. Pa. 1999).

For an example of an opinion refusing to dismiss a complaint against insider trading defendants despite the invocation of the 1995 Reform Act, see *In re Cendant Corp. Sec. Litig.*, 60 F. Supp. 2d 354, 369-72, 378-79 (D.N.J. 1999).

The Reform Act also imposes a stay on discovery during the time a motion to dismiss is pending. See, e.g., Securities Exchange Act of 1934 § 21D(b)(3)(b). For discussion of this discovery stay, see *Medhekar v. United States Dist. Court for the Northern Dist. of California*, 99 F.3d 325 (9th Cir. 1996) (stating that a stay applies to the initial disclosure requirements of Rule 26(a)(1) of the Federal Rules of Civil Procedure); Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141, 148-50, 161-62 (1999); Todd R. David & Kelly C. Connerton, *Developing Issues Arising out of the Private Securities Litigation Reform Act's Discovery Stay Provision and Proposals for Clarification*, 27 SEC. REG. L.J. 275 (1999); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537 (1998); Elliott J. Weiss & Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457 (1998).

This stay may make it difficult for plaintiffs to meet the Act's particularized pleading standards in private actions for damages against insider trading defendants under the Exchange Act. Cf. Sale, *supra* (discussing the difficulty of surviving a motion to dismiss a private securities claim after the combined effect of the heightened pleading requirement and discovery stay); Weiss & Moser, *supra*.

SG Cowen Sec. Corp. v. United States District Court for the Northern District of California, 189 F.3d 909, 912-13 (9th Cir. 1999), refused to allow discovery by a plaintiff alleging that an issuer violated federal securities law by engaging in selective disclosure to an analyst. For discussion of this case, see INSIDER TRADING, *supra* note 5, § 6.2 & nn.35-36.

objectives.⁴³ The rest of my piece concerns only his first objective: to analyze whether Regulation FD's prohibition of selective disclosure should apply to foreign issuers listed in the United States.⁴⁴ When adopting Regulation FD, the SEC decided to exempt foreign issuers "at this time."⁴⁵

To address this issue, Professor Fox poses two questions: "What are the harms and/or benefits that selective disclosure can generate? Are U.S. residents among the persons in the world who experience these effects when a foreign issuer listed in the United States engages in this practice?"⁴⁶

Professor Fox concedes that if, based on fairness considerations, the answer to the second question is yes, that would justify the SEC's forbidding selective disclosure by foreign issuers listed in this country.⁴⁷ He says that, if selective disclosure by foreign issuers involves "fundamental unfairness" to U.S. investors, these issuers should *not* be allowed to continue selective disclosure and their listing on U.S. markets "regardless of whether U.S. investors represent only a minority of all investors suffering from this unfairness."⁴⁸

Professor Fox concludes that selective disclosure by foreign issuers listed in the United States may unfairly harm U.S. residents *ex post*.⁴⁹ I agree. He feels, however, that the appropriate analysis is *ex ante* and that U.S. residents are not unfairly harmed *ex ante*.⁵⁰ I shall argue that U.S. residents are unfairly harmed *ex ante*.

Professor Fox notes that, *ex post*, under the Law of Conservation of Securities, each stock market insider trade either induces a disadvantageous trade or preempts an advantageous trade.⁵¹ He also mentions a third class of victims, market makers or specialists.⁵² (One

42. See *supra* notes 1-5 and accompanying text.

43. Fox, *supra* note 1, at 656-58.

44. *Id.* at 656.

45. *Adopting Release*, *supra* note 2, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,676, 83,689, text accompanying note 75. See Fox, *supra* note 1, at 655 & n.5.

46. Fox, *supra* note 1, at 656.

47. *Id.* at 656-57, 668-69, 678-84.

48. *Id.* at 669.

49. *Id.* at 665-68.

50. *Id.* at 669-73.

Professor Fox also analyzes the efficiency effects of selective disclosure by foreign issuers and concludes that because the primary efficiency impact is on residents of the issuer's home country, foreign, not U.S., officials, should determine whether to forbid foreign issuers from selective disclosure. See *id.* at 656-57, 673-84.

51. *Id.* at 665-66 & n.51 (citing William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1234-35 (1981)).

52. Fox, *supra* note 1, at 667.

can view this third class, however, as a subclass of either induced or preempted traders.⁵³ To the extent that a specialist or market maker ends up with a larger inventory of stock at the time of a bearish announcement or a smaller inventory of shares at the time of a bullish announcement, the specialist or market maker can be called an "induced trader."⁵⁴)

In any event, despite this ex post harm, Professor Fox argues that, ex ante, induced or preempted traders are *not* injured because share prices will discount the risk of becoming a victim of an insider trade.⁵⁵ In his opinion, if market makers and specialists increase their spreads to compensate for the risk of becoming a victim,⁵⁶ public investors will further discount share prices to reflect the loss of liquidity.⁵⁷

Presumably, this discount will harm issuers by decreasing the price at which they issue shares.⁵⁸ If issuers are the principal victims of selective disclosure, that would support Professor Fox's conclusion that the political representatives of the issuer's country (not the SEC) should make the decision whether to regulate selective disclosure by foreign issuers listed in the United States.⁵⁹

How does an investor determine the discount in stock prices that appropriately reflects the risk of becoming a victim of insider trading? Estimating that risk is extremely difficult. It depends on the future frequency of the investor's own trades and the future amount of insider trading. The former is not certain. The latter is largely unknown. Even were it legal, insider trading would be surreptitious. To analogize, adultery may be legal, but usually remains clandestine.

Also, unlike most harm, *investors injured by insider trading rarely if ever know they are victims*.⁶⁰ Therefore, in actual practice, they may not

53. See INSIDER TRADING, *supra* note 5, § 3.3.6.

54. See *id.*; Wang, *supra* note 17, at 35.

55. Fox, *supra* note 1, at 669-71.

56. For discussion of this possibility, see *infra* notes 68-71 and accompanying text; INSIDER TRADING, *supra* note 5, § 2.3.4.

57. Fox, *supra* note 1, at 671.

58. See INSIDER TRADING, *supra* note 5, § 2.3.2 & nn.16-20. Professor Fox notes that if selective disclosure reduces investor confidence in the market, this would result in higher costs of capital. Fox, *supra* note 1, at 676-77.

59. See Fox, *supra* note 1, at 657, 678-84.

Two commentators, however, argue that, with appropriate safeguards against managerial self-dealing, each issuer, not political representatives, should decide whether to allow selective disclosure, as long as the issuer discloses its policy in advance. See Ian Ayres & Stephen J. Choi, *Internalizing Outsider Trading*, Parts III(C), IV(B)(1), Yale Law School, Public Law and Legal Theory Working Paper No. 04, UC Berkeley Public Law and Legal Theory Working Paper No. 60 (Aug. 31, 2001), available at <http://www.ssrn.com>; Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533 (2002).

60. See INSIDER TRADING, *supra* note 5, § 3.3.3, § 3.3.4 nn. 36-47 and accompanying text, §

be able to set any discount.

Nevertheless, assume *arguendo* that they do determine one; also, assume *arguendo* that selective disclosure by foreign issuers is legal. If the SEC forbids selective disclosure by foreign issuers listed in the United States, insider trading tippees will be worse off. (These tippees may be more likely to be foreigners than Americans.)

In addition, the discount will decline. This increase in stock prices will benefit all stockholders, including those in the United States. In short, the prohibition transfers wealth from insider traders (probably foreigners) to all shareholders generally, including Americans.

As a result, some investors may receive a windfall because they originally bought at a discount. Nevertheless, the Commission may decide that insider trading profits are an even less deserved benefit.

Finally, even if stock prices discount the risk of being a victim of insider trading, American investors would benefit from the decline in the uncertainty of injury that would result from a broad SEC prohibition of selective disclosure.⁶¹ Investors are risk averse.⁶²

A counterargument is that a diversified portfolio eliminates the variance in the possibility of being a victim of an insider trade.⁶³ The problem with this contention is that the risk is associated with *trading* (or preempted trading), not holding shares.⁶⁴

A diversified investor may engage in numerous small transactions (or preempted trades), and this might make the likelihood of injury somewhat more predictable. It is doubtful, however, that the harm from insider trading would be both certain and knowable.

In any event, many investors are *not* diversified.⁶⁵ In adopting

3.3.7; Wang, *supra* note 17, at 32-35.

Market makers and specialists are more able than regular investors to make *ex ante* adjustments in reaction to insider trading. If a market maker or specialist gets a flood of orders just before a major public announcement, the specialist/market maker may suspect insider trading. Even if the specialist or market maker never knows when it is a victim, however, insider trading will erode profits. In response, specialists and market makers may widen spreads. See *supra* notes 56-57 and accompanying text; *infra* notes 68-71 and accompanying text; INSIDER TRADING, *supra* note 5, § 2.3.4.

61. See Fox, *supra* note 1, at 671-72.

62. See sources cited in INSIDER TRADING, *supra* note 5, § 2.2.1 n.6.

63. See Fox, *supra* note 1, at 672.

64. See INSIDER TRADING, *supra* note 5, § 3.3.6 notes 36-44 and accompanying text; Wang, *supra* note 17, at 32-35.

65. See Marshall E. Blume & Irwin Friend, *The Asset Structure of Individual Portfolios and Some Implications for Utility Functions*, 30 J. FIN. 585 (1975) (analyzing a special sample of 1971 Federal Individual income tax returns and the Federal Reserve Board's 1962 Survey of the Financial Characteristics of Consumers; concluding that a large proportion of households do not hold diversified portfolios) [hereinafter Blume & Friend, *Asset Structure*]; Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1099 (1983) ("The actual distribution of stockholdings, as well as a certain amount of

observed investor 'irrationality,' suggests that even in a perfect market many investors are not—and are not likely ever to be—sufficiently diversified to avoid undue unsystematic economic risk.”) (footnotes omitted) (citing New York Stock Exchange, Shareholder Ownership 1981, at 2, 26-27); *id.* at 1117; John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 748 (1984) (“[M]any, and probably most, investors do not hold fully diversified portfolios.”); Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L.Q. 47, 64 (1987) (“[M]any, perhaps most, shareholders are not in fact efficiently diversified....”) (footnote omitted); Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1309 (1991) (“A large portion of households does not hold diversified stock portfolios.”) (citing MARSHALL E. BLUME & IRWIN FRIEND, *THE CHANGING ROLE OF THE INDIVIDUAL INVESTOR* 46-50 (1975); Blume & Friend, *Asset Structure*, *supra*, at 585); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1099 (1988-89) (“[E]vidence suggests that the most sophisticated investors are not diversified....”) (citing Blume & Friend, *Asset Structure*, *supra*); Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANT. ANALYSIS 353, 361 (1987) (citing several sources). *See also* Kathy Chen, *Pension Plans Are Adjusted After Enron*, WALL ST. J., Jan. 29, 2002, at A2 (describing the high percentage of company stock in many defined contribution plans); Ellen E. Schultz & Theo Francis, *Companies Hot Tax Break: 401(k)s*, WALL ST. J., Jan. 21, 2002, at C1 (explaining the tax incentive for employers to contribute stock to employee 401(k) plans); Pui-Wing Tam, *Hard Drive: Why Tech-Stock Junkies, Despite Advice, Often Fail to Diversify*, WALL ST. J., Jan. 6, 1999, at C1 (“in many 401(k) retirement plans, employees have a whopping 30% or so of their money in their own company’s stock”; many other investors “have built up huge stakes in the seemingly can’t lose technology sector”). *Cf.* Ian Cooper & Evi Kaplanis, *Home Bias in Equity Portfolios, Inflation Hedging, and International Capital Market Equilibrium*, 7 REV. FIN. STUD. 45 (1994) (stating that investors’ bias towards domestic, rather than foreign, stocks cannot be explained by either inflation hedging or direct observable costs of international investment unless investors have very low levels of risk aversion); Azriel Levy & Miles Livingston, *The Gains from Diversification Reconsidered: Transaction Costs and Superior Information*, 4 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1 (1995) (transactions costs significantly reduce the optimal number of securities in a portfolio; surprisingly small amounts of superior information provide a strong incentive to concentrate a portfolio); *id.* at 1 (“[M]any investors have portfolios with a surprisingly small number of securities...”) (citing MARSHALL E. BLUME & IRWIN FRIEND, *THE CHANGING ROLE OF THE INDIVIDUAL INVESTOR* (1975); Blume & Friend, *Asset Structure*, *supra*; Marshall E. Blume, Jean Crockett & Irwin Friend, *Stock Ownership in the United States: Characteristics and Trends*, 54 SURV. OF CURRENT BUS. 16 (1974); Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222 (1991)). *But see* Levy & Livingston, *supra*, at 2-17 (under certain simplifying assumptions, close to 90 percent of the maximum diversification benefits occur with a portfolio size of 10 securities, confirming the simulation studies of John L. Evans & Stephen A. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. & QUANTITATIVE ANALYSIS 761 (1968)).

In 1998, 33.8 million individuals in the United States owned stock directly only and not through any mutual fund. *See* New York Stock Exchange, Fact Book 2000 Data, at 55-56 (2001), available at <http://www.nyse.com/about/factbook.html> (under “The Investing Public”). Many of these individuals may not have held diversified portfolios.

The Vanguard Total Market Portfolio uses sophisticated sampling techniques to match the performance of the Wilshire 5000 index, which contains over 7,000 stocks. The Vanguard fund matches certain characteristics of the index, such as industry weightings, market capitalization, and dividend yield. Even with these sophisticated sampling techniques, the Vanguard Total Market Portfolio found it necessary to hold 3,429 stocks as of October 31, 2001. *See* E-mail message from Mr. Terrance Holmes, Vanguard Voyager Service, to William K.S. Wang (Nov.

regulations, the SEC should accept the world as it is.

Moreover, even if, *ex ante*, share prices accurately discount the risk of being a victim of insider trading and the liquidity cost of increased bid-ask spreads, a decline in the price of all publicly traded stocks would *not* adequately compensate all investors for the risk of being victims of a stock market insider trade. This risk of harm is associated with the act of trading (or of *almost* trading, in the case of a preempted trader). Consequently, the risk varies with the frequency of one's trades (or near trades).

In short, even if the return on all publicly traded stocks were slightly higher because of the risk of harm from insider trading, the higher return would not adequately compensate frequent traders for incurring that risk. These victims of a stock market insider trade are injured even if they originally purchased their stock at a price that reflected the *average* possibility of insider trading.⁶⁶

27, 2001) (on file with the VA. J. INT'L L.).

The Fidelity Spartan Total Market Index Fund is similar to the Vanguard Total Market Portfolio. See Fidelity Spartan Total Market Index prospectus, *available at* <http://www.fidelity.com>. This Fidelity fund may also use sophisticated sampling techniques to match the performance of the Wilshire 5000. See *id.* On October 31, 2001, the Fidelity Spartan Total Market Portfolio held 3,736 stocks. See E-mail message from Ms. Heather Doherty, Fidelity Investments Institutional Operations Company, Inc., to William K.S. Wang (Dec. 7, 2001) (on file with the VA. J. INT'L L.).

Using a 500-stock portfolio as a benchmark, one study concluded that a well-diversified portfolio of randomly chosen stocks must include at least 30 stocks for a borrowing investor and at least 40 stocks for a lending investor (an investor who also holds bonds). See Statman, *supra*. The study criticized as incorrect Evans & Archer's conclusion that approximately ten stocks are sufficient for a diversified portfolio. See *id.* at 353 (criticizing J.L. Evans & S.H. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761 (1968)).

Despite Professor Statman's conclusion that at least 30 to 40 stocks are necessary to mimic a 500-stock portfolio, his article said: "we claim neither that a 500-stock portfolio is a proxy for the market portfolio, nor that we cannot obtain better diversified portfolios." See Statman, *supra*, at 355. Furthermore, the article noted that even under the 30 to 40 stock standard, investors' actual portfolios are not well diversified. See *id.* at 361-62.

For additional criticism of the measurement techniques of earlier studies that suggested a relatively small number of stocks provides adequate diversification, see Thomas M. Tole, *You Can't Diversify Without Diversifying*, 8 J. PORTFOLIO MGMT., Winter 1982, at 5. The study also concluded that if investors choose stocks using fundamental or technical analysis rather than random selection, the number of stocks necessary for diversification increases. See *id.*

66. More frequent trading does *not* increase the benefit from any discount in share prices (resulting from the risk of harm from insider trading). With each purchase, a frequent trader would buy at a discount. Nevertheless, with each sale, the frequent trader would sell at a discount. Over time, through dividends, the frequent trader would earn the same return as the infrequent trader (ignoring transaction costs).

To illustrate, suppose closed-end fund shares sell at a constant percentage discount from net asset value per share. Suppose an investor often switches from one closed-end fund to another, buying and selling at the same discount. Assume that, without the discount, she would earn a 6% rate of return. With the discount, she receives a 7% return. The infrequent trader who buys at a discount and holds long-term gets the same 7% return. For discussion of discounts on closed-end

To analogize, suppose apartment rents in one neighborhood are slightly lower because a small percentage of arbitrarily chosen residents will be mugged and/or assaulted. Ex post, the unfortunate victims suffer disproportionately and are only minimally compensated by the lower rents.⁶⁷ Ex ante, residents who take walks often are not adequately compensated because they take more risk than others.

Because specialists and market-makers trade so frequently, they may be disproportionately harmed by insider trading,⁶⁸ although they may sometimes pass the injury to other individual investors prior to disclosure by altering prices and thereby readjusting inventory to the level preferred.⁶⁹

Ex ante, the presence of insider trading may cause specialists and market makers to widen their spreads to compensate for the risk of becoming a victim.⁷⁰ If so, ex ante, specialists and market makers may

fund shares, see William K.S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 387-94 & nn.147-54 (1986).

67. For the same analogy, see INSIDER TRADING, *supra* note 5, § 3.3.6; text accompanying note 50; Wang, *supra* note 17, at 38. For a similar analogy, see INSIDER TRADING, *supra* note 5, § 3.5.2.

68. See INSIDER TRADING, *supra* note 5, § 3.3.6 n.49a, § 3.3.7 nn.52, 66.

69. See *id.* at § 3.3.6 nn.39-47 and accompanying text, § 3.3.7; Wang, *supra* note 17, at 33-34.

70. See INSIDER TRADING, *supra* note 5, § 2.3.4; MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 855-56 (1995); William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863, 888-89 (1987); Kee H. Chung & Charlie Charoenwong, *Insider Trading and the Bid-Ask Spread*, 33 FIN. REV., Aug. 1998, at 1 (stating that, over time, market makers establish larger spreads for stocks with more insider trading; on insider trading days, however, spreads are not wider; therefore, although market makers may be unable to detect insider trading when it occurs, they protect themselves with wider spreads for stock with more tendency to insider trading); John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., July 31, 1997, at 5, 6; Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 307 n.12 (1998); Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 18 n.46 (1993); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 331 (1987); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1449, 1457 (1986); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 161-62 (1998) (and sources cited therein); Hartmut Schmidt, *Insider Regulation and Economic Theory*, in EUROPEAN INSIDER DEALING 21, 26-27 (Klaus J. Hopt & Eddy Wymeersch eds., 1991); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 434 (1998); Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1722-24 (1992); Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 397 (1989). *But cf.* Bradford Cornell & Erik R. Sirri, *The Reaction of Investors and Stock Prices to Insider Trading*, 47 J. FIN. 1031, 1032 (1992) (examining court documents to identify the allegedly illegal insider trading surrounding Anheuser-Busch's 1982 acquisition of Campbell Taggart; although the insider purchases bid up the share price of Campbell Taggart, they did not result in a widening of the bid-ask spread; reviewing literature with models predicting a widening of the spread in

pass some or all of their injury from insider trading to the general public. The increase in spreads would harm all public trading investors,⁷¹ but especially those who trade often. Even if investors discount stock prices to reflect the increase in bid-ask spreads,⁷² more frequent traders would still suffer disproportionately from the wider spreads.⁷³

Should the SEC concern itself with protecting such frequent traders? Some commentary argues that society should discourage excessive stock trading.⁷⁴ Extrapolating from these authorities, if insider trading increases bid-ask spreads and disproportionately harms frequent traders, the country arguably might benefit because of the deterrence of excessive stock trading and speculation.

response to insider trading); Raymond P.H. Fishe & Michel A. Robe, *The Impact of Illegal Insider Trading in Dealer and Specialist Markets* (June 2001), available at <http://www.ssrn.com> (discussed *infra* note 79); Omesh Kini & Shehzad Mian, *Bid-Ask Spread and Ownership Structure*, 18 J. FIN. 404 (1995) (using 1985 data for 1,063 NYSE firms, examining relationship between bid-ask spread and ownership structure; finding a nonpositive relation between bid-ask spread and four proxies for insider trading: insider ownership, trades by insiders as a percentage of total trading volume, institutional ownership, and amount of large-block-holding; finding no evidence of a positive relation between bid-ask spread and insider ownership and trading by insiders; finding a *negative* relation between the spread and institutional ownership, and finding a positive, but not statistically significant, relation between spread and blockholding).

Even if bid-ask spreads do not widen in immediate response to particular instances of insider trading, spreads may widen generally because insider trading decreases the profits of market makers over time.

71. See INSIDER TRADING, *supra* note 5, § 2.3.4.

72. See Fox, *supra* note 1, at 671; *supra* text accompanying note 57.

73. The wider bid-ask spread would increase the cost of buying and selling stocks. Those who trade more often would bear a greater burden from the higher transaction costs.

Again, more frequent trading does *not* increase the benefit from any discount in share prices (that develops in reaction to the increased bid-ask spreads). See *supra* note 66.

74. See Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 281 (2001) (suggesting increasing taxes on extremely short term capital gains to deter gambling in the stock market); Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERV. RES. 101 (1989) (stock transfer tax is likely to increase overall efficiency of the American economy by discouraging short-term speculative trading); Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U.L.Q. 791, 808-10 (1997) (arguing that, if investor demand for speculative trading is highly elastic, increasing investors' marginal costs of trading may actually decrease both speculative trading and investors' aggregate transaction costs and thereby increase investor welfare); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 667-91 (1995) (stating that much stock trading is speculative: "alleged efficiency benefits of speculative trading are at least exaggerated, and possibly illusory"); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERV. RES. 261 (1989) (United States stock markets may have "excessive" liquidity, thereby encouraging speculation, increasing volatility, and possibly shortening managerial horizons). Cf. Ribstein, *supra* note 70, at 163-65 (questioning whether decreased liquidity is harmful).

On the other hand, the Commission may view its mission as encouraging trading so as to increase the liquidity of the stock market. Both Congress and the SEC have expressed opposition to insider trading because it undermines investor confidence.⁷⁵ They may wish to preserve that confidence to encourage *both* trading and investment.

If so, the Commission may wish to forbid selective disclosure by all issuers, both domestic and foreign. Such a prohibition would improve the liquidity in U.S. markets by encouraging stock transactions. The incentive to trade would increase due to narrower bid-ask spreads⁷⁶ and the reduced variance in the possibility of being a victim of a stock market insider trade.

IV. DIGRESSION: SOME REASONS WHY THE INSIDER TRADING RESULTING FROM SELECTIVE DISCLOSURE MAY NOT NECESSARILY RESULT IN MORE ACCURATE STOCK PRICES AND IMPROVEMENT IN CAPITAL ALLOCATION

Among the possible benefits of the insider trading resulting from selective disclosure is more accurate share prices.⁷⁷ Some commentators, including Professor Fox, contend that, *all other things being equal*, this increased accuracy will improve capital allocation.⁷⁸

75. See INSIDER TRADING, *supra* note 5, § 2.3.1 & nn.2-3.

76. See *id.* at § 2.3.1 & nn.10a-10f.

77. See Fox, *supra* note 1, at 674-77; INSIDER TRADING, *supra* note 5, § 2.2.2 & nn.36-42.

78. See INSIDER TRADING, *supra* note 5, § 2.2.2 & n.35; Coffee, *supra* note 65, at 734 (“[I]f we view the securities market as the principal allocative mechanism for investment capital, the behavior of securities prices is important. . . because of their effect on allocative efficiency. . . . Depending on a firm’s share price, its cost for obtaining capital will be either too high or low as compared to the cost that would prevail in a perfectly efficient market.”); Fox, *supra* note 1, at 660 n.21, 674; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2544-50 (1997); Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1015-25 (1983); James H. Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819, 819 (1980); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 752 (2000). See also Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 341 (1979) (stating that if the market prices of securities correspond more precisely to the values of the enterprise, “[t]he market will . . . function efficiently to allocate savings to enterprises which are more profitable and divert them from enterprises which are less profitable”).

Professor Fox also argues that increased price accuracy will reduce the risk for hostile takeover bidders and for executives with share price based compensation. Fox, *supra* note 1, at 660 n.21, 674-75.

He also points out that selective disclosure nevertheless may be inefficient on balance because of market failure, reduced investor confidence in the market, or a decrease in price accuracy (because of a corrupting game between issuers and analysts that leads to a distortion in analyst recommendations). Fox, *supra* note 1, at 675-78.

Other authorities, however, question whether insider trading would have a significant effect on stock prices.⁷⁹ Still others contend that, even if the trading changes prices, this will have little impact on resource allocation, especially if the interval between the insider trading and dissemination is short.⁸⁰ In the words of one article: "private information often consists of advance knowledge that would become public in due course Little or no social advantage is gained when this information is transmitted by trading."⁸¹

Moreover, the increased price accuracy argument assumes that, absent insider trading, the stock market is already fairly efficient in

79. See INSIDER TRADING, *supra* note 5, § 2.2.2 & n.43; Steven M. Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1239-40 (1995).

Professor Fox himself states that insider trading sometimes may not cause a price change because "the issuer's stock will have one or more market makers or specialists, persons who act to bridge what appear to be stochastic short term differences in the number of shares demanded and the number supplied at the prevailing price." Fox, *supra* note 1, at 667 (footnote omitted).

One paper studied the effect on market makers of the illegal trades of five stockbrokers who bought stock based on information from advance copies of Business Week's "Inside Wall Street" column. The illegal trades did not cause market makers to change their bid-ask spreads. Instead, the market makers altered the number of shares they would sell at their ask quotations. See Fishe & Robe, *supra* note 70. For related discussion, see *supra* note 70.

For citations of sources on both sides of the debate about the elasticity of the demand for stocks, see INSIDER TRADING, *supra* note 5, § 3.3.7 n.63.

80. See INSIDER TRADING, *supra* note 5, § 2.2.2 & nn.45-46; Fried, *supra* note 70, at 315 ("Recent work by economists and legal commentators . . . suggests that the 'accuracy' of stock prices has little effect on the allocation of capital in the economy and that, therefore, there is little social value to 'accurate' stock prices.") (citations omitted); *id.* ("[E]ven if accurate stock prices were socially desirable . . . the period during which insider trading can make prices more accurate is likely to be rather short..."); Kahan, *supra* note 18, at 1016 ("[A] repeal of the disclose or abstain rule is not likely to improve capital allocation . . ."). Cf. Stiglitz, *supra* note 74, at 103 (stating that if you assume that the issuer will take no action on new information prior to public announcement, but someone is able to trade on the information in the stock market prior to public disclosure: "The information has only affected who gets to get the return. It does not affect the magnitude of the return. To use the textbook homily, it affects how the pie is divided, but it does not affect the size of the pie."); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 645-57 (1988) ("The argument that efficient stock markets are essential to allocate properly investment capital assumes that, despite a plethora of alternate financing sources, corporations rely primarily on stock issues for raising funds. . . . In fact, firms largely appear to avoid the stock market as a source of funding.") (citations omitted). But see Ayres & Choi, *supra* note 59 (arguing in Part II(A) that the timing of accurate prices is important for employees receiving compensation in shares or an acquisition target's shareholders getting shares as consideration; in addition, the pricing decision in a new stock offering may depend on the share prices of related companies); Fox, *supra* note 1, at 660 n.21, 674-75 (arguing that increased price accuracy will reduce the risk for hostile takeover bidders and for executives with share price based compensation).

81. Michael Manove, *The Harm from Insider Trading and Informed Speculation*, 104 Q.J. ECON. 823, 827 (1989).

accurately pricing stocks at their fundamental value.⁸² If not,⁸³ whether insider trading makes prices more accurate is less clear.

To illustrate, suppose the price of a “dot com” stock is already far in excess of its fundamental value. The president of the corporation learns material nonpublic bullish information. If the stock was already quite overvalued, the stock market price may still be excessive *even in light of the new nonpublic bullish information*.

Before the news is public, the president discloses the information to certain analysts, whose tippees purchase the company’s shares and cause the price to rise. Because the stock was previously overvalued, *even in light of the new nonpublic information*, the insider trading has moved the price farther away from its fundamental value.

In other words, if stock prices are not fundamental valuation efficient, the “second-best” alternative may not be easy to determine.⁸⁴ Even if

82. For discussion of the meaning of “fundamental valuation” stock market efficiency, see Wang, *supra* note 66, at 344 (prices reflect the discounted present value of future payouts). For the distinction between “fundamental valuation” efficiency and “information arbitrage” efficiency (prices reflect all relevant public information; if future investors will be irrational, the relevant information would relate to future irrational investor preferences; if future investors will be rational, the relevant information would relate to future payouts), see *id.* at 344-49.

83. For arguments that the stock market is not efficient, see Wang, *supra* note 66; contrary sources cited in INSIDER TRADING, *supra* note 5, § 2.2.2 n.27, § 3.3.7 n.62; ANDREW W. LO & ARCHIE C. MACKINLAY, A NON-RANDOM WALK DOWN WALL STREET (1999) (questioning the efficient capital market hypothesis); ROBERT J. SCHILLER, IRRATIONAL EXUBERANCE 173-90 (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000) (questioning the efficient market hypothesis and describing research on an alternative model, behavioral finance); Victor L. Bernard, Christine Botosan & Gregory D. Phillips, *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of the Fraud on the Market Theory*, 73 NEB. L. REV. 781, 786-92 (1994) (describing recent evidence challenging the efficient market hypothesis); Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes, The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994) (arguing that the efficient capital market hypothesis is false); Henry T.C. Hu, *Buffett, Corporate Objectives, and the Nature of the Sheep*, 19 CARDOZO L. REV. 379, 397 (1997) (“Fads, bubbles, noise traders, and psychological and other quirks can cause the actual trading prices to depart from the price that rationally reflects all publicly available information.”). See also Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853-54 (1992) (“This ferment has led to a counterreaction to the efficient market hypothesis within the economics profession.”); SCHILLER, *supra* (at the time of writing, concluding that high stock market prices were the result of a speculative bubble). Cf. Gabaldon, *supra* note 74, at 229-30 (“[M]any modern financial market transactions have been strongly reminiscent of gambling...”).

For discussion of studies or phenomena questioning “fundamental valuation” efficiency, see Wang, *supra* note 66, at 359-62. For discussion of studies or phenomena questioning even “information arbitrage” efficiency, see *id.* at 349-63, 377-94.

For citations of sources questioning the validity of the semi-strong form of the efficient market theory, see *Kaufman v. i-Stat Corp.*, 754 A.2d 1188, 1198-99 (N.J. 2000).

For arguments that the stock market is efficient, see sources cited in INSIDER TRADING, *supra* note 5, § 2.2.2 n.27.

84. For discussion of “second-best” alternatives, see *Symposium on Second-Best Theory and*

insider trading affects stock prices, some of this movement may be *away from*, not towards, the stock's fundamental value.⁸⁵

V. SUMMARY AND CONCLUSION

Selective disclosure by issuers may sometimes violate Rule 10b-5 if the issuer, as an entity, obtains an improper "personal benefit."

Uncertain is the stock price accuracy benefit of the insider trading resulting from selective disclosure. Even if the insider trading affects prices, the interval between the trading and public disclosure may be too short to produce a significant economic benefit. Furthermore, if share prices are already quite far from their fundamental value, the insider trading may sometimes move prices farther away from accuracy.

Are U.S. residents injured when a foreign issuer listed in the United States engages in selective disclosure that results in insider trading? The answer may be yes, both *ex post* and *ex ante*. *Ex post*, the insider trading injures preempted and/or induced traders, including Americans.

Professor Fox argues that, *ex ante*, induced or preempted traders are not injured because share prices will discount both the risk of becoming a victim of an insider trade and any loss of liquidity caused by a widening of bid-ask spreads by market makers and specialists. Presumably, this discount will harm issuers by lowering the price at which they issue shares. If issuers are the principal victims of selective disclosure, that would support Professor Fox's conclusion that the political representatives of the issuer's country (not the SEC) should make the decision whether to regulate selective disclosure by foreign issuers listed in the United States.

Nevertheless, *ex ante*, insider trading may still harm preempted and/or induced traders if the market is unable to determine an appropriate discount for the risk of becoming a victim. For several

Law & Economics, 73 CHI.-KENT L. REV. 3-247 (Richard S. Markovits ed., 1998). For discussion of the ability in practice to determine "second best" alternatives, see John J. Donohue, *Some Thoughts on Law and Economics and the General Theory of the Second Best*, 73 CHI.-KENT L. REV. 257 (1998); Richard S. Markovits, *Second-Best Theory and the Obligations of Academics: A Reply to Professor Donohue*, 73 CHI.-KENT L. REV. 267 (1998).

85. For the same analysis, see INSIDER TRADING, *supra* note 5, § 2.2.2 & nn.44a-44d.

For a somewhat similar approach, see Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001); *id.* at 2064 ("When much of a nation's industry is monopolistically organized, maximizing shareholder wealth would maximize the monopolist's profits, induce firms to produce fewer goods than society could potentially produce, and motivate firms to raise price to consumers beyond that which is necessary to produce the goods.").

For an analogy to a magic box, see William K.S. Wang, *The Metaphysics of Punishment—An Exercise in Futility*, 13 SAN DIEGO L. REV. 306, 329-30 (1976).

reasons, estimating that risk is extremely difficult. Unlike most harm, investors injured by insider trading rarely if ever know they are victims.

Assume *arguendo* that the market does determine a share price discount for the risk of harm from insider trading. Also assume *arguendo* that selective disclosure by foreign issuers is legal. If the Commission forbids selective disclosure by foreign issuers, the discount would decline. The prohibition transfers wealth from insider trading tippees (probably foreigners) to all shareholders, including Americans.

In addition, even if stock prices discount the risk of harm from insider trading, American investors would benefit from the decline in the uncertainty of injury that would result from a broad SEC prohibition of selective disclosure. Because the risk is associated with trading, not holding stocks, a diversified portfolio does not eliminate the risk (even assuming investors are diversified).

Furthermore, even *ex ante*, frequent traders are *disproportionately* harmed by insider trading, again because the risk is associated with trading. Among these victims are market makers and specialists, who may increase their spreads because of their reduced profits (even if they do not know when they are victims of insider trading). Again, *ex ante*, among ordinary investors, more frequent traders would bear the brunt of the harm from the larger spreads.

One might argue that, because of the deterrence of excessive stock trading and speculation, the nation might actually benefit from an increase in bid-ask spreads and disproportionate harm to frequent traders. Nevertheless, the SEC may disagree. It may view its mission as encouraging securities trading in this country to improve the liquidity of the domestic stock market.

If so, the Commission may wish to forbid selective disclosure by all issuers, both domestic and foreign. Such a prohibition would reduce both bid-ask spreads in this country and the uncertainty Americans face in becoming victims of a stock market insider trade. As a result, the liquidity of U.S. markets would increase.

In short, selective disclosure by foreign issuers listed in the United States harms Americans, both *ex post* and *ex ante*.