University of Miami Law Review

Volume 69
Number 3 *Volume 69 Number 3 (Spring 2015)*

Article 9

5-1-2015

The Importance of “The Law of Conservation of Securities”: A Reply to John P. Anderson’s “What’s the Harm in Issuer-Licensed Insider Trading?”

William K.S. Wang

Follow this and additional works at: https://repository.law.miami.edu/umlr

Recommended Citation

William K.S. Wang, *The Importance of “The Law of Conservation of Securities”: A Reply to John P. Anderson’s “What’s the Harm in Issuer-Licensed Insider Trading?”*, 69 U. Miami L. Rev. 811 (2015)
Available at: https://repository.law.miami.edu/umlr/vol69/iss3/9

This Symposium is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.

The Importance of "The Law of Conservation of Securities": A Reply to John P. Anderson's "What's the Harm in Issuer-Licensed Insider Trading?"

WILLIAM K.S. WANG*

Professor John P. Anderson's article, What's the Harm in Issuer-Licensed Insider Trading?*, argues that my "Law of Conservation of Securities" has no moral relevance to the question whether to allow such trading.*

The Law of Conservation of Securities demonstrates that each stock market insider trade has specific victims and is "advantage-taking." Some "advantage-taking" stock transactions are moral; others are not. To determine whether stock market insider trading is immoral, applying a principle such as utilitarianism or Professor Anthony Kronman's "paretianism" requires consideration of the harm stemming from the conduct. The Law of Conservation of Securities identifies the victims of each insider trade and enables analysis of the indirect consequences of that injury, such as wider bid-ask spreads by market makers and impaired investor confidence—both of which, in turn, increase firms' cost of equity capital.

Specifying the actual victims also helps to determine whether the market would know how much to adjust share prices for the possibility of insider trading and whether such adjustments (even if accurate) would compensate all investors for the risk of injury. With corporation-approved insider trading, the issue also arises whether the decisionmakers adequately consider the interests of non-shareholder victims.

I. INTRODUCTION 812
II. "NON-DISCLOSURE VICTIMS" VERSUS "TRADE VICTIMS" OF A STOCK MARKET INSIDER TRADE 812
III. THE ROLE OF THE "LAW OF CONSERVATION OF SECURITIES" IN THE DEBATE ABOUT INSIDER TRADING AND ABOUT WHETHER ISSUERS MAY PERMIT INSIDER TRADING BY EMPLOYEES 814
IV. THE HARM OF INSIDER TRADING TO INDUCED OR PREEMPTED TRADERS, EVEN WITH A LOWER MARKET PRICE RESULTING FROM ISSUER APPROVAL OF INSIDER TRADING 816

* Professor, University of California Hastings College of Law. I am grateful to Professors Abe Cable, John Crawford, Marina Lao, and Amanda Rose for their valuable comments on an earlier draft of this piece.

V. CORPORATE GOVERNANCE, EXECUTIVE COMPENSATION, AND GOVERNMENT PATERNALISM . . . 817
VI. EXTERNALITIES RESULTING FROM ISSUER-APPROVED INSIDER TRADING OR TIPPING . . . 820
VII. PERMISSIBLE AND IMPERMISSIBLE "ADVANTAGE-TAKING" . . . 821
VIII. SOME MINOR QUIBBLES . . . 824
IX. SUMMARY AND CONCLUSION . . . 825

I. INTRODUCTION

Professor John P. Anderson's article, *What's the Harm in Issuer-Licensed Insider Trading?*,[1] argues that my "Law of Conservation of Securities" has no moral relevance to the question whether to allow such trading.

Although the Law of Conservation of Securities does not resolve the issue, the "law" does identify the victim(s) harmed by each stock market insider trade and aids in ascertaining the indirect effects of such harm, such as wider bid-ask spreads by market makers and impaired investor confidence—both of which, in turn, increase firms' cost of equity capital. Specifying the actual victims of insider trades also helps to determine whether the market would know how much to adjust share prices for the possibility of insider trading and whether such adjustments (even if accurate) would compensate all investors for the risk of injury from an insider trade. With company-approved insider trading, the question also arises whether the decisionmakers adequately consider the interests of *non*-shareholder victims.

Some argue generally against the regulation of victimless crimes, but my Law of Conservation of Securities demonstrates that each stock market insider trade actually injures specific individuals. Whether to permit an insider trader to "take advantage" of these individuals is a separate question whose answer likely depends in part on the direct and indirect consequences of the Law of Conservation of Securities.

II. "NON-DISCLOSURE VICTIMS" VERSUS "TRADE VICTIMS" OF A STOCK MARKET INSIDER TRADE

A stock market insider trade has two different classes of victims:

(1) Those *both* harmed by the accompanying non-disclosure[2] *and* owed a duty to disclose by the insider trader (*possible* victims include the party on the other side of the trade, "contemporaneous" opposite-type traders, or all opposite-type traders between the time of the insider

1. John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795 (2015) [hereinafter Anderson, *What's the Harm?*].

2. For a discussion of the harm from the non-disclosure aspect of a stock market insider trade, see WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 3.4 (3d ed. 2010).

trade and public dissemination of the non-disclosed information).[3]

(2) Those harmed by the insider trade itself (i.e., those who have suffered but-for injury from the insider transaction).[4] The Law of Conservation of Securities identifies these victims: those whose trades were preempted and/or induced by the insider transaction.[5] The Law of Conservation of Securities does not deal with the non-disclosure victims.

To illustrate, suppose I sell one share based on material, nonpublic, adverse information. If I had a pre-existing duty (or my sale triggered a retroactive duty) to disclose the bad news to my buyer (or to a larger class of purchasers), my *non-disclosure* harmed the buyer(s). Had I disclosed, she/they would not have purchased.[6]

Apart from the injury caused by my non-disclosure, who is harmed by the *transaction* itself? Had I not sold my stock, the person on the other side *might* have bought from someone else who was attempting to sell.

Nevertheless, even if my trade did not injure the party on the other side, my transaction must have a victim. Assume that the number of shares is constant.[7] At the time of dissemination of the material adverse information, I have one less share. Someone else must have one more

---

3. For a discussion of those to whom a stock market insider trader might owe a duty to disclose, see *id.* § 3.4.3. For a discussion of the U.S. Securities and Exchange Commission ("SEC") Rule 10b-5 insider trading classical relationship triangle (issuer, insider, and party on the other side of the insider trade), see *id.* § 5.2.1. For a discussion of a private cause of action against a stock market insider trader by "contemporaneous" opposite-type traders, see *id.* §§ 6.2–6.4, 6.5.3–6.5.7, 6.10.1. "Opposite-type trades" are those opposite in type from the insider transaction. If the insider trade is a purchase, "opposite-type" transactions are sales. If the insider trade is a sale, "opposite-type" transactions are purchases.

4. For a discussion of the harm from the *trade* aspect of a stock market insider transaction, see *id.* § 3.3.

5. *See id.* §§ 3.3.5–3.3.7; 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, 29–30 (2000) [hereinafter Wang, *Victims, Violators and Remedies*]. *See also* Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. PA. L. REV. 801, 806 (2014) [hereinafter Fried, *Insider Trading*] ("When insiders use private information to time their personal trades, they directly reduce shareholders' returns. Each dollar reaped by insiders comes at public investors' expense."); *id.* at 806–07 (explaining the diversion of value from public investors that is created by insider trading). *Cf. id.* at 827–28 (estimating that value diversion by insiders from *indirect* trading through company transactions amounts to several billion dollars a year). In an earlier article, Professor Fried estimated that through *direct* insider trading transactions, corporate insiders diverted almost $5 billion a year from the public. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 323 (1998).

6. *See supra* notes 2–3 and accompanying text. For a related discussion, see *infra* notes 63–65 and accompanying text.

7. Even if the number of shares is not fixed, the insider trade still harms preempted and induced traders. *See* WANG & STEINBERG, *supra* note 2, § 3.3.8. Nevertheless, assuming a constant number of shares simplifies the analysis. *See id.*; Anderson, *What's the Harm?*, *supra* note 1, at 802 n.43.

share. That someone is either an induced buyer or a preempted seller. Directly or indirectly, my sale either induced someone to purchase one share or preempted someone from selling one share.[8]

III. The Role of the "Law of Conservation of Securities" in the Debate About Insider Trading and About Whether Issuers May Permit Insider Trading by Employees

Many opponents of the regulation of stock market insider trading seem to assume that it has no victims,[9] and this assumption supports the argument against regulation.

One analogy is to the controversy over regulating pornography. Some contend that pornography is a victimless crime, while others argue that pornography increases sex crimes and/or undermines respect for women.[10] "Whether pornography has victims does not resolve the question of how to regulate it. Nevertheless, society is more likely to regulate pornography strictly if it has victims. Similarly, whether insider trading is a victimless crime does not resolve the question of how to regulate it. Nevertheless, society is more likely to regulate insider trading strictly if it has victims."[11]

One source of confusion about insider trading's harm is that even without the insider trade, the party on the other side of the trade *might* have traded anyway.[12] The Law of Conservation of Securities explains that even if a stock market insider trade does not injure the party on the other side, the insider trade still harms particular individuals—i.e., the preempted traders (who would have transacted but for the insider trade) and/or the induced traders (who would not have transacted but for the insider trade).[13]

Professor Anderson's article discusses the debate whether to regulate insider trading[14] and notes that those who argue that the practice yields a net harm to society "typically claim that [insider trading] increases the bid-ask spread set by market makers and . . . undermines investor confidence in the markets (both of which in turn increase the

8. *See supra* note 5 and accompanying text.

9. For a discussion of the position that stock market insider trading is a "victimless crime," see John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 Utah L. Rev. 1, 7–10 (2014) [hereinafter Anderson, *Greed, Envy*]. For a discussion of commentary opposing regulation of stock market insider trading, see Wang & Steinberg, *supra* note 2, § 2.2.

10. *See* Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28 n.12.

11. *Id.* at 28–29.

12. *See* Wang & Steinberg, *supra* note 2, §§ 3.3.2–3.3.3.

13. *See supra* text accompanying notes 7–8; Wang & Steinberg, *supra* note 2, §§ 3.3.5–3.3.7; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28–40.

14. *See* Anderson, *What's the Harm?*, *supra* note 1, at 798–99 & nn.18–25.

cost of capital to firms)."[15]

Market makers trade frequently and thus will often be either the preempted or induced trader-victims of insider trading.[16] Consequently, market makers are likely to respond by widening their bid-ask spreads.[17] In short, the Law of Conservation of Securities explains why stock market insider trading increases bid-ask spreads.

The Law of Conservation of Securities also explains why ordinary investors are rational when insider trading undermines their confidence in stock market investing despite the possible lack of harm to the other side of the insider trade.[18] Investors do not know whether they will be injured (or generally even when they *are* injured).[19] The fear of becoming a victim of stock market insider trading may make risk-averse individuals especially reluctant to participate in the market.[20]

Because the risk is associated with the act of trading (or nearly trading),[21] "an investor cannot diversify away the risk by holding a . . . portfolio of [diverse] stocks."[22] Many small transactions, as opposed to a single large one, would decrease the extent of any harm but increase the risk of injury. The risk of harm varies with the frequency of one's trades or near-trades.[23]

With a utilitarian approach, Professor Anderson would allow each company to weigh the benefits and detriments of permitting employees to trade on material nonpublic information. The costs include larger bid-

15. *Id.* at 205. Stock market insider trading increases the cost of equity capital of public corporations generally and particularly for firms whose employees have a reputation for insider trading. *See* WANG & STEINBERG, *supra* note 2, § 2.3.2, at 30 & nn.89–94; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 37 & nn.31–33. For a discussion of commentary supporting regulation of stock market insider trading, see WANG & STEINBERG, *supra* note 2, § 2.3.

16. *See* WANG & STEINBERG, *supra* note 2, §§ 2.3.4, 3.3.6, at 67 & n.84, § 3.3.7, at 74 n.106; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 38–40. For a related discussion, see *infra* text accompanying notes 21–23, 27–29.

17. *See* WANG & STEINBERG, *supra* note 2, § 2.3.4; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 38–40 ("The presence of insider trading may cause specialists and market makers to widen their spreads to compensate for the risk of becoming a victim.").

18. In an earlier article, Professor Anderson stated: "[T]here is no measurable risk of direct harm to counterparties from insider trading, so that is not a concern that should discourage investors from market participation." Anderson, *Greed, Envy*, *supra* note 9, at 10. *See id.* at 52–53 (suggesting envy as one possible reason for the public antipathy toward stock market insider trading). For a general discussion of the possible harm to investor confidence from stock market insider trading, see WANG & STEINBERG, *supra* note 2, § 2.3.1.

19. *See* WANG & STEINBERG, *supra* note 2, § 3.3.7; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 34 & n.25 (describing the task of identifying a preempted seller or induced buyer as "impossible").

20. *See* WANG & STEINBERG, *supra* note 2, § 2.2.1, at 14 & nn.23–25.

21. *See id.* § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 31–35.

22. WANG & STEINBERG, *supra* note 2, § 2.2.1, at 14.

23. *See infra* notes 27–30 and accompanying text.

ask spreads, less investor confidence, and higher cost of equity capital.[24] Contrary to Professor Anderson's conclusion, the Law of Conservation of Securities has moral relevance because it underlies the costs that he says issuers should consider.

IV. The Harm of Insider Trading to Induced or Preempted Traders, Even with a Lower Market Price Resulting from Issuer Approval of Insider Trading

Suppose a firm adopts and publicizes a policy that permits insider trading by some or all of its employees. How does an investor determine the discount in stock price that appropriately reflects the unknown risk of becoming a victim of such trading and the uncertain liquidity cost of larger bid-ask spreads? Determining the appropriate price adjustment is extremely difficult,[25] especially if the insider trading by each employee is surreptitious.[26]

Even if, ex ante, the share price somehow accurately discounts the risk of being a victim of insider trading (and the liquidity cost of increased bid-ask spreads), this price decline would *not* adequately compensate all investors for the risk of being a victim of a stock market insider trade. As discussed above, "[t]his 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')."[27] Therefore,

> [E]ven if the return on [one or] 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 . . . [insider trading] are injured even if they originally purchased their stock at a price that reflected the *average* possibility of insider trading.[28]

---

24. For a discussion of those possible costs, see Anderson, *What's the Harm?*, *supra* note 1, at 799. For a related discussion, see *supra* note 15 and accompanying text.

25. *See* Wang & Steinberg, *supra* note 2, § 3.3.6, at 64 & nn.71–73 (explaining that the discount in stock prices necessary to reflect the risk of becoming a victim of insider trading depends on both "the future frequency of the investor's own trades and the future amount of insider trading," neither of which is easy to predict accurately); Wang, *Victims, Violators and Remedies*, *supra* note 5, at 37.

26. For a discussion of whether the issuer-approved insider trading by each employee would be secret, see *infra* note 33 and accompanying text. Were the issuer to allow tipping, another question is whether direct and remote tippees would disclose their profits after the fact. *See infra* note 33 and accompanying text.

27. Wang & Steinberg, *supra* note 2, § 3.3.6, at 66; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 37.

28. Wang & Steinberg, *supra* note 2, § 3.3.6, at 67. *See id.* § 3.3.6, at 64–67; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 37–38. More frequent trading does *not* increase the benefit from any discount in share prices (resulting from the risk of harm from insider trading).

(Examples of such frequent traders include market makers, day traders, and many hedge funds.)

> To analogize, suppose apartment rents in one neighborhood are slightly lower because a small percentage of arbitrarily chosen residents will be mugged . . . or assaulted. Ex post, the unfortunate victims suffer disproportionately and are only minimally compensated by the lower rents. Ex ante, residents who take walks often are not adequately compensated because they assume more risk than others.[29]

Similarly, investors who often transact suffer disproportionately from the wider bid-ask spreads resulting from insider trading.[30]

V. Corporate Governance, Executive Compensation, and Government Paternalism

The size of public firm executive compensation is controversial.[31] Were a company to permit some or all of its employees to trade on material nonpublic information, the corporation would, in effect, be increasing compensation at the cost of induced or preempted traders.[32] Unless each employee were required to disclose the insider trading profit after the fact, the compensation would be secret.[33]

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, the frequent trader would earn the same return as the infrequent trader through dividends (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 six percent rate of return. With the discount, she receives a seven percent return. The infrequent trader who buys at a discount and holds long term gets the same seven percent return. For a discussion of discounts on closed-end 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) [hereinafter Wang, *Stock Market*].

29. Wang & Steinberg, *supra* note 2, § 3.3.6, at 67; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 38. For a somewhat similar analogy, see Wang & Steinberg, *supra* note 2, § 3.5.2, at 94 & n.166.

30. *See* Wang & Steinberg, *supra* note 2, § 3.3.6, at 68; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 40.

31. *See* Robert E. Wagner, *Mission Impossible: A Legislative Solution for Excessive Executive Compensation*, 45 Conn. L. Rev. 549, 551–68 (2012); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 Wake Forest L. Rev. 1 (2000). For symposiums on executive compensation, see *Symposium on Executive Compensation*, 64 Vand. L. Rev. 349 (2011); Symposium, *Executive Compensation*, 35 Wake Forest L. Rev. 1 (2000).

32. *But cf.* M. Todd Henderson, *Insider Trading and CEO Pay*, 64 Vand. L. Rev. 505, 506 (2011) (presenting evidence that company boards of directors "bargain" with executives about the profits they expect to make from transactions in firm stock and that executives whose trading freedom increased through Rule 10b5-1 plans experienced reductions in other forms of compensation to offset the potential profits from trading).

33. In an earlier article, Professor Anderson said that any objection to secrecy "can be overcome by requiring that corporations announce publicly any policies permitting insider

If a firm were to permit some or all of its employees to tip, the (possibly secret) compensation would be even larger. For gigantic amounts, employees could sell material nonpublic information to hedge funds and other institutional investors, also at the expense of induced or preempted traders. Another issue is whether direct and remote tippees would publicly disclose their profits after the fact.

In addition to the problems posed by its possible secrecy, employee insider trading or tipping is inefficient compensation. Because of its uncertainty, it is likely less valuable than regular compensation to risk-averse employees.[34] Were an insider allowed to tip, the profits of immediate and remote tippees would be even less valuable to the insider/tipper because the benefit might be solely vicarious or the tippee might share only a part of the profit with the insider.[35]

Moreover, insider trading or tipping would be especially costly to risk-averse public investors who do not know whether they will be victims.[36]

The amount of trading profit is also not directly linked to the contribution of the employee.[37] In addition, employee insider trading may decrease the alignment between shareholders and managers and enable the latter to profit by short-selling stock after business decisions turn out poorly.[38] Insider trading may also distort incentives by inducing execu-

---

trading." Anderson, *Greed, Envy*, *supra* note 9, at 17. Announcement of the policy would not disclose the amount of profit gained by each employee. In a later article, however, Professor Anderson said that, were companies to permit insider trading, they "should . . . disclose their insiders' . . . profits in some summary form." John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 381 (2015) (footnote omitted) [hereinafter Anderson, *Anticipating a Sea Change*].

34. *See* WANG & STEINBERG, *supra* note 2, § 2.2.1, at 12 & n.13 ("[I]nsider trading may be inferior to other forms of executive remuneration because of insider trading's nature as a form of special 'in kind' compensation. . . . [T]he manager is uncertain exactly what amount of profit he will receive. Insider trading as a fringe benefit is like a lottery ticket, which risk-averse managers will value at less than the payoff.").

35. *See id.* § 2.2.1, at 13 & nn.15–16.

36. *See id.* § 2.2.1, at 14 & nn.23–25 ("Any benefit to the firm is subsidized not by all the shareholders, but by arbitrarily determined individuals who bear a disproportionate burden. . . . [T]o the extent that investors are risk averse, the fear of becoming a random victim of an insider trade may be a great cost."). For a related discussion, see *supra* notes 19–23 and accompanying text.

37. *See* WANG & STEINBERG, *supra* note 2, § 2.2.1, at 13 & n.14 ("many firm employees may obtain inside information and trade on it without having any role in the production of the information"); *id.* § 2.2.1, at 13 & n.18 (listing several reasons why insider trading is an inferior method of executive compensation, including the fact that "profits from insider trading depend not on the value of the insider's contribution to the company but on the number of shares her wealth allows her to purchase"); Fried, *Insider Trading*, *supra* note 5, at 807 ("[I]insider-trading profits are a peculiar type of pay. They are tied to insiders' informational advantage and their ability to control the flow of information to the market, not to their contribution to economic-value creation by the firm."). *But see* Henderson, *supra* note 32.

38. *See* WANG & STEINBERG, *supra* note 2, § 2.2.1, at 13 & n.21 (allowing insider trading as a

tives to embark on (1) overly risky projects, (2) those difficult to assess by outsiders, and/or (3) deliberately disastrous projects, which would allow executives to profit by short selling.[39]

Another question is why the issuer does not publicly announce that it will itself trade or tip based on material nonpublic information, rather than allowing some or all of its employees to do so.[40]

Were a company board to approve insider trading or tipping by some or all of its employees, one might question whether the board really has the interests of the shareholders at heart. What if the original founder of a public company still controls the board and holds a controlling block of shares?[41] Were even *independent* shareholders to approve

---

form of manager compensation could potentially mean rewarding managers for failure or otherwise enabling a manager to benefit from adverse developments); Fried, *Insider Trading*, *supra* note 5, at 807 ("permitting insiders to sell before their firm discloses bad news reduces the financial payoff differential between good and poor performance, thereby undermining insiders' incentive to increase value").

39. *See* WANG & STEINBERG, *supra* note 2, § 2.2.1, at 12 & nn.11–12 & 20 (discussing (1) the incentive to engage in overly risky projects and those that are difficult for outsiders to assess (to increase information asymmetry), and (2) the relative ineffectiveness of insider trading in aligning interests of executives with those of shareholders); Fried, *Insider Trading*, *supra* note 5, at 807, 826, 830–31 (weakening and distortion of incentives). *But see* Anderson, *Greed, Envy*, *supra* note 9, at 10–11 (questioning whether executives would delay the release of material information in order to trade); *id.* at 13–14 (questioning whether insiders would intentionally create bad news to profit from it); *id.* at 16–17 (arguing that insider trading can be efficient compensation). For a discussion of arguments for and against insider trading as compensation, see WANG & STEINBERG, *supra* note 2, § 2.2.1.

40. Of course, corporate insider trading or tipping raises its own problems, including the following: (1) Would a firm in financial distress be tempted to raise funds by insider trading? (2) How would investors react to a company that stated it would engage in insider trading or tipping? For criticism of corporate insider trading, see Fried, *Insider Trading*, *supra* note 5, at 803–08, 826–33, 839. For criticism of corporate tipping, see William K.S. Wang, *Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox*, 42 VA. J. INT'L L. 869, 876–87 (2002) [hereinafter Wang, *Selective Disclosure*]. For a discussion of policy arguments both for and against allowing corporate insider trading, see Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45, 72–77 (2005), *reprinted in* 35 BANK & CORP. GOVERNANCE L. REP. 425 (2005) [hereinafter Loewenstein & Wang, *Corporation*]. For a discussion of the legal regulation of company insider trading (or tipping) in its own shares, see WANG & STEINBERG, *supra* note 2, § 5.2.3[C], at 310; Fried, *Insider Trading*, *supra* note 5, at 812–15, 820–24; Loewenstein & Wang, *Corporation*, *supra*, at 47–72 (discussing both state and federal law); Wang, *Selective Disclosure*, *supra*, at 871–76.

41. A recent *Wall Street Journal* article said:

> Meet the renegades of executive pay: two dozen companies, including Oracle Corp., RadioShack Corp., and Nabors Industries Ltd., that keep giving top officers sky high pay packages and luxury perks despite shareholder ire.
>
> Investors have repeatedly voted against the salary and bonuses of these companies at annual meetings. Yet the companies appear to have dug in their heels—often because they have founders who still run the business.

Emily Chasan, *Companies Say 'No Way' to 'Say on Pay,'* WALL ST. J. (Aug. 26, 2014, 1:36 PM), http://blogs.wsj.com/cfo/2014/08/26/companies-say-no-way-to-say-on-pa.

such a policy, one might question whether they understood the consequences of the policy.

Suppose the *independent* directors and the *independent* shareholders adopt a fully disclosed corporate by-law that allows certain employees to embezzle from the corporation. Paternalistically, the government might simply nullify the by-law. Similarly, the government might nullify a by-law permitting insider trading or tipping because of a paternalistic conclusion that the decisionmakers must have made a mistake. A full discussion of the complex issue of corporate governance is beyond the scope of this article.

VI. Externalities Resulting from Issuer-Approved Insider Trading or Tipping

Under the Law of Conservation of Securities, a stock market insider trade harms induced and/or preempted traders.[42] With an insider sale, the victim is a preempted seller and/or induced buyer. With an insider purchase, the victim is a preempted buyer and/or induced seller.[43]

Suppose the victim is either an induced purchaser or a preempted buyer who has not previously held shares in the company. Even if the corporate decisionmakers are independent and sophisticated when deciding to allow insider trading, they may not adequately consider the interests of individuals who do not presently hold shares.[44] Although insider trading may raise the firm's cost of equity capital,[45] the company may be relying on other sources of financing.[46]

---

42. *See supra* text accompanying notes 7–8; Wang & Steinberg, *supra* note 2, § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28–40.

43. *See* Wang & Steinberg, *supra* note 2, § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28–35.

44. *But see* Henderson, *supra* note 32, at 543–44 ("Diversified shareholders are as likely to be current shareholders of a firm as they are future shareholders of the firm . . . ."). Many U.S. shareholders, however, are *not* diversified. *See* Wang & Steinberg, *supra* note 2, § 3.3.6, at 66 & n.80; Wang, *Selective Disclosure*, *supra* note 40, at 879 & n.65.

45. *See supra* note 15.

46. *See* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 646 (1988) ("In fact, firms largely appear to avoid the stock market as a source of funding."). *See also* Lawrence E. Mitchell, *The Limits of the Public Stock Market: Theories, Empirics, and Regulatory Implications* (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2569171 (stating that United States public stock market does not provide meaningful financing for industrial production); *id.* (manuscript at 44) ("It appears to be the case that American industrial corporations, both historically and in more recent times, have demonstrated little need for public equity financing, at least as a matter of normal development and growth."); Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 66 Wash. & Lee L. Rev. 1635, 1646–66 (2009); *id.* at 1665 ("The data are clear. Creditors own American business. Public shareholders have made

VII. Permissible and Impermissible "Advantage-Taking"

I know little about moral philosophy and shall leave the debate on that topic to Professors Anderson and Katz. Nevertheless, I shall make a few comments.

The Law of Conservation of Securities shows that stock market insider traders benefit by "taking advantage" of others—namely preempted and induced traders.[47] Professor Anderson responds by claiming that *every* stock market trader intends to inflict harm by profiting at the expense of others.[48] This is an overstatement. Some sellers may solely want to raise cash;[49] others (e.g., purchasers of index funds) may want to invest long-term without attempting to "time" the market or select undervalued securities. Many others—such as dollar-cost averagers (those buying a fixed dollar amount at periodic intervals)[50] or SEC Rule 10b5-1 plan participants (corporate insiders using a SEC "safe harbor" against insider trading liability)[51]—may want automatically to purchase or sell a set amount at specific time intervals.

Nevertheless, many stock market traders do attempt to purchase undervalued shares or sell overvalued ones. If these traders are successful, does the Law of Conservation of Securities show that they gain at the cost of induced and/or preempted traders?

For the following reason, the answer is yes. The Law of Conservation of Securities focuses on the pool of outstanding shares at the time of dissemination of the material nonpublic information. At that time, the insider trader holds either more or less stock at the expense of the preempted and/or induced traders.[52]

Suppose a mispricing-seeking ordinary investor actually succeeds in purchasing an undervalued stock or selling an overvalued one. Further assume that, at some future date, the mispricing disappears. At that time,

---

little contribution to the core functions of American industrial corporations, the financing of productive activity.").

47. *See supra* text accompanying notes 7–8; Wang & Steinberg, *supra* note 2, § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28–40.

48. *See* Anderson, *What's the Harm?*, *supra* note 1, at 803–04.

49. In an earlier article, Professor Anderson acknowledges "the case of a seller who is trading solely to liquidate to cash . . . ." Anderson, *Greed, Envy*, *supra* note 9, at 36.

50. For a discussion of dollar-cost averaging, see Mitat Lika, *How to Keep Up with the Big Guys*, Legal Times, Mar. 23, 1998, at S45.

51. *But see* Anderson, *Anticipating a Sea Change*, *supra* note 33, at 357, 362–66 (insiders may be using unintended loopholes in Rule 10b5-1 plans to trade strategically and beat the market). For a general discussion of SEC Rule 10b5-1 plans, see Wang & Steinberg, *supra* note 2, § 4.5.3; Anderson, *Anticipating a Sea Change*, *supra* note 33, at 345–54.

52. *See supra* text accompanying notes 7–8; Wang & Steinberg, *supra* note 2, § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 28–40.

under the Law of Conservation of Securities, the successful trader has either more or less stock at the cost of preempted or induced traders.

The stock market insider trader knowingly profits by "taking advantage" of others before imminent public dissemination of material information. On the other hand, without knowledge of material nonpublic information, mispricing-seekers *attempt* to "take advantage" of others before the share price corrects. Thus, the question is whether a moral distinction between the two exists.

Often, mispricing-seekers mistakenly purchase overpriced securities or sell underpriced ones.[53] Assume that, at some future date, the mispricing disappears. At that time, under the Law of Conservation of Securities, the mistaken trader has either more or less stock to the *benefit* of preempted or induced traders. In contrast, insider traders rarely, if ever, make errors about mispricing. Therefore, both market makers and the public will react far more adversely to corporate insiders transacting based on material nonpublic information than to traders engaged in the difficult and possibly futile[54] attempt to identify mispricing based on widely available information.

In a somewhat similar context, Professor Anthony Kronman has tried to distinguish between proper and improper "advantage-taking" for the libertarian.[55] One of his examples of impermissible "advantage-taking" is a contract executed because of a threat of violence.[56] Other examples of permissible or impermissible "advantage-taking" are the use of deceit, wealth, talent, *knowledge of certain facts*, and monopoly of a scarce resource.[57] Professor Kronman mentions three possible principles to determine which forms of "advantage-taking" do not invade the rights of the "victim" and thus are permissible: natural superiority, utili-

---

53. Under the semi-strong version of the efficient capital market hypothesis, it is futile to attempt to find mispriced stock based on public, as opposed to nonpublic, information. *See* William A. Klein, John C. Coffee, Jr., & Frank Partnoy, Business Organization and Finance: Legal and Economic Principles 441–42 (11th ed. 2010). For numerous citations to commentary both endorsing and rejecting this hypothesis, see Wang & Steinberg, *supra* note 2, §§ 2.2.2, at 16 nn.33–35, 2.3.1, at 26 n.66. For arguments against the hypothesis, see Wang, *Stock Market*, *supra* note 28; William K.S. Wang, *Index-Fund Outperformance Not Logical in Rational World*, Pensions & Inv., Aug. 5, 2013, at 23, *available at* http://www.pionline.com/article/20130805/PRINT/308059994/index-fund-outperformance-not-logical-in-rational-world. Even if not completely futile, identifying mispricing may be extremely difficult. *See id.*

54. *See supra* note 53.

55. *See* Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 Yale L.J. 472, 472–97 (1980). Professor Kronman uses the phrase "advantage-taking" in a non-pejorative fashion. *See id.* at 480. To emphasize the neutral nature of the term, this article will always place quotation marks around the word "advantage-taking."

56. *See id.* at 477–78.

57. *See id.* at 478–83.

tarianism, and "paretianism."[58] The latter is a form of distributive justice: A particular form of "advantage-taking" should be allowed only if it works to the *long-run* benefit of *most* people "taken advantage" of in that particular way.[59]

To determine whether stock market insider trading is immoral, applying a principle such as utilitarianism or "paretianism" requires weighing the harm caused by the conduct. The Law of Conservation of Securities ascertains the victims of each insider trade and enables analysis of the indirect results of that injury. These results include wider bid-ask spreads, decreased investor confidence, and higher equity cost of capital.

With insider trading, "paretianism" would first use the Law of Conservation of Securities to identify the direct and indirect victims. Then, "paretianism" would ascertain the general benefits of stock market insider trading and somehow determine whether *most* victims are better off *in the long run*.

A utilitarian would weigh any benefits of insider trading against the detriments,[60] including the direct and indirect injury resulting from the Law of Conservation of Securities. In an earlier rule-utilitarian analysis of the morality of insider trading,[61] Professor Anderson considered the

58. *See id.* at 483–97. Kronman argues that only "paretianism" "is consistent with the basic ethical commitments of libertarianism." *Id.* at 485. Presumably, *non*-libertarians might endorse one or more of these three principles: natural superiority, utilitarianism, and "paretianism." A separate part of Kronman's article contends that *liberals* should not have a blanket preference for tax over contract rules as a method for redistributing wealth. *See id.* at 474–75, 498–511.

Kronman's article discusses *face-to-face* contracts rather than stock market transactions. The line between face-to-face stock trades and stock market transactions is blurry. Especially with large blocks, such trading sometimes involves conversations between buyer and seller. *See* Dan Strumpf, *Markets Keeping Faith in Humanity*, WALL ST. J., July 29, 2014, at C1 ("Last year, about 55% of stock trading by dollar volume took place in a 'high-touch' fashion, among human beings communicating one on one and agreeing on the price. . . ."). For a discussion of the blurred distinction between block trades and face-to-face trading, see WANG & STEINBERG, *supra* note 2, §§ 3.3.1, 8.2.2, 15.2.1; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 30–31.

For additional discussion of a principled distinction between permissible and impermissible "advantage-taking," see Anderson, *Greed, Envy*, *supra* note 9, at 27–53.

59. *See* Kronman, *supra* note 55, at 487 ("[O]ne reasonable approach is to interpret paretianism as requiring only that the welfare of *most people* who are taken advantage of in a particular way be increased by the kind of advantage-taking in question. . . . [I]t is only necessary to decide whether most victims of fraud will be better off in the longrun . . . .") (footnote omitted). For discussion and disagreement with aspects of Kronman's analysis, see Larry Alexander & William Wang, *Natural Advantages and Contractual Justice*, 3 L. & PHIL. 281 (1984), *reprinted in* 2 CONTRACT LAW 453 (Larry Alexander ed., 1991); William K.S. Wang, *Reflections on Contract Law and Distributive Justice: A Reply to Kronman*, 34 HASTINGS L.J. 513 (1982).

60. For a discussion of the alleged general benefits and detriments of stock market insider trading, see WANG & STEINBERG, *supra* note 2, §§ 2.2–2.3.

61. *See* Anderson, *Greed, Envy*, *supra* note 9, at 29–33. At one point, Anderson includes a utilitarian analysis of whether society is justified in criminally punishing insider trading. *See id.* at 31–33. For discussion of the practical difficulty of a utilitarian analysis of punishment, see

possible widening of bid-ask spreads and increases in the equity cost of capital[62]—both indirect consequences of the Law of Conservation of Securities as applied to insider trading.

VIII. Some Minor Quibbles

Professor Anderson faults the Law of Conservation of Securities for finding harm in every omission to disclose by someone making a profitable trade.[63] As noted at the beginning of this article, the Law of Conservation of Securities identifies the victims of the stock market insider *trade* itself and does not address the injury from the accompanying *non-disclosure*.[64] (In fact, the material non-disclosure accompanying an insider trade injures those opposite-type traders to whom the insider trader had a duty to disclose, possibly the party on the other side of the trade, contemporaneous opposite-type traders, or all opposite-type traders from the time of the insider trade to public dissemination of the information.[65])

In addition, Professor Anderson argues that an insider trade has no innocent victim when the transaction preempts another insider trade.[66] Such preemption is highly unlikely, however. A preempted buyer must be quite interested in transacting in the company stock but dissuaded by the price change resulting from the insider trade.[67] Assuming someone is willing to trade on material nonpublic information, as long as she knows that the price remains inaccurate, a price change is unlikely to dissuade her from acting.

William K.S. Wang, *The Metaphysics of Punishment—An Exercise in Futility*, 13 San Diego L. Rev. 306, 318–28 (1976).

62. *See* Anderson, *Greed, Envy*, *supra* note 9, at 30. To determine the morality of insider trading, Professor Anderson also applies principles other than utilitarianism. *See id.* at 27–29, 33–53 (applying, inter alia, principles of deontology).

63. *See* Anderson, *What's the Harm?*, *supra* note 1, at 804 ("Moreover, it is not just that the Law of Conservation of Securities finds some harm in every profitable trade prior to an unanticipated material disclosure; it identifies the same harm in every profitable trade *omission*.").

64. *See supra* Part II.

65. *See supra* notes 2–3 and accompanying text.

With SEC Rule 10b-5 private class actions by either purchasers or sellers, under certain circumstances the U.S. Supreme Court creates a rebuttable presumption of reliance when the issuer makes a *materially misleading statement*. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2414 (2014) ("[I]f the plaintiff also shows that he purchased stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant's misrepresentation."); Basic Inc. v. Levinson, 485 U.S. 224, 240–50 (1988). For a discussion of this rebuttable presumption, see Wang & Steinberg, *supra* note 2, § 4.7.3.

66. *See* Anderson, *What's the Harm?*, *supra* note 1, at 805 & n.63.

67. *See* Wang & Steinberg, *supra* note 2, § 3.3.6; Wang, *Victims, Violators and Remedies*, *supra* note 5, at 31–35.

IX. Summary and Conclusion

A stock market insider trade has two different classes of victims: those harmed by the accompanying non-disclosure and those harmed by the transaction itself. The Law of Conservation of Securities identifies the individual(s) injured by the insider trade itself, which does not necessarily include the party on the other side.

Were stock market insider trading victimless, society would be less likely to regulate the conduct strictly. The Law of Conservation of Securities demonstrates that victims do exist.

As Professor Anderson acknowledges,[68] stock market insider trading may have negative consequences. These include wider bid-ask spreads by market makers and lower investor confidence. Both of these effects increase the cost of equity capital of public companies. The Law of Conservation of Securities explains why the decrease in investor confidence is rational, especially because risk-averse individuals do not know whether they will be victims. The Law of Conservation of Securities also explains why market maker bid-ask spreads will increase: because market makers transact so frequently, they are especially likely to be induced or preempted traders.

With a utilitarian approach, Professor Anderson suggests that companies should weigh the negative results against the positive effects when deciding whether to allow employee insider trading.[69] The Law of Conservation of Securities underlies the costs that Professor Anderson wants issuers to consider.

Even if the firm fully discloses its policy of allowing insider trading, and even if the stock's market price somehow accurately adjusts (despite a general lack of knowledge of the size of the bid-ask spread increase and possibly the extent of insider trading), the price change will *not* fully compensate those who trade especially frequently.

Professor Anderson's willingness to allow issuer-approved insider trading also raises corporate governance questions. Employee insider trading (or tipping) is a form of inefficient, possibly huge, and perhaps secret, compensation. Were a corporate board of directors to grant such compensation, one might question whether the board really has the interests of the company and the shareholders at heart. Were the fully independent directors and shareholders to approve such compensation, one might question whether they understand the consequences.

A victim of insider trading may be either an induced purchaser or a preempted buyer, neither of whom has previously held shares in the

---

68. *See* Anderson, *What's the Harm?*, *supra* note 1, at 799.
69. *See id.*

company. Even if the company decisionmakers are both extremely independent and sophisticated in deciding to permit insider trading, they may not adequately consider the interests of these individuals who do not presently hold shares. While insider trading may raise the firm's cost of equity capital,[70] the company may be relying on other sources of financing.

The Law of Conservation of Securities demonstrates that stock market insider trading is "advantage-taking." Some "advantage-taking" stock transactions are moral; others are not. To determine whether stock market insider trading is immoral, applying a principle such as utilitarianism or Professor Anthony Kronman's "paretianism" requires consideration of the harm stemming from the conduct. The Law of Conservation of Securities identifies the victims of each insider trade and enables analysis of the indirect consequences of that injury.

70. *See supra* note 15.