A Decision-Theoretic Approach to Insider Trading Regulation
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Regular readers will know that several of us TOTM bloggers are fans of the "decision-theoretic" approach to antitrust law. Such an approach, which Josh and Geoff often call an "error cost" approach, recognizes that antitrust liability rules may misfire in two directions: they may wrongly acquit harmful practices, and they may wrongly convict beneficial (or benign) behavior. Accordingly, liability rules should be structured to minimize total error costs (welfare losses from condemning good stuff and acquitting bad stuff), while keeping in check the costs of administering the rules (e.g., the costs courts and business planners incur in applying the rules). The goal, in other words, should be to minimize the sum of decision and error costs. As I have elsewhere demonstrated, the [Roberts Court's antitrust jurisprudence](#) seems to embrace this sort of approach.

One of my long-term projects (once I jettison some administrative responsibilities, like co-chairing my school's [dean search](#) committee!) will be to apply the decision-theoretic approach to regulation generally. I hope to build upon some classic regulatory scholarship, like Alfred Kahn's *Economics of Regulation* (1970) and Justice Breyer's *Regulation and Its Reform* (1984), to craft a systematic regulatory model that both avoids "regulatory mismatch" (applying the wrong regulatory fix to a particular type of market failure) and incorporates the decision-theoretic perspective.

In the meantime, I've been thinking about insider trading regulation. Our friend Professor Bainbridge recently invited me to contribute to a volume he's editing on insider trading. I'm planning to conduct a decision-theoretic analysis of actual and proposed insider trading regulation.

Such regulation is a terrific candidate for decision-theoretic analysis because stock trading on the basis of material, nonpublic information itself is a "mixed bag" practice: Some instances of insider trading are, on net, socially beneficial; others create net welfare losses. Contrast, for example, two famous insider trading cases:

- In *[SEC v. Texas Gulf Sulphur](#)*, mining company insiders who knew of an unannounced ore discovery purchased stock in their company, knowing that the stock price would rise when the discovery was announced. Their trading activity caused the stock price to rise over time. Such price movement might have tipped off landowners in the vicinity of the deposit and caused them not to sell their property to the company (or to do so only at a high price), in which case the traders' activity would have thwarted a valuable corporate opportunity. If corporations cannot exploit their discoveries of

hidden value (because of insider trading), they'll be less likely to seek out hidden value in the first place, and social welfare will be reduced. *TGS* thus represents "bad" insider trading.

- *Dirks v. SEC*, by contrast, illustrates "good" insider trading. In that case, an insider tipped a securities analyst that a company was grossly overvalued because of rampant fraud. The analyst recommended that his clients sell (or buy puts on) the stock of the fraud-ridden corporation. That trading helped expose the fraud, creating social value in the form of more accurate stock prices.

These are just two examples of how insider trading may reduce or enhance social welfare. In general, instances of insider trading may reduce social welfare by preventing firms from exploiting and thus creating valuable information (as in *TGS*), by creating incentives for deliberate mismanagement (because insiders can benefit from "bad news" and might therefore be encouraged to "create" it), and perhaps by limiting stock market liquidity or reducing market efficiency by increasing bid-ask spreads. On the other hand, instances of insider trading may enhance social welfare by making stock markets more efficient (so that prices better reflect firms' expected profitability and capital is more appropriately channeled), by reducing firms' compensation costs (as the right to engage in insider trading replaces managers' cash compensation—on this point, see the excellent work by our former blog colleague, Todd Henderson), and by reducing the corporate mismanagement and subsequent wealth destruction that comes from stock mispricing (mainly overvaluation of equity—see work by Michael Jensen and yours truly).

Because insider trading is sometimes good and sometimes bad, rules restricting it may err in two directions: they may acquit/encourage bad instances, or they may condemn/prevent good instances. In either case, social welfare suffers. Accordingly, the optimal regulatory regime would seek to minimize the sum of losses from improper condemnations and improper acquittals (total error costs), while keeping administrative costs in check.

My contribution to Prof. Bainbridge's insider trading book will employ decision theory to evaluate three actual or proposed approaches to regulating insider trading: (1) the "level playing field" paradigm, apparently favored by many prosecutors and securities regulators, which would condemn any stock trading on the basis of material, nonpublic information; (2) the legal status quo, which deems "fraudulent" any insider trading where the trader owes either a fiduciary duty to his trading partner or a duty of trust or confidence to the source of his nonpublic information; and (3) a laissez-faire, "contractarian" approach, which would permit corporations and sources of nonpublic information to posit their own rules about when insiders and informed outsiders may trade on the basis of material, nonpublic information. I'll then propose a fourth disclosure-based alternative aimed at maximizing social welfare by enhancing the social benefits and reducing the social costs of insider trading, while keeping decision costs in check.

Stay tuned...I'll be trying out a few of the paper's ideas on TOTM. I look forward to hearing our informed readers' thoughts.

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