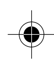


16 Insider trading, takeovers and property rights

Pierre Garello

Why should we deal with these two issues and what relates them?

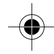
The first common point is surely that both issues, insider trading and takeover, have attracted much attention, not only from the media but also from regulators and legislators, and consequently, from scholars. Today, insider trading and takeovers are among the most regulated property rights transactions. Moreover, those regulations have been and still are the object of many controversies.

Another common point is that both issues are related to corporate governance. Insider trading, at least initially, describes a type of behaviour on the part of top employees that was judged to be detrimental to the owners of the company, that is, the shareholders; while the goal of a takeover is most of the time to change the management of a corporation, or at least to modify its strategy. Hence at the heart of both issues we find the relationship uniting shareholders and managers, even though, as will be recalled below, the general functioning of the market is also a matter of concern for the regulator.

A third common point relates to the problem of jurisdiction. In both cases the search for a solution to the problem could either be left to the parties directly involved in the contractual relationship (the contract between managers and owners, the contract between co-owners, or the contract between companies and trading centres), or entrusted to the local state; a third possibility, is that it could be left to the federal level (for example in the United States) or at the level of the Union in Europe. The tendency, again in both cases, has been towards 'centralization', 'forced harmonization' and 'federalization', rather than competition. One of the aims of the present study is to evaluate that tendency: does it go in the right direction? To answer this question we shall need to specify what a good direction would be, which in turn raises the preliminary question of what is meant by a proper functioning of the market.

Finally, the two topics are naturally linked by the fact that most insider trading violations appear to be related to takeovers.[1]

To address these issues properly and evaluate related laws and regulations requires first a reflection on the nature of the title of ownership bought by a shareholder, and in particular on the status of limited liability. The desire to regulate or prohibit insider trading and takeovers comes largely from a lack of consideration for the reasons that initially led the parties to choose a



regime of co-ownership and limited liability. Following this general reflection on limited liability, we shall examine respectively the economics and law of insider trading and then of takeovers. In a final section, we shall leave aside the more theoretical questions to ask ourselves who has a direct interest in such regulations? This public choice perspective might give us a better prediction on the future of those rules and regulations that govern insider trading and takeovers.

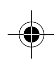
Limited liability: its origins and consequences

What types of property rights are traded by an insider or during a takeover? Those are titles that make their bearers co-owners of a company, most of the time with limited liability. It is interesting to reflect on the reasons why such a specific form of ownership developed in the first place.[2] At the beginning was the need to raise significant amounts of capital. Due to the size of the investment, the enterprise was too risky for a single investor. Hence the desire came to develop some legal concepts of partnership, and indeed many new legal arrangements have been invented, from the twelfth century to the present. But each ‘solution’ had its own drawbacks. In particular, as more partners were called into a project, and as the project increased in size, liability became a preoccupation. Each partner had less control on the way the business was run as well as on the way his/her partners were handling their own business.

Limited liability can be seen as a possible response to the control problem that resulted from the increased number of partners.[3] It is easier to convince investors – at least some of them –to invest capital in a company if they know their liability is limited. Hence, limited liability was a compensation offered for joining a business in which one has little control. Nonetheless, this contractual solution came, as always, at some cost: to third parties and to the co-owners themselves.

Third parties include clients of the company (consumers, suppliers), as well as lenders to the company. Following the introduction of limited liability, third parties have to increase their control of the company precisely because co-owners, being made less liable, have less incentive to exercise that control themselves.[4] Lenders, therefore, will most probably ask for higher rates while clients will ask for lower prices, both situations leading, everything else equal, to lower returns for shareholders. Hence, limited liability shifted risk, and it is customary for those who bear more risk to demand a premium that will be paid by those who have reduced their exposure to risk, namely, the shareholders.

Being imperfect, the limited liability option is not always the most interesting form of co-ownership. An alternative could be to stick to unlimited liability. In that case, co-owners will have to diversify risk themselves. They



will most probably choose to rely on 'internal diversification' – the same company diversifying its activities – rather than 'external diversification' – individuals buying shares in a variety of companies which are each rather undiversified. Furthermore, in an unlimited liability company, co-owners will not only have greater incentives to check on management's behaviour and on the degree of risk involved in the project they undertake, but they will also have to control the behaviour of the other co-owners, their liabilities being tied.

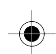
Which option – limited or unlimited liability – is the best probably depends on time and place, on whether external or internal diversification is more appropriate, on the degree of risk aversion of market participants, and, last but not least, on the availability and cost of insurance. The point needing to be stressed for the purpose of our inquiry on insider trading and takeovers is that by choosing limited liability, as many companies did, the choice was made, so to speak, to 'get around' the control problem instead of trying to deal with it in a more direct way. One can hardly opt for limited liability while simultaneously keeping a high degree of control. There may be many ways of diversifying risk, but there is no way to eradicate it, at least as long as we are participating in a dynamic, changing economy.

Finally, it should be recalled that, besides limited liability, another complementary strategy has been adopted to raise more funds: to reduce substantially the cost of exit. Nowadays, in many instances it is possible to sell shares by means of a simple phone call, no authorization being required from other shareholders or managers. Clearly, when such a strategy is used to raise capital a worsening of the control problem is to be expected.

However, although no institutional arrangement is perfect, we should not embark on the slippery slope of resignation. Property rights arrangements can and do evolve as will be shown below; and many ways exist and are still being invented in order to improve the simplest form of limited liability. It remains nonetheless evident that limited liability and the low cost of exit constitute a handicap for those who are seeking tight control over choices made by the company's management, including insider trading and takeovers.

Insider trading

Insider trading occurs when an insider is trading in securities while in possession of material non-public information. In the United States, Section 16 (a) of the Securities Exchange Act of 1934 started by defining an insider as an officer, director or anyone who holds more than 10 per cent of equity shares. That definition, however, was judged to be unsatisfactory because someone in possession of a valuable piece of information, without holding one of the positions specified by the law, could trade without having to worry about insider trading regulation. Later, the definition was therefore broadened, so



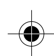
much so that, as we shall see, the regulation on insider trading has been applied to 'outsiders' who were trading on the basis of information which was not even coming directly from inside the company. What a misnomer!

Leaving aside the definition of an insider, the general idea is that the private use of inside information would be detrimental to shareholders' interests and undermine market morality. As a consequence, in order to protect actual shareholders and attract new ones, either information should be made public or its use should be illegal. Before developing and examining this argument, one can, in the light of our previous discussion, question its robustness. Indeed, if the intention with limited liability was to avoid rather than solve the control problem, then shareholders cannot reasonably expect that their trading partners will never be better informed than themselves. Hence, the promise formulated by legislators and regulators to ensure relatively equal access to information to all traders, appears, at first sight, unreasonable. Below, the logic of this approach will be further studied before we examine the history of legal prohibition.

To start with, there is no evidence that insider trading drives investors away from the market. As a matter of fact, while more insider trading cases were brought to the attention of the general public in the 1980s and 1990s, securities market capitalization kept growing.[5] An explanation for this lack of reaction to insider trading could simply be that there is little to react about: shareholders' interest would hardly be affected by such behaviour. So, let us look more carefully at the likely consequences of insider trading for shareholders.

Shareholders could be injured because part of the gains associated with 'good news' for their company will go to the insider rather than to them. This could be especially true when they *sell* their shares to insiders. More precisely, in order to grasp their profit opportunities, insiders would have to trade with some shareholders of their company, and those shareholders will therefore reap little advantage from the good news.

Without denying this fact, it must be emphasized that the damage thereby caused to shareholders is neither so great nor so immoral for the following reasons. First, insiders will trade only on a limited volume of shares due to their wealth constraint and to their fear of being unmasked, thus, only a small portion of shareholders will lose the opportunity to gain from the good news. In the meantime, the other shareholders, those who do not sell to the insider, will benefit from insider trading because, assuming that insider trading has an effect on the price of the share, it will precipitate a price increase. Second, it must be recalled that those shareholders who sell to the insider do it voluntarily: they were looking for a buyer when the insider offered to trade. This means that either they thought no good news was likely to come from that company – in which case they should blame themselves for holding errone-

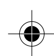


ous expectations – or they had some liquidity problem that the insider helped to solve. Without the insider they would have had to wait or to sell at an even lower price.

The damage to shareholders could well be limited for another, indirect, reason. As pointed out by Manne (1966), the possibility of trading on inside information gives further incentives for managers to 'produce' good news. Gains realized by insiders would hence compensate them for their effort; the compensation being positively correlated with the increase they generate in the assets' value, and therefore with the increase in shareholders' wealth. This argument is, however, weakened by two considerations. On the one hand, the insider is not necessarily the producer of the good news; he/she is not necessarily responsible for the value increase. On the other, the material non-public information on the basis of which the insider trades is not always goods news for the company; it can as well be bad news. When looking at the two sides of insider trading, it appears then that, as far as incentives are concerned, allowing insider trading will tend to push managers to undertake riskier projects since it is possible for them to grasp the potential profits without having to bear the potential losses. Now, whether or not it is desirable to have more risk and potentially higher returns is a matter of subjective preference, and surely shareholders' preferences will in general differ: some may welcome a riskier strategy, while others may wish to avoid it.

Bad news for the company, as said above, will lead the insider in possession of that piece of information to sell his/her shares either to someone who already owns some, or to some 'outside' investors. The first case is similar to the one we just dealt with. The second case is different because here the insider is not, prior to trade, related to the outsider and, consequently, there can be no breach of fiduciary duty through trade. The case for prohibition is therefore weakened. Nonetheless, even though no fiduciary duty can be established it has been argued that the market would be more efficient and attract more participants if insider trading were prohibited. This line of argument, however, reveals, in our opinion, a misunderstanding of the functioning of the market. Markets are not efficient to the extent that each trader is perfectly informed (Fama's approach); they are efficient *because* they allow us to trade on the basis of our personal and incomplete knowledge, thereby giving us an incentive to develop new knowledge (see Hayek 1945). Indeed, the strength of the market system is that it promotes the expansion of knowledge through a greater division of knowledge. The battle for equal access to information for all traders is therefore not only a lost battle, but a battle that is more likely to reduce efficiency.

While in agreement with the above analysis of the market system, some may add that the market system is nothing but an institutional arrangement based on property rights and contracts, and that it will perform its task even

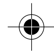


better if information is protected by property rights. Hence, insider trading regulation will increase efficiency, just as patents, copyrights and trademarks do.

To see insider trading regulation as defining *de facto* property rights on information is, however, problematic. The problem arises when one must clarify who owns the rights. If they belong to shareholders then the insider who owns some shares, also owns the rights. Therefore it is not enough to point out that shareholders have property rights on information to ban insider trading; one must also add that those who own the rights cannot trade on the basis of these rights. But then the economic advantage commonly attached to the definition of property rights vanishes. The most obvious solution is therefore to allocate the property rights to the company. But here again the economic argument is weak. Indeed, contrary to the case of patents and copyrights, the insider's use of information does not necessarily harm the company. In some cases, such as takeovers, the company can even benefit from insider trading which increases the chance of success of the takeover. Hence, there is no clear economic argument in favour of an assignment of property rights on non-public information.

To end our theoretical inquiry let us add that, even if one agrees that insider trading has to be banned, the question still remains: who will be in the best position to do it, and at what cost? It is sometimes argued that economies of scale are realized when the control is entrusted to a general administration such as the Securities Exchange Commission in the United States, but even those studies that examine the effectiveness of insider trading regulation do not take into account the administrative cost of such a regulation.[6] The economies-of-scale argument is therefore far from being conclusive. Also, could insider trading be dealt with at the level of the firm? Would not a contractual solution to that agency problem be as efficient – from a cost–benefit point of view – as an administrative control? The company desirous of signalling to its shareholders that something is being done in the company in order to avoid insider trading could then hire a private agency that would do the work currently performed by the administration. Insider trading cases would then be treated just like any other breach of contract.

Turning now to the legal aspect of the problem, our first observation is that law and regulation have been using various arguments since insider trading became an issue (for references, see Bainbridge 2001). Prior to the 1934 Securities and Exchange Act, insider trading cases were in the competence of state laws and there was little prohibition. Of course, fraudulent concealment or misrepresentation were a matter of liability, but, in the absence of such behaviour, the rule was that the officers of the company had no duty to disclose all the information they might have about the company before trading in their company's shares. In 1903, the Georgia Supreme Court reversed

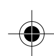


this rule by establishing a duty to disclose for officers; but a 1909 US Supreme Court's decision recognized that such a duty could exist only under special circumstances, and furthermore, only for the purchase of shares, since there could be no fiduciary duty with respect to non-shareholders to whom you sell shares.

The year 1934, however, marked a complete change in the way insider trading was to be legally handled in the future. The Securities and Exchange Commission (SEC) was created 'to protect investors and increase public confidence in the reliability of the securities markets'. To do so, it was believed necessary to go beyond the mere condemnation of fraudulent behaviour and to impose full disclosure of information by insiders wishing to trade. The 1934 Act, however, did not target insider trading as one of the behaviours to be banned and, as a matter of fact, insider trading was not explicitly mentioned in the law. The closest it comes to mentioning it was probably with Rule 10b, which states that it is unlawful 'to use any manipulation or deceptive device or contrivance or contravention of such rules and regulation as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors'.[7] Even though that rule was completed in 1942 (Rule 10b-5), the prohibition of insider trading remained at that time limited to face-to-face transactions.

A new turn occurred in 1961 when the SEC ruled that insider trading on an impersonal stock exchange was violating Rule 10b-5.[8] Shortly after, the Second Circuit Court of Appeal confirmed the SEC decision and developed the 'disclose or abstain' rule, according to which insiders must either disclose all relevant information they possess or abstain from trading in the shares of their company. The decision was founded on the necessity, according to the judges, of ensuring that all traders have 'relatively equal access to material information'.

But this was far from ending the legal controversy. Indeed, in the early 1980s, the Supreme Court temporarily put a hold on a trend of ever-increasing prohibition. In the *Chiarella* case it reversed a decision that condemned someone who traded on the basis of privileged information but was not an employee, while in the *Dirk* case, Dirk, a securities analyst who had tipped off some clients, was also declared innocent.[9] The SEC, however, did not remain silent and its reply came soon after with the addition of a new rule, Rule 14e-3. Under this rule it is forbidden to release information about a tender offer to someone who is likely to trade on the basis of that information for his/her own interest. Besides Rule 14e-3, which applies only to tender offer transactions, the doctrine of 'misappropriation' was also developed. According to that doctrine, an outsider, although not violating any fiduciary duty to the person with whom he or she trades, can nonetheless be convicted of infringing a fiduciary duty to the source of the information. Then in 1984,



Congress passed the Insider Trading Sanction Act, followed in 1988 by the Insider Trading and Securities Fraud Enforcement Act, both aimed at an enhanced compliance with insider trading regulation in the United States.[10]

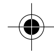
As one can see, most of the regulation of the last 50 years was initiated at the federal level. State corporate law, however, is not totally silent on the question. Indeed, one can rely on agency law and the fiduciary duty it acknowledges between the principal and the agent. Hence, to give an illustration, Section 395 states that the agent may not use for personal gain any information given to him/her by the principal or acquired by him/her during the course of or on account of his/her agency. But agency law also requires that the principal be injured by the behaviour of the agent, which, as recalled above, is often not the case.

Having surveyed both the law and the economics of insider trading, we are left with a feeling of disproportion: the fierce attacks on insider trading launched by the administration, with the support of most legislators, appears out of proportion to the problem potentially raised by insider trading. Because, without denying that insiders may harm some shareholders, insider trading can just as easily be beneficial to many other shareholders and to the company as well, so a cost–benefit analysis can hardly be conclusive. Now, if instead of a cost–benefit analysis one wishes to justify the prohibition with a fiduciary duty towards one's employee – a justification which, as we argued, is weak – this will limit the prohibition to cases in which insiders have themselves been purchasing shares, thus injuring the company, or some of the shareholders. Finally, to argue that the insider is 'stealing' the information from the company, thereby violating property rights is not satisfactory, because the economic incentives to define and enforce such rights are doubtful.

Takeovers

To take over a company is one way to gain control over it and often, to dismiss the incumbent management.[11] However, many takeovers are negotiated with the incumbent management; and when they are not, they can nonetheless receive its approval (friendly takeover), so that takeovers met with fierce resistance (hostile offer) are rather the exception. For reasons that will be developed below – related mainly to the capital structure of publicly traded corporations – it is mainly in the United States and the UK that takeovers have attracted a lot of public attention and raised many questions such as: what motivates those changes in control, do they promote economic development, and, consequently, should they be regulated?

Takeovers are heavily regulated and if this regulation is nowadays closely tied to insider trading regulation, such has not always been the case. Historically, the first regulation of takeovers was conceived mainly as a safeguard for consumers and small businesses rather than for shareholders. In other



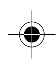
words, the problem was seen not with the transaction *per se* – one party to the transaction requiring protection – but with the distribution of power among market participants that could result from those transactions; a distribution of power that was judged to be detrimental to 'social welfare'. We shall start with a critical examination of this line of argument against takeover before dealing with the more recent and more corporate governance-oriented aspect of takeover regulation.

At the end of the nineteenth century, important innovations in corporate law took place (supported in particular by the states of Delaware and New Jersey), giving a good illustration of the process of institutional innovation, and more particularly of innovation in property rights arrangements. The Sherman Act, a federal law, was then passed essentially out of fear that some of those innovations would impede on interstate businesses.[12] It was thought that large cartels could destroy competition. At that time, most economists saw essentially positive aspects to mergers, which were judged to be the source of economies of scale and therefore to enhance economic efficiency. Indeed, to confirm that this first piece of legislation was not directed against mergers, it is enough to recall that between 1898 and 1902 there was a great wave of mergers.

After the election of Theodore Roosevelt, hostility towards mergers grew. However, this did not last and, in the 1920s, as enforcement of antitrust law was somehow scaled back, a new wave of mergers and acquisitions took place, giving rise to the modern corporation as we know it, with a great number of shareholders and a new allocation of power between managers and shareholders. It is this evolution that motivated A.A. Berle and G.C. Means to write their famous book *The Modern Corporation and Private Property* (1932) in which they criticized such a development.

As in the case of insider trading, the regulation framework changed and became largely a matter of federal law in 1934 when the Securities Exchange Act was passed. Indeed, 1934 marked the beginning of a long period of hostility towards takeovers which came to be seen as means to obtain monopoly power; monopoly power being in turn perceived as incompatible with competition and therefore suboptimal in the neoclassical–Paretian sense of the word. The Williams Act passed in 1968 completed the work by imposing even stricter disclosure requirements and restricting the terms of a tender offer.[13] Hence, by the end of the 1960s, market authorities were typically forbidding a merger involving market shares of as little as 5 per cent of the 'relevant market'.[14] Not surprisingly, however, takeovers did not disappear; rather, they changed tack: it is probably due to those regulations that conglomerates, which sometimes had little economic sense, were formed.[15]

If in the 1980s most economists still considered the degree of concentration of a 'given' market as a threat to economic efficiency, the judgement,



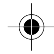
however, was now more cautious.[16] Hence, any takeover – and more generally any business practice – likely to lead to a 'substantial lessening of competition' had to be checked out and eventually forbidden. The era of a priori control and of the 'rule of reason' hence entered the stage. According to that rule, prior to any takeover, experts mandated by the market authorities must check whether or not the transaction would be to the benefit of the whole community (see Kovacic and Shapiro 2000).

From a theoretical point of view, however, such an approach raises new problems. To ask experts to weigh social costs (essentially, monopoly power) and social benefits (essentially economies of scale, more rapid spreading of new technology, or business synergies) can hardly be reconciled with a dynamic understanding of the market. Indeed, the neoclassical paradigm on which that regulation is in great part founded could soon start to stumble under the attack of competing views that saw the market as a discovery process whose outcome is therefore unpredictable – even to the best expert – and monopoly as a natural phenomenon in a competitive framework rather than a state of affairs incompatible with a state of competition.[17] Perhaps because economic theory was faltering, or, perhaps because the mere fact that you dislike the outcome of a transaction is not a sufficient reason to ban it, in 1982 the Supreme Court declared unconstitutional a wave of restrictive anti-takeover laws that were passed by some states' legislatures.[18]

As mentioned above, to prevent monopoly power from being seized is not the only justification for supporting takeover regulation. We need now to analyse the other justification brought forward to maintain strict control over a takeover: namely, that it might injure shareholders, and more generally the functioning of the capital market.

The debate on this point is animated and brings us back to corporate governance.[19] Empirical evidence (starting with Jensen and Ruback 1984) tends to show that a target's shareholders gain from takeovers, while the shareholders of the acquiring company, on average, neither gain nor lose from such an operation. Also, some empirical studies have looked at the evolution of productivity after a takeover and have found no significant effect, while other studies support the thesis that mergers increase companies' profitability and are correlated with growth (see Healey et al. 1992; Lichtenberger 1992). Putting aside empirical evidence – evidence that remains, anyway, unclear[20] – through what mechanism could takeovers increase, or lessen, the well-being of shareholders?

Again, to address this question we should recall the nature of the title owned by a shareholder, and in particular the limited liability property of that title. If, as argued in previous sections, limited liability is a way to acknowledge the control problem, that is, if it is essentially a compensation granted in order to surrender, at least in part, the control over the management of the



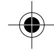
asset, then shareholders can hardly expect to have the company's assets managed exactly as it pleases them.

In that spirit, and as forcefully argued by Henry Manne, takeovers could even be seen as a blessing for shareholders. A shareholder with limited liability, and little incentive or capacity to exercise thorough control of the management could rely on outsiders to check on the quality of the work done by incumbent managers. If the latter perform poorly, if they do not get the best out of the company's assets, outside entrepreneurs will then attempt to seize the profit opportunity and shareholders will be able to sell their shares at a premium (Manne 1965).

This is surely a powerful argument. It is in fact the traditional argument used to underline the benefits from a property rights system: if you believe that a given asset can be managed in a more profitable way (in the widest sense of the word, that is, it might be that you attach a high but very subjective and unusual value to the asset), and if you can make the actual owner of the asset better off, then a transfer of property can occur that will make everyone better off.

In the case of a takeover, however, two complications may arise that need to be dealt with. First, it is a case of co-ownership (and therefore some shareholders may hold on to their shares, refusing to tender them to the acquirer). Second, one might argue that actual owners do not realize where their own interest lies. They might run after short-term benefits and, if everyone does the same, no company will be able to engage in strategies that are beneficial only in the long run. Let us start with that second problem: Can the short-sightedness and lack of information of investors force managers to adopt a short-sighted strategy?

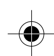
The mere fact that some shareholders are interested only in the short-term benefit does not provide a sustainable argument against takeover. For, indeed, two cases may arise. Either, prior to the offer, the share was 'correctly' valued – by that we mean here that market participants had correctly assessed the quality of the work done by managers[21] – or the share was undervalued. In the first case, shareholders are surely not harmed by an offer to tender their shares at a premium. In the second case one must again distinguish between two possibilities: either the shareholders were aware of such undervaluation, or they were not. If they were, then they should rationally have bought more shares and hence their benefits from and chances of success of a takeover would be even greater. If they had not yet realized the quality of the work done by the incumbent management, then one may reasonably believe that the high premium offered at the takeover is based on the present value of the asset, given that good investments have been realized. Hence, through a takeover process, the shareholders will, at worst, have to share part of the profits that the 'raider', and not they, has discovered. This again can hardly be seen as an injury.



Now, it is still possible that some shareholders judge the offered premium to be too low compared to what they believe to be the real value of the share. In such circumstances, shareholders may be disappointed by the fact that other co-owners tender their shares. In other words, they may wish the takeover attempt to fail and be disappointed in their expectations. Conversely, they may wish the takeover to be successful – thinking that it is a good deal – and be disappointed by the behaviour of those shareholders who, holding on to their shares, force the acquirer to withdraw his/her offer. Even if understandable, such a disappointment by definition concerns a minority of shareholders and, anyway, this problem is not specific to takeovers; it is a general problem with co-ownership and arises as well in a proxy contest or any vote of the general assembly of the corporation. Hence, if the possibility of holding out is a real problem, it will, in our view, best be dealt with by shareholders themselves when drafting the chart of the company and defining the contractual arrangement binding all shareholders.[22] Now, due to the diversity of shareholders' preferences, it is to be expected that choices will differ from one company to another. For that same reason, it is difficult to find a clear interpretation to the change in share value that occurs when the board of a company decides to move to a state where corporate law makes takeover transactions more difficult (such as Delaware).[23] Indeed, some investors might take that move as good news because they trust their management and think they can control their behaviour through other means. But the reverse is also possible: shareholders can interpret the change as bad news because they wish to rely more on outside control. What one should worry about, in that case as in similar ones, is harmonization of the law across states. Such harmonization would reduce the alternatives open to shareholders as well as to managers. As long as contractual freedom is preserved, there is no reason to be, as a matter of principle, for or against anti-takeover strategies.

The above presentation stresses the diversity of ways of controlling the performance of the managerial team as well as the various possible motives behind a takeover. The bottom line is that such transactions can be profitable for all the parties in the long run, or to the disadvantage of one party or even both. Can we know beforehand what will be the case? While partisans of the rule of reason tend to answer positively, we have argued to the contrary that, the market being essentially a discovery procedure, a social costs–social benefits analysis of the consequences of a takeover is impossible, even to the best experts. In short, the rule of reason does not appear to us reasonable when one takes into account its cognitive requirement.

But even if it were possible to assess beforehand with 'enough' accuracy the outcome of the transaction, would that constitute a sufficient reason to prohibit it? To answer positively would be tantamount to greatly reducing



contractual freedom, for, if the idea is accepted in the case of takeovers, why not interfere as well in many, otherwise valid, property transactions?

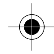
Public choice considerations

The analysis so far has not enabled us to find clear arguments – economic or other – in favour of a regulation of takeover and insider trading; at least nothing that justifies the kind of strong prohibition that has developed. If one wishes to understand the origin of such regulations and rules one must therefore look in another direction and ask who, if anyone, benefits from those regulations. It is with this public choice approach of the problems that we shall end this chapter.

To start with, let us see who benefits sufficiently from a prohibition of insider trading to formulate a demand? The motivation of shareholders does not seem to be strong enough, since, as was argued earlier, a single shareholder does not lose much through insider trading and, furthermore, getting all shareholders together to lobby in favour of such a regulation is costly. If not from shareholders, the demand for regulation could eventually come from those managers who fear that insider trading transactions conducted by their colleagues will in the long run affect their reputation and salaries. Such managers may welcome a regulation that will impose control for them. But, it could also come from those managers who feel under threat from a hostile takeover, since insider trading may lower the cost of such an operation.[24] More importantly, and as suggested by Haddock and Macey, the demand for regulation could come from market professionals (see Haddock and Macey 1987; Macey 1991). Indeed market makers will always be on the wrong side of the transaction when dealing with an insider. Consequently, they will increase the bid–ask spread to protect themselves, thereby indirectly hurting professional investors. Finally, market analysts would be more than happy to see their main competitors, the few who are better informed than them, severely punished by the administration.

On the supply side, regulating agencies are interested in an enlargement of their mission and in the increase of power that goes with it.[25] In this respect, insider trading, because it is presented as a symbol of the war against supposedly unfair trading, as a battle for the weak against the privileged, and more generally as a necessary step towards the reconciliation of market and morality, is a benediction for regulators.

As far as takeovers are concerned, the demand for regulation could come from managers to the extent that the threat of a takeover is not always welcomed. That explanation, however, is hard to reconcile with the fact that most takeovers are friendly. Besides protecting managers' interest, the regulation could be welcomed by companies trying to stop the growth of their competitors.[26] Let us also note that competition law cases make extensive use



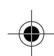
of experts (economists, lawyers and so on). Those experts will surely push the demand for regulation, or at least are unlikely to ask for a relaxing of the regulation. Finally, mention should be made of stakeholders' interest, and in particular of employees' motivation. As Bittlingmayer (2000, p. 743) argues, one of the reasons behind a hostile merger would be to allow for the kind of heavy restructuring which is so difficult to undertake from inside. One could then understand the hostility of stakeholders – in particular of employees – towards such a change of control.

On the supply side, the motivation would be identical to that already mentioned for insider trading. More regulation translates into more power for 'market authorities'. In many countries, the trend clearly has gone in that direction, and the level of fines that can be imposed gives a rapid idea of that new power. In a case of insider trading, the SEC can ask the Justice Department to initiate criminal prosecution (the fine can be as high as $2.5 million and up to ten years in jail). In addition, the SEC may pursue civil penalties seeking a permanent or temporary injunction, or seeking disgorgement of the profits realized, or decide on a monetary penalty that can be up to three times the profit gained or loss avoided. It is even allowed to pay a bounty to informers of up to 10 per cent of the penalty it has collected, not to mention other sanctions such as revocation, or suspension of activities for a broker.

Concluding remarks

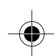
Both insider trading and takeovers are the subject of a great many legal rules and regulations set at various levels (the Federation or the Union, the states, corporate law). In both cases the interference is motivated by the desire to protect the weak party to the transaction – because that party is believed to be uninformed or ill-informed – and hence to promote general (social) efficiency (including the well-being of third parties not directly involved in the transaction). We have argued that such regulations and rules can be called into question for various reasons. The most important one, in our opinion, is that this trend neglects the main features of that form of ownership, namely, shared ownership and limited liability. Because of those features, the words of the Massachusetts Supreme Judicial Court are more than ever to be remembered: '[Law] cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud'.[27]

Surely, institutional arrangements need to evolve. And, in that field as elsewhere, competition remains the safest route, albeit not a perfect one. Regulation from the top and harmonization of regulation across jurisdictions is what we should be afraid of.



Notes

1. According to Meulbroek (1992), 79 per cent of insider trading cases initiated by the Securities Exchange Commission between 1980 and 1989 were related to takeovers.
2. For a history of and extensive references on limited liability, see Carney (2000).
3. That solution required the development of the legal concept of a corporate body.
4. At this point, it would be interesting to investigate to what extent bankruptcy law offers some protection to third parties, thereby reshaping the control problem. However, a discussion of bankruptcy law is beyond the remit of this chapter.
5. Of course, it is still possible to argue that, without insider trading, capitalization would have been even higher.
6. On the effectiveness of insider trading regulations see, for instance, Boardman et al. (1998) who are rather optimistic, and Jaffe (1974) or Seyhun (1992) who are sceptical.
7. Rule 16b also relates indirectly to insider trading.
8. The case, furthermore, was one of tipping, that is, the transaction was not conducted by an insider. Instead, it was conducted by an outsider who had been informed (tipped) by an officer of the company which shares were traded.
9. *Chiarella v. United States*, 445 US 222 (1980) and *Dirks v. SEC*, 463 US 646 (1983).
10. Meanwhile, in 1989, a European Community directive (Council Directive 89/592) harmonized insider trading regulations throughout the Community.
11. Other ways, such as the election of a new board of directors through a proxy contest, are usually more expensive.
12. This is actually the Supreme Court's interpretation of the law. We come back to the public choice aspect of regulation in the last section. For a history of takeover regulation see Kovacic and Shapiro (2000) for the United States, or or Neumann (2001) for Europe.
13. More precisely, the Act stipulates that, following a tender offer, shareholders have a right to withdraw their offer to tender during the first seven days. The Act also imposes prorationing of tendered shares after 60 days and stipulates that increased offers apply retroactively to shares tendered earlier. It also requires from any acquirer who buys 5 per cent of outstanding shares on the open market that he/she discloses his/her purchase to market authorities.
14. Brown shoe case, reported in Glais (1992).
15. That those conglomerates made little economic sense can be deduced from the fact that, as soon as horizontal mergers were allowed to resume, the '*fashion*' changed, many of those conglomerates being dismantled and the new dogma becoming one of coherent development centred on a clearly identified know-how. Bittlingmayer (1996, 2000) goes further and argues that a negative correlation could exist between the degree of takeover prohibition and the return on stock exchanges. In particular, the crisis and crashes that took place in the twentieth century would have followed announcements of tighter regulations.
16. Two publications, by Posner (1976) and Bork (1978), have revisited the case for antitrust.
17. For more details on what is meant here by 'a discovery process', see Hayek (1978) or Kirzner (1997). The traditional, neoclassical approach still has many adherents. See, for instance, Neumann (2001) for a recent presentation.
18. In *Edgar v. Mite*, 457 US 624 (1982). We must note, however, that a later wave of anti-takeover law more carefully drafted by the states' legislations was upheld.
19. The corporate governance side of the debate has various dimensions according to the structure of ownership in the company, and more generally in the jurisdiction. Hence, in Germany or Japan, because banks hold large shares of companies, managerial control is less evident during takeovers. In the United States, on the contrary, the Pujo 'Money trust investigation' drove banks off the boards of directors in 1912, and investment funds and other financial intermediaries are also restricted in their stockholdings, giving corporate governance a different outlook.
20. But recall that any voluntary transaction, even in a strict Paretian–neoclassical framework, increases the well-being of both parties. Although of course some will argue that this is untrue when there are informational problems.



21. Of course, only as the future unfolds will it be possible to find out whether or not the share was correctly valued. Market evaluation always rests on subjective expectations.
22. A central point in the actual drafting of the European Union takeover code is precisely the harmonization of the rules concerning voting rights. But should not this be a matter left to the company?
23. Empirical studies show that this change is not significant. See Bittlingmayer (2000, p. 740).
24. Through so-called 'warehousing', the raider informs outsiders of his/her intention to take over the target, so as to increase the chances to have enough shares tendered once the operation is publicly launched. Rule 14e-3 is mainly directed against this type of strategy.
25. To use Niskanen's terminology, they wish to maximize 'the size of their office'. See Niskanen (1971).
26. See McChesney and Shughart (1995) for evidence that antitrust is most often a weapon for rent seekers to wield against their rivals.
27. 186 N.E. 660 (Mass. 1933), as quoted in Bainbridge (2001, p. 8).

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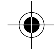

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