ARTICLES

Can Agency Theory Justify the Regulation of Insider Trading?

Alexandre Padilla

Insider trading occurs if an insider uses material, nonpublic information about a corporation in a securities trade.[1] This sort of activity is generally prohibited by securities regulation. Its prohibition has been the subject of an important debate since the 1960s.

One of the most famous arguments against the prohibition of this kind of behavior is that insider trading represents the most appropriate compensation scheme to reward the entrepreneurial activity of insiders. Consequently, we should expect that some corporations will allow their insiders to use inside information in order to stimulate their entrepreneurial and innovative activity (Manne 1966).

This argument has been strongly challenged. Some argue that letting firms allow their insiders to trade on inside information gives rise to agency problems that shareholders would be unable to resolve. No firm should be authorized to allow insider trading because shareholders are not able to control the activity of their insiders (Easterbrook 1981 and 1985). This is closely related to the Berle and Means argument that modern corporations are characterized by the separation of ownership and control. In other words, the owners have lost the control of the corporation and are unable to control the activity of the management (Berle and Means 1932).

Alexandre Padilla is a Ph.D. candidate at the University of Law, Economics, and Science of Aix-Marseille and an Earhart post-doctoral fellow at George Mason University.

[1]It is necessary to clarify that, even if the legislation and, in particular, United States legislation, has a different definition of an insider, most of the literature generally defines an insider as an employee of the corporation, such as the corporation manager, who has an access to nonpublic information. However, we will see below that the definition of insider in the securities regulation has an important impact on the structure of the corporate governance in the limitation of agency problems. See the section below on the weakening of governance devices.

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We discuss here these arguments against insider trading and argue that this type of analysis falls into the trap of Demsetz's (1969, 1989) "Nirvana fallacy" because it fails to engage in what the standard literature calls "comparative economic systems," or what Coase (1964, p. 195) calls "comparative institutional analysis."[2] Such analysis justifies public regulation by emphasizing the existence of discrepancies between the market and an ideal norm that is the perfect market in which costs, uncertainty, and ignorance are absent. Therefore, according to such analysis the only alternative solution is government intervention, which is implicitly assumed as not failing.

We therefore engage in such comparative institutional analysis, and compare two economic systems: the unhampered market or market economy and the hampered market or interventionism. The unhampered market is characterized by a system of private ownership of the means of production in which owners can use their property as they see fit insofar as they do not violate property rights. The hampered market is also based on private ownership, but the fundamental difference is that owners may be coercively prevented from using their property in some way even if it does not imply a violation of property rights. In other words, interventionism "seeks to retain private property in the means of production, but authoritative commands, especially prohibitions, are to restrict the actions of private owners" (Mises 1977, pp. 15-16).

First, we show that, in an unhampered market, means do exist to limit and minimize agency problems that insider trading may create. Second, we demonstrate that government regulations and other interventions in the market increase and make worse agency problems that insider trading is likely to generate. Government interventions hinder the "controlling" function of market mechanisms underscored in our analysis of insider trading in the unhampered market.

It is not argued that agency problems are the result of government intervention in the market economy. To do so we would fall in the same trap as the "Nirvana" approach. We are not arguing that the market economy is a perfect system where there is no error, no conflict, no agency problem, etc., and that such problems are caused completely by government intervention. Our approach is realist; therefore, we do not presuppose that a perfect a system, where agency problems are absent, exists or can exist.

It must be made clear that this article is not a criticism of agency theory, but a criticism of authors who stress agency problems without pointing out solutions provided by both agency theory and corporate-governance theory.

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[2]It should be pointed out that our assertion results from the fact that the author has never found such an approach in the insider trading debate and, in particular, on the issue of insider trading as an agency problem. Traditionally, the debate argues the pros and cons of insider trading and draws conclusions about the desirability or undesirability of a public regulation of insider trading. See also Bris (2000, p. 2, n. 4), pointing out that the literature on insider trading regulations implicitly assumes that there is no such thing as failing governmental regulatory agencies.

In part two we present the agency-problem argument and its implications for insider trading problems. This argument is an emanation of the separation-of-ownership-and-control theory developed by Berle and Means. In part three, we show that in an unhampered market, shareholders are able to minimize agency problems that insider trading may generate. Part four analyzes the consequences of interventionism on the control relation between shareholders and insiders and the behavior of insiders. Part five offers some concluding remarks.

Insider Trading as an Agency Problem

Some authors argue that one of the main problems with insider trading is that it *inherently* goes hand-in-hand with agency problems. Assume that insider trading is not subject to public regulation and that the firms are free either to allow or to forbid their insiders to trade on nonpublic information. There will be firms that will allow insider trading and other firms that will contractually prohibit it.[3] However, the argument goes, agency problems emerge irrespective of these contractual stipulations.

In firms allowing their insiders to profit from nonpublic information, insider trading cannot help but create a moral hazard problem. Because insiders can profit both from bad news and from good news, they are indifferent to working to make the firm prosper or working to bankrupt it. They may therefore engage in "discretionary" behavior (Levmore 1982, p. 149; Mendelson 1969, pp. 489–90; Posner 1977, p. 308; Schotland 1967, p. 1451). For example, insiders are said to have an incentive to increase the volatility of a corporation's stock prices:

> The opportunity to gain from insider trading also may induce managers to increase the volatility of the firm's stock prices. They may select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss. (Easterbrook 1981, p. 312)[4]

Insiders can also conceal or disseminate false information in order to profit by buying and selling mispriced securities (Posner 1977, p. 308). Finally, insiders, and particularly, lower-level managers can delay transmitting important corporate information to their superiors in order to trade on it and make a profit (Haft 1982, p. 1051). Hence, shareholders may have no interest in allowing their insiders to trade on inside information because they will not be able to prevent insiders from engaging in discretionary behaviors (Easterbrook 1981, p. 333).

Moreover, firms that contractually prohibit their insiders from trading on nonpublic information are confronted with an adverse selection problem.

[3]Here we do not deal with the question of why the shareholders would allow or prohibit insider trading.

[4]See also Brudney (1979, p. 156) and Leftwich and Verrecchia (1981).

They will not know whether their applicants are being truthful when they say they will respect their contract. Because insider trading is difficult to detect, the firms that wish to ban it will be the prey of unscrupulous insiders.

> Whenever firms write contracts that they do not plan to (or *cannot*) enforce, however, they face a serious problem of adverse selection. Dishonest agents will find employment with the firm especially attractive. They will get their salaries and be able to engage in inside trades as well; they will be overcompensated. To avoid overcompensating the dishonest agents, the firm must reduce salaries across the board. Now the honest agents–those who do not trade on material inside information–will be underpaid and will leave. Bad agents drive out the good. (Easterbrook 1985, p. 94)

Hence, the major problem with insider trading is that, whether or not shareholders contractually prohibit their agents from using inside information to their personal advantage, the shareholders face agency problems. These problems result from the inability to control the activity of their agents.

Interestingly, there is no fundamental difference between the agency argument and the separation-of-ownership-and-control argument. The analysis of insider trading from an agency perspective is only an extension of the separation problem. Berle and Means argue that with the emergence of the modern corporation, characterized by diffused ownership, the firm is no longer controlled by its owners, the shareholders, but by the managers.[5] The managers have interests different from the shareholders, and consequently they can engage in perverse behaviors, against which the shareholders cannot protect themselves because they lack enforcement devices:

> These [agency problems] suggest that granting insiders property rights in their knowledge about the firm is not necessarily beneficial. . . . Michael Dooley asked the right question: If insider trading is undesirable, why do not firms voluntarily curtail the practice? . . . One possible explanation of the firms' failure to do away with insiders' trading on material information–assuming that would be beneficial–is that *they lack adequate enforcement devices.* (Easterbrook 1981, pp. 333-34; emphasis added)

The insider-trading-as-an-agency-problem argument has two dimensions. The first focuses on the negative incentives that insider trading may create in manager's behaviors. The perspective of trading on inside information will incite them to undertake inefficient decisions that harm shareholders. This aspect is directly related to the issue of corporate governance, namely, how

[5]The author considers that Berle and Means is understood as the separation of ownership and control, that is, that managers "abusively" control the corporation instead of shareholders. As Alchian (1969, p. 339) pointed out, there is a difference between saying that there is a dispersion of stock holdings and a separation from ownership and control. The dispersion of stock holdings does not necessarily mean that shareholders are not in control of the corporation.

shareholders can "control" manager's activity. The second is related to the issue of enforcement of contracts and how shareholders can provide incentives for managers to respect their contract. When shareholders contractually prohibit insider trading, they may not be able to enforce the contracts because of the nature of insider trading, which is difficult to detect. As we have seen, Easterbrook's reply to both questions is in the negative.

However, as we shall now proceed to demonstrate, these arguments are unsatisfactory. Let us first examine how the problem of insider trading is dealt with on the free market.

INSIDER TRADING IN THE UNHAMPERED MARKET

The unhampered market or market economy defines "that form of social cooperation which is based on private ownership of the means of production" (Mises 1998, p. 1). We understand social cooperation as a system based on the division of labor and the respect for property rights.[6]

In the unhampered market, there is a whole set of devices allowing shareholders to control the activity of insiders. It is necessary to underscore that some of these devices are more appropriate to address moral hazard problems, and others are intended to solve adverse-selection problems.

Advocates of insider trading prohibition, and, in particular defenders of the insider-trading-as-an-agency-problem argument, seem to overlook the crucial role of property rights and other devices that enable shareholders to exercise their property rights and put pressure on the behavior of insiders.

Property Rights, Shareholders, and the Board of Directors

One of the most important overlooked aspects in the literature on insider trading is the control function of property rights. The very nature of property rights is to allow owners control of what they own. To have a property right to a good means to control this good.[7] It means to control the use, the allocation, and the disposal of goods owned. In the unhampered market, this control is exclusive and absolute (Lepage 1985, pp. 13-14). In other words, controlling the goods owned means that the owner has the right to supremely decide how his goods will be used, to keep the proceeds and returns that result from their use, and to transfer willingly to a third party the whole or part of the specific rights.

Therefore, and due to the very nature of property rights, the shareholders of a corporation, as owners of the means of production, keep the control over

[6]See Mises (1998b, pp. 258-60) for a complete description of the characteristics of the market economy.

[7]Property rights are in fact a *necessary* condition for human action. Human action is the use of means to satisfy ends either directly (consumer goods) or indirectly (means of production). This presupposes at the outset that the acting person is the owner of the means or, if he is not, that he is authorized by their owner(s) to use them. See Menger (1981, pp. 96-98). See also Campan (1999, pp. 24-26) and Alchian (1977, p. 130; 1969, pp. 352-53).

the corporation, and not the managers. Mises and Rothbard have well perceived this control function of owners. To be sure, the owners can contractually delegate all or part of this control to managers, and the latter may hold considerable autonomy over the day-to-day operations of the firm. However, ultimately the owners decide:

> Hired managers may successfully direct production or choose production processes. But the ultimate responsibility and control of production rests inevitably with the *owner*, with the businessman whose property the product is until it is sold. It is the owners who make the decision concerning how much capital to invest and in what particular processes. And particularly, it is the *owners* who must choose the managers. The ultimate decisions concerning the use of their property and the choice of the men to manage it must therefore be made by the owners and by no one else. (Rothbard 1995, p. 338)[8]

The fact that shareholders do not participate in each decision in the corporation and instead entrust the board of directors with this task does not mean that they do not have a control over the corporation. On the contrary, they retain the ultimate right of control, which is the "authority to revise the membership of the management group and over major decisions that affect the structure of corporation or its dissolution" (Alchian and Demsetz 1972, p. 788; also Hart and Moore 1990, p. 1121). To be sure, shareholders delegate a great deal of control and authority to the board of directors. In most cases, directors have the responsibility to hire and fire top managers. They have the task of monitoring managers to make sure the managers do not make non-value-maximizing decisions or break their contracts. And above all, they must make sure that the firm makes profits and avoids losses. Shareholders, however, hold the ultimate control of the corporation. If the board of directors does not carry out its task, it will be removed from the management of the corporation and replaced by new directors whom the shareholders judge to be more efficient.

While it can happen that the board of directors does not respect its contract with the shareholders, the empirical evidence suggests that the board of directors generally performs its duty.[9]

Hart argues that the board is ineffective in practice because the board consists of executive directors who are themselves part of the management team, and we cannot expect that they monitor themselves. Moreover, the board consists also of nonexecutive directors who may not perform their duty either because they do not have financial interests in the company or they are loyal

[8]See also Mises (1998, pp. 302-04).

[9]See, for example, Morck et al. (1989), who present empirical evidence that boards of directors perform the monitoring role of management and that the probability of complete turnover of the top management team rises when the firm significantly underperforms in its industry. They also show that when the whole industry is performing poorly, another mechanism, the hostile takeover, ousts the board of directors.

to those to whom they owe their positions, that is to say, the management who proposed them as directors. Such outsiders want "to stay in management's good graces, so that they can be re-elected and continue to collect their fees" (Hart 1995, p. 682).

To be sure, such a situation may occur. However, this does not change anything: directors never owe their positions to the management; they owe their positions to shareholders, the owners of the firm's assets.[10] And, as owners of the firm's assets, the shareholders have the right to remove the board of directors if they do not fulfill their monitoring role.

One of the mechanisms to remove the board of directors is the proxy fight. Shareholders who are not satisfied with the incumbent board of directors offer a new list of candidates they consider to be more efficient in the management of the corporation. They then canvass other shareholders' votes (proxies) to challenge the direction of the incumbent management. Once the dissident group of shareholders has gathered enough votes, the group is in position to dismiss the incumbent board and replace it with new directors who they believe will be more loyal to them, in the sense that they will manage the company in shareholders' interests. Ultimately, such a change results in the turnover of the management of the corporation.

Some authors have argued that the proxy fight is not a very efficient tool for disciplining managers because of the free-rider problem:

> The dissident bears the initial cost of figuring out that the company is underperforming and also typically incurs the expense of launching the proxy fight—this may include everything from the cost of locating the names and addresses of the shareholders and mailing out the ballots, to the cost of persuading shareholders of the merits of the dissident slate. In contrast, the benefits from improved management accrue to all shareholders in the form of higher share price. Given this, a small shareholder may quite rationally refuse to undertake a proxy fight that is socially valuable. (Hart 1995, pp. 682-83)

Moreover:

> [E]ven if a proxy fight is launched, shareholders may have little incentive to think about whom to vote for since their vote is unlikely to make a difference. A reasonable rule of thumb for a small shareholder may be to vote incumbent management on the grounds that "the devil you know is better than the devil you don't." (Hart 1995, p. 683)

The problem with such an argument is that it overlooks, in the unhampered market, that there is no evidence that the ownership structure would consist of only small shareholders. Actually, we can reasonably argue that in the unhampered market, the ownership would consist of a variety of small,

[10]Such an argument also overlooks the importance of other forces, such as the internal and external managerial competition. This is discussed below.

medium, and large shareholders. One explanation of such diversity is that the division of labor implies a division of knowledge. Some shareholders have more knowledge of finance, of the business world in general, and of the industry in which they invest, and will hold larger blocks of shares than shareholders who do not have such knowledge. They can more easily monitor management's activity and, in particular, detect the cause of the managerial underperformance when it occurs. Because they hold larger blocks of stocks, such shareholders will have more interest in monitoring the activity of the management and engaging in retaliatory measures if the management's decisions are non-value-maximizing.[11] That is who exercises control over the management.

On the other hand, small shareholders do not have the incentives to monitor the management closely because it is expensive in time and money. Moreover, they may not have the appropriate knowledge to assess the performance of the management. Therefore, the behavior and decision criteria of the small shareholder differ greatly from that of the large shareholder. The small shareholder is only interested in the market price of his shares, the profits or losses made by the firm. If he is not satisfied with the firm's performance, he will not burden himself with finding out why; he will simply sell his shares. Therefore, the rule of thumb for a small shareholder that "the devil you know is better than the devil you don't" is not very realistic. The rule of thumb for a small shareholder should be "it is better to lose a little now than to lose everything later." In some ways, small shareholders are more ruthless than large shareholders.

Now, in light of this, it is difficult to accept that small shareholders will vote for incumbent management. Actually, the presence of large shareholders may convince them that if the latter engage in a proxy contest, it is because they know something (because they actually monitor the management) that small shareholders do not. Therefore, small shareholders may model their behavior on that of large shareholders and vote for the dissident group's slate of candidates.

To be sure, the large shareholder may use his position at the expense of other shareholders (Hart 1995, p. 683; also Shleifer and Vishny 1997, pp. 758-61). But, again, harmed shareholders have the opportunity to sell off their shares.

It is difficult to accept the idea that shareholders are not really in control of the corporation and cannot sanction managers if they make non-value-maximizing decisions. The issue of insider trading does not change anything. Shareholders decide who is entitled to trade on inside information and who is not. If managers do not comply with shareholders' decisions, shareholders

[11]Shleifer and Vishny (1986, p. 478) explain that large shareholders also engage in monitoring because they prefer dividends while small shareholders favor capital gains. They explain this difference of behavior with tax considerations. This also explains the difference of decision criteria when shareholders have to decide whether to sell or to hold their shares.

or their elected mandataries—the directors—will discharge them. If managers entitled to trade on inside information adopt discretionary behavior, consequences are the same. On the unhampered market, property rights is the ultimate control device for shareholders.

Contract, Contract Law, and Enforcement

In an unhampered economy, contract and contract law are important devices to control the activity of insiders and, more particularly, breaches of contract. The advocates of insider trading prohibition do not see any role whatsoever for contract and contract law to prevent insiders from engaging in discretionary behavior and, in particular, from discouraging insiders not to respect their contractual prohibition to trade on inside information. The insider-trading-as-an-agency-problem argument is based on a tacit premise that insiders will systematically break their contract. However, this theory suffers from two major fallacies.

First, it overlooks the fact that, in a market economy, all contracts are voluntary; that is, both parties agree on the terms of the contract. Therefore, there is no reason why the insider would not respect his contract. Whether insiders are allowed to trade on inside information does not change anything. It is a striking argument to say that because there is inequality of information between shareholders and insiders, the latter will systematically be inclined to break their contract. No significant evidence exists that proves such a tendency. In the market economy, contracts and exchanges are voluntary, and both parties agree on the terms of the exchange. Both parties believe that they will benefit by the exchange-contract. The contract is not a zero-sum game but is always a positive-sum game.[12]

Second, the argument that insider trading inherently involves agency problems overlooks the importance of contract law. A roundabout of production here is necessary in order to understand in what sense contract law acts as a deterrent and sanction device.

A distinction must be established between "contract-as-an-obligation-to-give" and "contract-as-an-obligation-to-do."[13] The contract-as-an-obligation-to-give is typically a bilateral agreement to exchange titles of property.[14] The failure (the refusal) of one of the parties to respect his agreement, that is to say, to transfer his title of property to the other party, is in itself an act of aggression

[12]See Rothbard (1993, p. 77). Note that when we argue that all contracts are a positive-sum game in the sense that parties always benefit from the exchange, we mean that parties will increase their utility *ex ante*. This does not mean that, from an *ex post* point of view, they have not made an error. See also Rothbard (1993, pp. 768, 772; 1977, pp. 13, 18-19; 1997, pp. 240-41).

[13]Most of our discussion about contract and contract law is largely derived from Kinsella (2001b). The author would like to thank Stephan Kinsella for drawing our attention to his work and, therefore, for having helped to clarify the argument.

[14]For example, when I buy a Porsche for $50,000, I consent to give him $50,000, and he consents to give me the car. We both agree to exchange our titles of property.

(a theft), and therefore force can be used against the failing party. In other words, contract-as-an-obligation-to-give is enforceable by law because any breach of contract necessarily and implicitly means an act of aggression. By forcing the failing party to transfer his title of property to the other party, the law enforces the contract; that is to say, it recognizes "the new owner, instead of the previous owner" as the legitimate owner of the title of property.

On the other hand, the contract-as-an-obligation-to-do is generally not enforceable (in the sense of using force to make the failing party perform) because it "can be enforced only by threatening to use force against the promisor to force him to perform, or by punishing him afterwards for failing to perform. Yet the promisor has not committed aggression. He has done nothing to justify the use of force against him" (Kinsella 2001b, pp. 5-6).[15] However, it is possible to enforce contract-as-an-obligation-to-do through title transfer as in the case of contract-as-an-obligation-to-give by awarding monetary damages to the injured party. In Kinsella's words, a contract to do something can be defined as follows:

> When a contract to do something is to be formed, the parties simply contract for a *conditional* transfer of title to a specified or determinable sum of monetary damages, where the transfer is conditional upon the promisor's failure to perform. (Kinsella 2001b, p. 7)

Therefore, in the context of insider trading, the contractual prohibition to trade on inside information falls into the category of contract-as-an-obligation-to-do or, more exactly, not-do.[16] When the insider signs his contract and agrees not to trade on inside information, he also agrees to pay a determinable sum of monetary damages if he violates his contract. The threat of being sued for breach of contract and the resultant monetary damages will likely overshadow the incentives for the insider to break his contract.[17]

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[15]It should be noted that a breach of contract-as-an-obligation-to-do might be an act of aggression. For example, when a CPA embezzles a corporation's funds, he is committing an act of aggression (theft) insofar as he misappropriates shareholders' property.

[16]We should add here that the fact that the insider has broken his contract by trading on inside information cannot be considered as theft insofar as shareholders do not have property rights in information. The reason for our argument is that property rights can only apply to scarce resources (economic goods), that is, resources of which "the demand" is greater than the "supply" and of which use prevents other people from using them. In the case of insider trading, the use of (inside) information does not prevent shareholders from using it, nor is it a valid argument that insiders' use of inside information reduces the "value" of inside information and consequently prevents shareholders from using it. We can see the concept of property rights and violation of property rights is inherently related to the notion that a change of physical attributes of the property results from its use. For a similar criticism of the concept of property rights in information (ideal objects) applied to intellectual property, see Kinsella (2001a, pp. 15-25). The author thanks Guido Hülsmann for having drawn his attention to his issue.

[17]These are certainly not the only consequences that the insider may face if he breaks his contract. See the section on reputation, blacklist, and boycotting below. We do not deal here with the issue of the optimal damages to be included in the contract to deter

Three questions can be raised against our arguments. The first is opportunism.[18] An insider may officially agree to respect the contractual prohibition to trade on insider information while at the same time intending to break his contract if an opportunity presents itself, and if he thinks he can get away with it. In the same vein, the employer may sign the contract because he believes that the employee will respect his contract or that he can prevent the employee from breaking his contract. Therefore, signing the contract does not mean that the insider and his employer demonstrate their preference to perform according to the specified terms of the contract; rather, it demonstrates their preference for signing over not signing.

It is reasonable that the insider may sign his contract while intending to break it if an opportunity arises. However, such an objection overlooks two important points. One, there are other forces at work to discourage the insider from breaking his contract. Two, even if we can accept the idea that the insider may actually plan to break his contract if an opportunity arises, it is difficult to accept such an objection insofar as opportunities are hardly foreseeable. Moreover, even if such an opportunity arose, there is no guarantee that the insider would take it. It depends on whether he believes it is worth doing; after all, if caught, there would be consequences that might include: monetary damages, losing his job, ruining his reputation, etc.

The second objection is that because prosecuting insiders for breach of contract involves costs, shareholders may prefer to renegotiate the contract or even tolerate a certain amount of breach of contract. This argument is both right and wrong. It is right that, because prosecuting for breach of contract may be very costly, shareholders may prefer to tolerate a certain amount of fraud. Nevertheless, it is wrong because if shareholders know that an insider has broken his contract and they tolerate it, there *is* no more fraud but only renegotiation. By not prosecuting or sanctioning, shareholders demonstrate their preference for renegotiation over prosecuting the insider "at fault." Easterbrook's argument is that every time a firm writes a contract it does not plan to enforce, it faces an adverse-selection problem. If such firms do not intend to enforce their contracts, they demonstrate their preference for not enforcing over enforcing them. The problem is not that shareholders tolerate a certain amount of breach of contract but rather that shareholders do not know that the insiders trade on inside information without shareholders' permission. Now we come to the third objection.

The third objection is that insider trading is difficult to detect. Consequently, it is difficult to enforce contracts, and therefore the role of contract and contract law in reducing breaches of contract is insufficient.

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the insider from breaking it. But, see Rothbard (1998, pp. 138-41) on performance *bonds* as voluntary penalty or conditional penal bonds evolved on the market during the Middle Ages and in the early modern period. Penal bonds are monetary damages that the obligator must pay in case of breach of contract to the obligee.

[18]Williamson (1988, p. 569) defines opportunism as a "self-interested seeking with guile."

Moreover, there is a problem of economies of scale. As Macey (1984, p. 62) argues, this position overlooks the existence of private organizations such as the "New Stock Exchange and the National Association of Securities Dealers which conduct monitoring activities at no charge of the taxpayer." These organizations serve as monitors of illegal transactions; that is, noncontractually allowed transactions on inside information, and provide the information to the shareholders who will decide to sanction the wrongdoer or not (p. 63; see also 1991, pp. 40-41).

The Disciplinary Role of (Hostile) Takeovers

The hostile takeover is the mechanism used when shareholders do not succeed in disciplining managers through internal controls such as the board of directors, large shareholders, or proxy fights. Hostile takeovers, as mechanisms of the market for corporate control, can be considered as the expression of competition that brings together management teams for the right to control, that is to say, to manage corporate, resources (see Jensen 1984, p. 110).

Since Henry Manne (1965), hostile takeovers have been considered by far the most powerful mechanism to discipline managers when they make non-value-maximizing decisions. It provides shareholders with power and protection against mismanagement (p. 112). The takeover represents a threat of displacement for the management that engages in discretionary behavior. When its deterrent effect is not powerful enough to deter managers from engaging in such behaviors, the market for takeovers sets immediately in motion.

As we have previously argued, a takeover substitutes for internal mechanisms when the latter fail to discipline managers. The trigger effect of a takeover process is the perception by a raider of the possibility to realize a capital gain by managing a company whose value might increase if it was managed by a more efficient management team:

> [When the company] is poorly managed—in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements—the market price of the shares declines relative to the shares of other companies in the same industry or relative to the market as a whole. . . The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous. (pp. 112-13)[19]

> Managers of a competing firm . . . almost automatically know a great deal of the kind of information crucial to a takeover decision. Careful analysis of cost conditions in their own firm and the market price of shares of other corporations in the same industry will provide information that can be relied upon with some degree of confidence. (p. 118)[20]

[19]See also Mises (1981, pp. 121-22; 1998b, p. 303).

[20]See also Mises (1981, p. 122).

Certainly, it could be argued that shareholders will sell their shares only insofar as they detect that managers have made decisions going against shareholders' interests. It might prove a difficult task to determine whether a firm is underperforming because managers are engaged in discretionary behaviors or simply because the firm's environment was unfavorable.

Such an argument implicitly assumes some kind of homogeneity among the shareholders. It assumes that their decisions to sell or not is partly dependent on their ability to determine the reasons for the firm's low value. As we have already argued, in the unhampered market, ownership will consist of both small and large shareholders. Their interests and behaviors will be different. It is likely that small shareholders will not invest time and money trying to determine why firm value is low, or why the company does not make profits. Their main criteria to sell or to hold their shares will be the firm's profit or loss, stock price, and their expectation for future performance. On the other hand, we can expect that larger shareholders will have more incentive to determine the reasons for the firm's underperformance. Their decisions will depend upon the results of their "investigation." If such shareholders, through the board of directors or proxy fights, cannot prevent managers from adopting discretionary behaviors, we may expect that some of them will sell off their shares. It is also correct that some shareholders may not sell their stock because, following their analysis of the situation, they judge that a takeover is very likely and they expect to benefit from it.

The main feature of the takeover device is that even if managers are not deterred from engaging in discretionary behavior, this mechanism always places strict limits on their behaviors (Klein 1999, p. 30). Takeovers play an essential role for shareholders, particularly for small shareholders, in controlling management activity. Shareholders who have neither the ability nor the incentive to monitor the existing management team to ensure that its decisions are in their best interests can always count on "an army of corporate raiders on the lookout for a mismanagement firm" whose performance could be enhanced under new management (Stiglitz 1993, p. 557). Managers know that they are constantly under the monitoring of competing management teams. If they do not work in shareholders' interests, they know that, at any moment, they may be threatened with a takeover and be replaced.

Some authors have questioned, at various levels, the effectiveness of the disciplinary role of takeovers. They argue, first, that takeovers may be ineffective and have no disciplinary value because of a free-rider problem. If, when a competing management team or a raider makes a tender offer during a takeover process, small shareholders who believe that their decisions are unlikely to affect the success of the bid expect an increase in profitability of the firm under a new management, will not tender their shares, but hold them, because the shares are more valuable if takeover succeeds. The raider can only expect to succeed with his takeover if he makes an offer that incorporates all expected capital gains that result from improved management. Under such conditions, the raider does not make any profit offsetting his

costs of planning the takeover, that is, the costs of identifying and acquiring information about the target. If bids are tendered, then takeovers have no disciplinary effects (Grossman and Hart 1980; Shartstein 1988, pp. 186, 194–95).

This argument fails for two reasons. First, it assumes shareholders know that firm value is low because managers have made non-value-maximizing decisions. However, as we have just argued, it is unlikely that small shareholders will invest sufficient time and money to identify the origin of such firm underperformance because their stakes are small. The benefits for them do not offset the costs. This is why they delegate such responsibilities to the board of directors and the managers (see Klein 1996, p. 19, n. 20). Such behavior is more likely for the large shareholders, whose interests are larger. However, their decisions to tender or not tender their shares depend not only on whether the takeover will succeed but also on whether the new management will be better.

Second, these authors argue that shareholders will not tender their shares because they know that if the takeover succeeds, their shares will *automatically* become more valuable. This statement is not necessarily true. Shares become more valuable and stock prices increase after a successful takeover only if investors expect that the new management will improve the corporation's performance. They may judge correctly, for example, that this takeover is nothing more than a means for new managers to expand their empire, to enhance their reputation and prestige. Or, they may believe that new managers will not succeed in rectifying the corporation's results or that, because this takeover is the result of a diversification strategy, the new management has not the competence to succeed in making the firm profitable. There is no automatic (positive) relationship between the success of a takeover and an increase in share price. The share price will increase if people believe that this takeover is a good thing for the future of the corporation, not because the takeover has been successful.

Some authors argue that takeovers are only a means for competing management teams to expand their empires, aggrandize their power, enhance their reputation or their prestige, and satisfy their egos rather than improve the firm's efficiency (Shleifer and Vishny 1988, p. 14). This kind of behavior appears particularly in companies where management owns a relatively small share of the stock. We certainly cannot deny that the only purpose of some takeovers is to satisfy private interests of a bidder's management team. However, such arguments overlook the fact that companies whose goal it is to build an empire themselves often become takeover targets if they score poorly in performance (see Jensen 1984, p. 114). With the development of high-yield (junk) bonds,[21] the problem of size has been eliminated, insofar as they allow "Davids" to take control over "Goliaths" when the latter are poorly managed (Jensen 1988, p. 39).

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[21]High-yield bonds, or "junk" bonds, are bonds rated below investment grade by the bond-rating agencies. These bonds are usually more risky and therefore carry higher interest rates than bonds with investment-grade ratings.

Critics of takeovers also claim that takeovers may be ineffective disciplinary devices because managers can adopt defensive measures to thwart takeovers. This argument is certainly true, but it is necessary to distinguish defensive measures that are adopted by managers with shareholders' approval from those adopted unilaterally, without shareholders' consent. In the first case, we can distinguish five kinds of antitakeover amendments: the supermajority amendments, fair-price amendments, dual-class recapitalizations, changes in the state of incorporation, and reduction in cumulative voting rights.[22] Empirical studies show that when such amendments are harmful for shareholders, the latter resist adoption of such amendments, and, when adopted, negative stock-price effects follow (Jarrell et al. 1988, pp. 59-62). On the other hand, more harmful for shareholders are antitakeover measures that do not require shareholders' approval. We can distinguish four kinds of such defensive measures: litigation by target management, targeted block stock repurchases (greenmail), poison pills, and state-antitakeover amendments.[23] Such measures are generally very harmful for shareholders because they eliminate the deterrent effect of takeovers on mismanagement. However, it is necessary to point out that such measures are often associated with political decisions at a state or federal level.[24] Therefore, even if it is right that the disciplinary role of takeovers is reduced when managers adopt antitakeover devices, it is difficult to accept that, in the unhampered market, such devices will take place without shareholders' approval. In the same way, it is difficult to accept that shareholders will accept such antitakeover amendments if the latter harm them insofar as they reduce the effectiveness of the disciplinary role of takeovers.

The literature has provided some empirical studies that support our argument that takeovers play a disciplinary role in deterring and sanctioning managers from adopting discretionary behaviors and in aligning their incentives with shareholders' interests.[25] These studies show that turnover in top management increases following takeovers and that there is a correlation with pre-takeover performance of target firms. Targets in which management is replaced after the takeover perform worse than the average firm in their industry and much worse than target firms in which the incumbent management has not been replaced after the takeover.

Takeovers undoubtedly play a disciplinary role in controlling the decisions of managers and insiders. They play a role at two levels: the deterrence

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[22]For a description of such antitakeover amendments, see Jarrell et al. (1988, pp. 59-62).

[23]Ibid. (pp. 62-65) for a description of such antitakeover devices and for reference to empirical studies showing the harmful effect of such defenses.

[24]See Shleifer and Vishny (1997, p. 757). We shall discuss this issue in more detail in the next section on the effect of interventionism in the weakening of corporate governance mechanisms.

[25]See, for example, the works of Jensen and Ruback (1983), Jarrell et al. (1988), and Martin and McConnell (1991).

and the sanction. Takeovers represent a threat to managers who adopt decisions that are not in the shareholders' interests. If they mismanage the firm, one or several raiders will come to take control of the firm, and they will lose their jobs and be replaced by managers that the raider believes are more competent to manage the firm's corporate resources. Therefore, for managers who are afraid of losing their jobs, the takeover represents an efficient mechanism to limit their discretionary behaviors.

Internal Managerial Competition

The mechanism of competition also plays an important role in controlling the activity of insiders. Managers have career concerns that compel them not to engage in non-value-maximizing behaviors. These career concerns result in competitive behaviors, which play out at two levels: competition between managers and competition between firms.

Managerial competition is one aspect of competition that often has been overlooked by the critics of insider trading as an agency problem. However, Mises (1983, pp. 31-39) showed in 1944 that career concerns play an important role in deterring managers' discretionary behavior (see also Mises 1981, p. 302; Alchian 1969, pp. 340-41, 348; Alchian and Demsetz 1974, p. 788; and Fama 1980, pp. 292-93). This managerial competition plays out at two levels, inside and outside the firm.

Internal managerial competition, which results from career concerns, expresses itself by a manager's will to accede to higher-level positions, or simply to keep the current position. Lower-level managers want to accede to top-level positions and top-level managers want to accede to the highest-level positions—to become the "boss of bosses" (Fama 1980, p. 293). The fulfillment of their plan is dependent on their performance. Either they want to accede to higher-level positions, or they wish to keep their positions. Probably their current performance does not immediately affect their current position, but it impacts on their future position. As we have said, the owners, the ultimate decision makers, will not hesitate to discharge managers if they are unproductive. Consequently, it is in the manager's interest to be successful.

However, a manager's performance is dependent on his subordinates' performance. In other words, the higher-level manager will be considered successful if he has been able to "elicit" productive lower-level managers, that is, profit-making managers. If he fails, he will have to answer to his superior, who will have to answer to his superior. At the top of the hierarchical system of the corporation, the directors will have to answer to the shareholders. If directors fail, they will be discharged and replaced by other directors whom owners expect to be more successful (see Mises 1983, pp. 33-34; 1998b, p. 302). Therefore, because it is in a higher-level manager's interest that his subordinates are profit makers, he will monitor lower-level managers in order to avoid any discretionary behavior. "[S]o there is a *natural* process of monitoring from higher to lower levels of management" (Fama 1980, p. 293; emphasis added).

The internal managerial competition also creates a control process from bottom to top. The manager's will to accede to a higher-level position gives

him an interest in monitoring higher-level managers. Submanagers have an interest in monitoring higher-level managers because if the latter prove to be unsuccessful, they have the opportunity to take their place. Therefore, they must be alert to these career opportunities.

> Less well appreciated, however, is the monitoring that takes place from bottom to top. Lower managers perceive that they can gain by stepping over shirking or less competent managers above them. (Fama 1980, p. 293)[26]

There is also another important reason to explain this monitoring process. It is in the interest of submanagers to monitor the activity of higher-level managers, because if the latter engage in discretionary behavior, they not only hurt their own interests but also the interests of submanagers.[27]

The double-sense controlling process reduces incentives for managers to engage in perverse behaviors. We can understand now that the moral-hazard aspect of insider trading is considerably reduced. It is irrelevant whether insiders are able to trade on inside information. In all cases, this monitoring process works. Insiders have a strong interest to act in the shareholders' interests and to make as much profit as possible. If they fail, they will be sanctioned either by higher-level managers or directly by the owners of the firm, the shareholders.

Moreover, this internal controlling process exercised between the managers within the firm plays a role in reducing incentives for insiders to break their contracts insofar as contract-breaking insiders are under the "monitoring" of other managers who are ready to take their place if they break their contracts. This monitoring behavior can be explained even if managers work in teams. The managers, being self-interested, are concerned with their own compensation and will not be willing "to take the fall for somebody else."

The External Managerial Competition

The *external* managerial competition is also used as a control device. The external managerial competition puts pressure on managers within the firm to make value-maximizing decisions. As we have already said, the career interests of insiders involve competition between managers within the firm; career interests also encompass competition between managers within the firm and managers outside the firm.

Competition as a rivalrous process "compels" managers (insiders) to give their best. The insider has an interest in honoring his contract, that is to say, in avoiding discretionary behavior and in respecting the insider trading prohibition; for if he fails, shareholders or top managers will replace him with another manager whom they expect to be more successful. This rivalrous process has an important incentive effect on the performance of insiders. It places the manager (insider) in an ejector-seat position. He knows perfectly

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[26]See also Mises (1981, p. 302).

[27]For a similar argument see Carlton and Fischel (1983, p. 874).

well that if he fails, his future job security will be strongly at risk. Therefore, the external managerial competition acts as a deterrent and a sanction to prevent managers (insiders) from adopting non-value-maximizing behaviors (see Fama 1980, p. 292).

The competitive pressure on insiders comes not only from within the firm but also from outside the firm. It is these two forces combined that reduce incentives for insiders to engage in non-value-maximizing behaviors.

Competition in the Product Market: The Role of the Profit-and-Loss System

The discretionary behavior of insiders can also be controlled through competition in the product market. The competition from other firms gives insiders incentives to give their best. This is a result of the profit-and-loss system.

The profit-and-loss system is the only way to evaluate the satisfaction of consumers. Competition in the product market is a rivalrous process to win the patronage of consumers. If consumers are not satisfied, the firm will suffer losses, and these losses will be imputed to the insiders (managers), who will be sanctioned for their failure.[28] Ultimately, if shareholders believe that the firm suffers too many losses and becomes insolvent, they will sell their shares, and the firm will go into bankruptcy. In both cases, insiders are sanctioned (see Mises 1964, p. 15).

They therefore have a strong incentive to do their best for the company. Thus, we see that competition in the product market monitors managers (insiders) and, in particular, reduces the moral hazard problems of insider trading. It limits the extent to which insiders can engage in discretionary behavior (see Fama 1980, p. 289; also Schmidt 1997; and Raith 2001).

Schmidt shows that the size of the firm does not reduce the incentives for managers to avoid discretionary behaviors insofar as the free entry that characterizes a competitive market always places the industrial giants in front of a risk of liquidation. It is indeed one aspect of a competitive market that a firm never has a secured position. There are many casual examples that demonstrate that no firm is protected from competition. One of them is Microsoft©. Microsoft©, which has been dominating the market of the server-operating-system environment with Windows©, is now confronted with the appearance of such platforms as Linux© (Shankland 2001 and Hewitt 2001).

More important is the competition in the market for product; the more latitude consumers have to select products, the more satisfied and more demanding the consumers will be. Easterbrook argues that if insiders engage in riskier projects in the hope of capturing a portion of the gains in insider trading,

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[28]It is also important to recall that the more profit the firm makes, the more attractive the firm will be for potential investors. If the firm is more attractive, the demand for shares will increase and then share price. Consequently, profits will be higher for incumbent shareholders when they sell their shares. Therefore, the profit-and-loss system is another system shareholders have to evaluate the behavior of their insiders (managers) and to sanction them.

and if the project fails because consumers are not satisfied, the shareholders will bear the loss. The shareholders are not the only ones to suffer a loss; the insiders will lose their jobs.

The competition and threat-of-liquidation effects unambiguously induce managers to avoid adopting non-value-maximizing behaviors.

Reputation, Blacklist, and Boycott

Along with managerial competition, reputation is another important control device that acts as a deterrent and a sanction. Reputation may actually be a crucial factor when an employer has a choice between two candidates of similar background. It provides shareholders with an established appraisal of the person's reliability (honesty). Reputation reduces the incentives for insiders to trade on inside information when it is forbidden in their contract. However, it also works for insiders who are *allowed* to trade on inside information. In this case, it guides them to avoid behaviors going against shareholders' interests.

Reputation is the expression of value judgments of others (Block 1976, pp. 59-62; also Fombrun and Van Riel 1997, p. 5). In the context of business, these value judgments result from others' appreciation of the manager-insider's competence and reliability. Reputation is evaluated through past performance, previous positions, the reputation of companies for which he has worked, his awards (for example, best CEO of the year), etc. Reputation is the reflection of past actions; it does not mean that because a manager has a very good reputation, he will not engage in a discretionary behavior or break his contract if he has the opportunity to do so. A reputation is just a business card that conveys some degree of reliability that saves the employer time and money in checking information provided by the employee, because even if people build their reputation through their actions, their reputation always results from the perception of others. Managers consequently have an interest in behaving in the shareholder's interests, working hard, and having a good record. A manager's reputation is important because it has an impact on the corporation's reputation.[29] Therefore, it is in the manager's interest to maintain a good reputation if he wants to keep his job or find a new job.

Reputation is then a deterrent and a signal device, but it can also be a sanction device. For example, the shareholders or their mandataries will be able to publicly criticize the insider at fault for not having respected his contract. As a consequence, this insider will not only be sued under contract law, but will see his reputation suffer, and he will not be able to do anything about it. This inability to fight against a bad reputation following a breach of contract results from the fact that the individual is not the owner of his reputation. Blacklisting and boycotting are legitimate on the unhampered market and allow shareholders to protect themselves against breaches of contract by insiders.

[29]For example, Burson-Marsteller's (2001) recent research finds that CEO reputation can represent 45 percent of a company's reputation.

Following a breach of contract, shareholders may publicly disseminate a "blacklist" of managers (insiders) who have poor records or who have broken their contracts by trading on inside information when contractually forbidden to do it.[30]

Shareholders can also urge other corporations' shareholders not to hire the insiders in the wrong. The boycott is a way to sanction insiders for having broken their contracts (see Rothbard 1993, p. 154).[31]

Therefore, insiders have an interest in not breaking their contracts by engaging in perverse behavior or trading on inside information. Reputations, blacklists, and boycotts are powerful deterrents and an important means of sanction against agency problems.[32]

One limitation to the reputation mechanism is that when agents are coming close to the end of their careers, the incentive to maintain a good reputation decreases.[33] This limit, however, is mitigated by the competition on the managerial market insofar as the older manager will find it more difficult to find a new position at the same level.

The reputation mechanisms undoubtedly play a role in mitigating agency problems that insider trading may create even if we cannot deny that they are not enough to resolve agency problems by themselves (Holmstrom 1982). Rather, it is the combination of the various mechanisms previously described that significantly reduces the incentives for insiders and managers to engage in discretionary behaviors.

Insider Trading in the Hampered Market

When we examine the control relationship between shareholders and insiders (managers) in the context of the unhampered market, it is difficult to accept the idea that there is such a thing as separation of property and control.[34] Berle

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[30]One could challenge our argument that such mechanisms work only as soon as insider trading is detected. As we have argued, market organizations can play this monitoring role. The probability of detection increases the more effective the deterrent is. Such an argument might have been true fifty years ago, but it is difficult to advance such an argument today, and it will be increasingly difficult to advance it in the future. To be sure, there is always a chance to slip through the net. Again, we do not argue that such mechanisms are perfect.

[31]See also Rothbard (1998, pp. 131-32) for a defense of blacklist and boycott from a property rights perspective in the libertarian tradition.

[32]In the real business world, some forms of blacklist and boycott exist. For example, it is usual for an employer to call previous employers or individuals for their opinion of the applicant. It is why potential employees are usually asked for references. It is a fact of the real world that employers do not rely only upon the job applicant's résumé and his oratorical skills during interviews. Reputation plays an important role in the labor market at all levels.

[33]The recent literature in managerial economics increasingly recognizes reputation as a disciplinary mechanism. See Brickley et al. (1996, pp. 161-62).

[34]"The emergence of an omnipotent managerial class is *not* a phenomenon of the unhampered market economy" (Mises 1998b, p. 304; emphasis added).

and Means's theory is hardly tenable when it is applied to the insider trading problem. To be sure, there are principal-agent problems, but the market can solve them.[35]

The corollary of this proposition is that, as soon as the control relation between shareholders and insiders (managers) is destroyed, or, at least, is strongly lessened, agency problems generated by insider trading worsen. Therefore, we now have to examine the causes of this phenomenon.

The Nature of Interventionism

Before analyzing the implications of interventionism for insider trading in a hampered market, it is useful to briefly state the nature of interventionism.

We have already pointed out that interventionism, as an economic system, is different from the market economy in the sense that, even if the system is still based on private ownership of the means of production, the owners are not free to use their property as they see fit. In other words, interventionism is characterized by a set of authoritative commands and prohibitions that seek to restrict the actions of private owners. The coercive nature of interventionism involves several consequences for the behavior of market participants.

The first consequence of interventionism is that coerced owners of the means of production will act "in a way different from what they would do" in an unhampered market:

> *Interventionism is a limited order by a social authority forcing the owners of the means of production and entrepreneurs to employ their means in a different manner than they otherwise would.* (Mises 1977, p. 20; emphasis in original)[36]

Another consequence of interventionism understood as a set of restrictive measures is that, most of the time, it results in a set of privileges. Interventionism "brings advantages to a limited group of people while it affects adversely all others, or a least a majority of others. . . . The interventions, therefore, may be regarded as privileges, which are granted to some at the expense of others" (Mises 1998, p. 19).[37]

Finally, interventionism always results in conflicts of interest. Each individual wants to be granted a privilege, that is to say, to be the "net gainer" rather the "net loser" (Rothbard 1993, p. 769). The very nature of interventionism is conflict. It hampers the use that owners can make of their property rights, and consequently it creates conflicts of interest because it allows some individuals to get gains at the expense of others. Contrary to the market economy where each actor tries to satisfy the interests of other people in

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[35]To say that the market can solve every agency problem does not mean that it solves them all. Errors can be made.

[36]See also Mises (1998, p. 10) and Rothbard (1993, p. 768; 1970, p. 13).

[37]See also Hayek (1995, p. 156).

order to better satisfy his own interests, under interventionism, each actor tries to satisfy his own interests to the detriment of others.

In identifying the nature of interventionism and its general consequences on individuals' behavior, we can analyze the consequences of interventionism for the relation between shareholders and insiders and for insiders' behavior. We will show that interventionism strongly lessens the control of shareholders over insiders, and that the latter, as a consequence, are allowed to engage in behaviors denounced by proponents of insider-trading-as-an-agency-problem argument.

The Weakening of Governance Devices

The prime effect of interventionism is to hamper shareholders in the exercise of their property rights since it involves a transfer of power from shareholders to managers (insiders). This phenomenon gives rise to a separation of property from control. In other words, government's interference in the market creates the emergence of an omnipotent class of insiders (managers). Commenting on this impact of interventionism, Mises observed:

> [The emergence of an omnipotent managerial class] was, on the contrary, an outgrowth of the interventionist policies consciously aiming at an elimination of the influence of the shareholders and at their virtual expropriation. (Mises 1998b, p. 304)

In emphasizing the consequences of interventionism for the control relation between shareholders and managers (insiders), Mises anticipates recent work. Shareholders are no longer able to control their insiders, and consequently, the latter can adopt non-value-maximizing behaviors or break their contracts. In the same way, some recent works on "comparative corporate governance" have tried to show the interaction between politics and governance in the United States. Roe's works lead him to the same conclusion as Mises:

> The analytic result is fundamental: the modern American public corporation is not an inevitable consequence of technology that demands large inputs of capital. . . . Politics confined the terrain on which the large American enterprise could evolve. . . . By restricting the terrain on which the large enterprise could evolve, *politics created the fragmented Berle-Means corporation.* (Roe 1994, pp. 284–86)

With the emergence of Berle-Means corporations, control shifts to managers. Owning the control, insiders (managers) are more able to engage in behavior going against the interests of the shareholders. This "virtual expropriation" of shareholders by managers and the prevalence of managerial behaviors that do not serve the interests of shareholders is not a phenomenon of the unhampered market; rather it is a phenomenon of interventionism because shareholders have less control of their property rights.

Several regulations have especially contributed to the lessening of the control relation between shareholders and their insiders: legal restrictions on

financial institutions, insider trading regulation, antitrust regulation, state and federal antitakeover restrictions, and contract and labor legislation.[38]

According to Roe, legal restrictions on financial institutions taking large stock positions were key to the weakening of the control relation between shareholders and managers (insiders):

> The regular prohibition on financial institutions' taking large stock positions was crucial to the development of the Berle-Means corporation, with its fragmented share ownership. . . . Managers eventually benefited from this fragmentation. (Roe 1994, p. 93)

In the United States, banks, mutual funds, and pensions are either barred from the securities business and from owning stock or are significantly restricted in their portfolios and cannot easily devote their portfolios to big blocks. Moreover, some financial institutions, such as mutual funds and pensions, face legal and structural problems that prevent them from going into the boardroom. The general consequence of these legal restrictions is that ownership has been diffused and a shift of power from owners to managers has taken place (p. 283).

Another factor that imposes a deterrent effect on ownership is the insider trading regulation and Section 16 of the Securities Exchange Act of 1934, which includes in the definition of "insider" any beneficial owner holding more than 10 percent of a company's stock. Therefore, considered as insiders, shareholders are necessarily monitored by the Securities and Exchange Commission and are prohibited from making any insider trading transactions as defined by the insider trading regulation (ECGN 1997, p. 12; Beny 1999, pp. 18-19; also Bris 2000, p. 24). The impact of such regulation is the same as the regulation of ownership by the financial institutions, such as banking, insurance, and investment companies, and pension funds. For smaller investors (institutional or not), the incentive to monitor management is reduced because their stake in the company is smaller and, consequently, the benefits of the monitoring are reduced.[39] Another consequence is that if managers are less monitored, they have more latitude to engage in discretionary behaviors or break their contracts. Finally, the last consequence is that such a rule increases the costs of a takeover because it increases the cost of acquiring a majority of shares in a potential target, since the ownership is dispersed among many shareholders.

Federal and state antitakeover restrictions lessen the role of takeovers in disciplining the activities of managers. A fundamental consequence of such

[38]We do not deal here with all regulations in detail because of their overwhelming number. However, it is important to give some illustrations to understand how such regulations can hamper the functioning of the corporate governance mechanisms that help to minimize agency problems.

[39]See Maug (1999, pp. 24-25). See also Seyhun (1998, p. 31): "[M]any large investors prefer to keep their ownership below the 10 percent level that would trigger the insider status . . . insider trading laws in fact discourage monitoring."

regulations is that insiders feel protected; they are no longer deterred from engaging in non-value-maximizing behaviors.[40]

The 1968 Williams Act to the Securities Exchange Act of 1934 enables managers (insiders) to easily thwart a takeover.[41] It requires that acquirers *disclose* their acquisitions to the Securities and Exchange Commission along with any other information necessary or appropriate in the public interest for the protection of investors, *after* they purchase more than 5 percent of the outstanding shares on the open market.[42] Rule 14(e)-3 also hampers market control in favor of corporate control.[43] It then prevents acquirers from having recourse to arbitrageurs to make takeovers easier.

In Europe, legislation compels any person or legal entity to disclose within seven calendar days to the concerned company and regulatory agency of the member state in which the company is settled any acquisition or disposal of "a holding in a company and where, following that acquisition or disposal, the proportion of voting rights held by that person or legal entity reaches, exceeds or falls below one of the thresholds of 10 percent, 20 percent, 1/3, 50 percent and 2/3" (Council Directive 1988). The community legislation adds that "Member States may provide that a company must also be informed in respect of the proportion of capital held by a natural person or legal entity." The effect is the same as for the Williams Act, insofar as such legislation helps managers to adopt antitakeover measures in cases where acquisition of a large block of shares would precede a raid.

Much has been written about the harmful consequences of state antitakeover regulations and defensive measures, such as poison pills, that do not require shareholder approval and that have been enforced by state Supreme Court decisions.[44] The literature generally agrees that such measures are harmful to shareholders because they shield managers from the disciplinary role of takeovers.[45]

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[40]See Block and McGee (1992, p. 225, n. 24) accompanying text for references arguing against federal and state antitakeover restrictions.

[41]See also Scharfstein (1988, p. 196), which shows such federal takeover regulation as the 1968 Williams Act, which gives shareholders more time to evaluate a takeover and, if they perceive that such a takeover may benefit them, they will not tender their shares at a low price and, therefore, will unintentionally wreck the takeover.

[42]See 15 U.S.C. §§78m(d)-(e) and 15 U.S.C. 78n(d)-(f). See also amended sections 13(d)-(e) and 14(d)-(f) of the Securities Exchange Act of 1934 that includes now the 1968 Williams Act.

[43]Rule 14(e)-3 makes it illegal for anyone to trade the securities of the firm involved in a tender offer while in possession of material, confidential information. See 17 C.F.R. §240.14e-3.

[44]See, for example, Jarrell et al. (1988, pp. 62-65) for an account of antitakeover measures that do not require shareholder approval. The Delaware Supreme Court's 1985 ruling in *Moran v. Household International* is usually cited as the first state enforcement of adoption of antitakeover measures not requiring shareholder approval.

[45]See Jarrell et al. (1988) for an account of empirical studies reporting the undoubtedly harmful effects of antitakeover measures and of state antitakeover regulations.

Another factor that contributes to the weakening of the control relation between shareholders and managers (insiders) is the nonenforcement by the courts of the contract and, in particular, the voidance of penalty clauses.[46] The direct consequence of such intervention is the possibility that not paying monetary damages gives insiders more incentives to break their contracts.[47]

Labor legislation has also contributed to lessening the control relation between shareholders and managers (Mises 1983, pp. 69-71; also Roe 1994, p. 39). It interferes at several levels and hampers governance mechanisms that would prevent insiders from either mismanaging the shareholders' corporate resources or breaking their contracts. For example, the interference with the freedom of contract by regulating the conditions of redundancy allows the managers greater latitude to engage in discretionary behaviors.[48]

The separation of ownership and control, understood as the lessening of the control relation of shareholders on insiders (managers), is *not* a consequence of a general evolution of the market process. On the contrary, as Mises and later Roe have shown, this phenomenon results from the meddling of government in the market. The separation-of-ownership-from-control phenomenon emerges with interventionism.

Some authors have tried to challenge Roe's theory by arguing that the emergence of the Berle-Means corporation is not the result of government

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[46]For example, the Uniform Commercial Code states:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty. (U.C.C. §2-718)

Under the Uniform Commercial Code, the question of whether damages are "unreasonable" may be determined not only at the time the contract is signed, but also *ex post* in light of the actual harm suffered by the parties. Moreover, the rationale for the nonenforcement of penalty clauses is that parties are not free to establish remedies, since that is the role of public law rather than private contractual law.

[47]See also Rothbard (1998, pp. 140-41), explaining the suppression of performance bonds as resulting from a misunderstanding by the courts of the concept of contract enforcements. Rothbard argues that the role of contractual enforcement is to make sure that agreements are performed, not to provide compensation for loss suffered by failure to perform agreements.

[48]The French case is a perfect example of such interference with freedom of contract and of regulation of labor conditions. The new law on "social modernization" adopted by the Assemblée Nationale is the most recent case of such interference that illustrates how government interventions indirectly hamper the disciplinary role of contract, contract law, and competition in general. When employers cannot let their employees go because the firm is underperforming in the industry, employers do not have incentives to avoid non-value-maximizing behaviors. See Assemblée Nationale (2001, pp. 32-42).

interventions in the market but rather can be explained by the degree of minority-shareholder protection (La Porta et al. 1997, 1998, 1999). They argue that in countries (generally common-law countries such as the United States or the United Kingdom) with good legal protection of minority shareholders, ownership is widely dispersed. On the contrary, in countries (generally civil-law countries such as France, Italy, Germany, and Belgium) with poor legal protection of minority shareholders, ownership is usually concentrated. Beny (1999), Maug (1999), and Bris (2000) have extended La Porta et al.'s studies and applied them to the insider trading issue. They show that where insider trading laws (interpreted as legal protection of minority shareholders) are tougher, ownership is more dispersed. Unfortunately, such studies are wandering from the Mises-Roe argument in three ways.

First, the issue is not the structure of ownership (concentrated or dispersed) but the expropriation of shareholders by the managers. The definition of Berle-Means should not be understood in terms of degree of ownership concentration (or dispersion) but rather in terms of degree of control that shareholders have on managers' behaviors. It is not whether ownership is dispersed or concentrated but rather whether shareholders have lost control of the corporation, that is, whether shareholders can no longer discipline managers' behaviors. Ownership can be concentrated and shareholders can still be harmed by the managers' discretionary behaviors.[49]

Second, such studies cannot be considered as challenging the Mises-Roe argument insofar as they make a comparison between two systems characterized by more or less intervention. Such studies only show that in countries where property rights are less hampered and contracts are more enforced, equity markets are both broader and more valuable than in countries where property rights are more hampered and contracts less enforced. This point is illustrated perfectly by their observation that corporations in civil-law countries are typically controlled by the State (such as in France), while corporations in common-law countries have been under dispersed ownership. Their comment about State-controlled corporations is without appeal; such corporations are "extremely inefficient" and expropriate minority shareholders. Moreover, they show that such countries are also marked by more corruption because of the strong bond with the political sphere (Shleifer and Vishny 1997, pp. 767-69). Finally, such studies show that in civil-law countries, insider trading scandals usually have a connection to political power. The Triangle Industries scandal is one illustration. The scandal involved insider purchases of Triangle shares shortly before Pechiney bought it in 1989. Among the six French buyers who were indicted for insider trading, one (Roger-Patrice Pelat) was a close, longtime friend of the president of the Republic. Two others (Max Théret and Harris Puisais) were also close to political power (Bris 2000, p. 9).

[49]See after.

Third, studies applied to insider trading, in the same spirit as La Porta et al., investigated expropriation of minority shareholders by large shareholders. Unfortunately, we cannot consider whether there is any expropriation of minority shareholders when large shareholders trade on inside information insofar as large shareholders have as much legitimacy to trade on inside information as minority shareholders. The fact that large shareholders have easier and less costly access to inside information does not invalidate such legitimacy to trade on inside information.[50]

The Encouragement of Discretionary Behavior

Our analysis has shown consequences of interventionism on the control relationship between shareholders and insiders. As soon as this control relationship is weakened, insiders are able to engage in breaches of contract. Now we will show briefly that securities regulation–and, more specifically, insider trading regulation–is not able to substitute or complement the market to solve agency problems. On the contrary, insider trading regulation worsens them, in the sense that it inclines insiders to develop new forms of behavior in order to trade. This results from the arbitrary nature of any regulation.

Because restrictive measures are arbitrary, insiders have no difficulty finding strategies to escape regulation. Several examples illustrate this point.[51]

Section 16 (b) of the Securities Exchange Act of 1934, also called *insider's short-swing profit rule*, prohibits any transaction involving purchases and sales within a six-month period. The weakness of such a rule is that insiders have only to make a transaction within six months and one day, and they are not under the prohibition.[52]

From 1980 to 1997, the very definition of insider trading (as a fraudulent activity) relied on the concept of "fiduciary duty" (*Chiarella v. United States* 1980, pp. 227-28).[53] First, this allows an insider to engage in inside information exchange with insiders from other corporations, or to give inside information to someone who will undertake to trade on the insider's behalf.

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[50]See, for example, Easterbrook (1981, p. 330) on the inconsistency of characterizing insider trading as fraudulent following the argument that insider trading is unethical because access to inside information is unequal between insiders (large shareholders, management) and outsiders (minority shareholders, potential shareholders).

[51]It seems necessary to point out that the regulation of insider trading has been amended many times at the mercy of the U.S. Supreme Court, making some of our examples no longer valid. However, our point is rather to show how the regulation of insider trading, because of its arbitrary nature, can reach some paradoxical results.

[52]As Manne (1966, p. 30) explained, this rule did not have the expected effect, that is, a reduction in insider trading activities and profits realized by insiders, and that is why the SEC asked for a broad rule against all trading with inside information but the Congress expressly declined such an option. But, in 1942, the SEC had recourse to Rule 10(b) of the Securities Exchange Act of 1934 and adopted an application rule, rule 10b-5. See Georges (1976, p. 94, n. 1) and Manne (1966, p. 34).

[53]See Strudler and Ort (1999, p. 389) for a restatement of the definition of insider trading as a fraudulent activity based on the fiduciary-duty principle:

Manne (1966, pp. 59-75) described this behavior and the emergence of a "black market" for private information in order to escape insider trading regulation.[54] Moreover, such a definition of fraudulent activity excludes from the scope of the regulation persons who have a non-full-time contractual relationship (outsiders) with the corporation (see Easterbrook 1996, p. 269). The *Chiarella v. United States* case–the case to define insider trading as a breach of fiduciary duty–is a typical case of some paradoxical consequences to which an arbitrary rule can lead. Chiarella, an employee of a financial printing house that printed announcements for corporate takeover bids, deciphered documents concerning takeover clients. Chiarella was able to identify five companies, and he purchased stock in the targeted companies. Chiarella was not convicted because, first, he never received confidential information from the target companies and, second, he did not owe any fiduciary duty to the target company's shareholders from whom he bought shares. However, Chiarella did trade on confidential information belonging to the printing house's client. The question that arises is: did the client bidder allow him to trade on information that he could "discover" in their contractual relationship? The reply is that documents Chiarella had to print for the client bidder were encoded. Therefore, we can implicitly assume that the client bidder would not have allowed him to trade on information that he could discover during his work. Chiarella clearly broke his contract with his employer but was not convicted because of the "fiduciary-duty" doctrine.

We have the same kind of paradoxical consequences with the recent *O'Hagan* case (*United States v. O'Hagan* 1997), which is an updated version of the misappropriation theory and of the fiduciary-duty doctrine. In this case, the conviction was established on the fact that the defendant had broken his fiduciary duty that he owed, not to stock market investors, but rather to the company's shareholders, who were the legitimate owners of the inside information. Here, the definition of insider trading (as a fraudulent activity) relies on a new version of fiduciary duty. The fraud is committed when the person misappropriates inside information for securities trading purposes in breach of duty owed to the source of the information (pp. 7 and 28, n. 6). The problem of such a definition of insider trading (as a fraudulent activity) is that

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> Insider trading is wrong because whenever it occurs, the inside trader breaches fiduciary duties owed to the trader's principal, namely, the corporation or the corporate shareholder with whom he engages in securities transaction. By trading without disclosing material non-public information to the principal, the insider violates a duty owed to the principal corporation or its shareholders.

[54]In an unhampered market, such a market would not emerge because all contracts are voluntary. Therefore, both parties will expect *ex ante* that they will be better off after contracting than before contracting.

the only criterion to escape a conviction is for the insider to disclose the source of information and his intentions to trade on inside information (p. 8). The liability lies in the nondisclosure of insider's intentions and not in the authorization. Therefore, the insider only has to disclose his intention to escape the liability for insider trading; he does not need to have the authorization from the source of the information, namely, the shareholders.

Another example is that securities regulations compel corporations to publish financial information according to well-defined accounting criteria in order to increase the informational equity, namely, the equal access to information for market participants.[55] Such regulation is supposed to reduce insiders' profits resulting from their privileged access to information. The problem is that these criteria are arbitrary, and consequently insiders can keep the material information in order to trade on it.[56]

Alternative behaviors to avoid regulations are a common reaction to interventionism. Because any regulation is based on *arbitrary* criteria, individuals will engage in alternative behaviors to reach their ends.

We can find empirical studies that have tested the efficiency of regulation on the volume of insider trading, the volume of inside transactions, and the profitability of inside transactions that support our analysis. For example, Seyhun (1992) investigates the effectiveness of increased federal regulation of insider trading and its sanctions on a period from January 1975 to December 1989. The study only examines insiders' open market sales and purchases. He finds that (1) the profitability of insider trading has increased; (2) there is no evidence of a decline in the frequency; (3) the volume of trading by insiders has doubled; and (4) insiders have become more aggressive in exploiting the private information by trading larger volumes over time. Seyhun explores the relative deterrent effects of federal regulation and case law on insider trading around specific events. He finds that, at the time when earnings are announced, insiders' transactions decrease significantly, and that in the thirty days prior to takeover bids, the volume of trading activities of insiders

[55]The Securities Act of 1933 regulates the information that must be disclosed to investors in new securities issues. The Securities Exchange Act of 1934 regulates periodic disclosure of financial information by publicly owned corporations. The other reason for such regulations is to encourage people's participation in the securities market. See also the European Community legislation in force: Council Directive 80/390/EEC (1980), coordinating the requirements for the drawing up, scrutiny, and distribution of listing particulars to be published for the admission of securities to the official stock exchange listing; Council Directive 82/121/EEC (1982), on information to be published on a regular basis by companies with shares that have been submitted to the official stock-exchange listing; and *Council Directive 89/298/EEC* (1989), coordinating the requirements for drawing up, scrutiny, and distribution of the prospectus to be published when transferable securities are offered to the public.

[56]See Benston (1969, 1973, 1982, 1998), who shows that this consequence results from the harmonization of accounting rules to report financial information. Such harmonization results in the removal of all subjective information, such as intangible assets.

decreases. He concludes that while the federal regulation of insider trading does not appear to have a significant deterrent effect on insiders overall, "court cases regarding insider trading around earning and takeover announcements did affect insider trading patterns" (p. 176).

The Seyhun study is consistent with our argument that federal insider trading regulation is inefficient and that such regulations do not deter insider trading but rather give incentives for insiders to generate alternative and strategic behaviors to escape regulation.[57]

In a more recent study, Bris analyzes the effects of insider trading regulation in fifty-six countries and shows that laws that prosecute insider trading make it more profitable to violate them and fail to eliminate profits made by insiders around tender-offer announcements. He shows that the tougher the laws, the more profitable the opportunities to insiders, due to (1) the fact that the increase of stock liquidity resulting from insider trading laws gives more insiders opportunity to hide informed trades, and (2) the fact that uninformed investors participate more if they infer that insiders are not going to take advantage of them (Bris 2000, pp. 9, 23).[58] "Therefore, the expected penalty from being prosecuted by the regulator decreases," and the volume of insider trading increases (p. 15). Finally, consistent with our criticism of interventionism, he shows that the profitability of insider trading is lower in common-law countries (United States, United Kingdom, Australia) than in civil-law countries (France, Spain), not because insider trading regulations are efficient but because shareholders' property rights are better protected and contracts are better enforced.

What we have to remember about interventionism and, in particular, the regulation of insider trading deals with the agency-problem issue is, first, interventionism neither substitutes for complements the market mechanisms in resolving agency problems that insider trading raises. Second, interventionism

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[57]It could be argued that our argument is flawed because the increased number of insider trading convictions is evidence of the effectiveness of insider trading regulation. However, this argument is erroneous in the sense that insider trading regulation (as any prohibition) should be considered as effective not when the number of convictions increases but when it decreases. It is the deterrence impact that is crucial as a measure of the effectiveness of insider trading prohibition. From a statistical point of view, an increase in the volume of convictions and crimes is not a measure of effectiveness, but of ineffectiveness.

[58]See also Holden and Subrahmanyam (1992), Foster and Viswanathan (1993), and Spiegel and Subrahmanyam (1995).

Two factors may explain why investors participate more. First, the insider trading regulations create the illusion that there is no insider on the stock market to "take advantage" of their "ignorance." Second, the rules about publications of corporate information create the illusion that they are "equally informed." It is necessary to recall here that the main purpose of insider trading regulations has been to place investors on a "level playing field," that is, to place investors on an equal footing for the access of information and for profit-making on the stock market. See, for example, Council Directive 89/592/ECC of 13 November 1989, coordinating regulations on insider trading in Europe.

actually hampers these market mechanisms and consequently makes these agency problems worse. Finally, interventionism gives incentives for insiders to adopt alternative and strategic behaviors to escape regulations.

The first result of interventionism is to shift control from shareholders to managers (insiders). The second result is that insiders adopt alternative (perverse) behaviors in order to get net gains offered by interventionism. Advocates of the insider-trading-as-an-agency-problem argument denounce these perverse behaviors. However, they do not result from a natural evolution of markets, but from government meddling with the market.

Conclusion

The insider trading debate traditionally discusses the pros and cons of insider trading and draws a conclusion about the desirability or undesirability of public regulation of insider trading. One of the most important arguments against insider trading is that it generates agency problems that shareholders cannot resolve and that, therefore, insider trading should be publicly regulated. We have challenged this argument for failing to engage in comparative institutional analysis. We argued that when the negative aspects of insider trading, namely, the agency problems that it may create, are considered, it is necessary to engage in comparative institutional analysis and how these problems can be resolved under two different economic systems: the market economy and interventionism.

We have been led to the conclusion that under a market economy, shareholders do have mechanisms to protect themselves against agency problems generated by insider trading and that these problems are reduced to a minimum. We have shown that interventionism hampers the functioning and reduces the disciplinary role of such mechanisms. Therefore, insiders have indeed more latitude to engage in these discretionary behaviors, pointed out by the supporters of the insider-trading-as-an-agency-problem argument, that harm shareholders. Finally, we have shown that the failures of government regulation reinforce this tendency of insiders' behavior.

We conclude that we cannot justify a public regulation of insider trading based on the insider-trading-as-agency-problem argument.

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