The optimal regulation of Insider Trading

The economic implications of insider trading have been broadly analysed in terms of market efficiency and its consequences on the performance of the economy [Manne 1966 – Kyle 1985 – Admati and Pfeiderer 1988 – Laffont and Maskin 1990 - Fishman and Hagerty 1992]. Furthermore, insider trading generates a detrimental effect that can be interpreted as an adverse selection problem [Copeland and Galai 1983 – Glosten and Milgrom 1985 - Manove 1989 - Ausubel 1990 – Fishman and Hagerty 1992 – Leland 1992 - Shin 1996]. Consequently, the specificity of insider trading and its attractiveness by the literature is due to the controversial external effects it imposes on the economy. A debate has emerged from the question of the desirability of the prohibition of insider trading [Hu and Noe 1997]. This debate has not been really solved since most of the papers modelling the insider’s behaviour under a prohibition rule consider that insider orders are completely eliminated from the market. The complexity and diversity of the economic implications of insider trading undermines the understanding of what the optimal regulation of insider trading should be.

The economic analysis of the optimal regulation of insider trading is in fact an emerging literature, which faces two major impediments. Firstly, some authors argue that harm brought about by insider trading is very low [Engelen 1997] or only consider its implications as a wealth transfer from uninformed investors to the insider [Estrada 1994]. They either conclude that insider trading should not be regulated or better disciplined by taxation. Shin [1996] and DeMarzo, Fishman and Hagerty [1998] address the question of the optimal regulation of insider trading when it reduces the loss imposed to uninformed investors. As a consequence, no previous model raises the question of optimal regulation of insider trading on the basis of all external effects implied by this misconduct. Secondly, most models, and notably Spiegel and Subrahmanyan [1995] and Shin [1996], are not able to determine the nature and level of the optimal parameters of the regulation.

This paper deals with the question of the optimal regulation of insider trading, taking in account the whole economic implications of fraud. It is organised in two steps. Firstly, the economic analysis of external effects applied to insider trading shows that the optimal amount of trade for each type of insider may be positive. This first insight is twice important for our statement. It enlightens the debate on the desirability of the prohibition of insider trading, proving that there are undesirable transactions, which should be regulated, and desirable transactions that should not be deterred by policies. The analysis furthermore provides an objective for each policy, regulating insider trading. Secondly, we analyse the optimal regulation of insider trading under a “threshold policy”, inspired from the actual setup of the French authority. The strategic behaviour of insiders under a threshold policy leads us to the conclusion that the optimal policy is the one that completely deters insiders to trade above the threshold. The threshold is moreover the lowest given the budget allocated to this area of public policy. This second insight emphasizes the strength and the drawbacks of the threshold policy. On one hand, the desirable transactions are not deterred and the amount of the most harmful orders is reduced under the threshold. On the other hand, insiders behave strategically, a behaviour that indeed reduces the amount of their trades, but also let them free to trade without any risk of sanction. It is then straightforward to understand that the more the equilibrium under the threshold policy deviates from the one defined as the first best, the more insiders behave strategically.

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