Regulating Insider Trading When Investment Matters[¤]

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Abstract

We analyze the e¤ects of insider trading on real investment and welfare, and the consequences of di¤erent regulatory policies: a disclose-or-abstain rule, "fair" disclosure, laissez-faire, and forbidding insider trades based on "precise" information. We perform the analysis in a model in which all traders are rational expected-utility maximizers and aware of their position in the market. We compare the equilibrium with insider trading with the equilibrium in the same market without insider trading in two scenarios: costly and costless information acquisition. We …nd that with costly information acquisition a mandated abstain-or-disclose rule tends to be optimal while with free information acquisition laissez faire is better. This suggests the following rule ot thumb: Mandate an abstain-or-disclose rule with a high standard of proof for inside information. Then insiders only have to worry about information which is costly to acquire. The rule of thumb advocates a laissez policy both for selective disclosure and in high-tech industries. Our approach rationalizes modelling hedgers as noise traders for certain extreme parameter con…gurations and uncovers the pitfalls of welfare analysis in the noise trader model.

JEL Classi…cation: D82, G12, G14

Keywords: insider trading, selective disclosure, disclose-or abstain rule, real investment, welfare, hedging, speculation, noise traders.

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