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# Insider trading and the short-swing profit rule

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## Abstract

The short-swing profit rule is a federal statute that requires insiders to forfeit any trading profit earned from a combined purchase and sale that occurs within a six-month period. Using a multi-period strategic rational expectations equilibrium framework, I demonstrate that the rule tends to reduce both the amount of insider trading and the amount of profit earned by an informed insider from information-based trades because the rule imposes a constraint on the insider's dynamic trading strategy. Nevertheless, the rule increases the insider's welfare at the expense of uninformed investors (outsiders) because the rule inhibits risk sharing, which leads to an ex ante wealth transfer from outsiders to the insider.

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## 1. Introduction

The short-swing profit rule is a federal law that was enacted to prevent corporate insiders from exploiting their private information in the financial market. The statute, which is codified by §16(b) of the Securities Exchange Act of 1934, is a “crude rule of thumb” that prevents statutory insiders (officers, directors, and beneficial owners of more than 10% of a company's

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shares) from earning short-swing trading profits.<sup>2</sup> Specifically, the rule enables a firm to recover any trading profit realized by an insider resulting from a combined purchase and sale (or sale and purchase) of the firm's stock that occurs within a six-month period.<sup>3</sup>

Unlike other laws and regulations intended to curtail insider trading, which are narrowly-tailored, the scope of the short-swing profit rule is extremely broad.<sup>4</sup> The rule does not require proof that an insider actually traded on the basis of private information or even possessed such information at the time of the trade. Rather, the statute imposes strict liability on insiders who violate its provisions, as the only requirement for recovery under the rule is that an insider realize a short-swing profit. Given its extensive reach, the rule has the potential to greatly affect markets.

To evaluate the impact of the short-swing profit rule, I construct a two-period strategic rational expectations equilibrium model in which an informed insider must disgorge any profit earned from short-swing trading. During the first period, the insider trades with uninformed investors (outsiders), and all agents have symmetric information sets. The insider then acquires an information advantage over outsiders during the second period regarding the future payoff of a stock, and he may exploit his advantage by trading in the financial market, subject to the restriction imposed by the rule.<sup>5</sup> An endowment shock for the insider during the second period prevents his trade from fully revealing his information in equilibrium.

Relative to an economy without a prohibition against short-swing profits, I find that the rule inhibits the insider's ability to hedge his endowment shock and exploit his private information because it creates transaction costs (in the form of profit forfeiture) that incentivize the insider to forego trading during the second period in many cases where he would otherwise be required to forfeit his profit. Because the rule may hinder the insider's ability to trade during the second period only when he trades during the first period, however, the insider mitigates these effects by making a smaller first-period trade. This leads to a less efficient allocation of the stock among the insider and outsiders in the first period, which hampers their ability to share risk at that time.

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<sup>2</sup> According to testimony provided at a hearing before the Senate Banking and Currency Committee in 1934, “[Y]ou have to have this crude rule of thumb because you cannot undertake the burden of having to prove that the [insider] intended, at the time bought, to get out on a short swing... You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule.”

<sup>3</sup> The relevant text of §16(b) reads:

For the purpose of preventing the unfair use of information which may have been obtained by [an insider] by reason of his relationship to the issuer, any profit realized by [an insider] from any purchase and sale, or any sale and purchase, of any equity security of such issuer... within any period of less than six months... shall inure to and be recoverable by the issuer, irrespective of any intention on the part of [the insider] in entering into such transaction of holding the security... purchased or of not repurchasing the security... sold for a period exceeding six months. Suit to recover such profit may be instituted... by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter[.]

Recovery of short-swing trading profit is facilitated by §16(a) of the Act, which requires insiders to publicly disclose their trades within two business days.

<sup>4</sup> The other primary deterrent to insider trading is SEC Rule 10b-5, which prohibits trading on material non-public information. However, such trading is difficult to detect and prove. Rule 10b-5 also does not prohibit trading on information that is not “material.”

<sup>5</sup> This setup reflects the fact that while insiders often make “routine” trades driven by diversification or personal liquidity motives, insiders sometimes make “opportunistic” trades that appear to be based on private information (see [Cohen et al., 2012](#)). The setup is discussed further in Section 2.

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