

## Original Paper

# Insider Trading and Regulatory Efficiency in Europe

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### Abstract

*How insider trading affects market efficiency and whether it should be regulated has long been controversial. Nowadays, it is widely recognised that insider trading is a harmful activity in capital markets and should be prohibited. However, proponents of insider trading argue that it should not always be viewed as a destabilising, illegal and harmful market practice. This paper attempts to organise their views and evaluate the arguments of the proponents on three levels: legislation legitimacy, corporate governance and market efficiency. Based on a critical analysis of these arguments, the paper states that regulating insider dealing therefore becomes a legal imperative, aiming to ensure the proper functioning of markets, safeguard them from illegal practices, and maintain investor confidence in the premise that the markets offer a fair trading environment in a context of informational equality and transparency.*

### Keywords

*insider trading, market efficiency, corporate governance*

The issue of insider trading is as old as stock market trading. In all developed markets around the world, it is seen as potentially damaging to public confidence in securities trading. But the induction of this consensus took decades. Until the end of the Second World War, there was considered to be no distinction between the buying and selling of insider information and company shares. At that time, insider trading was seen as a legitimate state of nature. It was not until the Companies Act 1980 that the first legislative intervention to combat insider trading took place in the UK. This essay analyses the reasons for banning insider trading in terms of regulatory legitimacy, management incentives and market efficiency. It also considers the impact of such regulation on corporate governance and market efficiency.

## 1. Legitimacy of Regulating Insider Trading

Proponents of insider trading argue that insider trading involves the private sphere of companies and insiders. Such trading should be left to the discretion of the company and the state should not interfere. Macey sees the distribution of insider information as a part of contract law. Carlton & Fischel illustrate the possibility of binding insider trading by contract. According to them, the relationship between the company and the insiders is based on a private contract. If a company and its shareholders object to insider dealing, they can include a prohibition clause in that contract. The terms of the contract are used to partially prohibit insider trading. The state should not interfere with private contracts, which are in the realm of autonomy, and there is no need to adopt laws to prohibit insider trading generally.

Proponents, however, overlook the impact of insider trading on public investors and the securities market. When an insider trades with information that is not known to other investors, he harms the interests of his counterparties. In this case, insider dealing involves the interests of public investors and is not just a private matter between the company and the insider. If regulating insider trading by private contract ignores the interests of public investors, would it then be more legitimate to intervene by law? “Fairness” and “integrity” are two important aspects that motivate the state to combat insider trading. In terms of fairness, insider information leads to an information gap between insiders and public investors, with the former having an unfair advantage over the latter. In terms of integrity, investors put their capital to work—and their wealth at risk—based on the belief that markets are honest. This view is supported by the Securities and Exchange Commission’s (SEC) statement on insider trading, which they believe “undermines investor confidence in the fairness and integrity of securities markets”. This explains, in part, why many countries chose to regulate insider trading by law in the face of the proliferation of insider trading in the 1990s. Laws take into account the interests of a wider public of investors than private contracts and are more likely to stabilise investor confidence in the financial system.

## 2. Insider Trading and Corporate Governance

In analysing the function of insider trading, proponents argue that this mechanism can compensate management and stimulate them to perform innovative functions. Manne distinguishes between different types of individuals involved in business operations. He considers that entrepreneurs can play a more active role than managers and capitalists—not only in terms of inventions, but also in terms of product innovation, marketing strategies and financing methods more generally. Since “the process of innovation in a business is the production of insider information”, where insider trading is permitted, entrepreneurs innovate diligently and use the insider information generated by the innovation for insider trading. This can contribute to the progress of the enterprise while rewarding the entrepreneur accordingly. According to this proposition, if insider trading is allowed in a business, it will give

managers with an entrepreneurial mindset a great opportunity to fulfil their ambitions and receive adequate compensation. This view is supported by Frank, who believes that insider trading is the best form of compensation for management.

The entrepreneurial compensation theory has limitations in three areas: the nature of information, the managerial decision-making mindset and the payoff cycle. For one, there is a distinction between beneficial and detrimental insider information. Insiders can profit from both good and bad news. When profiting from bad information, management is not required to contribute or be responsible for the company. They are also “compensated” even if the information may put the company in a bad light. In such circumstances, insider trading does not act as an incentive to innovate and promote business. Second, when managers expect financial gain, they may choose riskier investments. The impact of insider trading on management’s decision-making psychology may be driven by the enhanced value of options arising from potential cash flow fluctuations. It may also be due to the fact that managers learn about the solution to uncertainty before the market does. At that point, the greater uncertainty allows them to reap greater trading profits. Whatever the rationale, insider trading will induce managers to take on some desirable risky projects. Such a short-term mentality, however, is not conducive to the long-term growth of the business. And third, innovation takes time to generate revenue for a company. According to statistics from the 1990s, the platform pre-clinical study cycle for a new drug was 6.1 years, the average clinical study cycle was 6.3 years, and the average approval time for a new drug application at the FDA was 1.8 years, adding up to about 14 years. The example of the pharmaceutical industry serves to illustrate the distance between innovation and stock price appreciation. The long return cycle creates uncertainty about the value of insider trading. In Baum’s view, allowing entrepreneurs to exploit information of uncertain value amounts to permitting a form of stock manipulation.

### **3. Insider Trading and Market Efficiency**

Proponents of the view that insider trading can improve market efficiency are based on the theory of price efficiency. Carlton & Fischel do not believe that mandatory full disclosure is an optimal situation, as opposed to insider trading, which they believe allows for more convenient and accurate transmission of information. They apply Coase’s theory to demonstrate that insider trading can achieve the optimal allocation of property rights. Proponents of insider trading acknowledge that insiders may control the amount of information disclosed to maximise their own interests, which makes the information transmitted incomplete. But this “trusted” incomplete disclosure is beneficial to companies in controlling the manner and scale of information dissemination.

This opinion attempts to change the standard of information disclosure from full disclosure to trustworthy disclosure. As long as the issuing company provides information that is truthful and

sufficient to enable investors to make sound market judgements, the disclosure requirement is satisfied. In this case, insider trading provides an adequate mechanism to protect the company's trade secrets and other competing interests, while allowing for de facto disclosure of "trusted" information. However, the positive impact of insider information depends on the "even distribution of insider information among investors". Moreover, this information transmission function of insider trading is based on the abuse of information advantage, which also has liquidity costs such as increased moral hazard, shaken investor trust in the market and may even jeopardise the functioning of the securities market. Data from an empirical study in 2004 further indicated that in a contest between the negative effects of liquidity and the positive effects of information efficiency, insider trading has a negligible impact on market efficiency.

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