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Book Reviews

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BOOK REVIEWS

DIVIDING THE WATERS, A CENTURY OF CONTROVERSY BETWEEN THE UNITED STATES AND MEXICO. BY NORRIS HUNDLEY, JR. Berkeley and Los Angeles: University of California Press. 1966. Pp. ix, 186. \$6.95.

Up to now, literature concerning international rivers has been scarce. Perhaps this is due to the fact that until recently concern with international rivers was limited to problems of boundaries and navigation. Today, the general scarcity of water throughout the world, the increased dedication of land to farming, and the growing need for energy have caused countries to examine the possibility of exploiting the international hydraulic currents as a possible supplement to their internal water sources.

The problems which arise from the possibility of this exploitation are relatively new. Besides the lack of methods to deal with international waters, conflicting foreign interests have complicated the matter, with the result that development of legal standards has been disperse and unsatisfactory. Furthermore, each river basin and water system differs from another. Traditional ideas and standard definitions have been further confused by the infiltration of economic concepts and interests. Nevertheless, some progress is noticeable. The problem is discussed more and more frequently in scientific congresses, in international meetings, and by specialists; it has already begun to assume a definite significance.

Controversies between the several countries have acted as an important catalyst in the difficult integration of standards concerning the exploitation of international water currents. Of particular consequence is the water dispute between the United States and Mexico. The confrontation of opposing concepts and the necessity of adjusting several situations which urgently required solution by both countries have resulted in a valuable body of ideas and developments. True, there is still much to be done. The need to formulate more definite standards is imperative since the hydraulic resources of the world are becoming exhausted. A logical, practical, and just solution must be found.

Due to the above problems the book by Professor Hundley has been timely published. It contributes new and impartial analyses of this debated issue and provides fresh and unbiased information in an interesting way. The book is mainly concerned with the struggle between the United States and Mexico to reach a legal solution to the important political problem of the international distribution of waters. This legal solution must be reached without the assistance of accepted precedents or pre-established standards. Concededly, the treaty of 1906 between the two countries, con-

cerning the distribution of the waters of the upper part of the Bravo River, was an important step. It was the first treaty of its kind in the world, and until that time there had been no investigations anywhere which could clarify the situations which confronted the diplomats of both nations. Hundley states, however, that although the treaty of 1906 was suitable for the circumstances existing at that time, it lacked foresight and was the product of elementary drafting techniques. It is therefore inadequate to deal with current problems.

The treaty of 1944 attempted to reach a final solution of the problems between the two countries concerning international water currents. It was preceded by violent and well-organized resistance by the riparians of the upper Colorado River. This conflict is carefully investigated and studied by Hundley. In a concise, elegant, and most illustrative style he discusses the facts which led to the conflict. One must conclude that, in view of the attitude of the riparian farmers of the Colorado and Gila Rivers who had appropriated almost all useful waters, it is surprising that Mexico was able to obtain some of the water. In this part of the book Professor Hundley gives a most interesting example of the powerful effect of water on internal and international politics. He presents a psychological portrait of those persons who took part in the bargaining, and an analysis of the interests which influenced each of them. The struggle in the United States Senate for the ratification of the pact is sparkingly disclosed, and the author's clear commentary elucidates many aspects which had been previously unnoticed and are now important.

It is obvious, as Hundley points out, that the 1944 Treaty for the Distribution of Waters of the Bravo, Colorado and Tijuana Rivers could have been better constructed and more precise. It resolved only the main point of the controversy, and unfortunately left the rest of the matters open. For example, the concepts "extraordinary drought" and "water quality" did not have the same scope for the two parties signing the treaty, and for this reason conflicts began anew as soon as the water flow in the Colorado diminished. The problem of salinity arose and, once more, the doctrinary concepts had to be confronted. The treaty, precariously put on trial, led only to temporary solutions of doubtful pragmatism and not to definitive legal solutions.

Hundley deals quite well with this new dispute, and he correctly states that the provisional Mexican-North American settlement of March 22, 1965, does not provide a final solution to the quality of the Mexican portion of the waters of the Colorado River. As the author clearly indicates, this problem soon must be solved to the complete satisfaction of both parties. If it is not, the very scarcity of the water could provide new and more serious incidents and challenge the entire efficacy of the treaty.

The future does not seem very promising. The increasing demand for water by the dehydrating riparian states of the Colorado River and the needs of the northwestern part of Mexico indicate the possibility of the disputes becoming more accentuated. Moreover, what has been gained in understanding may be lost through lack of vision. Perhaps, while there is still time, it will be necessary to bring about new complementary treaties. Be that as it may, books as wholesome and impartial as the one by Professor Hundley, will be extremely valuable in helping to reduce the area of conflict. In addition, Hundley must be credited with having written a pleasing, nimble, and illustrative narrative of a confusingly technical, political, and diplomatic entanglement. His book helps to dissipate doubts related to the question of the international distribution of waters and will be extremely useful in reaching adequate solutions for similar problems in other parts of the world. Furthermore, it will help to create more effective standards for a better understanding between Mexico and the United States concerning this problem.

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INSIDER TRADING AND THE STOCK MARKET. BY HENRY G. MANNE. New York: The Free Press. 1966. Pp. 274. \$6.95.

Professor Manne has attempted to equate insider trading profits in the stock market (profits from trading on information not publicly disclosed) to the entrepreneurial profit concept of the economic theories of Frank Knight and Joseph Schumpeter (profits which initially arise automatically as a result of some new innovation in the economy). His thesis is that insider trading in all markets, in all securities, of all corporations is the only proper method of compensating entrepreneurial contributions to our society. His grandiose conclusion is, "People pressing for the rule barring insider trading may inadvertently be tampering with one of the wellsprings of American prosperity."¹

The book begins by stating that the entire problem of insider trading has been exclusively the province of lawyers and law professors who have concentrated on settling disputes between two live human beings. It concedes that in this context it is easy to conclude that there is something unfair (unequal) about insider trading. Professor Manne suggests that more important questions than those concerning individual rights and duties

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¹ MANNE, INSIDER TRADING AND THE STOCK MARKET 110 (1966).

are those of the economist: How are all shareholders affected by the practice? Does it result in a desirable allocation of economic resources? And does the return to insiders reflect a "competitive" or a "monopoly" gain in the economic sense?

After analyzing early economic writings on the subject, the book traces the development of the law from *Strong v. Repide*² through the complaint of the Securities and Exchange Commission (SEC) in *SEC v. Texas Gulf Sulphur Co.*³ (decided subsequent to publication of the book). There follows a brief discussion of the provisions of the Securities Exchange Act of 1934 and the rules thereunder, which Professor Manne concludes are valuable anti-manipulative devices, but valueless in dealing with the insider trading problem. The next chapters contain an elaborate analysis of the types of information which affect or may affect the market generally or an individual security. Information which qualifies as "insider information" is that which (a) if known (and all other factors were held constant), would substantially affect the price of a security, and (b) can be exploited in the market by those possessing the information before it is made public. Professor Manne treats such information as a commodity having a determinable market value. Such news is variously described as "volatile" and "more mercurial than mercury."

Mechanisms for marketing such information at a profit for the seller are then described. The simplest device is the barter of information by corporate executives on the golf course. A more elaborate method involves the selection of directors for their ability to trade information rather than for their ability to direct. The most elaborate exchange market for "inside information," however, is the investment banking house. These are described as clearing houses for information, which function effectively both as information depositories (through control over the appointment of directors), and as distributors of information to insiders of other corporations on what may best be described as a "what have you done for me lately" basis. The distribution function is facilitated through the use of finesse in handling "priority lists" and discretionary accounts.

Professor Manne then devotes two chapters to the market effects of a free insider trading rule; no insider trading rule; suspension of trading prior to public announcement rule; and, for analytical purposes only, a free insider trading in puts, calls, and options rule. The effect of each of such rules on various types of "trader-investors" is explained in hypothetical circumstances. For purposes of analysis, traders are divided into "know-it-all" insiders and "know-nothing" outsiders. The know-nothing outsiders are further divided into short-term traders, long-term investors,

² 213 U.S. 419 (1909).

³ 258 F. Supp. 262 (S.D.N.Y. 1966).

time-function traders, price-function traders (including "chartists" and technical traders, those who trade on the basis of rate of change or other theories involving present and past price movements), and outright speculators. The book concedes that there are several circumstances under which insider trading may result in a real but undeterminable loss to outsiders but concludes that this is not necessarily an overall economic loss to the community. Apparently, outsider-losers will have to be satisfied with this consolation rather than with compensation for their losses. Professor Manne concludes that his laborious discussion of what may happen in the market does not constitute a strong argument for insider trading. On the other hand, market analysis does not present any strong argument in defense of a rule against insider trading. In fact, his entire analysis does little more than demonstrate that the market for securities which involves countless individual decisions to purchase and sell at any given time, for an equally countless number of reasons, may defy rational analysis on any meaningful basis.

The next several chapters are devoted to a critical analysis of the "entrepreneurial" theories of Knight and Schumpeter. The distinction between the functions of the manager, the capitalist, and the entrepreneur, and the methods and means of compensating each, are clearly drawn. It is pointed out that one man may be performing all of these socio-economic functions to a greater or lesser degree at any given time. The entrepreneur is referred to as one who "is to make new combinations of productive factors," "the innovator," the "organizer of uncertainties," and he "who sets progress in motion." Professor Manne concludes that this function is critical to the survival of any corporation in a competitive society; the crucial theoretical difficulty has been to find an appropriate method of compensation for such services. He rejects compensation such as salaries, bonuses, profit-sharing plans and stock options as appropriate for the entrepreneur although he concedes they are proper for managerial services. Without citing any authority that entrepreneurial activity is not adequately rewarded at present by society, he concludes that entrepreneurial activity can be compensated only by giving the entrepreneur "a piece of the action," that is, free insider trading.

Professor Manne contends that the entrepreneur cannot reap the full reward of his economic contribution unless he captures its entire value by purchasing all of the outstanding shares of his own corporation prior to public announcement of this "contribution." The entrepreneur should therefore be allowed to reap all the rewards immediately possible by trading in the stock of his own company; deposit the information with a clearing house enabling other outsider-insiders to share his profits; and thus finally to earn a credit which will be repaid at some time in the fu-

ture, enabling him to reap insider profits from another's contribution.

This work, like most writings on currently controversial subjects, raises more questions than it answers. Nowhere does Professor Manne support the essential propositions that there is any shortage of entrepreneurial talent, that this talent is not adequately compensated, that increased compensation will produce increased entrepreneurial talent or contributions, or that insider trading as a particular form of compensation will produce such results. Even conceding that compensating the entrepreneur is a present major economic problem, mere juxtaposition of the problem with an analysis of insider trading is not equivalent to applying the economic theory of Professor Schumpeter to the insider trading problem. To permit free insider trading solely for the purpose of filling a gap in economic theory does not solve the practical problem of insider trading. Furthermore, in spite of valiant endeavor and a disproportionate display of erudition,⁴ the book fails to fill the gap in economic theory by failing to establish that insider trading profits will in any way equal entrepreneurial profits in the economic sense. In order to establish this thesis, it is first necessary to equate "entrepreneurs" to insiders. Manne admits that it is access to the information alone that characterizes the insider and not job, status, position, or any other factor. Very few insiders are in fact entrepreneurs and if the defendants in past insider trading litigation, including the cases discussed by Professor Manne, are taken as examples, the lion's share of insider trading profits will fall to the golf companion, the director who does not direct, the investment banker and his discretionary accounts, and others who have performed no entrepreneurial services to society and who therefore are not entitled to entrepreneurial profits. Manne's thesis is that the full value of the entrepreneur's contribution will be reflected in the increased market value of the stock. Although the individual entrepreneur cannot reap the full benefits, he has the right to make a gift of a portion of such profits to others participating in the information exchange. Even if it be conceded that all members of the information pool are entrepreneurs, by association, the power over who receives the magnanimity of the individual entrepreneur passes from him to the banker who runs the information pool, perhaps on the basis of actual entrepreneurial contribution but more likely upon some personal and hence more capricious basis. For example, in the *Texas Gulf* case,⁵ Mr. Thomas Lamont, a director of both Texas Gulf and the Morgan Guaranty Bank, saw fit to distribute information and hence a portion of the insider profits, to various

⁴The textual discussion, itself, is 189 pages, the text of the opinions in three "insider trading" cases account for another 32 pages, and there are 38 pages of notes, a substantial number of which cite earlier writings of Professor Manne.

⁵SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

clients of the bank, a hospital, and the bank's own employees' profit-sharing fund. Manne concedes that such evaluation more nearly resembles an art than a science and further that the entire success of the whole scheme of the information pool depends upon the successful performance of this function of distributing the information to the right parties. It should be pointed out that the particular investment banker running the books may not perform any discernible entrepreneurial function. As a practical, legal, social or economic matter, insiders do not equate to entrepreneurs.

A second unanswered problem the book raises in attempting to equate insider profit with entrepreneurial profit is that substantial insider trading profits may result when insiders sell before the release of bad news. Although the book discusses such profits, it does not face squarely the problem that bad news may not be a result of extrinsic factors, but may in fact be the result of directors who fail to direct and the entrepreneur who fails to perform his function. Manne argues that this compensation for failure by members of the pool is counter-balanced by the inability to capture all of the profits to which entrepreneurs are entitled, and that the loss to investors, in any event, is too small to be of any consequence. Moreover, the objection which Professor Manne raises regarding salaries, bonuses, profit-sharing plans and option plans as fitting entrepreneurial rewards are equally applicable to insider trading profits. The profits to be made in insider trading may or may not bear a relationship to the prolonged value of the innovation but more likely will depend on totally outside factors. The tax consequences may or may not be equally disadvantageous to the entrepreneur depending upon individual factors not discussed. The amount of insider trading profits received by the true entrepreneur who trades in the market by reason of his access to the information pool will bear no more relationship to his entrepreneurial contributions, and quite possibly a great deal less, than bonuses, options and profit-sharing plans, since insider trading profits are much more likely to depend solely upon personal financial conditions at the time he receives his "hot tip." Finally, as Professor Manne points out, the opportunity "to make a killing" in any company stock occurs only approximately once each ten years in the life of a New York Stock Exchange listed company. Insider profits will therefore not necessarily accrue to the entrepreneur at any meaningful time in relation to his entrepreneurial contributions. Entrepreneurial compensation under Professor Manne's theory must be distributed to him over a period of time before and after his contribution at such times as the "information pool" chooses to disclose to him (and even then only in accordance with his priority rating at any particular time) "hot tips" deposited with the pool. Also, the information which

occurs only once in ten years may be totally fortuitous, unrelated in any way to any "entrepreneurial activity." While the book sometimes tortuously wrestles with such problems, it never convincingly resolves them. As a practical, legal, and economic matter, the book fails to establish that "insider profits" are the result of entrepreneurial activity or equate to entrepreneurial profits.

The characteristic of the entrepreneur is that he innovates; the characteristic of the insider is that he has access to information. Insider trading profits are those that result from trading on insider information, which may or may not arise from innovational activity, and in fact often result from a lack of innovational activity, either fortuitously or because of the failure of the "innovators." Entrepreneurial profits, as Manne suggests, are almost impossible to define, detect, or segregate from other types of economic profits. They arise initially and immediately from innovational activities. They are one of the types of "economic profits" of Schumpeterian economics, and it is the innovator and the economy that jointly reap the benefits of this profit. Manne has presented no case that any benefit to the economy will arise from permitting only "access to information insiders" to share such profits with the entrepreneur rather than allowing the economy to share the benefits with the entrepreneur. Indeed, he has not even demonstrated that the entrepreneur will receive any greater share of entrepreneurial profits than he now enjoys, regardless of whether the courts adopt a free insider trading rule or a no insider trading rule.

Manne concedes that individuals do in fact lose as a result of insider trading. He concedes that his arguments and analysis of the market, which take up a substantial portion of his book, do not constitute a strong argument against a rule prohibiting insider trading. Without substantial evidence that in our society entrepreneurs can be equated with insiders, and insider trading profits can be equated with entrepreneurial profits, he has failed to establish his conclusion that "a rule allowing insiders to trade fully may be fundamental to the survival of our corporate system."⁶ Unless a great deal of concrete evidence can be submitted in support of this thesis, we can expect to see the SEC and a long line of plaintiffs, like the unidentified female law student Professor Manne describes, stamping their feet before the courts, angrily declaiming, "I don't care; it's [insider trading] just not right."⁷

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⁶ MANNE, *op. cit. supra* note 1, at 110.

⁷ *Id.* at 233 n.42.

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