



Case Western Reserve Law Review

Volume 50 | Issue 2

1999

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Recommended Citation

Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 Case W. Res. L. Rev. 269 (1999)

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SECURITIES TRADING: A CONTRACTUAL PERSPECTIVE

Jonathan R. Macey[†]

INTRODUCTION

When Henry Manne wrote his famous article, *In Defense of Insider Trading*,¹ following his classic book *Insider Trading and the Stock Market*,² insider trading was viewed as an immoral, unscrupulous, unfair, and vicious attack on the market and investors. The same, of course, is true today.

The development of the justifications for outlawing insider trading date back at least to a 1910 article written by legal scholar H.L. Wilgus.³ Drawing on lawyerly appeals to the ideals of fairness and morality, Wilgus concluded that the practice of insider trading was morally offensive.⁴ Other legal scholars, namely Professor A.A. Berle, agreed with Wilgus and continued scholarly work supporting Wilgus' initial desire to outlaw insider trading.⁵

These views were reflected during those portions of the Congressional hearings on the promulgation of the Securities Laws that were held in 1933 and 1934 to discuss the practice and impact of insider trading. As Dean Manne observed, these hearings resulted in the practical adoption of many of the ideas of Wilgus and Berle without any concrete explanation for their blanket acceptance.⁶ In particular, Sections 10(b)⁷ and 16(b)⁸ of the Securities Exchange Act of 1934 and Rule 10b-5⁹ were enacted to prevent insiders from trading on their superior knowledge of corporate affairs.

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¹ Henry G. Manne, *In Defense of Insider Trading*, HARV. BUS. REV., Nov.-Dec. 1966, at 113.

² See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

³ For further discussion, see H.L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267 (1910).

⁴ See MANNE, *supra* note 2, at 4.

⁵ See *id.* at 5.

⁶ See *id.* at 10-11.

⁷ 15 U.S.C. § 78j (1994).

⁸ 15 U.S.C. § 78p (1994).

⁹ 17 C.F.R. § 240.10b-5 (1999).

The rules prohibiting insider trading are justified on the grounds that insider trading represents the abuse of information that was intended exclusively for corporate purposes. The rules also are defended on the grounds that it is inherently unfair for insiders to trade on the basis of information that is unavailable to those with whom the insider is dealing. Section 16b applies to statutorily defined insiders (officer, director, or 10% shareholder) and forbids them from having a purchase followed by a sale (or vice versa) within a six-month period.¹⁰ Like Rule 10b-5, Section 16b, though applied in different situations, was predicated and defended on the basis of the notion of immoral unfairness stated first by Wilgus and further supported by Berle.

The purpose of this essay is to make a simple point that has been largely ignored in the literature. My point is that the academic debate surrounding insider trading in general, and the reaction to Professor Manne's work in particular, tells us as much about the culture of academia as it does about the law, economics, and policy of insider trading.

While dozens of legal scholars have entered the halls of debate to present their views of the subject, none has done so with the courage of Henry Manne. Sometimes I ask myself whether I would have the courage to write something as controversial and contrary to accepted academic doctrine as Manne's classic 1966 work *Insider Trading and the Stock Market*. This seminal work challenged the ideas of Wilgus, Berle and the holdings of Congress, and led to Dean Manne's ostracism, at least for a time, from polite academic circles in law.

Two things about Dean Manne's work—and the visceral reaction to it by legal academics—are instructive. First, regardless of whether one agrees or disagrees with Dean Manne's outlook, Manne was the first person to attempt to analyze the phenomenon of insider trading from a serious interdisciplinary perspective. In rejecting the 'it's just not right' reasoning and offering his own theory to analyze insider trading, Professor Manne did not merely improve the quality of the intellectual discourse concerning insider trading; he revolutionized it.

Manne's thorough analysis and comprehensive conclusions provide a reasonable and practical explanation for why non-government-regulated insider trading might be considered not only a feasible, but also a desirable part of the compensation scheme of a rational publicly held corporation. But Manne's historical achievement in writing about insider trading is reflected at least as much in the approach he

¹⁰ See 15 U.S.C. § 78p.

takes in this work as in the conclusions he reaches. By taking an analytical welfare-economics approach to this subject, Dean Manne single-handedly raised the quality of the discourse in this area and began the transformation of legal academia, from sleepy backwater to its current position at the center of the intellectual life of the modern university.

Perhaps even more important than the nature of Dean Manne's discourse about insider trading was the sheer moral courage Manne displayed. Legal academia is a club, and to be ostracized by its elite can curtail or ruin a young academic's career, even a career with Manne's stellar credentials. I wonder how many people in academics today would have the courage to risk everything to write what they want to write, to reach the conclusions they think are justified, and then to stand by those conclusions in the midst of the unprecedented criticism that Dean Manne initially received for his work. I am sure that the number is not very large. For this alone, Dean Manne deserves recognition.

Part I of this paper considers Professor Manne's ideas about insider trading and explores how those ideas can be practically applied. Part II focuses on some insider trading cases and discusses the relationship between the law and Manne's ideas.

I. HENRY MANNE'S CONTRIBUTIONS TO INSIDER TRADING SCHOLARSHIP

Rejecting scholarship that substituted platitudes for analysis, one of the principal insights of Manne's analysis is that in order to analyze insider trading properly, one must identify who is harmed by trading on the basis of non-public information.¹¹ Professor Manne reached the conclusion—which remains highly controversial today—that it is difficult and often impossible to identify shareholders damaged by a system that permits insiders to trade on non-public information. To explain his point, Manne drew an analogy between the operation of the securities markets and the Brownian effect in physical science.

In physics, the Brownian effect illustrates how gas molecules will perform under pressure as they interact with one another. According to the theory, when gas molecules collide with each other, they create a completely random pattern. Similarly, according to

¹¹ See MANNE, *supra* note 2, at 93. This argument is especially pertinent to long term investors. Because a long-term investor will be less likely to sell based on a price fluctuation, insider activities will have little effect on the investment choices of such an investor. Manne also asserts that short-term investors will also benefit from the activities of insiders. *Id.*

Manne, in a market that is denied the additional information that an insider possesses, stock prices will be randomly decided and fail to reflect any prior transaction prices.¹² Without the presence of additional information that only an insider can provide, investors will randomly gamble on particular stocks, thus creating a pattern of arbitrary stock pricing.¹³

Stock market prices can become less "random" only through an increase in knowledge.¹⁴ Such an increase in knowledge will result from allowing insiders, who possess superior knowledge, to enter the trading arena and participate. Through their participation in trading, insiders' informational advantage will be passed on to outsiders, and share prices will become more accurate barometers of a firm's true net value.

Conversely, one can argue, as the Security and Exchange Commission (hereinafter "SEC") has done, and continues to do, that an outsider would not sell his shares to an insider if the outsider possessed the same level of knowledge as the insider.¹⁵ Professor Manne countered this argument with an observation about causation. He pointed out that one would need to know whether an outsider would have behaved differently if insiders were not allowed to trade before the information was disclosed. Barring any empirical evidence to support the SEC's arguments, Manne argued that its conclusions were premature.

Manne observes that, "[o]bviously every shareholder would like to have access to more valuable information, just as he would like to have access to more wealth. But there is no reason to believe that the rule about insider trading will have any effect on the time of his sale"¹⁶ In other words, in the absence of evidence to show that an outsider would behave differently prior to the disclosure of inside information, it is by no means clear that the insider's trading harmed his counter-parties. Indeed, it may actually have helped them. In subsequent work, David Haddock and I applied Dean Manne's work through the use of the accompanying graphical illustrations.¹⁷ The basic point builds on the intuition that when informed traders pur-

¹² See *id.* at 97.

¹³ See *id.*

¹⁴ See *id.* (arguing that the best way to combat the problem of inaccurately valued stocks is through increased information flow).

¹⁵ See William H. Painter, *Manne, Insider Trading and the Stock Market*, 35 GEO. WASH. L. REV. 146, 147-48 (1966).

¹⁶ Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 934 (Winter 1985) [hereinafter *Property Rights*].

¹⁷ David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986).

chase stock, they tend to drive up the price (as illustrated in Figure 5-1), and when informed traders sell stock they tend to drive down the price of the stock (as illustrated in Figure 5-2).¹⁸ As such, if an uninformed outside investor buys stock when an insider is selling, his purchase is likely to be at a lower price than it would have been in the absence of the insider's sales. Likewise, if an uninformed outside investor sells stock when an insider is buying, that sale is likely to be at a higher price than it would have been in the absence of the insider's trading activity.

Thus, when investors are so-called "time-function traders"—that is, when they simply are basing their decisions about when to buy and sell stock on their own internal patterns of consumption and investment over their life cycle—Dean Manne argued that insider trading provided benefits rather than imposed costs. In other words, as long as the insider trading did not *cause* the trading by the outsider—that is, as long as the outsider would have traded anyway—then insider trading may be seen as beneficial, at least to the shareholders who are selling while the insiders are buying and those buying while the insiders are selling.

Where outsiders believe there is the potential for negative effects from insider trading, outside investors may limit the negative impact by anticipating which particular stocks have the highest potential to be negatively affected by inside traders. Outsiders would naturally shy away from such stocks. There are indications that outsiders do, in fact, discount such stocks.¹⁹ This behavior by outsiders indicates that a defense mechanism to potentially negative insider trading is currently in place.

Of course, any outsider would, at zero cost, want to know more about his specific stocks and their intrinsic value. However, regardless of whether insider trading is allowed, the outsider will never be privy to all of the possible information that exists concerning his specific shares and a specific corporation. Allowing insider trading will likely benefit the insider, but the true outsider is no worse off than he was when insider trading was restricted.

In addition to the above-mentioned "time-function trader," whose trading is timed on the basis of his desire to save and his need to consume over the course of his life-cycle, there is another class of trader: the "price-function trader." Changing patterns of consumption and investment over the life cycle of the trader and his family does

¹⁸ See *id.* at 1469.

¹⁹ See Harold Demsetz, *The Market for Corporate Control: Corporate Control, Insider Trading and Rates of Return*, 76 AM. ECON. REV. 313, 316 (1986) (analyzing the effects of insider trading on controlling shareholders).

not motivate the trading patterns of price-function traders. Rather, these traders are harmed by insider trading because the trading of insiders induces their trading.

A simple example illustrates the point. Suppose that the share price of Symonics stock is \$50.00 per share. Suppose that a professional stock trader has analyzed the firm carefully and has reached the conclusion that this is the "appropriate" price for the firm's stock from a financial perspective. This professional investor is of the view that the properly discounted present value of the future income to shareholders (which comes in the form of dividends, capital gains, and/or liquidating dividends generated by the firm for its shareholders) justifies the current share price of \$50.00 per share, but no more.

Suppose further, however, that an insider is in possession of material, non-public negative information about the company. For example, imagine that the company's chief financial officer knows that the company's earnings for the next quarter will be substantially lower than the consensus forecast of the Wall Street analysts who follow the stock. As in the previous example of trading by the time-function trader, insider trading by this corporate officer—in this case, selling—is likely to drive down the value of the company's stock.

Unlike the effect on the time-function trader in the above example, trading by the insider is likely to harm the price-function trader. These price-function traders, unlike time-function traders, are market professionals who have views about the intrinsic value of the shares they are trading and are *induced* by the insider's trading to buy. Turning back to the above example, if the insider's selling on the basis of his information about earnings drives down the value of the firm's shares, say, to \$48.00 per share, the professional time-function trader is likely to decide to buy the stock. After all, his analysis leads him to the conclusion that the stock is really worth \$50.00 per share. Thus, the time-function trader's view is that risk-based arbitrage profits of \$2.00 per share are available to traders who purchase at \$48.00, because the stock really is worth \$50.00 per share.

Insider trading activity induces time-function traders to trade, whereas it does not have the same effect on price-function traders. As such, while time-function traders benefit from insider trading on the basis of material non-public information, such trading harms price-function traders.

Thus, one important implication of Dean Manne's scholarship on insider trading is that much of the debate about insider trading involves issues of allocation. In other words, from a practical perspective, at least some of what is at stake in the debate about insider trad-

ing is how the gains and losses from trading should be allocated within the galaxy of investors and potential investors that constitutes a corporation's investment community. In a nutshell, insider trading harms price-function traders, while time-function traders may benefit from such trading. Of course, whenever there are both gains and losses from a particular activity within a community, the Coase Theorem suggests that unless transaction costs present insurmountable obstacles, or unless there are effects on third parties, externalities, that are not reflected in bilateral contracts, private contracting will lead to outcomes that are efficient and socially desirable.

Thus, Dean Manne's cogent analysis remains, as Dennis Carlton and Daniel Fischel have observed, truly "[t]he starting point for anyone interested in the subject" of insider trading.²⁰ Manne's work focused attention first on issues of efficiency and later on issues of intra-firm contracting and politics. These issues remain intensely interesting to scholars. However, the core implication of Dean Manne's work is that the intellectual foundation of the regulations and policies that govern insider trading should be grounded in contractual theories, not generalized notions of "fairness" or tort. It is this intuition that drove Dean Manne to his now famous idea that insider trading might represent an efficient way to compensate managers.

A. Insider Trading and Market Efficiency

Dean Manne argued that trading by insiders would cause the stock market to function more efficiently.²¹ To understand this argument, one must first understand the concept of efficiency as it is applied in the context of capital markets because the concept is used somewhat differently than it is in microeconomics generally.

The concept of stock market efficiency is comprised of two components: speed and accuracy. The first component involves the speed at which information about a security gets to the market and comes to be reflected in stock prices. The more efficiently information about a security is reflected in price, the more efficient the market for that security is thought to be.

Second, efficiency is concerned with how accurately information is reflected in the market price of a security.²² Economists generally

²⁰ Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 857 n.1 (1983).

²¹ See Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565 (1970) [hereinafter *Law Professors*] (providing a defense after his previous work, *Insider Trading and the Stock Market* received much criticism).

²² See George J. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23,

agree that insider trading will generally lead to more accurate stock prices, since insider trading will increase the amount of available, real information concerning a specific firm.²³ Simply put, insiders do not trade on the basis of non-public information unless current prices are inaccurate. Insiders will sell if and only if current prices are too high. Insiders will buy if and only if current prices are too low.

At the same time, however, it is far from clear how quickly information becomes public with or without insider trading, although it is clear that market prices are more accurate once the information is released. Dean Manne observed that insider trading might effectively accomplish the goal of having a more efficient stock market by causing insiders' knowledge about the value of firm shares to become reflected in the market more quickly than they otherwise would.

Absent insider trading, companies choose to disclose certain pertinent information concerning the company for a number of reasons.²⁴ In particular, firms may choose to disclose information about themselves to attract outside investment; to permit current investors to sell their shares to outsiders at the appropriate price; to gauge the success or lack thereof of their corporate managers thereby encouraging or discouraging corporate control transactions; or to comply with contractual obligations to investors.²⁵ Dean Manne argued that there are times when insider trading would be the most effective and appropriate means of communicating certain information to the market. For example, disclosure by some firms, particularly of good news, may simply not be credible to outside investors in companies where management lacks a proven track-record of reliability unless such disclosure is made credible by insider purchases. In other words, insider purchases operate as a sort of bond, rendering credible the assertions by managers that the firm is performing above the expectations of investors.

Insider trading also could allow a firm to release information through trading that it would not release through a public announcement. For example, when announcing certain information publicly could destroy the value of the information by providing information to competitors, or depriving the firm of the ability to exploit the value of the information, Dean Manne would permit insiders to trade.²⁶ At

26 (Henry G. Manne ed., 1969) (studying the effects of accounting disclosure requirements on corporations and investors).

²³ See *Property Rights*, *supra* note 16, at 935 (discussing economic issues of insider trading) (citation omitted).

²⁴ See Carlton & Fischel, *supra* note 20, at 867.

²⁵ See *id.*

²⁶ See *id.* at 868.

the same time, if a firm does not want to release all of its available information at a particular time, it can control the release of information by self-regulating the trading of its insiders.²⁷ Implicit in this analysis is the assumption that inside information is a valuable property right that rightfully belongs to the corporation to which it pertains. The corporation should have the right to authorize or to prohibit trading by insiders and other fiduciaries. Insider trading enables a firm to control how much information it is willing to release into the market depending on the time-specific needs of the firm, and permits such information to be released in a credible manner.

Dean Manne's analysis also led him to the conclusion that insider trading accomplishes another important goal related to efficiency. Because information is costly to locate and verify, it may not be cost-effective for analysts and other market professionals to seek out and verify information that is not clearly valuable. In other words, securities prices may not fully reflect small pieces of information. According to Dean Manne, however, permitting insider trading allows market prices to reflect small inputs of information more quickly and accurately than they would in the absence of such trading.²⁸ These small pieces of information may have a cumulative importance that is out of proportion to their individual, piecemeal value. This is likely true because if the market price reflects all of the little pieces of information affecting returns to shareholders, then overall stock prices will be more accurate.

Therefore, Dean Manne's analysis led him to the conclusion that insider trading can contribute to market predictability and stability. One aspect of this intuition is relatively straightforward: as the efficiency of the stock market increases, everyone is better off. In a perfectly efficient market, capital would be allocated to those firms that could best use it.²⁹ This, in turn, would mean that resources in the economy would be utilized as effectively as possible to promote employment and the appropriate utilization of scarce commodities.³⁰

In fact, however, the actual effects of insider trading on market efficiency are by no means clear. It is not ambiguously true that insider trading results in information becoming reflected in firm share prices more quickly. Whether insider trading will improve stock market efficiency is an empirical question about which we lack in-

²⁷ See *id.*

²⁸ See *Law Professors*, *supra* note 21, at 574 (arguing that the dissemination of information through insider trading provides a more efficient mechanism for stock valuation).

²⁹ For further historical discussion of this concept, see ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 280 (1932).

³⁰ See *Carlton & Fischel*, *supra* note 20, at 867.

formation. One possibility that Dean Manne did not take into consideration is the possibility that insiders may, under certain circumstances, actually delay the release of important information. This would allow insiders to gain the time necessary to implement a trading strategy permitting them to extract the maximum gain from the use of the information. For example, it might be best, from the point of view of an insider with non-public positive information, to make a series of small purchases of stock (or derivatives) over a relatively protracted period of time in order to minimize the price impact of such purchases. This tactic allows insiders to minimize their acquisition costs by reducing the price impact of their purchases. By stringing out their purchases or sales over a longer period of time, insiders could minimize the effects of their purchases on average trading volume in order to impede the ability of market professionals to "decode" the information being conveyed by the insiders' trading.

Another effect that must be taken into account when gauging the effects of insider trading on market efficiency is its effect on transaction costs that such trading imposes on market participants. As David Haddock and I observed in earlier work, all traders bear a share of the increased costs to market makers that are associated with insider trading.³¹ The logic behind this observation is simple. The bid-asked spread, quoted by exchange specialists and other market makers, represents a transaction cost for market participants. In turn, from the perspective of the market makers, this bid-asked spread represents the risks, as well as the carrying costs and other expenses associated with holding an inventory of securities and maintaining a continuous two-sided market. Increases in the incidence of insider trading cause, in turn, an increase in the expected losses that market makers experience as a result of maintaining an inventory and making a two-sided market in a firm's stock. This is because market professionals systematically profit—by difference, or "spread" between the bid price and the offered price—in trades to outsiders. However, because insiders will never buy on the basis of inside information unless the offered price is too low, and because they will never sell unless the bid price is too high, market makers and other market professionals, such as exchange specialists, will systematically lose in their trading interactions with insiders.

Consequently, holding all else equal, as the percentage of insiders among the entire population of traders in the shares of a particular firm goes up, expected losses to market-makers and other liquidity

³¹ See David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 331 (1987) (using a private interest model to examine regulations promulgated and enforced by the SEC).

providers will concomitantly increase. In order to compensate themselves for these expected losses to insiders, providers of liquidity must increase their bid-asked spread.³²

The above analysis reveals two vitally important contributions provided by Dean Manne's work on insider trading. The first is that the direct costs of insider trading are borne in the first instance by market professionals, particularly specialists and market makers. Analysts, arbitrageurs, and others who attempt to profit by being the first to trade on the basis of public information are harmed by insider trading because they are induced to trade at the wrong prices. Market-makers systematically lose in their trading interactions with insiders because they trade at the wrong prices—although these losses are passed on to the trading population generally in the form of higher trading costs, particularly larger bid-asked spreads.

Second, these costs are *internalized* within the firm whose shares are being traded. Because the costs and benefits of insider trading are internalized, the solution to the policy question of whether insider trading should be permitted must be contractual in nature. This, in turn, leads to the question of how the rights to trade on the basis of material non-public information should be allocated within a firm. This question, as Dean Manne first pointed out, boils down to an inquiry about executive compensation and whether the right to trade on inside information might comprise an element of an efficient executive compensation package. It is to this issue that we now turn.

B. Insider Trading and Compensation for the Entrepreneurial Executive

In 1942, Joseph Schumpeter wrote that large corporations were ineffective at providing compensation for entrepreneurs working for the corporation.³³ Building on this premise, Manne vigorously as-

³² Several empirical studies report that higher incidences of insider trading lead to increases in bid-asked spreads. See, e.g., Walter Bagehot, *The Only Game in Town*, FIN. ANALYSTS J. Mar.-Apr. 1971, at 12 (arguing that confusion between market gains and trading gains caused people to continue to play the market game, although their trading performance rarely departed from neutral); George J. Benston & Robert L. Hagerman, *Determinants of Bid-Asked Spreads in the Over-the-Counter Market*, 1 J. FIN. ECON. 353 (1974); Thomas E. Copeland & Dan Galai, *Information Effects on the Bid-Ask Spread*, 38 J. FIN. 1457 (1983) (modeling the dealer's bid-ask spread as a tradeoff between expected losses to informed traders and expected gains from liquidity traders); H. Nejat Seyhun, *Insiders' Profits, Costs of Trading and Market Efficiency*, 16 J. FIN. ECON. 189 (1986) (examining the relation between the bid-ask spread and insiders' abnormal profits).

³³ See JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 134 (1942) (analyzing the effects and impact of political systems on capitalist markets).

serted and defended the proposition that insider trading could solve the problems of ineffectual or inadequate managerial compensation.³⁴

Dean Manne argued in *Inside Trading and the Stock Market* that corporate employee financial compensation opportunities are limited—for example, through bonuses or perhaps stock options. These limitations handcuff firms regardless of the magnitude of the employee's idea or innovation or the size the marginal contribution of the employee to the overall value of the enterprise. Dean Manne observed that when managers are compensated with stock or with options, an employee's compensation is limited to the number of shares or options granted.³⁵ In a substantial number of cases, this compensation falls short of the magnitude of the employee's contribution to the corporation.

Dean Manne argued that allowing insider trading as a method of entrepreneurial compensation availed intra-corporate entrepreneurs of the opportunity to be fully compensated for the value of their marginal product to the firm. According to Manne, because corporate employees are not entitled to "a direct proprietary interest in their ideas," insider trading allows such entrepreneurs to be able to capitalize on their knowledge within the market.³⁶

Additionally, Manne argued that while compensation in the form of stock and options may be correlated with, and limited to, the amount of money an entrepreneur currently holds and is able to invest, trading profits on the basis of inside information will not be similarly constrained. According to Dean Manne, insiders can disclose the information to a financial intermediary, lender, and thereby obtain credit to exploit fully the benefit of some entrepreneurial discovery.³⁷

The most common argument raised against a system of entrepreneurial compensation based on inside information is that it places average investors at a competitive disadvantage.³⁸ Dean Manne responded to this argument by noting that a typical entrepreneur in a company is not on the same footing as a typical investor. The entrepreneur, most likely, will not already hold an investment in the firm. Only if she holds such an investment will she be starting on the same

³⁴ See MANNE, *supra* note 2, at 138-141. *But see* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981) (arguing that a rule allowing information to be used freely may maximize the wealth of both the users and society).

³⁵ See MANNE, *supra* note 2, at 138.

³⁶ *Id.*

³⁷ See *id.* at 139.

³⁸ See *id.* at 140 (arguing that allowing insiders to trade on information gained as a result of their insider status unfairly compromises other investors' ability to compete in the market).

playing field as the typical investor. Although being on the same playing field sounds just or reasonable, we return to a situation where the entrepreneur is no longer compensated for her ideas and innovations. From an egalitarian standpoint, why should an entrepreneurial insider be forced to merely hold a common investment and receive the same rate of return as other investors, when the entrepreneur is directly contributing to the prosperity and success of the corporation in general? Without allowing for insider trading to take place, the entrepreneur "is thus forced to share with all other shareholders the profit that otherwise he alone could have gained."³⁹

It would seem to me that whatever the merits of Dean Manne's arguments about executive compensation, outside investors also must be compensated for the risks associated with making investments. For example, suppose that the current price of a firm's stock is \$9.00. Suppose further that an entrepreneurial insider makes a discovery that promises to add sufficient value to the company to cause the price of the stock to rise from \$9.00 per share to \$12.00 per share. The question is how these gains should be allocated between the insiders and the outside shareholders. Dean Manne's intuition is that the insiders should receive some of these gains. The question, of course, is how much and how to engineer such compensation. Presumably, Dean Manne did not believe that insiders should receive all of the gains, because if they did, shareholders would have no incentives to invest in the first place. Rather, the implication of Dean Manne's analysis is that these gains should be shared, and that the precise contours of the distribution should be a matter of contract.

Dean Manne's depiction of insider trading as a matter of intra-firm contract remains a stunning intellectual achievement. This simple idea transformed the nature of the debate about insider trading. As noted above, the problem posed by insider trading is the issue of how the gains associated with the discovery of material, non-public information ought to be divided within a firm, and whether it is possible to permit insiders to trade in a manner that can be made transparent to shareholders and directors who vote on executive compensation issues. Seen from this perspective, however, the propriety of insider trading becomes "simply" an applied executive compensation problem. But the question whether transparent, fair contracts condoning insider trading can be crafted remains unanswered. The decision to grant a corporate executive a seven-figure, end-of-year bonus is also an executive compensation problem. From the perspective of the

³⁹ *Id.* at 141.

firm, the issues involved in deciding what is best are not so radically different.

At bottom, the problem with bonuses or stock option plans for executives is how to allocate surplus cash flows within the firm. The point here is not to minimize the severe conflict-of-interest problems and agency cost problems associated with insider trading. Rather, the point is to emphasize that with the exception of the problem of monitoring insider behavior, these problems are no more severe with insider trading than they are with other forms of aggressive executive compensation.

In a follow-up article written in response to the numerous, uniformly negative reviews of his initial work, Manne noted that at the outset of his investigation of insider trading he assumed that the United States Securities and Exchange Commission was fully and efficiently discharging its duties and enforcing the rules outlawing direct insider trading.⁴⁰ After publishing his initial work, however, Dean Manne came to the view that the rules against insider trading were being selectively enforced and that only a fraction of insider trading was investigated and pursued.⁴¹ Professor Manne believed that the SEC's limited dollars would be spent pursuing those who either opposed and/or were disliked by the SEC.⁴²

As a result of this selective enforcement, Dean Manne expressed the belief that a group of unregulated insiders would emerge. In a prescient analysis that anticipated much later work in public choice, including my own joint work with David Haddock, Dean Manne predicted that this lucky group would not only gain access to exorbitant wealth, but also would gain strong influence over a regulatory agent of the government.⁴³

As the following sections illustrate, what has emerged in the decades following Dean Manne's analysis is a state of the world remarkably close to what he envisioned. The law has developed along vaguely contractual lines. Today, the rules against insider trading seem to do more to police internal employment relationships within firms than to police against conduct that harms outside investors or markets.

⁴⁰ See *Law Professors*, *supra* note 21, at 562.

⁴¹ See Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980) (arguing that the legal system has been ineffective in regulating insider trading); James H. Lorie & Victor Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J.L. & ECON. 35, 37 (1968) (indicating that proper and prompt analysis of data on insider trading can be profitable).

⁴² See *Law Professors*, *supra* note 21, at 554.

⁴³ See *id.* at 555.

II. THE COURTS AND INSIDER TRADING

The development of insider trading law got off to a slow start in cases like *SEC v. Texas Gulf Sulphur Co.*⁴⁴ and its progeny. The facts of the case are well known, I will only recount them here in brief. The Texas Gulf Sulphur Co. ("TGS") was a mining company in financial distress. On the verge of bankruptcy, TGS officials commenced a series of aerial geological surveys in Timmens, Ontario. These surveys revealed large mineral deposits on land they did not own. In order to exploit the value of its discovery, and perhaps even to survive, it was crucial that TGS be able to secure the mineral rights.

Subsequent to the initial discovery of the mineral deposits, a number of individuals who can be classified as insiders bought both TGS stock as well as call option contracts on the stock. The SEC brought suit against a number of these traders. Relying on cases such as *In re Cady, Roberts & Co.*⁴⁵ and its progeny, the SEC took the categorical position that insiders with access to information that is intended to be available only for a corporate purpose—not for their personal benefit—may not use this information to their own advantage when dealing with the uninformed investing public. The Second Circuit Court of Appeals also took an extremely aggressive stance in its opinion in *Texas Gulf Sulphur*. The court was of the view that "all members of the investing public should be subject to identical market risks, . . . [and that] inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life . . ." ⁴⁶ One commentator not generally identified with the Law & Economics school aptly described this approach to Rule 10b-5 as the "utopian dream of information parity among investors."⁴⁷

Finally, in *Texas Gulf Sulphur*, rather than simply denying insiders the ability to trade, the court held that insiders may in fact trade, as long as they disclose the information first. This has become known as the "disclose or abstain" rule.⁴⁸

One might ask how Dean Manne would deal with the legal issues presented by the fact pattern in *Texas Gulf Sulphur*. First, it seems clear that Manne would reject the generalized "fairness" approach in which the use by a trader of *any* informational advantage,

⁴⁴ 401 F.2d 833 (2d Cir. 1968) (en banc).

⁴⁵ Securities Exchange Act of 1934 Release No. 34-6668, 40 S.E.C. 907 (Nov. 8, 1961).

⁴⁶ 401 F.2d at 852.

⁴⁷ James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 631 (1986).

⁴⁸ See 401 F.2d at 859 (prohibiting insiders to trade on information not yet disclosed to the investing public).

regardless of the source of such an informational advantage, would be a violation of Rule 10b-5.⁴⁹ He presumably would also reject the disclose-or-abstain approach embraced in the *Texas Gulf Sulphur* opinion.

It is easy to see why this is so. Implicit in Manne's view that the potential financial benefits from trading on material non-public inside information can be used as a valuable component of an executive compensation package is the assumption that such information is in the nature of a valuable property interest. Consequently, it seems clear that Dean Manne would object to the disclose-or-abstain approach taken in *Texas Gulf Sulphur* because this approach assumes that non-public information of the type at issue in that case belongs to the general trading public rather than to the corporation to which it pertains. In other words, if material non-public information really belongs to the corporation, then it would not be proper to trade on that information after first disclosing it. In this sense, Dean Manne's approach to insider trading regulation can be seen as even more strict (or, at least different) than the approach taken by the SEC and early court opinions.

Interestingly, however, it would seem that Dean Manne would agree with the "corporate purpose" concept espoused by the court and the SEC in *Texas Gulf Sulphur*. Consistent with the position taken by the Securities and Exchange Commission in *Texas Gulf Sulphur* and subsequent cases, Dean Manne would agree that material, non-public information should be used only to serve a "corporate purpose."

Where Manne would part ways with the SEC, of course, is in relation to the meaning of the term "corporate purpose." First, Dean Manne's perspective clearly advocates that if information is to be used for a "corporate purpose," then it should be the corporation and not the courts, the SEC, or the plaintiffs' bar that decides how that information should be used. And, if the information is available for a corporate purpose, then it should be the proper subject of executive compensation agreements, because compensation of executives is a valid corporate purpose.

Dean Manne, however, clearly suggests that the executive compensation arrangements within the firm inevitably would permit the insiders of TGS to trade on the information concerning the mineral-rich land. To Manne's way of thinking, these insiders provided the company with a chance to rise out of their poor economic predica-

⁴⁹ See Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 355 (1979) (concluding that the disclose-or-abstain rule derives both justification and limitations from the policy of the legislation).

ment and regain power in the mineral market. For these efforts, according to Manne, the insiders should be allowed to trade as a reward for these entrepreneurial achievements. As noted above, however, the benefits of such trading that Dean Manne identifies must be weighed against the costs, which come in the form of higher transaction costs for traders and reduced incentives for initial investment.

Texas Gulf Sulphur's intellectually empty fairness approach described above provided the intellectual underpinnings for the rules against insider trading until 1980. In that year, the entire regulatory paradigm for Rule 10b-5 and insider trading was shifted by the landmark Supreme Court opinion in *Chiarella v. United States*.⁵⁰ *Chiarella* adopted an entirely new or, at the very least, an entirely more lucid legal interpretation to govern insider-trading cases brought under section 10(b) of the Securities Act of 1934.

In *Chiarella*, the Court had to decide whether a non-insider who learns about a future business transaction violates section 10(b) when she trades on the information and does not disclose.⁵¹

Vincent Chiarella was employed by Pandick Press, a financial printing company. Chiarella handled the printing of documents concerning certain business takeovers. The identities of the purchaser and target were concealed when Chiarella received material for processing. The names of these entities were added when the final copies of the documents were printed. Chiarella was able to deduce the names of the target companies.⁵² After doing so, the petitioner traded on the information, despite the fact that not trading was clearly a condition of his employment contract with his employer, and despite the fact that Chiarella must have known that his employer's printing services had been retained on the condition that they respect the confidentiality of the information that had come to them in the course of their work.⁵³

Justice Powell, writing for the majority, stated that an individual must have a pre-existing affirmative fiduciary duty in order to be liable for violating section 10(b)(5): "We hold that a duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information."⁵⁴

It is interesting to ponder how Dean Manne would have dealt with Chiarella's conduct if he had been on the Supreme Court. I think that Manne would embrace Justice Powell's observation that

⁵⁰ 445 U.S. 222 (1980).

⁴⁶ *See id.* at 222-23.

⁵² *See id.* at 223-25.

⁵³ *See id.*

⁵⁴ *Id.* at 235.

mere possession of non-public information does not generate a duty either to disclose such information or to refrain from trading on the basis of that information. Moreover, I believe that Dean Manne would take the position that the information belonged to the firm that created it. Nevertheless, Dean Manne's idea that insider trading should be used to compensate entrepreneurial managers could not be used to justify Chiarella's activities. After all, Chiarella was not an entrepreneur. Indeed, from Manne's perspective, Chiarella's trading might be seen as harmful to the extent that it deprived an entrepreneurial insider within the firm of the opportunity to profit on the basis of the discovery that the target firm's shares were undervalued. Chiarella's trading also deprived the bidding firm's shareholders of the ability to profit from this discovery.

Thus, like the SEC, Dean Manne would not have endorsed Vincent Chiarella's behavior. But, unlike the SEC, and consistent with the approach to Rule 10b-5 taken in *Chiarella*, Dean Manne would not have endorsed the idea that Chiarella's conduct was wrongful because it violated some generalized duty to the marketplace. Rather, like the majority opinion, Dean Manne's approach reflects the view that some fiduciary relationship, like Chiarella's employment relationship with Pandick Press, is necessary to create a duty not to trade.

In response to the Court's decision, the SEC promulgated Rule 14e-3, which makes it illegal to purchase or sell, or to cause to be purchased or sold, securities that are the subject of a tender offer when a person is in possession of material information relating to such tender offer if the person knows or has reason to know was acquired from the tender offeror or the target.⁵⁵ Rule 14e-3 was promulgated by the Commission to overrule *Chiarella* in the tender offer context. Rule 14e-3 overrules *Chiarella* because Rule 14e-3 liability arises when the person trading on non-public information in the tender offer context is trading on the basis of material non-public information, regardless of the source. In 1997, the Supreme Court upheld the SEC's authority to craft Rule 14e-3 in *United States v. O'Hagan*.⁵⁶ Dean Manne would reject the approach to insider trading in the tender offer context reflected in Rule 14e-3.

A number of legal principles were generated by the decisions discussed above. After *Chiarella*, anyone who trades on non-public information must have a pre-existing duty of a fiduciary nature in order for the trading to constitute a violation of section 10(b). Once the SEC adopted Rule 14e-3 in the wake of *Chiarella*, whenever infor-

⁴⁸ See 17 C.F.R. § 240.14e-3 (1999) (codifying, in amended form, SEC Rule 14e-3).

⁵⁶ 521 U.S. 642 (1997).

mation traded upon pertains to a tender offer, then no trading is permitted, regardless of whether the trading involves the violation of a fiduciary duty.⁵⁷ Finally, after *O'Hagan*, an insider faces potential liability for misappropriating confidential information for the purpose of trading in securities when such trading is in breach of a duty owed to the source of the information.⁵⁸

However, in an important footnote, the Court in *O'Hagan* noted that:

[T]he textual requirement of deception precludes § 10 (b) liability when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal—even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory. . . . Moreover, once a disloyal agent discloses his imminent breach of duty, his principal may seek appropriate equitable relief under state law. Furthermore, in the context of a tender offer, the principal who authorizes an agent's trading on confidential information may, in the Commission's view, incur liability for an Exchange Act violation under Rule 14e-3(a).⁵⁹

Thus, the Court in *O'Hagan* not only follows, but extends the important conception that insider trading liability is based on concrete conceptions of property rights in information, contract, and fiduciary duty that the Court first advanced in *Chiarella*. The Court's dicta, however, went too far in suggesting that insider trading liability could be avoided by disclosure. *O'Hagan* still would have breached his duty of confidentiality to his law firm and its clients by disclosing the information and then trading on it.

Dean Manne's work on insider trading is frequently mischaracterized. Despite popular belief, Manne never advocated the complete and widespread practice of insider trading. Rather, he made clear that "[a]t no point in my entire book do I express the belief that corporations should be *required* to tolerate insider trading."⁶⁰ Instead, Dean

⁵⁷ Courts are divided whether "knowing possession" of information is enough to convict the possessor of the knowledge who later trades, or whether there must be a causal connection between the possession of the information and the "use" of the information in a trade. See Irwin H. Warren & Beth J. Jacobwitz, *Courts Weigh Causation Requirement in SEC's Insider Trading Cases*, 220 N.Y. L.J. 1, 8 (Oct. 21, 1998).

⁵⁸ See *O'Hagan*, 521 U.S. at 642.

⁵⁹ *Id.* at 659 n.9.

⁶⁰ *Law Professors*, *supra* note 21, at 581.

Manne argued that it should be up to the corporation to decide whether (and how) they want to allow or prohibit insider trading. Though he states that he personally would prefer to invest in a company that allowed insider trading,⁶¹ he does not believe that there should be a blanket allowance or restriction. At most, one can quibble with Dean Manne's empirical assumptions about what companies would do in a world in which executive compensation contracts could permit insiders to trade; perhaps footnote 9 of *O'Hagan* sets the stage for such an empirical test.

Thus, it is inaccurate, and a bit unfair to Dean Manne to assert, as was done in the *New Palgrave Dictionary of Economics and the Law* and *The Economist* during the summer of 1998 that:

The biggest failure of law-and-economics to influence policy, according to "Law and economics in action", concerns insider-trading law. In most countries, the law restricts trading in a firm's shares by people who have confidential information about the firm's prospects. Law and economics teaches that insider trading causes no important harm and, by transmitting the inside information to the market, brings an important benefit: more accurate share prices. This argument has, however, failed to persuade most legislators or market practitioners, who object to insider trading on the ground that it might deter outside investors.⁶²

In fact, I argue that the movement of the law reflects a movement toward the law and economics way of thinking, and toward notions of efficiency. At the same time, the assertion that law and economics teaches that insider trading causes "no important harm," as well as the assertion that insider trading brings an important benefit in the form of more accurate share prices by transmitting the inside information to the market, clearly are derived from Dean Manne's scholarly contributions.

Professor Manne argues that the SEC should adopt a rule requiring corporations to disclose whether or not they allow their insiders to trade on information in the stock market and under what conditions.⁶³ This disclosure process would facilitate the SEC's governance of the market and would provide corporations with the opportu-

⁶¹ *See id.*

⁶² The Law is an Ass: But Don't Worry, Economists Are Trying to Make it Smarter, *ECONOMIST*, Aug. 29, 1998, at 68.

⁶³ *See Law Professors, supra* note 21, at 581.

nity to choose which trading method better meets the needs of that particular firm.

As Dennis Carlton and Daniel Fischel observe, there is little evidence that corporations have ever put forth measures intended to outlaw insider trading at the corporate level unless such action was taken in accordance with a governmental regulation.⁶⁴ Thus, it appears to some that corporations would prefer to have the choice and further, it is possible to conclude that corporations would prefer to allow it. Such views, however, may not afford sufficient attention to the difficulty in drafting an appropriate ban on insider trading because nobody—not even the SEC—would categorically ban all trading by officers, directors, or other insiders. Similarly, Deans Fischel and Manne and Professor Carlton may not give sufficient respect to the role historically played by norms, implicit contracts, and fiduciary principles in limiting the incidence of insider trading.

III. CONCLUSION

Dean Manne was certainly correct when he observed, almost twenty years after publication of his original work, that even though his theory doesn't yet represent the majority view in this area, his work now sets the debate agenda.⁶⁵ Manne's view, however, has been extremely influential and has clearly exerted an enormous gravitational pull on law and policy in this area. In particular, the original fairness and moral arguments espoused originally in cases like *Texas Gulf Sulphur* have been completely rejected. Dean Manne certainly deserves credit for moving the debate about insider trading from a discourse based on emotion and empty assertion to a discourse based on economic analysis and, increasingly, empirical hypotheses accompanied by testing.

Following up on Dean Manne's early theory that insider trading law and policy may be a product of politics rather than economics, others including Judge Richard Posner have argued that regulation may reflect an effort by the SEC to reallocate wealth through regulation.⁶⁶ The wealth comes in the form of the information that motivates the trading. When corporate officials who cannot trade are forced to give this information to market professionals who can trade, then wealth is transferred from the corporate officials and the corpo-

⁶⁴ See Carlton & Fischel, *supra* note 20, at 858.

⁶⁵ See *Property Rights*, *supra* note 16, at 933.

⁶⁶ See Richard A. Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGMT. SCI., Spring 1971, at 22.

ration who bears higher compensation costs to the market professionals.⁶⁷

Dean Manne's comprehensive analysis presented a plausible theory that is far richer, more coherent, and more easily tested than its inchoate rivals. Manne's achievement in writing about insider trading certainly was as important an advancement in legal theory and law and economics as the Modigliani-Miller irrelevance theory or the Black-Scholes options pricing model were in finance, for which Alfred Nobel Prizes in Economic Science were richly deserved and ultimately awarded to Franco Modigliani, Merton Miller, Fischer Black and Myron Scholes. Sadly for Manne, there is no Nobel Prize in Law.

⁶⁷ See *Property Rights*, *supra* note 16, at 942.