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Efficient Markets and Insider Trading

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Atlanta, GA

EFFICIENT MARKETS AND INSIDER TRADING

Time: 4:00 p.m. October 11, 1984 Room: 52 Law School

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INSIDER TRADING, ENTREPRENEURIAL INCENTIVES, AND DISCLOSURE
(A summary)

by

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INSIDER TRADING, ENTREPRENEURIAL INCENTIVES, AND DISCLOSURE
(A summary)

The development of laws against insider trading has revealed some of the worst characteristics of bureaucratic policy making. The SEC's arguments have been childishly moralistic, rarely rising above the "it's just not fair" level of discourse. But the absence of rigorous economic analysis of the subject has not been the only failing. The issues of economic and civil liberties inherent in this topic have been peculiarly underemphasized by most parties to the debate.

There are at least four arguments against the SEC's position that need to be examined for their relevance to our liberties. The first of these is the restraint that has been placed on corporations that would prefer to allow their executives to trade on undisclosed information. Several recent scholarly contributions suggest considerable merit to the argument I advanced nearly 20 years ago for information as compensation. It is now impossible for a company to contract out of the SEC's rules; an attempt to do so might well make the company a co-conspirator with an insider who subsequently profited. This would probably be true even though the company disclosed to its shareholders that it was following this policy or even if the shareholders unanimously approved it. The SEC has never explained why a mandatory approach was more appropriate than an elective one with disclosure.

A second problem inherent in the SEC's position is the degree of arbitrary power it places in the hands of enforcement officials. The SEC takes an ex

post rather than a more appropriate ex ante view of insider trading. Thus an ongoing relationship between a stock trader and a broker proposing trades may generate one transaction out of many that ex post has all the indicia of insider trading, even though the pattern viewed ex ante would preclude this interpretation. Almost any regular stock trader could run afoul of this statistical function and be found in violation of Rule 10b-5. Certainly the SEC has no objective and reliable means of detecting insider trading, and if indeed it is endemic, as many commentators believe, we have lodged discretionary power in the hands of the SEC not unlike that which the IRS developed during prohibition.

A related problem to the last occurs from the fact that a large amount of insider trading can never be detected, since in fact it does not involve stock trades. Withholding goods from the market (a change in reservation price) has the same impact on price as an offer to purchase the same amount of goods at the higher price. Thus anyone holding or following a given security can profit by knowing when not to trade, though this obviously cannot be the basis for a 10b-5 violation. In many instances the impact of new information on a stock's price occurs through dissemination of the information and not by overt stock trades. The SEC's inability then to reach different uses of inside information is reason enough to examine the strength of the case against overt traders. Like other "crime tariffs," this one too will cause distortions in portfolio decisions and will probably lessen liquidity in the stock market, as traders develop less efficient substitutes for directly trading in stocks.

Finally there is an important economic issue with a variety of overtones for other aspects of market freedom that continues to be ignored by econometricians, both in and out of the SEC. Since insider trading always moves the price of a stock in the direction indicated by new events, such trading probably contributes significantly to the efficiency of the stock market. However, we know little about how new information is actually impacted into the price for securities. In the absence of empirical proof that the SEC's obsession with insider trading helps the market, or at least is not significantly injuring it, it is plausible to assume that the stock market is being made less efficient by the SEC's rules. This impacts portfolio decisions, the market for corporate control, the allocation of capital, and the market for corporate managers.

25. What Kind of Controls on Insider Trading Do We Need?

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Editor's Summary Recent developments in the theories of efficient markets and the random walks of stock prices provide convincing evidence that the stock market is a "fair game," the SEC's alleged desire to regulate insider trading notwithstanding. Although competition for access to information may not be as efficient as desired, there appears to be no serious insider trading problem. It is logically impossible to deter insider trading significantly. And, the costs of enforcing SEC rules should be balanced against the expected benefits of additional regulations. The SEC has displayed a cavalier attitude toward individual citizens' constitutional rights. A fair and objective observer must conclude that the existing regulations and their enforcement present worse evils than the problems they were designed to cure.

An often-voiced belief about the stock market is that in the absence of certain Securities and Exchange Commission regulations, it would not present a "fair game" for small investors. Corporate insiders would use information to their own advantage rather than allow shareholders to learn about that information and benefit from it in the market. The same insiders would also have an increased incentive to manipulate corporate financial affairs so that they could profit from trading in a corporation's stock, rather than profit from properly managing a company.

Insider trading often is claimed to be not only inherently manipulative but also damaging. Critics say that it can lead to a loss of investor confidence in the stock market, thus making people unwilling to invest in American enterprise. Full disclosure of material information before insiders can trade in their companies' shares is legally and popularly viewed as the correct antidote to this financial skulduggery.

Like so many notions about modern corporate affairs, the idea of corporate insiders trading to the general detriment of investors in the market is more remarkable for its perseverance than for its logic or supporting evidence. One can be sure, when rules of law survive in spite of stronger arguments against them than for them, that there are significant interests at stake in the preservation of the suspect rules. In the instant situation, the likely interests are those of the staff of the Securities and Exchange Commission and those of a small band of highly paid

private securities lawyers, all of whose power and income would drop significantly if a more reasoned and reasonable approach to the topic were taken.

THE DEVELOPMENT OF INSIDER TRADING RULES

Restrictions on insider trading did not result from any popular hue and cry. The subject was only *made* to sound scandalous during the congressional hearings that led to the federal securities laws of 1933 and 1934; insider trading had not been a secret before that. Even so, Congress adopted a quite restrained provision dealing with the subject. This is the well-known Section 16(b) of the Securities and Exchange Act of 1934, which requires directors, officers, and 10 percent shareholders in a corporation to pay over to the corporation any short-term trading profits: those made from a buy and a sale within six months of each other.

During its hearings on this provision, a Senate committee was presented with a draft outlawing any trading by "anyone" with inside information. This would include any trading known to be done on the basis of information that had not yet been made public. The history of that provision, which would have covered members of Congress, speaks eloquently to the negative intent of Congress on the matter of a rule broader than Section 16(b). The threatening provision was dropped from the next draft of the bill as completely and silently as if it had been a provision to repeal the Declaration of Independence. No one has ever seriously doubted the committee's real view of this effrontery.

The legal history of this topic suggests that there could not have been much demand for a broad ban on insider trading. The courts had long before developed a common-law doctrine known as the "special facts" rule. This doctrine was designed to cover situations involving share trading in small corporations—situations in which the potential for fraud was as great as the difficulty of proving it. But no court, at least before 1968, ever saw reason to apply that rule in the case of a corporation with publicly traded shares. As we shall see, the judicial sense of the economics of the situation was quite correct.

Through a rather tortuous, legally strained, and arguably unconstitutional series of moves between 1942 and 1965, the SEC managed to promulgate precisely the rule that Congress explicitly had declined to accept. The period begins in 1942, the date of adoption of Administrative Rule 10b-5, under which all insider trading cases are now brought, and culminates in 1965 with the well-known *Texas Gulf Sulphur* litigation [*United States v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir., 1968); *cert. denied*, 394 U.S. 976 (1969)]. Indeed, in a concurring opinion in the *Texas Gulf Sulphur* case, Judge Henry J. Friendly, the distinguished Court of

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Appeals judge, gave the SEC a rather sharp slap on the wrist for the administrative techniques it had used. The SEC has received other rebukes since, but there has been no further serious claim made in litigation that 10b-5 as a rule against insider trading is invalid, though there is strength in the argument.

THE PRACTICAL CASE AGAINST THE RULES

Quite the opposite is true, however, if one looks at the overwhelming weight of the economic arguments offered against the rule. First, one might look at what some wags term the "SEC's Confidence Game," the argument that shareholders would lose confidence in the stock market if they thought that insider trading was occurring regularly. There are at least three (and probably more) things wrong with this notion.

First, if the SEC allows shareholders to believe that it does effectively prevent insider trading, it is practicing a shameful deception. Or, alternately, the market is composed of a greater number of idiots than we have any reason to believe.

Second, individual confidence is *not* shaken by the belief or knowledge that insider trading occurs. During the frenzied period of popular participation in the stock market in the 1920s, news about pools using undisclosed information was published regularly in the financial press, with no apparent loss of investor confidence. Third, it is well known that the one and only thing that does cause investors to lose confidence is losses. After any period of significant downturn in market prices, the number of investors regularly declines, and there seems to be no other factor significantly influencing this variable.

THE ECONOMIC ARGUMENT AGAINST THE RULES

A proper economic excursion into the rather complex subject of insider trading necessitates a brief detour to explain two developments in modern finance economics. One of these is called the "efficient market hypothesis" and the other the "random walk theory" of stock prices. Each of these notions has been the subject of an enormous amount of high-quality scholarly research, analysis, and testing. It is unquestionably safe to say that no "discovery" of modern economic theory has ever received the genuine, unanimous agreement accorded these two related notions. And, while the implications of these notions may disturb the SEC and other more explicit critics of the free-market system of corporate capitalism, no one has come up with any countermanding evidence.

An "efficient" stock market is one that rapidly and correctly evaluates new information and integrates that information into the market price of

shares. Study after study demonstrates the almost unbelievable efficiency with which our major stock markets perform this function. Indeed, no matter at what point econometricians test to see whether a given new development has yet impacted a share price, the impact always seems to have already occurred. This finding has even led some slightly incredulous researchers to conclude that the stock market instantaneously reflects any available information relevant to stock price.

Since stock prices do rapidly and correctly reflect new developments in a corporation's affairs, the movements of stock prices (apart from general industry or market movements and certain other oscillations or "noise" not relevant here) should follow a course dictated by these exogenous events. But, as Paul A. Samuelson shows in an important writing on this subject, one cannot imagine anything happening much more randomly than such events [372, SB 22]. They would include, for instance, with infinitely varying degrees of severity and with no predictable pattern, reactions from competitive products, changes in demand, changes in political rulings, international events, changes in the weather, managerial changes, and production difficulties.

These two theories, the efficient market hypothesis and the random walk theory, suggest two problems in connection with the subject of insider trading. The first problem is how the market can possibly be as efficient as has been suggested, and the second is how, if stock prices follow a random movement, shareholders can be injured by insider trading.

The answer to the first question, why the market is so efficient, probably relates in some fashion to insider trading, though the exact nature and characteristics of this relationship have not been clearly isolated or described. It does seem apparent, however, that information in most instances develops an increasing probability of its assumed impact as the time of the event draws closer. That is, the probability that the value of unanticipated earnings actually will be realized only becomes 100 percent on the day that the board of directors announces the fact. But, many weeks earlier those earnings may have appeared to some people to have a 20 percent probability of occurring. Such people include accountants or financial analysts who have information that could not, in and of itself, be said to be significant or material inside information. This information might include, for example, knowledge of an increase in sales, a disabling power struggle within a competitor company, or an important but early technological breakthrough. If this increasing-probability-of-truth hypothesis is correct, the closer one reaches to the actual development, the greater will be the extent to which the assumed value of the information has already been incorporated into the share's price. This reasoning helps to explain why we often see that an important news announcement meets with little or no change in the day's stock price quotations.

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Whatever the mechanism by which information is being impacted efficiently into share prices, so long as the information generates a random movement of those prices, there is really no way in which insider trading can injure shareholders, even though shareholders are not privy to the information. This is not to say, of course, that shareholders could not be richer if they had the information. But, that is merely a truism. What it does suggest is this line of reasoning. First, people trade anonymously in an organized stock market. Second, by definition, prior (random) price movements tell "outsiders" nothing about subsequent price movements. Therefore, that a subsequent movement may have been predicted by an "insider" cannot affect the average rate of return investors realize from trading in corporate securities. Whether an insider was on the other side of the trade or not is utterly irrelevant to the noninsider's calculations about whether the stock market is a fair game.

But, one still may complain that there seems to be an immoral windfall profit gained by the insider in these situations. Thus, some believe that insider trading allows corporate officials to secure greater gains than they bargained for, or are entitled to. This argument would have merit if—and only if—the availability of possible trading gains resulting from access to information could not be known or recognized by others. That possibility, to say the least, is very unlikely. Once it is recognized that a special possibility for gain inheres in a given position, competition necessarily will drive down the total remuneration for that position to the competitive level indicated by the discounted value of all future income, including both salary and trading profits.

This observation about competition and bargaining for remuneration is relevant to the charge that allowing insider trading encourages manipulation and lessened attention to business affairs. If profitable opportunities for such activities were common, there should be considerably fewer corporate financial scandals today than there were, for example, in the 1920s. Yet, the evidence points the other way. A rational market theory of corporations reinforces the view that an unregulated corporate system's incentive structure generates efficient (and therefore honest) managerial action. This is not to say, of course, that dishonesty, fraud, and embezzlement do not occur. But, it does mean that the amount of such criminal activity is not a function of the insider trading rule.

There is tremendous uncertainty and variability, of course, in opportunities for profits from insider trading. And, while this uncertainty and variability mean that the competition for access to information is not as efficient as we might like, they also indicate that the entire topic may hardly be worth the posturing and moralizing it has engendered. Even if one agrees that there is a fundamental issue of business morality involved with insider trading, the seriousness of the problem, the possibility of correcting it, and the costs of enforcing rules against the practice still must

be taken into account before a rational policy can be adopted. We seem to have evolved, instead, regulatory positions far worse than the evils sought to be cured.

HOW THE SEC VIOLATES CONSTITUTIONAL RIGHTS

The SEC has systematically displayed a cavalier attitude toward both the letter and the spirit of the constitutional rights of those it investigates or regulates. Brokerage offices, for instance, must employ "compliance officers" (generally, former employees of the SEC), whose job it is to report, to the SEC if necessary, violations of securities laws. The SEC's enforcement branch long has condoned (and, of course, denied) compliance officers' listening in on telephone calls between security salespeople and customers to find out whether sales talk regulations are being properly adhered to.

On one occasion, when confronted with charges of these and other dubious practices, the present director of the Enforcement Division of the SEC replied, "Well, you forget, these are the fat cats we are dealing with." A remark like this represents a totalitarian mentality that should be thoroughly expunged from any democratic political structure. Unfortunately, the remark is characteristic of the views of many SEC staff members, and much of the development of this attitude can be traced directly to their enforcement of Rule 10b-5.

TWO KINDS OF INSIDER TRADING

There is an ultimate irony in connection with the SEC's self-proclaimed moral crusade against insider trading. The prices of any goods, as anyone with a modicum of economics training knows, are functions of the demand to acquire additional goods, in this case securities, and also of the demand by present holders of existing goods to keep what they have. This notion of a demand by present holders sometimes is referred to as the "demand to hold," and it is generally signified by reference to a person's "reservation price," the price at which the person is indifferent between continuing to hold or sell the security in question. For a variety of reasons, which space limitations preclude exploring here, it is likely that the demand to hold, rather than the demand to acquire, dominates price changes in securities listed on major stock exchanges.

Given that the supply of outstanding shares remains constant, price, then, becomes primarily a function of the reservation prices of persons who already hold shares. These investors obviously are those most likely to pursue new information about their companies. Consequently, a person who mentally raises his or her reservation price for a given share from \$70

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to \$80 because of becoming privy to new information about the company has gained \$10 per share just as effectively as would a person who went out and purchased shares at \$70. The gain in the former case was generated by knowing when not to sell rather than by knowing when to buy and hold. Economically speaking, there is no difference between the two cases.

But, notice the difference from the point of view of the poor, confused SEC. There is simply no way the gain realized by an increase in a reservation price can ever be called a result of insider trading, since it involves only a mental act, not a purchase or sale of shares. The real economic gain results from the knowledge that leads to changing one's mind about the price at which a share should be sold. Until it develops mind reading powers, even the SEC can hardly argue that acting on such knowledge constitutes a violation of Rule 10b-5.

ADDITIONAL READINGS: 39, 45, 47, 48, 108, 127, 156, 171, 214, 249, 266, 277, 279, 280, 281, 284, 379, 380, 421, 444.