INSIDER TRADING AND PROPERTY RIGHTS IN NEW INFORMATION

Henry G. Manne

I have been dealing with the insider trading issue for over 20 years. I am happy to report that the tone of the discussion has changed dramatically over those years as a new generation of legal and economic scholars are now able to take a less emotional view of the topic. Not all of these newer and more sophisticated commentators agree with everything I wrote in 1966 in my book *Insider Trading and the Stock Market,* but that work apparently does now set the agenda for the debate, and we all know that the power to set the agenda may determine the outcome.

There is a different view today largely because people have been willing to look at insider trading as an issue that requires serious analytical work. However, one aspect of the topic has had much too little attention. This is the fundamental question of whether, even if economic welfare were maximized by the Security and Exchange Commission's (SEC's) insider trading enforcement program, we should give up the economic and human freedom involved in the nonregulated regime to gain those assumed benefits. I shall try to elaborate these noneconomic arguments along with the more traditional kinds in this paper.

Who Is Injured?

The most fundamental economic proposition in the whole topic of insider trading is that no shareholder is harmed by a rule of law that allows the exploitation of nonpublicized information about shares of publicly traded corporations. The naive argument in defense of the SEC's position on this subject is that if the shareholder had the

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information (good news) the insider had, he would not sell his shares.[1] The rhetorical fallacy in this proposition kept much of the early debate at fever pitch, so let me explain why it is a fallacy.[2] The statement compares the behavior of an "outside" shareholder who is in possession of valuable information with one who is not. Unfortunately for the proponents of this view, however, that is not the relevant comparison. The real question is whether the person wanting to sell shares for exogenous reasons would behave differently *before the information has been disclosed* if insiders are or are not allowed to trade on the information. Obviously 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, which is the critical issue in the matter. Obviously the argument demonstrates no injury to any prepublication interest that should be protected.

The modern academic literature now recognizes that there is no significant economic harm to any identifiable group of investors from insider trading. The serious literature does not even address that question anymore. The SEC still makes the "fairness" argument[3]—the argument that it is not fair for some people to have property and others not to have it—but most scholars now understand the intellectual merit of that kind of argument.[4]

There is a related point that is more an exercise in legal than in economic logic, but the end result is the same. The argument is that insiders, by using information that has not been disclosed previously to shareholders, are violating a fiduciary duty or an implied contractual obligation to the shareholders.[5] The question-begging aspect of this proposition should be immediately apparent. The question at issue is whether or not it is desirable to have just such an implied contractual provision or fiduciary obligation. One cannot argue meaningfully to a conclusion from such a question-begging proposition.

[1]William Painter, review of *Insider Trading and the Stock Market*, by Henry G. Manne, *George Washington Law Review* 35 (October 1966): 146–60.

[2]For an elaboration of this argument, see Henry G. Manne, "Insider Trading and the Law Professors," *Vanderbilt Law Review* 23 (December 1969): 547, 551–53.

[3]See, for example, John M. Fedders and Michael Mann, "Waiver by Conduct versus Fraud," *Wall Street Journal*, 21 December 1984, p. 18.

[4]But see Victor Brudney, "Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws," *Harvard Law Review* 93 (December 1979): 322–76.

[5]Richard Jennings, review of *Insider Trading and the Stock Market*, by Henry G. Manne, *California Law Review* 55 (October 1967): 1229–35.

Again this problem does not seem to plague current writing on this subject as it did some 20 years ago.

The Efficient Stock Market

The next fundamental economic argument, one no economist has ever denied, is that insider trading will always push stock prices in the "correct" direction.[6] That is, the effect of insider trading will always be to move a share's price towards the level correctly reflecting all the real facts about the company. There is a debate on how quickly insider trading will do this and what the impact of insider trading is on the timing of public disclosure. But there is no debate on the basic proposition, and the economic logic underlying it is straightforward. The price of any commodity reflects individuals' subjective measurements of a good's utility. But individuals' subjective measurement of the value of any good is obviously a function of information they have about that commodity. A nugget thought to be iron oxide is discovered to be gold. That discovery tells us that the "market" will put a higher value on the nugget than was previously thought to be true. And that is precisely the process by which insider trading (or for that matter any informed trading, whether by insiders or not) will shift stock prices in the correct direction. The direction is "correct" simply because it reflects more valid information. Obviously the process whereby markets process information into prices is conceptually and institutionally quite complicated,[7] but happily this matter, as it relates to insider trading, is not in dispute.

What is new since I first made this argument is a tremendously increased sensitivity to the importance of "correct" stock prices, or of an efficient market. Dependent functions include, for instance, investment decisions, the allocation of capital, the market for corporate control, and the market for managers. Each of these requires correct stock prices to function effectively. I might add that the welfare of the many economists basing their work on the accuracy of stock market pricing is also at risk.

Information as Compensation

In my 1966 book I made another economic argument that I believe has had too little attention from mainstream neoclassical economists

[6]See Hsiu-Kwang Wu, "An Economist Looks at Section 16 of the Securities Exchange Act of 1934," *Columbia Law Review* 68 (February 1968): 260–9.

[7]See, for example, Frank Easterbrook and Daniel Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review* 70 (May 1984): 669–715; Ronald Gilson and Reinier Kraakman, "The Mechanisms of Market Efficiency," *Virginia Law Review* 70 (May 1984): 549–644.

considering large, publicly held corporations. It was a matter Joseph Schumpeter first raised as a fundamental failing of the large corporation: that it did not by its nature encourage or reward entrepreneurship,[8] probably because appropriate compensation devices for entrepreneurs were unavailable in the large corporate system. I pointed out that for all the psychological tendencies that do exist for bureaucratization of large corporations, insider trading does provide one possibility for appropriate entrepreneurial compensation.[9] Only the Austrian economists in recent years have attempted to develop the theme of the entrepreneur,[10] though little effort has been directed to the form-of-compensation problem as such. Other commentators have, however, recognized the general compensatory implications of the rule for or against insider trading. Particularly Professors Fischel and Carlton have noted that allowing corporate insiders early access to information is indeed a form of compensation and one which, through familiar Coase theorem logic, is going to be paid in any event.[11] Professor Easterbrook, on the other hand, has concluded that allowing insiders to trade will encourage them to manage the company without sufficient concern for the shareholders' aversion to risk.[12] This argument, however, is presented without reference to the countervailing incentives managers already have to behave in too risk-averse a fashion.

We could not talk intelligently about the costs and benefits of the SEC's rule without at least noting the high compliance and escape costs from rules against insider trading. The lawyers advising corporations, shareholders, and others today on how to avoid the risks of an SEC complaint do not come cheaply. Furthermore, the fact there is so much money potentially available means that people will use inefficient devices to exploit the information if straightforward methods are apt to be discovered.[13] For instance, they will ship the

[8]Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Row, 1942), p. 134.

[9]Manne, *Insider Trading*, pp. 138–41.

[10]See, for example, Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1978).

[11]Dennis Carlton and Daniel Fischel, "The Regulation of Insider Trading," *Stanford Law Review* 35 (May 1983): especially 861–66.

[12]Frank Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information," *Supreme Court Review* (1981): 309–65. But see Richard Leftwich and Robert Verrecchia, "Insider Trading and Managers' Choice Among Risky Projects," CRSP Working Paper no. 63, University of Chicago Graduate School of Business, August 1983.

[13]Harold Demsetz, "Perfect Competition, Regulation, and the Stock Market," in *Economic Policy and the Regulation of Corporate Securities*, ed. Henry G. Manne (Washington, D.C.: American Enterprise Institute, 1969).

information overseas and perhaps trade through an obscure mutual fund or a Swiss bank.[14] Delays in disclosure and a variety of barter arrangements also add to the real costs of these rules.

Enforcement Problems

The SEC has recently given convincing evidence of its own inability to police its rules against insider trading, particularly where foreign funding of such trades may be involved. Mr. John M. Fedders, Director of the SEC's Division of Enforcement, has proposed a rather extraordinary exportation of American law to foreign jurisdictions, particularly Switzerland. Under his proposal any purchase or sale of securities in the United States would automatically carry with it a waiver of the applicability of foreign secrecy laws.[15] The real effect of this is likely to be to force Swiss banks, which are unlikely to give up the advantages of bank secrecy, to refuse in the future to finance trading in American stocks. A more classic use of regulatory apparatus to restrain foreign competition would be hard to imagine. And for the U.S. Securities and Exchange Commission even seriously to consider such an idea can only mean that it is severely frustrated in its efforts to bar insider trading.

This argument is revealing in another regard since it suggests that there may be greater political pressure from some important SEC constituency than has been generally realized. After all, everyone understands today that insider trading is in the nature of a "victimless crime." Somehow it seems unlikely that such extraordinary pressures would be mounted by the SEC merely to police Swiss bankers' morality. We shall return subsequently to this point.

The enforcement problems I have just been referring to are inherent in the SEC's insider-trading rule. The ability to detect the practice will always be difficult, and when the gains that can be realized from the practice, discounted by the risk of being apprehended, are compared to the potential costs, many people will have the incentive to trade on inside information. But there is an even more fundamental reason why there can never be significant enforcement of a rule against the profitable use of new information in the stock market.

Most of us think that insider trading only takes place when the officers or other insiders, as in the classic *Texas-Gulf Sulfur*[16] case,

[14]Henry G. Manne, "Offshore and On—The SEC's Reach Threatens to Exceed Its Grasp," *Barron's* 2 November 1969, p. 1.

[15]Fedders and Mann, "Waiver by Conduct."

[16]SEC v. Texas Gulf Sulphur Co. 401 F. 2d. 833 (2d Cir., 1968) cert. denied, 404 U.S. 1005 (1971).

place an order with their brokers to buy stock before important new information about the company is disclosed publicly. That kind of trading may have some price impact, but we cannot be sure a priori how much impact it will actually have, if it will have any at all.[17] Given modern portfolio theory,[18] the assumption is that the demand curve for any given company's stock is extremely elastic. Thus even large purchases of a stock will not necessarily have an immediate and noticeable effect on its price since many other stocks are seen as perfect substitutes for this one in other investors' portfolios. This elasticity, however, is never perfect and, in general, heavy purchases or sales of a stock eventually will have an effect on its price.

In fact, many people who exploit new information do not buy additional stock; rather, they simply *do not sell*.[19] If the stock is already in their portfolio, it may be sold or not as conditions dictate. However, with inside information, they know when *not* to sell any of their present holdings. Refraining from selling stock that would otherwise have been sold has exactly the same economic effect on market price as a decision to buy that same number of shares. But there is one crucial legal distinction: A failure to sell cannot be a violation of the SEC's Rule 10b-5, because there has been no securities transaction. The SEC might like to punish people for what is in their head, but under the present state of law they cannot.

The upshot of all this is that people can make abnormal profits in the stock market simply by knowing when *not* to buy and when *not* to sell. They will not make as much perhaps as if they could trade on the information more efficiently, but nonetheless they will still make supra-competitive returns. And this is a form of insider trading that no one can do anything about. It may also be the dominant method of using inside information.[20]

Civil Liberties Issues

The amount of insider trading actually occurring, as compared to the amount effectively policed by the SEC, suggests a serious civil liberties problem in this area. As our national experience with

[17]See Henry G. Manne, "Economic Aspects of Required Disclosure Under Federal Securities Laws," in *Wall Street in Transition: The Emerging System and Its Impact on the Economy*, ed. H. Manne and E. Solomon (New York: New York University Press, 1974), p. 21.

[18]See generally Eugene Fama, *Foundations of Finance: Portfolio Decisions and Securities Prices* (New York: Basic Books, 1976).

[19]This argument was first elaborated in Manne, "Economic Aspects."

[20]Ibid., p. 78; and see Gilson and Kraakman, "The Mechanisms of Market Efficiency."

prohibition demonstrated, it is difficult to give government enforcement agencies vast discretionary powers over large numbers of people without that power being abused. If large numbers of people are regularly violating a particular law, that law becomes a device by which government powers may be used abusively through selective enforcement.

We have no direct evidence that the SEC has used its powers in an abusive fashion, but we should not have to wait for a situation to develop before recognizing the danger. Two recent cases are certainly suggestive. In 1984 the SEC brought an action against Mr. R. Foster Winans, then in charge of the *Wall Street Journal's* "Heard on the Street" column, for trading on information that would appear subsequently in the column.[21] Mr. Winans bore little resemblance to the usual insider, since he was not privy to any valuable market information about the company for which he worked. The SEC claimed that his "misappropriation" of the *Journal's* information was sufficient to run him afoul of its Rule 10b-5. The more fundamental legal question here seems to be the right of the SEC to expand its own jurisdiction into an area of law that has been traditionally a matter of state enforcement. However, the specter of regulation of reporters' behavior, including their financial activities, has certainly been taken as a warning shot by many thoughtful commentators. And while the Winans matter cannot be viewed in itself as a threat to freedom of the press, the fears expressed by some journalists do not seem entirely without justification.

Also last year, an Assistant Secretary of Defense, Mr. Paul Thayer, was forced to resign his government post in order to defend against a charge of insider trading. No one has suggested that the SEC's powers were being used against Mr. Thayer by his political enemies within the government. And yet, he had been the center of some heated political controversy in the months before the SEC's charge, and again, even though the reality of political abuse may not be present in this case, the potential is certainly clear. Given that many (most?) individuals of substance and of active business experience before assuming government positions could be colorably charged with a violation of Rule 10b-5, the danger of lodging this kind of power in a government agency is again brought home.

The matter involving Mr. Thayer raises still another civil liberties issue in connection with insider trading enforcement. We also should be concerned about potential abuses of individuals' right to privacy,

[21]See John C. Boland, *Wall Street's Insiders* (New York: Wm. Morrow & Co., 1984), p. 58.

unless some strong countervailing interest is to be served. In the famous *Dirks* case,[22] the U.S. Supreme Court ruled that in order to show a violation of Rule 10b-5, the SEC had to show that a person giving out the information got some benefit in return. The SEC found that Mr. Thayer had not used the undisclosed information himself to buy stock, and therefore he had made no profits in the stock. However, he did receive "sexual favors" from a woman to whom he gave the news.[23] A goodly number of insider trading cases have been found to involve intimate or close family relationships,[24] undoubtedly reflecting some form of payment. The SEC's rule seems to lead this government enforcement agency ineluctably into these areas. But these relationships are only examined by government agencies at a price we probably should not pay. There are subtle yet real dangers to liberty lurking in this "ethical" rule.

Contracting Out

We have already noted that insider trading is a victimless crime, with only amorphous and rhetorical claims about the "integrity of the market" to justify its prohibition. But there is further internal evidence suggesting intellectual hanky-panky in connection with this campaign by the SEC. Consider the fact that no corporation is allowed to adopt rules, even broadly publicized, specifying that its insiders are authorized to engage in insider trading. That is, no one may in effect contract out of the SEC's rule. The SEC's defenders have great difficulty in showing any reason why this should be a mandatory rather than elective rule. There once were in fact a few companies that adopted their own internal rules against insider trading, before anyone at the SEC had even thought of the subject in its modern form. Clearly, however, the overwhelming number of companies, when they were perfectly free to contract their way into such a rule, did not do so. This failure of corporations to design internal rules against insider trading could not have been an accident or oversight. Indeed, as Professors Fischel and Carlton have recently argued,[25] *given industrial competition and efficient capital markets*, this is a very strong indication that a rule against insider trading would actually be harmful to shareholders. But, as we shall see, the SEC may be responding to other interests by not allowing companies to contract out of the present rule.

[22]Dirks v. SEC 463 U.S. 646 (1983).

[23]See Boland, *Wall Street's Insiders.*

[24]Ibid., chap. 1.

[25]Carlton and Fischel, "The Regulation of Insider Trading."

It has been argued that SEC enforcement of a mandatory rule is necessary because the companies themselves are incapable of enforcing an internal rule on the subject.[26] That could also explain why they did not voluntarily adopt such a rule earlier. But there are two peculiarities to this. One is the explicit factual assumption that the SEC could do a better job of ferreting out insider trading than could a corporation that wanted to enforce such a rule against its employees. But corporations could surely detect activities, particularly repeat activity of heavy trading, very quickly.[27] And the enforcement record of the SEC is nothing to brag about. Market studies clearly show that there is vastly more of this activity than the SEC has uncovered.[28] But the SEC's public relations staff is good at telling the world what efficient policemen they are.

The second peculiarity stems from the argument that the SEC should enforce this rule for companies that would like to have it but who cannot do it themselves. Clearly at some price they could do it, so why should the SEC be using taxpayer's money to subsidize corporations in that fashion? No "economy of scale" or public goods argument can justify a rule, even if the corporations want it. But, of course, they do not want it. And this "gift" from the SEC is no subsidy if it has no value to the companies. The argument simply will not wash.

Political Interests

It seems fairly clear then that the economic, moral and legal arguments are very strong against the SEC's stand on insider trading. There remains then only one area of investigation, and that is a political one. Ever since George Stigler elaborated the modern "interest theory" of regulation,[29] scholars have been well-advised in seeking the explanation for a particular regulatory position to ask who would be benefitted most by the rule. Ethical and economic welfare arguments aside, who stands to benefit most if in fact the arguments for enforcement against corporate insiders carry the day?

[26]Easterbrook, "Insider Trading."

[27]Michael Dooley, "Enforcement of Insider Trading Restrictions," *Virginia Law Review* 66 (February 1980); 1–83.

[28]See authorities cited in Carlton and Fischel, n. 12, p. 59.

[29]George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2 (1971): 3–21. Revised and reprinted in G. Stigler, *The Citizen and the State: Essays on Regulation* (Chicago: University of Chicago Press, 1975).

If we know the answer to that question, we will have an important insight into what is really going on here.[30]

The answer starts with some economic aspects of the partial enforcement of economic regulations. Naturally we cannot have perfect enforcement of any economic regulation, since enforcement is not costless. Indeed no one argues for perfect detection and conviction of every inside trader. But since partial enforcement is a fact of life, we will find that some potential violators will be more risk-averse than others. People who value their personal reputations highly will not take the risk of being indicted or charged by the SEC, and they will pull out of the competition for "illegal" information. As they do, the supply of the service they had been providing will be reduced, and those left will thereby profit more.[31]

Prohibition is the best known example of how this scenario unfolds. When the mom-and-pop liquor stores were closed, the progenitors of modern racketeers took over the industry, and they liked the monopoly rents they received by the restriction of competition afforded by the police. Therefore, they actively opposed repeal of prohibition. Something similar is happening here. It is difficult to know the exact alternative channels for the flow of new information, but it is very valuable and it is going somewhere. Look for the supporters of the rule, and you will have a good idea of who benefits from it.

It is not too hard to find some suggestive evidence to support the hypothesis that investment bankers and their related functionaries are trying to get valuable information that would otherwise go to corporate insiders. Maybe corporate insiders do not look like mom-and-pop liquor-store owner types, but the economics of the two situations is identical.

What we are likely seeing in this whole insider trading binge is another attempt by regulation to reallocate wealth,[32] in this case the value of information from one set of users, corporate officials, to the financial service people who are the next in line to gain access to information before the public does. It is not surprising then that when information goes through the bankers' hands first, for "security analysis," it is no longer "illicit" inside information. Now it is the "data" the financial analysts use to make their evaluation of stocks. But no amount of semantics can change the fact that if insiders cannot

[30]I am indebted to my colleague Jonathan R. Macey for this excellent argument.

[31]See Herbert Packer, "The Crime Tariff," *American Scholar* 33 (Autumn 1964): 551–57. Note that this argument does not apply easily to most common types of crime, but it seems particularly apposite in all areas of victimless crime.

[32]See Richard Posner, "Taxation by Regulation," *Bell Journal of Economics and Management Science* 2 (Spring 1971): 22–50.

use the information, these functionaries will get it and use it to their advantage more quickly than anyone else.

There have, of course, been suggestions before that the SEC has long performed a valuable function for leading firms in the investment banking industry.[33] It is also noteworthy that elite Wall Streeters have long supported the SEC in its campaign against insider trading, though it is difficult to believe that sophisticated financial experts are really taken in by the "integrity of the market" argument or the traditional fairness position on insider trading. It is more likely that the SEC has again proved that it is no different from other agencies that have protected competitors instead of consumers.

[33]See Manne, "Economic Aspects."

MANNE'S INSIDER TRADING THESIS AND OTHER FAILURES OF CONSERVATIVE ECONOMICS

Homer Kripke

Introduction

In his Cato Institute conference paper, Henry Manne (1985) continues his longstanding attack on the Securities and Exchange Commission (SEC) for its prohibitions on insider trading. Since the lower courts have very widely sustained the SEC and the Supreme Court has sustained it in part, Manne has had also to attack the courts. He did not really need to make this a lifetime occupation, because after he initiated this endeavor with his 1966 book, *Insider Trading and the Stock Market,* he has gone on to attain a better-grounded fame for his other accomplishments.

I want to recognize his remarkable achievements. His Law and Economics Centers, first at the University of Miami and now at Emory University, have had a tremendous influence in educating lawyers to the importance of economics. It is not too much to say that next only to conservative appointments to the Supreme Court, his teaching of conservative economics to federal judges and to law professors may have been the most important single influence in broadening the acceptance of conservative economics in legal thinking, and I say so while disclaiming complete sympathy with this brand of economics.[1] I should add that Manne seems to have been

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[1]Indeed, I recently declared: "I was a minor Roosevelt New Dealer during my period of service at the SEC, which was roughly during its fifth to tenth years. I remain sympathetic to the role of government in the economy and the society. However, I think that government tended to go too far in the 1970's and the SEC was an example of this tendency" (Kripke 1984a, p. 258). The task of the thinker who tries to pick between two extremes is not an easy one.

scrupulously fair in bringing to his program a sampling of economists more sympathetic to regulation.

Manne also deserves credit for having coined the phrase and the concept, "the market for corporate control," with fortunate timing before the vast outpouring of interest and activity in that topic, which stems from our current tender offer practice and litigation, from going private devices, and from leveraged buy-outs.

It is for his work on insider trading, however, that Manne is best known, primarily through his 1966 book, but also through several other treatments of the topic.[2] Although Manne is right in some of his detailed criticisms of insider trading regulations, his main point is wrong.

The Fallacy of Manne's Insider Trading Thesis

Manne's insider trading thesis in 1966 was strong and simple: *Nonpublic information is a corporate asset.* After displaying his erudition by expounding the distinction between entrepreneurs and managers, as set forth in Schumpeter (1950), Manne asserted that the opportunity to exploit this asset through insider trading by transfer of this asset to entrepreneurs is the only adequate form of compensation for the entrepreneurs as distinguished from managers or other leading corporate figures. Restriction of this transfer and exploitation would impair the efficiency of the market. He then announced the importance of his thesis: "[P]ressing for the rule barring insider trading may inadvertently be tampering with one of the wellsprings of American prosperity" (Manne 1966a, p. 110).

I was one of a number of law professors who criticized this thesis after publication of his book. (The references are collected in Manne 1970.) I left the moral ground to others, but argued that his description of the influence of insider trading in causing the market efficiently to arrive at a proper price for a security was unsound, in that he failed to show why managers could be expected to leave the opportunity for inside trading gains to the entrepreneurs instead of taking the opportunity themselves (Kripke 1967).

Manne's thesis was also rejected by Oliver Williamson, an economics professor, in a lecture series that Manne himself had organized and edited (Manne 1969). Williamson (1969, pp. 301–6) pointed out that it is not easy to allocate corporate success between causes: The attribution problem between "luckies" and entrepreneurs is difficult. Limiting the reward to a proper amount is also difficult.

[2]In particular, Manne (1966b and 1967). Other later treatments are discussed in the text.

Williamson pointed out that Manne had to make, and then was making, the contention, obviously impossible of achievement, that the entrepreneur must rise above the *mores* of bureaucratic organization. Williamson also found an absence of evidence for Manne's assertion that there is a competitive marketplace at the top of corporations for entrepreneurs. He pointed out that the insider trading basis for compensating and evaluating decision makers would not necessarily work, for genuine corporate benefits do not necessarily produce rapid stock price movements suitable for insider trading.

Manne criticized all of the unfavorable reviews of his book by law professors in a 1970 article, though he failed to mention the rejection of his thesis by Professor Williamson. In the article Manne put himself on safer ground by abandoning his emphasis on entrepreneurs and arguing that it is not important whether the individual who is permitted to trade on inside information is an entrepreneur or a manager, so long as he is not randomly selected. This abandonment made irrelevant the long discourse in his 1966 book about Schumpeter's theories of the entrepreneur, who in contrast to the manager was viewed as the wellspring of corporate activity. He also rescued himself from his naive position which I had attacked, that corporate managers would forego the opportunity to reap the rewards of insider trading themselves, and would pass the opportunity to the entrepreneurs.[3]

For a long period the general view of law professors toward Manne's thesis remained adverse while economists generally thought it was a good try, but not quite successful. Professor Harold Demsetz was among the group of economists who lent their early support to Manne's

[3]Manne's thesis has persisted essentially unchanged since 1970. The only exception being a minor refinement in his 1974 Moskowitz lecture (Manne 1974, pp. 76–77) that is repeated in his Cato Institute conference paper (Manne 1985). According to Manne, insider use of inside information could impact the market and help toward reaching a proper clearing price not merely through trading but through holding without trading, that is, through the use of inside information by existing owners of securities to increase their reservation prices, hold their securities, and reduce the trading supply without risk of enforcement action.

In his Cato Institute conference paper, Manne listed this circumstance as an example of discriminatory enforcement. The beauty, to him, of this point must be that there is no way to cure it by even-handed enforcement. Under present law if a person comes into possession of inside information, he can avoid a violation by not trading. The courts have sanctioned this position from the beginning. But Manne says that this is discriminatory: The insider should be in violation because of mere possession of the information, whether he trades or does not trade. The only escape from this dilemma would be to violate his duty to his employer, destroy the employer's valuable information asset, and make the information common property.

contention that the prohibition of insider trading decreases market efficiency (Demsetz 1969, pp. 11–18).

Manne's efficiency argument is doubtless correct so far as it goes. However, in espousing Manne's argument, Professor Demsetz was effectively answered by Dean Bayliss Manning (1969, p. 84), who said: "[T]he one thing that is clear about securities regulation is that, whatever the SEC is all about and whatever the regulations are all about, they are not about efficiency." As we shall see, some loss of efficiency must be endured for the sake of a larger goal.

Manne has recently found support among law professors who stress conservative market-oriented economics. For example, Carlton and Fischel (1983) treat corporate licensing of the use of inside information as a proper means of corporate compensation. They agree with Manne that any moral issue can be obviated by the corporation announcing publicly whether it does or does not permit such use.[4] I discuss this point more fully below.

In his paper Manne (1985) introduces a whole array of issues of fairness or governmental oppression, with some of which I agree. He is correct and has been correct in saying that the concept of insider trading gives the SEC a large measure of prosecutorial discretion. Thus, the SEC can determine questions of materiality and of willfulness in its own collective mind, and it can gear enforcement to its current manpower and budget problems. But this kind of prosecutorial discretion is characteristic of the enforcement of any criminal or civil prohibition, and creates no different civil liberties issues of unequal enforcement than do any other such prosecutorial choices. The fact that some amount of insider trading still continues does not make enforcement unfair any more than the persistence of street crime makes enforcement of the criminal laws unfair. In fact, if there is any unfairness in unequal treatment, it is presently being reduced under an antiregulatory Republican administration, which makes enforcement of the SEC prohibitions on insider trading one of its key goals.

Manne fails to mention, however, what to my mind is the most glaring example of an opportunity for uneven enforcement and bad administrative and congressional policy, namely, the Insider Trading Sanctions Act of 1984 (P.L. 98-376), which permits the SEC to demand a triple penalty in cases of trading on nonpublic information in violation of the Securities Exchange Act of 1934. This is objectionable because it is discretionary with the SEC whether to demand that sanction and still more because the wrong involved is not defined

[4]See also Dooley (1980).

by the statute, but is left to subsequent determination by the courts. The only condition is that the person trading be in possession of material nonpublic information. Whether the holding of the *Chiarella* and *Dirks* cases[5] will survive in requiring that the person trading be violating a preexisting fiduciary duty to the person he is trading with remains to be resolved by the courts with no help from Congress. Moreover, whether the law will follow some dicta of the Supreme Court in the *Chiarella* case—that violation of fiduciary duty to someone other than the corporation or misappropriation of the information from a third party is sufficient to invoke Rule 10b-5 and the triple penalty—remains to be determined. The ability of the SEC staff to preclude trial of factual and legal issues and to bring pressure for acceptance of consent decrees or consent settlements under threat of the triple penalty remains a serious threat in my opinion, and the possibility that the commissioners might be more statesmanlike than the staff is of little comfort to a respondent dealing with the staff, particularly in the face of such a drastic possible penalty.

I agree that the statutory and rule basis for the prohibitions on insider trading, which the new 1984 act does not clarify, is so vague as to create a civil liberties issue. Rule 10b-5 employs principally the word "fraud" and its derivatives, and those words had a reasonably well-recognized meaning in the common law. If Rule 10b-5 represented no more than an adoption of the common law doctrines, including their capacity for development, I could have no objection. But the SEC has said that the term "fraud" in the rule is not bound by common law conceptions, but includes "statutory" or "constructive" fraud, whatever those terms mean. Actually, they have come to mean anything that the SEC dislikes because by picking cases in which it can dramatically describe the facts, the SEC hopes that the facts will carry the law.

I have heretofore expressed the wish that Rule 10b-5 be declared unconstitutionally vague; or if constitutional doctrine is too pretentious for this problem, I would hope that the courts would apply the concept announced by Judge Friendly in *Colonial Realty Company v. Bache*,[6] which considered a stock exchange and SEC rule requiring brokers to adhere to "just and equitable principles of trade." Judge Friendly said that this phrase was so broad as to be meaningless, or to mean only "behave yourself," and that such a prescription was insufficient to serve as the basis for any discipline. I think that the

[5]Chiarella v. United States, 445 U.S. 222 (1980) and Dirks v. S.E.C., U.S., 103 Sup. Ct. 3255 (1983).

[6]358 F.2d 178 (2d Cir. 1966).

same criterion should apply to Rule 10b-5 as it has been interpreted. There is no reason that the SEC could not define the wrongs more specifically in detailed rules. Nor is there any reason not to believe that the SEC could have asked Congress to be more specific in drafting the Insider Trading Sanctions Act of 1984, as it affected such an important matter as extending the inside information concept to improper use of information by legal printers and others in tender offer situations, an extension that the Supreme Court has thus far in the *Chiarella* and *Dirks* cases refused.

I have also criticized the extension of insider trading beyond the scope set forth in the *Cady Roberts* case,[7] namely, misuse of material inside information concerning the corporation and which was the property of the corporation. Thus, I have criticized the SEC staff's mosaic theory, under which information that would not be material to anyone else is said to be material to the analyst using it—because the information completes a "mosaic" picture of the company and if the analyst acts on it, he has violated Rule 10b–5 (Kripke 1979, app. B). While commissioners always said that Rule 10b–5 would be invoked only for really vital information, the SEC staff disregarded this. We may at least hope that the staff will now abandon this uncertain theory after the Supreme Court's strong remarks in *Dirks* about the importance of analysts' work in keeping the market efficient.

Long before the *Chiarella* case, I disapproved of the efforts to extend the prohibition on trading on true insider information to trading on nonpublic market information and to produce complete equality of information in the marketplace, as the SEC sought to do in the *Oppenheimer*[8] and *Dirks* cases. *Chiarella* and *Dirks* decisively reject this extension of Rule 10b-5, unless it can be shown that there has been a violation of a preexisting duty to the person with whom the possessor of the information is trading. It remains to be seen whether the law will follow some dicta in individual opinions in *Chiarella* that violation of 10b-5 can be predicated on violation of duty, but duty not to the counterpart in the trading but to employers who hire the trader or to the employers' principals, for example, the printing company and the tender offeror who engages the former.

It is strange that Manne (1970) and his supporters, such as Carlton and Fischel (1983), far from objecting to these regulatory extensions, have supported them in a backhanded way. They argue that "inside" information need not be "inside," because, in an economic sense, there is no difference between trading by insiders on inside corporate

[7]Cady Roberts & Co., 40 SEC 907 (1961).

[8]Oppenheimer & Co., SEC Rel. 34–12319, Fed. Sec. L. Rep. (CCH) 80551 (1976).

information and any trading by anyone in possession of nonpublic information of any kind.[9] Furthermore, they contend that from the point of view of efficiency, it makes no difference whether the trader is an insider, whether the information is "inside" information of the corporation, where the trader got his information, or how he got it. Thus, they define the insider trading problem solely in terms of efficiency, arguing that one case of inequality of information is like any other.

When Manne first advanced this broad definition of inside information and rejected a prohibition on inside trading so defined, he was attacking a straw man. The SEC had not yet given any hint that it wanted to prohibit trading on both true insider information and on nonpublic market information to ensure equality of information in the securities markets. By the time Carlton and Fischel joined Manne, the SEC had approached this position in its arguments in the *Chiarella* and *Dirks* cases. The Supreme Court, however, rejected this expansion of the SEC's regulatory power in both cases. Consequently the current Manne–Carlton–Fischel argument against prohibiting the more broadly defined "insider" trading is again attacking a straw man.

Manne and his supporters would, of course, have been right in opposing a restriction on trading on inside information if such a broader definition had been accepted. I, too, opposed this breadth of prohibition when the SEC argued for it as the *Dirks* case first arose, on the ground that it is impractical in a profit-making society to require everyone to give up his informational advantage as against his counterpart in bargaining.[10] There is nothing coming even close to such a rule outside of the securities field.[11] By defining the problem their way, Manne and his supporters have been able to ignore the important real reason for the restrictions (which I discuss below) and to focus their objection simply on the question of the efficiency of the market.

[9]Yet in their discussions of the issue Manne and his supporters use the term "insider" as applying to corporate insiders only, and argue that the information is a corporate asset, which the corporation should be free to dispose of. Their quibble on the definitions seems to have no operative effect on their reasoning.

[10]Kripke (1979, pp. 295–97; 1984a, pp. 282–84, 289–90).

[11]I would have had no objection to legislation prohibiting one type of case which the SEC sought to reach by trying to define insider trading so broadly, that is, trading by printers such as Chiarella and others who obtain nonpublic information as to a planned tender offer for corporate stock. But as stated in the text, I do object to the Insiders Trading Sanctions Act of 1984, which is aimed at such trading but which imposes a triple penalty for violation and leaves the wrong undefined.

Failures of Conservative Economics

There are four basic reasons why I have thought it worthwhile to expound the history of Manne's insider trading thesis and its support in detail, instead of overlooking Manne's long-held position as an idiosyncracy of an able lawyer and educator.

First, Manne's insider trading thesis has considerable value to illustrate what is wrong with much conservative economic thinking.[12] Manne and his supporters are guilty of a fault which I find in many academic economists, particularly conservatives, namely, they assume that man is a single-faceted individual, engaged solely in maximizing personal financial gain. The academics confidently assume without empirical examination that he will therefore act as abstract economic reasoning predicts, undistracted by extraneous facets like psychological feelings about fairness, honesty, respect for law, self-respect, consideration of others, and so on. I cannot here undertake to expound in detail any of the examples I have in mind. Therefore, I forbear to mention them, except one that has already been discussed in detail by Meckling (1977), namely, if the consequences of bankruptcy are made less onerous, more debtors will elect bankruptcy and borrowing will cost more. Such reasoning, however, fails to take account of psychological factors motivating filing or nonfiling in bankruptcy, such as pride in avoiding bankruptcy. Meckling and this theoretical academic process of reasoning are beautifully rebutted in Shuchman (1977). Shuchman also points out that the fragmentation of markets, which Meckling ignored, precludes ready generalizations about the correlation of risk and the rate of interest.[13]

[12]I do not mean to suggest that conservative economics has a monopoly on error. Enthusiastic proregulatory economics persists despite the established points which have tempered my own original pro-New Deal point of view: substantial failures of regulation to achieve its purposes; capture of the regulatory structure to serve the purposes of those regulated; and the formation of the "iron triangles" of regulators who keep jobs, regulatees who like the anticompetitive regulation, and congressional committees and their staffs who gain power and prestige and election contributions through maintenance of the regulatory apparatus.

[13]See also the following note. An excellent statement of psychological motivations that should temper abstractly logical single-faceted economic reasoning appears in Maital (1982). It may be worthwhile to quote for Manne and other single-faceted thinkers a few lines from pages 262–63 of that book:

> I began by noting how economics has had its conceptions of the world turned upside-down literally. . . . Such contortions are a clear signal that economics is on the threshold of . . . a complete revision in the fundamental framework of analysis. . . . [E]conomists . . . go on to describe what they think those breakthroughs will be, at the top of the list: "Explicit merger of economic theory with aspects of political science, psychology, sociology, sociobiology and law in which various political and social institutions are treated as identifiable determinants of economic behavior." . . . I believe the major contribution to economics' breakthrough will come from psychology.

With their narrow vision Manne and his supporters produce the single-faceted chain of reasoning that information is a scarce commodity that has economic value to its possessor; that this information belongs to the corporation (never mind the inconsistency of this position with the broad definition of "inside information" which they use); and that the corporation should be able to use this information to compensate employees by licensing the exploitation of the information by trading in the securities markets.[14]

Second and most important, Manne's narrow approach ignores the true reason that the prohibition on trading on inside information is justified, when properly confined to true inside information under the concepts of the *Cady Roberts* case or under a proper statute extending it.[15] In a narrow sense, Manne has been right in saying that insider trading is a victimless crime (at least when done not face to face but anonymously in public markets). Daniel Seligman (1983) takes a pragmatic view supporting Manne, and points out that no one knows whether those hurt by insider trading are more numerous than

[14]It is surprising that some of these economic thinkers, even those whose judgment *ought to have been improved* by legal training, can be so single-faceted as they have proved to be. Carlton and Fischel (1983) offer the idea that one virtue of insider trading is that it will reduce "agency costs" that are incurred by stockholders or their representatives in "monitoring" the activities of the managers, their agents, to prevent the managers from acting in his own interest rather than of that of the stockholders. Carlton and Fischel argue that the monitoring involves a periodic renegotiation of compensation to the managers and that renegotiation is expensive. They claim that by simply helping himself to such compensation as he desires by trading on inside information, the manager can avoid the necessity for renegotiation, thus saving agency costs.

Since Manne asserted after our oral presentation of these papers at the Cato Institute Conference that I had misread Carlton and Fischel, I quote excerpts from pages 870 and 871 of their article:

> Contracts that provide for periodic renegotiations ex post . . . are alternatives to contracts that ex ante tie compensation to output . . . [T]he bargaining process itself is costly. To reduce these costs, firms seek to minimize the number of renegotiations. But reduction in the number of renegotiations itself creates a cost. If renegotiations occur too infrequently, they are less likely to exert the proper incentives at any given time. . . .
>
> Insider trading may provide a solution to this cost-of-renegotiation dilemma. The unique advantage of insider trading is that it allows a manager to alter his compensation package in light of new knowledge, thereby avoiding continual renegotiation. The manager, in effect, "renegotiates" each time he trades. This in turn *increases the manager's incentive to acquire and develop* valuable information . . .—he will be more inclined to pursue this opportunity if he is rewarded upon success. Insider trading is one such reward. . . . The insider trading alternative reduces the uncertainty and cost of renegotiation and thus increases the incentives of managers to produce valuable information. Moreover, because managers themselves determine the frequency of "renegotiations," they can tailor their compensation scheme to their particular attitudes toward risk.

[15]*See supra, note 11.*

those hurt by trading before inside facts have impacted the market, so that they are price-takers taking a faulty price.

My erstwhile colleague, Professor William K. S. Wang (1981), has pointed out that it is extremely difficult to determine whether there is a victim of insider trading on public markets, and if so, who he is. But all of this reasoning ignores the real victim of insider trading—the public. Such trading runs the risk of destroying an important public interest, namely, confidence in the national securities markets. Our strong and deep securities markets with many participants, direct and indirect, is one of the strongest supports of our enviable economy. A true reading of the early history of the federal securities legislation is that it was intended to restore public confidence in the securities markets after the 1929 debacle (Kripke 1984a, pp. 260–623). Its purpose was not, as Manne (1974) has contended, to preserve a monopoly for traditional underwriting firms as against upstarts; or, under the more popular view, that it was to hand out free information to individual traders. The latter was a means to the primary end.

It is no answer to say that if trading on inside information were permitted, the public would realize the risk of trading against persons who have nonpublic inside information. Nor is it an answer to argue that the public would treat this as one more uncertainty involved in pricing securities, and would adjust their trading prices accordingly. Admittedly, anyone trading in securities must deal with enormous uncertainties such as the future of national and international business, the future course of a particular industry and company, and future interest rates. However, the uncertainty coming from trading against inside information is of a different kind, since it relates to the fairness of the game.

Informed persons may be willing to gamble in professional casinos even if they know that the odds are rigged to provide a percentage for the house, but they will act differently if they know or suspect that the house is marking the cards or controlling the roulette wheel by a secret pedal. Protection of the markets against unfairness is ultimately the justification for the regulation of insider trading,[16] and

[16]It does not rebut persons who have a perception that the public sense of fairness enters into the equation, to disparage their thinking as "obvious non sequitur" or "illogical" (Manne 1967, pp. 14–15). In enacting the Insider Trading Sanctions Act of 1984 Congress cheerfully and almost unanimously joined the SEC in fulminating against trading which was deemed to make the markets unfair, and imposed a triple damage penalty for wrongs to be defined by subsequent litigation. The lower courts have in general accepted the SEC's broad view of this unfairness. Even the Supreme Court was equally strong in the *Dirks* case about the importance of preserving fair markets.

this concern outweighs the slight adverse effect it may have on the efficiency of the securities markets.

Manne is also wrong in complaining about the fact that the SEC and the Department of Justice, rather than regular criminal prosecutors, handle cases like *Chiarella* and the current *Winans-Brant-Clark* group of cases, which he looks at as ordinary cases of theft of information (Manne 1985). Again, he misses the point: These thefts are of national importance only because they jeopardize the public perception of the *fairness* of securities markets in tender offer cases.

Third, the narrow reasoning found in Manne's thesis fails to recognize that permitting trading on inside information would not work even under carefully controlled corporate authorization, and after the corporation had first made clear through its SEC filings and its periodic stockholder reports that it sanctioned insider trading. Such a program could not be practical. It would require the corporation to announce rules for insider trading and forbid such trading unless it had been authorized for specified persons as to specified nonpublic information and with a limited range of permitted profits. Moreover, the corporation would have to police the program as to amounts and timing in order to produce fairness among the licensees, thus necessitating a private gestapo that would be at least the equal of any SEC intrusion into a person's private affairs.

How could the corporation decide how much trading each individual would be permitted to do without making conjectures as to how much compensation an individual could thereby obtain? In order to avoid recapture of profits under Section 16(b) of the Securities Exchange Act, some individuals might have to hold the stock for at least six months after purchase, and any estimates of their profits would depend on guesses of the market level after expiration of that time and the complex matching rules of Section 16(b). How could the corporation tell whether an individual was abiding by the volume and timing restrictions, or had tipped off others who might be trading and might have more buying power than the individual in question? Would the corporation dictate the timings so as to control properly the influence of early insider trading on the market price at which subsequent insider activity by others authorized to trade would take place? Would the corporation supply a chairman for a manipulative pool of the licensees controlling the timing of their placement of orders to buy and sell? I cannot imagine that any corporation that valued its relationship with its employees—or stockholders—would undertake to control such a program.

Finally, there is a fourth fault in Manne's thesis, characteristic of conservative economics, which is why I have entitled this comment

in part, "and Other Failures of Conservative Economics." For good or evil, we are not at the world's economic dawn. We are dealing with an existing regulatory environment, which includes the federal securities regulation and, more particularly, its requirements of disclosure of corporate compensation in proxy statements and annual reports. If the entrepreneurs or managers permitted to trade were officers or directors, the corporation would have to know the amount of profit involved, for it would have to be disclosed in a total figure for all officers and directors under the SEC's remuneration disclosure rules. What corporation would want to ride herd to accumulate this information, to enable it to make this disclosure of compensation from insider trading profits based on information withheld from present and prospective stockholders and from the market?

Conclusion

Conservative economists ought not to spin out in a vacuum the anticipated effects of deregulation of a single set of regulations. They should make explicit assumptions as to whether the supposed changes would occur in a continued regulatory atmosphere which might impact the success of their forecasts, as does the general set of required securities disclosures in the situation above; or whether all relevant regulatory restraints would be simultaneously removed and their proposals would unfold in a state of nature. If they make the latter assumption, the question of its realism has to be considered in the light of the small amount of deregulation attempted by the most conservative administration in 50 years, its even lower level of success in deregulation, and the fact that its life has just been extended for another four years.

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