Insider Trading:

Revisiting Manne’s Lack of Harmed Party and Entrepreneurial Compensation Claims

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**Introduction**

Insider trading is generally accepted as a white collar crime, an abuse of the general public by the rich, privileged, corporate types of Wall Street. However, the exact nature of the abuse is not clear. The question of who is harmed by insider trading is not easily answered, and the reasoning used to apply the law is often convoluted. Although the main driving force behind insider trading regulation seems to be a concern for information asymmetries and a need for “parity of information,” this rationale has not found support in court decisions and common law principles. This development forced regulators and courts to propose and approve rationales that require mental gymnastics to be grounded in the statute and common law. Henry G. Manne was the first to point out the problems with regulation, and this paper will revisit and affirm two of his primary arguments in favor of relaxing the law in this area: insider trading does not clearly harm anybody and may in fact provide an efficient and useful compensation scheme to certain corporations.

**Background**

General insider trading is not expressly forbidden in any legal statute. Most insider trading is prosecuted under is Rule 10b-5, an SEC regulation empowered by § 10(b) of the Securities Exchange Act of 1934 (Bainbridge, “Insider Trading” 1). Rule 10b-5 specifically targets manipulative or deceptive practices leading to securities fraud. However, there is no straightforward argument detailing how any person with inside information who does not manipulate or deceive the market, but merely keeps silent, commits securities fraud. Because of this hole in the application of Rule 10b-5 to insider trading, courts have upheld and struck down various lines of arguments, making the development of insider trading law similar to common law, as much of it is judge-made. Specifically, the two actionable harms are the breach of fiduciary responsibility by a corporate insider to the shareholders he is supposed to be acting in the interest of, and the misappropriation of inside information by outsiders who deceive the source of the information. However, the application of these rationales leaves significant holes while breaking with traditional interpretations of fiduciary responsibilities.

Nobody questioned the illegality of insider trading until Manne, with the publication of his book, *Insider Trading and the Stock Market*, in 1966. Manne argued three main points in favor of allowing insider trading: it promotes market efficiency, nobody is actually harmed, and it provides an efficient method of compensation for entrepreneurial activity within the firm (Manne 2: 88-168). Manne’s bold statements initiated a backlash by supporters of the law, but it also rejuvenated the scholarship of corporate law and legal theory (Bainbridge, Introduction vii-viii). All of Manne’s supporting arguments have been dissected and challenged, but out of the three primary points, the most accepted is the improved efficiency of the markets. Although challenged on the *extent* that insider trading actually improves efficiency, critics do not usually focus their attention to this point. However, his other two arguments are often challenged. If Manne is right that insider trading is a victimless crime, there is no good rationale for regulation and sacrificing efficiency. Furthermore, if Manne is right that insider trading can encourage entrepreneurial activity, regulation goes beyond just hindering market efficiency to actually harming firms. For these reasons, Manne’s second two positions bear closer examination in light of developments since they were first proposed.

Insider trading law has evolved since its origin. The first interpretation by the SEC in 1961, the “disclose or abstain” rule, required anybody with material nonpublic information to either disclose it before trading or abstain from trading; if company directors could not disclose without breaking other responsibilities, then no trading could occur (Bainbridge, “Insider Trading” 2). This was applied to *SEC v. Texas Gulf Sulphur Co.* (1968). However, the U.S. Supreme Court narrowed the limits of these responsibilities in *Chiarella v. United States* (1980), and *Dirks v. SEC* (1983) to those with a fiduciary duty to disclose (Bainbridge, “Insider Trading” 2; Langevoort 12-18). The fiduciary duty can be extended to outside parties and tippees, but the breach of fiduciary duty is still necessary to the prosecution. The misappropriation theory was then developed by the SEC to extend liability to those who did not have fiduciary duties to the shareholders on the other end of a trade, but did have duties to the source of the information. The U.S. Supreme Court upheld this theory in *U.S. v. O’Hagan* (1997) (Bainbridge, “Insider Trading” 4). Then, in 2000, the SEC enacted Regulation FD (for “fair disclosure”), requiring corporations to release material information simultaneously to all the public through a press release (Bainbridge, “An Overview of Insider Trading Law and Policy” 9). Thus, insider trading law, loosely based in statutory and common law, has changed significantly throughout the years.

The legality of insider trading is not an ivory tower debate without real world consequences. The law is rather ill-defined and murky, yet the consequences of breaking the law are serious. Just ask Martha Stewart, who served time in prison for an insider trading investigation and associated convictions, or more recently, Mark Cuban, who had to spend a small fortune defending himself against insider trading charges (“Martha Stewart Convicted”; Pruet). If no compelling argument exists pointing to the harm caused by insider trading, then people who have done no wrong are at risk of being convicted and having their reputations sullied. Furthermore, if compelling arguments point to societal benefits arising out of insider trading activity, then regulating insider trading has damaging consequences. In fact, the whole development of insider trading law may be a misguided attempt at legislating areas where the majority of common law tradition did not, and where no law is indeed necessary today.

**Main Arguments**

Trading on inside information does not explicitly harm anybody. Because of the impersonal and anonymous nature of securities markets, ascertaining who is on the other end of a trade involving inside information is impossible. The classic example is that of Trader A, who knows that a specific company will soon publish news of a development that increases the value of that company. Trader A buys stock from Trader B at the current price, before the price rises on the news of the development. However, Trader A does not know Trader B, and vice versa. Trader A did not deceive Trader B, but merely kept silent, and Trader B willingly, free of fraud or coercion, chose to sell the stock of the company (McGee and Block 6). The parity of information view expressed in the “disclose or abstain” view rests on the idea of silence as fraud. Yet, as McGee and Block point out, under no legal tradition is knowledge of an impending change in price and refusal to share this with the other party a fraudulent action (5-7). The harm imposed on the seller, Trader B in the example, is simply a missed chance at capital gains from stock price appreciation, and cannot be legally pinned on Trader A. This case is no different than anybody in any other speculative endeavor that misjudges the future price of a good and is not a basis for regulation.

While in the above example, no harmful activity occurred, the situation changes slightly if Trader A is a director or manager of the company in question. In this case, because of the separation of ownership and management in corporations, the director is entrusted with the management of the company by the owners, the stockholders. In this situation, the argument goes, Trader A has a fiduciary duty to Trader B to manage the company in Trader B’s best interests, a duty that is breached when Trader A buys stock from Trader B on the basis of information gained through entrusted duty of managing the firm. The alleged fraud occurs through silence only because the insider has a duty to speak up. This is the fiduciary restriction that the U.S. Supreme Court imposed in the *Chiarella* and *Dirks* cases. Therefore, a trader with inside information but no fiduciary duty to the stockholder does not violate any rights of the stockholder on the other side of the trade, even if the stockholder turns out to be worse off when the inside information is made public (Langevoort 18-24). The harm proposed by the fiduciary duty does not turn on the fact that the seller in the example is worse off, but that the seller was made so by somebody in whom they had entrusted the management of their assets and was obligated to disclose the information.

Curiously enough, when the U.S. Supreme Court upheld the breach of fiduciary responsibility line of reasoning as a limit on SEC regulation, the common law referred to was actually the minority of common law in the United States, with only three states adopting it (Manne 2: 27-30). Common law in the majority of the states held that directors have a fiduciary responsibility to the corporation, but not to the shareholders themselves (Nagy 9). Furthermore, in the minority of states where the directors had a fiduciary responsibility to the shareholders, failure to disclose was only considered fraudulent in a face-to-face transaction where the outsider could prove reliance on the insider’s silence in the transaction, and only when the outsider had a pre-existing fiduciary relationship with the insider (Nagy 9). Clearly this doctrine would not apply to transactions on anonymous exchanges. The *Chiarella* decision not only used the minority common law doctrine instead of the majority doctrine, but it also failed to apply the doctrine faithfully. Therefore, although the U.S. Supreme Court restricted the abilities of the SEC to regulate insider trading, they actually did not restrict it as much as the common law they based their reasoning on would seem to have required. Hence, it is still not clear that the insider actually commits fraud by silence in an anonymous transaction.

This interpretation and application of minority common law and fiduciary duties has other complications. First, as Nagy points out, even the minority jurisdictions did not extend the fiduciary duties to all employees of the company or to temporary outsiders; it was only the officers and directors that owed a duty to the shareholders (9). However, employees and temporary insiders are considered to have fiduciary duties by extension today. McGee and Block elaborate that fiduciary responsibilities “do not exist in a vacuum,” but only apply “to those who have voluntarily taken them upon themselves” (30). Additionally, the misappropriation theory does not have a coherent basis under the fiduciary line of reasoning originally held up by the courts. Under the misappropriation theory, it is a fiduciary duty to the source of the information that is breached, not a fiduciary duty to the party on the other side of the trade. It is then quite a stretch to consider this transaction a fraudulent breach of an obligation to disclose where no such obligation existed, and many have commented on the incoherency of the law under these rationales (Prakash 1491-1550; Nagy 23). While not explicitly stated as such, it seems that behind this assortment of complementary but not entirely consistent rationales, the parity of information view is still the dominant understanding of the law (Nagy 12-16). What remains is a situation where the driving theory is one that was struck down by the U.S. Supreme Court but reintroduced by workaround regulations, supposedly an extension of traditional legal concepts, but actually inconsistent with them.

The outsiders are not the only parties that are supposedly harmed by insider trading; some have argued that the company itself is harmed. Schotland outlines several different potential harms to the company due to insider trading: profits can be made by trading on negative news as well as positive, and thus there is an incentive to harm the company; there is an incentive to “create” information and manipulate markets; profits can be made by those who had no hand in creating the good news; focus on looking for insider trading opportunities could distract from day to day operations (1449-1454). Manne anticipate these objections, but Schotland was not satisfied with his answers.

Nevertheless, these objections still fail to support the claim that companies are harmed by insider trading in a manner that requires Federal regulation. The first and fourth objections are still more properly a matter for corporate oversight, as the managers responsible for bad news or who overlook their responsibilities can be fired. The second objection is legitimate, but at its core it is not an objection to insider trading but general securities fraud, which is directly addressed by § 10(b) of the Securities Exchange Act of 1934, requiring no confusing stretches of the imagination to be applied faithfully. The third objection is by itself not enough to require Federal oversight but is also more rightfully a matter of corporate oversight; if the firm wants to set forth restrictions on insider trading, it can tailor them to fit its objections. Ultimately, all of those who would abuse insider trading are liable to other forms of oversight: the employees and managers can be fired by their superiors, directors who drive down share prices are subject to replacement through takeover bids, and market manipulators engaging in fraud are still subject to federal oversight, but not essentially due to insider trading.

As demonstrated previously, the misappropriation theory does not prove harm according to the fiduciary responsibility theory, as it applies to those without fiduciary duties. Furthermore, the harms that are addressed by the misappropriation theory are best covered by other types of law. The misappropriation theory is based on deception of the source, where the misappropriator acquires inside information from a source and trades on it without informing the source of the intent to do so. However, if the source anticipates harm from the misappropriator’s use of inside information, a contract could be entered into which stipulates non-use of the information, and the matter becomes one of contract law. Similarly, if the source is afraid the misappropriator will disseminate the information for personal gain, a confidentiality contract could provide a matter of legal recourse for the deceived source.

If the source is the employer of the misappropriator, as was the case in both the *Winans* and *O’Hagan* cases, the employment contract itself could stipulate the confidentiality and trading requirements regarding information that the employee could potentially use. Ironically, even though the misappropriation theory is based on the deception of the source, this argument is only available to the government in prosecuting insider trading (O’Hara and Blakely 108-109). So even though the source is the harmed party under the misappropriation theory, they do not have access to private legal recourse themselves.

Indeed, the theory behind the misappropriation theory, while ostensibly driven by fraud and deception of the source of the information, still seems to be primarily a matter of information asymmetry. If a misappropriator signs a confidentiality agreement but not a non-trade agreement, and without telling anybody trades on that information, there is no traceable harm. The source is not harmed, as no agreement was made regarding the use of the information, as long as it was kept confidential. The stockholder on the other side of the trade was not harmed: no fraud was committed as the misappropriator had no fiduciary duty to disclose. The fact that this misappropriator is still liable under the law hints at the issue at stake: the fact that there was an information asymmetry, the parity of information line of reasoning inconsistent with traditional legal principles and already struck down by the U.S. Supreme Court in *Chiarella* and *Dirks*.

In addition to arguing that insider trading was a “victimless crime,” Manne also proposed that insider trading could be an effective and efficient way to compensate entrepreneurial activity within a firm. In essence, a firm’s manager that oversees a development that increases the firm’s value could be compensated by trading on that information before it is generally disclosed. Manne points to the various ways in which firms already add variable forms of compensation in addition to fixed salaries to encourage managers to seek to improve the firm’s value. Stock options are quite common and rely on changes in stock price to provide feedback on the firm’s behavior, benefitting managers when the stock price goes up. However, stock options are not a perfect solution, as the benefits are still limited to the number of options, and many conditions and restrictions govern their use (Manne 2: 146-148). They are also costly to the company and not generally mobile or liquid.

However, with inside trading, certain benefits of stock options and other compensation schemes are realized naturally. An insider who is involved from the beginning on projects that will increase the firm’s value will have an opportunity to buy stock in anticipation of a price increase. Many have pointed out that the benefits are not limited to those responsible, and as the information travels within the firm, others will also act on it (Moore 179; Schotland 1454). However, that objection is true to a greater extent with stock options, an already excepted form of compensation, where the managers do not even need to be abreast of the inside information to benefit. Carlton and Fischel have added the support for insider trading as compensation on the grounds that renegotiating contracts for managers is a costly process, but insider trading allows managers to essentially renegotiate their compensation to fit their anticipated contribution without the need for a renegotiated contract (870-872). They also propose that insider trading helps upper-management analyze their managers on the basis of risk-taking tendencies and entrepreneurial ability.

Manne points out that insider trading would need to be disclosed, just like any other form of executive compensation. However, disclosure of the company’s specific insider trading policy before the fact, and disclosure of the gains realized from the actual trades after the fact would be sufficient for all parties to recognize the rules of the game, as well as the actual level of executive compensation (349). Smaller firms, especially, that do not have funds available for generous compensation, could embrace insider trading as compensation for the entrepreneurial activity of their managers. Furthermore, for those companies that think insider trading would be harmful to their ends, their company policy and employment contracts could reflect that, and such breaches of contract could be legally addressed without recourse to a general ban on insider trading.

**Rebuttals of Opposition**

When boiled down to its essence, the motivating force behind insider trading law and regulation is not a strictly legal concern for breaking fiduciary responsibilities or stealing information, but the fact that some people are able to access important information that others are not. The original statute said nothing specifically about insider trading, and while there are traditional legal precedents for the fiduciary responsibility, their application to insider trading goes well beyond the common law principles themselves. The extension of insider trading liability to misappropriators also stretches well beyond what can be determined by statute or common law. The theme behind all of these stretches and extensions is an attempt to break down “unfair” information asymmetries.

As McGee and Block theorize, this concern over equal access to information may stem from the neo-classical economic model of “perfect competition,” where one starting assumption is that everyone has full and perfect information (25-26). While such a model may have uses in an academic setting, it is an unrealistic expectation to impose on real world markets, and certainly not one that regulation should seek to achieve. Another potential reason for the concern could stem from the “efficient market hypothesis,” which states that the market incorporates all known information at any time. However, this hypothesis requires actors to be able to use their information to trade, and as long corporations are allowed to keep some things secret, insider trading will only enhance market efficiency. If anything, the efficient market hypothesis should warn the small investors that far more information than they have access to is being factored into the price at any given moment. Finally, McGee and Block also theorize that this concern for information asymmetries stems simply from an egalitarian, wealth-equalizing impulse of certain intellectuals. This theory would find support in the quote of a juror in Martha Stewart’s case after her conviction: "Maybe it's a victory for the little guys who lose money in the market because of these kinds of transactions" (“Martha Stewart Convicted”).

Nevertheless, regardless of where this concern for information parity stems from, it has already been explicitly denied by the U.S. Supreme Court as a proper basis for regulating insider trading. Information is not free, and gathering information is costly, a fact recognized but not properly assessed by the parity of information school of thought. Instead of creating parity by preventing anybody from using material, nonpublic information, small investors that are concerned about information asymmetry and are supposedly helped by regulation should instead be willing to pay a fee for access to helpful information, inside or not. Market analysts and financial journalists play an important role in disseminating information to investors, and investors have the option to subscribe to various sources to help make up for the disadvantage they have. Prosecutors and courts should consider it their realm to enforce private contracts and agreements and to prosecute fraudulent behavior. Most, if not all, of the dangers of insider trading could be addressed through private, corporate oversight and proper enforcements of contracts.

Of all of Manne’s original arguments in favor of legalizing insider trading, the compensation argument has perhaps been the most aggressively challenged. Furthermore, Bainbridge sees this as the claim which Manne’s argument mainly rested on, although the force of the other claims are still significant (“Insider Trading” 7). In immediate response to Manne, Schotland pointed out that it is impossible to isolate the entrepreneurial component of any individual’s contribution or prevent leakage of information to those with no apparent involvement (1454). Still, Manne has a valid argument that in light of the difficulties outlined by Schotland, the matter could still be resolved by the firm setting its own policy. Critics have pointed out that the returns a manager can earn through insider trading are limited by the manager’s wealth (Bainbridge, “Insider Trading” 9). On the other hand, other critics comment that if outside financing is possible, the manager’s wealth no longer restricts returns (Dent 247). Although meant to show that the harm of insider trading can be magnified, it also contradicts the limits stemming from wealth.

Empirical studies can shed light on the matter, but unfortunately are not definitive one way or the other. Empirical evidence from Givoly and Palmon in 1985 found that insiders did indeed earn abnormal returns, but that these returns lasted well beyond the period following the disclosure of inside information. This, incidentally, works against the compensation argument in terms of encouraging entrepreneurial behavior, but also works against the argument regulating insider trading at all, as the returns were not due to specific inside information, but more general superior assessment of the firm (85-86). On the contrary, Roulstone found that companies that allowed insider trading paid less in executive compensation than those that restricted insider trading (525-549). This finding would suggest that insider trading is indeed an effective form of compensation.

Ultimately, many economists and legal theorists have proposed models and carried out empirical studies, but no general consensus has been reached. However, as there seem to be firms that could benefit from allowing insider trading, this issue could be left to individual companies to decide for themselves, as long as insider trading is properly disclosed as compensation, and associated fraud is still prosecuted.

**Conclusion**

Although many changes in the insider trading law and the theories backing them have developed since he first wrote, Manne’s arguments still hold up quite well. This paper did not address the argument of improved market efficiency, but it examined the lack of a harmed party in insider trading interactions and addressed the muddled and confused legal rationale used to justify regulation. The current law, as developed by the SEC and by judges in court decisions, extends well beyond the fiduciary responsibilities present in common law. The implicit theme in the collection of regulation is that of correcting information asymmetries, despite the *Chiarella* case which struck down the parity of information rationale. Additionally, this paper moved beyond the lack of harm to the potential benefit from allowing insider trading. Assuming the general lifting of insider trading regulations, firms could incorporate insider trading into their executive compensation plans to encourage entrepreneurial behavior and provide managers opportunities to change their compensation without the need for a costly renegotiation.

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