

BOOK REVIEW

INSIDER TRADING AND THE STOCKMARKET. By *Henry G. Manne*.†
New York: The Free Press, 1966. Pp. xiii, 274. \$6.95.

Professor Manne's work is bold; the rules against insider trading are questioned. Whatever may be the position of the Securities and Exchange Commission regarding Section 16(b) of the Securities Exchange Act of 1934¹ or rule 10b-5 under that act,² the common law provided no foundation for any blanket prohibition of insider trading. Indeed, the author argues—morality aside—neither precedent nor reason support what has become the majority view and the clear policy of the SEC.

Not without basis Professor Manne reasons that insider trading has a stabilizing effect on the market.³ In this regard, Dr. Irwin Friend, who is more than familiar with the economic impact of securities regulation, said late in 1964:

[A] legitimate criticism of the SEC might be that it has not devoted sufficient attention to the basic studies which would be required to determine satisfactorily whether specific types of speculative activity do or do not tend to stabilize prices by minimizing transaction costs to the public and, more important, by anticipating short-term, intermediate and long-run changes in

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¹ 48 Stat. 896, as amended, 15 U.S.C. § 78p(b) (1964).

² 17 C.F.R. § 240.10b-5 (1964).

³ This conclusion is drawn from Professor Manne's demonstration, admittedly in the abstract, that changes in the price of a share of stock at the market will occur more rapidly when insider trading is prohibited than when it is permitted. Manne reasons as follows: An item of inside information has value, and the change in the stable price of a share of stock due to disclosure of the information may be computed by dividing the dollar value of the information by the number of shares of stock outstanding; disclosure of the information will ultimately result in a shift in the market price of the stock from the price reflecting its value without the information to the price which reflects its value in light of the information; if absolutely no trading in the market is permitted until the information is completely public and completely understood, the price rise (or fall) will occur in literally no time once trading is resumed; if insiders alone must suspend trading until disclosure is complete or until the price change is complete, those outsiders who have the capability of quickly gathering, evaluating, and acting upon valuable information will enter the market and cause a rapid (though not immediate) price change; but if insiders are free to exploit on the market or otherwise the information they have, the price change will occur more slowly, since an initially small but increasing number of people will receive the information and begin acting upon it over a longer period of time. See MANNE, *INSIDER TRADING AND THE STOCKMARKET* 77-91 (1966).

equilibrium price. For example, studies which I have seen suggest that trading by corporate insiders may be stabilizing, which from an economic viewpoint would raise questions about Section 16 (b) of the Securities Exchange Act. I am aware, of course, that Section 16 (b) might still be considered justified on equity grounds, but I would like to see the SEC carry on the types of studies which would indicate more clearly than we now know the price tag attached to specific pieces of securities regulation.⁴

Insider trading, so we are told, not only brings stability, it works to the benefit of outside shareholders. The long-term investors—those who hold their stock—will share in the price rise that good news will bring, and their holdings will be worth a greater amount in the market. Those who sell their stock will also profit, since it is a rise above the stable market price which induces them to sell; they simply will not gain as much as those who hold.⁵

There is some merit in the logic. The kind of trading with which Professor Manne is concerned relates to the exploitation of inside information—that is, “knowledge of specific events or of the probability of future events that will ultimately cause a change in share prices.”⁶ Such information has a value which by definition

⁴ Friend, *The Economic Impact of Securities Regulation*, in DUKE UNIVERSITY SCHOOL OF LAW CONFERENCE ON SECURITIES REGULATION 119, 130 (Mundheim ed. 1965). Dr. Friend, Professor of Economics and Finance, Wharton School of Finance and Commerce, prefaced his remarks by stating: “Thus, a good case might be made in many situations on grounds of equity for giving public orders priority over those placed on the trading floor by exchange members, or for limiting corporations, officers, directors and principal stockholders in their use of insider information for private gains even if there was a resulting loss in allocational efficiency. However, we would still want to look at the economic cost of such action and weigh it against the equity gain.” *Id.* at 129-30.

⁵ This is perhaps an over-simplification of Manne’s conclusion, since the outsider who sells at a price which reflects something less than the full value of the information may suffer a constructive, if not actual, loss. Professor Manne recognizes this. “[T]here is both a plus and a minus for outside sellers from inside trading. The plus is the higher price received by those who would otherwise have sold at the stable, lower price, and the minus is the number of sales that now occur but which otherwise would not have occurred. . . . Those sellers who lose will tend to be those whose trades are a function of price, and those who gain will tend to be those whose trades are a function of time only. . . .”

“If we limit our concern to the long-term investor rather than the short-swing share trader, there is little likelihood for injury from insider trading. The long-term investor is much less likely than the trader to sell because of price changes effected by insiders. He is more likely to become a seller because of changed financial circumstances or death. A strong argument can be made for limiting our concern to this group of shareholders, but . . . the effects will be small in any event.” MANNE, *op. cit.* *supra* note 3, at 102.

⁶ *Id.* at 54. To Professor Manne this kind of unpredictable information is to be

will be reflected on the market. Share prices for all stockholders will rise in direct proportion to the value of the information.⁷

The lawyer must have difficulty in directing his attention to share prices generally without at the same time viewing the effect on shareholders individually. For every share purchased there must be a share sold. Insiders buy in essence at a discounted price; none but they know the true worth of the stock. Selling outsiders may profit, but surely not as much as will the buying insider. This is a matter of great moment in measuring fairness but is of slight concern to the economist, and Professor Manne, it must be emphasized, has attempted a theoretical economic analysis.⁸

Concluding that insider trading causes no harm, Professor Manne moves to his central proposition: Insider trading is the only way properly to compensate the entrepreneur who performs the function of innovation so necessary to the survival and growth of a free enter-

distinguished from that which is known and perhaps provides the basis for enlightened action, such as a "knowledge of the manner in which specific events that may occur in the world affect the stock market." *Id.* at 49.

⁷The author did not forget the possibility of trading in bad news. He concludes that: (a) for rather obvious reasons the entrepreneur will strive to create good news rather than bad; (b) bad news is less significant as a subject of insider trading, since it occurs less frequently, develops more slowly and often affects a whole industry rather than a single corporation; (c) even if the inside information is bad, the entrepreneur ought to be allowed to trade in it. "There will be no important loss to shareholders if insiders do trade on this news, and it will be possible, in an inexpensive way, to give entrepreneurs within the corporation a greater opportunity for gain. Because the cost to the corporation for this form of compensation is so low, competition among corporations for entrepreneurs would quickly force all of them to allow their insider-entrepreneurs to trade in bad news as well as good. And the corporate form of business organization, with publicly traded shares, would enjoy a competitive advantage in securing entrepreneurial services over noncorporate forms, where profits from bad news are impossible." *Id.* at 155-56.

⁸The distinction was well defined in a recent review of Professor Manne's work. Painter, Book Review, 35 GEO. WASH. L. REV. 146, 152-55. (1966). Professor Manne leaves no doubt concerning his analysis as an economist. At the outset he stated: "Economists think with a different tradition behind them. Theirs is perhaps the most scientific of the social sciences. Here the word *scientific* must connote objectivity and moral detachment, as well as systematic verification of results. Economists tend to view any controversy as reflecting a platonic, ideal conflict. The question for an economist is rarely one of the mutual fairness of a transaction between individual parties. He is not a specialist in matters of individual morality. *Fairness* ordinarily connotes to economists the propriety of allocation of resources or income among large, distinguishable bodies or groups of individuals. To the economist individuals are a fungible commodity, each substitutable for another. The economist, viewing the issue of insider trading, will ask how all shareholders are affected financially by the practice, whether it results in a desirable allocation of resources, and whether the return to insiders reflects a competitive or a monopoly gain." MANNE, *op. cit. supra* note 3, at 3.

prise economy.⁹ Manne supports his position in the following manner:

Insider trading meets all the conditions for appropriately compensating entrepreneurs. It readily allows corporate entrepreneurs to market their innovations. . . . [T]his is not a direct marketing of the idea but rather a "sale" of information about an innovation. Thus, although we do not allow entrepreneurs a direct proprietary interest in their ideas, we can allow recovery for their ideas by permitting them to exploit information about the existence of the ideas in a market primarily based on information.¹⁰

Judged solely on economic terms, substantial problems are presented. Perhaps the most readily apparent difficulty arises from the fact that innovation, like invention, is usually not of immediate value. Rather, the technocrats and managers must make those corporate administrative decisions and take those corporate steps which will give the innovation value. A drug discovery, by way of example, can hardly cause a real stock appreciation until the necessary long-term clinical testing has been completed, and no corporate advantage is gained until the discovery can be marketed. To allow the entrepreneur to exploit information of uncertain value is to permit a form of stock manipulation.¹¹

Grant that the innovator ought to be compensated. Why should insider dealing, so fraught with danger—not the least of which is insuring that only the innovator will have access to it—be the exclusive means for compensating the corporate creator? One by one Professor Manne views and discards existing forms of compensation, including salaries, profit-sharing plans, and stock options. None, he concludes, save insider trading will permit the innovator full value for his contribution. His reward is in direct proportion to what he has given. Who is to know when the innovator will again create? All other forms of compensation are not geared to the uncertainty that characterizes the entrepreneur; they are merely forms of investment.¹²

⁹ "[T]he argument . . . is that a rule allowing insiders to trade freely may be fundamental to the survival of our corporate system. People pressing for the rule barring insider trading may inadvertently be tampering with one of the wellsprings of American prosperity." *Id.* at 110.

¹⁰ *Id.* at 138.

¹¹ *Cf.* Weston, Book Review, 35 GEO. WASH. L. REV. 140, 144 (1966).

¹² MANNE, *op. cit. supra* note 3, at 134-38.

The analysis is neat but difficult to accept. Are we to believe that the entrepreneur will be motivated to offer the benefit of his genius only on the basis of inside trading? The emoluments of office of the corporations listed on the New York Stock Exchange¹³ are not to be taken lightly; nor are they to be viewed purely in terms of dollar compensation.¹⁴ Further, can we rule out as inconsequential the incentive to create merely to improve a corporation? Are we cynically to dismiss what a former chief executive of Standard Oil of New Jersey said of personal pride and stewardship?¹⁵

We have a stewardship in a company like Jersey Standard and a personal pride. We would like to leave the company in a sounder and more assured position than when we took it over. We are not looking to the company just to support us; we want to make it healthy for future generations and for the employees who will come along. We like to feel that it is a good place for people to work. We have equal responsibilities to other groups: stockholders, customers and the public generally, including government. What is the proper balance for the claims of these different sections? What part of the profits should go to the stockholders? What part to employees' wages? What part to the customer in lower prices and improved quality? Keeping the proper balance in these things is one of the most important matters that corporate management has to consider. We hope that we learn more about them (and each generation of management that comes in has to learn them); we are making some progress toward responsible direction.

Thought has gone into Professor Manne's book. It is clear that he has weighed carefully each of his recommendations. While he questions the economic harm of insider trading generally, he not only recognizes but encourages selective regulation. Indeed, he makes a splendid argument for even tighter controls over government officials who could profit, for example, from their inside knowledge of an agency contract award.¹⁶ Disagreement with the

¹³ Professor Manne believes that the value of insider trading will be enhanced in the smaller corporation as contrasted, perhaps, to the "blue chip" favorite fifty traded on the New York Stock Exchange. *Id.* at 156. However, there is no question that he is dealing in no small measure with those companies registered on the Big Board.

¹⁴ There is prestige that comes from office which is more than mere title. Consider the corporate tax-free foundation which the corporate officer might control and the moneys that he could direct to charities of his own choosing. See Baum & Stiles, *Power Pools: Private Foundations and Public Corporations*, 13 U.C.L.A.L. REV. 938 (1966).

¹⁵ Quoted in MAURER, *GREAT ENTERPRISES—GROWTH AND BEHAVIOR OF THE BIG CORPORATION 75-76* (1955).

¹⁶ MANNE, *op. cit. supra* note 3, at 171-89.

author, let it be said in conclusion, should not detract from his basic contribution: His work compels a re-examination of section 16 (b) and rule 10b-5. The result might well be not a loosening but a more severe system of regulation which will bear express congressional approval.¹⁷

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¹⁷The recent report of the Securities and Exchange Commission on investment companies is a case in point. Recognizing that it has general power to formulate insider-trading rules in the investment company industry, the Commission nevertheless has asked the Congress for specific authorization to do so. Securities and Exchange Commission, *Report on the Public Policy Implications of Investment Company Growth*, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 200 (1966). For a more detailed discussion of the agency's findings, see *id.* at 195-99.

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