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Manne: Insider Trading and the Stock Market

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INSIDER TRADING AND THE STOCK MARKET. By *Henry G. Manne*. New York: Free Press. 1966. Pp. xiii, 274. $6.95.

"Socrates is an evil-doer, and a curious person, who searches into things under the earth and in heaven, and he makes the worse appear the better cause; and he teaches the aforesaid doctrines to others."[1] This indictment should have been a warning to Professor Manne about what happens to a person who questions the fundamental beliefs of his community. He is fortunate that the Securities and Exchange Commission (SEC) does not have hemlock among what it likes to refer to as its "arsenal of weapons."

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1. 3 WORKS OF PLATO 103 (B. Jowett transl. 1937).

In this book, which has become something of a *cause célèbre*, Professor Manne asks: "What is wrong with insider trading on the basis of secret information not generally available to the public?" And he answers: "Nothing." In fact, he goes somewhat further and concludes that insider trading is probably beneficial to the economy and to the stockholders of the corporation whose shares are involved. This serious effort to understand and evaluate the policy choices inherent in any rule regulating insider trading should not, and I believe cannot, be brushed aside by mere silence or indignation.

Ignoring the charts and other economic paraphernalia, which I suspect impede the communication of ideas, Professor Manne's argument begins by testing the effects of insider trading under two alternative assumptions: first, that insiders *do not* trade during the interval between the development of material information affecting the value of a corporation's shares and public announcement of that information; and second, that they *do* trade. Under the first assumption, the price will remain relatively stable during this interval (assuming other factors are equal) and will then rise very rapidly to a new level reflecting public evaluation of the new development. On the other hand, assuming that insiders and their tippees do trade during this period, the increase in demand will probably cause the price to rise gradually to the new level.[2]

Examining who might be injured under the latter assumption, Professor Manne finds that the long-term investor, who during this period is impelled to sell by factors extraneous to temporary minor fluctuations in the price level, will be better off if insiders trade than if they do not. Long-term investors will on the average sell at a higher profit if the price has increased gradually due to insider purchases than they would have if the price had remained stable at the old level. On the other hand, the short-term speculator who intends to sell after a slight increase in price is presumably interested in a short, quick ride. With insider trading, he will certainly get his money's worth. He cannot meaningfully be said to have any "right" to the additional profit represented by the undisclosed favorable news. In any event, it is literally impossible to determine which short-term speculators were induced to sell by the gradual price rise, and which would have sold even in the absence of a price rise due to insider trading.

The conclusion which Professor Manne draws is that it is impossible to demonstrate that the public or the shareholders as a group are "injured" by insider trading. I am not aware that he or anyone else has made any empirical study to prove his assertions—in fact, he complains that the SEC has not done so. I do not happen to share

2. The same analysis could, of course, be made regarding unfavorable news, with the price movement being in the opposite direction.

the current belief of some academic economists that assumptions become "facts" when they are illustrated by a graph or chart or stated in an algebraic formula. I regret that Professor Manne occasionally seems to adopt this attitude, probably because his mind has been slightly poisoned by reading too much economic literature. Nevertheless, it seems to me that on the basis of common sense and general experience Professor Manne has thus far made a reasonably plausible case.

Now, however, we come to the crucial point in Professor Manne's argument. Thus far he has assumed that there will be a considerable time lapse between the insiders' discovery of material information affecting the value of the corporation's securities and public announcement of that information. He now faces the obvious question: Why is not the alternative to insider trading immediate public announcement of such information, rather than delayed announcement with no insider trading? His answer is that in many cases immediate public announcement would be impractical or harmful to the corporation and its shareholders. To illustrate, he relies primarily on the *Texas Gulf Sulphur* case,[3] in which the corporation postponed announcement of its mineral strike in order to lease adjacent land.

However, he recognizes that a rule permitting insider trading may encourage the insiders, who also control the timing of disclosure of material information, to delay public announcement even when the interest of the corporation is not involved or beyond the time when the corporation would benefit from nondisclosure. Professor Manne here sets forth his most controversial conclusion: insiders *should* be permitted to delay disclosure in order to profit by insider trading. To Professor Manne, such trading is a desirable form of compensation to "entrepreneurs."

He draws an elaborate distinction between "entrepreneurs" and "managers" which I find impossible to follow. He seems to be saying that an "entrepreneur" is a brilliant manager, and a "manager" is a pedestrian entrepreneur. In any event, the distinction seems irrelevant or perhaps even destructive of his own argument; nowhere does he even attempt to demonstrate that more "entrepreneurs" than "managers" will have access to inside information, or that a significant fraction of the persons having access to such information are "entrepreneurs." I suppose that he would respond that even if mere "managers" account for most of the insider trading, that is not an objection to his theory since outsiders are not "harmed" by the practice anyway. As long as some entrepreneurial activity is rewarded by insider trading, the practice is beneficial to the economy since it presumably encourages invention and innovation.

The only effective way to criticize this elaborate theory is to ex-

3. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

amine the basic assumption upon which the entire superstructure rests. The author asserts at the very outset of the book that the stock market is a mechanism for the purchase and sale of "information." This is one of those propositions which is so preposterously silly that it could have been thought of only by a very learned man. The stock market is a mechanism for the purchase and sale of *securities*; its function is to reflect the freely competitive security prices determined by willing buyers and sellers who are fully informed of the material facts. This is of course an ideal, but a market which strives to attain this ideal is an essential condition if the investing public is to have confidence that securities can be disposed of at a fair price in a reasonably competitive market. And public confidence in the integrity of the market is a prerequisite to the raising of new equity capital for productive investment.

Professor Manne seems to conceive of the stock market as a gigantic floating crap game, or perhaps more accurately as a roulette wheel which may be legitimately fixed by the "entrepreneurs." There is no doubt that many persons, with both large and small amounts of money, enter the market with this attitude, although they frequently turn crybaby when they lose—or when they fail to win as much as they think they should have—and protest their "investment intent." The question is whether the market should be run to please these people, or whether their influence is a cancer in the market which should be eliminated to the extent possible.

The logic of Professor Manne's position seems to compel the conclusion that no disclosure by corporations should be required. If it is desirable to permit insiders to trade on the basis of information prior to the filing of the 8-K Report[4] ten days after the end of the month in which a material event occurs, would it not be even better to abolish the 8-K Report altogether and permit insiders to trade for seven, eight, or nine months on the basis of such information? If it is desirable to permit them to trade on the basis of information developed during the current year, would it not be even better to permit them to trade on the basis of information generated in prior years and also abolish the 10-K Report?[5]

We need not speculate about the results of such a system, for we have already experienced it in this country between 1925 and 1935. While one experiment may not constitute a demonstration, I doubt if very many people in the corporate or financial world would want to try it again. In summary, the basic objection to insider trading, in the words of former Chairman Cary of the SEC (which Professor Manne ridicules) is that it jeopardizes the "integrity of the stock market."

4. 17 C.F.R. § 249.308 (1968).
5. 17 C.F.R. § 249.310 (1968).

If this analysis is correct, then the basic purpose of a rule against insider trading is not to compensate or punish anyone or prevent unjust enrichment but to force prompt disclosure of important corporate developments *as soon as this is feasible.* No elaboration of periodic reporting can effectively accomplish this result. I do not by any means discount the difficulties of formulating a workable rule of this nature. I have been engaged over the past few months in trying to draft such a provision in connection with the new California Corporate Securities Law of 1968, and I would be the last to say that it is an easy task. Nor do I minimize the administrative and judicial problems of enforcement. However, if we can agree upon the objective of such a rule, I believe that its formulation will be feasible.

Professor's Manne's book performs a badly needed and highly valuable service in forcing consideration of basic policy questions. I happen to arrive at the opposite conclusion from his because I start with different assumptions. But, unless we are willing to formulate and defend our assumptions regarding basic policy objectives, the law will continue to flounder around in this area as it has in the recent past. For this reason, the book is a significant contribution and deserves the most serious consideration.

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