

# INSIDER TRADING: REVISITING MANNE'S LACK OF HARMED PARTY AND ENTREPRENEURIAL COMPENSATION RATIONALES

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*ABSTRACT: Insider trading is widely perceived as somehow harmful. However, the exact nature of that harm is often very hard to pin down, and in many cases no party is harmed when people who have inside information but no fiduciary duty to shareholders trade on material, nonpublic information. Due to the complicated problem of tracking harm, insider trading regulation and case law often rests on misapplied, convoluted, or inconsistent legal foundations, driven by a concern for information asymmetries among market participants. Furthermore, the harms that are generated by insider trading can be dealt with by private agreements, whether through corporate bylaws or contracts, including non-disclosure or non-use agreements. Finally, in some situations, it may be preferable to allow insider trading as a form of compensation for entrepreneurial activity, and insider trading may actually be socially beneficial.*

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## I. INTRODUCTION

Insider trading occurs when a person uses material, non-public information to make a profit in a securities transaction, usually through the purchase or sale of stocks or options. This practice 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 whether anyone is harmed by insider trading is in many cases not easily answered, and the reasoning used to apply the law is often convoluted. Although the 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 or common law principles. The judicial rejection of these rationales has 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 one of the first to point out the problems with regulation of insider trading, and this essay 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.<sup>1</sup>

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1 Although Frank P. Smith explored a similar thesis in *MANAGEMENT TRADING, STOCK-MARKET PRICES AND PROFITS* (Yale University Press 1941), it was Manne's work that brought the topic to the attention of legal academia, see HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (Free Press 1966). Manne was a pioneer in the Law and Economics movement, and he influenced legal practice both through his groundbreaking academic work and through his entrepreneurial approach to legal education. The Law and Economics Center he founded has been attended by federal judges and Supreme Court justices, and he served as Dean of the George Mason Law School from 1986 to 1997. Sadly, Henry G. Manne passed away recently on January 17, 2015. This author

## II. 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.<sup>2</sup> Rule 10b-5 specifically targets manipulative or deceptive practices leading to securities fraud.<sup>3</sup> There is no straightforward argument. However, it is detailed that any person with inside information who does not manipulate or deceive the market, but merely keeps silent, commits securities fraud. Due to 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 in whose interest he is supposed to be acting and the misappropriation of inside information by outsiders who

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will never forget the thrill he experienced after Manne sent him an encouraging email out of the blue after an earlier version of this essay was posted online for an undergraduate economics conference.

2 Stephen Bainbridge, *Insider Trading: An Overview*, SSRN 1 (2000). This essay will focus on Rule 10b-5, but insider trading around a tender offer is also subject to Rule 14e-3, the interpretation of which is less murky than that of Rule 10b-5.

3 Rule 10b-5 reads as follows: It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 C.F.R. §240.10b-5 (2015).

deceive the source of the information. However, the application of these rationales leaves significant holes while breaking with traditional interpretations of fiduciary responsibilities.

Few questioned the illegality of insider trading until Manne's book, *Insider Trading and the Stock Market*, was published 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.<sup>4</sup> Manne's bold statements ignited a backlash by supporters of the law, but it also rejuvenated the scholarship of corporate law and legal theory.<sup>5</sup> All of Manne's supporting arguments have been dissected and challenged, but out of the three primary points, the most widely-accepted is the improved efficiency of the markets. Although they remain in disagreement on the *extent* that insider trading actually improves efficiency, critics do not usually focus their attention to this point. However, Manne's other two arguments are often challenged. If Manne is correct in 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 through well-aligned incentives, regulation goes beyond just hindering market efficiency to actually harming firms. For these reasons, Manne's subsequent two positions bear closer examination in light of developments since he first proposed them.

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4 Manne, *supra* note 1, 78-158.

5 Stephen Bainbridge, *Insider Trading: An Overview*, vii-viii.

Insider trading law has evolved since its origin. The first interpretation by the SEC in 1961, the "disclose or abstain" rule, required anyone 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.<sup>6</sup> This rule was applied by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.* in 1968, where officers and employees of Texas Gulf Sulphur Co. bought the company's stock when a mineral exploration returned positive results and released a misleading statement to quell rumors of the discovery before the news was made public.<sup>7</sup> However, in *Chiarella v. United States* in 1980, a case involving an employee of a financial printing company trading on information gleaned from handling documents relating to corporate takeover bids, and in *Dirks v. SEC* in 1983, a case involving a research analyst who was notified about fraudulent activity at a company and told clients about the fraud, the U.S. Supreme Court narrowed the limits of these responsibilities to those with a fiduciary duty to disclose.<sup>8</sup> In neither case was the defendant employed by the company that they were buying or selling stock in, nor did an insider breach a fiduciary duty to tip them of the inside information. The fiduciary

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6 *In re Cady, Roberts and Co.* 40 S.E.C. 907 (1961). In this case, a board member of Curtiss Wright Corporation who was also a partner at the brokerage firm, Cady, Roberts and Co., divulged the details of a pending dividend cut during a recess of the directors' meeting to a partner at his brokerage firm, who then sold and shorted shares of the company for several accounts before the decision was announced.

7 *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

8 *Chiarella v. United States*, 445 U.S. 222 (1980). See also *Dirks v. SEC*, 463 U.S. 646 (1983).

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 first encountered this theory in *Carpenter v. U.S.* in 1987, a case where a *Wall Street Journal* reporter, whose columns were known to move the markets, would share their content with two co-conspirators and share in their profits.<sup>9</sup> The Second Circuit decided that the reporter misappropriated information that was the property of *Wall Street Journal*, and the Supreme Court affirmed that decision with a rare 4-4 tie, due to the retirement of Justice Powell.<sup>10</sup> The U.S. Supreme Court later upheld this theory in *U.S. v. O'Hagan* in 1997, a case where a partner at a law firm learned that the firm's client was planning to make a tender offer and misappropriated that information by buying stock options for the target company.<sup>11</sup> 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.<sup>12</sup> Most recently, in *U.S. v. Newman*

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9 *United States v. Carpenter*, 791 F.2d 1024, 1026-27 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

10 The appeal from the Second Circuit was originally denied certiorari, but Justice Powell wanted to accept the case to reject the misappropriation theory because it did not follow from *Chiarella*, but although he succeeded in convincing his colleagues to grant certiorari, he retired before the case was heard. See Adam C. Pritchard, *Justice Lewis F. Powell, Jr. and the Counterrevolution in the Federal Securities Laws*, 52.5 DUKE L.J. 841-949 (2003).

11 *United States v. O'Hagan*, 521 U.S. 642 (1997).

12 Exchange Act Rel. No. 43,154 (Aug. 15, 2000).

in 2014, the Second Circuit held that the tippee must know that the insider received a personal benefit for the tip in order to be convicted, continuing the trend of the courts restricting the government's pursuit of "remote tippees."<sup>13</sup> Thus, insider trading law, loosely based in statutory and common law, has changed significantly throughout the years.

The legality of insider trading is not just an ivory tower debate. 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 making false statements to investigators in an insider trading investigation, or more recently, Mark Cuban, who had to spend a small fortune defending himself against insider trading charges.<sup>14</sup> If no compelling argument exists pointing to the harm caused by insider trading, then people who have caused no harm 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 necessary today.

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13 United States v. Newman, Nos. 13-1837-cr, 13-1917-cr, slip op. at 18 (2d Cir. Dec. 10, 2014).

14 *Martha Stewart Convicted on All Four Counts*, FOX NEWS (2004), <http://www.foxnews.com/story/2004/03/08/martha-stewart-convicted-on-all-four-counts/>. See also Jana Pruet, *Billionaire Mark Cuban Cleared of Insider Trading; Blasts U.S. Government*, REUTERS (2013), <http://www.reuters.com/article/2013/10/16/us-usa-sec-cuban-verdict-idUSBRE99F0ZM20131016/>.

### III. MAIN ARGUMENTS

Trading on inside information in securities markets does not explicitly harm anyone. 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 in the market from Trader B at the current price, before the price rises on the news of the development. However, given the anonymity of the market, Trader A and Trader B do not know each other. 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.<sup>15</sup> 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 in their 1989 article "Information, Privilege, Opportunity and Insider Trading," under no legal tradition is knowledge of an impending change in price and refusal to share this knowledge with the other party a fraudulent action.<sup>16</sup> The harm imposed on the seller, Trader B in this example, is simply a missed chance at capital gains from stock price appreciation, and cannot be legally pinned on Trader A. Trader B could just as readily have sold his stock to Trader X, another outsider, with the same resulting economic impact on Trader B. This case is no

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15 Robert W. McGee and Walter E. Block, *Information, Privilege, Opportunity and Insider Trading*, 10.1 N. ILL. U. L. REV. 6, 2-35 (1989).

16 *Id.* 5-7.

different than anyone in any other speculative endeavor that misjudges the future price of a good and is not a basis for regulation.

While no harmful activity occurred in the above example, 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 shareholders. In this situation, the argument goes, Trader A has a fiduciary duty to Trader B, a shareholder, 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 becomes worse off when the inside information is made public.<sup>17</sup> The harm proposed by the fiduciary duty does not rely 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

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17 Donald C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-'Chiarella' Restatement." 70.1 CAL. L. REV. 18-24 (1982).

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.<sup>18</sup> Common law in the majority of the states held that directors have a fiduciary responsibility to the corporation, but not to the shareholders themselves.<sup>19</sup> 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.<sup>20</sup> 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 upon which they based their reasoning would seem to have required. Hence, in a number of cases, it is still unclear whether 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 in her 2009 article, "Insider Trading and the Gradual Demise of Fiduciary Principles," even the minority jurisdictions

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18 Manne, *supra* note 1, 17-20.

19 Nagy, Donna M, *Insider Trading and the Gradual Demise of Fiduciary Principles*. 94 IOWA L. REV. 1337, 1315-1379 (2009).

20 *Id.* 1337-1338.

did not extend the fiduciary duties to all employees of the company or to temporary insiders, such as an outside law or accounting firm; it was only the officers and directors that owed a duty to the shareholders.<sup>21</sup> Today, however, employees and temporary insiders are considered to have fiduciary duties by extension. 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."<sup>22</sup> Additionally, the misappropriation theory does not have a coherent basis under the fiduciary line of reasoning originally enunciated 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.<sup>23</sup> 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.<sup>24</sup> 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, while actually inconsistent with them.

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21 *Id.* 1337-1340.

22 McGee and Block, *supra* note 15, 30.

23 Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99.6 COLUM. L. REV. 1491-1550 (1999). *See also* Nagy, 1378-1379.

24 Nagy, *supra* note 19, 12-16.

The outsiders are not the only parties that are supposedly harmed by insider trading; some have argued that the company itself is harmed. In a 1967 article, "Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market," 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, thus allowing insider trading would create 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.<sup>25</sup> Manne anticipated these objections in his original book, but Schotland was not satisfied with the answers provided.

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 objection, profiting on negative news, and fourth objection, insider trading as a distraction, 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, the manipulation of markets with false information, 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.<sup>26</sup> The third objection, profiting from insid-

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25 Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53.7 VA. L. REV. 1449-1454, 1425-1478 (1967).

26 See note 3.

er knowledge without contributing to the success of the company, is not enough to require Federal oversight by itself, but it 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 laws. The misappropriation theory is based on deception of, or disloyalty to, 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 situation in both the *Carpenter* 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.<sup>27</sup> Therefore, although the source is the harmed party under the misappropriation theory, it does not have access to private legal recourse itself.

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.<sup>28</sup> 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. That this misappropriator is still liable under the law hints at the underlying driving force: the harm is still that there was an information asymmetry, the parity of information line of reasoning inconsistent with traditional legal principles and rejected as rationales by

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27 Patricia A. O'Hara and G. Robert Blakey, *Legal Aspects of Insider Trading*. ETHICS AND THE INVESTMENT INDUSTRY 101-120 (Rowman & Littlefield 1989).

28 In practice, most confidentiality agreements prohibit both disclosure and use for purposes not for the benefit of the company. Thus, the agreements already provide a legal recourse, although the discovery of the insider trading by a private party is much more difficult than by the SEC or the operator of the stock exchange.

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 overseeing 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 multiple 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. Stock options are not a perfect solution, however, as the benefits are still limited to the number of options, and many conditions and restrictions govern their use.<sup>29</sup> They are also not generally mobile or liquid, and the benefits are not concentrated on the managers who are contributing to and aware of the profitable developments.

However, with insider 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.<sup>30</sup> However, that

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29 Manne, *supra* note 1, 136-138.

30 Jennifer Moore, *What Is Really Unethical About Insider Trading?* 9.3 J. Bus. Ethics 179, 171-182 (1990). See also Schotland 1454.

objection is true to a greater extent with stock options, an already accepted form of compensation, where the managers do not even need to be abreast of the inside information to benefit. Carlton and Fischel, in their 1983 article "The Regulation of Insider Trading," have added support for legalized 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.<sup>31</sup> They also propose that insider trading helps upper-management analyze their managers on the basis of risk-taking tendencies and entrepreneurial ability. Company policies could also stipulate that only trading strategies that pay off when the stock appreciates are allowed, to address the concern over profiting from negative information.

Manne points out that insider trading would need to be disclosed, just like any other form of executive compensation. Disclosure of the company's specific insider trading policy before the fact, with 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.<sup>32</sup> 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, companies that think insider trading would be harm-

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31 Dennis W. Carlton and Daniel R. Fischel, *The Regulation of Insider Trading*, 35.5 STAN. L. REV. 870-872, 857-895 (1983).

32 Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 587 (1970).

ful to their ends could legally address breaches of contract in their company policy and employment contracts without recourse to a general ban on insider trading. If companies or investors demanded it, the stock exchanges could even offer an investigative audit service, similar to the investigations conducted now by the SEC, to alert companies to probable insider trading that might violate their contracts.<sup>33</sup>

#### IV. 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

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33 This proposal needs some defense. Corporate managers themselves may prove unlikely to demand strict enforcement on insider trading, as they are well-positioned to profit from it. In this case, the demand would have to be from shareholders, probably in the form of choosing to invest in companies with restrictive policies that are listed on the exchange that advertises and delivers on its promise to provide enforcement. If shareholders do not display a preference for the stock exchange that cracks down on insider trading, then the "fraud on the market" hypothesis that is concerned with a lack of trust driving away potential investors is perhaps inconsequential. If, however, shareholders do display a real concern with the fairness of the exchange, the companies that adopt insider trading restrictions and list on the exchange that will enforce them will see greater trading volume in their shares. In essence, the market can balance the need for fairness and potential harms with the potential benefits.

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 a starting assumption is that everyone has full and perfect information.<sup>34</sup> 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 as 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. Additionally, 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”.<sup>35</sup>

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34 McGee and Block, *supra* note 15, 25-26.

35 *Martha Stewart Convicted on All Four Counts*, Fox News (2004), <http://www.foxnews.com/story/2004/03/08/martha-stewart-convicted-on-all-four->

Finally, the concern may come from a moral sense that insider trading is just somehow wrong. People might not be able to explain why or how in a manner satisfactory to the courts, but they know it intuitively. Manne's response is that "it is not enough simply to say that insider trading is unfair. If it is unfair, it must be unfair to somebody."<sup>36</sup> Many different classifications of inside information and explanations of the unfairness have been proposed, even beyond those specifically enumerated by the SEC or the courts, but all are accompanied by their own problem points.<sup>37</sup> 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

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counts/. See also Jana Pruet, *Billionaire Mark Cuban Cleared of Insider Trading; Blasts U.S. Government*, REUTERS (2013), <http://www.reuters.com/article/2013/10/16/us-usa-sec-cuban-verdict-idUSBRE99F0ZM20131016/>.

36 Manne, *supra* note 1, 93.

37 Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39.4 WM. & MARY L. REV. 1289-1353 (1998). See also Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, 56.3 LAW & CONTEMP. PROBS. 123-173 (1993). Scheppele provides an analysis based on contractarian ethics that focuses on equal access to information rather than equal information or breaches of fiduciary duties.

various sources to help make up for the disadvantage they have. Courts should consider it their realm to enforce private contracts and agreements and prosecutors could target actually 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 upon which Manne's argument primarily rested, although the force of the other claims is still significant.<sup>38</sup> 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.<sup>39</sup> 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.<sup>40</sup> On the other hand, other critics comment that if outside financing is possible, the manager's wealth no longer restricts returns.<sup>41</sup> Although meant to show that the harm of insider trading can be magnified, it also contradicts the limits stemming from wealth.

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38 Bainbridge, *supra* note 5, 7.

39 Schotland, *supra* note 25, 1454.

40 Bainbridge, *supra* note 5, 9.

41 George W. Dent, *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 247-273 (2013).

Empirical studies can shed light on the matter but, unfortunately, are not definitive one way or the other. Givoly and Palmon's 1985 article "Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence" found that insiders did indeed earn abnormal returns, but that these returns lasted well beyond the period following the disclosure of inside information.<sup>42</sup> This, incidentally, works against the compensation argument in terms of encouraging entrepreneurial behavior. It 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.<sup>43</sup> On the contrary, Roulstone's 2003 article "The Relation Between Insider-Trading Restrictions and Executive Compensation" found that companies that allowed insider trading paid less in executive compensation than those that restricted insider trading.<sup>44</sup> 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.

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42 Dan Givoly and Dan Palmon, *Insider Trading and the Exploitation Of Inside Information: Some Empirical Evidence*. 58.1 J. BUS. 69-87 (1985).

43 *Id.* 85-86.

44 Darren T. Roulstone, *The Relation between Insider-Trading Restrictions and Executive Compensation*. 41.3 J. ACCT. RESEARCH 525-551 (2003).

## V. 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 essay 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.



