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ACADEMIC HOSTILITY AND SEC ACQUIESCENCE: HENRY MANNE'S INSIDER TRADING

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Henry Manne was not one of the pioneers in the economics of insider trading; he was *the* pioneer. Before Manne, few scholars even thought the issue worth much serious consideration. A pretty clear path had been beaten through those woods with no heavy lifting required—like any other form of theft, it had casually been concluded, insider trading damaged society by discouraging investment. It seemed that nobody beyond the inside traders themselves could possibly benefit, and even they might well be injured in the larger scheme as the economy as a whole under-performed.

But sometime in the early 1960s as he was contemplating a phenomena recurring repeatedly in the real world, Manne suddenly asked: "Wait a minute, is the received wisdom really accurate?" Why does a man do that? Why did Adam Smith's brain tell him one day that an economy required no central direction?[1] Why did Ronald Coase's brain tell him that Pigou was focusing on only half of the externality problem?[2] Why did Henry Manne's brain tell him that insider trading might improve, rather than retard, the functioning of an economy?[3] Great ideas seem almost to come to great thinkers unbidden. I doubt that Smith, Coase, or Manne themselves could point to the precise origin of those ideas (if one could understand such a thing, then everyone could be a Nobel-caliber thinker by merely following a recipe).

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1 *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (R.H. Campbell et al. eds., Oxford Univ. Press 1976).

2 *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2 (1960) (positing that in assessing social costs, the potential harm is reciprocal, and thus the proper question is not how to restrain A from harming B, but whether A should be allowed to harm B or B should be allowed to harm A).

3 *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 77-110 (1966) (analyzing the market effect of various trading rules).

However it happened, Manne had his idea. The true path to understanding insider trading wound along a difficult route through deep intellectual woods, not along the easy, thoughtless path that nearly everyone had been travelling (when they thought of insider trading at all). After long and careful research, Manne's idea bore fruit in 1966 with the publication of *Insider Trading and the Stock Market*[4] and *In Defense of Insider Trading*.[5] To this day there remain bitter academic critics of Manne's work, but no serious scholar who reflects on insider trading dares ignore Manne—the easy path has been forever closed.

As Macey points out in his commentary in this Symposium, Manne's point was simply that the opportunity to reap trading profits motivates insiders to create events on which they can trade. Those innovative efforts, in turn, can increase the value of the company for whom the insider works. As Manne well knows, there are other ways to motivate insiders, but those other ways require active evaluation by individuals who are not directly involved in any particular innovation, which is a costly and error-filled process. Moreover, as will become important below, many of the alternatives can lead to legal disputes when insiders who feel deserving of benefits are denied them, when shareholders object to seemingly overgenerous benefits, and so on.

Price function traders who are ignorant of the event that motivates an instance of insider trading may well be induced to sell when they should have bought, or buy when they should have sold. And some of those traders may be acting in a way that benefits the firm—market makers in the company's securities, for example. Those actions may be diminished by insider trading. But that merely calls into play a cost-benefit question: are the enhanced efforts of the insiders worth more to the firm than the diminished efforts of the traders? If so, the firm's investors should favor insider trading; if not, they should oppose. Thus, as Manne reformulated the problem, insider trading is properly a matter of contract between the firm and its insiders, not a desirable sphere for externally-imposed blanket bans.

I will add some detail to two points that Macey raises in his insightful commentary. First, briefly, though insider trading had previously been a rarely-scrutinized backwater in which hardly any scholars reflected much interest, Manne's temerity in suggesting that the casual intuition was faulty led to his being ostracized by many law professors. Why such a close-minded reaction from a group that so often boasts of its open-mindedness?

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[4] *Id.*

[5] Henry G. Manne, *In Defense of Insider Trading*, HARV. BUS. REV., Nov.-Dec. 1966, at 113.

Second, and perhaps of more importance, Macey asserts that (despite continuing hostility in the legal academy) the SEC has essentially adopted Manne's viewpoint. Manne would be the first to note the paradox. Public choice theory tells us that political institutions rarely alter policy merely because some academic commentator makes a compelling argument that the prior policy was faulty.[6] Indeed, bureaucrats often scorn academic commentary, which they consider to misunderstand political realities. If the SEC has altered its policy, then, it is doubtful that it was because Manne critized their prior policy, but because the preferred policy of the SEC's interest groups has changed. How does one account for that?

With regard to the first issue, note that vociferous hostility toward Manne's position on insider trading is, and always has been, limited largely to legal academics.[7] Few observers outside the academy express any strong viewpoint on either side of the issue. Even within universities emotional opposition comes almost exclusively from law schools. Though within economics and finance departments there remains controversy regarding the proper treatment of insider trading, Manne's argument that the phenomena ought to be a contractual rather than criminal matter invokes no suspicion of evil intent, as it so often does within law schools.

The explanation, it seems to me, is rather straightforward. How is any economic activity to be regulated? The two poles are (1) atomistically via the private decisions of the individuals involved, or (2) centrally via the fiat of experts. Though the real world very often reflects a mix of atomistic and central regulation, a stronger tilt toward the latter clearly increases the demand for expertise. Where does expertise regarding regulation through the legal system originate? Predominantly from law schools.

Manne's proposal, in a nutshell, was to get the lawyers mainly out of the business of regulating insider trading, and to let those directly involved decide for themselves through contract terms what regulations were best. It is, in effect, a proposal to reduce the demand for the services of legal experts, the legal academics directly, and those who are trained by the academics. Though the average reduction in demand across all such individuals would be slight, the reduction facing those who specialized in securities law would be noticed.

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[6] *See generally* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962) (examining how individual decision-making processes affect group decision-making and rationalist democracy); ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 279-94 (1957) (discussing why governments do not consistently act in ways that maximize public welfare).

[7] *See* Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 547-49 (1970) (discussing the reception of INSIDER TRADING AND THE STOCK MARKET within various academic communities).

Is there really much mystery surrounding the locus of opposition to Manne's insider trading hypothesis? I think not.

Turn now to the second issue. If, as Macey asserts, SEC policy today is broadly consistent with Manne's theory, what has turned that organization in such a direction? Surely it was not the force of Manne's argument, which, as noted above, is largely irrelevant to bureaucrats due to its academic origins. In this instance, the explanation is a subtler one.

As Macey and I wrote several years ago, an effective ban on insider trading would increase the returns of market professionals at the expense of insiders.[8] Market professionals are a concentrated interest group with respect to securities trading as compared to insiders, whose main activity is running companies, not trading in securities. Public choice theory teaches that, all else equal, concentrated interests command disproportionate influence in political markets.[9] Thus, if market professionals would predictably wield disproportionate influence over securities law, and they would benefit from an effective ban on insider trading, it would not seem puzzling that the SEC would compel a ban on insider trading even within firms that might prefer that their insiders be able to trade on non-public information.

European securities markets have only recently begun to embrace any ban on insider trading, and then not enthusiastically.[10] Individually, those economies are small relative to the United States, and there is greater economic integration within Western Europe than between Europe and the United States. If, as Manne asserts, banning insider trading often retards firm performance, then such a ban by one European nation would induce firms to list their securities on a market in a neighboring country which had no similar ban. Market professionals in Britain, for example, would not gain from a ban on insider trading; they would lose as their business moved to securities markets on the Continent. In brief, the greater integration of the European markets induced Tiebout competition on insider trading

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[8] *See* David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 312 (1987) (arguing that "if one adopts the conventional view that the battle lines of insider trading regulation are drawn between insiders and ordinary stockholders (or the general public), the SEC would seem to be channeling wealth that otherwise would be captured by a group with relatively cohesive interests (the insiders) toward those with extremely weak and diffuse interests (ordinary shareholders or the general public)") (citation omitted).

[9] *See* Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

[10] *See* David D. Haddock & Jonathan R. Macey, *Controlling Insider Trading in Europe and America: The Economics of the Politics*, *in* LAW AND ECONOMICS & THE ECONOMICS OF LEGAL REGULATION 149, 149 (J.-Matthias Graf von der Schulenburg and Göran Skogh eds., 1986) (noting that "insider trading is legal in most European countries. A few other European countries have mild rules constraining insider trading, but those rules have not been enforced actively").

regulation among European nations,[11] and that competition retarded the imposition of laws similar to those long evident in the United States.

Until the past decade or so, United States securities markets were largely isolated from foreign ones. Hence, the U.S. faced little Tiebout competition with respect to securities laws. Thus, it was in the interest of the market professionals in the United States to induce the SEC to ban insider trading—little of the market professionals' business would move abroad, but some trading profits would be diverted to them from insiders.

But as the ability to trade electronically has rapidly improved, United States securities markets have become integrated with those of the rest of the world. If banning insider trading retards the typical company's performance, new listings will tend to be on securities markets outside the United States unless the SEC relaxes its posture, enforcing the ban only when there is reason to believe that the company involved would desire that result.[12] The Tiebout competition facing United States securities law has increased. That the SEC in consequence has relaxed its position on insider trading may not imply that Henry Manne talked them into it, but it is consistent with the hypothesis that his theory is sound. In short, the SEC's alteration of its policy probably owes little to Manne's theory, but it is nevertheless implied by that theory. Manne's theory has thus been empirically tested, and the evidence does not reject the null hypothesis.

It is difficult to overestimate Henry Manne's contribution to our understanding of insider trading. It is the very foundation of our knowledge of the phenomena. It is the basis of all our academic debates on the issue. And it correctly predicted the evolution of SEC policy in the face of the electronic revolution. Theory, implications, test; that is the scientific method. It is well past time for the scientific method to permeate the study of law. Henry Manne has shown the way.

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[11] *See generally* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418-19 (1956) (arguing that mobile citizens will move preferentially toward a community that better reflects their social, political, or economic preferences).

[12] For a discussion of instances in which firms would prefer that insider trading be forbidden, see Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Property Rights, Legal Wrongs in Insider Trading*, AM. ENTERPRISE, Sept.-Oct. 1990, at 57.