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Insider Trading, Investor Harm, and Executive Compensation

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INSIDER TRADING, INVESTOR HARM, AND EXECUTIVE COMPENSATION

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The core questions in most law school classes change little from year to year even as the contexts in which those questions are raised and the answers which are provided sometimes move dramatically to reflect cutting-edge adaptations and changing regulatory policy. Insider trading has been one of those core questions in corporate and securities law since the early 1960s when the Securities and Exchange Commission's decision in *In re Cady, Roberts & Co.*[1] propelled Rule 10b-5 into the center of the debate over the regulation of such conduct. With the publication of Henry Manne's book *Insider Trading and the Stock Market* five years later defending this practice,[2] the issue was joined in a way that still shapes how courts and writers frame the topic. This essay addresses insider trading at the turn of the century by looking at three key assertions from Manne's 1966 book: (1) there is no coherent theory explaining regulation of insider trading;[3] (2) there is no significant injury to corporate investors from insider trading;[4] and (3) insider trading constitutes the most appropriate device for compensating entrepreneurs in large corporations.[5] Each of the parts which follow this introduction identifies the underlying premise for each assertion, the flourish with which Dean Manne presented it, the extent to which it has shaped debate over the last thirty-three years, and its place in the current discussion.

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1 Securities Exhange Act of 1934 Release No. 8-3925, 40 S.E.C. 907 (Nov. 8, 1961). Federal regulation of insider trading existed prior to 1961 under section 16 of the Securities Exchange Act of 1934, 15 U.S.C. §78p, but the reach of that statute extended only to a limited set of insiders (officers, directors, or 10% shareholders) who engaged in two transactions, both buying and selling, within a six-month period for companies whose shares are traded in a national market. Under Rule 10b-5, the reach of regulation has been extended beyond these statutory insiders to include tippees, constructive insiders and misappropriators with only one transaction required for any security, not just those listed or traded on a national exchange.

2 HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) [hereinafter INSIDER TRADING].

3 *See id.* chs. 1-3.

4 *See id.* chs. 4-7.

5 *See id.* chs. 8-10.

I. THE ABSENCE OF A COHERENT THEORY

Manne's book opens with chapters devoted to the assertion that "in the literature on insider trading almost no careful analysis of the subject exists."[6] In discussing the traditional legal approach and opinions from courts, commentators, and legislative hearings, Dean Manne's language was somewhat mild compared to the other topics addressed later in the book and he was ecumenical in suggesting that arguments on both sides were "disappointing"[7] and "conclusionary."[8] His underlying premise was that the existing doctrines based on morality or "it's just not right" provided no foundation for determining regulation of insider trading, but that economic analysis could.[9]

On this point Jon Macey's opening paragraph, "The same, of course, is true today"[10] is very apt. Commentators regularly assail the incoherence of the law of insider trading[11] terming it problematic,[12] if not "seriously flawed."[13] Since the Supreme Court's 1997 decision in *United States v. O'Hagan*,[14] legal commentaries have been appearing at an average of around one a month.[15] As summarized by former SEC commissioner Roberta Karmel, "despite the large number of articles discussing insider trading, a general consensus among commentators has not developed as to why insider trading is unlawful."[16]

There have been three movements so far in the development of federal law of insider trading under Rule 10b-5. Henry Manne en-

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[6] *Id.* at 15.

[7] *Id.* at 5 (describing the position of Robert Walker in a 1923 article opposing regulation).

[8] *Id.* at 5, 10 (describing arguments of Professor H.L. Wilgus in a 1910 article supporting regulation and in the House Report accompanying the Securities Exchange Act of 1934).

[9] *See id.* at 15; *see also id.* at 46 ("There is in today's literature, however, very little analysis helpful to a court or a legislature asked to resolve the issues posed by the *Texas Gulf Sulphur* case.").

[10] Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 269 (1999).

[11] *See* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 634 (asserting that aggressive enforcement of insider trading "without a coherent, let alone articulated, philosophy of regulation is one of the most unsettling aspects of the federal securities laws").

[12] *See* Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1293-94 (1998).

[13] *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 184 (1991).

[14] 521 U.S. 642 (1997).

[15] *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 53 SMU L. REV. __ (1999); Victor Brudney, *O'Hagan's Problems*, 1997 SUP. CT. REV. 249; Dalley, *supra* note 12; Fisch, *supra* note 13; Donna Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223 (1998); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading* (1999) (unpublished manuscript, on file with author).

[16] Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 83 (1998).

tered the debate as the first movement was already in progress. He clearly arrested the progression of that movement and shaped the second, but the third has spun in a different direction.

A. The First Movement: Establishment of a Federal Cause of Action for Insider Trading Under Rule 10b-5.

Although state insider trading cases go back through the twentieth century, it was only with the SEC's *In re Cady, Roberts & Co.* [17] decision in 1961 that the development of the federal cause of action began to gain momentum. Dean Joel Seligman tells us that when Bill Cary came to Washington to head the SEC in the Kennedy administration, he arrived with no overall agenda but with one priority:[18] to use section 10(b) to reverse state corporation law decisions such as *Goodwin v. Agassiz.*[19] It seems clear that Chairman Cary was successful as to this priority. As Louis Loss wrote in 1983, discussing the so-called majority and minority rules at common law, thanks to Rule 10b-5 the minority rule has become "the law of the land."[20] The law of the land perhaps, but it was not in Dean Manne's view a coherent theory.[21] The parity of information approach suggested by *SEC v. Texas Gulf Sulphur Co.*,[22] the leading judicial decision of this era, had the potential to take in any and all trading where there was any material information disparity, a breadth that subsequent courts were unable to fit within the statutory authorization.

B. The Second Movement: Narrowing the Focus in Chiarella *and* Dirks *and an Evolution Toward Property Rights.*

In 1980, the Supreme Court's opinion in *Chiarella v. United States* [23] ushered in the second movement of federal insider trading law. *Chiarella* rejected the broad parity of information rule from *Texas Gulf Sulphur*,[24] and the prior focus on generalized notions of

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[17] Securities Exchange Act of 1934 Release No. 8-3925, 40 S.E.C. 907 (Nov. 8, 1961).

[18] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 334 (1982).

[19] 186 N.E. 659 (Mass. 1933) (applying what has sometimes been termed the majority rule that directors have no fiduciary duty to shareholders in purchasing shares with inside information; such action is permissible when done impersonally through a stock market).

[20] LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 823 (1983).

[21] *See* INSIDER TRADING, *supra* note 2, at 13 (stating that Professor Cary's view "displays conviction but not proof").

[22] 401 F.2d 833 (2d Cir. 1968) (en banc).

[23] 445 U.S. 222 (1980).

[24] 401 F.2d at 848 ("The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public.") (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 at 912).

fairness and harm to investors.[25] It re-centered the legal focus on the other party to the transaction, emphasizing the fraudulent conduct of the insider and relying on tort concepts developed in the common law action of deceit.[26] The Court's decision three years later in *Dirks v. SEC*[27] recognized the idea of information as a commodity that was developed in Manne's book by finding that Raymond Dirks' use of information gained from his investigation of the Equity Funds scandal did not violate Rule 10b-5 where the person conveying the information to Dirks had breached no duty in doing so.[28] Indeed, Justice Blackmun's dissent suggested the majority had in effect adopted a position consistent with Manne's views that the dissent termed an extreme theory.[29] Yet the Court's structure and Manne's focus on information as a commodity opened the way for development of the property rights justification for insider trading regulation, a justification later championed by Frank Easterbrook and Ralph Winter, two notable economics-oriented law professors turned judges.[30]

Indeed, Stephen Bainbridge has observed that "there is an emerging consensus that the federal insider trading prohibition is most easily justified as a means of protecting property rights in information."[31] Unfortunately for the sake of theoretical consistency, this property rights justification fits uneasily within the structure of a federal statute addressing only securities fraud. As defined in a property rights context, federal insider trading regulation would extend to protect employment and other relationships in which a fiduciary used information of the principal. Indeed the focus necessarily ends up on protecting such relationships—traditionally a concern of state law—much more than protecting the securities transaction and securities

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[25] *See id.* ("[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.").

[26] *See* 445 U.S. at 232 ("[N]ot every instance of financial unfairness constitutes fraudulent activity under §10(b).").

[27] 463 U.S. 646 (1983).

[28] *See id.* at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts.").

[29] *See id.* at 677 n.14 (Blackmun, J., dissenting). This is one of the rare Supreme Court citations of Manne's work.

[30] *See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309; United States v. Chestman, 947 F.2d 551, 576-77 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) ("That rationale may be summarized as follows. Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information."), *cert. denied*, 503 U.S. 1004 (1992).

[31] STEPHEN M. BAINBRIDGE, INSIDER TRADING, ENCYCLOPEDIA OF LAW & ECONOMICS (forthcoming, 1999).

trader that is the focus of federal law. Judge Winter, who gave judicial recognition to this theory in *U.S. v. Chestman*, frankly acknowledged that:

> [A]ny obvious relationship to Section 10(b) is presently missing because theft rather than fraud or deceit, seems the gravamen of the prohibition .... Nevertheless, the law is far enough down this road—indeed, the Insider Trading Sanctions Act seems premised on Section 10(b)'s applicability—that a court of appeals has no option but to continue the route.[32]

C. The Third Movement: Agency Law and a Return to Broader Principles.

The federalism concern just described led to the third movement in federal insider trading regulation ushered in by the *O'Hagan* case two years ago. Two other federal courts of appeals did not feel the constraint of precedent Judge Winter identified in *Chestman*. Instead, they found that a trader who misappropriated information from a source other than a shareholder, or another to whom a fiduciary duty was owed, had not engaged in wrongful conduct that was "in connection with" the securities transaction in which the defendant purchased or sold shares.[33] In their view, such conduct may have been wrongful, but it was not a violation of the federal securities laws. The narrowing interpretations relied on an earlier Supreme Court interpretation in *Santa Fe Indus., Inc. v. Green*,[34] not an insider trading case, in which the Court sought to draw a line between federal securities regulation that focused on deception practiced on investors and state corporation law addressing the fiduciary responsibility of corporate officers. Misappropriation and the focus generally on property rights could make no strong claim to federal concern.[35] *Santa Fe* was paired with the Court's more recent decision in *Central Bank*,[36] also not an insider trading decision, but one that emphasized the limitations on judicial interpretations of implied private rights of action under Rule 10b-5.

This argument had no natural stopping point at misappropriation as the only strand of insider trading liability excluded from the reach of Rule 10b-5. It could apply as well to much of the traditional regu-

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[32] *Chestman*, 947 F.2d at 578.

[33] *See* United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997); United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).

[34] 430 U.S. 462 (1977).

[35] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[36] U.S. v. Brayn, 58 F.3d 933 (4th Cir. 1995); U.S. v. O'Hagan, 92 F.2d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

lation of classic insider trading liability excluded from the reach of Rule 10b-5. It could apply as well to much of the traditional regulation of classic insider trading which after *Chiarella* seemed to turn more on protecting the fiduciary relationship of directors and shareholders than on protecting deception practiced on investors. Yet the same Court that had pronounced the limitations of *Santa Fe* three years later decided *Chiarella*, unconstrained by *Santa Fe*. Two decades later, the Court in *O'Hagan* set out an interpretation of insider trading unconstrained by the holding three terms before in *Central Bank*. The Court reforged the connection between the wrongful insider conduct and securities trading using a justification that had more in common with the earlier *Texas Gulf Sulphur*-era opinions than it did with property rights.[37] This third movement shifts away from the tort focus of *Chiarella* with its emphasis on the common law elements of deceit and relies more on agency law and principles of restitution. While that touchstone may seem more consistent with the focus on information as the property of the corporation from the Manne book, the overall tone of the opinion is not to leave the rules to private ordering as Manne suggested, but rather to rules provided by government.

It also leaves some strange gaps. For example, a defendant can avoid liability under Rule 10b-5 simply by notifying the principal prior to making the trade. In that setting, the role for the federal government is surprisingly narrow and serves only to supplement the legal agency relationships created by state common law. By disclosing to the principal the violation of the agent's fiduciary duty, the principal will then be able to enforce existing agency obligations under common law—assuming the principal can find the agent and the proceeds of the trade. This illustrates what I have elsewhere described as the BASF model of federal/state roles in corporate governance, because of the similarity of the intended federal role to the television commercials of the international chemical firm that present a variation of the theme "[w]e don't make the cars you buy, we make them stronger."[38] Federal law doesn't define shareholder rights but rather serves to make effective the rights developed at common law to cabin the behavior of agents.

An alternative federal justification that could evolve in this broader theoretical environment defined by *O'Hagan* is that federal regulation can be explained as part of the SEC's efforts to protect markets from manipulation. This argument gives appropriate centrality to a federal purpose, and supports both classic insider trading and

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[37] *O'Hagan*, 521 U.S. 642.

[38] Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell and Sue*, 62 LAW & CONTEMP. PROBS. No. 3 (forthcoming, 1999).

misappropriation. Yet this justification is missing from *O'Hagan*. It seems fair to say that after almost forty years of judicial and academic efforts to develop a coherent theory to explain federal insider trading regulation, the literature is no more coherent than it was in 1966.

II. SHAREHOLDERS AS A WHOLE ARE NOT HURT BY INSIDER TRADING

The second assertion, the focus of the middle part of Manne's book, is that no significant injury to corporate investors results from insider trading.[39] The subtext here is one of efficiency of markets.[40] Insider trading makes the market more efficient by moving the price in the right direction. An event or information that alters the value of the company and its stock will create a gap between the stock's current value and what it will trade for once the market has incorporated the new information.

Time-function traders, whose trading decisions are based on reasons beyond a change in price, benefit by receiving a better price as compared to what they would have received absent the insider trading. The premise is that they would have traded anyway (and before the disclosure of the new information and the accompanying change in price), and therefore would have absorbed the entire gap related to the change in value. The time-function trader benefits by whatever amount toward the new price the insider trader causes the price to move.

In contrast, price-function traders, whose trading decisions are motivated by a change in price, can be disadvantaged as compared to where they would have been absent the insider trading. Absent the change in price caused by the insider trader entering the market, the price-function traders would not have traded and presumably still would have had their shares when the information was later announced and the price changed in response to that announcement. If this group is further segmented to focus on long-term investors rather than short-swing traders, and the lens is widened to focus on all such traders over time and not just those in a particular stock and a particular time, the magnitude of the loss defined this way gets considerably smaller. Indeed, Dean Manne does not hold back in how he describes this risk: "de minimis . . . almost infinitesimally small . . . [and] so small as to be unworthy of serious concern."[41]

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[39] *See* INSIDER TRADING, *supra* note 2, at 182.

[40] What is presented here as a subtext that insider trading promotes efficient market may be distinct from the injury to investors rationale if insider trading makes the market more efficient but shareholders are nonetheless injured. *See* STEPHEN BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 128-36 (1999).

[41] *Id.* at 110.

On this point, the impact of Manne's work is substantial. The challenge to show investor harm has been difficult and complex.[42] Despite explicit congressional action authorizing a cause of action for those who trade contemporaneously with an insider,[43] private enforcement of insider trading is small and the heavy lifting has been left to the SEC and the Justice Department. Professor Donald Langevoort has concluded that the addition of section 20A to the Securities Exchange Act of 1934 makes "private rights of action by marketplace traders something of relatively small practical importance in the world of insider trading enforcement."[44]

In the wake of the Private Securities Litigation Reform Act of 1995,[45] private actions for insider trading have taken on more importance as allegations of that conduct commonly are used as a way to meet the heightened pleading standards now required for securities class actions.[46] Insider trading is one of the two most common factors cited in securities class action complaints as evidence of particularized facts necessary for a pleading to survive the heightened standards required by the 1995 Act.[47] Yet, that statistic overstates the importance of private action for insider trading. Plaintiffs usually seek to use insider trading by individuals to reach not the traders, but the corporation that made false or incomplete disclosures. Based on data in the Stanford Securities Class Action Clearinghouse database, less than 10% of the cases alleging insider trading include a count seeking private relief under section 20A.[48] The thirty-seven complaints in the database as of June, 1999 that include a count based on section 20A reduce to only fifteen transactions because of multiple filings; there was no indication of recovery by that date for any of those lawsuits.[49]

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[42] *See* William K.S. Wang, *Trading on Material Nonpublic Information in Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981) (discussing the difficulty of identifying a victim of insider trading).

[43] *See* 15 U.S.C. §78t-1 (1994). This section was originally enacted as the Insider Trading and Securities Fraud Enforcement Act of 1988.

[44] Donald C. Langevoort, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION, *in* 18 SEC. L. SER., 9-17 (1998).

[45] *See* 15 U.S.C. § 78a (1995) (codifying, as amended, the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995)).

[46] Section 21D(b)(2) of the 1934 Act added by the 1995 Reform Act requires that plaintiff in any private action for money damages "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4.

[47] *See* Joseph A. Grundfest & Michael A Perino, *Securities Litigation Reform:The First Year's Experience* (John M. Olin Program in Law & Economics, Working Paper No. 140) (reporting that more than half of securities class actions claims filed in the year after the 1995 Act included allegations of insider trading) (Feb. 1997) (on file with author).

[48] *See Federal Court Securities Class Actions* (visited June 10, 1999) <http://securities.stanford.edu/complaints/complaints.html>. There were 761 cases in the database on that date, but only thirty-seven list section 20A. *See id.* Grundfest and Perino note that more than half of them mention insider trading. *See* Grundfest & Perino, *supra* note 47, at iii.

[49] *See Federal Court Securities Class Actions* (visited June 10, 1999) <http://securities.stanford.edu/complaints/complaints.html>.

There appears to be little, if any, overlap between those private cases and the insider cases brought by the government, which average around fifty per year.[50] Of the fifteen companies for which insider trading was alleged as part of a securities class action, all but one allege selling after inaccurate reports or that bad news was withheld or covered up.[51] For the government suits, the dominant setting is trading on the basis of good news, such as in advance of tender offers.[52] It may be that enforcement of insider trading might evolve into a division of responsibility with indirect private enforcement taking a stronger relative role where the insider's action is to cover up bad news. It is more likely that the relative unimportance of private enforcement in insider trading will continue.

Given the lack of observable direct insider trading harm to individual traders, the debate over insider trading has moved in a different direction. Professors Jon Macey and David Haddock adapted the S graphs from the middle portion of the Manne book to illustrate that direct costs of insider trading are borne first by market professionals and then passed along to market participants through higher spreads and trading costs.[53] They pursued this to a public choice explanation of regulation. Michael Dooley's work suggests similar conclusions,[54] as do Dean Manne's later writings about the SEC.[55]

The Supreme Court's current approach to insider trading regulation takes yet another approach to investor harm. In *O'Hagan*, there is no mention of individual harm in specific transactions. Rather, the focus is on harm from a decrease in public confidence in the market. This could be related to the harm to price function traders that was explicitly part of Manne's economic calculation. He discussed price function traders who might not otherwise have traded but who are induced to trade by the price effect from insider trading that moves the price off what the price function traders otherwise thought was the correct market price. The *O'Hagan* reasoning assumes traders will be pushed in the opposite direction—to put their money in a mattress or

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[50] The Annual Reports of the SEC show the number of insider trading prosecutions around fifty per year during the 1990s.

[51] That complaint was filed in *Susser v. Florida Panthers Holdings, Inc.*, No. 97-6084 1997) (S.D. Fla. 1997), *available in* Stanford Securities Class Action Clearinghouse database, (visited June 10, 1999) <http://securities.stanford.edu/complaints/floridap/97cv06084/001.html> (alleging that defendants who were officers and directors covered up good news in order to buy shares at a bargain price).

[52] *See* Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1678 (1992) (stating that 79% of all insider information is takeover related).

[53] *See* David D. Haddock & Jonathon R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1452-54, 1469 (1987).

[54] *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980) (measuring harm to investors and finding none).

[55] *See, e.g.*, Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 554 (1970); Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 937-943 (1985).

at least be less inclined to trade because of insider trading.[56] The focus, however, is not on the harm incurred from the foregone trade; such claims would not be easily susceptible to proof and would be difficult to calculate under the usual measures of damages. Instead of identifying individual loss in a specific transaction, the harm is the loss of market confidence and resulting loss of liquidity in the market generally.[57]

Dean Manne took on the investor confidence argument in his response to the critics of his book. He pointed to evidence in the 1920s and thereafter that "the public has never shown any signs of losing confidence in the stock market because of the existence of insider trading."[58] But it is difficult to separate and empirically test factors that would show such a connection. For example, similar national regimes under which one country banned insider trading and the other did not, or findings on liquidity before and after a change in the regulation of insider trading, cannot be easily isolated from other factors so as to observe the effect of insider trading. In the face of such challenges, with harm being so diffuse and difficult to measure, economics loses some of its relative advantage to politics as an explanatory tool for why we have government regulation.

In such a setting, understanding regulation may require not just the rational choice economics that is at the core of Manne's work, but also the learning of behavioral economics and cognitive psychology. Even if there is no loss or little individual effect as a result of insider trading, investors may still want the conduct regulated. There may be a parallel to preferences revealed in various experimental settings of the ultimatum game. In the ultimatum game, two parties are given a sum of money to divide. One of the parties is to propose the division; the other can then choose either to accept or reject. If accepted, the parties get to keep the proceeds as divided; if rejected, neither gets anything. Traditional rational choice economics and game theories based on similar assumptions of self-interested behavior would predict a small amount to be offered to the second party (so that the second party would be better off than if there were no transaction) but the disproportionate portion to the first party. Instead of such a split,

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[56] *See* United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").

[57] *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979) ("[S]ome investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages.").

[58] Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 577 (1970). For a current statement of that view, see BAINBRIDGE, *supra* note 40, at 155 ("The loss of confidence is further undercut by the stock market's performance since the insider trading scandals of the mid-1980s . . . . One can but conclude that insider trading does not seriously threaten the confidence of investors in the securities markets.").

many experiments find "offers typically average about 30-40 percent of the total, with a 50-50 split often the mode. Offers of less than 20 percent are frequently rejected."[59] Thus in some settings, players depart from the equilibrium predicted by rational self-interest and instead propose a division that is closer to equal sharing.[60] Similarly, shareholders may prefer to limit insider trading even if the harm is not immediately visible. Part of the attraction of the investor confidence argument for insider trading is likely a manifestation of the choices said to be evidenced by the outcome of the ultimatum game.

III. INSIDER TRADING AS EXECUTIVE COMPENSATION

The third assertion, and the one that provoked most of the uproar in the 1960s, was that insider trading constitutes the most appropriate device for compensating entrepreneurs in the large corporation. Again, Professor Macey has captured the underlying core of Manne's contribution and how it focused the debate on insider trading as a matter of intra-firm contract and private ordering; what Macey terms "an applied executive compensation problem."[61] Manne's description was a bit more dramatic, asserting that insider trading "may be fundamental to the survival of our corporate system"[62] and that those pressing for a rule banning insider trading "may inadvertently be tampering with one of the wellsprings of American prosperity."[63]

On this assertion, Manne's analysis has not changed the legal result. Our corporate system has both survived and prospered in the last third of the twentieth century even as insider trading has become more regulated. The rest of the world has moved more in the direction of regulating insider trading rather than away from it.[64]

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[59] Colin Camerer & Richard H. Thaler, *Anomalies: Ultimatum, Dictators and Manners*, J. ECON. PERSP., Spring 1995, at 209-10 (1995).

[60] This behavior is sometimes discussed in the context of reciprocity norms. *See, e.g.*, Jon D. Hanson & Douglas A. Kysar, *Taking Behaviorialism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 680-81 (1999) ("Reciprocity norms manifest themselves in numerous ways, most of which seem relevant to the market context. For example, individuals are often more willing to cooperate with those actors they feel are behaving cooperatively or fairly. On the other hand, individuals will often refuse to cooperate with others who are being uncooperative. Moreover, individuals are often willing to sacrifice to hurt others who are being unfair.") (citations omitted). *See also* Jennifer Arlen, *Comment: The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1776 (1998) ("[R]isk of perceived unfairness is greater that it might at first seem because people tend to have a self-serving assessment of what is fair.").

[61] Jonathan R. Macey, *Insider Trading, Henry Manne and Academic Life*, 50 CASE W. RES. L. REV. 269, 281 (1999).

[62] INSIDER TRADING, *supra* note 2, at 110.

[63] *Id.*

[64] In part, the preference may reflect an association with American prosperity of that period. More specifically it may reflect the efforts of American regulators. *See also* David D. Haddock, *Academic Hostility and SEC Acquiescence: Henry Manne's Insider Trading*, 50 CASE W. RES. L. REV. 313, 316-17 (1999) (discussing the status and evolution of government regulation of insider trading).

The executive compensation aspect has faltered in part because there has not been widespread acceptance of Manne's assertion that:

> Information is not a free good, and we should not assume, without more information than we now possess, that its distribution is generally capricious, arbitrary, random, or uncontrolled. Rational, self-serving individuals will not blithely and willingly allow information of tremendous value to pass freely to individuals who have no valid claim upon it. The safer assumption is that individuals with the power to control the flow of valuable information do so rationally and allocate it in a market-like system of exchange . . . .[65]

Yet except perhaps for Raymond Dirks, who was an entrepreneur of sorts and for whom the Supreme Court found no legal liability,[66] the defendants in the visible insider trading cases have not been entrepreneurs—the group for whom the compensation was seen as necessary. More illustrative is the lawyer, James O'Hagan, for whom takeover information provided a needed source of funds,[67] or Keith Loeb in the *Chestman* case,[68] two generations and one marriage removed from the entrepreneur. Despite Manne's recognition of leakage within the rational economic model,[69] and despite the possible distortions of the defendant pool because we no longer have a basis to test a control group in which insider trading is permitted,[70] the dominance of defendants like O'Hagan and Loeb continue to act as a drag on Manne's executive compensation argument.

More fundamentally, executive compensation has changed in a way that makes this prong of the insider trading argument less compelling. At the time of writing his book in 1966, Manne based part of his assertion for insider trading as executive compensation on his comparative analysis of the various alternatives for compensating entrepreneurs. Salary, bonus, profit-sharing plans, and stock options failed to meet the conditions for appropriately compensating entrepreneurs. Since 1966, changes in insider compensation have come closer to filling the need that Manne described. Not only has there

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[65] INSIDER TRADING, *supra* note 2, at 158.

[66] *See* Dirks v. SEC, 463 U.S. 646, 665 (1983).

[67] *See* United States v. O'Hagan, 521 U.S. 642, 648 (1997) (affirming O'Hagan's disbarment and reversing his theft conviction resulting from an insider transaction).

[68] *See* United States v. Chestman, 947 F.2d 551, 555 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

[69] *See* INSIDER TRADING, *supra* note 2, at 169 (discussing possible information leakage but dismissing it as unimportant).

[70] As Manne observed in discussing the economics of partial enforcement, "the absence of the more high-minded participants from a segment of the securities field makes it that much more lucrative and attractive for those we least want to encourage." Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 555 (1970).

been growth in executive compensation generally, but there is a richer array of forms that are regularly used.[71] The experience of venture capital financing has produced compensation agreements aimed directly at compensating start-up entrepreneurs and balancing their return with others who contribute to the enterprise. Options need not require that money already be invested, as concerned Manne in 1966, and there is a greater willingness to make differential awards that permit payment for entrepreneurial services.[72]

These various forms of compensation have some advantages over insider trading as entrepreneurial compensation. First, they seem less likely to reward the wrong people. Defining the target group is direct, although not perfect; information leakage is less likely. Second, this compensation is not secret, which makes it easier to monitor. The Securities and Exchange Commission requires extensive periodic disclosure of executive compensation for all public companies and also when companies are selling securities;[73] disclosure that was enhanced by extensive changes made in 1992.[74] In addition, these other forms of compensation typically require a corporate governance process prior to their initial availability, such as action by the directors or shareholders,[75] as opposed to insider trading, which is triggered by the insider's actions. Compensation is often a volatile issue and has been so for much of this century.[76] Currently, executive compensation is higher than in past periods,[77] and higher in the United States than in other countries.[78] In that setting, the disclosure and governance framework that governs non-insider trading compensation likely has a

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[71] *See generally* John Balkcom & Roger Brossy, *Executive Pay-Then, Now, and Ahead*, 22 DIRS. & BDS., Fall 1997, 55, 58 (noting that "trends in executive pay have gone far to align the interests of the managers and the shareholder").

[72] *See* INSIDER TRADING, *supra* note 2, at 140.

[73] *See* 17 C.F.R. §§ 229.401-05 (1999) (republishing as administrative rules, SEC Regulation S-K).

[74] *See* Securities Act of 1933 Release No. 33-6962, 52 SEC Docket 1961, 1963 (Oct. 16, 1992) (requiring new disclosure as to options and stock appreciation rights and requiring disclosure of the relationship between compensation and corporate performance designed to "furnish shareholders with a more understandable presentation of the nature and extent of executive compensation").

[75] *See generally* Balkcom & Brossy, *supra* note 71, at 61.

[76] *See, e.g.*, Rogers v. Hill, 289 U.S. 582 (challenging the compensation program of the American Tobacco Company); *Salary $12,000, Bonus $1,623,753*, THE LITERARY DIGEST, Aug. 9, 1930, at 10 (publishing the annual compensation of the president of Bethlehem Steel).

[77] *See generally* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 27 (1966) (explaining that executive pay was around thirty-five times the pay of the average manufacturing worker in 1974 and 120 times the average pay two decades later).

[78] *See, e.g.*, DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 95 (1993) (showing that American levels of corporate compensation are not replicated in other industrial nations); Deborah Orr, *Damn Yankees*, FORBES, May 17, 1999, at 206 (noting average U.S. chief executive's pay still far outpaces the rest of the world because of long term-incentives like stock options, which while common here, are rarer abroad).

comparative advantage as compared to insider trading as compensation.

IV. CONCLUSION

The three central assumptions that Henry Manne used to present his defense of insider trading in 1966 remain as relevant signposts in the debate over regulation more than three decades later. There still is no coherent analytical approach to this topic, although we have been through several, sometimes-conflicting approaches during that period. Economics, particularly the property rights approach that flowed from Manne's work, has contributed to a richer understanding of insider trading and became especially influential in judicial doctrine at the beginning of this decade. To date, there has been no effective answer to the lack of investor harm as defined by Manne. Instead, the focus has shifted back to the larger and more amorphous harm to collective investors. Manne's two challenges to defects in the then-existing attacks on insider trading have fared better than the positive justification put forward for permitting insider trading. The argument that executive compensation in the form of insider trading is needed to facilitate entrepreneurial activity was a difficult argument to make in 1966 and has receded in its impact since then.