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The Case Against Insider Trading: A Response to Professor Manne

*By David Ferber**

Professor Manne's article appears to be largely an attack on critics of his book *Insider Trading and the Stock Market.* I must confess I have not read his book. I did, however, read an earlier article by Professor Manne attacking the position of the Commission in the *Texas Gulf* case, and I once participated in a forum at which Professor Manne expressed his view that inside information should be something that a corporate official might sell.

I disagree with Professor Manne's basic position that "[t]he debatable aspects of insider trading are capable of resolution through tools of economic analysis,"[1] as well as his "downgrading of morals." With respect to the latter, many, if not most, laws on the books are based on concepts of morality. As I understand the Securities Exchange Act, its aim of preventing manipulative, deceptive, and fraudulent conduct in securities transactions was largely because of the congressional view that these activities were immoral. Under the securities laws Congress sought to have the securities markets honestly conducted.

Congress assumed that honest conduct of the markets would be good for the country economically. The Commission has accepted this view. It is probably not susceptible to proof one way or another, except that, in the light of revelations of what had occurred in the twenties, the extent to which investors would have gone back into the markets may be questioned had they not thought that many of the manipulative devices then used had now been made illegal.

Professor Manne's basic quarrel appears to be with the "full disclosure" approach of the Securities Act.[2] He appears to suggest that should investments in a particular business be made only if the investors were lied to, it would be justifiable to obtain money for the business through such lies, at least if the financing of such a business

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1. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970).
2. *Id.* at 569.

might be important to the economy. Professor Manne seems to think that the Commission's concern with conserving investor confidence is motivated largely by the desire to increase the profits of brokers.[3] This necessarily implies that a loss of investor confidence does no harm to anybody except brokers who lose commissions. Those who lived through the 1929 crash and its aftermath will not share that view. Wholly apart from the long-term results of a policy based solely on economics, it assumes a disregard of the rights of individuals because of an assumed "important economic benefit to the country"—a totalitarian philosophy with which I cannot agree. Certainly Congress has not accepted such a philosophy in its adoption of the securities laws.

Since I believe Congress was attempting to improve the morality of the marketplace, I think that the economic effect is largely irrelevant—at least in the absence of indications showing dire happenings to public investors or the market generally.

Professor Manne's suggestion that the Commission's enforcement action against Texas Gulf is an illustration of the "pushy way of federal regulatory agencies" would presumably be equally true of the Commission's position in the *Capital Gains Research Bureau*[4] case. In this case the Supreme Court held that the Commission properly determined that the publisher of an investment advisory service had violated the antifraud provisions of the Investment Advisers Act in purchasing securities he was about to recommend and selling them after his recommendation to his clients had raised the market price.[5] He could similarly describe the Commission's position that in appropriate circumstances the securities laws are applicable to interests in oil lands, rows of fruit trees, and savings and loan deposits.[6] Accordingly, Professor Manne is not disagreeing solely with the Commission but also with the Supreme Court.

So far as I am aware, the Commission has never defended its position in *Texas Gulf*[7] by urging that the information of insiders "is the 'property' of the shareholders". The Commission's position has been simply that it was deceptive for an insider to purchase securities of a stockholder when the insider had important information that the

3. *Id.* at 578.

4. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

5. *Id.*

6. Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

7. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 883 (2d Cir. 1968).

stockholder could not know about—a position taken years ago by the Supreme Court in *Strong v. Repide*.[8] Professor Manne suggests that shareholders are not injured by insider trading. In one sense this may be so—the purchase by an insider, as distinguished from anyone else, does not adversely affect the price received by the selling stockholder; indeed, the fact that insiders are adding to the demand would tend to enhance the price. But this should not be the test.[9] Viewed otherwise, the shareholder is hurt if, when needing cash, and attempting to determine which of his securities to sell, he is injured by determining to sell one which has great potential value of which he is not informed. This is particularly true if the insiders would have generally advised the public of this value but for the incentive of continuing to make purchases before the potential values are made public.

It is true, as Professor Manne points out, that declaring insider trading to be unlawful does not assure early disclosure. But if insiders were permitted to profit from inside information, there would be a natural tendency for insiders to prolong the period prior to disclosure. Moreover, the fact that trading on inside information is unlawful tends to encourage early disclosure, since disclosure is the best way a corporation has of preventing such trading by its officials and employees. Violations by such persons presumably would have a negative effect on the good will of the corporation.

I do not think the Commission has ever suggested that the prevention of insider trading was the perfect solution to problems of timely disclosure, and I agree with Professor Manne that "[e]nforcement" is necessarily "imperfect at best." This is true, however, of all areas of law enforcement. It is hardly a reason, however, to eliminate such enforcement. Even though some persons will necessarily get away with trading on the basis of inside information, just as undoubtedly the Commission is unable to catch up with all persons who sell securities through fraudulent means, the fact that the Commission is able to enforce the law against some violators necessarily discourages many other would-be violators.

There are also persons who as a matter of principle would not take steps in violation of the law, even though the possible immorality of such activities would not discourage their participation if they were not

8. 213 U.S. 419 (1909).

9. In the *Capital Gains* case, for example, presumably no one was hurt by following the recommendation of the adviser. 375 U.S. at 180. Nor would anyone usually be hurt if a SEC employee traded in the stock of a company in which his work involved him. I question whether even Professor Manne would contend that the rule prohibiting such trading by a Commission employee is not wise.

unlawful.[10] Certainly Professor Manne's diatribe against laws that cannot be fully enforced would apply equally to all antifraud provisions, and, to my knowledge, it has never been suggested that for this reason such provisions should not be in the law.

It has long been recognized that while it is healthy for corporate officials to own stock in their corporation, there are problems of possible conflict of interest in unlimited trading in that stock by such officials. This is particularly so during the reorganization of a corporation. In that situation the Supreme Court has stated:

> Access to inside information or strategic position in a corporate reorganization renders the temptation to profit by trading in the Debtor's stock particularly pernicious. The particular dangers may take two forms: On the one hand, an insider is in a position to conceal from other stockholders vital information concerning the Debtor's financial condition or prospects, which may affect the value of its securities, until after he has reaped a private profit from the use of that information. On the other hand, one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups.[11]

In recognition of these problems, Congress in Section 249 of the Bankruptcy Act, provided generally that "[n]o compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the [reorganization] proceedings in a representative or fiduciary capacity who at any time after assuming to act in such capacity has purchased or sold such claims or stock" of the debtor.[12] Similarly, Section 212 authorizes the judge to limit any participation on claims or stock acquired by certain persons in a fiduciary capacity "to the actual consideration paid therefor."[13] A similar holding has been upheld in a reorganization under the Public Utility Holding Company Act.[14] Even absent a reorganization, the problems of possible conflict, may exist to some extent whenever there is trading by corporate officials. Accordingly, Section 16(b) of the Securities Exchange Act makes corporate officials and certain insiders liable for their profits from trading in their corporation's securities within a six-month period.[15] The Commission's position in the *Texas Gulf* case in this regard was, in effect, that whenever a conflict can be shown

10. Professor Manne seemingly concedes this point. Manne, *supra* note 1, at 554.
11. Wolf v. Weinstein, 372 U.S. 633, 642 (1963).
12. 11 U.S.C. § 649 (1964).
13. *Id.* § 612.
14. SEC v. Chenery Corp., 332 U.S. 194 (1947).
15. 15 U.S.C. § 78p(b) (1964).

between an insider and the corporation's security holders by reason of the insider's trading, the insider should not be permitted to benefit.

Professor Manne's economic analysis seems to be based on an extraordinarily broad definition of insider trading. Essentially he seems to refer to any situation in which there is an inequality in the information possessed by the parties to a trade.[16] The Commission has not adopted any such definition. It could not stop such trading if it wanted to and I doubt that it would if it could, essentially for the reasons stated by Professor Manne. Consequently, his criticism of the inadequacy of the Commission's enforcement is based on its failure to do something which it has never tried to do. The Commission has objected only where the person taking advantage of information owes a duty of loyalty to the person he is trading with and is breaching that duty or where some type of aiding and abetting in such a breach of trust occurs. The principle that a fiduciary owes a duty of loyalty to his beneficiary is firmly imbedded in the law and is not dependent on economic efficiency. As Judge Cardozo has long since pointed out, a fiduciary is "held to something stricter than the morals of the marketplace" and "the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd."[17] Thus, if a real estate broker knows that a piece of land is far more valuable than is generally realized and has no other relationships, he can proceed to buy that land and economic efficiency may be furthered. If, however, he has been employed to buy the land for a client, he cannot buy it for a nominee of his, resell it to his client, and split the profits, whatever the economic advantages of this course of action might be.

Professor Manne states that he has no great quarrel with Section 16(b) of the Securities Exchange Act,[18] which was a specific attempt of Congress to counter trading on inside information. He states that the reason he does not quarrel with this provision is that he does not believe it is "effective to counter the most significant form of insider trading." This appears somewhat inconsistent with his argument a few pages earlier that the only good laws are the ones that can fully accomplish their purpose. If, as Professor Manne concedes, Section 16(b) "might possibly serve to prevent some manipulation in stock by statutory insiders," it seems to me that the Commission's position in the *Texas Gulf* and *Cady Roberts*[19] cases would do the same.

16. Manne, *supra* note 1, at 562.
17. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
18. Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).
19. Manne, *supra* note 1, at 556 n.29.

Professor Manne seems to assume that the Securities and Exchange Commission can never do anything right. Instead of praising it for being flexible when it has been convinced that certain accounting procedures that have gone on for years should not be necessarily applicable in all situations,[20] he criticizes it for changing its rules in mid-stream. No agency knows everything from the first day but necessarily learns from its experience.

Professor Manne's comment that law professors and others who have worked with the Securities and Exchange Commission have "a firm and unwavering conviction that what the SEC says is right" is perhaps the highest form of praise that a government agency could hope to obtain. I wish it were so. But it is true that the Commission's alumni both in the academic and business world do tend generally to respect positions taken by the Commission. This is flattering because, having been inside the agency, they are more aware than others of the problems faced and they are sufficiently sophisticated to be knowledgeable if Commission decisions were based on improper considerations.[21] They presumably also know many of the personnel involved intimately and are in a position to assess the fairness and conscientiousness of these officials.[22]

I have not attempted to cover everything in Professor Manne's article. For example, the relationship of insider trading to pornography, marijuana and prostitution is not clear to me.[23] Nor do I understand his comparison of profits from insider trading with the contingent fees of lawyers.[24] In the later situation the lawyer is paid for his services by contract with his client upon the basis of his success for the client—a better comparison might be to a lawyer who settles a case by taking a fee under the table from the other side. Nor do I comment

20. *Id.* at n.71.

21. The suggestion of Professor Manne that individuals who illegally profit on the basis of inside information will somehow gain strong influence with the Commission is simply at odds with the 36 years of the Commission's history.

22. Professor Schotland was not an employee of the Commission at the time he wrote his article and has never been employed in the Commission's enforcement activities. There is no basis whatsoever for Professor Manne to claim that the Commission "appears to admit the utilization of an extraordinary police state technique" in connection with its investigation in the *Texas Gulf* case. Despite Professor Manne's suggestion, the Commission has always made it a policy to prohibit wiretapping in the course of its investigations and to advise all witnesses of their constitutional rights. In the *Texas Gulf* case, the record shows how certain persons in Washington received their inside information—through Mr. Darke. The SEC could have learned by asking them whether these persons traded through a Washington broker.

23. Manne, *supra* note 1, at 578 n.92.

24. *Id.* at 579.