

Insider Trading, Agency Problems, and the Separation of Property and Control

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Abstract

The purpose of this paper is to deal with the implications of insider trading on an unhampered market and on the regulated market. We argue that insider trading will not always be allowed in all firms even if the absence of contract banning insider trading within the firms tends to confirm this phenomenon. Consequently, we show that market devices exist to help those firms that wish to prohibit to their insiders the use of inside information for their transactions. Moreover, we argue that insider trading becomes a problem in the relationship between shareholders and insiders when the government meddles with the market. Insider trading is a problem not because there are "market failures" but because the government intervention creates such failures.

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1 Introduction

Insider trading occurs if an insider uses material non-public information about corporation in a securities trade.¹ This trade can generally be a purchase, sale, or both. Nevertheless, non-purchases and non-sales of securities following an awareness of an inside information are also insider trading. Insider trading is generally prohibited by securities regulation. Its prohibition is the subject of an important debate since the sixties.

One of the most famous arguments against the prohibition of this kind of behaviour is that insider trading represents the most appropriate compensation scheme to reward the entrepreneurial activity of insiders and that, consequently, we should expect that some corporations will allow their insiders to use inside information in order to stimulate their entrepreneurial-innovatory activity.²

This argument has been strongly challenged. Some authors argue that letting firms allow their insiders to trade on inside information gives rise to agency problems that shareholders would be unable to resolve. No firm should be authorised to allow insider trading because shareholders are not able to control the activity of their insiders.³ This argument is closely related to Berle and Means's argument that modern corporations are characterised by the separation of ownership and control. In other words, the owners have lost the control of the corporation and are unable to control the activity of the management.⁴

The purpose of this paper is to discuss these arguments against insider trading. We compare two economic systems, the unhampered market or market economy and the hampered market or interventionism. The unhampered market is characterised by an absolute and total private ownership of the means of production.⁵ The hampered market is also based on private ownership but the fundamental difference is that it is not total and absolute.⁶ In

¹ See Carlton and Fischel (1983: 860-861). It is necessary to clarify that, even if the legislation has a different definition of an insider, most of literature generally defines an insider as an employee of the corporation, such corporation manager, who has an access to non-public information. In the same way, the definition of material private information is not very clear in the legislation. Usually, literature defines non-public information as information that disclosure to public would be likely to influence future corporation's share price.

² See Manne (1966a), Manne (1966b), Manne (1969), Manne (1985). See also Carlton and Fischel (1983), Haddock and Macey (1986)

³ See Easterbrook (1981), Easterbrook (1985). See also Levmore (1982), Mendelson (1969), Schotland (1967), Ross (1979), Leftwich and Verrecchia (1981).

⁴ See Berle and Means (1932).

⁵ A private ownership is said total when private individuals own all the means of production. The private ownership is said absolute when the owners can use their property as they see fit insofar as they do not violate the property right of other individuals. See below for a development of the implications of an absolute and total private ownership of the means of production.

⁶ It is important to understand that we are not making a comparison between a perfect and a less-than-perfect system in the Neoclassical definition but between systems that are marked by more or less interventions on the

other words, interventionism "seeks to retain private property in the means of production, but authoritative commands, especially prohibitions, are to restrict the actions of private owners."⁷

We inquire whether shareholders have means to dissuade insiders from not respecting their contract and to sanction their dissident activity. We show that, in an unhampered market, such means exist and allow shareholders to protect themselves against agency problems. We then demonstrate that the government regulations and other interventions in the market transform insider trading into an agency problem insofar as (1) shareholders can no longer efficiently control the activity of insiders and (2) deficiencies of the regulations result in perverse effects on the behaviour of insiders.

Part 2 presents the agency-problem argument and its implications for the problem of insider trading. We argue that this argument is an emanation of the-separation-of-ownership-and-control theory developed by Berle and Means. In part 3, we show that in an unhampered market, shareholders are able to protect themselves against agency problems. Part 4 analyses the consequences of interventionism on the control relation between shareholders and insiders and the behaviour of insiders. Part 5 offers some concluding remarks.

2 Insider Trading as an Agency Problem

The agency theory deals with problems resulting from the existence of asymmetric information in a principal-agent relation. A principal-agent relation exists when a principal wants a task to be carried out by an agent on the principal's behalf. The typical principal-agent relation is the one that exists between an employer (the principal) and his employee (the agent). Agency (principal-agent) problems arise when there is some kind of conflict of interest between the principal (the employer) and his agent (the employee) and when the agent has an informational advantage. Agency problems have two manifestations: moral hazard and adverse selection.

A moral hazard problem exists when the principal cannot observe the actions of the agent. This situation appears particularly when the outcome is not completely determined by the actions of a single agent because this agent works in a team, and consequently, the outcome is a combined result of the actions of many agents. In the context of the corporation, a moral

freedom of owners' exercise of property rights. The author's approach wants to be realistic, that is, it does not deal with perfect and imperfect system in the Neoclassical terminology.

⁷Mises (1977:15-16).

hazard problem appears because "the shareholders as principals cannot certainly observe in detail whether the management, their agent, is making appropriate decisions."⁸

An adverse selection problem exists when "the agent has made some observation that the principal has not made. The agent uses (and should use) this observation in making decisions; however the principal cannot check whether the agent has used his or her information in the way that best serves the principal's interest."⁹ In the context of a corporation, the typical case occurs when the employee (the agent) agrees to comply with clauses of his contract and the employer cannot check whether his employee really complies.

Now, according to the advocates of the insider-trading-as-an-agency-problem argument, insider trading inherently goes in hand with agency problems. Assume that insider trading is not subject to public regulation and that the firms are free either to allow or to forbid their insiders to trade on non-public information. There will probably be firms that will allow insider trading and other firms that will contractually prohibit their insiders to trade on inside information.¹⁰ However, the argument goes, agency problems emerge irrespective of these contractual stipulations.

Even in firms allowing their insiders to profit on insider information, insider trading cannot but create a moral hazard problem. Because insiders can profit both from bad news as from good news, they are indifferent between working to make the firm prosperous and working to make it bankrupt. They may therefore engage in "discretionary" behaviour.¹¹ For example, insiders are said to have an incentive to increase the volatility of a corporation's stock prices:

The opportunity to gain from insider trading also may induce managers to increase the volatility of the firm's stock prices. They may select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss.¹²

Insiders can also conceal or disseminate false information in order to profit by buying and selling mispriced securities.¹³ Finally, insiders, and more particularly, lower level managers can delay transmitting important corporate information to their superiors in order to trade on it

⁸ Arrow (1985: 38).

⁹ Arrow (1985: 39-40).

¹⁰ Here we do not deal with the question why the shareholders would allow or prohibit insider trading. Our scenario is realistic in the sense that today not all firms contractually prohibit insider trading. See Dooley (1980: 45-47) and Seyhun (1992: 151; 175-176).

¹¹ See Levmore (1982: 149), Mendelson (1969: 489-90), Posner (1977: 308), Schotland (1967: 1451).

¹² Easterbrook (1981: 312). See also Brudney (1979: 356) and Leftwich and Verrecchia (1981).

¹³ See Posner (1977: 308) and Ross (1979: 185).

and make profit.¹⁴ Hence, shareholders may have no interest in allowing their insiders to trade on inside information because they will not be able to prevent insiders from engaging in discretionary behaviours.¹⁵

Moreover, firms that contractually prohibit their insiders from trading on non-public information are confronted with an adverse selection problem. They will not be able to know whether their job applicants are truthful when they say they will respect their contract. Because, insider trading is difficult to detect, the firms that wish to ban insider trading will be the prey of unscrupulous insiders. In the words of Easterbrook (1985: 94):

Whenever firms write contracts that they do not plan to (or cannot) enforce, however, they face a serious problem of adverse selection. Dishonest agents will find employment with the firm especially attractive. They will get their salaries and be able to engage in inside trades as well; they will be overcompensated. To avoid overcompensating the dishonest agents, the firm must reduce salaries across the board. Now the honest agents – those who do not trade on material inside information – will be underpaid and will leave. Bad agents drive out the good.

Hence, the major problem with insider trading is that, whether or not shareholders contractually prohibit their agents from using inside information to their personal advantage, the shareholders face agency problems. These problems result from the inability to control the activity of their agents.

Interestingly, there is no fundamental difference between the agency argument and the separation-of-ownership-and-control argument. The analysis of insider trading from an agency perspective is only an extension of the separation problem. Berle and Means argue that with the emergence of the modern corporation, characterised by diffused ownership, the firm is no longer controlled by its owners, the shareholders, but by the managers. The managers have interests different from the shareholders, and consequently they will engage in perverse behaviours, against which the shareholders cannot protect themselves because they lack enforcement devices:

These [agency problems] suggest that granting insiders property rights in their knowledge about the firm is not necessarily beneficial. ... Michael Dooley asked the right question: If insider trading is undesirable, why do not firms voluntarily curtail the practice? ... One possible explanation of the firms' failure to do away with insiders' trading on material information — assuming that would be beneficial — is that they lack adequate enforcement devices. (Easterbrook 1981: 333-334) [Emphasis added]

¹⁴ See Haft (1982: 1051).

¹⁵ See Easterbrook (1981: 333).

However, these arguments are untenable. We show below that, in an unhampered economy, shareholders do have devices, which protect them against insiders intending to engage in discretionary behaviour. Control problems appear however when the government starts intervening into the market. It is these government interventions that make insider trading an agency problem.¹⁶

3 Insider Trading in the Unhampered Market

The unhampered market or market economy defines "that form of social cooperation which is based on private ownership of the means of production."¹⁷ We understand social cooperation as a system based on the division of labour and the respect of property rights.¹⁸

In the unhampered market, there is a whole set of devices allowing shareholders to control the activity of insiders.¹⁹ Advocates of insider trading prohibition and in particular defenders of the insider-trading-as-an-agency-problem argument completely overlooked the crucial role of the property rights and other devices, which enable shareholders to exercise their property rights and put a pressure on the behaviour of insiders.

3.1 Insider Trading and Property Rights

One of the most important overlooked aspects of property rights in the literature on insider trading is the control function of property rights. It is the nature of a property right to enable individuals to exercise control over goods they own. To have a property right to a good means to control this good.²⁰ It means to control the use, the allocation, and the disposal of goods owned. In the unhampered market, this control is exclusive and absolute.²¹ In other words, controlling the goods owned means that the owner has the right to supremely decide how his goods will be used, to keep the proceeds and returns that could result from their use, and to

¹⁶ We do not more deal with the conceptual problems of agency theory, that is, we do not deal with its hypotheses of the agency theory, such as the existence of informational asymmetries, but with its implications.

¹⁷ Mises (1998: 1).

¹⁸ See Mises (1998b: 258-260) for a complete description of the characteristics of the market economy.

¹⁹ We define a control device as a device that acts as a deterrent and as a sanction to an individual who intends engaging in a breach-of-contract behaviour. In other words, a control device dissuades and penalises insiders intending to act against shareholders' interest. This clarification is necessary because one could argue that to deter is not enough, there will always be somebody who will not respect the contract. However, we do not argue that, under a free market system, there is no breach-of-contract behaviour. We do not argue these devices always prevent insiders from engaging in behaviours going against the interest of shareholders. We argue that these devices minimize risks of breach-of-contract behaviour and at any rate sanction insiders for their behaviour.

²⁰ Property rights are in fact a necessary condition for human action. The human action is the use of means to satisfy ends either directly (consumer goods) or indirectly (means of production). The use of means presupposes at the outset that the acting person be the owner of these means or, if he is not, that he be authorised to use them by their owner(s). See Menger (1981: 96-98). See also Campan (1999: 24-26).

²¹ See Lepage (1985: 13-14).

transfer willingly to a third party the whole or party of the specific rights, which follow from the property right.²²

Therefore, and due to the very nature of property rights, the shareholders of a corporation, as owners of the means of production, have an exclusive and absolute control over the corporation and not the managers. Mises and Rothbard have well perceived this control function of owners. To be sure, the owners can contractually delegate all or part of this control to managers, and the latter may hold considerable autonomy over the day-to-day operations of the firm. However, ultimately the owners decide:

The managerial function is always subservient to the entrepreneurial function [exercised by the owners]. It can relieve the entrepreneur of a part of his minor duties; it can never evolve into a substitute for entrepreneurship. ... The function of the entrepreneur cannot be separated from the direction of the employment of factors of production for the accomplishment of definite tasks. The entrepreneur controls the factors of production. ... A successful corporation is ultimately never controlled by hired managers [but by its stockholders]. (Mises 1998: 302-304) [Emphasis added]

Hired managers may successfully direct production or choose production processes. But the ultimate responsibility and control of production rests inevitably with the owner, with the businessman whose property the product is until it is sold. It is the owners who make the decision concerning how much capital to invest and in what particular processes. And particularly, it is the owners who must choose the managers. The ultimate decisions concerning the use of their property and the choice of the men to manage it must therefore be made by the owners and by no one else. (Rothbard 1995: 538)

In the context of insider trading, the situation is not different. The shareholders decide who is entitled to trade on inside information and who is not. If managers (insiders) do not comply with shareholder decisions, shareholders or their elected mandataries, the directors, will discharge them.²³ Moreover, shareholders will always have the possibility to sell their shares; on no account, insiders (managers) have ultimately the control of corporation. The property right is the ultimate control device for shareholders. On an unhampered market, shareholders constantly control the corporation and therefore the activity of their managers (insiders).

²² Henri Lepage explains that this definition of property rights goes back to Renaissance students of Roman law who intended to reconstruct the Roman law in the light of the problems of their own time. According to them, property rights imply a trilogy of rights: jus ustendi, fruendi, and abutendi. See Lepage (1985: 16-17).

²³ See Mises (1998b: 303).

3.2 Contract and the Contract Law

In an unhampered economy, contract and contract law are important devices to control the activity of insiders. The advocates of insider-trading prohibition seem to ignore this.²⁴ The insider-trading-as-an-agency-problem argument seems to be based on a tacit premise, namely, on the theory of exploitation implied the Montaigne dogma. According to this doctrine, market exchanges are zero-sum games in which one party benefits at the expense of the other.²⁵ In other words, any contract is an exploitation of one party by another. In the context of the corporation, losers are employees (insiders) and winners (or exploiters) are employers (shareholders). Because they are exploited, insiders will seek to profit from their informational advantage in order to retrieve their losses. Thus, the exploitation resulting from the contract between shareholders and insiders gives insiders an incentive to systematically break their contract. However, this theory suffers from two major fallacies.

First, it overlooks the fact that, in a market economy, all contract are voluntary, that is, both parties agree on the terms of the contract. Therefore, there is no reason why the insider would not respect his contract. Whether insiders are allowed to trade on inside information does not change anything of the matter. It is a striking argument to say that because there is inequality of information between shareholders and insiders, the latter will systematically be inclined to break their contract. Yet, no significant evidence exists that proves such tendency in human behaviour. In the market economy, contracts and exchanges are voluntary, and since both parties agree on the terms of the exchange. Both parties believe that they will benefit by the exchange-contract. The contract is not a zero-sum game but is always a positive-sum game.²⁶

Second, the argument that insider trading inherently involves agency problems overlooks the importance of the contract law as a deterrent and a sanction device. Contract law deters breaches of contract, that is to say, thefts of property rights. Because a contract is an exchange of property rights between shareholders and insiders, any breach of contract amounts to a theft.²⁷ The perspective to be sued for breach of contract will certainly deter insiders from

²⁴ At least, it seems that they do not allow for any protection against breaches of contract.

²⁵ On the Montaigne dogma, see Mises (1998b: 660). See also Rothbard (1993: 769) who talks about Montaigne fallacy.

²⁶ See Rothbard (1993: 77). Note that when we argue that all contracts are always a positive-sum game in the sense that parties always benefit from the exchange, we mean that parties will increase their utility ex ante. This does not mean that, from an ex post point of view, they did not have made an error. See Rothbard (1993: 768; 772) and Rothbard (1977: 13; 18-19).

²⁷ In the context of insider trading, shareholders do not have a property right to inside information but to the means of production that enable insiders to get inside information from their activity. For example, the means of production can be funds of the company, computers, financial reports, or project reports issued during business

engaging in so-called discretionary behaviour. It is undeniable that contract and contract law are control devices that allow shareholders to prevent any insiders' breach of contract.

3.3 Reputation, Blacklist, and Boycott

Reputation is another important control device, which is underrated in the agency theory and a fortiori in the literature on insider trading as an agency problem. It is important because it acts as a deterrent and as a sanction. Moreover, it provides shareholders with a signal about insiders' reliability (honesty). Reputation is particularly efficient to prevent managers (insiders), who have contractually agreed not to trade on inside information, from not respecting their agreement. However, it also works for insiders who are allowed to trade on inside information. In this case, it prevents them from engaging in behaviours going against shareholder's interest.

Reputation is the expression of value judgements of others.²⁸ In the context of business, these value judgements result from others' appreciation of the manager-insider's competence and reliability. For example, the shareholders or their mandataries will be able to publicly criticise the insider at fault for not having respected his contract.²⁹ As a consequence, this insider will not only be sued under contract law, but also will probably see his reputation suffer from his failure, and he will not be able to do something against that. This inability to fight against a bad reputation following a breach of contract results from the fact that the individual is not owner of his reputation. The implication of the individual not being the owner of his reputation is that blacklist and boycott are legitimate on the unhampered market and allow shareholders to protect themselves against breaches of contract by insiders.

Following a breach of contract, shareholders may publicly diffuse a "black list" that lists managers (insiders) who have broken their contract either by engaging in discretionary behaviour or by trading on inside information even though they were forbidden to do it.

meeting. Therefore, the breach of contract does not result from the use of inside information but from the misuse of shareholders' means of production. In other words, there is a breach of contract or theft, not because insiders have used inside information to get personal profits, but because they have misappropriated the property of the shareholders. See Rothbard (1993: 77-78) and Rothbard (1995: 133-134). See also Kinsella (2000b: 6-7) for a different view on contract and breach of contract. According to Kinsella, "when a contract to do something is to be formed, the parties simply contract for a conditional transfer of title to a specified or determinable sum of monetary damages, where the transfer is conditional upon the promisor's failure to perform." The author thanks Stephan Kinsella for having drawn his attention on this point. See also Kinsella (2000a: 15-25) on the illegitimacy of property rights in information applied to intellectual property. The author thanks Dr. Jörg Guido Hülsmann for having drawn his attention to this problem.

²⁸ See Block (1976: 59-62).

²⁹ See Rothbard (1993: 157).

In the same way, shareholders can urge other corporations' shareholders not to hire in the future the insider in the wrong. The boycott is a way to sanction insiders for having broken their contract.³⁰

Therefore, insiders have an interest in not breaking their contract by engaging in perverse behaviour or by not complying with the contractual prohibition of trading on inside information. Reputation, blacklists, and boycotts are powerful deterrent, and important means of sanction against agency problems.³¹

3.4 The Market for Corporate Control

The market for corporate control is certainly the most discussed control device in the relevant literature.³² Henry Manne (1965) is widely considered the pioneer in emphasising the important role of the market for corporate control in the market economy.³³ His objective was to reply both to advocates of merger regulation and to Berle and Means' theory of separation of property and control. Manne argues that mergers avoid the wasteful function "performed by bankruptcies and liquidations" by "shifting assets from falling to rising firms."³⁴ The core of his argument is that there exists a market for corporate control, which plays a crucial role in disciplining the activities of managers; and mergers, as well as proxy fights and direct purchase of shares, are devices for taking over the control of corporations. It follows that on an unhampered market "the market for corporate control gives to the shareholders both power and protection" against mismanagement³⁵. Thus the market for corporate control provides shareholders with power and protection because of its important deterrent effect. It represents a strong menace of displacement for managers who intend to engage in a discretionary behaviour.

Even if its deterrent effect is not enough powerful to deter managers from engaging in such behaviour, the market for corporate control sets immediately in motion. The drop in

³⁰ See Rothbard (1993: 154). See also Rothbard (1998: 131-132) for a defence of blacklist and boycott from a property rights perspective in the libertarian tradition.

³¹ In the real business world, some forms of blacklist and boycott exist. For example, it is not unusual for an employer calls previous employers or individuals who know the job applicant to have an opinion about the latter. It is a fact of real world that employers do not only rely upon the job applicant's resume and its oratorical skills during interview sessions to judge the latter. Reputation plays an important role in the labour market at all levels.

³² In the "Market for Corporate Control" section, the Encyclopaedia of Law & Economics (1992: 351-358), bibliography lists no less than 201 entries.

³³ Actually, as Foss (1997: 46) and Klein (1999: 31) argue, we can find in the Austrian economics literature, and more particularly in Mises' works, an embryonic theory of the market for corporate control that anticipates Manne's works.

³⁴ Ibid, 112.

³⁵ Ibid, 112 (emphasis added).

share price resulting from their discretionary behaviour represents a potential capital gain for others competing firm shareholders and their managers:

[When the company] is poorly managed – in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements – the market price of the shares declines relative to the shares of other companies in the same industry or relative to the market as a whole. ... The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous. (Manne 1965: 112, 113)³⁶

[The shareholders and the] managers of a competing firm ... almost automatically know a great deal of the kind of information crucial to a takeover decision. Careful analysis of cost conditions in their own firm and the market price of shares of other corporations in the same industry will provide information that can be relied upon with some degree of confidence. (Manne 1965: 118)³⁷

Even if managers are not deterred from engaging in a discretionary behaviour, the market for corporate control always places strict limits on their behaviour.³⁸

The market for corporate control therefore plays an essential role for shareholders in controlling the activity of insiders. As soon as insiders engage in breaches of contract, this results in a drop of corporation share price, which sets in motion the market for corporate governance and leads to the replacement of corporation insiders.

³⁶ Compare Mises (1981: 121-22):

Under Capitalism, the capitalist decides to whom he will entrust his own capital. The beliefs of the managers of joint stock companies regarding the future prospects of their undertakings and the hopes of project-makers regarding the profitability of their plans are not in any way decisive. The mechanism of the money market and the capital market decides. This indeed is its task: to serve the economic system as a whole, to judge the profitability of alternative openings and not blindly to follow what the managers of particular concerns, limited by the narrow horizon of their own undertakings, are tempted to propose.

And Mises (1998b: p. 303):

[T]he changes in the prices of common and preferred stock and of corporate bonds are the means applied by capitalists for the supreme control of the flow of capital. The price structure as determined by the speculations on the capital and money markets and on the big commodity exchanges not only decides how much capital is available for the conduct of each corporation's business; it creates a state of affairs to which the managers must adjust their operations in detail.

³⁷ Compare with Mises (1981: 122):

[I]t is essential to realise that the capitalist does not just invest his capital in those undertakings which offer high interest or high profit; he attempts rather to strike a balance between his desire for profit and his estimate of the risk of loss. He must exercise foresight. If he does not do so then he suffers losses – losses that bring it about that his disposition over the factors of production is transferred to the hands of others who know better how to weigh the risks and the prospects of business speculation.

³⁸ Klein (1999: 30).

Moreover, the market of corporate control fulfils another important function: the enforcement of efficient contracts. In other words, it operates a selection between good and bad contracts, between contracts that incite insiders to work in the shareholder's interests and those that incite insiders to enter into a breach-of-contract behaviour. If contractual schemes incline insiders to engage in behaviour going against the interest of shareholders, the market for corporate control will lead to a replacement of bad contracts by better contracts.³⁹

The fundamental result of the analysis of market for corporate control device is that there is no difference between managers engaged in a discretionary behaviour and insiders engaged in breaches of contract. Both types of behaviour run counter to the interest of shareholders and in a certain sense, poor managers break also their contract because they did not fulfil their task, that is, to increase the value of the corporation. The subsequent drop of corporation share price, resulting from their behaviour, will always lead to a sanction of the market for corporate control.

3.5 Internal Managerial Competition

Competition understood as a rivalry process plays an important role in controlling the activity of insiders. Managers have career concerns that compel them not to engage in breaches of contract. These career concerns result in competitive behaviours, which plays at two levels: competition between managers and competition between firms.

The managerial competition is one aspect of the competition, which has been often overlooked by the critics of insider trading as an agency problem. However, Mises had already shown in 1944 that the career concerns play an important role in deterring managers' discretionary behaviour.⁴⁰ This managerial competition plays itself at two levels, within and outside the firm.

Internal managerial competition, which results from career concerns⁴¹, express itself by the manager's will to accede to higher-level position, or at least, to keep the position.⁴² Lower-

³⁹ This does not mean that new contracts will always be better or that errors are impossible.

⁴⁰ See Mises (1983: 31-39). See also Mises (1981: 302). Much later, Fama (1980: 292-293) has also shown that the managerial competition acts as a deterrent to discretionary managerial behaviour. Nevertheless, it should be noted that Fama's purpose was to demonstrate that the separation of ownership and control is an efficient form of organization. Fama has correctly seen the control device exerted by the internal managerial competition. However, he has completely overlooked the fact that there is no firm without property rights. The very notion of contract implies that there exist property rights. Property rights are the crux of the matter.

⁴¹ These career concerns vary according the preference scale of the manager. They can be monetary income, prestige, glamour, and so on.

⁴² Even if we can admit that not everybody wishes to accede to higher-level positions for personal motives (for example, because they are adverse to shoulder greater responsibilities), it is hardly thinkable that people would prefer to occupy a lower-level position.

level managers want to accede to top-level position and top-level managers want to accede to the highest-level position, to become the "boss of bosses."⁴³ The fulfilment of their plan is dependent on their performance. Either they want to accede to higher-level position or they wish to keep their position. Probably their current performance does not affect immediately their current position, but it impacts on their future position. As we have already said, the owners, the ultimate decision-makers, will not hesitate to discharge managers if they are unproductive. Consequently, it is in the manager's interest to be successful.

However, a manager's performance is dependant of his subordinates' performance. In other words, the higher-level manager will be considered successful if he has been able to "elicit" productive lower-level managers, that is, profit-making managers. If he fails, he will have to answer to his superior, who will have also to answer to his superior. At the top of the hierarchical system of the corporation, the directors will have to answer for their results to the shareholders. If directors fail, they will be discharged and replaced by other directors that owners expect to be more successful⁴⁴. Therefore, because it is in higher-level managers' interest that his subordinates are profit-makers, they will monitor lower-level managers in order to avoid that the latter engage in discretionary behaviour.

[S]o there is a natural process of monitoring from higher to lower levels of management. (Fama 1980: 293) [Emphasis added]

The internal managerial competition also creates a control process from bottom to top. The managers' will to accede to higher-level position gives them an interest in monitoring higher-level managers. Sub-managers have interest in monitoring higher-level managers because if the latter prove to be unsuccessful, they have the opportunity to take their place. Therefore, they must be alert to these career opportunities.

Competition operates among the workers when they compete for higher positions and for promotion to higher ranks. ... But for the workers themselves this is an important matter. Each is in competition with others. Of course each is interested to see every other foreman's job shall be occupied by the most suitable man and the best. But each is anxious that that one job which comes within his reach shall fall to him, even though he is not the most suitable man for the job; and the advantage to him outweighs the fraction of the general disadvantages which may eventually also come his way. (Mises 1981: 302)

Less well appreciated, however, is the monitoring that takes place from bottom to top. Lower managers perceive that they can gain by stepping over shirking or less competent managers above them. (Fama 1980: 293)

⁴³ Fama (1980: 293).

⁴⁴ See Mises (1983: 33-34). See also Mises (1998b: 302).

There is also one another important reason to explain this monitoring process as explained by Mises. It is in the interest of sub-managers to monitor the activity of higher-level managers because if the latter engage in discretionary behaviour; not only, they hurt their own interests but also the interests of sub-managers.⁴⁵

The double-sense controlling process prevents managers from engaging in perverse behaviours. This process also operates in the case of insider trading. It is irrelevant whether insiders are able to trade on inside information. In all cases, this monitoring process works. Insider's interest is to make as profit as possible. At any rate, if he fails, he will be sanctioned either by higher-level managers or directly by owners of the firm, the shareholders.

3.6 The External Managerial Competition

Along with reputation⁴⁶, we find external managerial competition as a control device. External managerial competition is closely connected with reputation because the latter is often a determining factor in the selection of managers. The external managerial competition puts pressure on managers within the firm not to engage in breach-of-contract behaviour. As we have already said, the career interests of insiders involve competition between managers within the firm; career interests also entail competition between managers within the firm and managers outside the firm.

Competition as a rivalry process "compels" managers (insiders) to give their best. The insider has an interest in honouring his contract, that is to say, in avoiding discretionary behaviour and in respecting the insider trading prohibition; for if he fails shareholders or top-managers will replace him by another manager whom they expect to be more successful. This rivalry process has an important incentive effect on the performance of insiders. It places the manager (insider) in an ejector seat position. He knows perfectly that if he fails his future situation will be strongly at risk. Therefore, the external managerial competition acts as a deterrent and a sanction to prevent managers (insiders) from breaking their contract.⁴⁷

3.7 Competition in the Product Market

The discretionary behaviour of insiders can also be controlled through competition in the product market. The competition from other firms in the product market gives incentives to insiders to give of their best. This can be explained with the profit and loss system.

⁴⁵ Ibid, p. 33. See also Carlton and Fischel (1983: 874) for a similar argument.

⁴⁶ See 3.3.

⁴⁷ Fama (1980: 292).

The profit and loss system is the only way to evaluate the satisfaction of consumers. Competition in the product market is a rivalry process to win the patronage of consumers. If consumers are not satisfied, the firm will suffer losses, and these losses will be imputed to the insiders (managers), who will be sanctioned for their failure.⁴⁸ They therefore have a strong incentive to do their best for the company. Thus, we see that competition in the product market is monitoring managers (insiders) and, in particular, reduces the moral hazard problems of insider trading. It prevents insiders from engaging in discretionary behaviour.⁴⁹

4 Insider Trading in the Hampered Market

It should be clear now that in an unhampered market, there is no such thing as separation of property and control.⁵⁰ Berle and Means's theory is untenable when it is applied to the insider-trading problem. There is no principal-agent problem that cannot be solved by the market.

The corollary of this proposition is that, as soon as the control relation between shareholders and insiders (and managers) is destroyed or, at least, is strongly lessened, insider trading becomes a problem⁵¹. Therefore, we now have to examine the causes of the emergence of this problem.

4.1 The Nature of Interventionism

Before analysing the implications of interventionism for insider trading in a hampered market, it is useful to briefly state the nature of the interventionism.

We have already pointed out that interventionism, as an economic system, is different from the market economy in the sense that, even if the system is still based a private ownership of the means of production, the owners are not free to use their property as they see fit. In other words, interventionism is characterised by set of authoritative commands and

⁴⁸ It is also important to recall that the more profit the firm makes, the higher shareholder dividends will probably be. Similarly, shareholders will see their dividends drop if the firm suffer losses. Therefore, the profit and loss system is another system shareholders have to evaluate the behaviour of their insiders (managers) and to sanction them.

⁴⁹ Ibid, p. 289. See also Klein (1999: 30).

⁵⁰ Mises (1998b: 302-03):

The emergence of an omnipotent managerial class is not a phenomenon of the unhampered market. (Emphasis added).

⁵¹ Manne (1965: 112):

[As soon as] we are unable to discern any control relation between small shareholders and corporate management [and insiders], the thrust of Berle and Means's famous phrase remains strong.

prohibitions, which seek to restrict the actions of private owners. The coercive nature of interventionism involves several consequences for the behaviour of market participants.

The first consequence of interventionism is that coerced owners of means of production will act "in a way different from that they would do" in an unhampered market:

Interventionism is a limited order by a social authority forcing owners of the means of production and entrepreneurs to employ their means in a different manner than they otherwise would.⁵²

Another consequence of interventionism understood as a set of restrictive measures is that, most of the time, it results in a set of privileges. Interventionism "brings advantages to a limited group of people while it affects adversely all others, or at least a majority of others."⁵³

The interventions, therefore, may be regarded as privileges, which are granted to some at the expense of others.⁵⁴

Finally, interventionism always results in conflicts of interest. Each individual wants to be granted a privilege, that is to say, to be the "net gainer" rather than the "net loser".⁵⁵ The very nature of interventionism is conflicting. It hampers the use that owners can make of their property rights, and consequently it creates conflicts of interest because it allows some individuals to get gains at the expense of others. Contrary to the market economy where each actor tries to satisfy the interest of other people in order to better satisfy his own interest, under interventionism each actor tries to satisfy his own interest to the detriment of others.

Identifying the nature of interventionism and its general consequences on individuals' behaviour allow us to analyse the consequences of interventionism for the relation between shareholders and insiders and for insiders' behaviour. We will show that interventionism strongly lessens the control between shareholders and insiders and that the latter, as a consequence, are allowed to engage in behaviours denounced by proponents of insider-trading-as-an-agency-problem argument.

4.2 The Weakening of Governance Devices

The prime effect of interventionism is to hamper shareholders in the exercise of their property rights since it involves a transfer of power from shareholders to managers (insiders).

⁵² Mises (1977: 20). See also Mises (1998: 10), Rothbard (1993: 768), and Rothbard (1970: 13). The direct effect of this consequence is that coerced individuals always lose in utility because they do not act in the way that they believe will maximise their utility ex ante. See Rothbard (1993: 769).

⁵³ Mises (1998: 19).

⁵⁴ Mises (1998: 19). See also Hayek (1995 [1976]: 156).

⁵⁵ Rothbard (1993: 769). Rothbard points out that John C. Calhoun has already seen that it was the intervention of the State that itself created conflicts of interest. See Calhoun (1953: 16-18) quoted in Rothbard (1970: 14-16).

This phenomenon gives rise to a separation of property from control. In other words, government's interference in the market creates the emergence of an omnipotent class of insiders (managers). Commenting on this impact of interventionism, Mises observed:

[The emergence of an omnipotent managerial class] was, on the contrary, an outgrowth of the interventionist policies consciously aiming at an elimination of the influence of the shareholders and at their virtual expropriation. (Mises 1998b: 304) [Emphasis added]

In emphasising the consequences of interventionism for the control relation between shareholders and managers (insiders), Mises anticipates recent work. Shareholders are no longer able to control their insiders, and consequently, the latter can engage in breaches of contract.⁵⁶ In the same way, some recent works on "comparative corporate governance" have also tried to show the interaction between politics and governance in the context of United States. Roe's works lead to the same conclusion than Mises:

The analytic result is fundamental: the modern American public corporation is not an inevitable consequence of technology that demands large inputs of capital. ... Politics confined the terrain on which the large American enterprise could evolve. ... By restricting the terrain on which the large enterprise could evolve, politics created the fragmented Berle-Means corporation." (Roe 1994: pp. 284-286)

With the emergence of Berle-Means corporations control shifts to managers. Owning the control, insiders (managers) are able to engage in behaviour going against the interest of the shareholders. Agency problems emphasised by advocates of public regulation of insider do not emerge under a market economy but under interventionism because shareholders have less control of their property rights.

Several regulations have especially contributed to the lessening of the control relation between shareholders and their insiders: legal restrictions on financial institutions, antitrust regulation, anti-takeover restrictions, and labour legislation.

According to Roe, legal restrictions on financial institutions' taking large stock position were crucial to the weakening of the control relation between shareholders and managers (insiders):

The regular prohibition on financial institutions' taking large stock positions was crucial to the development of the Berle-Means corporation, with its fragmented share ownership. ... Managers eventually benefited from this fragmentation. (Roe 1994: 93)

⁵⁶ It is very likely that Mises intended to reply to Berle and Means' theory of separation of ownership and control by emphasizing that this phenomenon is not the result of a natural evolution of the market process but a result of government interference in the market.

In the United States, banks, mutual funds, and pensions are either barred from the securities business and from owning stock or are significantly restricted in their portfolios and cannot easily devote their portfolios to big blocks. Moreover, some financial institutions like mutual funds and pensions face legal and structural problems that prevent them from going into the boardroom. The general consequence of these legal restrictions is that there is a diffuse ownership has involved a shift of power from owners to managers.⁵⁷

Antitrust regulation and anti-takeover restrictions have the same direct effects, particularly on the functioning of the market for corporate control. The regulation of takeovers and mergers prevents the market for corporate control from exercising its control function. It prevents shareholders from exercising their property rights and from replacing inefficient management.

A fundamental consequence of such regulations is that insiders feel protected; they are no longer deterred from engaging in breaches of contract.⁵⁸ The William Act, which is part of the Securities Exchange Act of 1934, enables managers (insiders) to easily thwart a takeover because it requires that acquirers that had bought 5 percent of outstanding shares on the open market disclose their acquisitions to the Securities and Exchange Commission.⁵⁹ Rule 14(e)-3 also hampers the control function of the market for corporate control.⁶⁰ It then prevents acquirers from having recourse to arbitrageurs to make takeovers easier.

Labour legislation has also contributed to lessening the control relation between shareholders and managers (insiders).⁶¹ For example, labour legislation interferes with shareholders' exercise property rights when it prevents them from sanctioning managers engaged in breaches of contract.

The separation of ownership and control, that is to say, the lessening of the control relation of shareholders on insiders (managers), is not a consequence of a general evolution of the market process. On the contrary, as Mises and later Roe have shown, this phenomenon results from the meddling of government in the market. The separation-of-ownership-from-control phenomenon emerges with interventionism. Let us now take a closer look at this phenomenon, and in particular at the impact of insider trading regulation on the behaviour of insiders.

⁵⁷ See Roe (1994: 283).

⁵⁸ Block and McGee (1989: 12).

⁵⁹ Ibid, p. 13. See also Bittlingmayer (1998: 23).

⁶⁰ Rule 14(e)-3 makes illegal for anyone to trade the securities of the firm involved in a tender offer while in possession of material, confidential information. 17 C.F.R. § 240.14(e)-3.

⁶¹ See Klein (1999: 36) quoting Mises (1983: 69-71). See also Roe (1994: 39).

4.3 The Encouragement of Discretionary Behaviour

Our analysis has shown consequences of interventionism on the control relation between shareholders and insiders. As soon as this control relation is weakened, insiders are able to engage in breaches of contract. Now, we will show briefly that securities regulation, and more specifically, insider-trading regulation is not able to resolve such agency problems. On the contrary, insider-trading regulation worsens them, in the sense that it inclines insiders to develop new forms of behaviour in order to trade on inside information. This results from the arbitrary nature of any regulation. Because restrictive measures are arbitrary, insiders have no difficulty to find strategies to escape regulation. Several examples illustrate this point.

The very definition of insider trading relying on the concept of "fiduciary duty"⁶² allows insiders to engage in inside information exchange with insider of other corporations, or to give inside information to a friend who will undertake to trade in on behalf of the insider for a consideration. Manne described this behaviour and the emergence of a "black" market for private information in order to escape insider-trading regulation.⁶³

Section 16 of the Securities and Exchange Act prohibits any transaction involving purchases and sales within six months. Insiders have only to make a transaction within six months and one day, and they are not under the prohibition!

The securities regulation compels corporations to publish information according to well-defined accounting criteria. But because these criteria are arbitrary, insiders can keep the material information in order to trade on it.⁶⁴

The recent Insider Trading Sanctions Act of 1984 has the particularity not to define insider trading. The argument developed by the Securities and Exchange Commission to justify this innovation is that "a clear definition of insider trading would be undesirable because clever traders would only devise schemes that did not violate the definitional

⁶² Chiarella v. United States 445 U.S. 222 (1980) and Dirks v. SEC 463 U.S. 646 (1983), quoted in Macey (1991: 1). It is necessary in order to come within the provisions of insider trading regulation to have a fiduciary relation with shareholders.

⁶³ Manne (1966: 59-75). In an unhampered market, such a market would not emerge because all contracts are voluntary. Therefore, both parties will expect ex ante that they will be better off after contracting than before contracting.

⁶⁴ The other consequence of such rules is that they create an illusory trust among the public. Therefore, the regulation misleads investors because they rely upon this kind of information and, in a certain sense; they are stolen because they pay taxes to be sure to trade on a "fair" market. "The Securities and Exchange Commission sells public a dud". It is a fraud in the sense of Thomas Aquinas' definition of fraud. See Block and McGee (1988: 5-6).

standard.⁶⁵ Therefore, the SEC recognises its inability to prevent insiders from engaging in trade on inside information.

It is a typical feature of interventionism to generate alternative behaviours to escape to the regulation. Because, any regulation is based on arbitrary criteria, individuals will engage in alternative behaviours to reach their ends.

The first result of interventionism is to shift control from shareholders to managers (insiders). The second result is that insiders adopt alternative (perverse) behaviours in order to get net gains offered by interventionism. Advocates of the insider-trading-as-an-agency-problem argument denounce these perverse behaviours. However, they do not result from a natural evolution of market but from government meddling with the market.

5 Conclusion

The objective of this essay was to reply to the argument that insider trading inherently involves agency problems because shareholders are not able to control their insiders. We have analysed the control relation between shareholders and insiders under two systems: the market economy and interventionism. We have been led to the conclusion that under a market economy, agency problems are reduced to a minimum; at any rate, behaviour of insiders that is contrary to shareholders' interest is sanctioned. Moreover, we have shown that, by its conflicting nature, interventionism involves a lessening of this control relation between shareholders and insiders. This enables insiders to engage in these behaviours denounced by supporters of insider-trading-as-an-agency-problem argument. Finally, we have shown that the failures of government regulation reinforce this tendency of insiders' behaviour.

Nothing in our study allows us to support a public regulation of insider trading based on the insider-trading-as-an-agency-problem argument.

⁶⁵ U.S. Congress, Senate, Subcommittee on Banking, Housing, and Urban Affairs, Hearings on the Insider Trading Sanctions Act of 1984, 99th Congress, 2d session; quoted in Macey (1991: 63).

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