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Insider trading and managerial incentives

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Abstract

We derive conditions under which permitting manager "insiders" to trade on personal account increases the equilibrium level of output and the welfare of shareholders. These increases are produced by two effects of insider trading. First, insider trading impounds information about hidden managerial actions into asset prices. This impounding of information allows shareholders to make better personal portfolio-allocation decisions. Second, allowing insider trading can induce managers to increase, on average, the correlation between their personal wealth and firm value beyond the level dictated by the employment relationship alone. This increased correlation increases managerial incentives. When these two effects are only weakly present, permitting insider trading harms shareholders, because insider trading reduces shareholder control over the performance–compensation relationship. In addition, when managerial effort incentives are high and corporate governance costs are low, managers may prefer insider-trading restrictions because such restrictions force shareholders to offer them a larger fraction of output through the employment relationship.

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1. Introduction

Securities trading by corporate officers has become one of the most heavily regulated capital market transactions. The securities and exchange (SEC) Act of 1933, as interpreted by the Supreme Court in cases such as *Speed v. Transamerica Corporation*, places broad prohibitions on trading by corporate insiders who use firm-specific private information. More recent legislative initiatives, such as the Insider Trading and Securities Fraud Enforcement Act of 1984, have fortified this prohibition.

Not surprisingly, the rationale for this elaborate structure of regulation has received significant attention from both financial economists and legal scholars. Much of this attention has been provided by the "law and economics" scholars. For the most part, these scholars have viewed insider trading prohibitions unfavorably. This view finds its classic expression in the work of Manne (1966). One Manne's for allowing insider trading is that such trading allows the information possessed by insiders to be rapidly impounded in the prices of securities and thus increases the efficiency of capital markets. The importance of this argument is evidenced by its profound impact on subsequent research into insider trading. Another aspect of Manne's discussion has received considerably less analytical attention: the effect of security market transactions on managerial incentives and agency problems within the corporation. According to Manne, and to other adherents of the law and economics school, security trading can improve the alignment of interests between outside claimants and management by allowing managers to profit from the appreciation in firm value engendered by their efforts.

Much of the subsequent literature on insider trading has been devoted to examining the arguments of Manne in a rigorous analytical fashion. The results of these analyses have not, in general, been supportive of Manne's conclusions. For example, Fishman and Hagerty (1992) show that insider trading may discourage the production of information by outside analysts and thus reduce the net informational efficiency of stock markets. It has also been demonstrated by Ausubel (1990) and Manove (1989) that, even in the absence of this effect, the adverse selection costs for outsiders engendered by insider trading make the raising of external finance more costly for outside investors. Manne's second argument in favor of insider trading also has been critiqued in Noe (1997) who demonstrates that, even if managerial short sales are prohibited, endogenous changes in the pattern of managerial compensation in response to a relaxation of insider trading restrictions may actually decrease the equilibrium level of managerial effort.

This paper develops a model that links the moral hazard and informational transmission aspects of insider trading and shows that the beneficial effects of insider trading, which are not entirely apparent when the informational and moral hazard arguments for insider trading are modeled separately, become