THE LOST HISTORY OF INSIDER TRADING

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Common conceptions about the history of insider trading norms in the United States are inaccurate and incomplete. In his landmark 1966 book Insider Trading and the Stock Market, *Dean Henry Manne depicted a world in which insider trading was both widespread and universally accepted. It was SEC enforcement efforts in the early 1960s, he contended, that swayed public opinion to condemn what had previously been considered a natural and unobjectionable market feature. For five decades, the legal academy has largely accepted Manne's historical description, and the vigorous debates over whether the federal government should prosecute insider trading have assumed, either explicitly or implicitly, the accuracy of those views. This paper challenges that conventional wisdom and shows that the shift in insider trading norms began earlier than has previously been supposed and substantially preceded governmental enforcement efforts. Insider trading, while generally believed to be ubiquitous in turn-of-the-century stock markets, was not universally condoned. In fact, the propriety of the practice at publicly traded companies was highly contested. Those debates coincided with the growth of public companies and an ongoing shift in views about how the stock market functioned. The early twentieth century debate over insider trading thus featured both modern arguments about property rights in information and the effect that insider trading has on stock market participation and older ideas about manipulation and market inefficiency that would generally not be accepted today.*

TABLE OF CONTENTS

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I. INTRODUCTION

Since the early 1960s, insider trading enforcement has been central to the Securities and Exchange Commission's ("SEC") mandate to police the securities marketplace.[1] The counter-revolution against that effort began almost immediately when, in 1966, Henry Manne published *Insider Trading and the Stock Market*.[2] In that book, Manne charged that the SEC was embarked on a quixotic mission that would actually harm the operation of the capital markets, and he called for a return to the pre-1900 common law approach—directors and officers should be allowed to trade freely on material nonpublic information so long as they refrained from making affirmative misrepresentations to shareholders.[3]

Over the next five decades, scholars, largely following Manne's consequentialist approach, have argued that requiring parity of information between market participants is unworkable and reduces valuable incentives to acquire information.[4] Insider trading increases market efficiency by allowing stock prices to move more quickly to their correct levels when companies cannot disclose information to the marketplace.[5] More controversially, permitting insiders to trade on nonpublic information provides a form of compensation that encourages them to maximize firm value.[6] Punishing insider trading, by contrast, is not about protecting innocent shareholders; indeed, insider trading arguably imposes no harm on contemporaneous traders.[7] The explanation for the ban lies instead in public choice theory because prohibiting corporate officials from trading confers

1. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady Roberts, 40 S.E.C. 907, 910 (1961); Andrew Ceresney, *Testimony on Oversight of the SEC's Division of Enforcement*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 19, 2015), https://www.sec.gov/news/testimony/031915-test.html ("Policing insider trading has long been central to the Commission's mission of ensuring confidence in the markets.").

2. Henry G. Manne, *Insider Trading and the Stock Market*, *in* 2 THE COLLECTED WORKS OF HENRY G. MANNE (Fred S. McChesney, ed. 2009).

3. *Id.* at 9.

4. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 253–54 (1991); Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEG. STUD. 1, 30 (1978). Contemporary insider trading doctrine rejects the equal access theory. *See* Chiarella v. United States, 445 U.S. 222, 232–33 (1980).

5. *See* Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 88–102; *see also* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983).

6. *See* Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 121–56; Carlton & Fischel, *supra* note 5, at 870–71.

7. Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 32–36 (1980). *But see* William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1243 (1981).

an advantage on insiders' main trading rivals, securities market professionals.[8] Most of these accounts posit that insider trading is primarily about property rights in information[9] and should therefore be a matter of contract individually negotiated between firms and those privy to material nonpublic information,[10] although at least some commentators recognize that difficulties in drafting and enforcing such contracts might justify public enforcement.[11]

Those who offer more generous support for governmental enforcement efforts tend to adopt the same consequentialist framework but argue instead that insider trading is largely about perceptions and the impact those perceptions have on the proper functioning of the stock market.[12] To be sure, they dispute the efficiency and compensation claims made for insider trading. Insider and derivatively informed trading, they argue, is unlikely to yield substantial efficiency gains.[13] It provides a poorly targeted compensation scheme[14] that, among other problems, allows insiders to take advantage of bad information just as easily as good.[15] Insider trading also arguably creates substantial agency cost problems that might lead managers to delay disclosure or increase stock price volatility in order to create more profitable trading opportunities.[16] The main argument in favor of robust insider trading enforcement, however, remains that such enforcement is crucial to protecting the perceived fairness and integrity of the securities markets.[17] Without vigorous enforcement, the cost of capital will rise and, at the

8. *See* David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading*, 30 J. L. & ECON. 311, 314–17 (1987).

9. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1192 (1995).

10. *See* Carlton & Fischel, *supra* note 5, at 870–72; Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading after* United States v. Newman, 125 YALE L.J. 1482, 1489 (2016).

11. *See* EASTERBROOK & FISCHEL, *supra* note 4, at 263.

12. Both sides of the insider trading debate agree that current legal doctrines are poorly theorized and riddled with inconsistencies. *See, e.g.*, James D. Cox, *Insider Trading and Contracting: A Critical Response to the 'Chicago School,'* 1986 DUKE L.J. 628, 634 (1986); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 184 (1991); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).

13. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 631 (1984) (explaining that insider trading is only likely to move the price of the security slowly and sporadically and therefore permitting it "is unlikely to have much effect on the efficiency of securities prices").

14. *See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 317; Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 4–6 (2010).

15. *See* Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 126 (1982).

16. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 599–601 (2002); EASTERBROOK & FISCHEL, *supra* note 4, at 260; Lucian A. Bebchuk & Chaim Fershtman, *Insider Trading and the Managerial Choice Among Risky Projects*, 29 J. FIN. & QUANTITATIVE ANALYSIS 1, 1 (1994) (arguing that the ability to trade on inside information may lead managers to choose riskier projects); Levmore, *supra* note 15, at 149 (speculating that insiders "might structure corporate transactions in a way that increases the number of occasions for secret-keeping").

17. *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."); Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979) (arguing that "investors will refrain from dealing altogether" in a market beset with insider trading); Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*,

extreme, investors will flee the equity markets, harming capital formation and the economy as a whole.

A second, less common line of argument focuses on whether it is "right" to permit insider trading.[18] Insider trading laws, in these deontological accounts, are not predominantly about efficiency; they are about protecting "the autonomy of public securities traders" and "structurally disadvantaged parties" from unfair and wrongful deception.[19] Donald Langevoort argues for the symbolic importance of the insider trading ban, which he contends demonstrates a deep societal commitment to equality of opportunity and a desire for strict adherence to fiduciary obligations.[20] Others link morality and agency costs, arguing that insider trading laws target improper, self-regarding gain and thus reflect generalized anticorruption norms.[21]

While vigorous, these debates over the costs and benefits of insider trading enforcement have been almost entirely ahistorical. There have certainly been analyses of the common law approach to insider trading,[22] but there has been no serious attempt to explore other, earlier conceptions about the legitimacy of insider trading, the function it was thought to perform, or the harm it might engender. Some modern commentators argue that there is little empirical support for claims about the harms associated with insider trading or complain that pervasive

4 CATO J. 945, 953–55 (1985); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne*, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1440–42 (1967). The same rationale underlies Regulation FD, which prohibits certain market participants from making selective disclosures of material nonpublic information to securities market professionals. Regulation Fair Disclosure, Securities Act Release No. 33-7881, 17 C.F.R. §§ 240, 243, 249 (Aug. 15, 2000).

18. *See* Stuart P. Green & Matthew B. Kugler, *When is it Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORD. URB. L. J. 445, 484 (2011); Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 123 (1993); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 376 (1999). Law and economics scholars dismiss these deontological theories as irrelevant to the normative question of whether law should ban insider trading. *See* EASTERBROOK & FISCHEL, *supra* note 4, at 262 (arguing that "the consequences of trading for investors' wealth" are "unrelated to fairness and beliefs about managers' preferred position"); Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 25 ("[N]o amount of moral exhortation can substitute for the rigorous analysis necessary to understand the problem of insider trading."); Carlton & Fischel, *supra* note 5, at 882 ("If insider trading is efficient, no independent notions of fairness suggest that it should be prohibited."); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 549 (1970) [hereinafter Manne, *Law Professors*] (arguing that moral arguments were "frequently either sham or a refuge for the intellectually bankrupt").

19. Scheppele, *supra* note 18, at 125; Strudler & Orts, *supra* note 18, at 382, 411, 428. *See* Schotland, *supra* note 17, at 1439.

20. Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1327–31 (1999).

21. *See* Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 928 (2014).

22. *See* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 7–14 (2d ed. 2007); STUART BANNER, SPECULATION: A HISTORY OF THE FINE LINE BETWEEN GAMBLING AND INVESTING 241–78 (2017); Douglas M. Branson, *Choosing the Appropriate Default Rule—Insider Trading Under State Law*, 45 ALA. L. REV. 753, 755–56 (1994); Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1295–96 (1998).

insider trading enforcement makes it impossible to assess the viability of contractual approaches to insider trading.[23] These critiques, however, do not consider historical evidence from the period before SEC enforcement efforts.[24] With respect to the acceptability of insider trading, many current commentators seem to assume the universality of modern societal norms,[25] a seemingly implausible assumption given what we know about how views about morality shift over time[26] and about how contested insider trading enforcement remains today.[27]

The dearth of historical analysis is, perhaps, unsurprising given the frequently expressed view that legal developments and scholarship in the 1960s revolutionized the approach to insider trading. Current scholars often assume that the terms of the modern debate began with the SEC's first insider trading enforcement action in 1961[28] or with Manne's economic analysis in 1966. Indeed, the insider trading literature is replete with claims that Manne's novel economic approach "changed the terms of the debate" regarding insider trading, which had previously been mired in unhelpful discussions of fairness.[29] Most of the voluminous insider trading literature remains squarely within the confines of the economic approach Manne championed.

The most notable exception to this ahistoricism was Manne himself, who argued that popular attitudes condemning insider trading are of relatively recent vintage and were the product of the SEC's decision to use Rule 10b-5 to target the practice.[30] Other scholars have offered similar theoretical accounts.[31] In earlier times, Manne claimed, market participants accepted unquestioningly that insiders with superior knowledge traded in the marketplace.[32] Indeed, he began the

23. *See* Cox, *supra* note 12, at 636–37; Epstein, *supra* note 10, at 1490.

24. *See* Cox, *supra* note 12, at 636–37; Epstein, *supra* note 10, at 1490.

25. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 308 (1998) (asserting that commentators and lawmakers "share the intuition that—regardless of the economic consequences—it is simply unfair for those with inside information to trade"); Strudler & Orts, *supra* note 18, at 377 n.6, 384 (asserting a "widely shared" moral intuition that insider trading was "wrong").

26. *See* KWAME ANTHONY APPIAH, THE HONOR CODE: HOW MORAL REVOLUTIONS HAPPEN 179–80 (2010).

27. *See* DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 62–86 (2016).

28. *See* Langevoort, *supra* note 20, at 1319 (arguing that William Cary's *Cady, Roberts* opinion "frames the subsequent intellectual history of insider trading regulation").

29. *See, e.g.*, BAINBRIDGE, *supra* note 16, at 587 (Manne "changed the terms of the debate" in 1966 by placing it "almost exclusively in the language of economics"); Ronald A. Cass, *One Among the Manne: Changing Our Course*, 50 CASE W. RES. L. REV. 203, 204 (1999) (Manne's insider trading scholarship was "novel" and "dramatically changed discourse about the issue"); Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. L. REV. 269, 269 (1999) (Manne "revolutionized" the "intellectual discourse concerning insider trading").

30. Henry G. Manne, *In Defense of Insider Trading*, *in* 2 The Collected Works of Henry G. Manne 235, 253–54 (Fred S. McChesney, ed. 2009).

31. *See* Dan Kahan & Eric Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J. L. & ECON. 365, 376–78 (1999) (suggesting that changes in how prosecutors approach insider trading might alter general beliefs about the morality of the behavior).

32. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 9–10.

first chapter of *Insider Trading and the Stock Market* with this categorical assertion: "Prior to the year 1910 no one had ever publicly questioned the morality of corporate officers, directors, and employees trading shares of corporations."[33] Later in his career, he would assert that there was "no evidence of any general revulsion by the business community or the public towards insider trading in those 'good old days'"[34] and that the public "has never shown any signs of losing confidence in the stock market because of the existence of insider trading."[35]

Manne's broad generalizations have remained unchallenged and, for the most part, accepted in the legal academy. They are, however, incomplete and sometimes substantially inaccurate. Manne's depiction of a time when insider trading was universally acknowledged and accepted probably never existed, and certainly not in the opening years of the twentieth century. We, of course, know (and Manne recognized) that by 1910, some courts had begun to change their approach to insider trading.[36] While most courts continued to hold that managers were free to trade with shareholders when in possession of material nonpublic information,[37] some found that the presence of "special facts" could lead to liability[38] while others held that silence alone could constitute a breach of fiduciary duty.[39] What is less understood is that by 1910, some legal academics, economists, and financial journalists had begun to question more broadly the propriety of insider trading.[40] Those concerns, however, were not confined to elite commentators. Indeed, by that time, the United States had already had its first major insider trading scandal. In 1906, the directors of the Union Pacific Railroad were accused of delaying announcement of a dividend increase so that they could purchase company shares before the expected price increase.[41] While some commentators continued to believe that this behavior was acceptable, for many observers the board had abused its power.[42] The shift in attitudes regarding the propriety of insider trading began earlier than has previously been supposed and substantially preceded governmental enforcement efforts.

A review of the turn-of-the-century literature also shows that modern economic arguments about insider trading were not nearly so revolutionary as is generally believed today. By the late 1800s, commentators had already begun to premise their arguments for or against insider trading on the predicted effect that

33. *Id.* at 9.

34. Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. CORP. L. 167, 175 (2005) [hereinafter Manne, *Hayek*]; *see* BANNER, *supra* note 22, at 241–45 (observing that insider trading remained a "normal, sound business practice" into the 1930s).

35. *See* Manne, *Law Professors*, *supra* note 18, at 577.

36. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 9; Henry G. Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 475 (1967) [hereinafter Manne, *Administrative Process*].

37. *See* Carpenter v. Danforth, 52 Barb. 581, 589–92 (N.Y. App. Div. 1868).

38. *See* Strong v. Repide, 213 U.S. 419 (1909).

39. *See* Oliver v. Oliver, 45 S.E. 232 (Ga. 1903); Stewart v. Harris, 77 P. 277, 279–80 (Kan. 1904).

40. *See* Jonathan R. Macey & Geoffrey P. Miller, *Origins of the Blue Sky Laws*, 70 TEX. L. REV. 347, 356–58 (1991).

41. MAURY KLEIN, UNION PACIFIC: THE REBIRTH 1894–1969, at 153–55 (1989).

42. *See infra* Section II.C.

the rule would have on the willingness of small investors to engage in stock market transactions, on the incentives the rule created for business executives, on the efficient functioning of the capital markets, and on who should hold the property rights in information.[43] Throughout this neglected history, one can find precursors to most of the recurring arguments in the current insider trading debate.

This Article seeks to recapture this lost history—to offer a deeper and more nuanced analysis of the social and intellectual history of insider trading, focusing specifically on the late nineteenth and early twentieth centuries, when the stock exchange began to assume a more prominent role in the economy.[44] What emerges from this analysis is a far more contested and complicated picture than the tidy history that to this point has been accepted by the legal academy.

The Article proceeds in two parts. Part II begins by reviewing and refuting the historical evidence Manne offered regarding the uniform acceptance of insider trading in the early 1900s. Manne was right in at least one respect—there was a widespread belief at the turn of the century that insider trading was endemic to securities markets. But as Part III shows, those beliefs were, for the most part, premised on very different views about how the stock market functioned. The market was not efficient; stock price movements were almost exclusively the product of the manipulative schemes of stock market professionals. Indeed, it was these perceptions regarding the prevalence of insider trading and manipulation that led many commentators to advise ordinary investors to avoid the equity markets lest they lose out to better informed insiders.[45] The link between investor confidence and stock market participation was a common theme in discussions of insider trading during this time period. Brief concluding remarks follow.

II. Insider Trading at the Dawn of the Twentieth Century

In October 1904, shareholders discovered that tens of thousands of dollars were missing from the Lillooet Gold Dredging Company, and Mrs. M. V. Hamilton, a young stenographer who worked at the firm, had recently been spending with abandon.[46] Hamilton offered an innocent explanation for her new-found riches.[47] She had not stolen the money, but she knew it was missing because of her access to internal corporate documents.[48] Hamilton used her inside information to sell the company's stock short.[49] The embezzler turned out to be the corporation's general secretary.[50] The company and its defrauded shareholders

43. *See infra* Section III.B.
44. *See infra* Part III.
45. *See infra* Section III.A.
46. *Shortage Was Not News to Her*, MINNEAPOLIS J., Oct. 5, 1904, at 12, https://chroniclingamerica.loc.gov/lccn/sn83045366/1904-10-05/ed-1/seq-12/.
47. *Id.*
48. *Id.*
49. *Id.*
50. Iowa Lillooet Gold Mining Co. v. Bliss, 144 F. 446, 446–48 (N.D. Iowa 1906).

pressed their claims against him,[51] and Mrs. Hamilton kept her stock market profits. No one seemed to question the legitimacy of her actions.

Manne did not discuss this anecdote, but it illustrates the world he believed existed before the SEC began to regulate insider trading and the myth that the legal academy has come to accept—a world in which insider trading was neither immoral nor improper, a world in which it was assumed that corporate insiders would take advantage of their superior access to information. While anecdotes like these are relatively easy to find, they depict only a portion of the complex, nuanced, and evolving attitudes regarding insider trading that existed in the early twentieth century.

This Part offers a fuller account of those attitudes. It first examines the completeness and accuracy of Manne's historical account. It then describes the work of several writers who challenged the propriety of insider trading at the turn of the twentieth century. Finally, this Part offers a case study of the insider trading scandal involving the Union Pacific railroad to illustrate how radically popular attitudes had begun to shift as stock ownership became more widespread.

A. The World According to Henry Manne

It might seem a bit misplaced to attack the historical underpinnings of *Insider Trading and the Stock Market.* After all, Manne was primarily making an economic argument. While his followers and his critics have engaged his arguments almost exclusively on economic grounds, it remains important to test Manne's historical claims for two reasons. First, Manne's history has, to some degree, become the legal academy's history, with many commentators unquestioningly repeating it[52] or, at a minimum, tacitly accepting it as true. Second, Manne grounded his position for why insider trading should be permitted on a set of beliefs about how the stock market operated and how market participants viewed the practice before the SEC began to regulate it.[53] By framing his argument in this way—insider trading was historically an accepted and universal practice that created no evident harm—Manne sought to strengthen the case for abolishing the SEC's new-found restrictions.[54] Even though Manne failed in his efforts to rollback insider trading prohibitions, his historical claims remain important. Widespread promulgation of a view that insider trading laws are simply a recent social construction imposed by misguided bureaucrats likely undermines the legitimacy of and compliance with those restrictions.[55] Such views also likely

51. *Id.* at 448; Miller v. Hawkeye Gold Dredging Co., 137 N.W. 507, 510 (Iowa 1912).

52. *See* Stephen M. Bainbridge, *Introduction* to Manne, *Inside Trading and the Stock Market*, *supra* note 2, at vii–viii; James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CALIF. L. REV. 1413, 1429 (1992) (referring to Manne's "ubiquitously cited work" on insider trading and to Manne's historical claims); Dooley, *supra* note 7, at 44–46; Kim, *supra* note 21, at 945–46; Macey, *supra* note 29, at 269.

53. *See generally* Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 88–120.

54. *See* Manne, *Administrative Process*, *supra* note 36, at 489.

55. *See* TOM R. TYLER, WHY PEOPLE OBEY THE LAW 19–32 (2006). *See generally* Kristina Murphy et al., *Nurturing Regulatory Compliance: Is Procedural Justice Effective When People Question the Legitimacy of the Law?*, 3 REG. & GOVERNANCE 1 (2009).

encourage academics to make proposals that weaken existing legal restrictions and inspire judges to narrowly interpret them.

The origin of insider trading restrictions matter, not just because it is important to understand their origins but because of how they shape our approach to these laws today. Unfortunately, the historical evidence Manne offered to support his claim that they arose from the SEC in the 1960s (rather than evolving from shifting marketplace norms in the early twentieth century) was sketchy. His original analysis is quite brief, consisting of citations to a handful of cases and academic articles.[56] Although much of it focused on the period from the 1920s through the 1940s, Manne made broad assertions about earlier periods. To support the claim that prior to 1910 "no one had ever publicly questioned the morality of corporate officers, directors, and employees trading shares of corporations,"[57] Manne relied, not on his own research, but on a 1927 law review article by Columbia law professor Adolf A. Berle, Jr.[58] But even that article was derivative. Berle claimed in 1910 that a law professor active in the Progressive movement, H.L. Wilgus, was the first to challenge the common law's permissive attitude toward insider trading.[59] Seemingly without looking beyond these two law review articles (and a *New York Times* article discussed in more detail below), Manne concluded that the "arguments against insider trading, interestingly enough, are not very old."[60]

Over the years, Manne would broaden his historical claims and sharpen his rhetoric. For example, in 2005 in one of his last full-length insider trading articles, Manne extended his claim by fifty years, contending that prior to the late 1960s, "insider trading was very common, well-known, and generally accepted when it was thought about at all."[61] Business leaders, Manne argued, did not raise concerns about the practice, a silence that he thought was telling:

> It is hardly conceivable that officers, directors, and controlling shareholders would have remained totally silent in the face of widespread insider trading if they had seen the practice as being harmful to the company, to

56. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 9–19, 26–33. His list of relevant cases contains only five decided before 1910. *See id.* at 200–01. Steve Thel has also examined conceptions of insider trading in the 1920s and 1930s. *See* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 419 n.77 (1991) (discussing acceptability of insider trading in the business and financial communities in the period before adoption of the Securities Exchange Act of 1934); Steve Thel, *Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934*, 1988 COLUM. BUS. L. REV. 359, 362–64 (1988).

57. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 9.

58. *Id.* at 12.

59. Relying on Berle's description, Manne wrote that Wilgus's 1910 "article collect[ed] the existing cases and comment[ed] on the then fresh U.S. Supreme Court decision in *Strong v. Repide*." Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 12 (footnotes omitted). The relevant articles are Adolf A. Berle, Jr., *Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827 (1927) and H. L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267 (1910).

60. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 12.

61. *See* Henry G. Manne, *The Case for Insider Trading*, WALL ST. J. (Mar. 17, 2003, 12:01 AM), https://www.wsj.com/articles/SB104786934891514900.

investors, or to themselves. And it is equally inconceivable that they would not have recognized some harm if it existed.[62]

Given that insider trading was widespread, but "studiously ignored by the business and investment communities before the advent of insider trading regulation," the most likely inference was that it simply was not considered a problem.[63] That silence (what Manne, borrowing from Sherlock Holmes, dubbed the "dog that did not bark")[64] should inform current debates. If "no one of significance in the business world was ever heard to complain about [it], much less declare it to be the moral equivalent of murder or rape in the commercial area"[65] and if there was "no evidence of any general revulsion by the business community or the public towards insider trading in those 'good old days,'"[66] then that was strong evidence that we should reconsider our approach to insider trading in light of the efficiency gains he claimed it provided.

To be sure, Manne recognized in his later work that there were some pre-1915 sources he had originally missed, in particular Congress's Money Trust investigation in 1912–1913.[67] But Manne remained convinced that those debates were unimportant. They focused too much on morality without any real appreciation for the benefits he said insider trading provided.[68] For Manne, the fact that no regulation resulted from these early criticisms supported his conclusion "that there was no serious public concern with insider trading."[69] As we shall see, Manne was wrong about the absence of public concern and about the lack of a regulatory response.

Manne was largely right, however, about the common law approach, although here, too, he downplayed the prevalence and significance of contrary approaches.[70] Prior to 1900, courts almost uniformly held that directors and officers owed no duty to shareholders when they dealt in the corporation's shares, even

62. Manne, *Hayek*, *supra* note 34, at 174.

63. *Id.* at 167, 174–77.

64. *Id.* at 174.

65. *Id.* at 175.

66. *Id.* Professors Prentice and Donelson have previously challenged Manne's conclusion about the acceptability of insider trading prior to SEC enforcement efforts, but their analysis focuses primarily on sources from the 1920s. *See* Prentice & Donelson, *supra* note 14, at 7–8.

67. The committee's final report called for the stock exchanges to limit insider trading. "The scandalous practices of officers and directors in speculating upon inside and advance information as to the action of their corporations may be curtailed if not stopped" if the exchanges required "complete publicity" regarding corporate affairs. H.R. REP. NO. 62-1593, pt. 3, at 115 (1913) [hereinafter MONEY TRUST REPORT]. For an overview of the Money Trust investigation, see Richard N. Sheldon, *The Pujo Investigation, 1912*, *in* III CONGRESS INVESTIGATES: A DOCUMENTED HISTORY 1792–1974 (Arthur M. Schlesinger, Jr. & Roger Bruns, eds., 1975). This Article does not discuss the Pujo investigation in any significant detail, as the committee's work has been thoroughly documented elsewhere. Instead, it focuses on critiques and discussions of insider trading that predated those hearings.

68. Manne, *Hayek*, *supra* note 34, at 175.

69. *Id.* at 175 n.33. Manne argued instead that "insider trading regulation had its primordial introduction in the muck of New Deal securities regulation." Manne, *The Case for Insider Trading*, supra note 61.

70. *See* Bainbridge, *supra* note 9, at 1220 ("After 1900 . . . the trend was towards the special circumstances rule and, to a lesser extent, the fiduciary duty rule.").

if they were in possession of material nonpublic information.[71] Those holdings were premised on both formal reasoning and on a judicial reluctance to interfere with what were viewed as the prerogatives of officers and directors.[72] As a formal matter, directors and officers owed a fiduciary duty to the corporate entity, not to each individual shareholder,[73] and so corporate officials were thought to be free to buy and sell stock "like any other individual."[74] Silence alone was not considered wrongful, either legally or morally.[75] Instead, most commentators viewed a director or officer as being fully "entitled to the benefit of his facilities for information."[76] In modern terms, courts assigned the property right in the information to the corporation's managers. The only circumstances in which corporate officials could be liable to the shareholders with whom they dealt were when they made affirmative misrepresentations, when they fraudulently concealed material facts, or in the presence of a variety of "special facts," the presence of which necessitated disclosure.[77]

The initial approach to insider trading, however, was not without its critics. Manne's work never discussed a growing body of literature (both inside and outside the legal academy) and so created an inaccurate impression of uniformity. In reality, as far back as 1877 (more than thirty years before Wilgus's article), legal commentators questioned the common law approach. Writing the twelfth edition of Joseph Story's *Commentaries on Equity Jurisprudence*, Jairus Perry sought to place the burden on directors to show that their trading profits had not come from the "intimate knowledge" they obtained from their positions.[78] Most often, these critiques were premised on morality. Treatise writer Henry Osborn

71. *See* Bd. of Comm'rs of Tippecanoe Cty. v. Reynolds, 44 Ind. 509, 513 (Ind. 1873); Krumbhaar v. Griffiths, 25 A. 64, 70 (Pa. 1892); Fisher v. Budlong, 10 R.I. 525, 528 (1873); Haarstick v. Fox, 33 P. 251, 253 (Utah 1893). For a contrary earlier example, see Adm'r of Spence v. Whitaker, 3 Port. 297, 325–26 (Ala. 1836).

72. *See, e.g.*, *Haarstick*, 33 P. at 253.

73. *Bd. of Comm'rs of Tippecanoe Cty.*, 44 Ind. at 514–16. Not all courts agreed. *See* Oliver v. Oliver, 45 S.E. 232, 233 (Ga. 1903) ("[T]he fact that [the director] is a trustee for all is not to be perverted into holding that he is under no obligation to each . . . . No process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder.").

74. WILLIAM W. COOK, A TREATISE ON STOCK AND STOCKHOLDERS 354 (2d ed. 1889).

75. *See* Crowell v. Jackson, 23 A. 426, 427 (N.J. 1891).

76. *See* COOK, *supra* note 74, at 354–55 ("The information [the director] has of the affairs of the corporation, whereby he is enabled to buy or sell at an advantage over the person with whom he deals, does not affect the validity of the transaction."). The law with respect to directors and officers mirrored the rule the Supreme Court laid down in 1817 for ordinary commercial transactions. Laidlaw v. Organ, 15 U.S. (2 Wheat) 178, 195 (1817) (holding that party to contract not required to disclose information to counterparty "where the means of intelligence are equally accessible to both"). How broadly the rule of *caveat emptor* should be applied in commercial transactions, however, was also the subject of significant dispute and controversy in the nineteenth century. *See* BANNER, *supra* note 22, at 245–52.

77. *See* Strong v. Repide, 213 U.S. 419, 431–33 (1909); Carpenter v. Danforth, 52 Barb. 581, 587–88 (N.Y. App. Div. 1868).

78. 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE: AS ADMINISTERED IN ENGLAND AND AMERICA 225 n.1 (12th ed. 1877) ("[W]here the director, either in the purchase or sale of the shares of the company gained an unequal advantage over the ordinary shareholder, it would be very natural to infer that such advantage might have been gained, more or less, by his position, and the more intimate knowledge consequent upon it, unless the contrary was made very clearly to appear by the proof.").

Taylor, for example, noted in 1905 that insider trading transactions were "eminently unfair" and "of questionable propriety."[79] But a few commentators made normative arguments similar to those raised by contemporary scholars. For example, in 1896, Seymour Thompson, a judge and treatise writer, offered what amounted to an agency cost argument when he suggested that the rule permitting insider trading created precisely the wrong incentives for corporate officials because it encouraged them to put their own financial returns ahead of shareholders' interests.[80] In other words, allowing insider trading would create incentives for executives to engage in private corruption, what Sung Hui Kim has recently dubbed "self-regarding gain."[81]

Cases that Manne dismissed as based only on vague moral assertions also raised consequentialist issues that remain at the heart of the modern insider trading debate. For example, the Georgia Supreme Court's decision in *Oliver v. Oliver*[82] (the first to recognize insider trading as a breach of fiduciary duty) can be read as a case about property rights in information. The court recognized that material nonpublic information was a "quasi asset" of the corporation.[83] As we shall see in the next Section, the question of how corporate law should assign such property rights was crucial during this time period because ownership of railroads and industrial companies was beginning to shift from private to public with a concomitant increase in the information asymmetries investors encountered.[84] It was for that reason that the court in *Oliver* found that directors held such "information in trust for the benefit of those who placed him where this knowledge was obtained, in the well-founded expectation that the same should be used first for the company, and ultimately for those who were the real owners of the company."[85]

These examples (and others discussed in more detail below) show the incompleteness of Manne's discussion of late nineteenth and early twentieth century sources. But the breadth of his research is only one source of concern. Manne cites only one nonlegal source for his claim about the broad acceptance

79. *See* HENRY OSBORN TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 692 n.1 (5th ed. 1905) ("The transaction which in this case was allowed to stand seems to the writer to have been eminently unfair, and indeed a rule—for which this decision is certainly authority—that directors in their dealings with shareholders are entitled to take advantage of their knowledge of facts not known to the latter, but which the directors are acquainted with by reason of their official position, seems of questionable propriety."); *see also* JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE AS ADMINISTERED IN THE UNITED STATES OF AMERICA § 1090 (2d ed. 1892) (arguing that directors were "quasi or sub modo trustees for the stockholders with respect to their shares of stock"); JAMES HART PURDY, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 1098 (1905) ("A director's relations are so far fiduciary with a stockholder to whom he is selling shares, that he is bound to reveal to the stockholder all material facts to him known affecting the value of the stock, and which are unknown to the stockholder.").

80. *See* 3 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS 4034 (1896) (stating that the majority rule "proceeds upon a conception which, if extended, would sanction nearly all of the fraud and injustice which the managers of corporations have committed against the stockholders").

81. *See* Kim, *supra* note 21, at 934.

82. 45 S.E. 232 (Ga. 1903).

83. *Id.* at 234.

84. *See infra* Part III.

85. *Oliver*, 45 S.E. at 234.

of insider trading in the early twentieth century, "a survey by the New York Times in 1915" which purportedly found that "90 per cent of business executives interviewed admitted to trading regularly in their own company's shares."[86] The "survey," however, was nothing of the sort. It was simply a selection of six responses the *Times* received when it questioned an unspecified number of "men known the country over for their active participation in financial and corporate affairs" about their views on insider trading.[87] To be sure, the *Times* concluded that "[a]ll but a very few held that a director has a right to use the information which comes to him in the board room for his own profit."[88] But the *Times* did not tally the responses it received, and even the printed excerpts did not indicate that 90% engaged in insider trading. The only reference to that figure was an unnamed state bank chairman who guessed that, as a matter of personal ethics, 10% of directors "never buy or sell to take advantage of coming price changes."[89] But that was nothing but pure conjecture, not the product of a "survey" of "business executives."

While hardly a scientific poll, the article nonetheless provides an important glimpse into elite public opinion in the business community. But to conclude from it, as Manne does, that business executives were overwhelmingly in favor of insider trading does not do justice to the nuances the interviews expressed. Attitudes were not unvarying, even among that small sample of business leaders. And why did the *Times* feel it was necessary to conduct these interviews? They came in the wake of a scandal a few weeks earlier in which the directors of the United Rubber Company allegedly delayed disclosing a dividend decision so that they could trade on the information.[90] Even the title (*Should Directors Speculate?*) suggested that the issue was subject to substantial dispute.[91] What is most apparent from these interviews is that the executives seemed to know that insider trading was no longer an unquestioned management prerogative, and they admitted that if directors were "Christian gentlemen with a very fine sense of honor" they would not trade.[92]

That same executive the *Times* interviewed who guessed about the percentage of directors who refrained from trading, conceded that there was a substantial evolution underway in what was considered acceptable behavior. There was "much less speculation than there used to be," a transformation that he believed was largely for the better.[93] And while the line between appropriate and inappropriate behavior remained uncertain, other business leaders were beginning to draw meaningful distinctions by focusing, for example, on the materiality of the

86. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 10 (citing *Should Directors Speculate?*, ANNALIST, Jul. 19, 1915, at 65).

87. *Should Directors Speculate*, *supra* note 86, at 65.

88. *Id.*

89. *Id.*

90. *Passing a Dividend*, ANNALIST, Jul. 5, 1915, at 5. United Rubber was a reprise of the Union Pacific scandal addressed in Section II.C.

91. *See Should Directors Speculate*, *supra* note 86, at 65.

92. *Id.*

93. *Id.*

information. A "self-made man of Wall Street" who was "the head of one of the great financial institutions of the country" opined:

> I am not sure that if a dividend is about to be passed the Directors have the right to sell their stock, or if a valuable contract is about to be entered into that they have the right to buy before the news is given out, but no rigid rule can be drawn against a Director's increasing or reducing his holdings.[94]

Another interviewee argued that "a Director should not sell or buy on important news affecting his company until it has been publicly announced" because it was only then that "all stockholders, theoretically at least, would have equal chance with the Director for turning the news to market advantage."[95] This ongoing evolution in business norms seemed to govern all managerial insider trading, especially trading on impersonal, secondary markets.[96]

Just two weeks earlier, the same publication described insider trading by directors as a "strange code of morals" that ran counter to stockholders' rights and suggested that qualms about it were not novel.[97]

> It is well enough to say that a Director has the same right as any other stockholder to buy or sell in the open market. So he has, but he has no greater right than any other stockholder. What he learns as a Director he has no right to use for his own benefit until all other stockholders have an equal chance to use that same information. It is as a stockholder that he buys or sells. As a Director he should do neither, for what he learns as a Director he holds in trust for all the stockholders until it has been made known to all. *There is nothing new in all this*, but unfortunately to some Directors, it will sound like some new and strange doctrine.[98]

In a separate article focusing on trading at United Rubber, the *Times* concluded that "more people in Wall Street agree" that directors did not have the right to trade ahead of unannounced changes in a corporation's dividend rate.[99] Insider trading was "harmful" to the reputation of the company, both inside the financial community and among ordinary investors.[100] Companies that allowed their directors to trade were held in lower "esteem" than those that did not.[101]

94. *Id.*

95. *Id.*

96. The emergence of these norms at the turn of the century is particularly interesting in light of what is generally believed to be the predominant common law approach. *See* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (noting that directors trading in impersonal markets have no duty to disclose material nonpublic information in their possession). The SEC's original decision to use Rule 10b-5 to address insider trading was aimed at changing the result in *Goodwin*. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 344–45 (3d ed. 2003).

97. ANNALIST, July 5, 1915, at 3.

98. *Id.* (emphasis added).

99. *Passing a Dividend*, *supra* note 90, at 5.

100. *Id.*

101. *Id.* Reputational harm to the company is also a feature in some modern discussions of insider trading, although courts and commentators have disagreed as to whether it provides a sufficient basis for either derivative or criminal claims. *See* Freeman v. Decio, 584 F.2d 186, 194 (7th Cir. 1978) (noting that damage to the corporation was "speculative"); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) ("When officers and directors

For this reason, some elite business leaders were (contrary to Manne's contention) beginning to rethink the propriety of insider trading, although they often faced resistance from their own directors. The most notable example was Elbert Gary, the chairman of U.S. Steel.[102] The first corporation with a billion-dollar market capitalization, U.S. Steel had been formed in early 1901 with the merger of a number of previously competing steel companies.[103] Gary surprised the directors at the end of that first year of operation, when he proposed to not only release publicly the company's financial statements but to make them available to shareholders at the same time they were made available to directors—in the late afternoon after the market had closed.[104] Gary believed that directors should have "no better opportunity on the market than the public at large."[105] This policy, according to Gary's biographer, Ida Tarbell, "outraged" several board members (including Henry Clay Frick) who were accustomed to getting advance information on other boards.[106] "Some of them," Tarbell noted, "had added handsome slices to their fortunes by this kind of maneuvering."[107]

Gary, however, "had rigid ideas on this matter" and liked to present himself as a modern and progressive business leader.[108] His "Methodist training" and legal background could make him "overly serious and pompous"[109] but also injected a Christian morality into his decision-making. Gary did not think that the corporation should be "managed for the stock market," and he objected to directors speculating in company stock:

> I always thought this use of inside information by directors—very common at the time—was akin to robbery of their own stockholders, and I had no hesitation in making my disapproval of it so clear that everybody on the board would understand. . . . It was wrong in principle and it set a bad example. How could we expect our officers and employees not to speculate if the members of the board did.[110]

Gary's views were certainly not universal, but they illustrate, especially in light of the *Times* interviews, that, contrary to Manne's contention, elite business leaders did not uniformly view insider trading as legitimate. Subsequent critiques of insider trading enforcement have, unfortunately, premised their analyses on

abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities."); STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 602 (2002) (raising concerns over whether any real shareholder injury exists).

102. IDA M. TARBELL, THE LIFE OF ELBERT GARY: THE STORY OF STEEL 127 (1925).

103. *Id.* at 126.

104. *Id.* at 144.

105. *Id.*

106. *Id.* at 142.

107. *Id.* at 143; *see* SAMUEL A. SCHREINER JR., HENRY CLAY FRICK: THE GOSPEL OF GREED 223–25 (1995).

108. TARBELL, *supra* note 102, at 143; KENNETH WARREN, TRIUMPHANT CAPITALISM: HENRY CLAY FRICK AND THE INDUSTRIAL TRANSFORMATION OF AMERICA 304 (1996).

109. TARBELL, *supra* note 102, at 142; WARREN, *supra* note 108, at 304.

110. TARBELL, *supra* note 102, at 144.

Manne's impoverished view of the historical record and have inaccurately concluded that firms had "made little, if any attempt to prohibit insider trading."[111]

The U.S. Steel example is important for another reason—it shows that recognizing that attitudes about insider trading were complicated and contested long before SEC enforcement efforts began does not require rejecting the contractarian approach Manne advocated. As Richard Epstein has recently argued, "the risks of fraud and manipulation are so deadly to the market that private firms have every incentive to seek out the optimal solution to insider trading . . . in order to preserve the value of their shares."[112] Professor Epstein recognized that the comprehensive governmental regulation that exists today makes it difficult to demonstrate empirically that firms would adopt private ordering mechanisms to address insider trading,[113] but that is precisely what Gary was doing at U.S. Steel. The firm engendered a good deal of controversy when it was launched, and many critics charged that the shareholders were the victims of a giant scam intended to enrich the founders and promoters of the enterprise.[114] Given the company's reliance on the capital markets—it had the largest capitalization of any publicly traded company—it should not be surprising that Gary would recognize the importance of promoting the belief among investors that they would not invariably lose out to informed insiders. The stock was one of the most actively traded on Wall Street, and the ability of the firm to signal credibly to investors that it was limiting insider trading could be expected to increase investor demand for the shares, particularly in a market otherwise thought to be dominated by such trading.[115] Maintaining a liquid market in U.S. Steel shares also benefitted J.P Morgan & Co. and other U.S. Steel underwriters, which were paid in stock for their investment banking services.[116] Gary's solution, a mix of rules and norms that would discourage insider trading at a firm likely to suffer substantial harm from it, is precisely what contractarians predict would happen in the absence of external regulation.[117]

The interviews in the *Times* and other commentary from the time period suggest the possibility that similar norms may have been forming at other public companies. For example, economist William Z. Ripley, writing in 1905, observed that one of the "peculiar *evils in corporate finance*" was the problem of

111. *See* Carlton & Fischel, *supra* note 5, at 858 (citing Manne for the proposition that: "Although no one has conducted rigorous empirical research in this area, it is generally believed that firms have made little, if any attempt to prohibit insider trading, at least until very recently and then perhaps only as a response to regulation.").

112. Epstein, *supra* note 10, at 1490. These scholars reject a comprehensive governmental approach because they argue that the optimal solution will vary from firm to firm. *See* Michael P. Dooley, *Comment from an Enforcement Perspective*, 50 CASE W. RES. L. REV. 319, 321–22 (1999).

113. Epstein, *supra* note 10, at 1490. There is evidence that some firms adopt insider trading policies that are more restrictive than current federal law, but it is difficult to know whether those restrictions are largely for public relations purposes. Laura N. Beny & Anita Anand, *Private Regulation of Insider Trading in the Shadow of Lax Public Enforcement: Evidence from Canadian Firms*, 3 HARV. BUS. L. REV. 215, 217 (2013). Nor can we know what approach those firms would take in the absence of governmental regulation.

114. *See* RON CHERNOW, THE HOUSE OF MORGAN 85 (1990).

115. *See* Cox, *supra* note 12, at 638–39.

116. CHERNOW, *supra* note 114, at 85.

117. *See* TARBELL, *supra* note 102, at 144, 146; Carlton & Fischel, *supra* note 5, at 894.

"speculative management."[118] Ripley acknowledged the difficulty of distinguishing "recklessness" from "downright dishonesty," and his views on stock compensation are clearly out of step with modern practices.[119] The "best" companies, he wrote, "prohibit dealings in the securities of a company by its own officers."[120] For Ripley, insider trading was simply a byproduct of the absence of mandatory disclosure. "Secrecy," he wrote, "is a constant invitation to the insider to take advantage of forthcoming events at the expense of the stockholders."[121]

How extensive actual limitations on trading by directors or officers were remains uncertain. U.S. Steel and perhaps a few other companies may have been outliers, driven by size and trading volume to impose restrictions on managers that other firms did not adopt or would not consider. As we will see with the Union Pacific insider trading scandal, large market capitalization and substantial trading volume were apparently insufficient, standing alone, to cause all firms with those characteristics to adopt such private ordering mechanisms.[122] Additional research could explore this issue in greater detail, illuminating whether, in a world without pervasive insider trading enforcement, multiple firms developed such mechanisms to address the potential costs and benefits of permitting managerial insider trading or whether they largely eschewed such devices in favor of maintaining this private benefit of control.

B. The Morality of Insider Trading

In 1904, the financial writer Edwin Lefèvre tackled the subject of insider trading. Over the previous seven years, Lefèvre had written extensively about Wall Street, first as a financial reporter for a New York newspaper and later turning to magazine features and short stories.[123] Although his best-known work, *Reminiscences of a Stock Operator*,[124] the thinly disguised biography of Jesse Livermore, was not published until 1923, Lefèvre was already a well-established market commentator when he wrote *Use and Abuse of Inside Information* for the *Saturday Evening Post.*[125]

Lefèvre would eventually conclude that nearly all of the "Captains of finance" were "utterly unconscious of moral turpitude or wrongdoing" and blind to "the rights and feelings of the individual."[126] He seemed less certain in 1904 about the immorality of directors trading ahead of soon to be announced mergers or dividend changes.[127] Such things, he assured readers, were commonplace.[128]

118. WILLIAM Z. RIPLEY, TRUSTS, POOLS AND CORPORATIONS xix (1905).
119. *Id.*
120. *Id.* at xxi.
121. *Id.* at xxii.
122. *See infra* Section II.C.
123. Otis Notman, *Men of Affairs Who Write Novels—Edwin Lefèvre's Views of Wall Street*, N.Y. TIMES, Mar. 9, 1907, at BR142.
124. *See generally* EDWIN LEFÈVRE, REMINISCENCES OF A STOCK OPERATOR (1923).
125. Edwin Lefèvre, *Use and Abuse of Inside Information*, SATURDAY EVENING POST, Dec. 31, 1904, at 1.
126. Notman, *supra* note 123, at BR142.
127. Lefèvre, *supra* note 125, at 1.
128. *Id.* at 2.

In fact, he provided some support for Manne's position, stating that insider trading was "taken as a matter of course, without indignation, without even passing comment."[129] He could think of only a single instance where a large corporation increased its dividend without the stock price increasing before the announcement.[130] He knew the practice was not illegal and conceded that it might not even be immoral, "though it would seem to be that."[131] Like Professor Kim, Lefèvre likened insider trading to political graft, by which he meant that in both cases individuals were selected to serve the interests of others, not for personal gain.[132] But Lefèvre's primary objection seems to have been a gentleman's concern for conduct that was unfair and unsporting. Insider traders played the game with "loaded dice."[133] They took advantage of the weak in an unseemly and "vulgar" pursuit for money.[134]

A year later, Thomas F. Woodlock, one of the leading financial writers in the country, tried to make a more forceful case against insider trading. Serving as an editor of the *Wall Street Journal* from 1902 to 1905, Woodlock was a man of varied interests and experience, writing extensively on railroad financing, the financial markets, and Catholicism before serving for five years on the Interstate Commerce Commission.[135] He was not afraid to let those various worlds intertwine. As the *New York Times* observed, "both in his writings and in his conversation on economic or political subjects he would unashamedly begin with a religious or a moral premise, and base his conclusions on it."[136] To his colleagues at the *Wall Street Journal*, Woodlock was a man "of rare moral stature."[137]

Indeed, Woodlock's 1905 essay on insider trading was entitled *Morality in Wall Street*.[138] While Woodlock recognized the utility of speculation (a hotly

129. *Id.*

130. *Id.*

131. *Id.* at 1.

132. *Id.* at 2.

133. *Id.*

134. *Id.* at 1–2.

135. *See* Harris & Ewing, *T.F. Woodlock Dies; A Financial Editor*, N.Y. TIMES, Aug. 26, 1945, at 44; *Thomas F. Woodlock to Resign from I.C.C.; Expected to Join the Wall Street Journal*, N.Y. TIMES, Jul. 27, 1930, at 1.

136. *Thomas F. Woodlock*, N.Y. TIMES, Aug. 27, 1945, at 18. Rejecting *caveat emptor* and reasserting morality into economic transactions was an integral part of the Progressive Era's approach to monopolies. *See* EDWARD J. BALLEISEN, FRAUD: AN AMERICAN HISTORY FROM BARNUM TO MADOFF 143–73 (2017); ROBERT H. WIEBE, BUSINESSMEN AND REFORM: A STUDY OF THE PROGRESSIVE MOVEMENT 4 (1962). Economist John Bates Clark, for example, argued that an "unrestricted struggle for wealth" was impossible to maintain and that the rise of monopolies demonstrated that pure, unrestrained competition had run its course as a viable economic philosophy. *See* JOHN B. CLARK, THE PHILOSOPHY OF WEALTH: ECONOMIC PRINCIPLES NEWLY FORMULATED 150 (1886). "Moral force as an economic agent," he claimed, "is the characteristic of the new regime," and he explicitly sought "to find a place in the system for the better motives of human nature." *Id.* at iv, 150.

137. *Thomas F. Woodlock*, WALL ST. J., Sept. 10, 1945, at 4.

138. Thomas F. Woodlock, *Morality in Wall Street*, MESSENGER, July 1905, at 1. Other editorial writers were, at the same time, making similar calls for an improvement in the morals of both Wall Street and corporate directors. "The plain truth is," the editors of *World's Work* wrote in 1905, "that Wall Street is yet a den of thieves; and the pity is that their thievery goes unpunished . . . ." *Constructive and Criminal Wall Street*, 9 WORLD'S WORK 5780, 5780 (1905). The real problem, they observed, was "that we have two codes of honor—one for

contested issue at the turn of the twentieth century),[139] for him the fiduciary relationship that existed between the corporation's managers and shareholders made insider trading inherently improper, although he too lends support to Manne's view that such trading was ubiquitous and accepted, at least in certain circles.[140]

> I dislike to bring a general indictment against a person or a community, but the plain fact is that in Wall Street speculation by insiders for their own exclusive personal profit is the rule. . . . My observation compels me to the conclusion that the "insider" who does not use his official position for his personal profit by means of speculation is extremely rare. Furthermore the Wall Street community cynically expects him to do so, and in no way blames him when he does it.[141]

As a result of this toleration, insider trading was the "most common defect" among "Wall Street speculators."[142] Substantial news items likely to affect securities prices, he observed, "are usually foreshadowed in market movements long before they are finally announced. The implication is that 'insiders' are exploiting their own interest engaged for their own benefit in the market before permitting the general public to know as much as they do."[143]

Woodlock, however, saw no reason why corporate officials should be permitted to exploit those informational advantages.[144] To be sure, Woodlock's analysis contained a healthy dose of Christian morality, but he also mirrored modern analyses of insider trading by focusing on property rights in information. Directors owe shareholders a fiduciary duty, and the information in their possession came to them "by virtue of their official position, which is conferred upon them by the stockholders."[145] These advantages "arising from fiduciary relations are not the personal property of the individual who derives them as trustee, but come to him as trustee."[146] Whether he used this information against the shareholders or not, Woodlock concluded that the director had "no moral right" to use

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dealings by private persons and firms, and another for dealings by the managers of corporations with their shareholders, present or prospective." *Id.* at 5781; *see also* B.O. Flower, *In the Mirror of the Present: The Blight of Wall-Street High Finance*, *in* 39 Arena 78, 78 (1908) (noting a "vicious shallow opportunism has taken the place of fidelity to the fundamental principles of morality").

139. *See* Thomas F. Woodlock, *The Ethics of Speculation*, TICKER & INV. DIG., Dec. 1909, at 77; BANNER, *supra* note 22, at 105–63.

140. Woodlook, *Morality in Wall Street*, *supra* note 138, at 7–8.

141. *Id.*; *see also* JEREMIAH W. JENKS, GREAT FORTUNES: THE WINNING: THE USING 27–28 (1906) (stating that insider trading was "by no means uncommon, and doubtless many of the large fortunes of London and New York have been made in good part in exactly this way").

142. Woodlock, *Morality in Wall Street*, *supra* note 138, at 6.

143. *Id.*

144. *Id.*

145. *Id.* For a similar analysis that did not specifically mention insider trading, see *Constructive and Criminal Wall Street*, *supra* note 138, at 5781.

> The directors and other officers of a corporation ought to be trustees for the stockholders. In theory they are trustees. The moral baseness of making personal profit out of such a trusteeship is as great as the moral baseness of making personal profit out of any other trusteeship—of the property of minors, for instance, or of the deposits in a savings-bank.

Id.

146. Woodlock, *Morality in Wall Street*, *supra* note 138, at 6.

the information for his own personal profit.[147] Any indirect profits from using the information would properly belong to the corporation.[148]

Woodlock's analysis was remarkably similar to the modern contours of insider trading law. For example, he saw tipping as equally problematic as trading, using the same moral and property rights claims he employed elsewhere.[149] "The advantage," he explained, was simply not "theirs to use or to give away at their good pleasure."[150] Professor Epstein recently made the same point as Woodlock when he advocated replacing the rules about tipper/tippee liability with the law of constructive trusts.[151] Unlike tipper liability, which requires a personal benefit to impose liability on the tipper, constructive trust law would impose liability simply because the trustee does not have the power or authority to give away the trust assets.[152]

Like modern courts, Woodlock saw no basis for imposing an equal access rule, and he drew a sharp distinction between "expert knowledge of values" and "early information":

> We are, I think, quite safe in assuming that, provided a man is morally competent to buy or sell the securities in which he speculates, not being restricted by pecuniary or fiduciary relations, and provided that he legitimately obtained his information and attempts no direct or indirect deception against the other man, he is entirely justified in making the contract. It is true that he may have an advantage which chance or superior enterprise or ability may have given him, but why is he not morally entitled thereto?[153]

Other writers followed Woodlock's lead, although they objected to insider trading almost exclusively on moral grounds.[154]

Those condemnations, not surprisingly, increased after the Panic of 1907. As another writer noted in the spring of 1909, around the same time as the Supreme Court's decision in *Strong v. Repide*[155] (that Court's articulation of the "special facts" doctrine):

> There is nothing more sordid in Wall Street than the use that is made in the stock market by insiders (directors, bankers, and their like) of information accessible only to themselves. They have the first information of changes in earnings; they are able to anticipate dividend changes months ahead; they know what financial transactions are impending, as, for instance, an increase of stock.[156]

147. *Id.*
148. *Id.*
149. *Id.* at 7.
150. *Id.*
151. Epstein, *supra* note 10, at 1530.
152. *See id.* at 1506–07.
153. Woodlock, *Morality in Wall Street*, *supra* note 138, at 13.
154. *See, e.g.*, HERBERT B. MULFORD & TRUMBULL WHITE, THE "SQUARE DEAL," OR FLASHES FROM THE BUSINESS SEARCHLIGHT 227–31 (1905) (arguing that when directors profited on news solely within their possession, they breached a "sacred trust" they owed the stockholders).
155. 213 U.S. 419 (1909).
156. John Parr, *The Stock Yards of New York: A Study in the Process of Making "Killings" in Wall Street*, 20 EVERYBODY'S MAG. 291, 298 (1909).

Consistent with the common law cases such as *Oliver v. Oliver*, insider trading was, in this view, improper even in situations where the corporate officials did not manipulate the stock or even in the absence of "special facts."[157]

Woodlock returned to the topic again in 1909, and that later essay contains some hints that popular attitudes were changing. In *The Ethics of Speculation*, Woodlock responded to an argument that the "existence of a free and open market for securities destroys altogether the trust-relationship between" shareholders and directors.[158] Twenty-four years later, the Massachusetts Supreme Judicial Court in *Goodwin v. Aggasiz*,[159] held that directors could trade in impersonal secondary markets without fear of violating their fiduciary duty to shareholders, but Woodlock took the opposite approach. He contended that "public opinion would not tolerate the action of directors who would speculate upon the strength of a dividend just ordered by them, but not yet announced to the public."[160] Still, Woodlock recognized the uncertainty in current ethical standards. Insider trading continued to exist in something of a netherworld in 1909, although support for prohibiting it seemed to be gaining strength:

> There is undoubtedly a large territory of business relationships arising from modern methods of corporate enterprise which has not yet been fully surveyed and mapped in an ethical sense and this matter of 'directors,' or 'inside' speculation falls partly in this territory. At present it is under a kind of provisional government with the principle *caveat emptor* as its main constitution. Perhaps some day the standard of strict *honesty* may more closely approximate the standard of *honor* than it now does. It is to be hoped that it will.[161]

Woodlock's hope would not be fully realized for another half century, but what is clear is that by 1910, significant figures in the business community had raised substantial concerns about the propriety of insider trading.[162]

C. The Union Pacific Dividend Scandal

The analysis has so far focused on generalized statements about the prevalence of insider trading and changing conceptions about whether it was acceptable for directors and officers of public companies to engage in it. The catalog has centered primarily on elite legal and financial commentators and business leaders. Manne's historical claims, however, were not so limited. He argued that there was "no evidence of any general revulsion by . . . the public towards insider trading in those 'good old days.'"[163] Subsequent legal scholars have accepted

157. *Id.*
158. Woodlock, *The Ethics of Speculation*, *supra* note 139, at 79.
159. 186 N.E. 659, 661 (Mass. 1933).
160. Woodlock, *The Ethics of Speculation*, *supra* note 139, at 79.
161. *Id.*
162. *See infra* notes 248–57 and accompanying text.
163. Manne, *Hayek*, *supra* note 34, at 175; *see also* BANNER, *supra* note 22, at 241–45.

that view, repeating uncritically that "popular attitudes towards corporate morality did not until recently condemn insider trading."[164] The overwhelming public reaction to one such episode, however, is inconsistent with that assertion, and a discussion of that scandal helps to contextualize the shifting insider trading norms during this period.

In 1906, the Union Pacific Railroad and its sister line the Southern Pacific were considered among the best run, most efficient, and most profitable railroads in the country.[165] Edward Henry Harriman had gained control of the bankrupt Union Pacific eight years earlier, his first full-time foray into railroads.[166] By the summer of 1906, Harriman had become one of the country's most notorious and most reviled business leaders.[167] In an age when one of the biggest public policy issues was how the government could rein in monopolies, muckraking journalists and progressive politicians charged that Harriman held sway over too much of the country's infrastructure.[168]

The enmity Harriman engendered came from another source as well, the rapidly growing intolerance during the Progressive Era for capitalism unrestrained by at least some governmental control. Otto Kahn—a leading investment banker who worked closely with Harriman—thought that Harriman's belief in "unfettered individualism" was out of step with the political temper of the times.[169] The "people appear determined," Kahn wrote shortly after Harriman's death in 1909, "to put limits and restraints upon the exercise of economic power and over-lordship, just as in former days they put limits and restraints upon the absolutism of rulers."[170] It hardly seems coincidental that these public policy concerns occurred simultaneously with changing views about the propriety of insider trading at public companies.

The manner in which the Union and Southern Pacific approached a change in their dividend policies in the summer of 1906 was emblematic of that ongoing transformation. Although extremely profitable, Harriman had, to that point, reinvested most of the companies' profits into upgrading the railroads.[171] The Union Pacific paid its stockholders a 5% quarterly dividend; the Southern Pacific paid no dividends.[172] Although rumors had begun that a dividend increase was forthcoming, a great deal of uncertainty remained, in no small part because the railroads were still grappling with the aftermath of the San Francisco earthquake

164. Carlton & Fischel, *supra* note 5, at 858 n.9 (citing Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 1–2).

165. MAURY KLEIN, THE LIFE & LEGEND OF E. H. HARRIMAN 358 (2000).

166. *Mr. Harriman's Death*, 263 LIVING AGE 188, 188 (1909).

167. *Id.* at 189 ("Mr. Harriman was the American market; the American market was Mr. Harriman.").

168. *Id.* at 188–91. For an overview of Harriman and the Union Pacific see generally KLEIN, *supra* note 165.

169. Otto H. Kahn, *Edward Henry Harriman*, *in* MEMOIRS OF THREE RAILROAD PIONEERS 46 (Stuart Bruchey ed., 1981).

170. *Id.*

171. *Id.* at 12.

172. KLEIN, *supra* note 165, at 280.

earlier that year and because Harriman, who dominated the boards of both companies, had such a well-developed reputation for paying low dividends.[173] On Friday, August 17, 1906, the railroads surprised the market when the Union Pacific announced it would double its dividend and the Southern Pacific announced it would pay a 5% quarterly dividend.[174] The share prices of both companies rose substantially in the days after the announcement.[175]

Commentators criticized the boards of both companies, focusing not on the dividends themselves but on two aspects of the announcement. First, as would eventually become clear, Harriman had told the Union Pacific board at its July meeting that he wanted to raise the dividend at the next board meeting.[176] What was not clear at the time was that Harriman had told at least one director earlier in the spring that he planned to raise dividends.[177] It was at that point that Harriman and director Henry Clay Frick (the same man who complained about not receiving advanced financial information as a director of U.S. Steel) began to jointly purchase shares and agreed to split the profits from those purchases.[178] Given Harriman's dominance of the board, an eventual dividend increase seemed like a foregone conclusion. There were suspicions at the time that this kind of trading occurred. In fact, there was widespread media speculation that Harriman, his fellow board members, and various tippees obtained substantial profits from the early information.[179] Second, the board finalized the dividend decision on August 15, but delayed announcing it until August 17.[180] Commentators generally asserted that both delays were intended to and did allow insiders and tippees to earn substantial profits from early receipt of the information,[181] precisely the kind of disclosure delay modern commentators predict would occur if law did not prohibit insider trading.

If Manne were correct about the acceptability of insider trading before 1910, then these delays and the trading assumed to be associated with them would not have engendered any significant criticism. But that was not the case. Instead, the directors' actions were almost universally derided as a "wrongful use of corporate power" and a "betrayal of trust."[182] Otto Kahn observed that the

173. *See id.* at 358–59, 373.

174. *Harriman Dividends Amaze Wall Street*, N.Y. TIMES, Aug. 18, 1906, at 1.

175. *Id.*

176. *See* KLEIN, *supra* note 165, at 358 (indicating the board's eventual acquiescence to Harriman's plan).

177. *See Harriman Dividends Amaze Wall Street*, *supra* note 174, at 2 (indicating suspicion that the apparently surprising announcement had in fact been long-planned).

178. Letter from Edward H. Harriman to Henry Clay Frick (Oct. 3, 1906) (on file with the Frick Collection, New York, correspondence, box 39, folder 11); Letter from Henry Clay Frick to Edward H. Harriman (Oct. 3, 1906) (on file with the Frick Collection, New York, correspondence, box 39, folder 11).

179. *Harriman Dividends Amaze Wall Street*, *supra* note 174, at 2.

180. *Harriman Dividends Amaze Wall Street*, *supra* note 174, at 1–2.

181. *See* KLEIN, *supra* note 165, at 28.

182. *Dividend Manipulation*, OMAHA DAILY BEE, Aug. 22, 1906, at 4; *Probing Speculation by Directors*, NATION, Apr. 18, 1907, at 353–54; *The Harriman Dividends*, RAILROAD GAZETTE, Aug. 24, 1906, at 151; *The Southern and Union Pacific Dividends*, RAILWAY AGE, Aug. 24, 1906, at 222–23; *Topics in Wall Street*, N.Y. TIMES, Sept. 11, 1906, at 11.

trading (along with Harriman's monopoly power in certain segments of the railroad industry) created a "hysteria of fury against him [that] swept over the land."[183] Harriman and the other directors were "denounced and anathematized as a horrible example of capitalistic greed and lawbreaking."[184] In fact, the drumbeat of criticism was so intense, that Harriman actually offered to resign as a director of the National City Bank of New York.[185] The bank, he wrote, "should not be exposed to any criticism because" he sat on its board.[186] The bank's chairman, James Stillman, thought that the railroad leader was too "valuable" to the bank and "too much esteemed by [his] co-directors" to allow him to resign.[187] Echoing Kahn, Stillman argued that Harriman was just the latest target in the much larger muckraking campaign against all business leaders.[188] "It is quite immaterial," Stillman replied, "which one of us is singled out at any particular time, the rest of us get the same treatment at other times."[189]

Although clearly part of a broader Progressive Era campaign against unchecked corporate power, many newspapers focused on insider trading as a particularly important problem for promoting investor confidence in publicly traded corporations. The Union Pacific episode struck "a grave blow . . . against confidence in railroad management and the control of great corporations generally" and even harmed the "prestige of American securities abroad."[190] In London, the *Economist* praised Harriman's management, but criticized the manner in which the dividends were declared.[191] "But when that prosperity is turned to the private advantage of a few speculators, who can postpone dividend announcements, declare what dividends they please, buy or sell at their own sweet will, the danger of gambling with these loaded-dice merchants stands out with a certain clearness."[192] With management willing to engage in such behavior and no requirement for companies to disclose accurate and timely information, the average investor, another paper opined, was better off in Monte Carlo.[193] As discussed in more detail in the next Part, that gambling imagery was prevalent in turn of the century stock market descriptions.[194]

Most of the commentary focused on the delay between the August 15 board meeting and the official announcement on August 17. Arguably, this delay might have fit within the existing prohibitions against directorial fraud. Indeed, some

183. Kahn, *supra* note 169, at 40.
184. JOHN STEELE GORDON, THE BUSINESS OF AMERICA 96–99 (2001); Kahn, *supra* note 169, at 40.
185. KLEIN, *supra* note 165, at 405.
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*; *see also* Letter from Edward H. Harriman to James Stillman (Aug. 21, 1906) (on file with Columbia University Library, Rare Book and Manuscript Library, New York, series 1, box 1).
190. *Topics in Wall Street*, *supra* note 182, at 11.
191. Alexander D. Noyes, *Finance*, FORUM, Oct. 1906, at 196.
192. *Id.*
193. Frank A. Munsey, *An Optimistic View of the Business Situation, and Its Bearing on Investments*, 39 MUNSEY'S MAG. 61, 61–66 (1908); *The Greatest Gambling-House*, 47 EVENING WORLD, Aug. 22, 1906, at 8.
194. *See infra* Part III.

commentators viewed the delay as standard stock manipulation, not insider trading. "Not in years," *The Evening Star* in Washington, D.C. observed, "has Wall Street been treated to such a scandalous episode. Even in the palmy days of the Goulds, Fisks and Drews no parallel can be found for such a glaring piece of manipulating stock jobbing."[195] "The coup was worked," the *Times Dispatch* in Roanoke explained, "by blinding the street to the probable action of the directors."[196] The company led investors into believing that there would be only a small increase. "Against this backdrop, the announcement was like a thunderbolt from a clear sky."[197]

But even those commentators who conceded that the company had not lied to investors—had in fact kept silent—remained troubled. The *New York Times* reported "outspoken denunciations" of the board's delay, which gave insiders a "golden opportunity" to "reap a rich harvest in the market at the expense of the great bulk of stockholders who had been kept in ignorance . . . until E. H. Harriman was ready to make the announcement."[198] For the *Times*, what made the criticism all the more remarkable was the "apparently absolute unanimity of opinion on the subject."[199] There was a building consensus that the Union Pacific insiders, by delaying the dividend announcement had made tens of millions of dollars and had managed to pull off "the most remarkable coup in the street's history;" in the words of the *New York Tribune*, "one of the biggest and most downright pieces of stock jobbery ever known."[200]

Throughout the coverage, one theme resonated consistently—whatever the law permitted, directors were now expected to behave differently than they had in the past. The New York *Sun* encapsulated what many other observers noted:

> In former times it was said, when there was a different idea of the responsibility of directors, such practices as making a definite statement of policy by way of encouraging stockholders to dispose of their stock and then adopting a different policy for the individual profit of the directors passed as brilliant coups and attracted little criticism. The situation now is different. Now, it is said, a director's obligations to his stockholders constitute nothing more or less than a breach of trust.[201]

Taking advantage of advance information was no different than any other kind of graft or corruption, and engaging in it could no longer be justified by notions of laissez faire or social Darwinism, both of which still pervaded the thinking of elite business leaders.[202] Trading directors, *The Nation* observed, "display a

195. *The World of Finance and Trade*, EVENING STAR, Aug. 18, 1906, at 15.
196. *Big Fortunes Won and Lost by Stock Rise*, TIMES DISPATCH, Aug. 18, 1906, at 1.
197. *Id.*
198. *Harriman Dividends Amaze Wall Street*, *supra* note 174, at 1.
199. *Id.* at 2.
200. *The World of Finance and Trade*, *supra* note 195, at 15.
201. *Stocks Start Up with Rush*, SUN, Aug. 19, 1906, at 1.
202. *See* RICHARD HOFSTADTER, SOCIAL DARWINISM IN AMERICAN THOUGHT 31–50 (1959); EDWARD CHASE KIRKLAND, DREAM AND THOUGHT IN THE BUSINESS COMMUNITY, 1860–1900 11–17 (1964). Prominent stock broker Henry Clews, for example, saw the laws of natural selection at work everywhere. In the general upheaval following financial panics, old conservative traders were eliminated in favor of a fitter, "younger race of financiers." HENRY CLEWS, FIFTY YEARS IN WALL STREET 2 (John Wiley & Sons ed., 2006) (1906). The sharp

greed, a brutality, a disregard of the rights of others, a cynical belief in the law of the stronger" that should no longer be tolerated.[203] When directors traded on inside information or tipped their friends and family, they acted immorally. If directors could not be trusted to look out for shareholder interests, investors should think twice about putting their money in the stock market. What assurance did the public have, the *Sun* noted, "that a stock in control of a gambling element and bulled by it may not in the future be beared by it?"[204]

Insider trading "was a clear abuse of power," which, the *Railroad Gazette* observed, was closely tied to the absence of regular disclosure obligations.[205] Mirroring Gary's approach at U.S. Steel, the journal argued that corporations should be required to disclose important news immediately, "thus giving, as far as possible, a fair chance to every one to act on the news."[206] Otherwise, concerns about unchecked corporate power would continue.

> As long as a great railroad leader has the chance *and takes it* to make millions of dollars at the expense of the stockholders, who are themselves helpless to foresee the future, depending alone upon his individual will, so long will hostility to corporations be rampant. A peaceful solution of the corporation question can only come when loaded dice are eliminated from corporation management.[207]

Criticism about insider trading at Union Pacific was particularly fierce outside New York, especially in the Midwest, where the same political forces that would soon give rise to the first blue sky laws were at play.[208] The papers there reported the "savage criticism" and "hot hatred" of Harriman from "all sides," and opined on how unfairly the insiders at the railroad had treated stockholders.[209] "The universal verdict," the *Omaha Bee* reported, "is one of condemnation of the deal, as a gigantic breach of trust, whereby the knowledge of trustees was used to beat stockholders out of unnumbered millions."[210]

But it was not just progressive newspapers who viewed insider trading as unacceptable. The *New York Times*, at the time a staid defender of the status quo, remarked that "any Director who used his information to procure any investor's stock is guilty of something worse than indiscretion. . . . It is nothing short of a

trading of Charles Woerishoffer, "the most brilliant bear operator ever known in Wall Street," was like a force of nature, "uncontrollable, irrespective of consequences to others." *Id.* at 352–53; CHARLES R. GEISST, WALL STREET: A HISTORY 96 (4th ed. 2018). Ruined investors were simply collateral damage. The trader "followed the bent of his genius by making money within the limits of the law, and did not care who suffered through his operations." CLEWS, *supra* at 353. His operations were evidence of the "natural selection in financial affairs" and therefore entirely appropriate. *Id.* at 2. "[I]t all resolves itself," Clews assured his readers, "into a question of the survival of the fittest." *Id.* at 352.

203. *Would-Be Harrimans*, 84 NATION 236, 237 (1907).
204. *Stocks Start Up with Rush*, *supra* note 201, at 1.
205. *The Harriman Dividends*, *supra* note 182, at 151.
206. *Id.*
207. *Id.* at 152.
208. *See generally* Macey & Miller, *supra* note 40.
209. *Lawson Writes a Red Hot Article on "System's" Latest Coup*, SPOKANE PRESS, Aug. 27, 1906, at 4.
210. *Dividend Manipulation*, *supra* note 182, at 4.

breach of trust to make market use of official information."[211] If directors could not resist the temptation to trade, then there should be legal restraints on their ability to do so. The *Wall Street Journal*, in an editorial dripping with sarcasm, assumed that the "honorable" Union Pacific directors must not have used this "tremendous bit of knowledge" because "[i]f they had done so they would have been not one whit less culpable than would the trustee who swindled his client."[212] The price run up, the editors suggested, must have been a "remarkable coincidence" or an "intensely interesting . . . study in spontaneous activity."[213] The paper was not exactly sympathetic to the needs of public investors, but it recognized that those needs now took precedence. Declaring that enormous dividend should have been the greatest day of Harriman's life, the *Journal* observed: "In his hour of triumph, however, he trampled upon some small prerogatives of the great, blind, stupid public. Therefore, of course, the public forgot everything but its own rights—and what should have been a day of Harriman triumph became a day of public vituperation."[214]

Even some on Wall Street saw that the rules governing the behavior of officers and directors simply had to change. Elbert Gary was apparently not alone. The *Times* reported:

> Conservative bankers whose names, if they could be used, would add great weight to the opinions expressed said unhesitatingly that the Union Pacific incident had furnished proof of the imperative need of rendering impossible in the future that Directors should profit by information regarding dividend actions and other similar matters which had been withheld from the stockholders.[215]

This reaction from securities market professionals is related to, but distinct from, modern public choice explanations for insider trading enforcement, a point which is addressed more fully in Part III.

To be sure, many still believed that insider trading was not only the norm, but such a natural part of the market that even talking about the propriety of the practice was "a purely academic [and] unprofitable search after counsels of perfection."[216] No government regulation, one railway journal wrote, could "eradicate from the human breast the deep-rooted desire to speculate and to take advantage of early knowledge for the purpose."[217] Even Harriman argued that any employee who was not "in" on the Pacific deal ought to be discharged for incompetency.[218] And long-term investors, at any rate, should not even care about such behavior—the only ones really harmed by the insiders' actions were short

211. *Directors' Perquisites*, N.Y. TIMES, Aug. 19, 1906, at 8.
212. *A Question of Honor*, WALL ST. J., Aug. 18, 1906, at 1.
213. *Id.*
214. *I.—Harriman—The Man*, WALL ST. J., Aug. 25, 1906, at 1.
215. *Harriman Dividends Amaze Wall Street*, *supra* note 174, at 2.
216. *Id.*
217. *Stocks Show Small Rallying Power*, RAILWAY WORLD, Mar. 1, 1907, at 193.
218. *Harriman Dividends Amaze Wall Street*, *supra* note 174.

sellers and other stock market gamblers.[219] The "widest benevolence," a financial reporter for the *New-York Tribune* wrote, could not afford to waste sympathy on "a keen band of speculators without the least vested interest in the country, without any other aim or purpose than to reap gambling profits by promoting disaster in others."[220]

Those objections, however, were in the minority. The uproar over Union Pacific made plain that attitudes were changing and that an increasingly large part of the public and of Wall Street did indeed care about such practices. They were beginning to take a different view about just how natural insider trading was and how accepting they should be when it occurred. Rather than seeing insider trading as a just reward for entrepreneurial effort, commentators fit insider trading into the traditional critique applied to all stock market transactions. The real problem with Union Pacific episode, according to *The Nation*, was that it allowed Harriman and his fellow directors to "get something for nothing, big money for no work."[221]

III. Insider Trading and Stock Market Participation

Modern arguments for prohibiting insider trading most frequently turn on the harmful effects that permitting such trading have on investors' willingness to participate in the stock market. Part of the SEC's mission is to ensure "the maintenance of fair and honest markets,"[222] and the government invariably explains that the rules against insider trading are about leveling the playing field[223] and encouraging investor confidence in the fairness and integrity of the marketplace.[224] After all, as the Supreme Court observed in a closely related context: "Who would knowingly roll the dice in a crooked crap game?"[225]

Nonetheless, the link between insider trading enforcement, investor confidence, and stock market participation remains contested. Manne, for example, claimed that the public "has never shown any signs of losing confidence in the stock market because of the existence of insider trading,"[226] and subsequent

219. A Prominent Financier, *Both Sides of Wall Street*: *Part II. The Quicksand Road*, 10 READER 587, 589–92 (1907).

220. H. Allaway, *The Financial World*, NEW-YORK TRIBUNE, Aug. 26, 1906, at 4; W.G. Nicholas, *Coup Will Put Dividends Up*, TIMES DISPATCH, Aug. 27, 1906, at 7; *Advance Information*, N.Y. TIMES, Aug. 25, 1906, at 6; *Harriman's Coup Enrages Bankers of Wall Street*, WASHINGTON TIMES, Aug. 20, 1906, at 9; *Probing Speculation by Directors*, *supra* note 182, at 353–54; *Stocks Show Small Rallying Power*, *supra* note 217, at 193; WESTERN LIBERAL, Aug. 24, 1906, at 2.

221. *Would-Be Harrimans*, *supra* note 203, at 237.

222. 15 U.S.C. § 78b (2018).

223. *See* Massimo Calabresi & Bill Saporito, *The Street Fighter*, TIME, Feb. 13, 2012, at 25–26 (quoting former Southern District United States Attorney Preet Bharara that insider trading "tells everybody at precisely the wrong time that everything is rigged and only people who have a billion dollars and have access to and are best friends with people who are on the boards of directors of major companies . . . can make a true buck").

224. *Id.*

225. Basic, Inc. v. Levinson, 485 U.S. 225, 247 (1988); *see also* United States v. O'Hagan, 521 U.S. 642, 658 (1997).

226. Manne, *Law Professors*, *supra* note 18, at 577; *see also* Manne, *Hayek*, *supra* note 34, at 168 n.5 (stating that concerns about investor confidence are "devoid of the scantest economic or empirical content").

scholars have similarly pointed to the absence of any direct empirical evidence that the level of insider trading in the market is negatively correlated with stock market participation.[227] Indirect evidence, however, is certainly suggestive of such a link.[228] Insider trading enforcement has been shown to lower the cost of capital by improving liquidity and reducing bid-ask spreads.[229] Comparative studies have shown a correlation between robust insider trading enforcement and firm valuations or widespread investor participation in equity capital markets.[230] Behavioral economists have similarly shown that lack of trust[231] and increased exposure to frauds[232] lead to lower stock market participation. Historical evidence, which has not played a significant role in the literature to date,[233] can provide additional insight into the link between insider trading and stock market participation by examining the expressed level of investor confidence when investors believed that insider trading was endemic in public equity markets.

This Part addresses these issues in two Sections. The first analyzes common conceptions of the stock market at the turn of the twentieth century, with particular emphasis on beliefs about the prevalence of insider trading and the advice offered to ordinary investors for how they should respond to that problem. The second analyzes evidence on how two market participants, the New York Stock Exchange ("NYSE") and investment bankers, responded to these concerns.

227. *See* LANGEVOORT, *supra* note 27, at 65; Bainbridge, *supra* note 9, at 1242–43.

228. For an overview of the literature, see Kim*, supra* note 21, at 968–70.

229. *See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 76 (2002); Hans B. Christensen et al., *Capital-Market Effects of Securities Regulation: Prior Conditions, Implementation, and Enforcement*, 29 REV. FIN. STUD. 2885, 2885 (2016) (noting that market liquidity improves after introduction of regulations to limit insider trading and manipulation); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1553 (2004) (observing that capital costs increase with the quantity of private information); Raymond P.H. Fishe & Michael A. Robe, *The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence from a Natural Experiment*, 71 J. FIN. ECON. 461, 465 (2004).

230. Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 272, 281 (2007). The law and finance literature links the rise of dispersed share ownership with sufficient legal protections for minority shareholders. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1127 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1136 (1997).

231. *See* Luigi Guiso, Paola Sapienza & Luigi Zingales, *Trusting the Stock Market*, 63 J. FIN. 2557, 2559 (2008).

232. *See* Mariassunta Giannetti & Tracy Yue Wang, *Corporate Scandals and Household Stock Market Participation*, 71 J. FIN. 2591, 2613 (2016).

233. For empirical analyses of the prevalence of insider trading during this time period, see Ajeyo Banerjee & E. Woodrow Eckard, *Why Regulate Insider Trading? Evidence from the First Great Merger Wave (1897–1903)*, 91 AM. ECON. REV. 1329, 1329 (2001) (finding that during the period from 1897 to 1903, stock price increases prior to merger announcements were not significantly larger than modern price increases); Fabio Braggion & Lyndon Moore, *How Insiders Traded Before Rules*, 55 BUS. HIST. 562, 565 (2013) (examining director sales in British firms during the period from 1890 to 1909, and finding that 20% were in the sixty days prior to a poor earnings announcement).

A. Insider Trading and Stock Market Perceptions

Part II illustrated several examples that highlight the link that commentators at the turn of the twentieth century made between insider trading, investor confidence, and stock market participation.[234] To fully appreciate this historical evidence, however, we need to understand how ordinary investors thought about the market at the turn of the twentieth century. The law and economics approach to insider trading is premised on the semi-strong version of the Efficient Capital Markets Hypothesis ("ECMH"). Insiders in this model are just another mechanism of market efficiency; their trading provides a vehicle for impounding otherwise undisclosed information into stock prices, thereby enhancing price discovery and the market's allocative efficiency.[235] But that is not how most people seemed to think about the stock market in 1900. Many Americans, instead, clung to an older conception of the market that had prevailed for most of the nineteenth century.[236] In the popular imagination, securities prices were driven almost exclusively by the manipulative schemes of stock market professionals. For many observers, the small investor was clueless while experienced traders "read the tape," seeing in "every little current and eddy" the work of "the man behind the curtain who runs things."[237] To one writer, variations in stock prices were "myths, bugaboos [and] will o' the wisps."[238] Tell-all books written by Wall Street operators,[239] instructional manuals,[240] and the financial pages of newspapers and magazines regularly reported stories about corners, pools, bear raids, wash sales, and other devices to engineer changes in securities prices. It was the insiders behind these schemes who caused "the rise and fall of listed stocks."[241]

The stock market was, in this view, highly inefficient, but in a way that is significantly different from modern views of market inefficiency. Behavioral finance posits that bubbles and other departures from fundamental efficiency are the products of herd behavior, investor overconfidence and irrationality, feedback mechanisms, and a host of inherent biases and heuristics common to the

234. *See supra* Part II.

235. *See* Gilson & Kraakman, *supra* note 13, at 572–79 (noting that trading may directly move the price or may lead to "derivatively informed trading," in which otherwise uninformed traders observe and react to insider trading).

236. *See* STEVE FRASER, EVERY MAN A SPECULATOR: A HISTORY OF WALL STREET IN AMERICAN LIFE 248–66 (2005).

237. The Scalper, *Ticker Talk*, *in* TICKER VOL. II 130, 132 (1908).

238. THOMAS D. RICHARDSON, WALL STREET BY THE BACK DOOR 11 (1901).

239. *See generally* THOMAS LAWSON, FRENZIED FINANCE: THE CRIME OF AMALGAMATED (1906); RICHARDSON, *supra* note 238, at 11.

240. *See generally* WILLIAM H. BLACK, THE REAL WALL STREET (1908); ARTHUR CRUMP, THE THEORY OF STOCK SPECULATION (1903); FRANK E. HORACK & CHARLES F. TAYLOR, THE ORGANIZATION AND CONTROL OF INDUSTRIAL CORPORATIONS 80 (1903); JOHN MOODY, THE ART OF WALL STREET INVESTING (1906); S.A. NELSON, THE ABC OF WALL STREET (1900); ELIOT NORTON, ON BUYING AND SELLING SECURITIES THROUGH A MEMBER OF THE STOCK EXCHANGE (1896); WILLIAM Y. STAFFORD, SAFE METHODS OF STOCK SPECULATION (1902).

241. *See* A Prominent Financier, *supra* note 219, at 589–92; Rollo Tape, *Market Lectures: IV.—A Manipulative Climax*, TICKER, May 1908, at 10; *Fictitious Trading*, N.Y. TIMES, Jan. 3, 1896; *Fictitious Trading*, N.Y. TIMES, May 10, 1901; *Fictitious Trading*, N.Y. TIMES, Jan. 15, 1905, at 15; *Jasper's Hints to Money-Makers*, LESLIE'S WEEKLY, Apr. 24, 1902, at 407.

mass of traders.[242] These factors, proponents argue, can cause, at least in the short term, prices to vary significantly from underlying values. Stock prices may overreact to news;[243] hard-to-interpret information may be incorporated more slowly into securities prices;[244] or there may be unexplained market volatility.[245] While there is a substantial debate about the significance of these anomalies and how and whether they should influence stock market regulation,[246] the important point for present purposes is that their existence is not the product of overt manipulation by corporate insiders. It is the collective actions of investors that "ultimately drive the market."[247]

At the turn of the twentieth century, by contrast, the underlying cause for those departures was commonly claimed to be individual agency—the machinations of market operators and corporate insiders. The "great swings in the market," one writer noted in 1910, were not from changes in fundamentals, but were "forced by manipulation."[248] No one doubted that crowds could be delusional. Six decades earlier, Charles Mackay wrote *Extraordinary Popular Delusions and the Madness of Crowds*, which chronicled the South Sea bubble and other well-known speculative manias.[249] For Mackay, people went "mad in herds" and only recovered their senses slowly.[250] To many popular observers in the early 1900s, the mass of traders was not solely, or even primarily, responsible for gyrations in securities prices. Ordinary traders were simply being manipulated by the financiers who really controlled the markets.[251] Even the soberest of investment guides treated manipulation by "a few large speculators" as a "common"

242. *See* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 177 (2d ed. 2005); H. Kent Baker & John R. Nofsinger, *Psychological Biases of Investors*, 11 FIN. SERV. REV. 97, 97 (2002); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PENN. L. REV. 851, 852 (1992).

243. Baruch Lev & Meiring de Villiers, *Stock Price Crashes and the 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 17 (1994).

244. *See* Paul A. Griffin et al., *Stock Price Response to News of Securities Fraud Litigation: An Analysis of Sequential and Conditional Information*, 40 ABACUS 21, 23 (2004).

245. Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSP. 83, 84–85 (2003).

246. *See* Ronald J. Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 731–33 (2003); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 60 (2003).

247. SHILLER, *supra* note 242, at xxi.

248. Frederic Norris Goldsmith, *The Investor and the Insider*, TICKER & INV. DIG., Nov. 1909, at 256; *see also* Thomas Gibson, *Influences Affecting Security Prices and Values*, 35 ANNALS AM. ACAD. POL. & SOC. SCI. 627, 627 (1910) ("Manipulation is the most common reason for the segregation of prices and values."); Horace White, *The Hughes Investigation*, 17 J. POL. ECON. 528, 531 (1909) ("Probably there is never a time when somebody is not seeking to raise or depress prices artificially.").

249. CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS 55 (Harriman House 2003).

250. *Id.* at viii.

251. *See* Parr, *supra* note 156, at 291–305.

tool for "inducing the public to buy."[252] It was those men (most often J. P. Morgan) whom cartoonists depicted blowing bubbles and inflating stocks to lure the unwary.[253]

The idea that individual agency lay behind stock price movements dominated popular writing about Wall Street in the first decade of the twentieth century. A typical piece consistent with this view was the anonymous *Confessions of a Stock Speculator*.[254] The author, a self-described "Wall Street Piker," assured readers that a "half dozen giants" controlled the stock markets.[255] "Their market maneuvers," he wrote, "are always 'sure things.' They know what is going to happen beforehand."[256] Other Wall Street critics made similar claims. B. O. Flower, the editor of the muckraking journal *Arena*, contended that a few men had the ability to arrange "a bull or bear market weeks and even months ahead, carefully getting the stock they intend to gamble with into the exact condition they desire."[257]

Manipulation occurred on even the most prestigious stock exchanges. While the NYSE was increasingly trying to market itself as a high-quality exchange that was safe for public investors,[258] its efforts faced significant skepticism, especially in the wake of the Panic of 1907. Anyone who knew about "the inner life of Wall Street," one journalist noted, knew that "the machinery of the NYSE is used daily to serve the selfish purposes of a single man, or rather of a group of men, acting as one, possessed of preponderating wealth, and of almost unlimited power."[259] When Theodore Roosevelt denounced the "malefactors of great wealth," he charged that his campaign against corporate immorality had "caused these men to combine to bring about as much financial stress [in the stock market] as possible, in order to discredit the policy of the Government and thereby secure a reversal of that policy, so that they may enjoy unmolested the fruits of their own evil-doing."[260] Manipulation was a fact of life for most market observers.[261]

252. THE ART OF WISE INVESTING 69 (Moody Publishing Co. 1904).

253. Udo J. Keppler, *Wall Street Bubbles—Always the Same,* PUCK, May 22, 1901 (Morgan depicted as a bull blowing bubbles to lure foolish investors); John S. Pughe, *Waiting for the Balloon Ascension*, PUCK, Dec. 10, 1902 (Morgan shown as circus strong man inflating a balloon labeled "Steel Stock").

254. Anonymous, *Confessions of a Stock Speculator*, INDEP., Mar. 21, 1907, at 669, 672.

255. *Id.*

256. *Id.* at 672.

257. *The Blight of Wall-Street High Finance*, *supra* note 138, at 78.

258. *See infra* notes 259 through 261 and accompanying text.

259. *See* Frederick S. Dickson, *The Poison of the Street*, 20 EVERYBODY'S MAG. 226, 226, 232 (1909).

260. THEODORE ROOSEVELT, PRESIDENTIAL ADDRESSES AND STATE PAPERS 1359 (1907). Roosevelt's speech reflected widely held beliefs about the causes of the Panic of 1907. *See* White, *supra* note 248, at 528 (noting that shortly after the panic, "a rumor became current that 'Wall Street' had designedly caused it in order to knock down the prices of stocks, frighten weak holders, and profit by the ruin of the community").

261. Those perceptions regarding manipulation would, of course, persist through and inform passage of the federal securities laws. *See* 15 U.S.C. § 78b(3) (2018) ("Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control . . . ."); Brudney, *supra* note 17, at 335 (observing that the legislative history of the Exchange Act frequently made a connection between insider trading and manipulation); Thel, *Regulation of Manipulation*, *supra* note 56, at 360 (arguing that the purpose underlying the Exchange Act was to prevent manipulation and ensure "appropriate" securities pricing).

The perception that inside information—about companies or about these planned manipulations—was essential for investment success was fueled by the severe information asymmetry that existed at the turn of the twentieth century,[262] a consequence of both the emergence of national securities markets and the absence of effective mandatory disclosure regimes.[263] Indeed, the shift in perceptions about the propriety of insider trading and the first changes in the common law approach to insider trading coincided with the first broad calls for enhanced corporate disclosure.[264]

Meaningful public ownership of securities began with railroad financing in the mid-nineteenth century and accelerated with the wave of industrial company mergers in the 1890s.[265] Before the Civil War, the typical manufacturing business operated out of just one location, with one or only a handful of owners.[266] Often, they were members of the same family. Most were organized, not as corporations, but as sole proprietorships or partnerships.[267] Unlike many modern corporations, most owners were typically the entrepreneurial founders of the firm and managers of its day-to-day operations.[268] Some antebellum corporations, to be sure, had hundreds of shareholders,[269] but they were often local and quite frequently the firm's customers. Those connections gave early shareholders (who

262. Kenneth A. Snowden, *American Stock Market Development and Performance, 1871–1929*, 24 EXPLORATIONS ECON. HIST. 327, 351 (1987) (providing evidence that the stock market was less efficient during this time period and attributing that difference to "informational shortcomings of the market"); Kenneth A. Snowden, *Historical Returns and Security Market Development*, 27 EXPLORATIONS ECON. HIST. 381, 400–01 (1990).

263. Jonathan Barron Baskin, *The Development of Corporate Financial Markets in Britain and the United States, 1600–1914: Overcoming Asymmetric Information*, 62 BUS. HIST. REV. 199, 201 (1988); Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887–1902*, 29 BUS. HIST. REV. 105, 126–27 (1955); Marian V. Sears, *The American Businessman at the Turn of the Century*, 30 BUS. HIST. REV. 382, 386–87 (1956).

264. *See* REPORT OF THE GOVERNOR'S COMMITTEE ON SPECULATION IN SECURITIES AND COMMODITIES 9 (1909) (advocating that NYSE develop "methods to compel the filing of frequent statements of financial condition" of listed companies) [hereinafter HUGHES COMMITTEE REPORT]. New York Governor Charles Evans Hughes formed the committee to investigate the causes of the Panic of 1907. Woodrow Wilson also advocated for greater corporate disclosure in his 1912 presidential campaign. *See* WOODROW WILSON, THE NEW FREEDOM 22 (1913) ("When you offer the securities of a great corporation to anybody who wishes to purchase them, you must open that corporation to the inspection of everybody who wants to purchase.").

265. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 29 (1970); NAOMI R. LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895–1904 1–8 (1988).
Turn-of-the-century observers recognized that stock exchanges now played a critical role in the economy. *See, e.g.*, S.S. Huebner, *Scope and Functions of the Stock Market*, 35 ANNALS AM. ACAD. POL. & SOC. SCI. 483, 483 (1910) ("[S]tock exchange markets may be said to represent the pulse of our economic life.").

266. GLENN PORTER, THE RISE OF BIG BUSINESS, 1860–1910 30 (1973).

267. *See id.*

268. *Id.*

269. *See generally* ROBERT E. WRIGHT, CORPORATION NATION (2013).

typically were as concerned with limiting possible monopolistic abuses as in garnering a financial return[270]) at least some sense of how the firms operated as well as often frequent contact with managers.[271]

At the turn of the twentieth century, as investment banking firms sought new sources of investment for the burgeoning industrial sector, they began to change how securities were marketed. While many of the first railroad securities were sold primarily to European investors or United States institutions, by the close of the nineteenth century, investment banks such as Lee, Higginson and the National City Bank were building sales forces, opening branch offices, and creating advertising campaigns.[272] Mirroring the simultaneous growth of mail-order businesses like Sears Roebuck, which were developing national marketing and distribution networks, these brokerage firms set out to induce middle class investors across the country to buy corporate stocks and bonds, both in primary and secondary transactions.[273]

Technological advances made that outreach possible, but also created an environment in which significant information asymmetries, and therefore insider trading, could flourish. The development over the previous fifty years of the telegraph, ticker tape, and telephone meant that stock prices could be wired anywhere in the country.[274] These technological advances improved market efficiency in some ways, primarily by leveling price disparities between exchanges.[275] Technology meant that traders would no longer need to be near an exchange to invest. "Business may be conducted as readily by letter, telegram or telephone as by being on the spot," one firm assured potential clients in 1898.[276] Rapidly declining communications costs made it profitable for stock brokers to solicit those distant customers, expanding the capital available for investment. By 1909, nearly 50% of the NYSE's business came from outside New York.[277]

Individual investors, however, still faced significant informational disadvantages. That same brokerage firm told small scattered shareholders that no matter where they were, they could feel "the beat of each pulse of the market,"[278] but the truth was far different. The controlling shareholders, directors, and officers—who had developed elaborate internal controls to monitor the corporation's

270. Henry Hansmann & Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, 123 YALE L.J. 948, 950–51 (2014).

271. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 30 (2001); Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1098 (2015).

272. *See* CAROSSO, *supra* note 265, at 44, 53.

273. *See* RANALD C. MICHIE, THE LONDON AND NEW YORK STOCK EXCHANGES 1850–1914 167–70, 222–23 (1987); Gene Smiley, *The Expansion of the New York Securities Market at the Turn of the Century*, 55 BUS. HIST. REV. 75, 75 (1981).

274. J. Peter Ferderer, *Advances in Communication Technology and Growth of the American Over-the-Counter Markets, 1876–1929*, 68 J. ECON. HIST. 501, 502 (2008).

275. *Id.*; Richard B. du Boff, *The Telegraph in Nineteenth-Century America: Technology and Monopoly*, 26 COMP. STUD. SOC. & HIST. 571, 571–72 (1984).

276. HAIGHT & FREESE, GUIDE TO INVESTORS 48 (1898).

277. HUGHES COMMITTEE REPORT, *supra* note 264, at 11.

278. HAIGHT & FREESE, *supra* note 276, at 45.

dispersed operations as the scope of those enterprises expanded[279]—would naturally know far more about the company than the increasingly dispersed outside investors. Because the new industrial securities were also extremely volatile, managers had ample opportunities to exploit their informational advantages.[280]

In the absence of mandatory disclosure laws, corporations tended to vary greatly in the information they provided stockholders. Before 1900, corporations provided almost no information to their shareholders.[281] Elbert Gary surprised the U.S. Steel directors in 1901 when he proposed to publicly release the company's financial results.[282] Henry O. Havermeyer, the Chairman of American Sugar, represented the more common approach, which denied that the corporation needed to disclose any financial information, even when it sold securities in public offerings.[283] His philosophy was rooted in *caveat emptor* and social Darwinism. "Let the buyer beware; that covers the whole business," he told the U.S. Industrial Commission in 1899.[284] "You can not wet-nurse people from the time they are born until the time they die. They have got to wade in and get stuck, and that is the way men are educated and cultivated."[285]

To be sure, the NYSE began during this time period to require some basic disclosures for companies seeking to list there, and some corporations, like U.S. Steel, sought to signal their quality to investors by voluntarily disclosing information.[286] But the NYSE was alone among the major stock exchanges in requiring disclosures, and even it was inconsistent in enforcing those obligations,[287] particularly in the period from 1885 to 1910. In many cases, disclosure requirements were ad hoc, applying to only some (usually smaller) companies that

279. *See* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 94–95 (1977).

280. MICHIE, *supra* note 273, at 172–77, 186–89; EDWIN G. NOURSE, BROKERAGE 24 (1910).

281. *See* David F. Hawkins, *The Development of Modern Financial Reporting Practices Among American Manufacturing Corporations*, 37 BUS. HIST. REV. 135, 135 (1963) ("[S]o secretive were some manufacturing companies that even into the twentieth century they failed to make available to investors any financial information other than the company's capitalization and dividend record.").

282. *See supra* notes 104–07 and accompanying text.

283. *In Pursuance of an Act of Congress Authorizing the Appointment of a Nonpartisan Commission to Collate Information and to Consider and Recommend Legislation to Meet the Problems Presented by Labor, Agriculture, and Capital: Hearings before the Industrial Commission on the Subject of Trusts and Industrial Combinations*, 56th Cong. 123 (1899) (testimony of Henry O. Havemeyer, President, American Sugar Refining Company).

284. *Id.*

285. *Id.*

286. One of the leading corporate lawyers of the day, James B. Dill, anticipated the law and economics' critique of governmentally imposed mandatory disclosure rules. Dill argued that "corporations of integrity" sought to distinguish themselves from their less worthy counterparts by voluntarily disclosing more information. Those companies "seek the light, not only because they feel conscious of their ability to stand examination but for the added and equally important reason that some of their neighbors cannot stand such a test." James B. Dill, *Dangerous Tendencies in Recent Consolidations*, IRON AGE, Jan. 11, 1900, at 5; *see* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682–84 (1984).

287. Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 54 (1983); *see* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1376–79 (1999) (discussing similar problems with NYSE listing standards in the 1920s); Hawkins, *supra* note 281, at 150.

sought an NYSE listing.[288] Facing increased competition from other securities markets, particularly with respect to the new industrial companies, the NYSE began to allow "unlisted" securities to trade on the exchange.[289] Although actively traded, companies in the "Unlisted Department" were not required to report any financial information to the exchange.[290] Even some listed companies felt free to ignore the Exchange's requests for information.[291]

While corporations slowly began to release more information over the course of this time period, the paucity of information available to the ordinary investor at the dawn of the twentieth century led the newly created federal Bureau of Corporations to conclude in 1904 that "secrecy" in corporate promotion and administration were among the "principal evils" in "present industrial conditions."[292] A leading corporate lawyer, James B. Dill, argued that it was the lack of reliable information (and not manipulation) that was responsible for the wild swings in securities prices that were often observed on the exchanges.[293] Concerns about the propriety of insider trading arose simultaneously within concerns about information asymmetry in public corporations.

In a market thought to be dominated by manipulative schemes and in which companies inconsistently disclosed information, many investors appeared to believe that the only sure way to profit was from inside information, either about the company itself or about any market operations that were about to be launched. Indeed, novice investors' quest to obtain valuable inside information gave rise to a perennial scam. Firms, dubbed "Information Bureaus," promised for a small monthly fee to alert subscribers whenever the "Kings of Finance" planned to manipulate a particular stock.[294] One such advertisement explained why its "Infallible Inside Information" was so crucial for successful investing:

> You are no doubt aware that it is the large operators who reap the profits in speculation while the outsiders, or small traders, are the "lambs" who are shorn. Our idea is to furnish a service that will put the small investor on an equal footing with the large trader, or, to use the parlance of the "Street," the "insider," and we unhesitatingly say that if our advice is followed fortunes can be made by those who have never seen Wall Street, equal to that of the largest operator on the floor of the Exchanges.[295]

288. BIRL E. SCHULTZ, STOCK EXCHANGE PROCEDURE 17 (1936).

289. Hawkins, *supra* note 281, at 150.

290. *Id.*

291. *Id.* at 135–36.

292. *See* Seligman, *supra* note 287, at 19–20. The Industrial Commission reached a similar conclusion, finding that "secrecy in promotion" had permitted promoters organizing large industrial combinations to dispose of their stock at prices far above its true value. *Id.*; Hawkins, *supra* note 281, at 136. *See also Hearings Before the Industrial Commission on the Subject of Trusts and Industrial Combinations*, *supra* note 283, at 6 (testimony of F.B. Thurber) (noting that the "only additional safeguards needed are for stockholders and investors, whose interests are often sacrificed through lack of publicity").

293. Dill, *supra* note 286, at 6. Dill recognized that publicity must be "reasonable" and restricted to matters about "which the public have a right to know." *Id.* at 7.

294. JOHN HILL, JR., GOLD BRICKS OF SPECULATION 140–42 (1904).

295. *Id.* at 141; *see* ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET 179–80, 189 (1965).

The Information Bureaus preyed on their customers' beliefs that advance knowledge "is invaluable to anyone who speculates or contemplates entering the markets."[296]

These advertisements, which were prevalent throughout the period, helped perpetuate the idea that corporate executives were regularly trading on inside information. One advertisement entitled "Why?" began: "President [Alexander] Cassatt, of the Pennsylvania Railroad, when asked how it is that officers of that road, while receiving but moderate salaries, have become such wealthy men, replied, 'They have great opportunities.' Inside information is the only road to wealth from speculation."[297] Small investors should "[g]et your information [about] what the insiders are up to now, and do likewise."[298] As noted previously, questions about the propriety of insider trading had already begun to be debated, but the view that insider trading was immoral and should be prohibited remained the minority position. None of these advertisements suggested that either the insiders or anyone purchasing this information was acting wrongfully, a conclusion underscored by the placement of these advertisements in prominent newspapers—including the *New York Times* and *Washington Post.*[299]

The information bureaus highlight a recurring theme in discussions of insider trading during this period. Inside information did have an unsavory connotation, but it was not so much because trading on inside information was considered immoral; rather it was primarily because so many people peddled false inside information. Phony "market tips" continually churned through the street "influencing the unwary to further the market operations of the man who sets them afloat."[300] Only the "veriest lambs" placed any credence in that kind of information.[301] Knowledgeable financial writers regularly excoriated the purveyors of these frauds and warned investors to steer well clear of them.[302] In his book *Fifty Years in Wall Street*, prominent stock broker Henry Clews offered similar advice.[303] Young traders should avoid the "slippery 'tips' of the professional 'pointers' of the Stock Exchange" and steer clear of the "specious frauds, who

296. HILL, *supra* note 294, at 142; *see Inside Information*, TICKER, Mar. 1908, at 22.

297. WASH. POST, Oct. 14, 1900, at 14.

298. *Id.*; *see also* DAVID A. KEISTER, KEISTER'S WALL STREET BUSINESS MANUAL: A HANDBOOK FOR EVERYBODY 135 (1900) ("The Sunday papers are filled with glittering opportunities, and many are lead to act upon the flashing advertisements which usually read as follows: 'Get our Inside Information and Make Money.' . . . Avoid all such advice and get-rich-quick schemes, or you and your money will part.").

299. *See, e.g.*, N.Y. TIMES, Feb. 11, 1900, at 24 (displaying an advertisement for the Kendrick Promotion Co., which claimed to "HAVE INSIDE INFORMATION with regard to several good gold and copper stocks"); N.Y. TIMES, Jun. 30, 1901, at 14 ("I have now inside information on an active industry which will have a move of 50 POINTS within a very short time. I know the price where to buy and will give this information to an operator who will deal in 300 shares, allowing me one-third of the net profits."); WASH. POST, May 21, 1905, at E4 (illustrating an advertisement offering "INSIDE information" that would lead to "GOOD PROFITS").

300. Anonymous, *Confessions of a Stock Speculator*, *supra* note 254, at 670.

301. *See* A Prominent Financier, *Both Sides of Wall Street: Part I. A Thoroughfare for Trade*, 10 READER 451, 461 (1907).

302. *See* HILL, *supra* note 294, at 141–42; *see also* WILLIAM YOUNG STAFFORD, SAFE METHODS OF STOCK SPECULATION 67 (1902) (explaining that men controlling the markets "guard their plans with great tenacity, confiding in none except those trusted few of the inner circle").

303. CLEWS, *supra* note 202, at 10.

pretend to be deep in the councils of the big operators and of all the new 'pools' in process of formation."[304] "Early information and a big bank roll," went one Wall Street proverb, "will 'break' the best man that ever came to Wall Street."[305]

These schemes, nonetheless, apparently engendered at least some level of success. "The average speculator," an anonymous stock broker wrote, "knows that 'tips' and 'rumors' are for the most part a delusion and a snare—but he is ever inclined to believe that the 'tip' he has just heard is a 'real one' and safe to follow."[306] In reality, another writer explained, it was only the broker and the insider who ever made money in the market.[307] Even those who perhaps should have known better were not immune to the promise of inside tips. One writer claimed that he had seen letters from "National Bank officials (on the bank's stationery), lawyers, merchants, [and] railroad officials" signing up for inside information alerts.[308] The perils of the market led one cartoonist to depict inside information as the foul breath of a witch ("Dame Rumor"), which poisoned hordes of small investors.[309]

Actual inside information was far different. As the "Wall Street Piker" explained, true inside information was only available to the "market giants," and they used it, in combination with affirmative misrepresentations or material omissions, for personal profit.[310] The small investor could not win, because he was "putting his insignificant capital and blank ignorance against billions of money and certain knowledge. He is guessing where they are certain sure."[311] The author's advice was that ordinary investors could not compete with the informational advantages insiders possessed. Since they were bound to lose when buying stocks, small investors should stay out of the market entirely.[312]

The view that insiders had a substantial trading advantage was not just the view of disgruntled traders and confidence men, but of sophisticated market observers. One market primer defined "insiders" as those "in a position to possess information which the public does not have."[313] Financial journalist Sereno Stansbury Pratt, commenting on the tendency for prices to decline on good news, explained how the market was always discounting the future. "The insider, or the far-sighted outsider," he wrote, "has foreseen the favorable development and bought in advance of the news."[314] For Pratt, the "director of a great corporation whose securities are listed on the Stock Exchange is an influential individual, with sources of information and opportunities of manipulation denied to others. He [rather than stock market operators and floor traders] is the true 'insider' of

304. *Id.*
305. NELSON, *supra* note 240, at 139.
306. *Confessions of a Stock Broker*, INDEP., Dec. 20, 1906, at 1467.
307. W.R. Givens, *Does Wall Street Speculation Pay?*, INDEP., Aug. 31, 1905, at 494.
308. *Inside Information*, *supra* note 296, at 21.
309. Udo J. Keppler, *Dame Rumor*, PUCK, Sept. 8, 1909.
310. *Confessions of a Stock Speculator*, *supra* note 254, at 670.
311. *Id.* at 672.
312. *Id.*
313. BLACK, *supra* note 240, at 9.
314. SERENO STANSBURY PRATT, THE WORK OF WALL STREET 65, 69 (1906).

the stock-market."[315] A banker from Cleveland, writing to *Leslie's Weekly*, expressed a similar view, reporting that the "change in ownership of the Louisville and Nashville shows how impossible it is for an outsider to always know what is going on and the great disadvantage he is under compared with the insider who does know."[316]

Most writers seemed to treat this kind of trading as a truism of financial life, although as shown previously that acceptance was beginning to change. Commenting on the future of one railroad, a writer noted that the "situation justifies a moderate, not an immoderate rise, and you can trust the insider to make the most of the situation in the shortest amount of time."[317] An anonymous "Prominent Financier" noted in 1907 that if someone had "inside information" indicating a stock would decline in value, then he was "equally privileged to 'go short' of the market."[318] Alexander Dana Noyes, a reporter at the New York *Evening Post* and one of the most influential financial journalists of his generation, wrote that in the bull market of 1901, everyday conversations were filled with tales of successful transactions made possible by the tips that "acquaintances on the inside had privately communicated."[319] Newspapers regaled their readers with stories of "bootblacks, barbers, and hotel waiters who had got rich by following such pointers from an accommodating Wall Street."[320] While many of these stories were no doubt apocryphal, what is significant about them is that the behavior they described—the kind of tipping that modern law prohibits—was viewed as a natural feature of securities markets.[321]

It should certainly come as no surprise that the norms of turn-of-the-century professional traders permitted insider trading. In the biographies and autobiographies of these individuals, trading on material, nonpublic information is a recurring theme. Consider, for example, Bernard M. Baruch, who began his trading career in the 1890s and successfully used inside information on many occasions.[322] Baruch's experiences suggest that inside information was treated as a commodity that could legitimately be parceled out to friends or colleagues.[323] Early in his career, Baruch bought stock in the American Spirits Manufacturing Company based on a tip that the well-known promoter Thomas Fortune Ryan was buying the stock.[324] Baruch had worked with Ryan on other market operations, but he never thought to ask Ryan whether the tip was accurate.[325] When Baruch lost money, he told Ryan the story. Ryan tried to set Baruch straight on

315. *Id.* at 69.
316. *Jasper's Hints to Money-Makers*, *supra* note 241, at 407, 409.
317. *See Home Railways Buoyant*, TRUTH, Nov. 6, 1902, at 1127–28.
318. A Prominent Financier, *supra* note 301, at 456.
319. ALEXANDER DANA NOYES, THE MARKET PLACE: REMINISCENCES OF A FINANCIAL EDITOR 195 (1938).
320. *Id.*
321. John Parr, *The Game Gets You*, 20 EVERYBODY'S MAG. 499, 502 (1909).
322. BERNARD M. BARUCH, BARUCH: MY OWN STORY 141–45 (1957); JAMES GRANT, BERNARD M. BARUCH: THE ADVENTURES OF A WALL STREET LEGEND 17–31 (1997).
323. *See* BARUCH, *supra* note 322, at 141–45.
324. *Id.* at 121.
325. *Id.* at 105–19, 122.

the difference between manipulative tips and inside information.[326] "Did I tell you to buy that whiskey stock?" Ryan asked the young trader.[327] When Baruch conceded that he had not, Ryan explained: "Never pay any attention to what I am reported to have said to anybody else. A lot of people who ask me questions have no right to answers. But you have the right."[328] Baruch apparently deserved access to accurate inside information because of his previous work with Ryan and because of the friendship that had developed between them. Despite the growing concerns about insider trading, among some market participants inside information remained a commodity that could be bartered freely among business associates or friends, precisely the kind of market that Manne believed existed in the United States through the middle of the 1960s. It was, for Manne, "neither crass nor undemocratic" for individuals to associate with those with whom they could engage in relatively equal exchanges of valuable inside information.[329]

What is perhaps more surprising than the quid pro quo among market professionals at the turn of the century was that, despite the emerging critical view of insider trading, a substantial number of ordinary traders seemed to accept that they would inevitably trade at a severe informational disadvantage. The "Wall Street Piker" did not blame insiders for abusing their positions for personal profit; he expressed grudging admiration of their actions. The insiders were simply "smart and shrewd," and thus presumably entitled to reap the rewards that flowed from this kind of market behavior.[330] Indeed, he seemed unwilling to condemn outright manipulation and not just nondisclosure of material inside information. The true fault lay with the public. They were the "fools" who continually let themselves be "deluded and hoodwinked."[331] Indeed, Wall Street depended, according to another account, on keeping "the public . . . misled and on the wrong side of the market."[332] The public "must be made to continually pour into this great hopper, the glittering gold, to feed the greedy mill of Wall Street speculation, that it may grind out colossal fortunes for a few rich insiders."[333]

For many observers, it seemed, the insiders were not to blame, because the conventional rules of morality did not apply in the purely competitive stock market, despite the common law rules prohibiting manipulation. "Whoever buys" on the stock exchange, New York stockbroker John Hume observed, "is understood to take all risks, no matter how much deception is used. He may be utterly victimized—often is so—but he has no redress."[334] Another writer expressed a similar view about criminal prosecutions of the information bureaus. Rather than asking the district attorney to "interfere with these wreckers of fortune," he thought that "those who subscribe for such stuff and who entrust their money

326. *Id.*
327. *Id.* at 122.
328. *Id.*
329. Manne, *Insider Trading and the Stock Market*, *supra* note 2, at 74–75.
330. *See Confessions of a Stock Speculator*, *supra* note 254.
331. *Id.*
332. Franklin C. Keyes, *Wall Street as Our American Monte Carlo*, 1 NEAL'S MONTHLY 113, 117 (1913).
333. FRANKLIN C. KEYES, WALL STREET SPECULATION: ITS TRICKS AND ITS TRAGEDIES 18 (1904).
334. John F. Hume, *The Heart of Speculation*, 2 FORUM 130, 133 (1886).

into such hands, should be given a through direct ticket to Bloomingdale Asylum." The foolish investors were at fault for recklessly venturing into the market, where "certain ruin" awaited them.[335]

There was, in short, widespread mistrust of the stock market at the turn of the twentieth century, which likely played a significant role in the unwillingness of investors to participate in it.[336] While it is difficult to obtain reliable data, it is clear that stock market participation remained quite low. Stock ownership and trading were clearly expanding; trading volumes on the NYSE tripled between 1897 and 1901.[337] Corporations reported substantial increases in share ownership.[338] In 1902, corporations with thousands of shareholders were not uncommon, and four—American Sugar, U.S. Steel, and the Pennsylvania and Union Pacific railroads—had between 10,000 and 50,000.[339] By 1913 the Pennsylvania railroad had almost 90,000 shareholders of record; for U.S. Steel, it was over 120,000.[340] Still, the actual number of individual securities holders remained small, with some estimates suggesting that at the turn of the century, less than 1% of the population owned stocks or bonds.[341] Small shareholders remained more rhetorical trope than reality, but public discourse increasingly (as discussed below) focused on their needs.

It is difficult to disentangle how much market distrust was attributable to fear of manipulation (which the common law prohibited) versus fear of insider trading (which the common law did not). Indeed, in some accounts the two were inextricably intertwined.[342] Nonetheless, it remains clear that both factors were

335. *Inside Information*, *supra* note 296, at 24; *Confessions of a Stock Speculator*, *supra* note 254, at 669, 672.

336. Other factors besides the prevalence of insider trading certainly contributed to low stock market participation in the early 1900s. For example, stock exchange standards set minimum transaction levels at $10,000. Even with 10% margins, standard stock market transactions were likely out of reach for most households, although they could still trade in odd lots or in the curb markets. *See* JULIA C. OTT, WHEN WALL STREET MET MAIN STREET: THE QUEST FOR AN INVESTORS' DEMOCRACY 18 (2011). These high thresholds also explained the prominence of so-called "bucket shops," where small investors could place bets on stock price movements rather than actually buying shares. *See* David Hochfelder, *"Where the Common People Could Speculate": The Ticker, Bucket Shops, and the Origins of Popular Participation in Financial Markets, 1880–1920*, 93 J. AM. HIST. 335, 335 (2006).

337. BANNER, *supra* note 22, at 206–08; MICHIE, *supra* note 273, at 167–70, 222–23; Smiley, *supra* note 273, at 5, 84.

338. Huebner, *supra* note 265, at 484–87.

339. *Id.* at 4.

340. *See* OTT, *supra* note 336, at 17–18.

341. *Id.*

342. The Hughes Committee Report, for example, blended manipulation and insider trading:

> The values of railway securities, for example, depend upon the management of the companies issuing them, the directors of which may use their power to increase, diminish, or even extinguish them, while they make gains for themselves by operations on the Exchange. They may advance the price of a stock by an unexpected dividend, or depress it by passing an expected one . . . . The existence and misuse of such powers on the part of directors are a menace to corporate property and a temptation to officials who are inclined to speculate, leading them to manage the property so as to fill their own pockets by indirect and secret methods.

HUGHES COMMITTEE REPORT, *supra* note 264, at 11–12. Recognizing the blurring of insider trading and manipulation is important in evaluating some modern critiques. Some commentators argue that the legislative history of the Exchange Act is primarily focused on manipulation and therefore conclude that "Congress simply was not at the heart of warnings to investors to avoid the stock market. Small investors were told that they had no chance to compete with the market professionals who were rigging stock prices or with the company officials trading on inside information. Many books and articles written in the early years of the twentieth century were attempts to explain why ordinary individuals should not invest in the stock market.[343] "What chance have you," one commentator observed in 1909, "against men who command the machinery of manipulation, have all the information first, and a great deal of the time control the news that makes prices go up and down?"[344] The small investor had "as much chance to win out as he would have in a card game in which the other fellow sees his hand."[345] Novice investors, another dictionary of Wall Street terminology observed, were "lambs" who were "always fleeced."[346] Even more experienced operators were bound eventually to suffer "serious or ruinous losses [that would] force them out of the 'Street.'"[347]

Framing can influence the decision to invest in stocks[348] and Wall Street was framed not as a place for sound and safe investments, but as a crooked game of chance. Cartoons from the late nineteenth and early twentieth centuries frequently used gambling imagery to represent how stock trading worked,[349] which likely deterred investors from participating,[350] given the disapprobation normally attached to gambling. To emphasize their power and innumerable advantages, stock manipulators were often depicted as giants who towered over small investors.[351] Wall Street was "iniquitous and immoral" because its denizens "systematically played with loaded dice."[352] Bolstering these media accounts were governmental reports, such as the 1909 Hughes Committee Report on Speculation

very concerned with insider trading." *See* Dooley, *supra* note 7, at 58; Thel, *The Genius of Section 16*, *supra* note 56, at 477. Careful examination of how these terms were actually used, however, undermines that conclusion.

343. *See, e.g.*, THOMAS GIBSON, THE PITFALLS OF SPECULATION 143–44 (1908); Parr, *supra* note 321, at 499 (noting that while margin traders probably deserved sympathy, what they really needed was education in how steep the odds against them were in the stock market); "A Manager," *A Hireling of Wall Street*, EVERYBODY'S MAG., Apr. 1909, at 505, 507 [hereinafter *A Hireling of Wall Street*].

344. Parr, *supra* note 156, at 298.

345. *Id.*

346. KEISTER, *supra* note 298, at 130.

347. HUGHES COMMITTEE REPORT, *supra* note 264, at 5.

348. Nicholas Barberis et al., *Individual Preferences, Monetary Gambles, and Stock Market Participation: A Case for Narrow Framing*, 96 AM. ECON. REV. 1069, 1085 (2006) (noting that media accounts of stock market are easily accessible to investors and may therefore frame investment decisions).

349. Will Crawford, *Watching the Tape or Watching the Wheel—What is the Difference Morally?*, PUCK, Aug. 28, 1912 (depicting a two-panel cartoon showing investors looking at the ticker tape on one side and gamblers looking at the roulette wheel on the other).

350. Dawn M. Dobni & Marie D. Racine, *Stock Market Image: The Good, the Bad, and the Ugly*, 16 J. BEHAV. FIN. 130, 136 (2015) (demonstrating correlation between low stock market participation and those who view the stock market as an unscrupulous tilted playing field that favored the rich and powerful); Carmen Keller & Michael Siegrist, *Money Attitude Typology and Stock Investment*, 7 J. BEHAV. FIN. 88, 88 (2006) (finding that some individuals are deterred from stock market participation to the extent they believe it is gambling or otherwise immoral).

351. *See generally* Udo J. Keppler, *What Show Have You Got Little Man?*, PUCK, Apr. 8, 1908 (depicting a tiny man with his "Savings" behind his back standing in front of a giant dealer labeled "Stock Manipulation" holding a crooked deck and loaded dice).

352. *The Blight of Wall-Street High Finance*, *supra* note 138, at 78.

in Securities and Commodities[353] and the Money Trust investigation of 1912–1913.[354] The Hughes Committee characterized the small-scale investor, who lacked "the means and experience" for "intelligent" investing as being in the "same class with gambling upon the race-track or at the roulette table."[355] Each was "wasteful and morally destructive" and each involved "a practical certainty of loss to those who engage in it."[356] There was little sympathy for those who lost money; gamblers who were foolish enough not to realize that the game was rigged against them got what they deserved.[357]

Naturally, we cannot accept at face value these descriptions of the stock market. What popular commentators said about the market and how the market actually operated were not necessarily the same. What we can say is that stock market rhetoric was intended to discourage middle class savers from making equity investments. Social norms viewed the stock market as a place of ruin.[358] Confirmation and availability biases likely contributed to existing predispositions to avoid the stock market since the rhetoric of rampant insider trading was consistent with the preconceived notions most people had about Wall Street. In the face of high perceived risks, stock market participation would naturally be lower.[359] With so much focus in the popular press on manipulation and insider trading, ordinary investors could have easily overestimated the actual likelihood that they would fall victim to these practices.[360] Many potential investors did not have a deep knowledge of the stock market, and modern studies show that individuals with low information are generally more likely to believe that the market is an immoral, tilted playing field.[361] And because the markets were so volatile, it is not very surprising that outside observers would find patterns that, in their

353. HUGHES COMMITTEE REPORT, *supra* note 264, at 5.

354. MONEY TRUST REPORT, *supra* note 67, at 116. Only "a small part of" NYSE transactions were of "an investment character":

> a far greater part represents speculation indistinguishable in effect from wagering and more hurtful than lotteries of gambling at the race track or the roulette table because practiced on a vastly wider scale and withdrawing from productive industry vastly more capital; that as an adjunct of such speculation quotations of securities are manipulated without regard to real values and false appearances of demand or supply are created. . . In other words, the facilities of the [NYSE] are employed largely for transactions producing moral and economic waste and corruption . . . .

Id.

355. HUGHES COMMITTEE REPORT, *supra* note 264, at 4.

356. *Id.*

357. *See A Hireling of Wall Street*, *supra* note 343, at 507–08; *Inside Information*, *supra* note 296, at 21 ("If the tipster's victims were confined to small-fry novices with little money and no knowledge of Street conditions, there would be little occasion for comment.").

358. *See* Baker & Nofsinger, *supra* note 242, at 110–11 (noting the influence social interactions can have on investment decisions).

359. *See* Jinsook Cho & Jinkook Lee, *An Integrated Model of Risk and Risk-Reducing Strategies*, 59 J. BUS. RES. 112, 119 (2005); Doron Kliger & Andrey Kudryavtsev, *The Availability Heuristic and Investors' Reaction to Company-Specific Events*, 11 J. BEHAV. FIN. 50, 50 (2010).

360. *See* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 81–82 (2011); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477–78 (1998).

361. *See* Dawn M. Dobni & Marie D. Racine, *Investors' Images of the Stock Market: Antecedents and Consequences*, 25 FIN. SERV. REV. 1, 18 (2016) [hereinafter *Investors' Images*]; Dobni & Racine, *supra* note 350, at 138; Maarten van Rooij et al., *Financial Literacy and Stock Market Participation*, 101 J. FIN. ECON. 449, 454 (2011).

minds, confirmed that insiders dominated price movements on Wall Street.[362] The fact that the law seemed to tolerate insider trading in the absence of manipulation would tend to confirm for knowledgeable potential investors the foolishness of playing the markets.

B. The Institutional Response to Insider Trading

In the years from World War I through the 1929 crash, stock market participation steadily increased.[363] The broad retailing of government bonds to fund the war, the federal policy of promoting broad securities ownership, corporate and Wall Street efforts to promote stock ownership, and the Jazz Age infatuation with the stock market spurred a cultural shift that saw the citizen-investor as an integral feature of modern American life.[364] Some estimates suggest that by 1929, roughly a quarter of United States households owned stock in publicly traded corporations, compared to approximately 1% at the turn of the twentieth century.[365] As historian Julia Ott has recently recounted, the change in public attitudes toward the market and the increase in stock market participation were driven, at least in part, by a concerted publicity effort on the part of the NYSE, working with corporations and leading financial firms, to encourage broader stock ownership.[366] As discussed below, the NYSE's efforts were part of a broader campaign aimed at creating a shareholder democracy that was thought to provide at least some antidote to the antitrust and labor problems that were at the forefront of public debate. Addressing the fear that investors would invariably lose out to better informed insiders was part of that effort.

Henry Manne claimed that any concerns about the propriety of insider trading—particularly the concerns raised in the Money Trust investigation—must have been insignificant because they did not lead to regulatory changes.[367] That conclusion is open to debate because he does not consider that the stock exchanges were the only stock market regulators during the early twentieth century.[368] Manne is certainly correct that the federal and state proposals to regulate the stock exchanges never passed,[369] but focusing solely on those efforts is far too narrow given the significant uncertainty during this time period over whether the government could regulate securities trading at all. The United States Supreme Court did not uphold the constitutionality of state blue-sky laws until 1917,[370] and for the next two decades, significant questions remained about

362. *See* KAHNEMAN, *supra* note 360, at 114–18.

363. *See* Julia Cathleen Ott, *When Wall Street Met Main Street: The Quest for an Investors' Democracy and the Emergence of the Retail Investor in the United States*, 9 ENTER. & SOC. 619, 620, 622 (2008).

364. *Id.* at 625.

365. *See* OTT, *supra* note 336, at 2.

366. *See id.* at 2–8. The NYSE reprised this effort in the 1950s after another decline in stock market participation. *See* JANICE M. TRAFLET, A NATION OF SMALL SHAREHOLDERS: MARKETING WALL STREET AFTER WORLD WAR II 9 (2013).

367. Manne, *Hayek*, *supra* note 34, at 175 n.33.

368. *See supra* note 34 and accompanying text.

369. *See* OTT, *supra* note 336, at 32–33, 47.

370. *See* Hall v. Geiger-Jones Co., 242 U.S. 539, 558–59 (1917).

whether the federal government possessed the power to regulate stock exchanges, a point that the report from the Money Trust investigations took pains to emphasize.[371]

Instead, stock exchanges, in particular the NYSE, were exclusively self-regulatory organizations that promulgated listing standards for the securities admitted for trading.[372] There is a substantial academic debate over the rigor of these standards and how scrupulously the NYSE actually enforced them in the face of its significant competition with other exchanges.[373] That debate is not directly relevant here, although it is fair to say that the NYSE rejected some securities for listing and at least promoted itself as the market for high quality securities suitable for public investors.[374] The important point is that any search for changes in insider trading regulation must include NYSE rules as well.[375] Indeed, the report of the Money Trust investigation that Manne rejected as not leading to significant regulatory changes specifically called for changes in stock exchange listing standards as the means for addressing the "scandalous practices of officers and directors in speculating upon inside and advance information . . . ."[376]

The NYSE first adopted listing standards in the 1850s and began to more consistently tighten them in about 1910.[377] As early as 1875, however, the NYSE had raised concerns about the propriety of officers and directors of listed companies engaging in insider trading. In a letter to listed companies, a special com-

371. *See* Jones v. SEC, 298 U.S. 1, 21 (1936); MONEY TRUST REPORT, *supra* note 67, at 115 ("It is doubtful, however, whether the Federal Government has power generally to regulate stock exchanges."); MICHAEL PERINO, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE 17 (2010).

372. The exchanges remain self-regulatory organization, albeit now under substantial SEC oversight. *See* 15 U.S.C. § 78f (2018).

373. For the view that during much of the time period before World War I these standards were lax, see MARY A. O'SULLIVAN, DIVIDENDS OF DEVELOPMENT: SECURITIES MARKETS IN THE HISTORY OF CAPITALISM, 1866–1922 43–48 (2016). Other financial historians and legal scholars argue that the NYSE faced significant competition from other securities exchanges, which led it to adopt relatively restrictive listing standards. Those studies tend, however, to focus on the rules for exchange membership and the initial application by a business entity for listing securities on the exchange, rather than the ongoing disclosure requirements applicable to listed companies. *See* MICHIE, *supra* note 273, at 271–72; Coffee, *supra* note 271, at 34–39; Larry Neal & Lance Davis, *The Evolution of the Rules and Regulations of the First Emerging Markets: The London, New York and Paris Stock Exchanges, 1792–1914*, 45 Q. REV. ECON. & FIN. 296, 302 (2005).

374. Coffee, *supra* note 271, at 39.

375. The NYSE was still, of course, a private club at this point, and so it is certainly possible to dispute the view that a change to its listing standards represented a regulatory response to insider trading. Instead, one could argue that this change was a market response to insider trading and thus consistent with the argument that governmental enforcement of insider trading prohibitions is unnecessary. While such a view is certainly plausible, it does not change the basic underlying point—if the NYSE changed its listing standards in response to insider trading concerns, it is evidence that in the early twentieth century, insider trading was not uniformly accepted as a natural and permissible practice.

376. MONEY TRUST REPORT, *supra* note 67, at 115.

377. BIRL E. SHULTZ, STOCK EXCHANGE PROCEDURE 11 (1936); O'SULLIVAN, *supra* note 373, at 47. By the 1920s, there is general agreement that the NYSE possessed the most rigorous listing standards in the United States. *See* SELIGMAN, *supra* note 96, at 46–47.

mittee (in what proved to be a futile quest to convince listed companies to publicly disclose more substantial information) criticized the practice and blamed it for the "disrepute" of corporations.[378]

> We presume no one will be bold enough to claim that a favored few are entitled to [corporate information] to the prejudice of the many, but the fact remains that the few officers and their friends do it while many stockholders must be content to wait and receive it at such times and in such manner as it may be doled out to them. This unjustifiable action has done more than anything else to bring railroads, especially, into disrepute. "Speculating Directors" have become so odious that we feel that honest officers owe it to themselves as well as to the public to correct this evil state of affairs, and we appeal to you in the earnest and confident hope that you will give us the aid of your influence.[379]

By 1877, the committee's "earnest and confident hope" had faded, and it gave up on efforts to wring more information from companies. But it also believed those efforts were no longer essential. Stockholders were demanding greater information, and the committee observed: "Apparently the Golden Age of the speculative director has passed away."[380]

That prediction was, as we have seen, premature; the NYSE's efforts at moral suasion were ineffective. But public attitudes and the political climate had changed substantially by the early twentieth century, and an insider trading episode eventually precipitated at least one change involving the disclosure obligations applicable to listed companies. In late 1913, critics alleged that the directors of B.F. Goodrich had delayed announcing a declared dividend on preferred shares.[381] When the stock price of the preferred dropped significantly before the public announcement, accusations abounded that the directors had deferred disclosure in order to trade.[382] While there is some uncertainty about whether those allegations were true, the criticism nonetheless provides additional support for the view that attitudes about the acceptability of insider trading had begun to shift. As the *Wall Street Journal* (focusing equally on morality, reputational harm, and property rights) editorialized:

> But it is necessary to state once more, in the most emphatic terms, that "inside" information is not a perquisite of directors, but a property of the stockholders. . . . A director is a trustee for the stockholder. He has no preferred rights; and he has grave legal and moral responsibilities. The incident should be a lesson to the directors of the Goodrich Company to avoid

378. Stainslav Dolgoplov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J.L. ECON. & POL'Y 311, 337 n.129 (2008) [hereinafter Dolgopolov, *Insider Trading*].

379. *Id.* at 337; *see also* Stanislav Dolgopolov, A Corporate System with Unregulated Insider Trading and Its Regulatory Pressures: Historical Experiences of the United States 14 (unpublished manuscript) (on file with author) (citing Letter from Brayton Ives, Salem T. Russell & Donald MacKay, New York Stock Exchange to listed companies (Oct. 11, 1875)) [hereinafter Dolgopolov, Unregulated Insider Trading].

380. Dolgopolov, Unregulated Insider Trading, *supra* note 379, at 15 (quoting Report to the Governing Committee of the New York Stock Exchange by Brayton Ives, Donald MacKay & Henry Meigs 3 (May 7, 1877)).

381. *Goodrich Dividend Stirs the Exchange*, N.Y. TIMES, Dec. 4, 1913, at 2.

382. *Id.*; *Director of Goodrich Co. Explains Dividend Matter*, WALL ST. J., Dec. 4, 1913, at 2.

> even the appearance of evil. In this instance their ignorance and indifference has cast an entirely undeserved slur upon the Stock Exchange, and upon the financial center of the country; and inflicted injury not only upon the stockholders, but upon corporation management generally.[383]

The B.F. Goodrich incident led the NYSE to amend its rules in 1914 to prohibit listed companies from delaying disclosure of specified material nonpublic information.[384] It is no coincidence that less than a year earlier, in an attempt to stave off external regulation, the NYSE had begun its public relations campaign to extol the values of a "free and open market."[385] The response to the B.F. Goodrich incident was almost certainly an attempt to show that the NYSE could engage in meaningful self-regulation. It was also an attempt to bolster stock trading, which was 70% lower than it had been at its peak in 1906.[386] By 1913, the last full year of trading before the NYSE's extended close during World War I,[387] volumes had declined to late 1890s levels, even though the number of stock issues had increased over 50%. Those declines naturally reduced member incomes and the value of exchange seats.[388]

To head off regulation and to increase trading volumes, the NYSE's president, William C. Van Antwerp, sought to portray the exchange as a safe venue for average Americans to make prudent investments. The "small investor," Van Antwerp wrote, "must be protected and safeguarded in every possible way" by assuring them "beyond peradventure that they are dealing with reputable men who uphold a fine standard of honor."[389] The "real Wall Street," he claimed, had nothing to do with the dubious promoters and bucket shops to which it was often linked.[390] The NYSE was not "the Wall Street of Mother Goose and Baron Munchausen."[391] Borrowing Theodore Roosevelt's phrase, he assured the public that the NYSE was "controlled by rigid rules of business morality as to insure to everyone who does business there, great and small, rich and poor, an absolutely square deal."[392] Addressing the risk of insider trading directly, Van Antwerp claimed that each "buyer and seller has an equal and a fair opportunity to profit by" the "earliest news" affecting listed companies.[393]

383. *Goodrich and Good Morals*, WALL. ST. J., Dec. 6, 1913, at 1.

384. *New Rule on Dividends*, N.Y. TIMES, Jan. 16, 1914, at 12.

385. *See* OTT, *supra* note 336, at 36–54.

386. *See Trading in Rails and Industrials*, WALL ST. J., Jan. 1, 1929, at 16.

387. The NYSE suspended trading on July 31, 1914 and reopened for limited bond trading on November 28, 1914. Stock trading did not resume until December 12, 1914. *See, e.g.*, SOBEL, *supra* note 295.

388. *See* O'SULLIVAN, *supra* note 373, at 3, 28, 36.

389. WILLIAM C. VAN ANTWERP, THE STOCK EXCHANGE FROM WITHIN 17 (1913). For all his professed concern for the small stockholder, Antwerp expressed outright disdain for "ignorant and silly people" who recklessly bought securities on margin with money they could not afford to lose. But Antwerp saw no way to exclude such individuals from the market. It was foolish to destroy the free and open market, he wrote, "merely because the proletariat below stairs sometimes indulges in speculation and suffers the consequences of its folly." *Id.* at 59–60.

390. *Id.* at 60.

391. *Defends Stock Exchange*, N.Y. TIMES, Jan. 25, 1914, at 12 (quoting Van Antwerp).

392. VAN ANTWERP, *supra* note 389, at 6.

393. *Id.* at 6–7. Ironically, in 1917, opera star Frances Alda sued Van Antwerp's firm, alleging that the broker misrepresented to her "that his firm had exceptional facilities for advance information" and that he would

The exchange tightened its listing standards to underscore that point. The NYSE now required listed corporations to "publish promptly . . . any action in respect to dividends on shares" as well as other specified information that might affect market prices.[394] That standard was not universal. It did not cover previously listed issuers and the obligation typically only appeared in the agreements negotiated with industrial companies.[395] Utilities and railroads were, in the words of one writer, "particularly slow to sign agreements."[396] In short, this change in listing standards was a weak response to public concerns about the prevalence of insider trading. Nonetheless, these agreements were a first, halting step toward addressing concerns about insider trading and a demonstration that the relevant regulatory authorities were altering their rules in the early twentieth century in response to those concerns.

The rationales offered for this change in listing standards represent a variation on the modern public choice model of insider trading enforcement, which is premised on the idea that securities market professionals seek to eliminate managers' ability to profit from inside information because they will then be the group best able to exploit that information.[397] This change in listing standards was a direct response to public concerns about the ability of corporate managers to profit from insider trading, and there is no doubt that requiring prompt release of material information would benefit the specialists and proprietary traders who were in position to learn of and act quickly on that information. Requiring prompt disclosure would help protect NYSE members from systematically losing out to better informed insiders.[398] The NYSE's position, however, was grounded on something more than giving its members preferential access to such information. Exchange members could also benefit from rules that limit insider trading to the extent that such rules increased investor confidence in the fairness of secondary markets. Sending that kind of signal could expand stock market participation and thereby increase trading volumes and commission revenue.

If building public confidence in the market were, at least partially, the explanation for limiting insider trading at public companies, then one would expect to see investment bankers who were engaged predominantly in primary transactions advocating for insider trading restrictions. Underwriters might certainly be able to undertake beneficial trading transactions if they had early access to material nonpublic information, but their overwhelming concern should be broadening the market of securities purchasers, which would make it easier to sell the

put her "in upon the ground floor" of various pools. OTT, *supra* note 336, at 191–92. The suit was ultimately settled. *Mme. Alda Settles Suit*, N.Y. TIMES, June 8, 1921, at 16.

394. *New Rule on Dividends: Stock Exchange Adopts It to Prevent Delay in Reports on Them*, N.Y. TIMES, Jan. 16, 1914, at 12. One member of the NYSE Board of Governors had previously complained that the exchange was unable to protect investors in these kinds of situations because there were no "laws that could be applied to a company for violating" the exchange's listing standards. *Goodrich Dividend Declaration*, WALL. ST. J., Dec. 5, 1913, at 1. The only remedy was to delist the securities, which was impractical because of the substantial harm it would impose on shareholders. *Goodrich and Good Morals*, *supra* note 383, at 1.

395. SHULTZ, *supra* note 377, at 19.

396. *Id.*

397. *See* Haddock & Macey, *supra* note 8, at 317–19.

398. Cox, *supra* note 12, at 630.

securities they underwrote.[399] As Vincent Carosso noted in his history of investment banking:

> The reputation and influence of the leading investment firms, such as J.P. Morgan, Kuhn, Loeb, and the First National Bank of New York, rested upon their ability to distribute large quantities of securities by selling them to their branches or correspondents abroad and to private and commercial banks, brokerage houses, and trust and life insurance companies in the United States; such firms then resold the stocks or bonds to the public or held them as investments.[400]

Crucial to this distribution network was cultivating a view among the ultimate securities purchasers that they were buying stable, legitimate investments, protected at least to some degree from insiders seeking to maximize their private benefits of control.[401] Investment bankers backed these issuances with their own reputational capital and thus needed to send investors a strong and credible signal about the quality of these securities.[402] Those dynamics help explain why investment bankers often played the role of the "protector of the public shareholder" by taking board seats on the companies they underwrote or reorganized.[403] If the belief in rampant insider trading made investors unwilling to purchase these securities (and that was certainly the advice they received at the time), then there should be evidence that investment banking firms opposed managers engaging in such activity.

Preliminary evidence suggests that some underwriters expressed precisely these concerns. We have seen some evidence of this already with respect to the reaction to the Union Pacific scandal. Media reports suggested that unnamed "conservative bankers" favored rules to limit managerial insider trading.[404] A more specific example arose from the same scandal. Harriman's primary investment banker, Otto Kahn, argued that directors and executives had to send a strong signal of their trustworthiness to investors.[405] Framing an approach that coheres closely to Professor Kim's view of insider trading as a form of private corruption,[406] Kahn asserted that business leaders were no longer free to act without constraint, because they occupied a conspicuous place in society.[407] Although most business leaders failed to realize it, for Kahn, the power they wielded in

399. *See* Coffee, *supra* note 271, at 32 (noting that during this period, J.P. Morgan and similar firms were primarily engaged in underwriting large securities offerings and arranging mergers and acquisition transactions).

400. CAROSSO, *supra* note 265, at 47.

401. *Id.*

402. Coffee, *supra* note 271, at 35.

403. *Id.* at 26–34.

404. *See supra* notes 211–15 and accompanying text.

405. Kahn's firm, Kuhn Loeb, was one of the more conservative investment houses; it did not begin to underwrite industrial securities until very late in the nineteenth century because of its concerns about the quality of those securities and because of the reluctance of its institutional clients to purchase them. *See* CAROSSO, *supra* note 265, at 43–44.

406. *See* Kim, *supra* note 21, at 933–34 (insider trading involves "the use of an entrusted position for self-regarding gain").

407. Kahn, *supra* note 169, at 20.

society made them "legitimate objects for public scrutiny."[408] Their actions were now judged under a new, more exacting standard that bore a strong resemblance to those holding public office:

> Tennyson wrote of the "fierce light that beats upon a throne," and the public insist very properly and justly upon the same fierce light beating upon those in dominant places of finance and commerce. The temptation to the arbitrary and selfish exercise of great power is so strong that the burden of proof that they can be safely trusted with its possession is nowadays rightly laid upon those in high positions. It is for them to show cause why they should be considered fit persons to enjoy the people's confidence, not merely for their ability, but just as much, if not more for their character, self-restraint, fair mindedness and sense of duty towards the public.[409]

Kahn was not arguing for limitations on managerial trading in order to enhance his own trading profits.[410] Instead, Kahn seemed to be focused on his firm's ability to sell securities in primary transactions. Implicit in Kahn's criticism of the director's actions is a belief that the securities of publicly traded companies could be sold more easily and at better prices by expanding the depth and breadth of the secondary market. Doing that meant convincing investors that they would not invariably lose out to better informed insiders.

Kahn's insistence that business leaders change their practices was about self-preservation. "The undisturbed possession of the material rewards now given to success can only be perpetuated if its beneficiaries exercise moderation, self-restraint and consideration for others in the use of their opportunities" and if they conducted "business as to do their full duty by their employees as well as by the public."[411] If they wanted to maintain their privileged position, business leaders had to realize that appearances mattered. "A man, and especially a man at the head of a great corporation, must not only do right, but he must be very careful to avoid even appearances tending to arouse the suspicion of his not doing right."[412] He left unsaid that tamping down on insider trading among officers and directors would also accrue to his and other underwriters' benefit. But his statement sent a strong message about what was considered appropriate behavior among the leading investment bankers. It was no longer acceptable—at least not universally so—for managers of publicly traded companies to take advantage of material nonpublic information for personal profit.[413]

Of course, one statement by one investment banker is by no means definitive. Additional historical research is necessary to evaluate how other investment bankers approached the issue. In particular, it would be helpful to evaluate the investment banking firms, like National City, whose primary clientele were mid-

408. *Id.*
409. *Id.*
410. Indeed, his firm did not engage in substantial proprietary trading. *See supra* note 405 and accompanying text.
411. Kahn, *supra* note 169, at 20–22, 24.
412. *Id.* at 17.
413. *Id.* at 15–17.

dle class investors. If bankers from those firms took strong positions against insider trading during this period, that would provide substantial evidence that norms were changing and that those changes were driven, at least in part, by a desire to expand the market for stocks. What we can say at this point is that the notion that stock market participants uniformly found insider trading acceptable is simply not true.

Economists and judges at the turn of the twentieth century also recognized the link between broad stock ownership and perceptions of market fairness. They argued that encouraging the former required improving the latter.[414] One of the most prominent was economist Jeremiah W. Jenks. An academic adviser to the United States Industrial Commission tasked with recommending legislation to address the "trust problem,"[415] Jenks argued that the profits from insider trading transactions were "tainted" because the director had won them "at the expense of stock-holders for whom he is a trustee."[416] Although Jenks recognized the important function that stock exchanges played in a modern economy, he thought that the profit earned in these transactions was unjustified because the corporate officials were not rendering a socially valuable service. In contrast to most modern views on the harm from insider trading, Jenks argued that the individual on the other side of the transaction had in fact suffered a tangible harm.[417] "When the gain of one person is made at the expense of another without any service to society," Jenks concluded, "and especially when that gain is brought about by special knowledge improperly withheld so that the chances in the gambling game are not even, the act is dishonorable, and unjust, and detrimental to the public."[418] Given Jenks's advisory role, it is hardly surprising that the Industrial Commission found that insider trading by directors and officers represented one of the principal evils of industrial combinations.[419]

Jenks's condemnation of insider trading was part of a larger project to encourage broad public stock ownership. Jenks, along with fellow economists Richard T. Ely, John Bates Clark, and Judge Peter S. Grosscup, were responding to the monopoly, income inequality, and labor unrest problems that dominated public debate in the early 1900s and to the increasing concern that the traditional American ideal of a proprietary democracy dominated by citizen-owners was impossible in a time of industrialization and great concentrations of wealth.[420] The dependency of labor, their separation from any ownership interest in the large enterprises in which they worked, Grosscup argued, was "'the most unrepublican and menacing fact' confronting the nation."[421]

414. *See* OTT, *supra* note 336, at 21–22.
415. *See id.* at 21.
416. JENKS, *supra* note 141, at 27.
417. *Id.* at 27–28.
418. *Id.* at 28.
419. OTT, *supra* note 336, at 22.
420. *See* RICHARD T. ELY, MONOPOLIES AND TRUSTS 238–39 (1900) (discussing how great disparities of wealth are inconsistent with republican government); OTT, *supra* note 336, at 9–35.
421. OTT, *supra* note 336, at 26.

For Jenks and his colleagues, it was futile to try to break up large industrial concerns and return to the republican ideal of a nation of small producers and yeoman farmers.[422] Instead, what was needed was government regulation and a reconceptualization of property ownership to include ownership of financial securities.[423] By sharing corporate profits more broadly, these men sought to promote competition for investment funds, maintain the "personal independence" of the average citizen, and blur the line between the capitalist and laboring classes.[424] The "old line of demarcation between the capitalist class and the laboring class" would start to disappear if a trust was "divided, in its ownership, into a myriad of holdings scattered widely among the people."[425] Not only, Grosscup argued, would broad-based stock ownership address income inequality by spreading "the permanent fruits of progress and prosperity," but it would create "a wide-spread habit of scrutiny" that would transform shareholders into watchdogs over corporate excesses.[426] Several publicly traded corporations took up this call, launching employee stock ownership plans in the first decade of the twentieth century.[427]

Encouraging this kind of investor democracy, Clark wrote, required making stocks "common and safe forms of investment of workmen's savings."[428] Given existing legal rules, many observers concluded that share ownership was simply too risky for the average wage earner.[429] The "plain people," Grosscup observed, "are distrustful of investing" in securities.[430] "No decent, honest citizen," he believed, "dare make an investment anywhere in this new property domain that has come to the republic."[431] The corporation, Grosscup wrote, had to be "be cleaned up, remodeled, if necessary rebuilt on lines of conservatism, fidelity to trust, and honesty" in order to encourage "the people at large" to invest in publicly traded securities.[432]

Echoing the calls of the U.S. Industrial Commission, Jenks, Clark, and Ely called for a federal bureau of corporations, improved corporate disclosures, and enhanced protections for shareholders.[433] The officers, Grosscup wrote, must be "trustees of the stockholders, held to the strict accountability to which individual

422. *Id.* at 24–25.

423. *Id.*

424. *Id.* at 25; *see* John Bates Clark, *Disarming the Trusts*, ATLANTIC MONTHLY, Jan. 1900, at 47, 50 (envisioning corporate capital divided "into a myriad of holdings scattered widely among the people"). In the 1920s, Ely and Clark's student, Harvard economics professor Thomas Nixon Carver, launched a similar but more successful campaign for broad stock ownership, which he called the "New Proprietorship." OTT, *supra* note 336, at 129–49.

425. OTT, *supra* note 336, at 25; Clark, *supra* note 424, at 50.

426. OTT, *supra* note 336, at 26–28.

427. *See id.* at 28. The companies adopting such plans included New York Life Insurance Co., U.S. Steel, McCormick Reaper, International Harvester, DuPont, and Procter & Gamble. *Id.*

428. Clark, *supra* note 424, at 50.

429. *See* OTT, *supra* note 336, at 29.

430. *Workingmen as Capitalists*, N.Y. TIMES, Feb. 17, 1903, at 8.

431. *See* OTT, *supra* note 336, at 26; Peter S. Grosscup, *The Corporation and the People: Are We on the Right Track?*, OUTLOOK, Jan. 12, 1907, at 71, 73.

432. Grosscup, *supra* note 431, at 73.

433. *See* ELY, *supra* note 420, at 267–70; OTT, *supra* note 366, at 24–26.

trustees are now held, and denied the privilege, as individual trustees are now denied, of making profit out of their trust."[434] Jenks went further, arguing that courts should change their approach to insider trading in light of the rise in dispersed share ownership and the increased information asymmetries between managers and owners.[435] This shift made the directors and officers "trustees for thousands of stockholders" and warranted changing the "standards of honor" that had previously applied to business dealings.[436] These proposals were all geared toward encouraging stock investment by eliminating the popular perception that the market was a rigged game that only the insiders could win.

IV. CONCLUSION

The goals of this Article have been largely descriptive—to challenge the prevailing view that insider trading was a universally accepted practice at the turn of the twentieth century. Although insider trading was thought to be widespread, this Article has shown that it was not uniformly regarded as a proper or benign practice. Many directors and officers of publicly traded companies certainly viewed the ability to trade on material nonpublic information as a perquisite of their positions and it is not hard to find evidence that, at least in some quarters, it was considered a natural, unavoidable feature of stock markets. But beginning in the late 1800s and continuing into the early twentieth century, legal scholars and practitioners, elite business leaders, economists, financial journalists, and the public all began to question the propriety of allowing corporate managers to use their superior information for trading purposes. These arguments were often morality based, but critics and supporters of the common law approach also raised modern agency cost and property rights arguments as well. Among the pubic, views about the prevalence of insider trading were closely linked to views about the inefficiency of the securities markets and to advice about why ordinary investors should avoid investing there. To encourage broader market participation, business leaders and the NYSE began to respond by altering existing disclosure practices while academic economists advocated limiting insider trading in order to make stocks "safe forms of investment of workmen's savings."[437] Those efforts were nascent attempts to signal to investors that they would not invariably lose out to better-informed insiders. These finding show that concerns about insider trading have existed since the beginning of public participation in the stock market and substantially predate the SEC's decision to target insider trading under the federal securities laws.

This preliminary analysis raises a number of important questions that future research can address. Additional research can analyze the extent to which, in the absence of legal restrictions, firms adopted private ordering mechanisms to limit

434. Grosscup, *supra* note 431, at 76.

435. JENKS, *supra* note 141, at 4.

436. Jeremiah W. Jenks, *The Modern Standard of Business Honor*, 8 PUBLICATIONS AM. ECON. ASS'N 1, 3 (1907).

437. Clark, *supra* note 424, at 50.

insider trading and, if so, the factors that led such firms to do so. A deeper understanding of this time period, as well as the time period between the progressive era and the early 1960s—when the SEC first addressed insider trading—can illuminate the interaction between changing legal rules and changing norms. In particular, and given the emerging norms outlined here that condemned insider trading at publicly traded companies, future research may be able to explain why legal rules took so long to reflect these changing market norms. Understanding how the approach to insider trading was changing during this time period and the role that the stock exchanges played in this process also contributes to our understanding of the role that law and market microstructures play in creating the foundations for dispersed stock ownership.