Abstract

This Paper presents evidence boards of directors “bargain” with executives about the profits they expect to make from trades in firm stock. The evidence suggests executives whose trading freedom is increased using Rule 10b5-1 trading plans experienced reductions in other forms of pay to offset the potential gains from trading. There are two benefits from trading—portfolio optimization and informed trading profits—and this Paper allows us to isolate them. The data show boards pay executives in a way that reflects the profits they are expected to earn from informed trades. The legal issues about paying using illegal profits are explored. As a matter of policy, the data seriously undercut criticisms of the laissez-faire view of insider trading most closely associated with Henry Manne. At least with respect to classic insider trading (that is, a manager of a firm trading on the basis of information about the firm where she works), if boards are taking potential trading profits into consideration when setting pay, it is difficult to locate potential victims of this trading. Current shareholders should be happy with a deal that pays managers in part out of the hide of future shareholders, and the firm should internalize any costs arising from this payment scheme, since future shareholders should take this into account when deciding whether and what price to buy shares. While there still may be good reasons to prohibit some individuals from trading on material, non-public information, the case for classic insider trading is made much weaker by this data.