What is Really Unethical About Insider Trading?

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ABSTRACT. Insider trading is illegal, and is widely believed to be unethical. It has received widespread attention in the media and has become, for some, the very symbol of ethical decay in business. For a practice that has come to epitomize unethical business behavior, however, insider trading has received surprisingly little ethical analysis. This article critically examines the principal ethical arguments against insider trading: the claim that the practice is unfair, the claim that it involves a "misappropriation" of information and the claim that it harms ordinary investors and the market as a whole. The author concludes that each of these arguments has some serious deficiencies; no one of them by itself provides a sufficient reason for outlawing insider trading. This does not mean, however, that there are no reasons for prohibiting the practice. The author argues that the real reason for outlawing insider trading is that it undermines the fiduciary relationship that lies at the heart of American business.

"Insider trading," as the term is usually used, means the buying or selling of securities on the basis of material, non-public information. It is popularly believed to be unethical, and many, though not all, forms of it are illegal. Insider trading makes for exciting headlines, and stories of the unscrupulousness and unbridled greed of the traders abound. As it is reported in the media – complete with details of clandestine meetings, numbered Swiss bank accounts and thousands of dollars of profits carried away in plastic bags – insider trading has all the trappings of a very shady business indeed.[1] For many, insider trading has become the primary symbol of a widespread ethical rot on Wall Street and in the business community as a whole.[2]

For a practice that has come to epitomize unethical business behavior, insider trading has received surprisingly little ethical analysis. The best ethical assessments of insider trading have come from legal scholars who argue against the practice. But their arguments rest on notions such as fairness or ownership of information that require much more examination than they are usually given.[3] Proponents of insider trading are quick to dismiss these arguments as superficial, but offer very little ethical insight of their own. Arguing almost solely on grounds of economic efficiency, they generally gloss over the ethical arguments or dismiss them entirely.[4] Ironically, their refusal to address the ethical arguments on their merits merely strengthens the impression that insider trading is unethical. Readers are left with the sense that while it might reduce efficiency, the prohibition against insider trading rests on firm *ethical* grounds. But can we assume this? Not, I think, without a good deal more examination.

This paper is divided into two parts. In the first part, I examine critically the principal ethical arguments against insider trading. The arguments fall into three main classes: arguments based on fairness, arguments based on property rights in information, and arguments based on harm to ordinary investors or the market as a whole. Each of these arguments, I contend, has some serious deficiencies. No one of them by itself provides a sufficient reason for outlawing insider trading. This does not mean, however, that there are no reasons for prohibiting the practice. Once we have cleared away the inadequate arguments, other, more cogent reasons for outlawing

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insider trading come to light. In the second part of the paper, I set out what I take to be the real reasons for laws against insider trading.

The term "insider trading" needs some preliminary clarification. Both the SEC and the courts have strongly resisted pressure to define the notion clearly. In 1961, the SEC stated that corporate insiders – such as officers or directors – in possession of material, non-public information were required to disclose that information or to refrain from trading.[5] But this "disclose or refrain" rule has since been extended to persons other than corporate insiders. People who get information from insiders ("tippees") and those who become "temporary insiders" in the course of some work they perform for the company, can acquire the duty of insiders in some cases.[6] Financial printers and newspaper columnists, not "insiders" in the technical sense, have also been found guilty of insider trading.[7] Increasingly, the term "insider" has come to refer to the kind of information a person possesses rather than to the status of the person who trades on that information. My use of the term will reflect this ambiguity. In this paper, an "insider trader" is someone who trades in material, non-public information – not necessarily a corporate insider.

I. Ethical arguments against insider trading

Fairness

Probably the most common reason given for thinking that insider trading is unethical is that it is "unfair." For proponents of the fairness argument, the key feature of insider trading is the disparity of information between the two parties to the transaction. Trading should take place on a "level playing field," they argue, and disparities in information tilt the field toward one player and away from the other. There are two versions of the fairness argument: the first argues that insider trading is unfair because the two parties do not have *equal* information; the second argues that insider trading is unfair because the two parties do not have equal *access* to information. Let us look at the two versions one at a time.

According to the equal information argument, insider trading is unfair because one party to the transaction lacks information the other party has, and is thus at a disadvantage. Although this is a very strict notion of fairness, it has its proponents,[8] and hints of this view appear in some of the judicial opinions.[9] One proponent of the equal information argument is Saul Levmore, who claims that "fairness is achieved when insiders and outsiders are in equal positions. That is, a system is fair if we would not expect one group to envy the position of the other." As thus defined, Levmore claims, fairness "reflects the 'golden rule' of impersonal behavior – treating others as we would ourselves."[10] If Levmore is correct, then not just insider trading, but *all* transactions in which there is a disparity of information are unfair, and thus unethical. But this claim seems overly broad. An example will help to illustrate some of the problems with it.

Suppose I am touring Vermont and come across an antique blanket chest in the barn of a farmer, a chest I know will bring $2 500 back in the city. I offer to buy it for $75, and the farmer agrees. If he had known how much I could get for it back home, he probably would have asked a higher price – but I failed to disclose this information. I have profited from an informational advantage. Have I been unethical? My suspicion is that most people would say I have not. While knowing how much I could sell the chest for in the city is in the interest of the farmer, I am not morally obligated to reveal it. I am not morally obligated to tell those who deal with me *everything* that it would be in their interest to know.

U.S. common law supports this intuition. Legally, people are obligated not to lie or to misrepresent a product they are selling or buying. But they are not required to reveal everything it is in the other party's interest to know.[11] One might argue that this is simply an area in which the law falls short of ethical standards. But there is substantial ethical support for the law on these matters as well. There does seem to be a real difference between lying or misrepresentation on the one hand, and simple failure to disclose information on the other, even though the line between the two is sometimes hard to draw.[12] Lying and misrepresentation are forms of deception, and deception is a subtle form of coercion. When I successfully deceive someone, I cause him to do something that does not represent his true will – something he did not intend to do and would not have done if he had known the truth. Simply not revealing information (usually) does not involve this kind of coercion.

In general, it is only when I owe a *duty* to the

other party that I am legally required reveal all information that is in his interest. In such a situation, the other party believes that I am looking out for his interests, and I deceive him if I do not do so. Failure to disclose is deceptive in this instance because of the relationship of trust and dependence between the parties. But this suggests that trading on inside information is wrong, *not* because it violates a general notion of fairness, but because a breach of fiduciary duty is involved. Cases of insider trading in which no fiduciary duty of this kind is breached would not be unethical.

Significantly, the Supreme Court has taken precisely this position: insider trading is wrong because, and when, it involves the violation of a fiduciary duty to the other parties to the transaction.[13] The Court has consistently refused to recognize the general duty to *all* investors that is argued for by proponents of the fairness argument. This is particularly clear in *Chiarella v. US*, a decision overturning the conviction of a financial printer for trading on inside information:

> At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud *only when he is under a duty to do so*. And the duty to disclose arises when one party has information "that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." . . . The element required to make silence fraudulent – a duty to disclose – is absent in this case. . . .
>
> We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent. . . .[14]

The court reiterated that "there is no *general* duty to disclose before trading on material nonpublic information" in *Dirks v. SEC*.[15] It is worth noting that if this reasoning is correct, the legal and ethical status of insider trading depends on the understanding between the fiduciary and the party he represents. Insider trading would not be a violation of fiduciary duty, and thus would not be unethical, unless (1) it were clearly contrary to the interests of the other party or (2) the other party had demanded or been led to expect disclosure. We shall return to this point below.

There is a second ethical reason for not requiring all people with informational advantages to disclose them to others: there may be relevant differences between the parties to the transaction that make the disparity of information "fair." Perhaps I invested considerable time, effort and money in learning about antiques. If this is true, I might deserve to reap the benefits of these efforts. We frequently think it is fair for people to benefit from informational advantages of their own making; this is an important justification for patent law and the protection of trade secrets. "Fairness" is often defined as "treating equals equally." But equals in what respect? Unless we know that the two parties to a transaction *are* equal in the relevant way, it is difficult to say that an informational advantage held by one of them is "unfair."

My point here is different from the frequently heard claim that people should be allowed to profit from informational advantages because this results in a more efficient use of information. This latter claim, while important, does not really address the fairness issue. What I am arguing is that the notion of fairness offered by proponents of the equal information argument is itself incomplete. We cannot make the notion of fairness work for us unless we supply guidelines explaining who are to count as "equals" in different contexts. If we try, we are likely to end up with results that seem intuitively *un*fair.

For these reasons, the "equal information" version of the fairness argument seems to me to fail. However, it could be argued that insider trading is unfair because the insider has information that is not *accessible* to the ordinary investor. For proponents of this second type of fairness argument, it is not the insider's information advantage that counts, but the fact that this advantage is "unerodable," one that cannot be overcome by the hard work and ingenuity of the ordinary investor. No matter how hard the latter works, he is unable to acquire non-public information, because this information is protected by law.[16]

This type of fairness argument seems more promising, since it allows people to profit from informational advantages of their own making, but not from advantages that are built into the system. Proponents of this "equal access" argument would probably find

my deal with the Vermont farmer unobjectionable, because information about antiques is not in principle unavailable to the farmer. The problem with the argument is that the notion of "equal access" is not very clear. What does it mean for two people to have equal access to information?

Suppose my pipes are leaking and I call a plumber to fix them. He charges me for the job, and benefits by the informational advantage he has over me. Most of us would not find this transaction unethical. True, I don't have "equal access" to the information needed to fix my pipes in any real sense, but I could have had this information had I chosen to become a plumber. The disparity of information in this case is simply something that is built into the fact that people choose to specialize in different areas. But just as I could have chosen to become a plumber, I could have chosen to become a corporate insider with access to legally protected information. Access to information seems to be a relative, not an absolute, matter. As Judge Frank Easterbrook puts it:

> People do not have or lack "access" in some absolute sense. There are, instead, different costs of obtaining information. An outsider's costs are high; he might have to purchase the information from the firm. Managers have lower costs (the amount of salary foregone); brokers have relatively low costs (the value of the time they spent investigating).... The different costs of access are simply a function of the division of labor. A manager (or a physician) always knows more than a shareholder (or patient) in some respects, but unless there is something unethical about the division of labor, the difference is not unfair.[17]

One might argue that I have easier access to a plumber's information than I do to an insider trader's, since there are lots of plumbers from whom I can buy the information I seek.[18] The fact that insiders have a strong incentive to keep their information to themselves is a serious objection to insider trading. But if insider trading were made legal, insiders could profit not only from trading on their information, but also on selling it to willing buyers. Proponents of the practice argue that a brisk market in information would soon develop – indeed, it might be argued that such a market already exists, though in illegal and clandestine form.[19]

The objections offered above do not show conclusively that *no* fairness argument against insider trading can be constructed. But they do suggest that a good deal more spadework is necessary to construct one. Proponents of the fairness argument need to show how the informational advantages of insider traders over ordinary investors are different in kind from the informational advantages of plumbers over the rest of us – or, alternatively, why the informational advantages of plumbers are unfair. I have not yet seen such an argument, and I suspect that designing one may require a significant overhaul of our traditional ideas about fairness. As it stands, the effectiveness of the fairness argument seems restricted to situations in which the insider trader owes a duty to the person with whom he is trading – and as we will see below, even here it is not conclusive because much depends on how that duty is defined.

The most interesting thing about the fairness argument is not that it provides a compelling reason to outlaw insider trading, but that it leads to issues we cannot settle on the basis of an abstract concept of fairness alone. The claim that parties to a transaction should have equal information, or equal access to information, inevitably raises questions about how informational advantages are (or should be) acquired, and when people are entitled to use them for profit. Again, this understanding of the limits of the fairness argument is reflected in common law. If insider trading is wrong primarily because it is unfair, then it should be wrong no matter *who* engages in it. It should make no difference whether I am a corporate insider, a financial printer, or a little old lady who heard a takeover rumor on the Hudson River Line. But it does make a difference to the courts. I think this is because the crucial questions concerning insider trading are not about fairness, but about how inside information is acquired and what entitles people to make use of it. These are questions central to our second class of arguments against insider trading, those based on the notion of property rights in information.

Property rights in information

As economists and legal scholars have recognized, information is a valuable thing, and it is possible to view it as a type of property. We already treat certain

types of information as property: trade secrets, inventions, and so on – and protect them by law. Proponents of the property rights argument claim that material, non-public information is also a kind of property, and that insider trading is wrong because it involves a violation of property rights.

If inside information is a kind of property, whose property is it? How does information come to belong to one person rather than another? This is a very complex question, because information differs in many ways from other, more tangible sorts of property. But one influential argument is that information belongs to the people who discover, originate or "create" it. As Bill Shaw put it in a recent article, "the originator of the information (the individual or the corporation that spent hard-earned bucks producing it) owns and controls this asset just as it does other proprietary goods."[20] Thus if a firm agrees to a deal, invents a new product, or discovers new natural resources, it has a property right in that information and is entitled to exclusive use of it for its own profit.

It is important to note that it is the firm itself (and/or its shareholders), and not the individual employees of the firm, who have property rights in the information. To be sure, it is always certain individuals in the firm who put together the deal, invent the product, or discover the resources. But they are able to do this only because they are backed by the power and authority of the firm. The employees of the firm – managers, officers, directors – are not entitled to the information any more than they are entitled to corporate trade secrets or patents on products that they develop for the firm.[21] It is the firm that makes it possible to create the information and that makes the information valuable once it has been created. As Victor Brudney puts it,

> The insiders have acquired the information at the expense of the enterprise, and for the purpose of conducting the business for the collective good of all the stockholders, entirely apart from personal benefits from trading in its securities. There is no reason for them to be entitled to trade for their own benefit on the basis of such information. . . .[22]

If this analysis is correct, then it suggests that insider trading is wrong because it is a form of theft. It is not exactly like theft, because the person who uses inside information does not deprive the company of the use of the information. But he does deprive the company of the *sole* use of the information, which is itself an asset. The insider trader "misappropriates," as the laws puts it, information that belongs to the company and uses it in a way in which it was not intended – for personal profit. It is not surprising that this "misappropriation theory" has begun to take hold in the courts, and has become one of the predominant rationales in prosecuting insider trading cases. In *U.S. v. Newman*, a case involving investment bankers and securities traders, for example, the court stated:

> In *US v. Chiarella*, Chief Justice Burger . . . said that the defendant "misappropriated" – stole to put it bluntly – valuable nonpublic information entrusted to him in the utmost confidence." That characterization aptly describes the conduct of the connivers in the instant case. . . . By sullying the reputations of [their] employers as safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money.[23]

The misappropriation theory also played a major role in the prosecution of R. Foster Winans, a *Wall Street Journal* reporter who traded on and leaked to others the contents of his "Heard in the Street" column.[24]

This theory is quite persuasive, as far as it goes. But it is not enough to show that insider trading is always unethical or that it should be illegal. If insider information is really the property of the firm that produces it, then using that property is wrong *only when the firm prohibits it.* If the firm does not prohibit insider trading, it seems perfectly acceptable.[25] Most companies do in fact forbid insider trading. But it is not clear whether they do so because they don't want their employees using corporate property for profit or simply because it is illegal. Proponents of insider trading point out that most corporations did not prohibit insider trading until recently, when it became a prime concern of enforcement agencies.[26]

If insider trading is primarily a problem of property rights in information, it might be argued, then it is immoral, and should be illegal, only when the company withholds permission to trade on inside information. Under the property rights theory, insider trading becomes a matter of *contract* between the company, its shareholders and its employees. If

the employment contract forbids an employee from using the company's information, then it is unethical (and illegal) to do so.

A crucial factor here would be the shareholders' agreement to allow insider information. Shareholders may not wish to allow trading on inside information because they may wish the employees of the company to be devoted simply to advancing shareholder interests. We will return to this point below. But if shareholders did allow it, it would seem to be permissible. Still others argue that shareholders would not need to "agree" in any way other than to be told this information when they were buying the stock. If they did not want to hold stock in a company whose employees were permitted to trade in inside information, they would not buy that stock. Hence they could be said to have "agreed."

Manne and other proponents of insider trading have suggested a number of reasons why "shareholders would voluntarily enter into contractual arrangements with insiders giving them property rights in valuable information."[27] Their principal argument is that permitting insider trading would serve as an incentive to create more information – put together more deals, invent more new products, or make more discoveries. Such an incentive, they argue, would create more profit for shareholders in the long run. Assigning employees the right to trade on inside information could take the place of more traditional (and expensive) elements in the employee's compensation package. Rather than giving out end of the year bonuses, for example, firms could allow employees to put together their own bonuses by cashing in on inside information, thus saving the company money. In addition, proponents argue, insider trading would improve the efficiency of the market. We will return to these claims below.

If inside information really is a form of corporate property, firms may assign employees the right to trade on it if they choose to do so. The only reason for not permitting firms to allow employees to trade on their information would be that doing so causes harm to other investors or to society at large. Although our society values property rights very highly, they are not absolute. We do not hesitate to restrict property rights if their exercise causes significant harm to others. The permissibility of insider trading, then, ultimately seems to depend on whether the practice is harmful.

Harm

There are two principal harm-based arguments against insider trading. The first claims that the practice is harmful to ordinary investors who engage in trades with insiders; the second claims that insider trading erodes investors' confidence in the market, causing them to pull out of the market and harming the market as a whole. I will address the two arguments in turn.

Although proponents of insider trading often refer to it as a "victimless crime," implying that no one is harmed by it, it is not difficult to think of examples of transactions with insiders in which ordinary investors are made worse off. Suppose I have placed an order with my broker to sell my shares in Megalith Co., currently trading at $50 a share, at $60 or above. An insider knows that Behemoth Inc. is going to announce a tender offer for Megalith shares in two days, and has begun to buy large amounts of stock in anticipation of the gains. Because of his market activity, Megalith stock rises to $65 a share and my order is triggered. If he had refrained from trading, the price would have risen steeply two days later, and I would have been able to sell my shares for $80. Because the insider traded, I failed to realize the gains that I otherwise would have made.

But there are other examples of transactions in which ordinary investors *benefit* from insider trading. Suppose I tell my broker to sell my shares in Acme Corp., currently trading at $45, if the price drops to $40 or lower. An insider knows of an enormous class action suit to be brought against Acme in two days. He sells his shares, lowering the price to $38 and triggering my sale. When the suit is made public two days later, the share price plunges to $25. If the insider had abstained from trading, I would have lost far more than I did. Here, the insider has protected me from loss.

Not all investors buy or sell through such "trigger" orders. Many of them make their decisions by watching the movement of the stock. The rise in share price might have indicated to an owner of Megalith that a merger was imminent, and she might have held on to her shares for this reason. Similarly, the downward movement of Acme stock caused by the insider might have suggested to an owner that it was time to sell. Proponents of insider

trading argue that large trades by insiders move the price of shares closer to their "real" value, that is, the value that reflects *all* the relevant information about the stock. This makes the market more efficient and provides a valuable service to all investors.[28]

The truth about an ordinary investor's gains and losses from trading with insiders seems to be not that insider trading is never harmful, but that it is not systematically or consistently harmful. Insider trading is not a "victimless crime," as its proponents claim, but it is often difficult to tell exactly who the victims are and to what extent they have been victimized. The stipulation of the law to "disclose *or* abstain" from trading makes determining victims even more complex. While some investors are harmed by the insider's trade, to others the insider's actions make no difference at all; what harms them is simply *not having complete information* about the stock in question. Forbidding insider trading will not prevent these harms. Investors who neither buy nor sell, or who buy or sell for reasons independent of share price, fall into this category.

Permitting insider trading would undoubtedly make the securities market *riskier* for ordinary investors. Even proponents of the practice seem to agree with this claim. But if insider trading were permitted openly, they argue, investors would compensate for the extra riskiness by demanding a discount in share price:

> In modern finance theory, shareholders are seen as investors seeking a return proportionate with that degree of systematic or market-related risk which they have chosen to incur. . . . [The individual investor] is "protected" by the price established by the market mechanism, not by his personal bargaining power or position. . . . To return to the gambling analogy, if I know you are using percentage dice, I won't play without an appropriate adjustment of the odds; the game is, after all, voluntary.[29]

If insider trading were permitted, in short, we could expect a general drop in share prices, but no net harm to investors would result. Moreover, improved efficiency would result in a bigger pie for everyone. These are empirical claims, and I am not equipped to determine if they are true. If they are, however, they would defuse one of the most important objections to insider trading, and provide a powerful argument for leaving the control of inside information up to individual corporations.

The second harm-based argument claims that permitting insider trading would cause ordinary investors to lose confidence in the market and cease to invest there, thus harming the market as a whole. As former SEC Chairman John Shad puts it, "if people get the impression that they're playing against a marked deck, they're simply not going to be willing to invest."[30] Since capital markets play a crucial role in allocating resources in our economy, this objection is a very serious one.

The weakness of the argument is that it turns almost exclusively on the *feelings* or *perceptions* of ordinary investors, and does not address the question of whether these perceptions are justified. If permitting insider trading really does harm ordinary investors, then this "loss of confidence" argument becomes a compelling reason for outlawing insider trading. But if, as many claim, the practice does not harm ordinary investors, then the sensible course of action is to educate the investors, not to outlaw insider trading. It is irrational to cater to the feelings of ordinary investors if those feelings are not justified. We ought not to outlaw perfectly permissible actions just because some people feel (unjustifiably) disadvantaged by them. More research is needed to determine the actual impact of insider trading on the ordinary investor.[31]

II. Is there anything wrong with insider trading?

My contention has been that the principal ethical arguments against insider trading do not, by themselves, suffice to show that the practice is unethical and should be illegal. The strongest arguments are those that turn on the notion of a fiduciary duty to act in the interest of shareholders, or on the idea of inside information as company "property." But in both arguments, the impermissibility of insider trading depends on a contractual understanding among the company, its shareholders and its employees. In both cases, a modification of this understanding could change the moral status of insider trading.

Does this mean that there is nothing wrong with insider trading? No. If insider trading is unethical, it is so *in the context* of the relationship among the firm,

its shareholders and its employees. It is possible to change this context in a way that makes the practice permissible. But *should* the context be changed? I will argue that it should not. Because it threatens the fiduciary relationship that is central to business management, I believe, permitting insider trading is in the interest neither of the firm, its shareholders, nor society at large.

Fiduciary relationships are relationships of trust and dependence in which one party acts in the interest of another. They appear in many contexts, but are absolutely essential to conducting business in a complex society. Fiduciary relationships allow parties with different resources, skills and information to cooperate in productive activity. Shareholders who wish to invest in a business, for example, but who cannot or do not wish to run it themselves, hire others to manage it for them. Managers, directors, and to some extent, other employees, become fiduciaries for the firms they manage and for the shareholders of those firms.

The fiduciary relationship is one of moral and legal obligation. Fiduciaries, that is, are bound to act in the interests of those who depend on them even if these interests do not coincide with their own. Typically, however, fiduciary relationships are constructed as far as possible so that the interests of the fiduciaries and the parties for whom they act *do* coincide. Where the interests of the two parties compete or conflict, the fiduciary relationship is threatened. In corporations, the attempt to discourage divergences of interest is exemplified in rules against bribery, usurping corporate opportunities, and so forth. In the past few years, an entire discipline, "agency theory," has developed to deal with such questions. Agency theorists seek ways to align the interests of agents or fiduciaries with the interests of those on behalf of whom they act.

Significantly, proponents of insider trading do not dispute the importance of the fiduciary relationship. Rather, they argue that permitting insider trading would *increase* the likelihood that employees will act in the interest of shareholders and their firms.[32] We have already touched on the main argument for this claim. Manne and others contend that assigning employees the right to trade on inside information would provide a powerful incentive for creative and entrepreneurial activity. It would encourage new inventions, creative deals, and efficient new management practices, thus increasing the profits, strength, and overall competitiveness of the firm. Manne goes so far as to argue that permission to trade on insider information is the only appropriate way to compensate entrepreneurial activity, and warns: "[I]f no way to reward the entrepreneur within a corporation exists, he will tend to disappear from the corporate scene."[33] The entrepreneur makes an invaluable contribution to the firm and its shareholders, and his disappearance would no doubt cause serious harm.

If permitting insider trading is to work in the way proponents suggest, however, there must be a direct and consistent link between the profits reaped by insider traders and the performance that benefits the firm. It is not at all clear that this is the case – indeed, there is evidence that the opposite is true. There appear to be many ways to profit from inside information that do not benefit the firm at all. I mention four possibilities below. Two of these (2 and 3) are simply ways in which insider traders can profit without benefiting the firm, suggesting that permitting insider trading is a poor incentive for performance and fails firmly to link the interests of managers, directors and employees to those of the corporation as a whole. The others (1 and 4) are actually harmful to the corporation, setting up conflicts of interest and actively undermining the fiduciary relationship.[34]

(1) Proponents of insider trading tend to speak as if all information were positive. "Information," in the proponents' lexicon, always concerns a creative new deal, a new, efficient way of conducting business, or a new product. If this were true, allowing trades on inside information might provide an incentive to work ever harder for the good of the company. But information can also concern *bad* news – a large lawsuit, an unsafe or poor quality product, or lower-than-expected performance. Such negative information can be just as valuable to the insider trader as positive information. If the freedom to trade on positive information encourages acts that are beneficial to the firm, then by the same reasoning the freedom to trade on negative information would encourage harmful acts. At the very least, permitting employees to profit from harms to the company decreases the incentive to avoid such harms. Permission to trade on negative inside information gives

rise to inevitable conflicts of interest. Proponents of insider trading have not satisfactorily answered this objection.[35]

(2) Proponents of insider trading also assume that the easiest way to profit on inside information is to "create" it. But it is not at all clear that this is true. Putting together a deal, inventing a new product, and other productive activities that add value to the firm usually require a significant investment of time and energy. For the well-placed employee, it would be far easier to start a rumor that the company has a new product or is about to announce a deal than to sit down and produce either one – and it would be just as profitable for the employee. If permitting insider trading provides an incentive for the productive "creation" of information, it seems to provide an even greater incentive for the non-productive "invention" of information, or stock manipulation. The invention of information is in the interest neither of the firm nor of society at large.

(3) Even if negative or false information did not pose problems, the incentive argument for insider trading overlooks the difficulties posed by "free riders" – those who do not actually contribute to the creation of the information, but who are nevertheless aware of it and can profit by trading on it. It is a commonplace of economic theory that if persons can benefit from a good without paying for it, they will generally do so. If there is no way to exclude those who do not "pay" from enjoying a benefit, no one will have an incentive to pay for it, there will be no incentive to produce it, and the good will not be supplied. In the case of insider trading, an employee's contribution to the creation of positive information constitutes the "payment." Unless those who do not contribute can be excluded from trading on it, there will be no incentive to produce the desired information; it will not get created at all.

(4) Finally, allowing trading on inside information would tend to deflect employees' attention from the day-to-day business of running the company and focus it on major changes, positive or negative, that lead to large insider trading profits. This might not be true if one could profit by inside information about the day-to-day efficiency of the operation, a continuous tradition of product quality, or a consistently lean operating budget. But these things do not generate the kind of information on which insider traders can reap large profits. Insider profits come from dramatic changes, from "news" – not from steady, long-term performance. If the firm and its shareholders have a genuine interest in such performance, then permitting insider trading creates a conflict of interest for insiders. The ability to trade on inside information is also likely to influence the types of information officers announce to the public, and the timing of such announcements, making it less likely that the information and its timing is optimal for the firm. And the problems of false or negative information remain.[36]

If the arguments given above are correct, permitting insider trading does not increase the likelihood that insiders will act in the interest of the firm and its shareholders. In some cases, it actually causes conflicts of interest, undermining the fiduciary relationship essential to managing the corporation. This claim, in turn, gives corporations good reason to prohibit the practice. But insider trading remains primarily a private matter among corporations, shareholders, and employees. It is appropriate to ask why, given this fact about insider trading, the practice should be *illegal*. If it is primarily corporate and shareholder interests that are threatened by insider trading, why not let corporations themselves bear the burden of enforcement? Why involve the SEC? There are two possible reasons for continuing to support laws against insider trading. The first is that even if they wish to prohibit insider trading, individual corporations do not have the resources to do so effectively. The second is that society itself has a stake in the fiduciary relationship.

Proponents of insider trading frequently point out that until 1961, when the SEC began to prosecute insider traders, few firms took steps to prevent the practice.[37] They argue that this fact indicates that insider trading is not truly harmful to corporations; if it were, corporations would have prohibited it long ago. But there is another plausible reason for corporations' failure to outlaw insider trading: they did not have the resources to do so, and did not wish to waste resources in the attempt to achieve an impossible task.[38] There is strong evidence that the second explanation is the correct one. Preventing insider trading requires continuous and extensive monitoring of transactions and the ability to compel disclosure, and privately imposed penalties do not

seem sufficient to discourage insider trading.[39] The SEC is not hampered by these limitations. Moreover, suggests Frank Easterbrook, if even a few companies allow insider trading, this could make it difficult for other companies to prohibit it. Firms that did not permit insider trading would find themselves at a competitive disadvantage, at the mercy of "free riders" who announce to the public that they prohibit insider trading but incur none of the enforcement costs.[40] Outlawing the practice might be worth doing simply because it enables corporations to do what is in all of their interests anyway – prohibit trading on inside information.

Finally, the claim that the fiduciary relationship is purely a "private" matter is misleading. The erosion of fiduciary duty caused by permitting insider trading has social costs as well as costs to the corporation and its shareholders. We have already noted a few of these. Frequent incidents of stock manipulation would cause a serious crisis in the market, reducing both its stability and efficiency. An increase in the circulation of false information would cause a general decline in the reliability of information and a corresponding decrease in investor trust. This would make the market less, not more efficient (as proponents of the practice claim). Deflecting interests away from the task of day-to-day management and toward the manipulation of information could also have serious negative social consequences. American business has already sustained much criticism for its failure to keep its mind on producing goods and services, and for its pursuit of "paper profits."

The notion of the fiduciary duty owed by managers and other employees to the firm and its shareholders has a long and venerable history in our society. Nearly all of our important activities require some sort of cooperation, trust, or reliance on others, and the ability of one person to act in the interest of another – as a fiduciary – is central to this cooperation. The role of managers as fiduciaries for firms and shareholders is grounded in the property rights of shareholders. They are the owners of the firm, and bear the residual risks, and hence have a right to have it managed in their interest. The fiduciary relationship also contributes to efficiency, since it encourages those who are willing to take risks to place their resources in the hands of those who have the expertise to maximize their usefulness. While this "shareholder theory" of the firm has often been challenged in recent years, this has been primarily by people who argue that the fiduciary concept should be widened to include other "stakeholders" in the firm.[41] I have heard no one argue that the notion of managers' fiduciary duties should be eliminated entirely, and that managers should begin working primarily for themselves.

III. Conclusion

I have argued that the real reason for prohibiting insider trading is that it erodes the fiduciary relationship that lies at the heart of our business organizations. The more frequently heard moral arguments based on fairness, property rights in information, and harm to ordinary investors, are not compelling. Of these, the fairness arguments seem to me the least persuasive. The claim that a trader must reveal everything that it is in the interest of another party to know, seems to hold up only when the other is someone to whom he owes a fiduciary duty. But this is not really a "fairness" argument at all. Similarly, the "misappropriation" theory is only persuasive if we can offer reasons for corporations not to assign the right to trade on inside information to their employees. I have found these in the fact that permitting insider trading threatens the fiduciary relationship. I do believe that lifting the ban against insider trading would cause harms to shareholders, corporations, and society at large. But again, these harms stem primarily from the cracks in the fiduciary relationship caused by permitting insider trading, rather than from actual trades with insiders. Violation of fiduciary duty, in short, is at the center of insider trading offenses, and it is with good reason that the Supreme Court has kept the fiduciary relationship at the forefront of its deliberations on insider trading.

Notes

[1] See, for example, Douglas Frantz, *Levine & Co.* (Avon Books, NY, 1987).

[2] This is certainly true of former SEC chair John Shad, one of the leaders of the crusade against insider trading, who recently donated millions of dollars to Harvard University to establish a program in business ethics. Also see Felix Rohatyn

of the investment banking house Lazard Frères: "... [A] cancer has been spreading in our industry. ... Too much money is coming together with too many young people who have little or no institutional memory, or sense of tradition, and who are under enormous economic pressure to perform in the glare of Hollywood-like publicity. The combination makes for speculative excesses at best, illegality at worst. Insider trading is only one result." *The New York Review of Books*, March 12, 1987.

[3] An important exception is Lawson, 'The Ethics of Insider Trading', 11 *Harvard Journal of Law and Public Policy* 727 (1988).

[4] Henry Manne, for example, whose book *Insider Trading and the Stock Market* stimulated the modern controversy over insider trading, has nothing but contempt for ethical arguments. See *Insider Trading and the Law Professors*, 23 Vanderbilt Law Review 549 (1969): "Morals, someone once said, are a private luxury. Carried into the area of serious debate on public policy, moral arguments are frequently either a sham or a refuge for the intellectually bankrupt." Or see Jonathan R.Macey, *Ethics, Economics and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 Harvard Journal of Law and Public Policy 787 (1988): "[I]n my view the attempt to critique insider trading using ethical philosophy – divorced from economic analysis – is something of a non-starter, because ethical theory does not have much to add to the work that has already been done by economists."

[5] *In re Cady, Roberts*, 40 SEC 907 (1961).

[6] On tippees, see *Dirks v. SEC*, 463 US 646 (1983) at 659; on 'temporary insiders', see *Dirks v. SEC*, 103 S. Ct. 3255 (1983) at 3261 n. 14, and *SEC v. Musella* 578 F. Supp. 425.

[7] See *Materia v. SEC*, 725 F. 2d 197, involving a financial printer and the Winans case, involving the author of the *Wall Street Journal*'s 'Heard on the Street' column, *Carpenter v. US*, 56 LW 4007; *U.S. v. Winans*, 612 F. Supp. 827. It should be noted that the Supreme Court has not wholeheartedly endorsed these further extensions of the rule against insider trading.

[8] See Kaplan, '*Wolf v. Weinstein*: Another Chapter on Insider Trading', 1963 *Supreme Court Review* 273. For numerous other references, see Brudney, 'Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws', 93 *Harvard Law Review* 339, n. 63.

[9] See Mitchell v. Texas Gulf Sulphur Co., 446 F. 2d. 90 (1968) at 101; *SEC v. Great American Industries*, 407 F. 2d. 453 (1968) at 462; *Birdman v. Electro-Catheter Corp.*, 352 F. Supp. 1271 (1973) at 1274.

[10] Saul Levmore, 'Securities and Secrets: Insider Trading and the Law of Contracts', 68 *Virginia Law Review* 117.

[11] See Anthony Kronman, 'Mistake, Disclosure, Information, and the Law of Contracts', 7 *Journal of Legal Studies* 1 (1978). The Restatement (Second) of Torts § 551(2)e (Tent. Draft No. 11, 1965) gives an example which is very similar example to the one above, involving a violin expert who buys a Stradivarius (worth $50 000) in a second-hand instrument shop for only $100.

[12] It seems clear that sometimes failure to disclose can *be* a form of misrepresentation. Such could be the case, for example, when the seller makes a true statement about a product but fails to reveal a later change in circumstances which makes the earlier statement false. Or if a buyer indicates that he has a false impression of the product, and the seller fails to correct the impression. A plausible argument against insider trading would be that failure to reveal the information to the other party to the transaction allows a false impression of this kind to continue, and thus constitutes a form of deception. It is not clear to me, however, that insider trading is a situation of this kind.

[13] An important question is whether trades involving the violation of *another kind* of fiduciary duty, constitute a violation of 10b-5. I address this second type of violation below.

[14] *Chiarella v. US*, 445 U.S. 222, at 227–8; 232–233. Italics mine.

[15] 445 US at 233. Italics mine.

[16] The equal access argument is perhaps best stated by Victor Brudney in his influential article, 'Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws', 93 *Harvard Law Review* 322.

[17] Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Supreme Court Review 350.

[18] Robert Frederick brought this point to my attention.

[19] Manne, *Insider Trading and the Stock Market* (Free Press, New York, 1966), p. 75.

[20] Bill Shaw, 'Should Insider Trading Be Outside The Law', *Business and Society Review* **66**, p. 34. See also Macey, 'From Fairness to Contract: The New Direction of the Rules Against Insider Trading', 13 *Hofstra Law Review* **9** (1984).

[21] Easterbrook points out the striking similarity between insider trading cases and cases involving trade secrets, and cites *Perrin v. US*, 444 US 37 (1979), in which the court held that it was a federal crime to sell confidential corporate information.

[22] Brudney, 'Insiders, Outsiders, and Informational Advantages', 344.

[23] *U.S. v. Newman*, 664 F. 2d 17.

[24] *U.S. v. Winans*, 612 F. Supp. 827. The Supreme Court upheld Winans' conviction, but was evenly split on the misappropriation theory. As a consequence, the Supreme Court has still not truly endorsed the theory, although several lower court decisions have been based on it. *Carpenter v. US*, 56 LW 4007.

[25] Unless there is some other reason for forbidding it, such as that it harms others. See p. 176 first column below.

[26] Easterbrook, 'Insider Trading As An Agency Problem',

Principals and Agents: The Structure of Business (Harvard University Press, Cambridge, MA, 1985).

[27] Carlton and Fischel, 'The Regulation of Insider Trading', 35 *Stanford Law Review* 857. See also Manne, *Insider Trading and the Stock Market*.

[28] Manne, *Insider Trading and the Stock Market*; Carlton and Fischel, 'The Regulation of Insider Trading'.

[29] Kenneth Scott, 'Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy', 9 *Journal of Legal Studies* 808.

[30] 'Disputes Arise Over Value of Laws on Insider Trading', *The Wall Street Journal*, November 17, 1986, p. 28.

[31] One area that needs more attention is the impact of insider trading on the markets (and ordinary investors) of countries that permit the practice. Proponents of insider trading are fond of pointing out that insider trading has been legal in many overseas markets for years, without the dire effects predicted by opponents of the practice. Proponents reply that these markets are not as fair or efficient as U.S. markets, or that they do not play as important a role in the allocation of capital.

[32] See Frank Easterbrook, 'Insider Trading as an Agency Problem'. I speak here as if the interests of the firm and its shareholders are identical, even though this is sometimes not the case.

[33] Manne, *Insider Trading and the Stock Market*, p. 129.

[34] For a more detailed discussion of the ineffectiveness of permitting insider trading as an incentive, see Roy Schotland, 'Unsafe at any Price: A Reply to Manne, *Insider Trading and the Stock Market*', 53 *Virginia Law Review* 1425.

[35] Manne is aware of the "bad news" objection, but he glosses over it by claiming that bad news is not as likely as good news to be provide large gains for insider traders. *Insider Trading and the Stock Market*, p. 102.

[36] There are ways to avoid many of these objections. For example, Manne has suggested "isolating" non-contributors so that they cannot trade on the information produced by others. Companies could also forbid trading on "negative" information. The problem is that these piecemeal restrictions seem very costly – more costly than simply prohibiting insider trading as we do now. In addition, each restriction brings us farther and farther away from what proponents of the practice actually want: unrestricted insider trading.

[37] Frank Easterbrook, 'Insider Trading as an Agency Problem.'

[38] *Ibid.*

[39] Penalties did not begin to become sufficient to discourage insider trading until the passage of the Insider Trading Sanctions Act in 1984. Some argue that they are still not sufficient, and that that is a good reason for abandoning the effort entirely.

[40] Easterbrook, 'Insider Trading as an Agency Problem.'

[41] See Freeman and Gilbert, *Corporate Strategy and the Search for Ethics* (Prentice-Hall, Englewood Cliffs, NJ, 1988).

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