The Ethics of Insider Trading

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ABSTRACT. Despite the fact that a number of economists and philosophers of late defend insider trading both as a viable and useful practice in a free market and as not immoral, I shall question the value of insider trading both from a moral and an economic point of view. I shall argue that insider trading both in its present illegal form and as a legalized market mechanism undermines the efficient and proper functioning of a free market, thereby bringing into question its own raison d'etre. It does so and is economically inefficient for the very reason that it is immoral. Thus this practice cannot be justified either from an economic or a moral point of view.

> Insider trading is the reverse of speculation. It is reward without risk, wealth generated – and injury done to others – by an unfair advantage in information . . . [T]he core principle is clear: no one should profit from exploitation of important information not available to the public.[1]

Insider trading in the stock market is characterized as the buying or selling of shares of stock on the basis of information known only to the trader or to a few persons. In discussions of insider trading it is commonly assumed that the privileged information, if known to others, would affect their actions in the market as well, although in theory this need not be the case. The present guidelines of the Securities and Exchange Commission prohibit most forms of insider trading. Yet a number of economists and philosophers of late defend this kind of activity both as a viable and useful practice in a free market and as a practice that is not immoral. In response to these defenses I want to question the value of insider trading both from a moral and an economic point of view. I shall argue that insider trading both in its present illegal form and as a legalized market mechanism violates the privacy of concerned parties, destroys competition, and undermines the efficient and proper functioning of a free market, thereby bringing into question its own raison d'etre. It does so and therefore is economically inefficient for the very reason that it is immoral.

That insider trading as an illegal activity interferes with the free market is pretty obvious. It is like a game where there are a number of players each of whom represents a constituency. In this sort of game there are two sets of rules – one ostensive set and another, implicit set, functioning for some of the players. In this analogy some of the implicit rules are outlawed, yet the big players manage to keep them operative and actually often in control of the game. But not all the players know all the rules being played or at least they are ignorant of the most important ones, ones that determine the big wins and big losses. So not all the players realize what rules actually manipulate the outcome. Moreover, partly because some of the most important functioning rules are illegal, some players who do know the implicit rules and could participate do not. Thus not everyone in a position to do so plays the trading game the same way. The game, then, like the manipulated market that is the outcome, is unfair – unfair to some of the players and those they represent – unfair not only because some of the players are not privy to the most important rules, but also because these "special" rules are illegal so that they

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are adopted only by a few of even the privileged players.

But suppose that insider trading was decriminalized or not prohibited by SEC regulations. Then, one might argue, insider trading would not be unfair because anyone could engage in it without impunity. Although one would be trading on privileged knowledge, others, too, could trade on *their* privileged information. The market would function more efficiently since the best-informed and those most able to gain information would be allowed to exercise their fiscal capabilities. The market itself would regulate the alleged excesses of insider trading. I use the term "alleged" excesses because according to this line of reasoning, if the market is functioning properly, whatever gains or losses are created as a result of open competition are a natural outcome of that competition. They are not excesses at all, and eventually the market will adjust the so-called unfair gains of speculators.

There are several other defenses of insider trading. First, insider information, e.g., information about a merger, acquisition, new stock issue, layoffs, etc., information known only to a few, *should* be and remain private. That information is the property of those engaged in the activity in question, and they should have the right to regulate its dissemination. Second and conversely, even under ideal circumstances it is impossible either to disseminate information to all interested parties equally and fairly, or alternately, to preserve absolute secrecy. For example, in issuing a new stock or deciding on a stock split, a number of parties in the transaction from brokers to printers learn about that information in advance just because of their participation in making this activity a reality. And there are always shareholders and other interested parties who claim they did not receive information of such an activity or did not receive it at the same time as other shareholders even when the information was disseminated to everyone at the same time. Thus it is, at best, difficult to stop insider trading or to judge whether a certain kind of knowledge is "inside" or privileged. This is not a good reason to defend insider trading as economically or morally desirable, but it illustrates the difficulties of defining and controlling the phenomenon.

Third, those who become privy to inside information, even if they take advantage of that information before it becomes public, are trading on probabilities, not on certainties, since they are trading before the activity actually takes place. They are taking a gamble, and if they are wrong the market itself will "punish" them. It is even argued that brokers who do not use inside information for their clients' advantage are cheating their clients.

Finally, and more importantly, economists like Henry Manne argue that insider trading is beneficial to outsiders. Whether it is more beneficial than its absence is a question Manne admits he cannot answer. But Manne defends insider trading because, he argues, it reduces the factor of chance in trading both for insiders and outsiders. When shares are traded on information or probabilities rather than on rumor or whim, the market reflects more accurately the actual economic status of that company or set of companies. Because of insider trading, stock prices go up or down according to real, factual information. Outsiders benefit from this because stock prices more closely represent the worth of their company than shares not affected by insider trading. Insider trading, then, actually improves the fairness of the market, according to this argument, by reflecting in stock prices the fiscal realities of affected corporations thereby benefitting all traders of the stocks.[2]

These arguments for insider trading are persuasive. Because outsiders are allegedly not harmed from privileged information not available to them and may indeed benefit from insider trading, and because the market punishes rash speculators, insider trading cannot be criticized as exploitation. In fact, it makes the market more efficient. Strong as these arguments are, however, there is something amiss with these claims. The error, I think, rests at least in part with the faulty view of how free markets work, a view which stems from a misinterpretation that derives from a misreading of Adam Smith and specifically a misreading of Smith's notions of self-interest and the Invisible Hand.

The misinterpretation is this. It is sometimes assumed that an unregulated free market, driven by competition and self interest, will function autonomously. The idea is that the free market works something like the law of gravity – autonomously and anonymously in what I would call a no-blooded fashion. The interrelationships created by free market activities based on self-interested competition are similar to the gravitational relationships between the

planets and the sun: impersonal, automatic interactions determined by a number of factors including the distance and competitive self-interest of each of the market components. The free market functions, then, despite the selfish peculiarities of the players just as the planets circle the sun despite their best intentions to do otherwise. Given that picture of the free market, so-called insider trading, driven by self-interest but restrained by competitive forces, that is, the invisible hand, is merely one gravitational mechanism — a complication but not an oddity or an aberration in the market.

This is a crude and exaggerated picture of the market, but I think it accounts for talk about the market *as if* it functioned in this independent yet forceful way, and it accounts for defenses of unrestrained self-interested actions in the market place. It allows one to defend insider trading because of the positive market fall-out from this activity, and because the market allegedly will control the excesses of self-interested economic activities.

The difficulty with this analysis is not so much with the view of insider trading as a legitimate activity but rather with the picture of economic actors in a free market. Adam Smith himself, despite his 17th century Newtonian background, did not have such a mechanical view of a laissez-faire economy. Again and again in the *Wealth of Nations* Smith extols the virtues of unrestrained competition as being to the advantage of the producer and the consumer.[3] A system of perfect liberty he argues, creates a situation where "[t]he whole of the advantages and disadvantages of the different employments of labour and stock . . . be either perfectly equal or continually tending to equality."[4] Yet for Smith the greatest cause of inequalities of advantage is any restrictive policy or activity that deliberately gives privileges to certain kinds of businesses, trades, or professions.[5] The point is that Smith sees perfect liberty as the necessary condition for competition, but perfect competition occurs only both parties in the exchange are on more or less on equal grounds, whether it be competition for labor, jobs, consumers, or capital. This is not to imply that Smith favors equality of outcomes. Clearly he does not. But the market is most efficient and most fair when there is competition between equally matched parties.

Moreover, Smith's thesis was that the Invisible Hand works because, and only when, people operate with restrained self-interest, self-interest restrained by reason, moral sentiments, and sympathy, in Smith's case the reason, moral sentiments and sympathies of British gentlemen. To operate otherwise, that is, with unrestrained self-interest, where that self-interest causes harm to others would "violate the laws of justice"[6] or be a "violation of fair play,"[7] according to Smith. This interferes with free competition just as government regulation would because the character of competition, and thus the direction of the Invisible Hand, depends on the manner in which actors exploit or control their own self-interests. The Invisible Hand, then, that "masterminds" the free market is not like an autonomous gravitational force. It depends on the good will, decency, self-restraint, and fair play of those parties engaging in market activities.[8] When self-interests get out of hand, Smith contends, they must be regulated by laws of justice.[9]

Similarly, the current market, albeit not Smith's ideal of laissez-faire, is affected by how people operate in the market place. It does not operate autonomously. Unrestrained activities of insider traders affect competition differently than Smithian exchanges which are more or less equal exchanges between self-interested but restrained parties. The term "insider trading" implies that some traders know more than others, that information affects their decision-making and would similarly affect the trading behavior of others should they become privy to that information. Because of this, the resulting market is different than one unaffected by insider trading. This, in itself, is not a good reason to question insider trading. Henry Manne, for example, recognizes the role of insider trading in influencing the market and finds that, on balance, this is beneficial.

Insider trading, however, is not merely a complication in the free market mechanism. Insider trading, whether it is legal or illegal, affects negatively the ideal of laissez-faire of *any* market, because it thwarts the very basis of the market: competition, just as "insider" rules affect the fairness of the trader even if that activity is not illegal and even if one could, in theory, obtain inside information oneself. This is because the same information, or equal information, is not available to everyone. So competition, which depends on the availability of equal advantage by all parties is precluded. Insider trading

allows the insider to indulge in greed (even though she may not) and that, by eschewing stock prices, works against the very kind of market in which insider trading might be allowed to function.

If it is true, as Manne argues, that insider trading produces a more efficient stock market because stock prices as a result of insider trading better reflect the underlying economic conditions of those companies involved in the trade, he would also have to argue that competition does not always produce the best results in the marketplace. Conversely, if competition creates the most efficient market, insider trading cannot, because competition is "regulated" by insiders. While it is not clear whether outsiders benefit more from insider trading than without that activity, equal access to information would allow (although not determine) every trader to compete from an equal advantage. Thus pure competition, a supposed goal of the free market and an aim of most persons who defend insider trading, is more nearly obtained without insider trading.

Insider trading has other ethical problems, Insider trading does not protect the privacy of information it is supposed to protect. To illustrate, let us consider a case of a friendly merger between Company *X* and Company *Y*. Suppose this merger is in the planning stages and is not to be made public even to the shareholders for a number of months. There may be good or bad reasons for this secrecy, e.g., labor problems, price of shares of acquired company, management changes, unfriendly raiders, competition in certain markets, etc. By law, management and others privy to knowledge about the possible merger cannot trade shares of either company during the negotiating period. On the other hand, if that information is "leaked" to a trader (or if she finds out by some other means), then information that might affect the merger is now in the hands of persons not part of the negotiation. The alleged privacy of information, privacy supposedly protected by insider traders, is now in the hands of not disinterested parties. While they may keep this information a secret, they had no right to it in the first place. Moreover, their possession of the information has three possible negative effects.

First, they or their clients in fact may be interested parties to the merger, e.g., labor union leaders, stockholders in competing companies, etc., the very persons for whom the information makes a difference and therefore are the objects of Company *X* and *Y*'s secrecy. Second, insider trading on privileged information gives unfair advantages to these traders. Even if outsiders benefit from insider trading, they are less likely to benefit as much nor as soon as insider traders for the very reason of their lack of proximity to the activity. Insider traders can use information to their advantage in the market, an advantage neither the management of *X* or *Y* nor other traders can enjoy. Even if the use of such information in the market makes the market more efficient, this is unfair competition since those without this information will not gain as much as those who have such knowledge. Even if insider trading does contribute to market stabilization based on information, nevertheless, one has also to justify the fact that insider traders profit more on their knowledge than outsiders, when their information becomes an actuality simply by being "first" in the trading of the stock. Do insider traders deserve this added profit because their trading creates a more propitious market share knowledge for outsiders? That is a difficult position to defend, because allowing insider trading also allows for the very Boeskyian greed that is damaging in any market.

Third, while trading *X* and *Y* on inside information may bring their share prices to the value most closely reflecting their real price-earnings ratio, this is not always the case. Such trading may reflect undue optimism or pessimism about the possible outcome of the merger, an event that has not yet occurred. So the prices of *X* and *Y* may be overvalued or undervalued on the basis of a probability, or, because insider traders seldom have all the facts, on guesswork. In these cases insider trading deliberately creates more risk in the market since the stock prices or *X* and *Y* are manipulated for not altogether solid reasons. So market efficiency, the end which allegedly justifies insider trading is not guaranteed.

What Henry Manne's defenses of insider trading do show is what Adam Smith well knew, that the market is neither independent nor self-regulatory. What traders do in the market and how they behave affects the direction and kind of restraint the market will exert on other traders. The character of the market is a product of those who operate within it, as Manne has demonstrated in his defense of insider trading. Restrained self-interest creates an approxi-

mation of a self-regulatory market, because it is that that allows self-interested individuals and companies to function as competitively as possible. In the long run the market will operate more efficiently too, because it precludes aberrations such as those exhibited by Ivan Boesky's and David Levine's behavior, behavior that created market conditions favorable to no one except themselves and their clients.

Notes

[1] George Will, 'Keep Your Eye on Guiliani', *Newsweek*, March 2, 1987, p. 84.
[2] See Henry Manne, *Insider Trading and the Stock Market* (The Free Press, New York, 1966), especially Chapters X and XI.
[3] Adam Smith, *The Wealth of Nations*, ed. R. A. Campbell and A. S. Skinner (Oxford University Press, Oxford, 1976), I.x.c, II.v.8–12
[4] *Wealth of Nations*, I.x.a.1.
[5] *Wealth of Nations*, I.x.c.
[6] *Wealth of Nations*, IV.ix.51.
[7] Adam Smith, *The Theory of Moral Sentiments*, ed. D. D. Raphael and A. L. Macfie (Oxford University Press, Oxford, 1976), II.ii.2.1.
[8] See Andrew Skinner, *A System of Social Science* (Clarendon Press, Oxford, 1979), especially pp. 237ff.
[9] See, for example, *The Wealth of Nations*, II.ii.94, IV, v.16.

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