Journal of Business Ethics (2008) 77:205–217
DOI 10.1007/s10551-006-9344-6 © Springer 2007

Applying Ethics to Insider Trading

Robert W. McGee

ABSTRACT. Insider trading has received a bad name in recent decades. The popular press makes it sound like an evil practice where those who engage in it are totally devoid of ethical principles. Yet not all insider trading is unethical and some studies have concluded that certain kinds of insider trading are actually beneficial to the greater investment community. Some scholars in philosophy, law and economics have disputed whether insider trading should be punished at all while others assert that it should be illegal in all cases. This paper explores the nature of insider trading and analyzes the issues to determine the positive and negative aspects of insider trading, and how policy should be changed. The best hope would be for studies to be made that isolate the individuals or groups who are fraudulently harmed by insider trading. If any such groups exist, then clearly worded legislation could be passed to prevent any fraud from being committed against these individuals and groups, while allowing non-fraudulent transactions to be completed without fear of prosecution. Until it can be clearly determined that someone is fraudulently harmed by insider trading, there should be no law or regulation restricting the practice, since such restrictions violate individual rights and will likely have a negative market reaction.

KEY WORDS: ethics, insider trading, level playing field, property rights, utilitarian ethics

Introduction

Practically all the articles that have been written on insider trading in recent years have treated it as something evil. The notable exception is the work of Manne (1966a, b, 1985). Two particularly hostile and vociferous attacks on Manne's position were made by Hetherington (1967) and Schotland (1967). But theirs were not the only attacks. In fact, it would not be incorrect to say that most articles that have been written about insider trading have taken the position, either implicit or explicit, that insider trading constitutes unethical conduct (Boatright, 1997; Brudney, 1979; Moore, 1990; Salbu, 1992; Strudler and Orts, 1999; Werhane, 1989). Unfortunately, many of those articles do not probe the ethical issues involved. They merely begin with the premise that trading on insider information is inherently unethical. But such a conclusion is incorrect.

One might also point out that what is ethical may not be legal and what is unethical may not be illegal. The two concepts are not identical, although one would hope that there is a certain amount of overlap. For example, it may be legal to discriminate on the basis of race, sex or age but it may not be moral to do so in certain cases. Likewise, it may be moral to discriminate in some cases where it might be illegal. So if we discuss which forms of insider trading are legal and which are illegal, one may not automatically infer that transactions that are presently illegal in some jurisdictions are also immoral, or that trades that are currently legal in some jurisdictions are necessarily also moral. That may be the case, but it also may not be the case.

People profit from using inside information all the time. Tax preparers use their expert knowledge of the tax law to save their clients' money in the preparation of their tax returns and charge professional fees for this service. Yet no one complains or accuses the service provider to performing an unethical activity. Both sides benefit by the transaction. The taxpayer benefits because the preparer helps satisfy the legal requirement to file the tax

Robert W. McGee is a professor at the Andreas School of Business, Barry University in Miami, Florida, USA. He has published more than 50 books and more than 400 scholarly papers in the fields of accounting, taxation, economics, law, philosophy and ethics. He holds doctorates in several fields, including accounting, economics, law and philosophy. He is an attorney and a certified public accountant (CPA).

return and probably also benefits by having his tax liability reduced. The tax preparer also benefits because he earns a fee for such services. It is a win–win situation because both parties to the transaction benefit. There are no losers, except perhaps the tax authority, but if the tax preparer does not violate any rules in the preparation of the tax return, the tax authority does not fail to receive what it is legally entitled to receive. It just does not receive more than it is legally entitled to receive because the tax preparer has applied the law in such a way as to minimize the amount of the tax liability.

What could be said about tax return preparers could also be said about all other professions. Medical doctors use their inside information, which was gained through years of study and practice, to cure or alleviate suffering. The general public does not possess the information that these doctors possess. Thus, they are profiting from the use of non-public information. Plumbers, chefs and airline pilots also make their living by applying the inside, non-public information they have acquired through study and work, yet no one accuses these people of acting unethically merely because they profit from applying the information they have acquired along the way.

Another common beneficial use of inside information occurs whenever a shopper takes advantage of a department store sale. Let's say that a shopper visits a department store to purchase a certain item and, upon arrival, reads a sign that states that all merchandise will go on sale tomorrow at a 30% discount. The only people who know about the pending sale are the people who visited the store and read the sale signs. Let's say that as a result of reading the sale sign, the shopper decides to go home and return the next day to take advantage of the 30% discount. The next day the shopper buys items costing $70 that would otherwise have cost $100, thus saving $30 as a result of using this inside information.

Is there anything unethical about profiting from the use of such information? The customer benefits and so does the store. True, the store would have benefited by an additional $30 if the shopper would have made the purchases yesterday instead of today, but the store still benefited by making the sale today. Otherwise it would not have made the sale. Furthermore, it was the store management's decision to put its goods on sale, so the store cannot be labeled as a victim of insider trading, since it was the store that initiated the sale. The fact that only a small percentage of the local community read the sale signs, and thus benefited because of this sale information, is completely irrelevant. The percentage of the community that is aware of any particular economic information has absolutely nothing to do with the determination of whether a trade constitutes ethical or unethical conduct.

Let's change the fact situation. Let's say that no signs were posted to alert shoppers to the pending sale, but that a sales clerk told a shopper "You should put that back on the shelf and come back tomorrow when it will be on sale." Does this change in the fact situation alter the ethics of the transaction? In either case the shopper benefits and so does the store. The only difference is that the information is not public information, in the sense that there were no signs posted to alert the public of the existence of the sale. But the only people who would know about the sale anyway were the people who happened to be in the store. So the subset of potential shoppers is smaller if no signs are posted, but no one is harmed by trading on this information regardless of how many or how few people know what will happen the next day when the sale begins.

From the perspective of utilitarian ethics, any transaction is ethical provided the gains exceed the losses. Therefore, since both the customer and the store benefited by the sales, the transaction is ethical. There were two winners and no losers, so the gains exceeded the losses. Whether signs were posted or whether a shopper learned of the pending sale from a sales clerk is irrelevant as far as the ethics of the matter is concerned. There were two winners and no losers as a result of this use of non-public information.

If there is nothing unethical about shoppers, doctors, chefs, airline pilots and tax return preparers trading on insider information, can it be said that trading on stock information is also not unethical, or are there other issues that need to be explored?

These examples could be criticized by those who take a narrow view of insider trading. The criticism might go something like this. Inside information is the information held by the board of directors, auditors and management of a corporation that is available to them solely due to their role inside the organization. Such information is not available to the public through any legal means. Tax-preparers use expert information to prepare a tax return and save

the client some money. However, such expert information used by the tax preparer is not known only to the tax preparers. It is public knowledge and is available to anybody who wants to spend the time and energy to locate it. The knowledge held by the doctors, chefs and plumbers, etc., is part of the public body of knowledge that is supplemented by the experience earned by these individuals through years of practice. Anybody who is willing to spend the money and time and practice the profession can earn similar knowledge. Such knowledge cannot be equated to what we commonly understand as ''insider information.''

This line of reasoning has some plausibility, at least on the surface. But the real issue is not whether it is ethical for privileged groups or individuals to profit from information that is not available to the general public, but whether it is ethical to profit from asymmetric information. There are at least two ways to determine whether profiting from such information is ethical. The utilitarian ethics approach looks at results. If the winners exceed the losers or if the result is a positive-sum game, then profiting from the use of such information is ethical.

The other approach is to look at the process and to ignore the results. If the process is ethical, then profiting from the use of the information is ethical regardless of whether the result is a positive-sum game, a negative-sum game or a zero-sum game. This article explores both views.

Whenever the term ''insider trading'' is used, the average listener/reader immediately classifies it as a bad practice, or something that is immoral or unethical. Inside traders are viewed as common criminals (McMenamin, 1988). The purpose of this paper is to explore the nature of insider trading and analyze the issues to determine the positive and negative aspects of insider trading, and how policy should be changed, if at all.

Regulation of insider trading

The regulation of insider trading is a relatively recent phenomenon. The United States was the first major country to enact an insider trading law and to place restrictions on insider trading. The roots of the U.S. insider law sprouted from the securities legislation that was enacted in 1934 to prohibit other kinds of stock manipulation (Bernardo, 2001). France was the second country to enact an insider trading law but France did not place prohibitions on insider trading until 1967 (Bhattacharya and Daouk, 2002). Other countries have followed, but slowly. The U.K., Australia, Japan, and Korea have adopted insider trading laws along the American model (O'Hara, 2001). As of 1990, only thirty-four countries had laws restricting or prohibiting insider trading, and only nine of them had prosecuted anyone for insider trading. By 2000, eighty-seven countries had passed insider trading laws and 38 had prosecuted at least one insider trading case (Bhattacharya and Daouk, 2002). China's insider trading law was not enacted until December 29, 1998 and was drafted with the assistance of the United States (Qu, 2001). In 1989, the EU passed a directive that required all member countries to pass legislation prohibiting certain kinds of insider trading by 1992. Any country that wants to join the EU must also have an insider trading law on the books.

Table I shows the year insider trading regulations were first adopted by the stock exchanges of selected countries and the year that violations of insider trading rules were first prosecuted.

Is insider trading fraudulent?

Whether insider trading is fraudulent is questionable. St. Thomas Aquinas said that fraud can be perpetrated in three ways, either by selling one thing for another or by giving the wrong quality or quantity (Aquinas; Dalcourt, 1965, p. 105). A more modern definition is ''intentional deception to cause a person to give up property or some lawful right.'' (Webster, 1964).

A typical case of insider trading occurs when a buyer with inside information calls his stock broker and tells him to buy, knowing that the stock price is likely to rise as soon as the inside information becomes public. In this case, the buyer does not deceive the seller into giving up property. Indeed, the buyer does not even know who the seller is, and the seller would have sold anyway, anonymously, through the same broker. The seller's action would have been the same whether an inside trader was the other party to the transaction or not. If the inside trader had not purchased the stock, someone else would have. Yet this ''someone else'' would not be

TABLE I

Enactment of insider trading restrictions selected countries

Country	Year insider trading rules adopted by national stock exchange	Year insider trading first prosecuted
Australia	1991	1996
Bangladesh	1995	1998
China	1993	No
Hong Kong	1991	1994
India	1992	1998
Indonesia	1991	1996
Iran	No	No
Japan	1988	1990
Kazakhstan	1996	No
Malaysia	1973	1996
Mongolia	1994	No
New Zealand	1988	No
Pakistan	1995	No
Philippines	1982	No
Russia	1996	No
Singapore	1973	1978
South Korea	1976	1988
Sri Lanka	1987	1996
Taiwan	1988	1989
Thailand	1984	1993
Turkey	1981	1996
United States	1934	1961
Uzbekistan	No	No
Median for 103 Countries	1991	1994
Median for 22 Developed Countries	1989	1993.5
Median for 81 Emerging Markets	1992	1995.5

Source: Bhattacharya and Daouk (2002).

accused of reaping unjust profits, even if the identical stock was purchased for the same price the insider would have paid.

Insider trading does not seem to fit the definition of fraud, so there does not seem to be anything fraudulent about it. Furthermore, according to Aquinas, if you are a seller, there is no moral duty for you to inform a potential buyer that the price of the good you are trying to sell is likely to decline in the near future (Aquinas; Barath, 1960, p. 420; Bartell, 1962, pp. 359–360).

In the case Aquinas discusses, a wheat merchant

> "...carries wheat to a place where wheat fetches a high price, knowing that many will come after him carrying wheat...if the buyers knew this they would give a lower price. But...the seller need not give the buyer this information...the seller, since he sells his goods at the price actually offered him, does not seem to act contrary to justice through not stating what is going to happen. If however he were to do so, or if he lowered his price, it would be exceedingly virtuous on his part: although he does not seem to be bound to do this as a debt of justice." (Aquinas)

Based on this view, an insider who knows the stock price is likely to rise in the near future has no moral duty to inform potential sellers of this fact. Where there is no moral duty, certainly there should be no legal duty either. In fact, the U.S. Supreme Court has ruled at least twice that those in possession of non-public information do not have a general duty to disclose the information to the marketplace (Chiarella, 1980; Dirks, 1983). Macey (1988) has also spoken on this point.

Who is harmed by insider trading?

While the transaction of buying and selling stock by an insider does not meet either the dictionary's or Aquinas' definition of fraud, the question of justice still remains. If no one is harmed, the act is not unjust; if someone who does not deserve to be harmed is harmed, the act is unjust. The obvious question to be raised is: "Who is harmed by insider trading?"

The most obvious potential "victims" of insider trading are the potential sellers who sell their stock anonymously to an inside trader. But as was mentioned above, they would have sold anyway, so whether the inside trader buys from them or not does not affect the proceeds they receive from the sale. If the sellers are hurt by having an inside trader in the market, it is difficult to measure the damage, and it appears that there is no damage. In fact, the academic literature recognizes that insider trading does not result in any harm to any identifiable group (Manne, 1985) and those who sell to inside traders

may actually be helped rather than harmed because they received a better price, so it appears illogical to allow them to sue for damages if, in fact, there are no damages (Carlton and Fischel, 1983; Easterbrook, 1981; Morgan, 1987). From the perspective of utilitarian ethics (Crisp, 1997; Goodin, 1995; Shaw 1999), sellers are no worse off as a result of having sold to an insider than they would have been if they had sold to a non-insider. Thus, there is nothing wrong with the practice from the perspective of utilitarian ethics. Of course, utilitarian ethics has been criticized for having certain structural flaws (Frey, 1984; McGee, 1994; Rothbard, 1970), but time and space do not permit an adequate analysis of those arguments.

It has been argued that employers are harmed by insider trading because employees misappropriate corporate information for personal gain (Martin, 1986; Morgan, 1987; Scott, 1980). Yet employers whose employees misappropriate information for personal gain have a remedy at law already. If anyone sues, it should be the employer that sues the employee. Government should not be a party to such a lawsuit, since it is a private harm rather than a public harm that has been committed, if in fact any harm has been committed at all. Padilla (2002a) sees insider trading as basically an agency problem.

Yet there has been little private restriction on trading on insider information (Dooley, 1980; Easterbrook, 1981), until recently, at least, and some authors have gone so far as to state that the gains derived from insider trading are equivalent to compensation that a corporation would otherwise pay to corporate officers for their entrepreneurial expertise (Easterbrook, 1981; Manne, 1966a, b; Scott, 1980) and that employers are not harmed at all by insider trading.

What are the beneficial effects of insider trading?

Insider trading serves as a means of communicating market information, which makes markets more efficient. Carlton (1983), Kelly et al. (1987), Manne (1985), Morgan (1987), and Wu (1968). When insiders are seen trading, it acts as a signal to others that a stock's price will likely move in a certain direction. If a director of General Motors purchases a large quantity of General Motors stock, that act reveals evidence that the stock's price is likely to rise in the near future. Likewise, if the director sells, it is likely that the price will soon fall. A chain reaction will take place as the brokerage firm handling the transaction alerts other brokers and clients, and the stock price will start moving in the correct direction, closer to its true value. There is no need to make a public announcement, because the market reacts almost immediately. Even if the insider is anonymous, an increase (or decrease) in demand for a particular stock will be noticed by the market, and the price will move accordingly. Placing prohibitions on insider trading has the effect of blocking this flow of information. Insiders will attempt to hide their trades, or perhaps not make them at all, thus preventing the market from learning this valuable information.

The potential acquirer in a takeover attempt may also benefit by insider trading. The investment banker hired by the acquirer may leak information to arbitragers, who then accumulate shares in the target company with the intent of tendering them shortly thereafter. The result is that the takeover's chances of success are increased, and the acquirer may actually benefit as a result of the investment banker's misconduct (Herzel and Katz, 1987).

The shareholders who sell at the time the arbitragers are buying may also benefit. The increased demand generated by the arbitragers increases the price the sellers receive when they sell. Without the leakage of the insider information to the arbitragers, the demand for the stock in question would have been lower, so the sellers (who would probably have sold anyway) would have received a somewhat lower price for their stock. Shareholders who do not sell also benefit, since the price of their shares rises as a result of insider trading.

A goal of most corporate managements is to increase shareholder wealth – in other words, increase the stock's price. Since insider trading has a tendency to increase the stock's price, inside traders assist management achieve its goal. Inside traders may benefit the corporation in another way as well.

> "A decision by the board or its delegates to 'tip' inside corporate information to certain outsiders, to facilitate trading by them, could also be in the

best interests of the corporation. For example, where the corporation has received valuable services from an outsider, one way of providing indirect compensation for those services is by providing the outsider with the authorized use of inside information owned by the corporation. Thus, if one accepts the notion that inside information is property of the corporation, even the tipping of that information to others ought not to be regarded as improper, if the board of directors or other authorized corporate decision maker has determined that such tipping is in the best interests of the corporation." (Morgan, 1987, p. 98)

Who is harmed by prohibitions on insider trading?

Who is harmed by prohibitions on insider trading? The obvious answer is inside traders. If there is nothing morally wrong with insider trading (and Aquinas and others seem to think there is not), then preventing insiders from gaining from their knowledge becomes an unjust act.

There is a case to be made that the company's shareholders may be harmed by placing prohibitions on insider trading (Carlton and Fischel, 1983). For example, the Williams Act, the part of the Securities and Exchange Act of 1934 that requires anyone contemplating a tender offer to announce the intention well in advance (Sections 13d and e, and Sections 14d, e and f), makes it easier for target managements to thwart a takeover. Several authors have argued that shareholders tend to benefit by takeovers, so making it easier to thwart a takeover may be against the stockholders' interest. A number of authors have addressed this point. This line of reasoning is not new. It goes back to the 1980s, if not before. Some of the criticisms during that time were made by Johnson (1986–1987), Manne (1986), Bandow(1988), Prychitko (1987), Coffee, Jr. et al. (1988), Bubb (1986), Romano (1987), Jensen (1984), Jarell et al. (1988), Buttarazzi (1987) and Woodward (1988).

Outlawing or restricting insider trading may have long-term adverse effects on the economy. The market certainly will operate less efficiently, since insider trading increases market efficiency (Finnerty, 1976). Hostile takeovers will be more difficult to make, so shareholders will lose, since shareholders tend to benefit by hostile takeovers (Jarell et al., 1988).

Having insider trading laws on the books will result in compliance and escape costs. The legal and accounting fees involved in complying with or circumventing the law can be fairly expensive, an expense that would not be incurred in the absence of insider trading laws. Using indirect means to accomplish what could otherwise be accomplished directly also leads to unnecessary costs (Demsetz, 1969; Manne, 1985). The delay in disclosure that results from using indirect means of accomplishing the goal also increases market inefficiency. There may also be other transaction costs, such as using an obscure mutual fund or a foreign bank or broker, when a more direct purchase would be less costly.

Taxpayers are adversely affected by insider trading laws, since enormous resources must be placed at the disposal of the police power to do any kind of policing. The resources used to police the insider trading laws might be better used to prevent some real criminal activity from being committed. For any use of government resources, there is a cost and a benefit. Since insider trading is regarded as a victimless crime (Manne, 1985), if, indeed, it is a crime at all, an argument can be made that the resources government uses to enforce the insider trading laws can be better employed elsewhere. Furthermore, the risk of being caught is small, and the potential gain from using insider information can be enormous, so having an insider trading law on the books will not stop the practice or even reduce it significantly.

The level playing field argument

The underlying philosophical argument of the level playing field argument is fairness. The market should be fair to all participants, meaning that the asymmetry of information should be minimized, in the case of insider trading. The level playing field argument has been used to justify any number of economic regulations, including prohibitions on insider trading. Trade cannot be free, it must be fair, whatever that means (Bovard, 1991).

The problem with this level playing field argument is that it is not possible or desirable to ever have a level playing field in the realm of economics. The level playing field argument is appropriate to apply to sporting events but not to economics. It would not be fair for one football team to have to run uphill for the entire game while its opponent can run downhill. It is not fair for one basketball team to have a larger hoop to shoot at than its opponent. But there is nothing unfair about allowing banana farmers in Alaska to compete with banana farmers in Honduras. Alaska banana farmers should not be subsidized so that they can compete more effectively with banana farmers from Honduras, and banana farmers from Honduras should not have to comply with punitive regulations or higher tax burdens to make them less able to compete with banana farmers from Alaska. Likewise, there is nothing unfair about allowing experts who work 60 hours a week to gather financial information as part of their job to profit from that information. What is unfair is to force them to disclose such information to people who have done nothing to earn it.

Ricardo's theory of comparative advantage (1871/1996) is at work here. Some individuals or groups are naturally better at some things than others, and some individuals or groups develop skills that are better than those of their competitors. Penalizing those who are better at something or subsidizing those who are worse at something results in inefficient outcomes and is unfair to some groups. Thus, the level playing field argument is inappropriate when discussing economics.

Comparative advantage works to the benefit of the vast majority of the population. It allows specialization and division of labor, which Smith pointed out in his pin factory example (1776/1953) leads to far greater efficiency, higher quality and lower prices. Not allowing individuals to use their special talents harms the entire community as well as the individuals who are being held back by some government law or regulation. Forcing a level playing field on people is always harmful because it reduces efficiency and violates rights. Using the level playing field argument to prevent individuals from using their insider knowledge for personal gain does not hold up under analysis. If insider trading is to be made illegal and if inside traders are to be punished, some other justification must be found.

Property and contract rights

One of the major criticisms of utilitarian ethics is that it is difficult, or perhaps impossible, to precisely measure gains and losses. Indeed, it is not always possible to even identify the winners and the losers in many cases. Leland (1992) attempted to measure gains and losses resulting from insider trading and came up with mixed results. He found that insider trading accelerates the resolution of uncertainty, which is a good thing. He also found that where insider trading is permitted, stock prices better reflect information, a conclusion that others have drawn a priori without the need for mathematical models. He also found that insider trading tends to lead to higher stock prices than would otherwise be the case, which is good for existing shareholders, but that outside investors and liquidity traders tend to be harmed. His conclusion is that total welfare may either be enhanced or reduced by insider trading. The policy conclusion from this and similar studies might be that insider trading should be permitted when the result is a positive-sum game and prohibited when the result is a negative-sum game.

There are several problems with taking such a policy position. For one, it is not always possible to determine, even after the event, whether the gains exceed the losses. Outright prohibitions on certain kinds of insider trading that would, if permitted, result in positive-sum games, result in reduced welfare. They also have a chilling effect on the practice, thus causing the economy to operate less efficiently, with the result that welfare is guaranteed to be reduced. Furthermore, having a policy that prohibits insider trading in cases where no one's rights have been violated is itself a violation of rights. Using a utilitarian approach has its dangers, since there is a tendency to overlook other issues, such as the violation of rights that would result from prohibiting the practice.

Machan (1996) rightly points out the danger of applying utilitarian ethics. The underlying premise of all utilitarian ethics is that the end justifies the means. Thus, according to this logic, insider trading should be permitted if the result is a positive-sum game and prohibited if it is not. The problem with this philosophical view is that property rights are totally ignored. Someone's property rights or even the right to life (Dostoevsky, 1952) can be violated if there is an overall benefit to society according to this view.

Information can be an asset. It is a form of property. Where the owner of an asset uses that information for gain, there should be no complaint, as long as there is no fraud or coercion. But where such asset is used for gain without the owner's permission, any gain belongs to the owner. That is a basic principle of law. It is a legal theory that has existed for hundreds, if not thousands of years.

Financial analysts generally obtain information about a company by analyzing public information and interviewing company officials, who are often too eager to provide whatever information is requested. In such cases, it can hardly be said that the financial analyst misappropriated information belonging to the company, and there should be no prohibition on using the information for profit. Such property is owned by whoever has taken the time and effort to gather it, and the company therefore has relinquished whatever claim it once had. Whatever information a financial analyst obtains in this manner is earned by considerable effort, and he/she acquires a property right in that information, which can then be sold to clients, published in a newsletter to clients or used for personal gain (Fleischer et al., 1973). There is no ethical duty to give this property to the world (Aquinas), just as there is no ethical duty to give any other property to the world. The property can be kept for personal use or given to any persons of the owner's choosing, either for profit or for free (Nozick, 1974). Forcing an analyst to give this information to the world before being allowed to trade on it would eliminate the incentive to develop the information in the first place, and the market would suffer as a result (Fama and Laffer, 1971; Ronen, 1977). Such coercive actions would also be unjust to the analyst, whose property rights are being impinged, and to the parties who would otherwise receive the benefits of the analyst's efforts.

Envy

Envy also plays a part in the prohibition against insider trading. Many people resent it when they see others become wealthy with little (visible) effort, while they are living from paycheck to paycheck. They would like to see inside traders punished or deprived of their property, not because the property is ill-gotten gain, but because the inside traders were able to acquire it whereas the envious person was not. Federal prosecutor Rudolph Giuliani even went so far as to brag that he not only wanted to bring inside traders to justice but also wanted to destroy their reputations (McMenamin, 1988). Timothy Tabor, Richard Wigton and Robert Freeman are three cases on point. Each of these three respectable Wall Street arbitragers were arrested and charged with insider trading. A few months later, the charges were dropped for lack of evidence, but by that time their careers were destroyed. A cloud is still hanging over their heads because the government has promised to indict them again although it had no more evidence when it made the threat than it did when it indicted them initially (McMenamin, 1988).

Envy is a vice that has existed since time immemorial (Schoeck, 1966; Sheaffer, 1988). The Bible calls it one of the seven capital sins. It encompasses the idea that people who have more property than you do should have it taken away from them. The fact that they might have earned it only adds to the ill feeling, and the fact that they might have earned it with little effort is worse yet.

Inside trading fits this scenario quite well. Inside traders can earn in a few weeks what it takes most people several lifetimes to earn. They earn it with little visible effort. There is something ''shady'' about how they earn it. The information is secret and they often obtain it through ''the good old boy network.'' The fact that the gain was earned without violating anyone's rights is totally ignored, as is the fact that the inside trader's actions have probably benefited society by helping the market operate more efficiently. The perception that the inside trader's actions were based on self-interest rather than altruism somehow makes the act evil rather than good, where in fact it is just a modern example of Adam Smith's Invisible Hand at work (1776/1953).

The civil liberties issue

There is also a civil liberties issue. Enforcement and punishment must necessarily be discretionary and discriminatory (Manne. 1970). There are just too many individuals who are violating the law to find

and prosecute them all. As is the case whenever a large number of people are breaking the law, government power can be abused through selective enforcement. Since the Securities and Exchange Commission (SEC) does not have the resources to prosecute all violators, it may tend to prosecute those offenders who are in the least favor with the prosecutor.

The SEC case against R. Foster Winans is a case in point (U.S. v. Carpenter, 1986). In that case, a *Wall Street Journal* reporter traded on information that he would later use in his column. He and some friends bought some stock shortly before his column appeared in print and sold it shortly thereafter. The information contained in his column caused the stock's price to rise. The SEC claimed that his use of this information was a violation of its Rule 10b-5. This case was seen as having a potential chilling effect on the first amendment freedom of the press – a regulation of a reporter's behavior (McMenamin and Gorenc, 1983. Also see Lowe V. SEC, 1985). Even if Winans were guilty of misappropriating his employer's property (the insider information), there are adequate state remedies for such offenses. There is no need for the federal government to intrude into an area that has traditionally been a state offense.

In the Dirks case (1983), a financial analyst used non-public information to alert his clients that something was wrong at Equity Funding, and he advised them to sell their stock. He blew the whistle after he alerted his clients. Rather than being regarded as a hero for disclosing information that led to the Equity Funding scandal, the government prosecuted him and he temporarily lost his right to continue in his employment, not to mention having to spend tens of thousands of dollars in legal fees to defend himself against an alleged crime that the Supreme Court eventually held was no crime at all. When individuals like Dirks are prosecuted for uncovering and disclosing fraud, the logical result is to expect that less fraud will be disclosed in the future. After all, why blow the whistle if you stand to be prosecuted?

The free speech aspect of insider trading has been neglected. To the extent the SEC prevents individuals from speaking, or threatens to punish them for speaking, or tells them how to speak or what to say, it places a chilling effect of the right of free speech (McMenamin and Gorenc, 1983; Central Hudson Gas, 1980). Wolfson (1987) points out that if Winan's failure to disclose his financial interest in his column constituted a violation of the securities laws, then the only way for Winans to avoid liability would be to disclose the financial interest he had in his column, or for the newspaper not to run the article. In effect, the SEC would be dictating what he should include in his story. If Winans could constitutionally be prosecuted on the misappropriations theory, there is no limit to the extent that government can intrude into all areas of communications.

It is not inconceivable that government could require a reporter who covers a steel strike to reveal the fact that he owns steel company stock (Wolfson, 1987). But what is more likely, the radio or television station covering the story would suppress it to avoid potential liability or loss of its license. Such suppression was exactly what happened when Congress passed the Fairness Doctrine (Powe, 1987). Any such regulations have a chilling effect on the first amendment, and on the public's right to know.

There is also an argument to be made that regulating stock transfers can impinge on freedom of association (Wolfson, 1987). Stock certificates represent a membership interest in an organization. Placing restrictions on buying and selling such membership interests and on communicating information between members constitutes a restriction on the freedom of association.

The Martha Stewart case

The Martha Stewart case provides an excellent example of how prohibitions against insider trading can do more harm than good. Martha Stewart, a female billionaire who has brought many useful products to market and who has created thousands, if not tens of thousands of jobs, was investigated for violating the insider trading laws because her stockbroker gave her a tip that the stock of another company she held shares in was probably going to decline in price in the very near future. She acted on this non-public information by selling her shares, thus avoiding a loss, which surely would have occurred if she had waited until the non-public information became public.

The government investigated her action for insider trading violations but never prosecuted her for

insider trading. That is because her sale did not violate any insider trading laws. What she was prosecuted for, and what she was found guilty of, was altering records and lying to federal prosecutors to cover up a crime she did not commit (Lehmann, 2004). Furthermore, and what is even more outrageous from the perspective of civil liberties, is that the government attempted to convict her of manipulating the price of the stock in her own company merely because she declared that she was innocent of the other charges the government had brought against her.

Their reasoning was rather curious. Basically, they argued that she declared her innocence against selling shares in the other company so that the market value of the shares in her own company would rebound, since her company's share price declined when it became public that she was being investigated for insider trading. In effect, she was being prosecuted for exercising her First Amendment right to declare her innocence. True, declaring her innocence caused the price of her company's stock to increase, but that is beside the point. Luckily, this charge was thrown out. If it had not been thrown out, any future corporate executive could be punished for declaring his or her innocence if the effect would be to increase the price of the stock in which the executive holds a material interest.

There was also a certain air of populism (Peyser, 2004) and envy involved in both the prosecution and the press coverage (Anderson, 2003a, b, 2002) of the Martha Stewart case. Some commentators accused the prosecutors of going after her just because she was rich and arrogant. The prosecution's actions were referred to as a ''Witch Hunt.'' (Padilla, 2002b). One economist stated that she was prosecuted for ''outsider'' trading (Ostrowski, 2002), since she was not classified as being within the category of an inside trader. The hunt for inside traders has been referred to as an example of socialism in capital markets because advocates press for the socialization of information (Anderson, 2002; Martin, 1986). Martha Stewart has been called a political prisoner (Anderson, 2002b) because she did not commit a crime against any individual but was prosecuted because of power hungry prosecutors. Some commentators have called insider trading a non-crime, since it has no identifiable victims (McDowell, 2003). Economists are continuing to call for the legalization of insider trading (Boudreaux, n.d.), an idea that Manne (1966a, b, 1970, 1985) has been espousing since the 1960s.

Concluding comments

There are laws that prohibit insider trading. The main legislation against insider trading in the United States is the Insider Trading and Securities Fraud Enforcement Act of 1988 (Fed. Sec. Law Rep. 1988; Nash, 1988). Yet the evidence so far uncovered strongly suggests that insider trading helps the market act more efficiently, while not harming any identifiable individual or group. The result of this legislation will likely be a market that operates less efficiently. This is true not only of the United States market, but also of the market in any other country that places prohibitions on insider trading.

The strongest criticism that has been leveled against the U.S.'s insider trading legislation is that the term ''insider trading'' was not defined. That omission was deliberate, perhaps because Congress could not clearly define what insider trading is. The result of this serious omission has been an increase in litigation, since the courts are left to form their own definition of the ''crime.'' To charge Congress with irresponsibility for this omission is an understatement. Insider trading is now officially a crime, yet nobody knows how to define the crime. Many legitimate transactions will not be made for fear of running afoul of the new insider trading law, and it is likely that the market will react negatively. It is not unforeseeable that dozens, or even hundreds, of individuals and brokerage firms will face prosecutions for something that the courts will find – years later and after tens of thousands or even millions of dollars of legal expenses – to be no crime at all. Lives and careers will be ruined for something that amounts to no crime at all. The Martha Stewart case is one of the more obvious examples of a life that has been at least temporarily ruined because of a flawed insider trading law, but it is by no means the only example that could be found.

The best short-term hope for preventing such travesties of justice from happening would be for the Supreme Court to rule that the law is unconstitutionally vague. But such a ruling could prove to

be of only temporary relief, since Congress could pass another law, or federal prosecutors could continue to prosecute alleged insider trading in the absence of any law prohibiting it, as they have been doing for years. Furthermore, such a ruling, if made, would apply only to the United States. It would not solve the problem of improperly regulating insider trading in other countries.

Our best long-term hope would be for studies to be made that isolate the individuals or groups who are fraudulently harmed by insider trading, if any such groups exist, then have the U.S. Congress and similar bodies in other countries pass clearly worded legislation that prevents any fraud from being committed against these individuals and groups, while allowing non-fraudulent transactions to be completed without fear of prosecution. Until it can be clearly determined that someone is fraudulently harmed by insider trading, there should be no law or regulation restricting the practice, since such restrictions violate individual rights and will likely have a negative market reaction.

Engelen and Van Liedekerke (2003) suggest that the default rule should be to allow insider trading, in the absence of clearly identifiable harm, with the option of allowing individual corporations to restrict or forbid the practice among their own executives. Their study reviews consequentialist and non-consequentialist ethical approaches and concludes that there is little justification for prohibiting insider trading, since it does little or no harm.

If one were to apply ethical theory to the practice of insider trading, it would appear that the individuals who are preventing consenting adults from entering into such transactions are the ones who are acting unethically rather than the traders themselves. Those who prevent non-rights violating activity from taking place necessarily violate the property and contract rights of the individuals who would otherwise engage in trade. They prevent individuals from trading what they have for what they want. Unless it can be shown that prohibiting such activity prevents someone's property or contract rights from being violated, it seems clear that it is the individuals who prevent such activity from taking place who are the ones who are acting unethically rather than the traders. Such blockages to trade cause the market to operate less efficiently, which violates utilitarian ethics. Thus, those who prevent such trades from taking place, either by force or the threat of force, are acting unethically, whether one applies utilitarian ethics or rights theory.

References

Anderson, W.: 2002, *The Attack on Martha* (The Ludwig von Mises Institute, Auburn, AL), June 26. www.mises.org.

Anderson, W. L.: 2003a, 'Martha and the Media', LewRockwell.com, June 13.

Anderson, W. L.: 2003b, *Martha Stewart: Political Prisoner* (The Ludwig von Mises Institute, Auburn, AL), June 9, www.mises.org.

Aquinas, St. Thomas. Summa Theologica, II-II, Q.77.

Bandow, D.: 1988, 'Curbing Raiders is Bad for Business', *The New York Times*, February 7.

Barath, D.: 1960, 'The Just Price and the Costs of Production According to St. Thomas Aquinas', *New Scholasticism* **34**, 413–430.

Bartell, E.: 1962, 'Value, Price, and St. Thomas', *The Thomist* **25**(3), 359–360.

Bernardo, A. E.: 2001, 'Contractual Restrictions on Insider Trading: A Welfare Analysis', *Economic Theory* **18**, 7–35.

Bhattacharya, U. and H. Daouk: 2002, 'The World Price of Insider Trading', *The Journal of Finance* **57**(1), 75–108.

Boatright, J. R.: 1997, 'Fiduciary duty', in P. H. Werhane and R. E. Freeman (eds.) *The Blackwell Encyclopedic Dictionary of Business Ethics* (Blackwell, Oxford).

Boudreaux, D. J.: n.d., 'Insider-Trading Prohibitions Should Go out of Style', Future of Freedom Foundation, Fairfax, VA, no date. www.fff.org.

Bovard, J.: 1991, *The Fair Trade Fraud* (St Martin's Press, New York).

Brudney, V.: 1979, 'Insiders, Outsiders, and Informational Advantage under the Federal Securities Law', *Harvard Law Review* **93**, 322–376.

Bubb, F. W.: 1986, 'Hostile Acquisitions and the Restructuring of Corporate America', *The Freeman, May* **36**(5), 166–176.

Buttarazzi, J. E.: 1987, 'Corporate Takeovers: What is the Federal Role?' Backgrounder 606, The Heritage Foundation, September 29.

Carlton, D. W. and D. R. Fischel: 1983, 'The Regulation of Insider Trading', *Stanford Law Review* **35**(5), 857–895.

Central Hudson Gas & Electric Corporation v. Public Service Commission: 1980, 447 U.S. 557.

Chiarella v. United States: 1980, 445 U.S. 222.

Coffee, J. C., Jr., J. A. Grundfest, R. Romano and M. L. Weidenbaum: 1988, 'Corporate Takeovers: Who Wins; Who Loses; Who Should Regulate?' *Regulation* **88**(1), 23–29, 47–51.

Crisp, R.: 1997, *Mill on Utilitarianism* (Routledge, London and New York).

Dalcourt, G. J.: 1965, *The Philosophy and Writings of St Thomas Aquinas* (Simon and Schuster/Monarch Press, New York).

Demsetz, H.: 1969, 'Perfect Competition, Regulation, and the Stock Market', in G. Henry Manne (eds.) *Economic Policy and the Regulation of Corporate Securities* (American Enterprise Institute, Washington, DC).

Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983).

Dooley, M. P.: 1980, 'Enforcement of Insider Trading Restrictions', *Virginia Law Review* **66**, 1–83.

Dostoevsky, F.: 1952,'The Brothers Karamazov', in M. H. Robert, editor in chief, *Great Books of the Western World*, Vol. 52 (Encyclopedia Britannica, Chicago).

Easterbrook, F. H.: 1981. 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information. *Supreme Court Review* **II**, 309–365.

Engelen, P. J. and L. Van Liedekerke: 2003, An Ethical Analysis of Regulating Insider Trading. Fifth International Conference on Ethics and Environmental Policy, Kyiv, April 2–6. Reprinted at www.fondazionelanza.it/epa/abstract/engelen_full.pdf.

Fama, E. and A. Laffer: 1971, 'Information and Capital Markets', *Journal of Business* July, 289–298.

Federal Securities Law Reports, No. 1304, Part II, September 21, 1988.

Finnerty, J. E.: 1976, 'Insiders and Market Efficiency', *The Journal of Finance* **31**(4), 1141–1148.

Fleischer, Mundheim and Murphy: 1973, 'An Initial Inquiry into the Responsibility to Disclose Market Information', *University of Pennsylvania Law Review* **121**, 798–841.

R. G. Frey: 1984, *Utility and Rights* (University of Minnesota Press, Minnedapolis).

Goodin, R. E.: 1995, *Utilitarianism as a Public Philosophy* (Cambridge University Press, Cambridge, UK and New York).

Herzel, L. and L. Katz: 1987, 'Insider Trading: Who Loses?' *Lloyds Bank Review* July, 15–26.

Hetherington, J. A. C.: 1967, 'Insider Trading and the Logic of the Law', *Wisconsin Law Review* **1967**, 720–737.

Jarell, G. A., J. A. Brickley and J. M. Netter: 1988, 'The Market for Corporate Control: The Empirical Evidence Since 1980', *Journal of Economic Perspectives* **2**(1), 49–68.

Jensen, M. C.: 1984, 'Takeovers: Folklore and Science', *Harvard Business Review* **62**(6), 109–121.

Johnson, J. A.: 1986–1987, 'Antitakeover Legislation: Not Necessary, Not Wise', *Cleveland State Law Review* **35**, 303–348.

Kelly, W. A., C. Nardinelli, Jr. and M. S. Wallace: 1987, 'Regulation of Insider Trading: Rethinking SEC Policy Rules', *The Cato Journal* **7**(2), 441–448.

Lehmann, J.: 2004, 'Martha's Head on a Platter', *New York Post*, Florida edition, March 6, pp. 2–3.

Leland, H. E.: 1992, 'Insider Trading: Should it be Prohibited?', *Journal of Political Economy* **100**(4), 859–887.

Lowe v. SEC, 105 S.Ct. 2557 (1985).

Macey, J. R.: 1988, *The SEC's Insider Trading Proposal: Good Politics, Bad Policy Policy Analysis No. 101* (Cato Institute, Washington, DC)March 31,2.

Machan, T.: 1996, 'What is Morally Right with Insider Trading?', *Public Affairs Quarterly* **10**(2), 135–141.

Manne, H. G.: 1966a, *Insider Trading and the Stock Market* (The Free Press, New York).

Manne, H. G.: 1966b, 'In Defense of Insider Trading', *Harvard Business Review* November/December, 113–122.

Manne, H. G.: 1970, 'Insider Trading and the Law Professors', *Vanderbilt Law Review* **23**, 547–590.

Manne, H. G.: 1985, 'Insider Trading and Property Rights in New Information', *The Cato Journal* **4**(3), 933–943, reprinted in James A. Dorn and Henry G. Manne (eds.), Economic Liberties and the Judiciary. Fairfax, VA: George Mason University Press, 1987, 317–327.

Manne, H. G.: 1986, 'The Real Boesky-Case Issue', *The New York Times*, November 25, A-27, column 1.

Martin, J. K.: 1986, 'Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?', *St. John's Law Review* **61**, 78–112.

McDowell, C.: 2003, 'The Non-Crime of Insider Trading', June 11. LewRockwell.com.

McGee, R.W.: 1994, 'The Fatal Flaw in NAFTA, GATT and All Other Trade Agreements', *Northwestern Journal of International Law, Business* **14**(3), 549–565.

McMenamin, M.: 1988, 'Witchhunt', *Reason* **20**(5), 34–40.

McMenamin, M. and W. Gorenc, Jr.: 1983, 'Subverting the First Amendment', *Reason* January, 23–28.

Moore, J.: 1990, 'What is Really Unethical about Insider Trading?', *Journal of Business Ethics* **9**, 171–182.

Morgan, R. J.: 1987, 'Insider Trading and the Infringement of Property Rights', *Ohio State Law Journal* **48**, 79–116.

Nash, N. C.: 1988, 'Congress Passes Greater Penalties and Detection on Insider Trading', *The New York Times*, October 22, **1**, 31.

Nozick, R.: 1974, *Anarchy, State, and Utopia* (Basic Books, New York).

O'Hara, P. A.: 2001, 'Insider Trading in Financial Markets: Legality, Ethics, Efficiency', *International Journal of Social Economics* **28**(10, 11, 12), 1046–1062.

Ostrowski, J.: 2002, *Wanted for Outsider Trading* (The Ludwig von Mises Institute, Auburn, AL), August 26. www.mises.org.

Padilla, A.: 2002a, 'Can Agency Theory Justify the Regulation of Insider Trading?', *The Quarterly Journal of Austrian Economics* **5**(1), 3–38.

Padilla, A.: 2002b, 'The Modern Witch Hunt', LewRockwell.com, October 22.

Peyser, A.: 2004, 'Arrogant Billionaire Played The Ultimate Fool', *New York Post*, Florida edition, March 6, p. 4.

Powe, L. A., Jr.: 1987, *American Broadcasting and the First Amendment* (University of California Press, Berkeley and Los Angeles).

Prychitko, D. L.: 1987, *Corporate Takeovers and Shareholder Interests*. Issue Alert No. 13 (Citizens for a Sound Economy, Washington, DC).

Qu, C. Z.: 2001, 'An Outsider's View on China's Insider Trading Law', *Pacific Rim Law Policy Journal* **10**, 327–352.

Ricardo, D.: 1871/1996, *Principles of Political Economy and Taxation* (Prometheus Books, Amherst, NY).

Rider, B. A. and L. Ffrench: 1979, *The Regulation of Insider Trading* (Oceana, Dobbs Ferry, NY).

Romano, R.: 1987, 'The Political Economy of Takeover Statutes', *Virginia Law Review* **73**, 111–199.

Ronen, J.: 1977, 'The Effect of Insider Trading Rules on Information Generation and Disclosure by Corporations', *The Accounting Review* **52**(2), 438–449.

Rothbard, M. N.: 1970, *Man, Economy and State* (Nash Publishing, Los Angeles).

Salbu, S. R.: 1992, 'A Critical Analysis of Misappropriation Theory in Insider Trading Cases', *Business Ethics Quarterly* **2**(4), 465–477.

Schoeck, H.: 1966, *Envy* (Harcourt Brace and World, New York).

Schotland, R. A.: 1967, 'Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market', *Virginia Law Review* **53**, 1425–1478.

Scott, K. E.: 1980, 'Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy', *Journal of Legal Studies* **9**, 801–818.

Shaw, W. H.: 1999, *Contemporary Ethics: Taking Account of Utilitarianism* (Blackwell, Malden, MA and Oxford).

Sheaffer, R.: 1988, *Resentment Against Achievement: Understanding the Assault Upon Ability* (Prometheus Books, Buffalo).

Smith, A.: 1776/1953, *The Wealth of Nations* (Henry Regnery Company, Chicago).

Strudler, A. and E. W. Orts: 1999, 'Moral Principle in the Law of Insider Trading', *Texas Law Review* **78**, 375–438.

United States v. Carpenter, 791 F.2d 1024 (1986).

Webster's New World Dictionary of the American Language: 1964, *College edition* (Cleveland and New York: World Publishing Co.).

Werhane, P. H.: 1989, 'The Ethics of Insider Trading', *Journal of Business Ethics* **8**, 841–845.

Wolfson, N.: 1987, 'Civil Liberties and Regulation of Insider Trading', in J. A. Dorn and H. G. Manne (eds.) *Economic Liberties and the Judiciary* (George Mason University Press, Fairfax, VA), pp. 329–334.

Woodward, S. E.: 1988, 'How Much Indiana's Anti-Takeover Law Cost Shareholders', *The Wall Street Journal*, May 5.

Wu, H. K.: 1968, 'An Economist Looks at Section 16 of the Securities Exchange Act of 1934', *Columbia Law Review* **68**, 260–269.

Robert W. McGee
Department of Accounting,
Barry University,
Andreas School of Business,
Miami Shores, FL, 33161,
USA
E-mail: bob414@hotmail.com