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. 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.

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. 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. 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
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 prelimi-
nary 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 think-
ing 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 transac-
tion. 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 \textit{equal} information; the
second argues that insider trading is unfair because
the two parties do not have \textit{equal access} to informa-
tion. 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 \textit{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
\textit{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 \textit{duty} to the