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# An Ethical Analysis of Regulating Insider Trading

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## Abstract

Although there seems to be a broad consensus to prohibit insider trading among supervising authorities and market professionals, the debate on insider trading has not settled definitively. We introduce a distinction between insider trading and market manipulation on the one hand and corporate insiders versus misappropriators on the other hand. This gives rise to four types of alleged wrong transactions. Using a utilitarian and a non-utilitarian fairness approach, we demonstrate that it is hard to find good arguments against insider trading in its purest form (type I transactions). Using a property rights perspective in particular, we show that neither a general ban nor a general permitting of insider trading is an efficient outcome. We propose a solution in which companies solve this compensation problem contractually with their corporate agents. In this way, insider trading can be used as a governance instrument which can reinforce the fiduciary relationship.

**Keywords:** insider trading, market manipulation, fairness, property rights

**JEL classification:** G18, K22

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## **1. Introduction**

Insider trading has a bad reputation and it is generally assumed that it should be banned. Nevertheless, the ethical and economic question whether insider trading is harmful or not is still an active one.<sup>1</sup> In this discussion economists often resort to ethics as the ultimate argument for a prohibition of insider trading, but rarely get far beyond simple exclamations as “it’s just not right” or “it’s unfair”.<sup>2</sup> On the other hand the ethical analysis of the problem offered in Moore (1990), Werhane (1989, 1991), Machan (1996), Ma and Sun (1998) and Snoeyenbos and Smith (2000) is sometimes hampered by a lack of empirical knowledge about the impact of insider trading and postulates all kinds of effects, e.g. a negative impact on investor confidence, for which the indications are lacking. Unfortunately, both strands of literature seldom meet due to the different vocabulary each discipline uses. In this contribution we try to bridge the gap.

A crucial step in this regard is the introduction of two conceptual distinctions: the first is the distinction between insider trading and market manipulation, the second between insiders and misappropriators. It is our contention that these distinctions have hampered discussions between economists and ethicists for a long time. Section two introduces the distinctions, section three examines consequentialist arguments against insider trading while section four focuses on non-consequentialist grounds more specifically on fairness, property rights and market morality arguments. Section five concludes.

## **2. Two essential distinctions**

Since Manne (1966) the distinction between insider trading and market manipulation is omnipresent in the economic literature on insider trading. Let us define insider trading as any form of trading based on information that is relevant for the fundamental value of a company but that is not publicly available.<sup>3</sup> From this definition it follows that there is a strong link

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<sup>1</sup> See the review articles by Scott (1998) and Bainbridge (2000).

<sup>2</sup> See the references in Lawson (1988), notes 17 to 19.

<sup>3</sup> Defining insider trading is not a simple affair (on this see Fletcher, 1991). There is for instance considerable difference between an economic and a legal definition. The economic definition starts from the information asymmetry that lies at the heart of the problem. It is a very broad definition and ultimately contains all trading based on asymmetric information. The legal definition of insider trading has to be much more restrictive, since excluding all trading on asymmetric information would simply close down financial markets. The legal definition of insider trading also differs from one legal system to another.

between insider trading and market efficiency defined as information efficiency.<sup>4</sup> Since insider trading is based upon private information that is crucial for the evaluation of a stock price, bringing this information into the open will automatically imply that the price of a stock moves closer towards its fundamental value. Insider trading will therefore by definition increase market efficiency. Market manipulation by contrast takes place whenever non-public information is used to push the price of a stock away from its fundamental value.<sup>5</sup> Again, by definition, market manipulation will decrease market efficiency. To visualise this distinction, consider Figure 1.

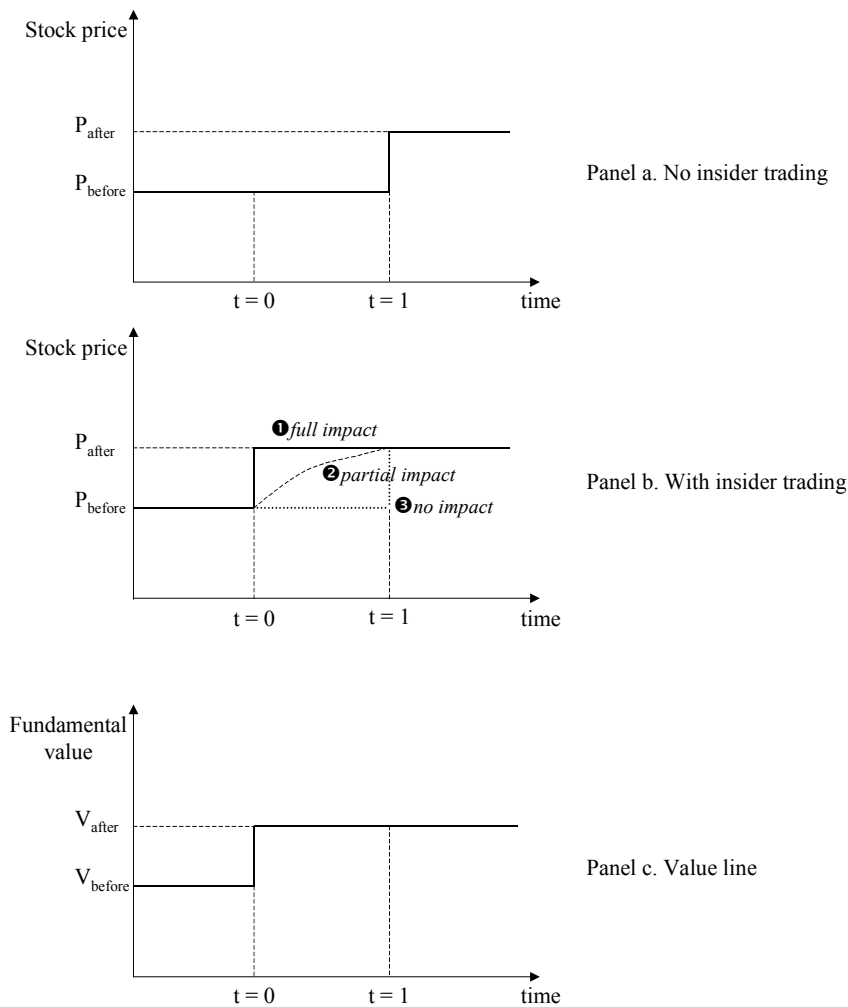
Assume a price-sensitive event occurs at moment  $t=0$ , increasing the fundamental value of the stock (panel c in Figure 1). If there is no insider trading, the stock price will remain at its pre-event level until the news is announced at moment  $t=1$  (panel a of Figure 1). If insider trading were allowed, the informed trading by the insider at  $t=0$  signals to the market that some value relevant event has occurred and the stock price will adjust according to the solid line ( $n^{\circ}1$ ) in panel b of Figure 1. If insiders, fearing criminal charges because of insider trading regulation, try to disguise their trading, the signal will be less clear and stock prices may adjust according to the dashed line ( $n^{\circ}2$ ) in panel b of Figure 1. Not surprisingly Vermaelen (1986) concludes that “reduction of insider trading will reduce, rather than increase market efficiency because it will slow down the speed with which information will be reflected in security prices.” (compare panel a and c in Figure 1).

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<sup>4</sup> A financial market operates efficiently if security prices instantaneously and fully reflect all relevant available information. In an efficient financial market, market prices are therefore a reliable criterion for the investment value of securities. A more explicit definition can be found in Malkiel (1992): “A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. Formally, the market is said to be efficient with respect to some information set if security prices would be unaffected by revealing that information to all participants. Moreover, efficiency with respect to an information set implies that it is impossible to make economic profits by trading on the basis of that information set.” One method to measure the efficiency of a financial market is thus to ask what set of information is reflected in securities prices. Traditionally three types of information can be distinguished: information in historical market prices, publicly available information and all information, irrespective of its public or nonpublic character. Based on these three types of information, three forms of the efficient market hypothesis can be distinguished: the weak form, the semi-strong form and the strong form of market efficiency (Fama, 1970).

<sup>5</sup> A security price is equal to its fundamental value when it accurately reflects investors’ expectations about the present value of the expected future cash flows, discounted at the appropriate risk-adjusted discount rate.

Figure 1. The impact of insider trading on security prices



Suppose, by contrast that false information is released that pushes the stock price below its fundamental value ( $V_{\text{before}}$  in panel c before  $t=0$ ) or above its fundamental value ( $V_{\text{after}}$  after  $t=0$ ). By this action the stock prices moves away from its fundamental value. At that moment market manipulation is taking place and results in a decrease of market efficiency (again by definition).

This conceptual distinction which is paramount in the economic literature, is relatively absent from the philosophical literature. For although a conceptual distinction is always possible, ethicists argue that it is unclear whether it reflects a reality. And if one cannot distinguish insider trading from market manipulation when trading takes place, the distinction itself becomes problematic when looking for a moral judgment on insider trading. Empirical studies provide the answer. Meulbroek (1992) examines the transactions of 320 individuals charged with insider

trading by the SEC during the period 1980-1989. The results show that in 81% of all cases insider trading led to quick price changes that follow the pattern indicated in panel b of Figure 1. Other empirical studies that corroborate these results are Cornell and Siri (1992) and Chakravarty and McConnell (1997). Many cases of insider trading therefore have the information effect that Manne in his initial study predicted and definitely augment information efficiency in markets.<sup>6</sup> We must therefore conclude that empirical studies confirm the possibility to discriminate between forms of inside trading that augment information streams in markets (which economists label insider trading), and other forms that hamper information streams in financial markets (which can be labeled as market manipulation). Whether they like it or not, philosophers have to take the distinction between insider trading and market manipulation serious and adapt their argumentation accordingly.

The second distinction which we want to elucidate is between insider traders and misappropriators. The term insider trader has gradually extended its scope from corporate insiders such as officers or directors to persons other than corporate insiders like tippees (people who get information from corporate insiders), temporary insiders (people who are temporarily inside the company) or people who happen to stumble upon crucial information (the innocent passer by who picks up a fax). As Moore puts it: "Increasingly the term insider has come to refer to the kind of information a person possesses rather than the status of the person" (Moore, 1990, p. 172). But when Manne discusses the issue his eye is firmly on the corporate insider, the manager leading the company who is mainly responsible for the creation of information that is valuable to the operation of the firm, and that is still how economists look upon the insider. Misappropriators are essentially all the rest, contributing nothing to the value of the firm. Once you take this distinction serious, it becomes possible for shareholders to use inside information as a compensation scheme and that is precisely what Manne argued for in his 1966 study. Manne has essentially two arguments in favor of insider trading. The first is the market efficiency component stressed above: insider trading will release information early into the market and make prices stick closer to their real value. The second argument is Schumpeterian in nature and stresses the fact that by allowing insiders to cash in on their private information, a more creative, productive, risk-taking breed of managers will be attracted to the firm. From the

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<sup>6</sup> This distinction is further supported by studies that try to estimate the damage connected to securities fraud. Crucial in this respect will be the distinction between the price line and the real value line as illustrated in panel a versus c of Figure 1. In case of market manipulation the damages are calculated by the difference between the price and the value line. In case of insider trading the opposite occurs, since the price line will move closer to the value line, leading to no damages. See in detail Fischel (1982) and Cornell and Morgan (1990).

point of view of the shareholders allowing insider trading has the double advantage that these new managers will create more value for the firm (and its shareholders), while at the same time being less costly because the fixed salary/benefit package can be reduced. All that is needed for this mechanism to work is a clear labor contract stipulating that shareholders hand over the right to deal on inside information to corporate insiders and to nobody else, thereby excluding all misappropriators. Given both basic distinctions we now have four different types of inside transactions, as shown in Table 1.

*Table 1. Taxonomy of different types of alleged wrong transactions*

	Insider	Misappropriator
Insider trading	I	II
Market Manipulation	III	IV

When Manne discussed insider trading he thought about type I transactions, the legal and philosophical literature however often mixes these different types. For instance, it uses correct arguments to dismiss for instance type III or IV transactions in order to dismiss type I transactions.<sup>7</sup>

We will hereafter round up most arguments against insider trading and order them in two classes: consequentialist and non-consequentialist arguments. When we discuss these arguments, it is vital for the reader to keep both distinctions into mind. When we refer to insider trading, we refer to transactions of type I and II, but not III and IV (where market manipulation takes place). Likewise, when we talk about insiders, we talk about the corporate insider and not about anybody else who might be involved in an inside transaction. Basically we will find out that many arguments against allowing inside transactions hold for type II, III or IV transactions, but it will prove to be very hard to find a sound argument against type I transactions.

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<sup>7</sup> Examples are Moore (1990) and Shaw (1990). Both excellent articles do not believe in the possibility of a distinction between market manipulation and insider trading. For Moore allowing type I transactions will result in type III and IV transactions, and because type III and IV are wrong, type I should also be excluded. Shaw argues that insider trading harms investors, but that is hard to follow once you believe in the possibility of an information enhancing form of insider trading.



### 3. Consequentialist arguments

The consequentialist approach to insider trading judges the pros and cons of insider trading with respect to its impact on social utility. After outlining the traditional arguments against insider trading, we refine or rebut some of these arguments in a review style.

Traditional consequentialist arguments against insider trading are: insider trading causes a wrong price formation of securities and therefore harms market efficiency, it undermines the confidence in the capital market, it decreases liquidity, it harms the non-informed counterpart of the insider, it is not in the interest of small investors and diverts part of the firm's earnings that would otherwise go to shareholders.<sup>8</sup> We shall go through these arguments one by one.

#### 3.1 Market efficiency

If a security market is informational efficient, security prices instantaneously and fully reflect all relevant available information. At that moment security prices are a reliable criterion for the optimal allocation of scarce financial resources at a 'fair' price. This is supposed to increase social utility and is therefore attractive from a consequentialist point of view.<sup>9</sup> Empirical research mostly confirms the semi-strong form of market efficiency. Because security prices in this case reflect all publicly available information, but not the non-public information, the transactions of insiders will reveal the private information component to the market. Precisely due to the transactions of insiders security prices will better and faster reflect the real fundamental value by incorporating the private information (see supra). Hence, allowing insider trading increases the allocation-efficiency of the security market. This is the classical argument in favor of insider trading.

A traditional counter-argument is that insider trading postpones the disclosure of information and therefore reduces market efficiency (Schotland, 1967). Using a theoretical model Leland (1992) shows that stock prices reflect information more quickly when insider trading is permitted. After examining some specific cases, Dooley (1980) finds that insider trading did not

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<sup>8</sup> See, among others, Schotland (1967), Mendelson (1969), Brudney (1979), Haft (1982) and Levmore (1982).

<sup>9</sup> We are well aware that there is quite a distance between information efficient markets and social utility, but most literature believes that more efficient markets automatically imply greater social utility and we will follow this interpretation. For a critical voice see Snoeyenbos and Smith (2000) who criticise the step from information efficiency to overall social utility.

delay the public disclosure of information. The improved informational efficiency is empirically confirmed by Meulbroek (1992), Cornell and Sirri (1992) and Chakravarty and McConnell (1997).

Carlton and Fischel (1983) point out that insider trading creates an additional method for communicating information. This is especially the case with diffuse, complex information that is not readily encapsulated in a public announcement (King and Roell, 1988). The case study of Healy and Palepu (1995) confirms this and shows that it is sometimes difficult to disclose value-relevant information effectively through an official public announcement. In such cases, insider trading can act as a replacement for public disclosure, thereby increasing information efficiency in financial markets.

### ***3.2 Investor confidence***

Allowing insider trading will decrease investor confidence in financial markets. This classical argument is hard to follow once you accept the distinction between insider trading and market manipulation. As Bainbridge (2000) points out, if insider trading improves the efficiency of the security market, the confidence of a rational investor in the security market should increase rather than decrease. It is irrelevant to him whether an insider can earn abnormal profits, because the investor can always buy or sell the security at a fair price, namely its fundamental value. For, in an efficient market an investor can rely on the accuracy of the market prices because every piece of information is already reflected in security prices, without the necessity to collect and process the information himself. If all information is reflected in security prices, investors can really *trust* market prices and confidence should grow.<sup>10</sup>

Moreover, no empirical study has ever shown a decrease of the confidence of investors if insider trading were allowed. For instance, Young (1985) points out that the number of small individual investors on the U.S. stock markets sharply increased during the 1980s, despite the many cases

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<sup>10</sup> Stock exchanges, as financial intermediaries, facilitate the acquisition of information about investment opportunities and thereby improve the allocation of resources. For, information costs create an incentive for the existence of financial intermediaries. Instead of each investor collecting and processing all the information on a wide array of companies, its management and economic conditions, it is more efficient for a financial intermediary to do all this work for all its members, hereby realizing economies of costs. Stock exchanges disseminate prices through published market prices. Investors don't have to collect and process information that is reflected in the market price by the information obtained by others. This is the consequence of the semi-strong form of the efficient market hypothesis (Engelen, 2005).

of insider trading during the same period. Carlton and Fischel (1983) point out that in Japan insider trading was considered proper and “there has never been a reported case under the limited insider trading prohibition currently in effect (p.860).” This has not limited the development of the Japanese stock market. Macey and Kanda (1990) point out that the Tokyo Stock Exchange is highly automated, enjoys a high liquidity, is of the same size as the New York Stock Exchange and has higher price-earnings ratios than the NYSE. Therefore, Bainbridge (2000) concludes that insider trading does not seriously threaten investors’ confidence.

### ***3.3 Liquidity***

Besides market efficiency, another major goal of securities regulation is liquidity.<sup>11</sup> Investors value liquid stock markets because it allows a quick and cheap disposal of their securities.<sup>12</sup> There exist several theoretical models making predictions about market liquidity in case of insider trading, and predictions differ widely. Different assumptions about the relative importance of insiders, liquidity traders, noise traders or market makers lead to different outcomes. For instance, Kyle (1985) predicts less liquid stock markets, while Grossman (1986) and Holden and Subrahmanyam (1992) predict just the opposite, i.e. an increase of market liquidity. The argument that banning insider trading increases liquidity ignores the liquidity enhancing role of the insiders themselves and of some noise traders (Kabir and Vermaelen, 1996). Ultimately, the question of the impact on liquidity is an empirical issue.

Unfortunately there are only a few empirical studies on the issue of market liquidity, but those that exist point out that a ban on insider trading could cause stock markets to become less liquid. Kabir and Vermaelen (1996) examined the effect of the introduction of insider trading restrictions on the liquidity of the Amsterdam Stock Exchange. They clearly show that liquidity decreased after the introduction of these restrictions, while the amount of company-specific information did not change. The authors conclude that this is an example of ‘regulatory overkill’ because market liquidity decreased while the main objective was to increase liquidity by eliminating insiders trades. Examining a clinical case of insider trading Cornell and Sirri (1992) also report that insider trading did not reduce market liquidity,

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<sup>11</sup> Liquidity is the ease and speed with which investors can convert their assets into purchasing power at agreed prices. In a liquid stock market investors can easily and quickly sell their shares if they seek access to their savings (Engelen, 2005).

<sup>12</sup> The analysis focuses on liquidity effects of insider trading on order-driven or auction markets and not on quote-driven or dealership markets.

mainly because of the increase in uninformed trading volume. Chakravarty and McConnell (1997) come to the same conclusion: insider's trades did not decrease market liquidity.

### ***3.4 The alleged damage to the insider's counterpart***

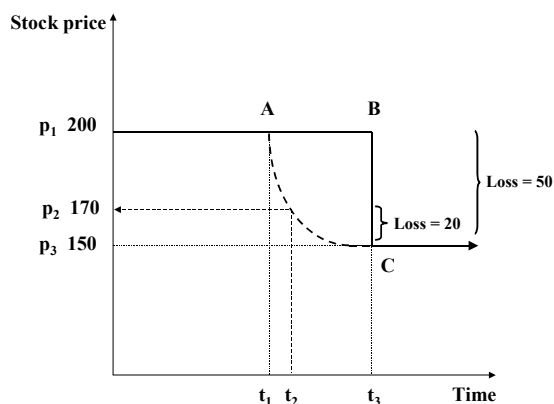
An argument that is often used to ban insider trading is the fact that it allegedly harms the insider's counterpart. Haddock and Macey (1986a) demonstrate that insiders do not harm the counterpart. On the contrary, the counterpart is often better off in a situation in which insiders use their privileged information rather than sitting on it. And if it is the case that insider trading augments market efficiency, then on average investors will be benefited rather than harmed by the insiders actions.

An example can eluminate the above conclusion. Suppose an event occurs which has a negative impact on the value of the firm. In such a case of bad news with regard to the security price, insiders can realize a profit based on their inside information by selling the security before the news is announced (see Figure 2). By this, the security price  $p_1$  will decrease between the price-sensitive event date  $t_1$  and the announcement date  $t_3$  (see the dashed line AC). If no insider trading occurs, the price will move along the solid line ABC and fall to price  $p_3$ . Suppose the original price at the moment  $t_1$  amounts to EUR 200. Because of the bad news insiders sell their securities so that the stock price falls as a result of the extra supply. Suppose an insider sells his security to the outsider-buyer for EUR 170. Hereafter, the price falls to EUR 150. By this, the outsider-buyer loses EUR 20. But without insider trading this buyer would have bought the security for EUR 200 and he would have suffered a loss of EUR 50. Precisely by the extra supply of the insiders, the buyers are better off, than when they also buy without the transactions of the insiders. A similar example can be given in case of good news.<sup>13</sup>

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<sup>13</sup> See Haddock and Macey (1986a) or Engelen (2005).

Figure 2. The alleged damage to the outsider in case of negative news with regard to the stock price



Source: based on Haddock and Macey (1986a)

### 3.5 Insider trading as a compensation scheme

It is generally assumed that a ban on insider trading transfers trading profits from corporate insiders to small investors. Unfortunately a ban on insider trading does not solve the informational asymmetry problem or the ‘unfair’ situation (see *infra*). It merely rearranges the ranking of ‘winners’ and ‘losers’. Both Haddock and Macey (1987) and Tighe and Michener (1994) clearly show that a ban on insider trading causes the largest gains to be earned by market professionals. Market professionals obtain the benefits of the insider trading regulation, while imposing the cost on a large number of small investors, who will not seriously challenge the banning because the costs associated with it are distributed at a low per capita rate. It is even likely that if we were to allow corporate insiders to trade based on their inside information, small investors would benefit from the enhanced shareholder value creation because of the variable equity-linked compensation and it would reduce the fixed wage cost of management (Manne, 1966).

As such insider trading is just one of the many instruments to compensate corporate insiders. However, an overview of equity-linked compensation schemes always seems limited to bonuses, stock options, shares, etc. Insider trading by corporate insiders is always excluded a priori. As nobody would argue seriously that salaries, options, bonuses and other compensation schemes allow insiders to profit at the expense of shareholders, why should insider trading be treated differently (Carlton and Fischel, 1983)? Instead of excluding this

compensation instrument a priori, it would offer an extra way of solving traditional compensation problems such as shirking, on-the-job consumption, etc. Put differently, insider trading could be used as an additional governance instrument. Section 4.3 discusses insider trading as an executive compensation problem in more detail.

### ***3.6 Balancing the pros and cons***

Balancing the pros and cons of insider trading, one has to conclude from the above analysis that there is very little harm caused by insider trading. First, one has to stress the social gains that come with informational efficient capital markets. The more prices reflect information accurately, the better prices guide capital investment in the economy. Moreover, it creates an additional signaling device for management to communicate complex news in a credible way. The confidence of investors is not expected to decline, empirical studies showed no decrease of market liquidity and the non-informed counterpart of the insider was not harmed, on the contrary. Another important social benefit from insider trading is the market-based compensation scheme, which makes it also possible to reward the innovative and entrepreneurial inputs of corporate insiders. Therefore, on consequentialist grounds we find little ethical basis for banning insider trading.

## **4. Nonconsequentialist arguments**

The conclusion from the previous section was that insider trading is likely to produce more social wealth rather than less. But even then we might still want to ban insider trading on non-consequentialist grounds. We discuss hereafter three common arguments in the literature on insider trading: a fairness argument, a property rights argument and a market morality argument.

### **4.1. Fairness**

It is often argued that insider trading is unethical because it is simply ‘unfair’ (Mendelson, 1969 and Schotland, 1967). Werhane (1991) refers to the lack of a level playing field as a reason for banning insider trading because ‘it gives the outsider an unfair comparative disadvantage that skews competition.’ Analogous to Lawson (1988) we can distinguish two versions of the fairness argument: the absolute equality version and the equal access view.

#### ***4.1.1 Absolute equality version***

The first version focuses on the possession of information and pursues absolute equality between market participants. Levmore (1982) defends this full disclosure theory on the basis of a general moral obligation to treat others as we would ourselves. Insider trading is thus unfair because one party uses superior information that the other party does not possess. Such strict notion of fairness would make every transaction in which there is asymmetric information unethical.

Moore (1990) rejects this, and using the classic example of the antique dealer who buys a genuine antique piece below-price at a jumble sale, she points out that one is 'not morally obligated to tell those whom we deal with *everything* that would be in their interest to know.' For instance, it is standard practice in news reporting that a journalist who discovers some important news facts, doesn't share this information with his colleagues, but instead scoops the competition. Among journalists this is considered professional behaviour and might even earn you a Pulitzer Prize.<sup>14</sup> Notice that also in this case money is made on non-public information. Machan (1996) rightly wonders why this should be any different with respect to insider trading. Without a substantive moral theory that tells us when it is permissible to allow the interest of some person to take priority over the interests of others, the absolute equality rule gives no guidance to assess insider trading (Lawson, 1988). Following a similar reasoning, Moore (1990) and Machan (1996) likewise conclude that the absolute equality version of the fairness argument fails. Moreover, there may be relevant differences between the parties that make the informational advantages fair. For instance, a doctor charging for her services profits from an informational advantage but is not acting unfair. Informational advantages are in fact at the very heart of the market economy (Macey, 1988).

#### ***4.1.2 Equal access view***

The second version of the fairness argument was advocated by Brudney (1979), and focuses on the access to inside information rather than the unequal possession of it. It is an advantage which 'cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access' (Brudney, 1979, p.346). However, the notion of equal access

remains unclear. Easterbrook (1981) shows that access to information is not an absolute matter, but related to the cost of obtaining such information. The inequality of information therefore rests upon the division of labour. Just as I can decide to become a plumber to have access to specialized plumber information, people can invest time and human capital to become a corporate insider with superior access to information (Moore, 1990). Since the equal access view does not explain why inequality in some means of access to information is morally more significant than others, it offers no solid ethical basis to argue against insider trading.<sup>15</sup>

Werhane (1991, p.730) rejects insider trading because it ignores two principles necessary for fair competition: 'an efficient market where as much complete information as possible is available to everyone, and the ideal of an equal comparative advantage between competitors.' However, she fails to see how this can be reached by the market mechanism itself. In an efficient market an investor can rely on the fact that every piece of information is already reflected in security prices, without the necessity to collect and process the information himself. In this way, efficiency provides individual investors a low cost access to the production and dissemination of all relevant information to value securities. For, in an efficient market investors only have to observe market prices and rely on the market to incorporate information into securities prices without the need to spend private resources to acquire and process information that is almost immediately publicly available through the pricing mechanism (Levine, 1997). Equality among market participants is therefore reached through the (efficient) pricing mechanism itself.

Ideally, one would like stock markets to be strong form informational efficient.<sup>16</sup> Unfortunately this is currently not the case. Market efficiency is in itself certainly not a sufficient ethical basis for allowing insider trading, but even if you start from an equal access view to information and keeping in mind our definition of insider trading, one should support rather than prohibit insider trading, since it is an easy way for all market participants to get access to non-public information.

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<sup>14</sup> See e.g. Bob Woodward and Carl Bernstein, who as young Washington Post reporters broke the Watergate scandal that led to the resignation of a president and who received the Pulitzer Prize in 1973.

<sup>15</sup> Any such attempt would quickly lead to a more general theory of property rights in information (Lawson, 1988).

<sup>16</sup> See also footnote 5.



Closely related to the equal access theory is the argument that insider trading is like a poker or casino game where some players ‘have marked cards’ (Werhane, 1991, p.730) or with ‘two sets of rules’ (Werhane, 1989, p.841). As Ma and Sun (1998) point out, these rules are clearly stated before the start of the game. Investors are fully aware ex-ante that some market participants are better informed and that insider trading may be possible. Even if we assume that investors would require an extra return for compensating this non-diversifiable risk<sup>17</sup>, causing a decline in stock prices, then it ‘is not an argument about fairness, but about [...] whether this decrease in share prices is outweighed by the incentives to produce valuable information and more efficient stock pricing’ (Lawson, 1988, p.758). Basically, we are again on consequentialist grounds and as we indicated above, the evidence is at that point rather in favour of insider trading.

As straightforward as it seems, the fairness argument is in the end difficult to hold. One of the basic reasons why it fails is that it starts from the illusion that once you eliminate the insiders, you end up with a level playing field. But that is simply not the case. Insider trading regulation rather moves the information advantage from one group (say the managers) to another (say the institutional investors), without reaching the ideal of a level playing field. There is nothing wrong with the ideal and with an equal access view in itself, on the contrary, but unfortunately the ideal will not be realised by this type of regulation. If anything, the argument above indicates that insider trading regulation actually can make markets more unfair.

#### **4.2 Property rights in information**

If one thing is clear about insider trading it is that information has value. As such privileged corporate information can be seen as a valuable, intangible property right. The existence of property rights in intangibles such as patents, copyright, trademarks, trade secrets and information, is well-established (Kitch, 1980, Easterbrook, 1981, Bainbridge, 2000). As material non-public information is also some kind of property, it is argued that insider trading is wrong because it involves a violation of property rights and can be seen as a form of theft. Irvine (1987) refers to this as the ‘theft theory’. However, this is jumping to conclusions. Macey (1988) offers a two-step procedure for answering the question whether property rights

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<sup>17</sup> Notice that it does not have to be the case and that it has not been empirically demonstrated.

are violated. First, one has to determine who holds the ownership rights over the material non-public information. Second, the relationship between the trader and the owner has to be determined. If the trader is also the rightful owner of the information, then there is no ‘theft’ problem.<sup>18</sup> If he is not, then one has to determine whether he has the actual or implied authority of the owner to use the information. Only in the case where he has not, there will be a violation of property rights.

So the central issue here is to determine whose property the inside information is. Moore (1990) assigns the property rights to the company. In this case, insider trading is wrong when the company prohibits the use of the property right. It is according to Moore (1990) also wrong because it threatens the fiduciary relations between shareholders and managers. But at least that part of the argument is not self evident. On the contrary, insider trading as a compensation scheme can strengthen rather than hamper the fiduciary relation between corporate insiders and shareholders.

Traditional arguments against allowing insider trading as a compensation scheme include (Scott, 1980, Easterbrook, 1981 and Moore, 1990): managers can trade on negative inside information, gaining personal profit but diminishing shareholder value; managers will be focused on short-term stock price movements to exploit insider trading opportunities; managers can create false information to induce stock price movements to capture profits based on inside information at the expense of shareholders; managers will choose risky projects to increase the volatility of stock prices in order to increase profits based on inside information; and the general meeting of shareholders will lose control over the amount of compensation of management if insider trading were allowed.

These are serious problems but the point is that all of them also hold for other forms of equity-linked compensation schemes that are not rejected but on the contrary universally applied (Macey, 1999). As Engelen (2005) demonstrates, these problems also exist with respect to executive stock options and leads to contractual limitations on the use of stock options that avoid the above problems.<sup>19</sup> For those shareholders who want to pay managers by allowing them to trade on inside information it is possible to create a similar contract that

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<sup>18</sup> Macey (1988) gives the example of a tender offer or purchasing stock in the target company before disclosing the takeover plans to the target’s shareholders.

<sup>19</sup> On the close parallelism between insider trading and stock options see Engelen and Van Liedekerke (2005).

avoids the above pitfalls. Moreover, insider trading as a compensation scheme has some clear benefits compared to these traditional remuneration devices. By its automatic and market-based compensation for the creation of shareholder value by management, insider trading avoids slow and costly (re)negotiations between the company and its management about the correct amount of remuneration (Engelen, 2005). As long as one does not show that other remuneration schemes yield the same benefits at a lower cost, insider trading can therefore not be excluded as a valid compensation scheme (Carlton and Fischel, 1983).

Looked upon from the property rights point of view regulating the use of inside information is simply an applied executive compensation problem. The distribution of the gains from inside information should be a matter of contract (Macey, 1999). Regulating the use of inside information in a contractual nature, allows companies to specify which ‘insiders’ may trade on private information and which not (Fischel, 1984). For instance, a company might want managers to trade, but not lawyers, accountants or consultants. Or, it might choose to exclude members of the board of directors to trade on inside information. Moreover, it allows companies to specify on what type of private information insiders may trade or not. For instance, a company might want managers to trade on private information, except on information related to an impending merger or acquisition.

### **4.3 Market morality**

The last argument that pops up regularly in the literature is the effect that the allowance of insider trading has on general market morality. In several publications Werhane (1989, 1991) goes back to Adam Smith in order to clarify the need for a basic market morality, carried by values like a certain fairness in competition, or a form of self-interest that is restrained by reason as necessary conditions for a free market. The problem about insider trading then becomes that the practice is connected to a ‘Boeskyian greed culture’ (Werhane 1989) that undermines market morality and if it takes the upper hand, destroys the market itself. It is very hard to argue with this type of general argument and on the whole we are rather sympathetic to it. However, if you dismiss insider trading along these lines it seems very difficult to see why one would not want to dismiss other forms of equity linked executive compensation on the same ground. The excesses of stock option compensation that we were exposed to the past decade seem to invoke the same greed culture as insider trading. Still stock options are considered rather unproblematic while insider trading is deemed to be very

problematic. If shareholders regulate insider trading in a contractual manner, this compensation mechanism comes very close to stock option compensation and should therefore have the same moral effects (Machan, 1996). Nevertheless the ban on insider trading has grown dramatically while stock option compensation is still hailed as a compensation system that allows us to solve the agency problem.

## **5. Conclusions**

In this contribution we pointed out that the distinction between market manipulation and insider trading is a real one. Most of the time when private information reaches the market this is sound information that signals a real change in value. Stock manipulation is the exception and much harder to put through. Private information might reach the market through corporate insiders or misappropriators, giving rise to four different types of inside transactions. It is not so hard to come up with moral (or economic) arguments against transactions of type II, III and IV, the really difficult part is finding arguments against type I. On consequentialist grounds we see no arguments against type I transactions. Using an ethical analysis of the fairness grounds, we showed that both the absolute equality version and the equal access approach offer no sound ethical basis for banning insider trading. It is however possible to ban insider trading from a property rights perspective. We need to accept at that point that the inside information is owned by the company and more specific the shareholders, and that they have the right to decide who can use this information. If they ban the use of inside information, insiders should accept this. Finally, arguments based on market morality strike a cord, but also hold for other types of executive compensation. Therefore the present situation in which insider trading is universally vilified while stock option compensation continues to grow is difficult to justify on moral grounds.

Given the property rights perspective, we would propose to leave it up to the companies to decide whether they want to allow or prohibit insider trading. They can solve this issue in a contract with their corporate insiders. Given the contractual nature of this agreement, it allows maximum flexibility to determine which insiders under what conditions may trade on private information. To make this system transparent to investors, companies should be obliged to disclose whether they allow their insiders to trade on private information and under what conditions.

The property rights perspective is also in line with the compensation view, which considers insider trading as one of the many instruments to reward corporate insiders and offers shareholders an additional governance instrument. It remains difficult from a moral point of view to argue why one would want to ban specifically insider trading and not other forms of executive compensation. For one thing, the ban has certainly not created the level playing field it was supposed to support. It has rather moved the centre of power to institutional investors who now hold the informational advantage and small investors are still left out in the cold.

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