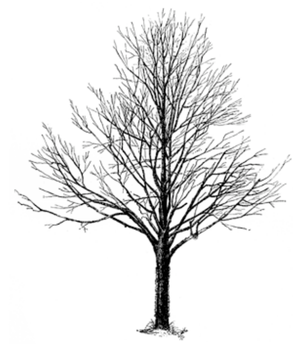

Insider Trading

A Legal and Ethical view on Insider Trading Legislation

By: Julian Vu
Legal and Ethical Perspectives on Business

The American equity markets are an integral part of the American economy. Some may argue that it is not the economy that affects the equity markets, but rather the equity markets that affect the economy. Equity markets hold a significant portion of our nation's money, and because our economy is dependent on the flow and supply of capital, the federal government has taken measures to assure that the equity market is stable, as well as fair to all investors. Whereas the federal government is concerned with building wealth for the nation collectively, American investors inversely view the equity market as a way to attain wealth individually. Luckily, it is possible to attain both goals (as shown through today's current American equity markets), though that's not to say that there is not any risk involved. This individualistic motive of financial gain is not only ethical, it is a social contract right protected to us by the constitution (pursuit of happiness clause). Though the motive is clear, the means or methods by which wealth is attained are rather ambiguous in ethicality. Within the equity market, there is not just buying and selling, there is short-selling, options-trading, pump and dump schemes, and many more questionably ethical procedures. The role of this paper however, is to discern the legality and ethicality of insider trading, and argue that insider trading, though currently illegal, should not be legally barred on the grounds of its ambiguity and being detrimental to economic growth and stability.

To understand insider trading, a few terms must be clearly defined. Insider trading is the act of buying or selling equity securities using non-public or "inside" information[1]. The act is done by an *insider*, which is a significant (10% or greater) equity-holder who has access to inside information (generally an executive, or employee of the company). An example of insider trading would be if an executive received information about a failed FDA approval for a product of his company's. Thus far, he only has insider information, and the act of having insider information is not illegal. According to the Securities and Exchange Commission (SEC), it becomes illegal when the executive uses this information to buy or sell securities of the corporation before the price

[1] Insider trading. (2008, November 10). In *Wikipedia, The Free Encyclopedia*. Retrieved 21:29, November 10, 2008, from http://en.wikipedia.org/w/index.php?title=Insider_trading&oldid=250942338

drops. On the surface, this appears to be an unfair advantage that the executive has over other investors in the market. We are concerned with the ethicality and legality of the situation however, and not the immediate perception of fairness.

In fact, an immediate assumption that must be made is that investors are not equal, and that ensuring equality for all investors would not only be impossible, it would be a huge detriment to our capitalist system. The basis of inequity amongst investors is based on information. In fact, all investors act based on information, whether prudent or driven by intuition. Information is what drives the decision-making, and therefore information also drives the outcomes of the market. Insider information is considered to be valuable information, the only difference is that it is non-public. If an insider makes a trade based on this information, then he must make the information public within a few days, otherwise he will be charged of insider trading. The point of this argument is that the insider has information other investors do not. Let me suppose the following then; “Is it unethical for investors to have private information about a company that does not come from inside the company?” Take for example an investor who by day works in a patent office, and by night trades stocks. If a company files a patent to be processed, and this investor receives information about the patent before it goes public, he could purchase the stock based on this information and make a gain just as easily as an insider would. The two used non-public information, the only difference is that one is not an insider. Granted, this is an extreme example. A more broad example would be investors who pay for information, an example being the Wall Street Journal, private equity research, or other similar sources of information. Theoretically, it is public information in that it is available to the public, albeit access is not equal in that not all investors can afford to purchase the information. In terms of the illegality of insider trading, the current argument is that insider trading does not grant equal and fair access to the information; a concept known as asymmetry of information. As I’ve indicated, asymmetry is very hard to maintain. Though this is a reason for Insider Trading laws, even the SEC knows that it is flawed, and does not make any convictions based on asymmetry related charges.

The information is not the problem, it is the act of trading based on the information that is problematic in the eyes of the government. The SEC was created to help regulate our capitalist economy. The term regulate has such negative connotations however. What most citizens (and investors, even) do not realize is that the SEC was created in conjunction with the Federal Reserve to help maintain two economic goals; stability and growth. Growth is what drives our economy, and the stock market is the means by which the economy is driven. The SEC is focused with the overall long-run growth of the economy such that effects of the business cycle do not have any lasting detrimental effects on the economy. With growth in mind, most SEC fiscal policy is based on a long-term agenda, which in equity securities terms translates to the SEC favoring conservative long-term investors who make decisions based on the dividends of a company as well as its' management and return on equity. Henry Manne, an economist from George Mason University, was in strong defense of helping the long-term investors. In his 1966 paper, he argues that insider trading only helps the short-term traders who are looking for a quick gain. These gains may come not only from buying and selling stocks, but options as well, all based on what is believed to be insider information. At the time, Manne was correct to say what he did. Insider trading legislation was only designed to protect short-term investors who are only affected by quick short-term decisions, unlike long-term investors. He made a distinction between traders and investors, in fact. Traders, Manne argues, are gamblers who make decisions based solely on price fluctuations, and not traditional information. Investors are in it for the long-haul, and believe that any negative information can be smoothed out over time. Altruistic though it may seem, the fact of the matter is that today's markets are different. Money moves a lot faster now, and insider trading laws and regulations simply slow down the process. This is a double-edged sword. Slowing down trading will get in the way of conducting business, undoubtedly, but also consider that slowing down trading can also help to stabilize the economy.

This is a serious point of contention, and brings up a debate of how “free” our “free-market” system should be. A totally free-market system would have no insider trading laws, and would perhaps even encourage insider trading as a form of distributing information. It appears that while information was not important in the realm of asymmetry, or parity, information is important in the aggregate movement of the market. In terms of stabilizing the economy, it is better to have mass movement of capital that trends in one direction, than to have it be dispersed, creating even more confusion among investors. This is particularly true in today’s economy which is shaken up by low (or non-existent) investor confidence. Insider trading can send signals about internal investor confidence, which to outside investors, is a mirror image of how well a company is being lead. Truthfully, insider trading could actually help the SEC to do their job.

The previous arguments I made were from a macroeconomic viewpoint. Now consider the role of the executive. As MBA’s, we are most concerned with how to behave as executives, and unfortunately this is an area for which there is confusion. Executives are assumed to be agents working for the stockholders (who are the principal). There becomes a conflict of interest when the executives not only serve as an agent, but also as a principal. Though the conflict exists, it is still common practice today for an executive to hold shares within the company. Not only do executives own shares, but so do employees through stock options. Part of being an employee or executive is the contractual agreement to certain fiduciary duties to the stockholders. If within the executive’s contract there is a clause specifically barring insider trading, then there is no question that insider trading is wrong. Though it may not have been commonplace in the past, it is now standard procedure. This is an example of free-market regulating itself. Where there has been a problem before, the current social convention of business has made anti-insider trading normal practice.

Insider Trading has been a tricky subject to tackle. There are proponents for it, and there are proponents against it. In the past, it has been difficult to implicate anyone of these charges due the to ambiguity of the law. As a result, information asymmetry is impossible to regulate. It is also difficult to determine if an insider actually used the information to make the trade. We have seen that insider trading is a natural catalyst for prudent market behavior by suggesting aggregate capital movement instead of creating further confusion within the market. Whereas insider-trading was difficult to regulate under the SEC's laws, it is now easy to control under contractual agreements. To conclude, I suggest that the SEC rescind its anti-insider trading laws. Any good business will tie insider-trading clauses into contractual agreements, and though insider trading will still take place, it will at the very least help to stabilize our economy.