An ethical analysis of regulating insider trading

P.J. Engelen[a]
L. Van Liedekerke[b]

[a] University of Antwerp
[b] University of Leuven, University of Tilburg

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Although there seems to be a broad consensus to prohibit insider trading among supervising authorities and market professionals, especially after the Enron and Worldcom cases, the debate on insider trading is still not settled definitively. The ethical and economic question whether insider trading is harmful or not is still an active one. Combining an ethical and a law & economics framework, the pros and cons of a ban on insider trading are analyzed. We will show the parallel between the economical and ethical reasoning, leading to similar conclusions. 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, both from an economic as well as an ethical point of view. We will present a model according to which insider trading is allowed as a default rule, but companies are given the option to exclude the use of inside information by its agents. This papers adds new (sometimes controversial) insights to the current debate on the ethics of financial markets.

0. Introduction

After the U.S. financial markets being troubled in 2002 by several major scandals, involving companies like Enron, Worldcom, Global Crossing and Tyco, financial ethics received a lot of attention. In the U.S. it even leaded to the enactment of the Sarbanes-Oxley Act of 2002[1]. Although there seems to be a broad consensus to prohibit insider trading among supervising authorities and market professionals, especially after this series of scandals, the debate on insider trading is still not settled definitively. Indeed, insider trading has a bad reputation and it is often blindly assumed that it should be banned. Nevertheless, the ethical and economic question whether insider trading is harmful or not is still an active one. Up to now, much of the literature was devoted to a legal or economic analysis of the phenomenon[2].

Running out of arguments in an economic debate against insider trading, the defenders of a prohibition often use ethics as the argument of last resort[3]. However, Lawson (1988) correctly points out that much of the literature did not get beyond simple expressions as 'it's

[1] H.R. 3763.
[2] See the review of literature in Scott (1998) and Bainbridge (2000).
[3] Or as Manne (1970, p.549) puts it: 'Morals, someone once said, are a private luxury. Carried into the arena of serious debate on public policy, moral arguments are frequently either a sham or a refuge for the intellectually bankrupt' (p.549) or 'moral indignation is used as a cover for unanalyzed conclusions' (p.581).

just not right' or 'it's unfair'. Moreover, it is not the conclusion of a moral analysis advanced by those authors, it *is* the argument itself[4]. But, a full ethical analysis should offer a well-founded assessment of insider trading instead of the use of empty phrases or vague moral arguments. Although insider trading receives so much widespread disapproval, it is surprisingly to see that it has received little ethical analysis. Exceptions are Moore (1990), Werhane (1989, 1991), Machan (1996), Ma and Sun (1998) and Snoeyenbos and Smith (2000).

One of the problems of analyzing insider trading from an ethical or from an economical point of view is the different vocabulary each discipline uses. However, by demonstrating a clear parallel between an economic and an ethical analysis of insider trading, we will bridge the gap between both disciplines. The ethical assessment of insider trading follows a classification analogously to the one used by Snoeyenbos and Smith (2000). Section one examines the consequentialist grounds, while section two focuses on the nonconsequentialist grounds. The latter deals with fairness and property rights grounds to assess insider trading. Section three contains the conclusions.

1. Consequentialist grounds

This approach balances the pros and cons of insider trading with respect to social utility to decide upon its ethical assessment. Such an assessment is basically an economic analysis of insider trading. Therefore, we will only briefly cover these grounds. After outlining the traditional arguments against insider trading, the section will refine or rebut some of these arguments.

Traditional arguments against insider trading include (Schotland, 1967; Mendelson, 1969; Brudney, 1979; Haft, 1982 and Levmore, 1982): insider trading causes a wrong price formation of securities and 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 it diverts part of the firm's earnings that would otherwise go to shareholders. Next these possible harmful effect of insider trading are examined. Both arguments for and against insider trading can be found.

Market efficiency

If a security market is informationally efficient, security prices instantaneously and fully reflect all relevant available information. Therefore security prices are a reliable criterion for the optimal allocation of scarce financial resources at a 'fair' price. 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 (Manne, 1966). Hence, by allowing insider trading, the allocation-efficiency of the security market will definitely improve. However, a traditional counter-argument is that insider trading postpones the disclosure of information and therefore reduces market efficiency (Schotland, 1967).

[4] See the references in Lawson (1988), notes 17 to 19.

Using a theoretical model Leland (1992) shows that stock prices more quickly reflect information when insider trading is permitted. After examining cases, Dooley (1980) finds that insider trading did not delay the public disclosure of information. The improved informational efficiency is empirically confirmed by Meulbroek (1992) who examined the transactions of 320 individuals charged with insider trading by the SEC during the period of 1980 to 1989. Other empirical studies supporting increased market efficiency are Cornell and Sirri (1992) and Chakravarty and McConnell (1997).

Another aspect of the efficiency-argument is the fact that insider trading creates an additional method for communicating information (Carlton and Fischel, 1983). This is especially the case with diffuse, complex information that is not readily encapsulated in a public announcement (King and Roell, 1988). See the case study of Healy and Palepu (1995) which 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.

Investor confidence

In the absence of a credible investor injury story (see infra), Bainbridge (2000) points out that it is difficult to see why insider trading should undermine investor confidence in the integrity of the securities markets. As insider trading improves the efficiency of the security market, the confidence of a rational investor in the security market will not be damaged. 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. 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 *trust* market prices[5]. 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 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.

Liquidity

Besides market efficiency, another major goal of securities regulation is liquidity. Investors value liquid stock markets because it allows a quick and cheap disposal of their securities[6]. There exist several theoretical models making predictions about market liquidity in case of insider trading, though these predictions differ widely. Different assumptions about the

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[5] This is the difference between insider trading and market manipulation. While insider trading moves stock prices closer to their fundamental value, market manipulation moves stock prices away from their fundamental value, thereby decreasing the allocative efficiency of market prices.

[6] The analysis focuses on liquidity effects of insider trading on order-driven or auction markets and not on quote-driven or dealership markets.

relative importance of insiders, liquidity traders, noise traders[7] 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.

Although there exist little empirical studies on the issue of market liquidity, the current studies show 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 on insider trading, 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) report as well that insider trading did not reduce market liquidity, mainly because of the increase in uninformed trading volume. Chakravarty and McConnell (1997) report as well that the insider’s trades did not decrease market liquidity.

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, he is better off than in a situation in which insiders do not use their privileged information[8].

Insider trading as a compensation scheme

By allowing corporate insider to trade based on their inside information, small investors will benefit by the enhanced shareholder value creation because of the equity-linked compensation of management (see infra), while in case of a ban on trading by corporate insiders, 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 current rules because these costs are distributed at a low per capita rate. For both Haddock and Macey (1987) as Tighe and Michener (1994) clearly show that a ban on insider trading causes the largest gains to be earned by market professionals, instead of transferring trading profits from corporate insiders to small investors, as is generally assumed. In the end, the prohibition of insider trading does not solve the informational asymmetry or the ‘unfair’ situation (see infra). It merely rearranges the ranking of ‘winners’ and ‘losers’. As such, the so-called ‘fairness’ argument is in reality a problem of distributing insider trading profits. Insider trading thus redistributes resources.

[7] These are investors who trade on the basis of what they believe, falsely, is special information. See Black (1986). In this case, they are investors who trade on fundamentals and who fail to recognize the extent of the inside information reflected in security prices and thus incorrectly believe they have superior information.
[8] See Haddock and Macey (1986a) or Engelen (2002) for an example illustrating this.

Balancing the pros and cons

Balancing the pros and cons of insider trading, one has to observe from the above analysis that there is very little harm caused by insider trading. First, one has to stress the social gains from informationally efficient capital markets. The more accurately prices reflect information, 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. To conclude, any ethical consequentialist ground for banning insider trading would require the burden of insider trading to exceed the benefits.

2. Nonconsequentialist grounds

Even if the conclusion in the previous section is that insider trading produces more social wealth, then insider trading might still be unethical based on nonconsequentialist grounds, such as the fairness argument and the property rights argument. So even if consequentialist grounds would allow insider trading, it still could be banned on these nonconsequentialist grounds. Both arguments are examined in this section in order to assess the ethical foundations of insider trading.

2.1. 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 because 'it gives the outsider an unfair comparative disadvantage that skews competition.' Analogously to Lawson (1988) we can distinguish two versions of the fairness argument: the absolute equality version and the equal access view.

Absolute equality version

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

However, using the classic example of the antique dealer who buys a genuine antique piece below-price at a jumble sale, as Moore (1990) points out that one is 'not morally obligated to tell those who deal with [him] *everything* that it 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 its colleagues, but instead scoops the competition. Among journalists this is considered professional behaviour and one might

even win the Pulitzer Prize[9]. Notice that in this case money is made on non-public information as well. Machan (1996) correctly asks why this should be 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 give no guidance to assess insider trading, since it would be impossible to rank human interests without such theory (Lawson, 1988). Following a similar reasoning, Moore (1990) and Machan (1996) also 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 his services is clearly profiting for an informational advantage is not acting unethical. Again one has to observe that informational advantages encourage almost every transaction in a market economy (Macey, 1988).

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 because 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). Again, this ethical argument is not convincing because the notion of equal access is unclear (Lawson, 1988). Easterbrook (1981) shows that access to information is not an absolute matter, but a function of the cost of obtaining such information and the resulting inequality of information is therefore a result of the division of labor, which is not unfair. Just as I can decide to become a plumber to have equal 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 while other inequalities are not, it offers no solid ethical basis against insider trading[10].

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). As such equality among market participants is reached through the pricing mechanism. Ideally, one would like stock markets to be strong form informationally efficient. Currently, stock markets seem to be semi-strong form informationally efficient. Because security prices only reflect all publicly available information, but not the non-public information, the transactions of insiders will reveal the private information component to the market (see supra). Although it must be admitted that market efficiency in itself is not a sufficient ethical basis for allowing

[9] 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.

[10] Any such attempt would quickly lead to a more general theory of property rights in information (Lawson, 1988).

insider trading, the equal access view neither gives an ethical justification for prohibiting insider trading on this basis.

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[11], causing a decline in stock prices, then it 'is not an argument about fairness, but about […] whether the decrease in share prices is outweighted by the incentives to produce valuable information, efficient stock pricing, and efficient managerial compensation that insider trading might provide' (Lawson, 1988, p.758). Basically, it is again a consequentialist ground then.

2.2. Property rights in information

Lockean approach to property rights

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 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 ethical problem[12]. 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. Or as Lawson (1988, p.766) puts it: 'The moral inquiry with respect to insider stock trading thus centers on where the network of contracts between the firm and its shareholders, suppliers, lawyers, accountants, investment bankers, printers, and so on, places the right to trade on the information.' The ethical foundation to conclude that the information belongs to the one who created it can be found in Locke's work. In *'The Second Treatise of Government'* Locke argues that *'Every Man has a Property in his own Person. This no Body has any Right to but himself. The Labour of his Body, and the Work of his Hands, we may say, are properly his. Whatsoever then he removes out of the State that Nature hath provided, and left in, he hath mixed his Labour with, and joyned to it something that is his own, and thereby makes it his Property. It being by him removed from the common state Nature placed it in, hath by this Labour something annexed to it, that excludes the common right of other Men.'* In Locke's view rightful acquisition of unowned property thus takes place when a person mixes his labor

[11] Notice that it does not have to be the case and that it has not been empirically been demonstrated.
[12] Macey (1988) gives the example of a tender offeror purchasing stock in the target company before disclosing the takeover plans to the target's shareholders.

with the property. Therefore, Moore (1990) assigns the property rights to the company. In this case, insider trading is wrong only when the company prohibits the use of the property right. Under the Lockean approach of property rights, insider trading is only unethical when the company withholds permission to trade on the inside information.

Efficiency-based property rights

In the law & economics literature, Easterbrook (1981) sees the right to trade on some piece of information about a company as a part of the larger question of whether and how to allocate property rights in intangible assets. In general, property rights refer to a bundle of exclusive rights of use. In particular ownership of a right means that a person controls at least a three-element bundle of rights in which each of the rights can be separated from the others (Demsetz, 1998). First, the bundle of rights includes the right to use a scare resource. Second, it includes the right to exclude others from exercising this right of use without permission. Finally, it includes the right to transfer control of the three-element bundle to other potential owners.

As the regulation of insider trading can be seen as an allocation of property rights within the company, the relevant question in the law & economics literature is how these property rights should be allocated efficiently. Assigning property rights to those who created it, gives them incentives to produce socially valuable information. In this way, social welfare is being increased. A rule allowing insider trading assigns the property right to the insider, while a rule prohibiting insider trading assigns this right to the company (Bainbridge, 2000). Depending on whether the property right in inside information is more valuable to the managers or to the shareholders, allowing insider trading will be beneficial (Carlton and Fischel, 1983). It should therefore be allocated to the party that values it most. No uniform legal rule is a solution to this allocation, because it depends on who is the next-best information processor after the insiders. In such a situation the best legal rule is contractual in nature (Macey, 1991)[13]. For Coase (1960) has shown that property rights will be allocated to their highest value user (absent of transaction costs). It is thus irrelevant to which party the property rights are allocated initially, because the parties can engage in a value-maximizing exchange by allocating the property right to its highest value user (Haddock and Macey, 1986b). As long as parties are free to contract around the initial rule, they can allocate the property rights in a way that increases the total value of the firm. Of course this depends upon the level of transaction costs. The cost of including provisions specifying the preferred insider trading rule in the corporate charter or in employment contracts is insignificant (Carlton and Fischel, 1983). One could argue that the enforcement costs of such contracts are high, but this is a separate issue unless one can show that all companies have attempted to limit insider trading by contract. Otherwise, a uniform legal rule banning inside trading displaces efficient private contracts with inefficient regulatory solutions (Carlton and Fischel, 1983). First, the cost-effectiveness of enforcement by a governmental body is never shown. Second, even if it is more efficient to enforce a ban on insider trading by such a supervisory authority, this does not prevent individual companies to customize their own rules (Haddock and Macey, 1986b).

[13] Historically, companies have made little or no attempt to prohibit insider trading (Carlton and Fischel, 1983). Or as Manne (1985, 940) puts it: "Clearly the overwhelming number of companies, when they were perfectly free to contract their way into such a rule, did not do so. This failure of corporations to design internal rules against insider trading could not have been an accident or oversight." The behavior of companies suggests that insider trading may be beneficial (Fischel, 1984). However, this does not mean that insider trading will be beneficial in all situations (see infra).

Bridging the gap between the economic and the ethical approach

Although ethical scholars seem reluctant to an efficiency-based property rights approach, by stating that 'the conceptual difference […] is enormous' (Lawson, 1988, p.770), it has to be admitted that 'obviously, if a system of property rights based on natural law is efficient, the partical difference between a Lockean and an efficiency-based property rights approach is minimal.' This link is offered by Miller (1987), leading Macey (1988) to conclude that the difference between the two approaches is non-existent.

Miller (1987) examines the relationship between economic efficiency and the so-called Lockean Proviso. Although people can justly acquire unowned property by mixing their labour with the property, Locke adds a limiting condition by stating that *'Labour being the unquestionable Property of the Labourer, no Man but he can have a right to what is once joyned to, at least where there is enough, and as good left in common for others.'* Miller (1987) demonstrates that the Lockean Proviso is not violated, 'so long as the value of the property that one has taken in excess of one's pro rata share is less than or equal to the benefits to others that flow from the appropriation of his excess land (p.410).' Suppose someone takes land out of the commons in excess of his pro rata share. Is this in line with the Lockean Proviso? Miller examines three possible cases depending on the market value of the land taken in excess of the pro rata share. In the first case where the market value of the land is zero, no problem arises with respect to the Lockean Proviso because it is certain that the benefits to others that flow from the extra enclosure will equal or exceed the loss of value of the extra land enclosed[14]. The second case is where the excess land has a positive value, but it is lower than the value that flows to the others. Again, the enclosure is still in line with the Lockean Proviso because the others receive 'as good' in exchange for what they give up. If the positive value of the excess land exceeds the benefits to others, as in the third case, the Lockean Proviso would rule out the enclosure, unless the appropriator is willing to pay compensation to the others for his action. In this scenario the others receive through compensation again 'as good' as what they lose. So, appropriation is permitted if at least one person is made better off and no one is made worse off than he was before. Thus, the Lockean Proviso rules out appropriations that are pareto-inferior. Thus it is 'apparent that the Lockean Proviso […] has a function not unlike the role of certain efficiency criteria in modern economic tought (p.410).' In this way, Miller (1987) clearly bridges the gap between a Lockean and an efficiency-based property rights approach.

Reinforcing fiduciary relationships

Contrary to Moore (1990) we don't see insider trading as a threat to the fiduciary relations between shareholders and managers. In many cases insider trading can even strengthen this fiduciary relationship. Because of the separation between ownership and control in publicly traded companies, agency problems may occur (Jensen and Meckling, 1976). Because of divergence of interests between shareholders and managers, the latter, driven by their personal utility function, will not act automatically in the interest of shareholders when adopting investment and financing policies (Fischel, 1982 and Coffee, 1999). This might lead to actions, e.g. in terms of investment decisions, that diverge from those that are maximising shareholders' value. However, several corporate governance mechanisms exist to align the interests of shareholders and managers. One of these mechanisms is the use of remuneration

[14] The benefits come from increased productivity of the enclosed land. Others will gain through lower purchase prices of the produce of the land and through higher salaries for their labor.

schemes which link compensation to the creation of shareholder value (as measured by the evolution of the stock price). This mechanism to align the interest of shareholders and managers is very adequate (Brindisi, 1985; Baker, Jensen and Murphy, 1988). Larcker (1983), Brickley, Bhagat and Lease (1985), Murphy (1985), Morck, Shleifer and Vishny (1988) and Mehran (1995) confirm the positive relationship between stock price evolution and the introduction of equity-linked compensation systems. By substituting a part of the fixed wage by a variable equity-linked part, interests of shareholders and managers are better aligned. Surprisingly, an overview of equity-linked compensation schemes is always 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)?

Nevertheless the problems with respect to insider trading as a compensation scheme are no more severe than they are with other forms of equity-linked compensation schemes (Macey, 1999). Traditional counter-arguments include (Scott, 1980, Easterbrook, 1981 and Moore, 1990): managers can also trade on negative inside information, 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. As Engelen (2002) demonstrates, these problems also exist with respect to executive stock options and it is possible to construct the appropriate conditions to rebut all of the traditional counter-arguments. 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 any slow and costly (re)negotiations between the company and its management about the correct amount of remuneration (Engelen, 2002). 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).

Choice left to the company

Being a simple application of the Coase theorem, companies and managers have the strong incentive to allocate the property right in valuable information to its highest value user (Fischel, 1984). As such the distribution of the gains from inside information should be a matter of contract (Macey, 1999). In this way, regulating the use of inside information is simply an applied executive compensation problem. Regulating the use of inside information in a contractual nature, allows companies to specify which ‘insiders’ may trade on private information and which not, because a company might want to prohibit some individuals, but not others, from trading on the same information (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 in the contract 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.

Haddock and Macey (1986a) show that the allocation to the highest valued user depends on the identity of the next-best information processor. Depending on who is the next-best information processor after the insiders (i.e. market professionals, dominant shareholders or small shareholders) determines whether the property rights are assigned to the corporate insiders or to the shareholders. So, again, the key question is who captures the benefits when insiders cannot. Haddock and Macey (1987), Tighe and Michener (1994) and Engelen (2002) argue that in companies with widely dispersed share ownership, it will mostly be the market professionals who will capture the gains from the new information when insider trading is banned. Neither the insiders, neither the small shareholders will benefit from this rule. So a ban on insider trading is not beneficial to small shareholders. It is therefore better to allocate the property rights to the corporate insiders. Allowing them to trade benefits shareholders in the form of reduced fixed salary obligations to the corporate insiders[15] and the enhanced shareholder value creation and innovation by the equity-linked compensation scheme (Haddock and Macey, 1986b). Similar conclusions can be drawn from the model in Zhang (2001), which suggests that insiders can be allowed to trade on private information so long as this trading also brings benefits to shareholders. These benefits result from a better shareholder control over corporate decisions because the insider trading is a useful mechanism to convey managerial private information. In order for this mechanism to operate properly, two conditions must be satisfied. First, the insider is required to report his trading activity, and second, he is prohibited from profiting by making short-term reversals of his trading position.

However, Haddock and Macey (1986a) indicate situations in which is more likely to assign the property rights to the shareholders instead of the insiders[16]. Such a situation arises when shareholders are the next-best information processors. This is the case of dominant shareholders who closely monitor the company. When the profits from trading on the inside information (when insiders are banned) is likely to exceed the benefits from fixed salary reduction, dominant shareholders will prefer a ban on insider trading by corporate insiders. They show that this will be especially the case if insiders are more risk-averse because the inside trading profits are less certain, thereby more unwilling to give up fixed salary. So, depending on the next-best information processor, insiders and shareholders will reach an arrangement that would make both sides better off.

3. Conclusions

This article shows that an ethical assessment of insider trading can be done either on consequentialist grounds or on nonconsequentialist grounds. The latter deals with fairness and property rights grounds to assess insider trading.

Any ethical consequentialist ground for banning insider trading would require the burden of insider trading to exceed the benefits with respect to social welfare. After balancing the pros and cons of insider trading, one has to observe from the above analysis that there is very little harm caused by insider trading. Therefore, on consequentialist grounds we find little ethical basis for banning insider trading.

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[15] This substitution effect between explicit fixed salaries of managers and insider trading opportunities is also reported in the model of Noe (1997). Thus by allowing insider trading shareholders provide lower fixed compensation packages.

[16] The model of Hu and Noe (2001) also predicts situations in which shareholders and situations in which insiders will benefit from insider trading.

But even if consequentialist grounds would allow insider trading, it still could be banned on these nonconsequentialist grounds. Using an ethical analysis of the fairness grounds, we showed that both the absolute equality version as the equal access approach offer no sound ethical basis for banning insider trading. We showed that the right ethical ground for assessing insider trading from an etical point of view is a property rights approach. Moreover, we showed that the assessment is parallel to an economic analysis.

Given the property rights perspective, we would propose a default rule that allows insider trading by corporate insiders. Realizing that sometimes shareholders would prefer a more efficient arrangement, i.e. a ban on insider trading, companies can contract around this default rule. In this way companies can opt out of this default rule and ban trading on private information by its corporate insiders. Ultimately, it is up to the companies to decide whether they want to allow or prohibit insider trading. 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 transparant to investors, companies should be obliged to dislose whether they allow their insiders to trade on private information and under what conditions.

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