

Insider trading is not unethical

[Economics](#), [Trade](#)



Martha Stewart was known as one of the richest and most powerful female executives of America before an insider trading scandal changed her life. In late 2001, a day before the Food and Drug Administration announced its refusal to review a cancer drug manufactured by ImClone System, Stewart had sold her 3928 shares of the company. Stewart was a friend of Sam Waksal, the Chief Executive Officer of ImClone, who had similarly sold his shares of the company before the announcement of FDA.

Peter Bacanovic had acted as a broker for both Stewart and Waksal. Telephone records revealed that Bacanovic had called up Stewart's office shortly after selling the shares owned by Waksal's daughter. However, Stewart denied that she had conducted insider trading. According to her, she had directed her broker to sell her shares in the event that the price per share fell below \$60. Bacanovic's assistant claimed that this was an outright lie. So therefore, Stewart had to face criminal charges.

She was also jailed for quite some time with the injunction that she would not be allowed to head any company for five years following her release (Ferrell). Of course, Stewart's case was not unique. A large number of organizations and individuals around the world have been persecuted because of insider trading. During the latter half of the year 2006, the former chief executive and founder of the online real estate listings company, Homestore Inc. , was sentenced to fifteen years in prison. Moreover, he was ordered to pay a fine worth \$5 million for devising a scheme that was meant to defraud investors.

The man was convicted for insider trading, for false statements to company accountants as well as federal regulators, and for conspiracy in a scheme that falsely inflated advertisement revenues in order to fool investors (Homestore. com). Seeing that individuals that are accused of insider trading usually land up in jails, it is essential to understand the ethical considerations attached to this form of trade. Insider trading is considered illegal when the trade of stocks is based on information that is not freely available to the public.

The Security and Exchange Commission considers insider trading a crime because perfect competition is based on perfect information, while imperfect information is considered a source of market failure (Rasmussen; " Perfect Competition"). When a large number of shares are sold based on insider information, the price per share is expected to fall dramatically in any case. Hence, opponents of insider trading assert that it is not fair to the other owners of shares if only a few individuals trade based on information that is solely available to them. All the same, they degrade the value of knowledge with this argument.

In the Information Age when knowledge is considered equivalent to power and wealth, the opponents of insider trading are actually claiming that it is illegal to possess special knowledge. But, if a scientist were to invent a new product that is meant to dramatically enhance the living standards of the people of the world, they would not consider it unethical to pay the self same scientist a huge sum of money for the special knowledge that he or she

possessed before sharing it with the public. With this line of reasoning, the argument of the opponents of insider trading is certainly illogical.

This is one of the reasons why a number of philosophers and economists have turned out to be defenders of insider trading with the claim that insider trading is both useful and viable in the free market (Werhane). After all, the quest for greater knowledge or new information is meant to enhance the value of knowledge, which happens to be a condition for efficiency. Machan explains the relationship of knowledge to insider trading further: ...[T]he concept “insider trading” employed in business ethics discussions has a broader meaning: it includes anyone’s ability to make deals based on not yet publicized knowledge of business opportunities.

Insider trading as such, apart from what it may be related to in some cases (such as fraud or the violation of fiduciary duty), involves making financial investments on the basis of knowledge others do not have and may not be able to obtain in ordinary ways. A knows the president of a firm who tells me that they are thinking of expanding one of their divisions or have struck oil in a new field, so A buys a block of stock in anticipation of the increase of value once the deal is done or the knowledge becomes public. A is not deceiving anyone, nor is A defrauding anyone.

A is not taking anything from others that A wasn’t freely given. A is acting on special, “insider,” information, that is all. It is conventional wisdom to treat this version of insider trading as morally wrong because it is supposed to adversely affect others by being unfair. As one critic has put it, “What causes injury or loss to outsiders is not what the insider knew or did, rather it

is what they themselves [the outsiders] did not know. It is their own lack of knowledge which exposes them to risk of loss or denies them an opportunity to make a profit.

” By the fact that these others do not know what the insider does know, they are harmed since they are not able to make use of opportunities that are in fact available, knowable to us. But what kind of causation is it that fails to make a difference when it does not exist? If someone’s knowing a good deal has no impact on what another he or she does, it cannot be said that any harm upon another had been caused by that someone. Certainly, had the other known what the insider knew, he or she could have acted differently.

By not acting differently, he or she could easily have failed to reap advantages the insider did reap. But nothing here shows that the insider caused any harm, only that he or she had a better set of opportunities. Unless we assume that valuable information known by one person ought, morally—and perhaps legally—be distributed to all interested parties—something that would beg the most important question—there is no moral fault involved in insider trading nor any causation of harm (Machen 3-5). With this understanding of insider trading, knowledge or extra information about one’s trade should not be considered harmful.

An analogy would be the use of new information on the part of an organization to create a new product that is expected to raise the living standards of consumers. Competitors of the organization that do not possess the means to innovate as the organization that uses the new information it has gathered are at a disadvantage. Nevertheless, the fact that the

organization used new information for innovation should encourage competitors to also search for diverse ways to gather new knowledge. After all, there is a price for knowledge, or all universities around the world would be free.

Of course, insider trading should be considered illegal only when the individual or organization that engages in it “ has a fiduciary duty to share” the obtained information with clients but refuses to do so because sharing information would translate into a reduction of profits that may be gained through such information (Machen 1). Machen also writes that newly obtained information may be used for criminal activity, or it may have been acquired by theft. In these cases, as in the case of the fiduciary duty violation, insider trading can be perfectly understood as illegal or unethical activity.

However, it remains ludicrous to consider it illegal when an individual or organization neither violates a fiduciary duty nor steals the information, but only gathers it by legal means to maximize profits. With a view of the national or global economy, profit maximization translates into economic growth. This is the reason why philosophers and economists that act as proponents of insider trading have a reasonable argument that must be seriously pondered upon by lawmakers. By declaring that insider trading is illegal by all means, lawmakers may in fact be hurting the national and global economy.

As a matter of fact, it is impossible to measure at this point in time the harm that the national and global economy are undergoing due to the fact that

insider trading - in all its manifestations - is considered illegal. Most of the industrial nations are consistently struggling against it and searching for new ways to end it in all its manifestations. What is more, the proponents of insider trading appear to have no say when this form of trading is labeled 'fraudulent without a doubt' (Tomasic).

Lawmakers should have wisely differentiated between the truly illegal and legal forms of insider trading before shunning this form of trade as criminal activity in all its manifestations. Scheppele explains that it is not really their fault, however. According to the author, it is rather difficult "to decide when special and valuable knowledge becomes an unfair advantage (Scheppele 126)." Still, it can be easily deduced that with Machen's descriptions of illegal insider trading, lawmakers may very well find a solution to the problem of calling all forms of insider trading illegal or unethical.

McGee writes that there are two fundamental philosophical approaches to evaluate the ethics of insider trading. The first approach - utilitarianism - happens to be the most popular one among the economists. Utilitarianism views actions as good if and only if the result of these actions is "the greatest good for the greatest number (McGee 2)." In the event that such results are achieved, economists refer to positive actions as positive-sum games where benefits exceed costs (McGee).

With this approach it is possible for lawmakers to evaluate the benefits and costs of insider trading whenever and wherever it is engaged in. If an organization or individual is using new knowledge or newly obtained information to gain an advantage - that would ultimately benefit a large

number of people because profit maximization is conducive to high economic growth – insider trading should not be considered illegal. If, however, they find that a certain form of insider trading hurts society more than it benefits the economy, there would be no argument against considering a specific form of insider trading illegal.

Even so, it must be borne in mind that insider trading is not illegal or unethical per se. The second approach to evaluate the ethics of insider trading is the rights-based approach – also according to McGee. Using this approach, lawmakers simply have to question whether a specific form of insider trading violates someone's rights (McGee). If there is a violation of someone's rights, it is perfectly logical to consider insider trading as unethical. If, however, there is no violation of rights, there is no reason to consider insider trading as illegal or unethical.

After all, competition in the matter of using new information to gain an edge is definitely not unethical or illegal, and neither is it a violation of the rights of competitors. In this context, it can be inferred that the concept of perfect information in a perfectly competitive market is misunderstood if not misleading. In point of fact, perfect information may even lead to market stagnation if there is no organization or entity that obtains new information for innovation. If every organization or individual possesses exactly the same information there can be no new developments in the pipeline.

In this case, economic progress may also come to a standstill seeing that the acquiring and use of new information may be considered unethical by lawmakers that have not seriously considered the benefits of insider trading

to the national and global economy – against the costs. Malachowski writes that there is no way to consider insider trading as unethical without an understanding of the existing contract between an organization, its employees, and its shareholders. If insider trading leads to a breach of trust between the contracting parties, it may very well be considered illegal or unethical.

However, lawmakers still need to work on legislations that consider all kinds of insider trading as illegal or unethical. Seeing that there are several penalties for insider trading, the benefits that might be accrued through this form of trading – if and when there is no violation of rights, nor a breach of contract involved – may never be enjoyed. But, when legislators consider the benefits of insider trading against its costs they may very well realize that all forms of this trade are certainly not unethical. Knowledge remains as power, and so it is always useful for organizations and entities to use it to their advantage.

In cases where the self same organizations and entities use newly obtained information to gain an unfair advantage, lawmakers may still need to weigh the benefits against the costs of insider trading. The fact that the economy must bear a loss when insider trading is considered downright unethical can be illustrated through the Martha Stewart case. Despite the evidence gathered by the legal system, Stewart had refused to admit that she had conducted insider trading. She had even issued a public statement that she was totally innocent.

After her release from prison and subsequent home confinement, she started work on new projects. The Apprentice: Martha Stewart was a prime-time NBC TV show that was aired in the autumn of 2005. Stewart also started a new magazine by the name of Blueprint. Although her company, Martha Stewart Living Omnimedia, had borne losses since the beginning of the public scandal, the prices of its shares were eventually raised (Ferrell). More importantly, during the time that her company had to bear losses, the United States economy also had to suffer a reduction in growth.

After all, Stewart's brand was popular enough to add great value to the economy. Another enlightening fact about her case was that the legal system had seemed to simply create it based on speculation. Stewart should not have been indicted simply because she was a friend of Waksal, and Bacanovic had given her a call right before she sold her shares of ImClone. Even though it is quite easy to understand that Stewart may have conducted insider trading, it was only conjecture on the part of the legal system, which should actually be based on foolproof evidence.

It may be inferred from the above mentioned facts of Stewart's case that the legislators' understanding of insider trading is not based on facts that may prove that this form of trade is definitely unethical or illegal. In point of fact, the number of approaches to consider the ethics of insider trading proves that there is no perfect way that legislators have so far pointed out for determining whether a certain form of insider trading is ethical or unethical. Philosophers and economists are certain that there are ways to benefit the economy through insider trading.

In order for the economy to reap the benefits of this form of trade, however, legislators must take the time to understand insider trading in each instance. It is perfectly easy to formulate a single law to label every other form of insider trading as unethical or illegal. So as to allow the economy to benefit through insider trading, however, lawmakers must spend more time to reconsider their evaluation of this form of trade. Besides, it may very well be that the individuals or organizations that engage in this form of trade are capable of boosting economic growth to a great extent.

As mentioned before, Stewart's organization was adding great value to the American economy. So, even if she had deliberately engaged in insider trading, she was probably more capable of using the profits that she gained through the trade to benefit the economy further. Shareholders of ImClone who did not possess the information that Stewart had obtained before she sold her shares would also have benefited through the growth of the American economy induced by the business acumen of Stewart. Regardless of the facts of actual cases of insider trading, however, it is clear that this form of trade is not unethical.

If and only if this form of trade violates the rights of others may the legislators be allowed to punish the organizations or entities that engage in insider trading. For all other forms of insider trading, the benefits of trade must be weighed against the costs. Insider trading may benefit the national and global economy immensely. Hence, it is illogical to consider this form of trade unethical simply because legislators have not thus far given thought to the evaluation of each insider trading case separately. What is more, the fact

remains that new knowledge benefits all even if a few people are responsible for obtaining it first.

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