

# Ethical Analysis of Insider Trading

## Abstract

By Larry Saylor

This paper evaluates the ethics of insider trading from the perspective of eight models. Based on economic, legal, and three distributive justice models, one concludes that insider trading is not appropriate. However, both of Kant's categorical imperative models as well as libertarianism support insider trading. A paradigm based on a Christian worldview is then developed. This is done by starting with the broadest, most basic statements of beliefs, and systematically narrowing in to the specific issue of insider trading. Beginning with the most basic premise possible, one can derive two principles, which lead to a policy, which in turn results in practice. The logical conclusion of these steps is that it is ethically impermissible to engage in insider trading.

Ethical Models Analyzing  
Insider Trading in the Stock Market

Larry Saylor  
Greenville College

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Ethical Issue of Insider Trading in the Stock Market:

Model Paper

Is insider trading, the buying or selling of stock when one party in a transaction possesses material, non-public information, ethically acceptable? This paper briefly examines the arguments supporting and refuting insider trading, and then applies various frameworks to this ethical dilemma – an economic model, a legal model, Kant’s two categorical imperatives, and four distributive justice models. These models lead to conflicting answers. The economic and legal frameworks, as well as three of the four distributive justice models, argue against insider trading. Both of Kant’s categorical imperatives and libertarianism, the fourth distributive justice model, support insider trading. Finally, a paradigm is developed from the perspective of a Christian worldview. This methodology of this model can be used to analyze any ethical issue. Using this model insider trading is found to be unethical.

The Ethical Issue – Pro and Con

The generally accepted view is that insider trading is wrong. Velasquez (2002) summarizes the two most common arguments against insider trading and says the effect of insider trading is harmful. One argument against insider trading is that the information used by the insider is stolen; it belongs to the corporation. When an asset is used for gain without the owner’s permission, then any gain belongs to the owner. Another argument is that the information advantage is unfair. Velasquez acknowledges that both parties to a stock transaction generally do not have equal knowledge, often because one party has been more diligent in research or analysis. But inside information is fundamentally different. The party without inside information has no way to obtain that information regardless of how much research or analysis he or she performs. Finally, Velasquez points out the harmful impact of insider trading. Insider trading reduces the size of the market because people are hesitant to

participate in a market with significant insider trading. Fewer people participating in a market means the market is less efficient, less liquid, and more variable.

McGee and Block (1992) discuss arguments in favor of insider trading and they claim that the overall impact of insider trading is positive. Arguments in favor of insider trading are arguments that insider trading is not wrong. According to McGee and Block, St. Thomas Aquinas believes “there is no moral duty to inform a potential buyer that the price of the good you are trying to sell is likely to change in the near future” (p. 221). Thus, insider has no moral duty to disclose that a price change will occur when the non-public information becomes publicly known. Next, McGee and Block argue that insider trading is not fraudulent because there is no loss. Without loss, there can be no fraud. (A seller benefits when an insider is buying because the price the seller receives is slightly higher. However, this does not take into account opportunity cost incurred because of future price changes.) Finally, no rights are violated, thus the act is not unjust. The rights of non-insiders are not violated because they receive a higher price for their stock. If a corporation believes its rights have been violated, it has other legal remedies available. McGee and Block conclude that “if the transaction is not fraudulent and the inside trader is not violating anyone’s property rights in information, there is nothing unethical about the practice” (p. 226).

Further, McGee and Block (1992) discuss several alleged advantages of insider trading. Because the stock price partially reflects the inside information, prices are more realistic. Also, insider trading encourages hostile takeovers. Hostile takeovers may be the only way to remove entrenched management. Thus, hostile takeovers and anything that facilitates hostile takeovers are good. Finally, inside information allows firms to indirectly compensate insiders and external parties who are given inside information. While many people regard these purported advantages as weak or non-existent, they should be noted.

## Models for Analyzing Insider Trading

### *Economic Model*

Certainly an economic model can be applied to the analysis of whether insider trading is appropriate. Perfect competition has many assumptions: many buyers and sellers, each too small to influence the price, no barriers to market entry or exit, full knowledge on the part of all participants, etc. While these assumptions are rarely, if ever, met, microeconomic theory clearly asserts that strict application of perfect competition to all markets results in “pareto optimality.” Pareto optimality is the enviable situation

in which the scarce resources of society are being used so efficiently by the producing firms, and the goods and services are being distributed so effectively by the competitive markets, that it would be impossible to make any single person better off without harming some other person (Hosmer, 1991, p. 36).

As Hosmer states so well: “Microeconomic theory is awesomely complete. . . . Microeconomic theory is also enviably unified.” (p. 52).

According to the economic model, although perfect competition is rarely or never achieved, because of the significant advantages of a perfectly competitive world, it is still a goal towards which one should strive. Actions which result in a more perfectly competitive world should be encouraged; actions which lead to a less perfectly competitive world should be discouraged.

Insider trading, with its inherently unequal information, clearly is counter to perfect competition. The preferred outcome, according to the economic model, is that the inside information be made publicly available so that all market participants have access to it. Barring that, market participants should have access to the same information. Thus, insider trading is not permissible in a perfectly competitive economic model.

*Legal Model*

The legal model posits that laws reflect the collective moral standards of society. With the legal model as a framework, any action that is legal is also, by definition, ethical. Conversely, any action that is illegal is also unethical.

There are some serious deficiencies with the legal framework as a model. Certainly legal requirements and moral requirements are similar, but just as certainly they are not completely in synch with each other. Laws tend to reflect relatively low levels of standards. Many “wrong” actions are not illegal because a high degree of consensus is usually required to enact necessary legislation. The biggest deficiency with the legal model, however, is that laws address negative requirements and actions. Good ethical decisions, on the other hand, depend on positive requirements and motives.

Notwithstanding these drawbacks to the legal model, it is still very useful to consider the legal restrictions on insider trading. The Securities Exchange Act of 1934 made it illegal to use material, non-public information to achieve personal gains in trading and required insiders to return profits obtained from buying and selling securities using such information (Bettis and Duncan, 1998). This original legislation has been broadened significantly with subsequent legislation in 1968 (Ma and Sun, 1998), in 1980 (Bettis and Duncan), in 1983 (Bettis and Chang, 1996), in 1984 (Rosen, 1993), in 1988 (Rosen), twice in 1990 (Bettis and Duncan; Rosen), twice in 1991 (Bettis and Chang; Breetwor, 1991), in 1997 (Smith, 1997), and most recently in 2001 with Regulation FD (Bird and Brusiloff, 2000; Munson and Leach, 2001).

When examined from a legal perspective, insider trading is clearly unacceptable.

*Kant's Categorical Imperative*

Immanuel Kant developed what he called the “categorical imperative” model to determine whether an action is ethical or moral. It is interesting to apply the categorical imperative model to insider trading because the results are not what one might expect.

*Kant's first imperative.* The categorical imperative is stated in two ways. The first formulation of the categorical imperative states:

An action is morally right for a person in a certain situation if, and only if, the person's reason for carrying out the action is a reason that he or she would be willing to have every person act on, in any similar situation (Velasquez, 2002, p.97).

Put another way, an individual's action is permissible only if that individual would find it acceptable if all people acted the same way in that situation.

Some would certainly argue that based on the categorical imperative, insider trading is not acceptable. At first this seems reasonable. After all, surely people would not find it acceptable to be in the position of executing a trade with someone who possessed inside information. But on further reflection the categorical imperative leads to the exact opposite conclusion. Suppose an individual has stock that he or she wants to sell. If someone with inside information is buying stock, the price the seller receives will be slightly higher than he or she would otherwise obtain. The seller may wish that the inside information would become public so the stock will increase significantly, but presumably that is not an option. The only alternatives under consideration are a stock market without insider trading, or a stock market with insider trading. Because the individual seller will receive slightly more for his or her stock, individuals will rationally accept insider trading.

*Kant's second imperative.* The second formulation of the categorical imperative leads to the same conclusion. The second formulation is as follows:

An action is morally right for a person if, and only if, in performing the action, the person does not use others merely as a means for advancing his or her own interests, but also both respects and develops their capacity to choose freely for themselves (Velasquez, 2002, p. 99).

The relevant implication of this is that people may be treated only as they have freely consented to be treated ahead of time.

What are the implications for insider trading? Again, at first it certainly appears that insider trading flunks this test and therefore is wrong. After all, surely no one would willingly consent to trade with someone who possesses inside information. However, trading with an insider is very rational and reasonable. By doing so one sells his or her stock for a (slightly) higher price, and therefore is better off. Thus, the rational response for people in the stock market is to consent to trade with people who may be insiders. The second formulation leads to the same conclusion as the first formulation – insider trading is acceptable.

#### *Distributive Justice Models*

Justice models comprise distributive justice, retributive justice, and compensatory justice. Distributive justice, which includes several methods for determining whether an action is proper, is the only model considered in this paper. Retributive justice is concerned with the fairness of the penalties imposed upon those who do wrong. Compensatory justice is concerned with the appropriateness of the compensation for those who have been wronged. This paper is attempting to determine whether insider trading is wrong. Penalties for or compensation resulting from insider trading is beyond the scope of this paper.

*Egalitarianism.* Egalitarian justice suggests that each person should receive equal benefits (Velasquez, 2002). Obviously there are tremendous incentive issues with such a system. An individual has little extrinsic motivation to do more or better if he or she must

share any resulting rewards with all other members of society. An individual trades on inside information in hopes of receiving a benefit. Under strict egalitarianism all such benefit is removed through tax and welfare programs or some other means. Thus, insider trading is unlikely. However, if any insider trading does occur, it is wrong because insider trading tends to promote unequal distribution of benefits.

*Capitalism.* With the capitalist system of distributive justice, benefits should be distributed based on the value an individual contributes to society (Velasquez, 2002). One could certainly argue that those who possess inside information tend to be higher level managers and presumably these people have contributed more to society. However, this argument is weak. It does not necessarily follow that those who possess inside information have contributed more to society. Often inside information is leaked, and there is no correlation between those who possess it and contribution to society. Because benefits are to be distributed based on contributions to society, and because insider trading is not always consistent with this, one can conclude that insider trading is not appropriate.

*Socialism.* Insider trading clearly is not acceptable with the distributive justice model of socialism. This model assumes that the benefits of society should be distributed according to people's needs. Profits from insider trading are distributed to those with inside information, which has little correlation with needs. In fact, one could easily make the argument that possession of inside information is inversely correlated with need. Thus, receiving benefits from insider trading is not acceptable.

*Libertarianism.* Applying a libertarian model, one clearly and certainly not surprisingly concludes that insider trading is acceptable. A libertarian believes that all actions are permissible as long as neither party coerces the other. Thus, as long as an individual possessing inside information does not coerce anyone else to buy or sell stock, than the

buying or selling of stock by this individual is acceptable. As the U.S. stock market is currently structured, it is hard to imagine how a person with inside information might be able to exercise coercion since one has no idea with whom one is trading. (Private transactions, are of course, an exception to this general rule.)

If one trades or transacts business with a strict liberterian, the warning caveat emptor is certainly in order. In fact, strict libertarian principles may be inconsistent with a civil society. At the very least, it is hard to imagine such a society. A libertarian world would not have speed limits, or any other driving regulations or restrictions; children could begin driving whenever they or their parents believed it was appropriate. Companies could unilaterally choose what information they wished to include in their annual reports, or whether they even wished to issue annual reports. They could choose whether they wished to have their financial statements audited or whether they even wished to release financial statements (audited or unaudited). As a practical matter, companies might have to release audited financial statements on a regular basis, even if not required by any governmental agency, in order to maintain investor confidence. But it seems unlikely that any similar sort of pressure would be exerted on those possessing inside information. Thus, trading on inside information would be rampant, and of course, acceptable.

#### Proposed Model for Analyzing Insider Trading – Christian View

To determine the appropriateness of insider trading, or any action, one can follow a four step process: enumerate ones most basic beliefs or *premises*, identify *principles* which result from these premises, determine *policies* which flow from these principles, and finally, consider *practices* which are based on these policies. One goes from premise, to principle, to policy, to practice. This is a process that starts with the very broad, most basic of statements, and which, through a process of logical, sequential steps, narrows in to a specific practice.

This paradigm is not exclusively a Christian model. It can be useful to one of any faith, or even to those with no strong religious belief system. It is especially useful to people, both Christians and non-Christians, because it forces one to identify one's most deeply held beliefs, and to act in accordance with those beliefs.

It is important to note that any premise leads to multiple principles, every principle leads to numerous policies, and each policy leads to several practices. Although presented in a fairly linear and direct manner, in reality there are many alternative paths not considered in this paper. Further, this paradigm is not absolute. As with all ethical models, different people utilizing the same model may arrive at different conclusions. In this situation, it is possible that someone else could begin with the same premise, but by following a different path come to an alternative conclusion about the ethical dilemma of insider trading.

#### *Premise*

Certainly one foundational premise of the Christian faith is that there is a personal God who cares about individuals and their actions. Some non-Christians subscribe to this premise, and not all Christians agree with it. But by and large, most Christians agree with this premise.

Those in the Methodist or Free Methodist heritage, including this author, are familiar with what has come to be known as John Wesley's quadrilateral (Thorsen, 1990). While Wesley never used this phrase, he taught that Christians can look to four sources of authority, primarily scripture, but also tradition, reason, and experience. It is useful to note that all four of these sources of authority bear witness to the premise of a personal and caring God.

While much more theologically penetrating arguments can be made, Jesus makes it abundantly clear in the Sermon on the Mount that God the Father cares about us.

Look at the birds of the air; they do not sow or reap or store away in barns, and yet your heavenly Father feeds them. Are you not much more valuable than they? . . .

And why do you worry about clothes? See how the lilies of the field grow. They do not labor or spin. Yet I tell you that not even Solomon in all his splendor was dressed like one of these. If that is how God clothes the grass of the field, which is here today and tomorrow is thrown into the fire, will He not much more clothe you, O you of little faith? (Matthew 6:26-31, New International Version)

*Principle*

In this model the premise is focused on God and the resulting principles are focused on man's actions that arise from this premise. There are two principles resulting from this premise that are appropriate. Both of these principles are logical extensions of the above premise.

The first principle is found in Micah 6:8: "He has showed you, O man, what is good. And what does they Lord require of you? To act justly and to love mercy and to walk humbly with your God." Chewning, Eby, and Roels (1990) believe this is the basis for all actions by a Christian in business. Note that this verse closely parallels the criteria set forth by Hill (1997) that the actions of a Christian must be guided by holiness ("walk humbly with your God"), justice ("act justly"), and love ("love mercy").

From the precept that there is a personal God who cares about an individual's actions, one can also derive the principle that one should love God and love one's neighbor.

Hearing that Jesus had silenced the Sadducees, the Pharisees got together. One of them, an expert in the law, tested Him with this question: "Teacher, which is the greatest commandment in the Law?" Jesus replied: "' Love the Lord you God with all your heart and with all your soul and with all your mind' [Deuteronomy 6:5]. This is

the first and greatest commandment. And the second is like it: ‘Love your neighbor as yourself’ [Leviticus 19:18]. All the Law and the Prophets hang on these two commandments.” (Matthew 22:34-40).

### *Policy*

From these two principles (act justly, love mercy, walk humbly with God; and love God above all else and one’s neighbor as oneself) one can derive numerous policies as to how one should live. Applicable to the discussion in this paper is the policy: One should not withhold relevant information when engaging in transactions. This policy is a clear and logical result of the principle enumerated above. Withholding relevant information is not acting justly or loving one’s neighbor as oneself. Sharing relevant information is acting justly and loving one’s neighbor as oneself.

This policy, that one should not withhold relevant information, is certainly applicable to much more than insider trading. Following this policy means that if one is selling a used car that is clearly a “lemon” one is obligated to reveal to a prospective buyer the known defects with the car. This is a direct result of acting justly, loving mercy, and walking humbly with God. It is a direct result of loving one’s neighbor as oneself.

### *Practice*

From the policy that one should not withhold relevant information when engaging in transactions, it is an easy step to derive the practice: One should not buy or sell stock when he or she possesses material, non-public information. This is self evident.

### *Conclusion*

Other models examined earlier in this paper lead to conflicting results with no clear method for determining which solution is preferred. They are certainly valid models, and conflicting results is not a reason to discard them. However, the derived model is superior

because it starts by forcing one to determine what is most important. What are one's core, fundamental beliefs? Then through a series of logical steps one derives an answer. The methodology utilized in this paradigm provides a clear, unambiguous result. One of the absolutely most basic premises for a Christian is that God is personal cares about the actions of an individual. From this premise one can easily derive the two principles that first, one must act justly, love mercy, walk humbly with God, and, second, one must love God above all else and one's neighbor as oneself. From these two principles one can clearly derive the policy that one should not withhold relevant information when engaging in a transaction. Then it is a very clear and logical conclusion that one should not engage in insider trading. Thus, by starting with the absolutely most fundamental beliefs, in a few steps one can derive the unambiguous result that insider trading is not ethical.

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## **Larry Sayler Biography**

Larry Sayler has a BA from Carleton College and an MBA from Wharton.

After approximately 15 years with General Electric in various financial positions, including CFO of a wholly-owned GE affiliate in California, Larry now teaches at Greenville College in Greenville, Illinois.

He teaches courses in the Management Department, primarily accounting.

He is currently pursuing his DBA at Anderson University, Anderson, Indiana.