RESEARCH SUMMARY

# The Ethics of Insider Trading Reform

Ethical opposition to insider trading all too often rests on a gut response that "it's just not right!" This claim is rarely tested or defended by principled argument. Any reform that would liberalize insider trading is typically dismissed on the grounds that, despite making economic sense, such trading is always unfair, fraudulent, or otherwise immoral. In "The Ethics of Insider Trading Reform," John P. Anderson proposes modifying the current enforcement regime to allow for issuer-licensed insider trading, a reform that would bring much-needed clarity and rationality to the law, reduce the cost of compliance, and better align the interests of firms and regulators.

## THE CURRENT ENFORCEMENT REGIME NEEDS REFORM

Vagueness in the law of insider trading in the United States has yielded an enforcement regime that is unjust, irrational, and in need of reform. Under the current enforcement regime, stiff penalties are imposed for insider trading, a crime which has never been defined by statute or rule. This vagueness, combined with the threat of harsh sanctions, has created inefficiencies and injustices that undermine many of the concrete market-related values that the current legal regime purports to promote. This vagueness has inadvertently led to the adoption of overly cautious, "play it safe" compliance programs that can decrease liquidity, increase the cost of capital, and ultimately undermine shareholder value.

## ONE PROMISING MEANS OF REFORM: ISSUER-LICENSED INSIDER TRADING

Authorizing issuer-licensed insider trading through rulemaking by the Securities and Exchange Commission is one promising means of reform. This reform trading would permit firms (the issuers), at their discretion, to allow their employees (the insiders) to trade the firm's shares based on material nonpublic information. The issuers would be required to provide a general disclosure to their shareholders that they allow such trades when it is in the interest of the firm and to separately disclose all trading profits resulting from approved insider trades.

This reform would

- Offer relative certainty to issuers and the corporate insiders whom they employ. Issuers who are concerned about the risk of civil and criminal exposure for their trading and the trading of their employees would take refuge in the safe harbor offered by the reform.
- Reduce the costs of compliance for issuers by eliminating the need for overbroad, inefficient compliance regimes.
- Bring the interests of issuers and regulators into better alignment. The firm's business judgment, not fear of regulatory scrutiny, would determine trading decisions and the liquidity of employee shares.

If a firm rejects an insider's trading request and the employee trades anyway, any regulatory action against the insider trading would be consistent with the firm's interests.

## ADDRESSING THE ETHICAL OBJECTIONS

Insider trading is commonly opposed on ethical grounds, so if issuer-licensed insider trading or any type of liberalization reform is to succeed, ethical objections must be addressed.

- *Objection:* Allowing issuer-licensed insider trading would increase trading costs, undermine investor confidence in markets, and create perverse incentives for employees by enabling them to profit from the company's bad news.
  *Response:* In the case of the issuer-licensed insider trading, the issuer has calculated that such trading will result in a net benefit to the firm. By retaining the power to approve or reject proposed trades, the issuer itself controls the risks. Presumably, when an issuer licenses a trade, it has already considered any potential increases in cost of capital and decreased share liquidity that might result from increased trading costs. Retaining the discretion to approve or reject trades in advance also diminishes the risk of perverse employee incentives. In addition, insofar as issuer-licensed insider trading actually benefits firms (if it did not, it would be licensed), the practice should reinforce rather than undermine market confidence. Finally, if such trading were not proscribed, costs of regulatory enforcement and compliance would decrease.

- *Objection:* Issuer-licensed insider trading is wrong in principle, regardless of the consequences, because it violates moral duties such as justice and fairness.
  *Response:* Issuer-licensed trading does not deceive or violate a promise to the firm because the firm itself has allowed the trade. And there is no deception of others who trade in the firm's shares because the issuer has disclosed that it allows its employees to trade based on material nonpublic information and has disclosed any profits earned by such trading. Such disclosures give counterparties adequate notice and opportunity to price the issuer's shares accordingly. All interested parties to issuer-licensed insider trading are fully informed in advance of the trade.

- *Objection:* Issuer-licensed insider trading should be prohibited because it promotes greed.
  *Response:* Issuer-licensed insider trades would not necessarily be motivated by greed. For example, the generous insider trader may seek profits to help a family member get through college, to pay for a friend's expensive medical treatment, or to engage in some other form of philanthropy. Moreover, because such trading is just another form of corporate compensation, it is no more the reflection of a greedy disposition than is taking a paycheck. Even if it could be proved that a trader was motivated by the vice of greed, greed alone is not a valid justification for imposing criminal sanctions because such trades would be harmless to others.