Business Ethics Journal Review
SCHOLARLY COMMENTS ON ACADEMIC BUSINESS ETHICS
businessethicsjournalreview.com

Cite as: **Bus Ethics J Rev** 9(9): 54–59, https://doi.org/10.12747/j1i09

Edited by **Chris MacDonald** & **Alexei Marcoux**

ISSN: 2326-7526

INSIDER TRADING AND THE POTENTIAL FOR SABOTAGE

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A COMMENTARY ON T. L. Smith and W. E. Block (2016[2]), "The Economics of Insider Trading: A Free Market Perspective," ***J Bus Ethics*** 139(1): 47–53, https://doi.org/10.1016/0304-405X(93)90039-E

ABSTRACT

Insider trading is widely reviled, and yet – as Smith and Block argue – it is consistent with the basic principles of a free market system. This article draws attention to an argument against insider trading that Smith and Block don't address, namely the potential for sabotage. However, this issue still fails to justify insider-trading legislation, and thus ultimately supports Smith and Block's view that regulatory attempts to prevent it are misplaced.

SMITH AND BLOCK (2016) discuss a valuable focal point in our understanding of the ethical basis of a capitalist economic system: insider trading. Their article can be described as a short, dated, but engaging polemic that articulates why securities markets are not deserving of special regulatory attention when it comes to information asymmetries. Although insider trading is widely reviled, standard economic theory casts doubt on how pernicious it is. The purpose of stock markets is to provide accurate information relating to company performance, and one should expect that the more information that is contained within that share price, the better. After all, in a capitalist

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[2] [**Editorial note:** *This target article is outside* Business Ethics Journal Review*'s usual three-year window for Commentaries. That is due to editorial mishandling of the author's original submission, which was accomplished within the three-year window. The Editors apologize to the author for the error.*]

system prices provide two functions: incentives and knowledge. To economists the issue isn't really whether successful traders deserve their profit (an ethical question), but how their actions are reflected in the grand communication system that we call market prices. In a classic defence of insider trading Manne (2005: 170n10) shows that inside trading moves share prices in the "right" direction, and Smith and Block (2016: 50) also recognise that insider trading improves market efficiency, saying that, "there is practically no disagreement that insider trading, whether legal or illegal, drives the prices of securities towards a more accurate valuation."[3]

The first section of this Commentary will summarise Smith and Block's (2016) defence of insider trading. Section 2 suggests that concerns around insider trading might relate more to the incentive for sabotage than allowing insiders to benefit from superior knowledge. Section 3 concludes.

1. Insider trading and failure of insider trading legislation

Trading by insiders is generally considered to be beneficial—if corporate governance improves when executives own shares, and if corporate culture improves when employees benefit from those shares becoming more valuable, then insiders need to be able to buy and sell them. Insider trading becomes problematic, and illegal, when those trades are prompted by the possession of material and non-public information.

In an important attempt to provide a free market perspective, Smith and Block (2016) present a case to abolish the Securities and Exchange Commission (SEC), arguing that insider trading fails to violate the rule of law. They discuss three popular criticisms of insider trading: that it causes a loss in market confidence; that it increases transaction costs; and that it violates the fiduciary duty of those doing the trading. They make a convincing argument that the first two objections aren't sufficient justification for regulating *any* activity, and although there's a stronger argument against the latter, this is mitigated due to the fact that "corporations will be pressured by their investors to prohibit insider trading by employees" (Smith and Block 2016: 48). As they point out, "similar contracts exist prohibiting the sharing of trade secrets, and they are effective" (Smith and Block

[3] Also see Meulbroek (1992); Lin and Rozeff (1995).

2016: 49). Acknowledging that shareholders already have strong incentives to monitor and reduce activity that harms their interests is a critical point in the case for self-regulation, because it means that even if we deem insider trading to be harmful, insider trading laws are not the only way to combat it. Indeed, they may even be counterproductive.

Smith and Block (2016: 49–50) point out that insider trading laws exist because they benefit elite investors, and they benefit regulators. Regarding the former, restricting the pace at which information is declared to the market, and ensuring that such information is declared simultaneously across the entire market, penalises those in possession of pertinent information and favours the financial institutions that are built on a calendar of public statements and quick trading. The amateur investor who reads the newspapers before phoning their broker to place an order stands no chance against the conglomerate with specialist analysts, Bloomberg terminals and fast trading accounts. This demonstrates that insider-trading laws are not necessarily in the public interest.

If a company has an interest in restricting information from coming to market (perhaps it would give an advantage to a competitor) insider trading laws seem a blunt tool to prevent a rogue employee from profiteering. Such an employee would earn far more selling that information than from selling shares and risking other events occurring that would move prices in a different direction (see Manne 2005: 187n58). Similarly, when an employee that has had access to sensitive information leaves a company, they will often be placed on gardening leave. This process covers a wide range of sensitive areas, and the terms of the contract could easily incorporate the trading of stocks. Blanket bans on insider trading are neither necessary nor appropriate in such cases.

2. Insider trading and manipulation

Although Smith and Block (2016) providing a convincing rebuttal of the rationale for laws against insider trading, they neglect a potential part of the hostility. Easterbrook (1985) supported insider trading laws by appealing to agency problems, drawing attention to the interplay between insider trading and potential mismanagement. However, Bhide (1993) showed that institutional investors may keep their holdings below arbitrary limits in order to avoid being treated as insiders (and thus have to abide by burdensome disclosure rules). Similarly, Padilla (2006) argued that by discouraging larger shareholders to play active roles in management, insider trading laws can impede corporate governance. Critically, this literature emphasises the role of mismanagement.

Consider the following two, hypothetical, scenarios facing a corporation:

> (i) Your main marketing executive has not yet decided how much budget to spend on the new campaign. His decision will play a critical role in generating sales. Should people who can control the outcome be allowed to trade shares?
>
> (ii) Someone in R&D believes that she has seen a major flaw in the product, and that it will be subject to a recall. Should people who have access to critical information be allowed to trade shares?

My claim is that the free market case for inside trading can quite easily be made regarding scenario (ii); although one could argue about whether it is "fair" that the person in R&D can profit from their private information, the involvement of that person would unambiguously move the price in the optimal direction. The only debate here is about an important element of capitalism—the ethical issues raised by the potential for some people to benefit financially through sheer luck. But, as Smith and Block (2016) point out, there is no more justification to prevent insider trading on the grounds that it permits some people to benefit disproportionally, and "undeservingly" than there is to ban any market activity.

Scenario (i), by contrast, prompts a deeper concern. In this situation, the issue is that the marketing executive has the ability to influence the outcome. The main justification for preventing him from participating in the market is not whether he should be able to profit from trading, but his incentive to engage in undesirable actions in order to profit. The concern isn't insider trading per se, but manipulation.

Smith and Block (2016: 50) do address the issue of manipulation: "[I]nsider trading critics also argue that if managers are permitted to trade on insider information they have a strong incentive to manipulate the stock price in the correct direction while they are trading." The problem here is the assumption that the manipulation is being done to the stock price, rather than to the activities of the organisation. Insider trading presents an opportunity to profit from the fact that prices do not incorporate all information, but also to profit from the fact that insiders may affect the activities being undertaken. After all, the reason we should be wary about tennis players being allowed to bet on their own matches is not because they have access to superior information about their condition and chances of success, but because they can control the outcome. The issue isn't about the legitimacy of profiting from an information advantage, but about incentivising sabotage.

However, this still doesn't justify insider-trading laws. If the concern is that executives will manipulate the way activities are being reported (for example via earnings reports) then you don't need insider trading laws because earnings manipulation is already illegal. If the concern is that employees will manipulate the activities themselves – for example the R&D employee in scenario (ii) deliberately creating a flaw in the product – then investors are already alert to the dangers of sabotage (of which there is an extensive corporate literature; see Mars (1982)), and insider-trading laws seem a very poor way to guard against it.

3. Conclusion

Whether it is corporate espionage, earnings manipulation, or sabotage, the wronged party are the shareholders and not the market as a whole. Therefore, a strong incentive already exists to prevent such activity, irrespective of insider trading laws. And even if insider-trading laws were repealed, there would be nothing to stop companies adopting them as a voluntary standard. It is conceivable that ordinary workers might be able to engage in insider trading (and indeed this may prove to be a highly effective source of compensation); whilst key decision makers such as senior executives, in order to install confidence in the market, would agree not to. (Although Manne (2005) pointed out that in the period before insider trading laws came into effect there were no examples of companies operating a policy that restricted certain executives from being able to trade on their knowledge, suggesting that this simply wasn't a problem.) It might remove some of the advantages enjoyed by elite investors, but for the market as a whole we should encourage, rather than discourage, insiders from being able to reflect their superior information in the share price of a company.

This Commentary expanded upon Smith and Block (2016) to claim that concerns about insider trading are often in fact concerns about other issues, such as the potential for sabotage. When the source of concern is identified, however, we realise that there are already actions and laws designed to prevent them, and they are likely to be better suited, and entail fewer negative consequences, than laws against insider trading.

Received 11 November 2019 / Posted 28 December 2021

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