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## **Insider-Trading Prohibitions Should Go out of Style**

**by Donald J. Boudreaux**

One of the most essential distinctions made in Anglo-American law is between acts that are *malum in se* and acts that are *malum prohibitum*. According to the law dictionary at [www.law.com](http://www.law.com), an act that is *malum in se* is “wrong in itself, in its very nature being illegal because it violates the natural, moral or public principles of a civilized society.” Examples are murder, rape, and theft.

In contrast, an act that is *malum prohibitum* is not obviously wrong — not obviously injurious to civil society — not clearly one that should be illegal. The Latin translation of this term is “wrong because prohibited”; that is, the only reason a *malum prohibitum* act is wrong is that the government has declared it to be wrong.

It’s revealing that the lead example that law.com gives of acts that are *malum prohibitum* is insider trading.

Keep this distinction in mind as you follow the SEC’s lawsuit against Martha Stewart stemming from her sale of \$277,000 worth of ImClone stock on the day before the Food and Drug Administration rejected ImClone’s anti-cancer drug, Erbitux. (She was also indicted on charges obstruction of justice for supposedly lying to investigators about the circumstances of the stock sale.)

Richard Posner, a U.S. Circuit Court judge, crisply defines insider trading as “the practice by which a manager or other insider uses material information not yet disclosed to other shareholders or the outside world to make profits by trading in the firm’s stock.”

The man on the street justifies outlawing insider trading on the ground that it is supposedly “unfair” for traders with nonpublic (i.e., “inside”) information to profit from it, when traders without this information cannot profit from it.

This justification fails. Part of the nature of a market economy is that experts can, and typically do, profit from their specialized knowledge. If I embark upon an occupation that I know nothing about — say, running a restaurant — I am likely to suffer substantial losses. These losses would result from the competition of other restaurants run by people who possess more

knowledge about the restaurant business than I do. No one thinks that the industry-specific knowledge possessed by experienced restaurateurs gives them any advantage that is *unfair*.

### **The benefits of insider trading**

Perhaps the greatest benefit of insider trading is that it causes equity prices to disclose all relevant information as quickly as possible. Take Martha Stewart's case.

The correct price of ImClone shares is one that reflects *all* relevant information. Insider trading brought this result about more quickly than otherwise would have been the case. The fact is, as soon as the FDA decided not to approve Erbitux, ImClone's true value fell. When Stewart sold her shares because of her inside knowledge, she helped to depress the market price of ImClone, causing it to reflect more accurately the firm's true value. Although the public didn't yet possess the specific knowledge that prompted Stewart's sales, investors lacking that knowledge caught a glimpse of it more quickly than they would have if Stewart had waited to sell. Public investors saw the price fall — that is, they saw reasonable evidence that something happened or was about to happen to make ImClone less profitable.

Reflecting as much information as possible is precisely what we want prices to do. (Explaining why this is so is one reason that F.A. Hayek won a Nobel Prize in economics.) When people trade on inside knowledge, they bring asset prices more quickly into line with underlying market conditions.

Another benefit of insider trading is that it lessens the need for corporate whistle blowers. The reason is that insiders who know that a corporation's management is engaged in accounting fraud or some other shenanigan that artificially gives a temporary boost to the firm's market value can benefit by selling the firm's shares short. If you had known in, say, October 2000 about the goings-on at Enron, wouldn't you have sold Enron shares then? Enron insiders knew that the company's share prices did not reflect the company's true, much-lower value. All it would have taken is just one or two such insiders to seek personal gain by selling their Enron shares (or by taking a short position in Enron shares) and investors worldwide would have learned much earlier that the company was nowhere near as valuable as it once seemed.

Another argument in favor of legalizing insider trading is the fact that *refraining from* buying or selling stock can be the result of inside information just as frequently as can active buying or selling, but there is no way to catch insiders who refrain from trading because of their inside information. So an inevitable unfairness afflicts the application of the prohibition on insider trading.

If insider trading were clearly harmful, tolerating this inescapable unfairness might be worthwhile. No law can be applied perfectly. But the case for keeping insider trading illegal is so

weak — and the case for repealing the current prohibition so powerful — that this unfairness only adds insult to injury.

Those who doubt the benefits of insider trading need not fear the less-restrictive regime proposed here. Corporations would obviously retain the right to not tolerate insider trading within their own company. If insider trading is as harmful to investors as some people believe, investors would flock to corporations promising such restrictions. By allowing insider-trading terms to be a dimension in which corporations compete for equity, we would more surely discover when, and just how, insider trading might be detrimental. But my guess is that few, if any, investors would demand such restrictions.

In 1966, Henry Manne, former dean of the law school at George Mason University, published a ringing defense of insider trading — and a damning indictment of government's attempt to prevent it. His book, *Insider Trading and the Stock Market*, remains the definitive treatment of this topic. Unfortunately, Manne's book is currently out of print. In the wake of the SEC's lawsuit and the Justice Department's indictment against Martha Stewart, perhaps she'll consider using part of her well-deserved fortune to bring it back into print. A new, updated edition could be part of a new line of her merchandise: books and other materials that are stylish yet functional at rescuing people from ill-informed or ill-intentioned politicians, bureaucrats, and lawyers.

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