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Insider Trading: Is There an Economist in the Room?

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Abstract
This paper examines economists' opinions on insider trading and their policy recommendations. We review the economic literature and survey 3,000 economists to ask them their thoughts on insider trading. We find that economists traditionally favor government regulation of insider trading. In addition, the results of our survey show that, when unfamiliar with insider trading, economists tend to rely on the more familiar model of the perfectly competitive market as a normative benchmark to assess the desirability of insider trading. As a result, these economists also tend to support government regulation of insider trading. Our analysis sheds a new light on the formation of economists' normative views. It also offers a possible explanation, complementing Public Choice models, for the origins and dynamics of the regulatory process.

JEL Codes: A11, K22
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I. Introduction

This paper investigates economists' opinions on insider trading. More particularly, it investigates the policy recommendations that economists give, with a special focus on whether insider trading should be regulated and whether the government should be the main force behind the regulation.

Insider trading is probably the most known and publicized white-collar crime. The media often depict the perpetrators, the insiders, as cutthroat, manipulative, greedy individuals. In addition, since the

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1930s, insider trading has been subject to ever-increasing attention on the part of the government. The Securities Exchange Commission, created in 1934 to regulate financial markets, has seen its budget dedicated to enforcing insider-trading laws increase exponentially. At the same time, Congress has supported imposing more and more severe sanctions against insider trading. By criminalizing insider trading and imposing monetary penalties as well as sanctions involving jail-time, the government has made this fight against insider trading a true "witch-hunt."[1]

On the other hand, not until 1966, when Henry Manne published his book, *Insider Trading and the Stock Market*, do we find some economic analysis of insider trading. In this book, Manne challenges the commonly accepted idea, at least among legal scholars, that insider trading should be prohibited. Manne's seminal work starts with a simple observation: No rigorous analysis of insider trading was ever done. According to Manne (1966b, p.113), economists did not pay attention to the issue, and lawyers were too incompetent to engage in a serious scientific analysis of the subject. There was a unanimous, dogmatic agreement among commentators, lawmakers, and policymakers that "insider trading is a sin, and the war against it is a holy one" (Manne, 1966b, p.113). *Insider Trading and the Stock Market* can be viewed as an attempt by Manne to put some sense and analytical rigor back into a debate in which "logic has been totally lost to emotion" (Manne, 1966b, p.113). As Bainbridge (2001, p.65) observes, "it is only a slight exaggeration to suggest that Manne stunned the corporate law academy by daring to propose deregulation of insider trading."

Whether we agree with Manne's arguments that insider trading ought to be deregulated for efficiency considerations, there is no doubt that his arguments are at the origin of the prolific debate that followed among lawyers, economists, financiers, and policy-makers. Moreover, the recurrent insider-trading scandals publicized in the media continue to fuel the seemingly endless debate.

At this point in time, it seems interesting to see what opinions economists have formed on insider trading. After all, as Manne argued, economists seem better equipped than others to analyze this

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[1] The reference to the continuous fight against insider trading to the point that it seems to have become an obsession for the government and the SEC as a "witch-hunt" is borrowed from Lemieux (1991).

issue, which receives a lot of attention from government officials, and is regularly the object of media attention every time a new major insider trading case arises. Therefore, if we agree that economists use the same set of analytical tools in their research, it seems reasonable to argue that they would be using these tools to form an opinion on insider trading when asked about it.

To examine what economists have to say on insider trading, we first review the economic literature and attempt to review the policy implications economists reach when they analyze insider trading. Second, we survey 3,000 economists and ask them to share their thoughts on insider trading.

In Section II, we present Manne's thesis regarding insider trading. In Section III, we review the literature and analyze the policy conclusions economists derive from their analysis. In Section IV, we discuss the results of a survey we conducted among economists. In Section V, we offer some concluding remarks.

II. *Insider Trading and the Stock Market:* Toward an Economic Analysis of Insider Trading

Manne's *Insider Trading and the Stock Market* (1966) can be viewed as the first attempt to develop an economic analysis of insider trading. His work rests on one big idea: A rigorous analysis of insider trading demonstrates that it is no longer certain that insider trading is harmful to society. Therefore, it does not necessarily follow that we should come down with "hobnail boots" on insiders, to use the expression that John Shad used when he took office in 1981 (Henry, 1986, quoting SEC chairman John Shad).

To support this idea, Manne advances two seminal arguments, which initiated the debate on insider trading. The first argument relies on the informational role of prices in improving capital market efficiency. The second argument relies on the entrepreneurial role played by corporate managers and how insider trading could be used to compensate those insiders for their entrepreneurial activities.[2]

Manne argues first that insiders trading on nonpublic material information contribute to improving the informational efficiency of stock prices. The argument recalls Hayek's (1945) "The Use of

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[2] Another argument advanced by Manne (1966a, 1966b, 2005) is that the practice of insider trading does not harm long-term investors, or, at least, not as much as "pure" speculators who try to "beat" the market.

Knowledge in Society."[3] Hayek believes that prices are crystallized pieces of local knowledge signaling to market participants where to allocate means of production. Similarly, securities prices could be seen as signal mechanisms to inform investors where to allocate the capital that will be used to produce the goods and services. The more accurate these prices are, the more likely it is that market participants will invest their capital in the correct lines of production. According to Manne, insiders, by trading on nonpublic material information, are going to contribute to moving securities prices toward their accurate value. Securities prices will move toward the value that market participants will give to the securities "if all information relating to the security had been publicly disclosed" as a result of the insider's trades (Bainbridge, 1999, p.777). Therefore, the investors benefit from this increased efficiency, as they will be more likely to invest their capital in lines of production that consumers value. Overall, the society at large benefits from insider trading.

Second, Manne argues that insider trading could be an efficient compensation scheme. More exactly, he argues that allowing trading on the information that the corporate entrepreneurs contribute to create would be an efficient way of compensating them. The profits realized through the use of the information these entrepreneurs produce acts as an immediate compensation for their entrepreneurial activities. In addition, as Manne (1966b, pp.117-118) explains, compared to other compensation schemes, insider trading is far superior to bonuses or stock options because price increases resulting from public disclosure of the information provides, even though imperfectly, a comparatively accurate measure of the value of the information created by the entrepreneur. By allowing the entrepreneur to profit from this information before it is disclosed to the general public, he can recover the value of his discovery. According to Manne (1966b, p.119), compensating entrepreneurs for their innovations by allowing them to inside trade will stimulate even more innovations on the part of these entrepreneurs.

As a result of Manne's work, a great deal of the literature including the legal, financial, and economic literature took the issue of insider trading and Manne's arguments very seriously and

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[3] Actually, Manne (2005) uses Hayek's seminal paper to justify this argument to deregulate insider trading.

attempted to find answers to the questions Manne raised. We now focus our attention on the economic literature on insider trading.

III. Economists and Insider Trading: A Review of the Literature

In our review of the economic literature on insider trading, we focus our attention on the literature that produces, more or less explicitly, normative implications. An article or book on insider trading is considered to be in the field of economics when at least one author is an economist (that is, the author's *curriculum vitae* states that the author has a Ph.D. in economics) or when the article is published in an economic journal.

There are both theoretical and empirical treatments of insider trading. In general, the economic literature attempts to answer, more or less directly, Manne's arguments. More particularly, the literature assesses the effects of insider trading to determine whether, as Manne argues, allowing insider trading is desirable from an efficiency viewpoint.

Demsetz (1969b, pp.11-16) addresses the issue of insider trading in his discussion of securities regulation. To the question as to whether insider trading should be policed, Demsetz (1969b, p.16) concludes:

> It seems unlikely that there are sizable efficiency gains, if there are any, from attempting to reduce the degree of insider trading. Moreover, the cost of enforcing a reduction in this practice would seem to be large. Again, from the viewpoint of efficiency, it would seem to be a mistake for the SEC or the taxpayer to attempt to eliminate this practice.

Carlton and Fischel (1983) investigate the various arguments why firms might want to allow managers to trade on inside information and why they might not. The analytical framework is a Coasian one. The authors see insider trading as problem of allocating property rights in valuable information to the highest-valuing user between the corporation's managers and its investors (Carlton and Fischel, 1983, p.863).

In a preliminary conclusion, Carlton and Fischel (1983, p.866) argue that:

> Our conclusion that a regulatory prohibition of insider trading (…) is unwarranted has relied heavily on the apparent lack of widespread attempts by firms to prohibit insider trading. …. No justification exists for precluding firms from contracting around a regulatory prohibition of insider trading.

However, Carlton and Fischel's conclusion is not an answer to the question of whether insider trading should be allowed or prohibited. While they spend some time analyzing the pros and cons of insider trading, the question they are trying to answer is whether the federal government should regulate insider trading. To the latter question, Carlton and Fischel (1983, p.895) answer that:

> Based on the available evidence (…), it appears that the allocation of the valuable property right in information would be better left to private negotiations and common law development.

Similar to Carlton and Fischel's analysis of insider trading, Haddock and Macey (1986) develop "a Coasian model of insider trading." This model examines whether shareholders would have incentives to adopt rules that would allocate the right to trade on inside information to insiders (Haddock and Macey, 1960, pp.1449-1450).

Haddock and Macey (1986, p.1450) expands on Carlton and Fischel's analysis in three ways: (1) they look at "how a competitive market for managers affects shareholder demands for an intrafirm rule constraining insider trading"; (2) they "examine the impacts of risk aversion and managerial preference for receiving income from insider trading as opposed to traditional forms of compensation"; and (3) they "consider the ramifications of both of these phenomena in light of the differing levels of information-processing ability among the shareholding population."

To their initial question as to "whether rational, value-maximizing shareholders would agree to permit insiders to trade on the basis of the nonpublic information that routinely comes into their possession," Haddock and Macey (1986, p.1467) answer: "it depends." According to Haddock and Macey (1986, pp.1467-1468), it depends on (1) whether insiders are risk averse and (2) "who stands in line after insiders as the second-best processors of information regarding the corporation?"

Haddock and Macey (1986, p.1468) find that their analysis:

> Leads to the conclusion that the legal prohibition against insider trading prevents shareholders from reaching compensation agreements with the managers of their firms that would make both sides better off. Thus, while insider trading law provide for centralized *monitoring* of insider activities, the per se prohibition on insider trading reflected in the current law seem deleterious to ordinary shareholders.

In other words, while Haddock and Macey do not go as far as arguing that insider trading should be allowed altogether, they seem to agree that corporations should be allowed to opt out of current restrictions if they believe they will be better off.

Some authors focused their attention toward Manne's first argument that insider trading improves the informational efficiency of capital markets. On this particular point, economists have difficulties in reaching a consensus. For example, theoretical papers such as Laffont and Maskin (1990) and Fishman and Hagerty (1992) argue that insider trading does not necessarily improve the efficiency of stock prices. Laffont and Maskin (1990, p.71) show that the insider will have incentives to ensure that his transactions do not reveal his private information to capture the maximum return from his informational advantage.

Similarly, Fishman and Hagerty (1992, p.107) show that "insider trading leads to less efficient stock prices" despite the fact that "with insider trading, the aggregate amount of information possessed by traders in the market is greater." Two adverse effects explain this paradox. First, the presence of insiders trading on inside information deters outside investors from acquiring information and trading. Second, as a result of insider trading, the information is not equally distributed across traders (Fishman and Hagerty, 1992, p.107).

These authors agree that insider trading does not always improve price efficiency. However, they do not necessarily reach the same conclusions with regard to the desirability of insider trading. On one hand, Laffont and Maskin are being careful not to make generalizations. As they argue, their "welfare conclusions are less likely to generalize" (Laffont and Maskin, 1990, p.87). They (Laffont and Maskin, 1990, pp.85-86) observe that, when investors have rational expectations, they clearly benefit from the presence of an insider, as if he were not allowed to trade on inside information, "they would be stuck holding all the risky asset themselves." In other words, as a result of insider trading, traders may actually be better off (Laffont and Maskin, 1990, pp.85-86).

On the other hand, Fishman and Hagerty (1992, pp.118-11) are more definitive in their conclusions:

> Fairness aside, the results of this article indicate that equal access may be important for reasons of stock price efficiency. These results stem from the deleterious effects of insider trading on the competitiveness of the securities market…. Therefore, under these circumstances, our results support the overall direction taken by case law in (i) limiting the scope of rule 10b-5 by not applying it to everyone, and (ii) expanding the scope of rule 10b-5 by applying to individuals who acquired their information solely because some fiduciary relationship, whether contractual, personal, or other, even if their relationship is not with marketplace traders.

Manove (1989) shows that "insider trading tends to discourage corporate investment and reduce the efficiency of corporate behavior" because "insider traders appropriate some part of the returns to corporate investments made at the expense of other shareholders" (Manove, 1989, p.823). However, while Manove argues that insider trading is harmful to securities markets, he refuses to offer some firm policy conclusions (Manove, 1989, p.843).

Following Manove, Ausubel (1990) focuses his attention on analyzing the effects that insider trading has on the confidence the public has in securities markets. The main purpose of his work is to use "the confidence rationale as an economic argument for insider trading regulation" (Ausubel, 1990, p.1022). According to Ausubel, if outsiders suspect that insiders trading on private information will take advantage of them, outsiders might choose to invest less. Consequently, insider trading should be banned because prohibiting insider trading would basically increase outside investment because outside investors will see their expected return on investment increase (Ausubel, 1990, pp.1022-1023).

Masson and Madhavan (1991) empirically assess the impact of insider trading on firm value and, more particularly, "whether insider trading by a firm's top (three to five) executives raises or lowers firm value" (Masson and Madhavan, 1991, p.334). Masson and Madhavan (1991, pp.349-350) find that insider trading is injurious to firm value. However, because firm value is tied to executives' performance, which is tied to their stockholdings, they argue that stiffening current insider trading laws may push executives to significantly reduce their stockholdings if their trading is restricted or is subject to close scrutiny. As a result, these laws designed to reduce insider trading may be injurious to firm value as well. In other words, insider trading does tend to be detrimental to firm value, but so may be the laws attempting to deter insider trading. Consequently, Masson and Madhavan (1991, p.350) ask:

> At a broader level the question arises as to whether external policy by a regulatory authority such as the S.E.C. is even necessary. The optimal level of insider trading may vary from firm to firm or industry to industry. Imposing a uniform standard may induce inefficiency, and it may be argued that the policing of insider trading is best left to the firm in question.

Leland (1992) investigates whether insider trading should be prohibited. He finds overall that liquidity traders are losing when insider trading is permitted because the market becomes less liquid. He also finds that outside investors are also hurt by insider trading, as it reduces their expected return even though their risks are reduced because insider trading makes prices more informative regarding risks. On the other hand, he finds that firm owners benefit from insider trading as the issuing price is, on average, higher (Leland, 1992, pp.883-884). However, Leland (1992, p.884) adds that, overall, the negative effects of insider trading will outweigh the positive effects.

Leland does not clearly say that insider trading should be prohibited. To the question that he asks in the title of his article, "Insider Trading: Should It Be Prohibited?" the conclusion should be read as him saying: "it depends but, in general, yes."

Bebchuk and Fershtman (1994) focus their attention on "the effects that insider trading possibly has on managers' choice among risky investment projects" by comparing "project choices that managers make under contracts that allow insider trading with those they make under contracts that prohibit such trading" (Bebchuk and Fershtman, 1994, p.2). Contrary to Easterbrook (1981, p.312) who argues that contractually allowing managers to trade on inside information will give them incentives to mismanage the firm to profit from short-swing stock prices by selecting projects riskier than shareholders would prefer, Bebchuk and Fershtman (1994, p.2) show that "insider trading is not necessarily harmful and can be a part of the optimal compensation scheme." However, they are careful not to be too categorical in their conclusions. Bebchuk and Fershtman (1994, p.3) also show that "the desire to increase trading profits might lead the managers to prefer a very risky project even if it offers a lower expected return than a safer alternative," and under certain circumstances the costs of insider trading might exceed the benefits. Therefore, from a normative perspective, they expect to see their findings used to determine "how much (if any) insider trading should be curtailed" (Bebchuk and Fershtman, 1994, p.3).

From an empirical perspective, Beny (2005; 2007a; 2008) investigates the effects of insider trading laws on market efficiency and liquidity within the spirit of a comparative institutional approach. She summarizes her findings in her testimony in front of the U.S. Senate Judiciary Committee in 2006 (U.S. Senate, 2007, p.55):[4]

> I find that countries with more stringent insider trading laws have more dispersed equity ownership; more liquid stock markets; and more informative stock prices...

Beny (U.S. Senate, 2007, pp.59-60) is careful to explain that her results are consistent with (*but do not prove*) the argument that stock markets benefit from insider-trading laws in the form of greater liquidity, lower cost of equity capital, and overall improvement of capital allocation. She concludes:

> The appropriate conclusion to reach from this research is not that the arguments of proponents of insider trading regulation have been proven to be sounder than the arguments of those who criticize such regulation, but rather

[4] See also Beny (2007b, pp.73-75).

> that there is greater reason to believe in their soundness than there was before this study was conducted. If insider-trading laws are detrimental, as Professor Manne and others have suggested, the patterns I find would have been improbable. (U.S. Senate, 2007, p.60)

Beny's results support the case for public regulation of insider trading. However, she is very careful not to argue that they prove causality and, contrary to most published research, she does not feel comfortable to confidently make any policy recommendations (Beny, 2005, p.176).

While the economic literature on insider trading is probably not as prolific as the financial or legal literature, we do not pretend we covered all the economic literature. Actually, it is most likely that we have only covered a very small fraction of what economists have written on insider trading. However, we have attempted to focus our attention on the literature where some policy implications are more or less explicitly pronounced.

Overall, it seems that the number of economists who agree that insider trading should be prohibited outweighs the number of economists who think insider trading should be deregulated.[5] It seems that, with the advancement and sophistication of economic tools, particularly econometric tools, in recent years, economists have progressively reached the same conclusion: that insider trading is harmful to investors, corporations, and stock exchanges, and, therefore, ought to be prohibited. Moreover, while this conclusion is not as clear, most of the economists who favor regulating insider trading also favor having the government being the main force behind the enforcement of insider trading laws.

IV. Surveying Economists on Insider Trading

We expanded our study to the general population of economists through a survey that we emailed to 4,459 economists using SurveyMonkey©. These economists were randomly selected from the American Economic Association directory by taking one name in

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[5] One should note that most economists are very cautious in their conclusions and always warn their readers that more research must be done. This "inability" of economists to pronounce clear conclusions might result from their fear of sounding too dogmatic or too politicized.

each column from alternating pages of the directory,[6] 50 preeminent American departments of economics, and the Federal Reserve Board. Of the 4,459 economists who were surveyed, only 228 economists completed the survey (5.1% return rate).[7]

Table 1: Surveying Professional Economists

Surveyed professional economists	N = 4459
Surveys bounced	N =822
Economists actually reached	N = 3637
Economists who opted out	N = 91
Surveys completed	N = 228 (6.27% return rate)

In addition to a few questions inquiring about what economists think of insider trading, we also tried to ascertain who the economists we interviewed are. So, we asked them: (1) what type of professional economists they are; (2) whether they list law and economics among their fields of expertise; and (3) whether they are familiar with Henry Manne's work on insider trading. A large majority of the respondents are academics (85.5%). The economists not listing law and economics as one of their fields of expertise were also prevalent (74.1%). In addition, 77.1% of the respondents said that they are not familiar with Henry Manne's work on insider trading. Finally, 95.5% of the respondents did not publish on insider trading.

A. Do Economists Think Like Economists? Some Basic Results

Our survey is articulated around one question: Do you think insider trading should be prohibited? It should be mentioned that, in the introduction to our survey, we informed surveyed economists that we were using a very generic definition of insider trading: "insider trading is trading in securities while in possession of material

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[6] We also selected people who are listed as residing in the United States. Obviously, there are some problems with the AEA directory, as some members are not economists or do not have an economics degree.

[7] Technically, the return rate is higher, as 91 economists signaled that they opted out of the survey, and 822 other economists' emails were either invalid or the survey email was rejected by the campus server. In other words, we actually reached 3,637 economists. By our approximate calculation, this increases our return rate to a little more than 6%.

nonpublic information." We also used a very loose definition of insiders "as individuals who have access or have been given access to inside information."[8] In addition, we asked economists to explain to us why they think insider trading ought to be prohibited and, more particularly, we asked them whether their answer is mostly influenced by the fact that they believe that "insider trading is inherently unfair (immoral, unethical) or insider trading is inefficient from an economic standpoint." Depending on their answer, we asked economists why they think that insider trading is immoral or inefficient. For the economists who answered that insider trading should be legalized, we asked them why. Finally, we asked the surveyed economists who they think "the decision to police insider trading should be left to." For each question, there were several possible answers that surveyed economists could choose when attempting to answer the question. It should be mentioned that when designing the survey we decided that the questions and their possible answers would be based on the ones we can find in the insider-trading literature. In other words, while we overlook other possible explanations or answers, these explanations and answers are not the ones we traditionally find in the literature.

Table 2:
Do Economists Think Insider Trading Should be Prohibited?

	Response Percent	Response Count
Yes	63.6%	145
No	22.4%	51
Sometimes	14.0%	32
	Answered Question	228

To the question of whether insider trading should be prohibited, as the results show, a majority of respondents answered that insider trading ought to be prohibited; only 22.4% thought that insider trading should *not* be prohibited. In addition, 14.0% of the respondents answered that insider trading should be prohibited

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[8] Obviously, from a legal perspective, the definitions of insider trading and insiders are more subtle and complex. Moreover, often the definition of what constitutes illegal insider trading and when an insider is guilty of such illegal insider trading has evolved through time following various Supreme Court decisions.

sometimes. Among the respondents who published on insider trading (10), 70% answered that insider trading should be prohibited, and the remaining 30% answered that insider trading should *not* be prohibited.

Table 3: Insider Trading Should Be Prohibited Because…

	Response Percent	Response Count
Insider trading is inherently unfair (immoral, unethical)	60.5%	107
Insider trading is inefficient from an economic standpoint	39.5%	70
	Answered Question	177
	Skipped Question	51

When asked whether their response is mostly influenced by moral or economic efficiency considerations economists' answers are somewhat surprising. As Table 3 shows, 60.5% of the respondents answered that they think that insider trading ought to be prohibited because it is inherently unfair. Only 39.5% answered that efficiency considerations guided their answers.[9] More importantly, when asked why insider trading is inherently unfair, 77.6% of the respondents answered that insider trading is unfair essentially because "it is based on informational disparity between insiders and the investors" (Table 4). More than half of the respondents also consider that insider trading amounts to a breach of fiduciary duty and/or the theft of valuable corporate information belonging to the corporation and its shareholders.

On the other hand, economists who opined that insider trading ought to be regulated because it is inefficient from an economic viewpoint, reach similar conclusions to the economic literature on insider trading. However, it seems that survey respondents see the inefficiency from insider trading as resulting more from the fact that insiders can undertake non-value maximizing decisions, as they can

[9] On the other hand, among the respondents who published on insider trading, 57.1% (4) of the respondents answered that their answer is guided by economic efficiency consideration, while 42.9% (3) of the respondents answered that their motivation was more ethical. Three respondents chose not to answer the question.

profit from short-term price swings (88.2%), than the fact that the presence of insider trading taking place on the market will tend to discourage non-insiders' investments in the market and, thus, will shrink the market and increase capital costs (64.5%) (Table 5).

Table 4: Insider Trading Is Immoral Because…

	Response Percent	Response Count
It is based on an informational disparity between insiders and investors	77.6%	83
It amounts to a breach of fiduciary duty	52.3%	56
It amounts to the misappropriation (theft) of valuable information about corporate plans that belongs to the corporation and its investors	56.1%	60
Answered question		107

Table 5: Insider Trading Is Economically Inefficient Because…

	Response Percent	Response Count
It discourages investors from investing in the stock market and, thus, decreases market liquidity and increases capital costs	64.5%	49
It generates agency problems and raises agency costs within the firm, that is, insider trading gives incentives to insiders (more particularly, managers) to make decisions not necessarily in the best interest of shareholders to profit from short-term stock price swings	88.2%	67
It raises bid-ask spread	14.5%	11
It enables individuals to manipulate stock prices	32.9%	25
Answered question		76

We also asked the economists who responded that insider trading should not be prohibited why it should be deregulated (Table 6). Of these economists, 82.4% answered that they think insider trading improves stock market (informational) efficiency, while 60.8% also answered that they think the costs of such laws exceed their benefits.

Table 6: Insider Trading Should Be Allowed Because…

	Response Percent	Response Count
Insider trading improves informational (market) efficiency	82.4%	42
Insider trading is an efficient compensation scheme for corporate manager	31.4%	16
Costs of insider-trading laws outweigh the benefits of such laws	60.8%	31
The question of insider trading is a contractual issue	51.0%	26
Answered question		51

Among the economists who answered that insider trading should be allowed, 51% also responded that insider trading is a contractual issue, leading to the interpretation that the decision to police insider trading should be left to the corporation and its investors. Part of our interpretation was confirmed by the results to our question: "Whether you believe insider trading should be prohibited or not, you ultimately think the decision to police insider trading should be left to…" (Table 7).

When asked who should police insider trading, 72.4% of the respondents answered that the government should police insider trading. However, because respondents could check multiple options, a large number of respondents also argued that the corporation and its investors along with stock exchanges should have a role in policing insider trading.

In an effort to identify more clearly where these answers are coming from, we applied several filters to our software, asking it to distinguish according to the answers (yes, no, or sometimes) given by the respondents who were asked if they think insider trading should be prohibited. As Table 8 shows, economists who are in favor of regulating insider trading traditionally favor the government as the main instrument when it comes to policing insider trading. On the other hand, respondents who are pro-insider trading tend to favor corporations and their investors and/or stock exchanges policing insider trading.

Table 7:
The Decision To Police Insider Trading Should Be Left To:

	Response percent	Response count
The corporation and its investors	43.4%	99
Stock exchanges	44.3%	101
The government[10]	72.4%	165
	Answered question	228

Table 8: Corporations, Stock Exchanges, or Government?
Who Should Police Insider Trading?

	Insider Trading Should Be Prohibited	Insider Trading Should Not Be Prohibited	Sometimes Insider Trading Should Be Prohibited
The corporation and its investors	28.3% (41)	80.4% (41)	53.1% (17)
Stock exchanges	44.8% (65)	39.2% (20)	50.0% (16)
The government	91.7% (133)	15.7% (8)	75.0% (24)
Answered question	145	51	32

Obviously, these statistics do not tell the entire story, which is why we offered surveyed economists the opportunity to provide additional comments.

[10] In the survey, the complete text of this option was: "The government because only the government can efficiently police insider trading because insider trading is difficult to monitor. The government benefits from economies of scale and have other monitoring and enforcement tools that firms or stock exchanges do not have at their disposal."

B. Additional Comments

Designing a survey always poses problems. More particularly, one cannot forget that the possible answers that people surveyed can choose when asked a question are, at best, proxies of what they actually would answer. The answers provided are the ones that the designer of the survey thinks people would consider when asked the question. Therefore, these answers might not be fully representative of what respondents would say if they were asked the question in person. To mitigate these problems, we allowed respondents to provide additional comments if they wished to. A few respondents gave us some interesting comments.

The respondents answering that insider trading should be prohibited because it is unfair added that the moral dimension was not completely detached (unrelated) from economic efficiency. More importantly, if the investors believe the market is not conforming to what they consider to be moral, investors will lose confidence in the market. As a result, they will refrain from participating in the market, thus making it more difficult for entrepreneurs to access the capital they need to start or expand their enterprises. Insider trading is seen as undermining the credibility of markets and thus negatively affects capital market development.[11]

Another question that received some interesting additional comments is the one on "who should police insider trading." Some comments show that although respondents do not necessarily believe that government is infallible, and while they might see some role for exchanges or corporations, they still believe that the government has disciplinary mechanisms that "that private operators don't possess,"

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[11] It is interesting to note that the economists making this argument assume implicitly that people generally assume, like they do, that insider trading is immoral. Therefore, if they, the economists who believe insider trading is immoral, would not invest in a market that allows insider trading (does not conform to the moral standard they think should be upheld), therefore, there is no reason to believe that people in general would. Obviously, there is a problem in the logic of this argument. People continue to invest in capital markets despite evidence that insider trading still takes place in these markets. Therefore, even if people think insider trading is immoral, it seems that they do not refrain from trading in these markets where insiders could potentially take advantage of their informational advantage and harm them. There are two potential explanations for this paradox. Either the investors do not really think insider trading is immoral, or they believe that the likelihood that they trade with an insider is very low, so they still invest in capital markets because the expected gains exceed the expected costs.

such as imposing criminal penalties and "imprisonment." To some extent, these comments complement Beny (2005, 2007a, and 2008), who suggests that public enforcement of insider trading laws is more effective than private enforcement would be.

C. Do Economists Think Like Economists? Part 2: Speculative Interpretations

The fact that almost two-third of the economists who completed our survey answered that they believe insider trading ought to be prohibited because of moral considerations is surprising. More surprising, however, is the answer that insider trading is immoral because, essentially, insiders have an informational advantage over other investors. Economics teaches us that uncertainty and informational advantages resulting from the division of labor are pervasive facts of markets, except for one market structure in which there is no uncertainty and, more importantly, there is no asymmetric information: the perfectly competitive market model.

In the perfectly competitive model, *all* market participants are equally informed regarding the decisions of the other market participants. In a transparent market, there is no asymmetric information or, in other words, *no* individual has an informational advantage over the other market participants. Textbook economics also argues that only perfectly competitive markets can be efficient. When one of the properties of the perfectly competitive model is no longer fulfilled (for example, when there is asymmetric information), textbook economics tells us that market efficiency breaks down and thus government should intervene to attempt to correct or, at least, mitigate these market "failures" through regulations and other mandates.

One might argue that attempting to explain why 77.6% of the respondents who answered that insider trading is unfair because insiders have an informational advantage over other traders (investors) is at best an exercise of pure speculation. However, given that the respondents are trained economists, one might speculate that the underpinnings of their beliefs may be rooted in their interpretation of the economic and possibly the ethical implications that they derive from the perfectly competitive market model.

If one defines fairness as the fact that market participants are being equally informed or, at least, that they have equal access to information, this definition is consistent with one of the defining properties of the perfectly competitive model. Consequently, if one believes that only a perfectly competitive market can be efficient and, from a strict economic viewpoint, efficiency should be the normative goal or, in other words, the perfectly competitive market model should be used as the normative benchmark against which every other type of market structure should be measured, it is not difficult to see how any deviation from the perfectly competitive market model, as is the case when an individual, such as an insider, has an informational advantage, could be judged as being not desirable. In other words, insider trading is unfair because it violates one of the properties necessary to achieve a perfectly competitive market. Only a perfectly competitive market can be efficient, and the unfairness of insider trading prevents capital markets from being perfectly competitive. Therefore, insider trading must be prohibited.

Another possible interpretation, not disconnected from the previous one, is that when confronted with complex issues, ambiguous from a moral and legal viewpoint and often not easy to understand, economists, like most people, will tend to use metaphors and similes to pronounce their normative conclusions (Cohen, 2003). A typical simile would be that investing in a stock market in which insider trading is present is like gambling in a casino where the roulette wheel is being rigged with a magnet or playing poker against a dealer who knows which card is coming because he marked them. In other words, insider trading is like cheating because an individual does not play by the rules of the game. Another simile compares insider trading to a sports contest in which some of players are using sport-enhancing drugs. Whether we use the sports contest or casino similes, the main idea is that when insider trading is present, the level playing field is being precluded. These metaphors and similes are often misleading (Cohen, 2003, p.361).[12] When used to solve complex and ambiguous issues, these metaphors and similes compare things that are not comparable because they result from a misunderstanding about the nature of markets and, in this case, of the capital markets.

Whether economists use sports contests, casino gambling, or the perfectly competitive market to derive their normative conclusions, the outcome is similar. It seems their analyses are flawed in the sense that they arise from a misunderstanding of the nature and functioning of market processes.

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[12] See also Sternberg (2000, p.190).

V. Concluding Remarks

Our analysis has three implications. The first implication is that the "nirvana approach" described by Demsetz (1969a, 1969b) is still being used by economists. Comparative institutional analysis is yet to be systematically used by economists, even when they address an issue with which they are not familiar.[13] Using the perfectly competitive market as a benchmark to assess the desirability of a state of affairs is not economically rigorous. Demsetz and Coase (1964) have warned against such dangerous pitfalls.

Second, our analysis can also explain why we observe more regulation instead of less. The solution to market anomalies is not less regulation but more regulation. While studies show that insider trading regulation is largely ineffective and does not discourage investors from trading on the basis of inside information when the opportunity presents itself, as illustrated by the many well-publicized insider-trading scandals through history, the main solution to insider trading is always further regulation. One can reasonably argue that insider trading should be policed because it generates negative externalities, increases capital costs, and reduces market liquidity. However, it does not follow that government regulation is the answer, nor does it mean that one should publicly or privately regulate insider trading if the costs of implementing and enforcing such regulation exceed its benefits.

A third implication is that our analysis opens the door for further research on the process through which a government regulation emerges and evolves. Several explanations have been advanced regarding why a regulation or a particular policy is being adopted. Public Choice models ground their explanations on powerful interest groups coupled with voters being rationally ignorant. Bryan Caplan's (2007) "anti-market bias" provides another interesting explanation of why "bad policies are being systematically chosen." Our analysis

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[13] Demsetz (1969a, 1969b) explains that practitioners of the "nirvana approach" use abstract constructions such as the perfectly competitive market model as a benchmark or norm to derive economic policy conclusions when real markets deviate from such ideal state of affairs. As Demsetz argues, using abstract models such as the perfect competition model is useful for analytical purposes to understand real world phenomena. However, using the perfectly competitive market model to derive normative conclusions, as practitioners of the "nirvana approach" do, is incorrect because the "nirvana approach is susceptible to committing serious logical fallacies. See also Coase (1964).

suggests that there might be a third, not competing, but rather complementary, explanation why some regulations and policies are being chosen over others: Policies and regulations are the products of similes and metaphors.

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