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# Ethics, Fairness and Efficiency in Financial Markets

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*Do prohibitions against insider trading hamper economic efficiency or promote fairness? Financial market regulations are the outcome of a continuous tug-of-war between concern for economic efficiency and concern for fairness. This is demonstrated by the histories of six major regulations and the forces that have affected changes in the tradeoff over time.*

*People often disagree about the relative weights that should be assigned to efficiency and fairness. They also disagree on the relative ranking of fairness rights. For example, prohibiting insider trading violates the right to engage freely in trade. Permitting legalized insider trading violates the right to equal information. Which right ranks higher?*

When laymen read newspaper accounts of insider trading, they think about *ethics*. When financial economists read about insider trading, they think about *efficiency*. The difference in perspectives usually translates into different prescriptions for public policy. What many financial economists seem to overlook is that the regulation of financial markets is shaped by considerations that go beyond efficiency or self-interest. These considerations include concern for ethics or fairness.

This article seeks to bridge the gap between the two perspectives as they meet in the arena of public policy. The regulation of financial markets in the United States cannot be understood without an appreciation of the continuous debate that has shaped it. Regulations are the outcome of a tug-of-war between efficiency and fairness, in which relative strength continually shifts from side to side.

This article describes the world of regulations as it is. Of course, not everyone agrees that the world should be as it is. Some people feel that too much emphasis is placed on fairness to the detriment of efficiency, while others feel that too little emphasis is placed on fairness and still others that some aspects of fairness are overemphasized at the expense of other aspects of fairness. We seek to illuminate the process by which a balance between fairness and efficiency is struck by the citizenry through the legislative process. The shaping of regulation is hardly confined to the history books. Serious debate is taking place today about stock market volatility, junk bonds and insider trading, and further debate is certain to continue.

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## FAIRNESS AND EFFICIENCY

What is fairness? One definition would hold that, in a fair market, all parties have equal access to information relevant to asset valuation, but are entitled to nothing more. This "mandatory disclosure" definition of fairness, however, cannot provide a framework for merit regulations, suitability regulations or margin regulations. A framework consistent with the reality of regulation requires a broader definition of fairness, as well as a classification of the various notions of fairness and efficiency that play a part in the debate.

*Efficiency* comes in two forms—Pareto efficiency and informational efficiency. *Pareto* efficiency exists when no other feasible allocation of resources and technology can improve one person's situation without harming that of another. Pareto efficiency ensures maximization of production by precluding the waste of resources. It also ensures that the riskiness of investment projects undertaken matches the attitudes of investors toward risk. Pareto efficiency does not imply, however, that investors make no mistakes. They might, for example, take on more risk than is objectively appropriate or overreact to information and cause security prices to be overly volatile.

*Informational* efficiency is achieved when all investors hold objective beliefs and information in common, so that competitive prices accurately reflect that information. Efficient prices provide proper guidance to entrepreneurs, managers and investors. By observing prices, managers can avoid projects with negative ex-