Chapter 10

ETHICAL DECISION-MAKING: CORPORATE GOVERNANCE, ACCOUNTING, AND FINANCE

CHAPTER OBJECTIVES

• After exploring this chapter, you will be able to:
  1. Explain the role of accountants and other professionals as “gatekeepers.”
  2. Describe how conflicts of interest can arise for business professionals.
  3. Outline the requirements of the Sarbanes-Oxley Act.
  4. Describe the COSO framework.
  5. Define the “control environment” and the means by which ethics and culture can impact that environment.
CHAPTER OBJECTIVES

6. Discuss the legal obligations of a member of a board of directors.
7. Explain the ethical obligations of a member of a board of directors.
8. Highlight conflicts of interest in financial markets and discuss the ways in which they may be alleviated.
9. Describe conflicts of interest in governance created by excessive executive compensation.
10. Define insider trading and evaluate its potential for unethical behavior.

PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• The watershed event that brought the ethics of finance to prominence at the beginning of the twenty-first century was the collapse of Enron Corporation and its accounting firm Arthur Andersen.

• The Enron case “has wreaked more havoc on the accounting industry than any other case in U.S. history,” including the demise of Arthur Andersen.

• The events that led to Enron’s demise brought into focus the necessity of the independence of auditors and the responsibilities of accountants like never before.

• Corporate governance has gained greater prominence since the early 1990s. It refers to the system by which business corporations are directed and controlled. These means that managers are accountable to:
  ➢ Owners
  ➢ Public interest or stakeholders
PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• Accounting is one of several professions that serve very important functions within the economic system itself.
  ➢ Even a staunch defender of free market economics such as Milton Friedman believes that markets can function effectively and efficiently only when certain rule-based conditions are met.
• It is universally recognized that markets must function within the law and they must be free from fraud and deception.
  ➢ Some argue that only government regulation can ensure that these rules will be followed.
  ➢ Others argue that enforcement of these rules is the responsibility of important internal controls that exist within market-based economic systems.

PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• Important business professions—attorneys, auditors, accountants, and financial analysts—can be thought of as “gatekeepers” or “watchdogs”
  ➢ Their role is to ensure that those who enter into the marketplace are playing by the rules and conforming to the very conditions that ensure the market functions as it is supposed to function.
  ➢ Roles provide a source for rules from which we can determine how professional ought to act. In entering into a profession, we accept responsibilities based on our roles.
  ➢ These professions can also be understood as intermediaries, acting between the various parties in the market, and they are bound to ethical duties in this role as well.
PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• All the participants in the market, especially investors, boards, management, and bankers, rely on these gatekeepers.
  ➢ Auditors verify a company’s financial statements so that investors’ decisions are free from fraud and deception.
  ➢ Analysts evaluate a company’s financial prospects or creditworthiness, so that banks and investors can make informed decisions.
  ➢ Attorneys ensure that decisions and transactions conform to the law.
  ➢ Boards function as intermediaries between a company’s stockholders and its executives and should guarantee that executives act on behalf of the stockholders’ interests.

PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• The most basic ethical issue facing professional gatekeepers and intermediaries in business contexts involves conflicts of interest.
  ➢ A conflict of interest exists where a person holds a position of trust that requires that she or he exercise judgment on behalf of others, but where her or his personal interests and/or obligations conflict with those of others.
  ➢ Conflicts of interest can also arise when a person’s ethical obligations in her or his professional duties clash with personal interests.
  ➢ Gatekeepers are said to have fiduciary duties—a professional and ethical obligation—to their clients, duties that override their own personal interests.
PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

- Many professional intermediaries are paid by the businesses over which they keep watch, and are also employed by yet another business.
  - For example, David Duncan was the principal accounting professional employed by Arthur Andersen and assigned to work at Enron. As the Arthur Andersen case so clearly demonstrated, this situation can create real conflicts between a professional’s responsibility and his or her financial interests.
  - Real and complex conflicts can exist between professional duties and a professional’s self-interest.

FIGURE 10.1 - CONFLICTS OF INTEREST IN PUBLIC CPA ACTIVITY
PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• In one sense, the ethical issues regarding such professional responsibilities are clear.
  ➢ Because professional gatekeeper duties are necessary conditions for the fair and effective functioning of economic markets, they should trump other responsibilities to one’s employer.
  ▪ David Duncan’s professional responsibilities as an auditor should have overridden his role as an Andersen employee in large part because he was hired as an auditor. But knowing one’s duties and fulfilling those duties are two separate issues.

PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• Agency responsibilities generate many ethical implications.
  ➢ If we recognize that the gatekeeper function is necessary for the very functioning of economic markets, and if we also recognize that self-interest can make it difficult for individuals to fulfill their gatekeeper duties, then society has a responsibility to create institutions and structures that will minimize these conflicts.
  • From the perspective of social ethics, certain structural changes would be an appropriate response to the accounting scandals of recent years.
  • For example, as long as auditors are paid by the clients on whom they are supposed to report, there will always be an apparent conflict of interest between their duties as auditors and their personal financial interests. This conflict is a good reason to make structural changes in how public accounting operates. Perhaps boards rather than management ought to hire and work with auditors since the auditors are more likely reporting on the management activities rather than those of the board. Perhaps public accounting somehow ought to be paid by public fees. Perhaps legal protection or sanctions ought to be created to shield professionals from conflicts of interests. These changes would remove both the apparent and the actual conflicts of interest created by the multiple roles—and therefore multiple responsibilities—of these professionals.
PROFESSIONAL DUTIES AND CONFLICTS OF INTEREST

• Perhaps the most devastating aspect of the banking industry meltdown of the first decade of this Century was the resulting deterioration of trust that the public has in the market and in corporate America.
  ➢ Decision makers in large investment banks and other financial institutions ignored their fiduciary duties in favor of personal gain, a direct conflict of interest leading not only to extraordinary personal ruin but also to the demise of some of the largest investment banks in the world.
• The fact is that major federal legislation enacted after Enron to provide regulatory checks on such behavior failed to prevent it from happening.

• Critics contend that government regulatory rules alone will not rid society of the problems that led to this tragedy.
  ➢ They argue that extraordinary executive compensation and conflicts within the accounting and financial industries have created an environment where the watchdogs have little ability to prevent harm.
    ▪ Executive compensation packages based on stock options create huge incentives to artificially inflate stock value.
    ▪ Changes within the accounting industry stemming from the consolidation of major firms and avid “cross-selling” of services such as consulting and auditing within single firms have virtually institutionalized conflicts of interest.
Effective Corporate Governance

1. Create a climate of trust and candor
2. Foster a culture of open dissent
3. Mix up roles
4. Ensure individual accountability
5. Let the Board assess leadership talent
6. Evaluate the Board’s performance
   • Corporate governance is about managers fulfilling a fiduciary responsibility to the owners of their companies
   • Fiduciary responsibility - based on trust
   • Key Safeguards
     ➢ Properly constituted boards
     ➢ Separation of the functions of chairperson and CEO
     ➢ Audit committees
     ➢ Vigilant shareholders
     ➢ Financial reporting and auditing systems
THE SARBANES-OXLEY ACT OF 2002

• Because reliance on corporate boards to police themselves did not seem to be working, Congress passed the Public Accounting Reform and Investor Protection Act of 2002, commonly known as the Sarbanes-Oxley Act, which is enforced by the Securities and Exchange Commission (SEC).
  ➢ The act applies to over 15,000 publicly held companies in the United States and some foreign issuers.
  ➢ In addition, a number of states have enacted legislation similar to Sarbanes-Oxley that apply to private firms.
  ➢ Some private for-profts and nonprofits have begun to hold themselves to Sarbanes-Oxley standards even though they are not necessarily subject to its requirements.

THE SARBANES-OXLEY ACT OF 2002

• Sarbanes-Oxley strived to respond to the scandals by regulating safeguards against unethical behavior.
• Because one cannot necessarily predict each and every lapse of judgment, no regulatory “fix” is perfect. However, the act is intended to provide protection where oversight did not previously exist.
• Sarbanes-Oxley seeks to provide oversight in terms of direct lines of accountability and responsibility.
• The following provisions have the most significant impact on **corporate governance** and boards:
  - Section 201: Services outside the scope of auditors—prohibits various forms of professional services that are determined to be consulting rather than auditing.
  - Section 301: Public company audit committees (requires independence), mandating majority of independents on any board (and all on audit committee) and total absence of current or prior business relationships.
  - Section 307: Rules of professional responsibility for attorneys—requires lawyers to report concerns of wrongdoing if not addressed.

• Sarbanes-Oxley includes requirements for certification of the documents by officers. When a firm’s executives and auditors are required to literally sign off on these statements, certifying their veracity, fairness, and completeness, they are more likely to personally ensure their truth.
THE SARBANES-OXLEY ACT OF 2002

• One of the most significant criticisms of the act is that it imposes extraordinary financial costs on the firms—the costs are apparently even higher than anticipated.
  ➢ In response, one year after its implementation, in May 2005, the Public Company Accounting Oversight Board (PCAOB) released a statement publicly acknowledging the high costs and issuing guidance for implementation “in a manner that captures the benefits of the process without unnecessary and unsustainable costs.”
  ➢ The PCAOB now advocates a more risk-based approach where the focus of internal audit assessments is better aligned with high-risk areas than those with less potential for a material impact.

THE INTERNAL CONTROL ENVIRONMENT

• Sarbanes-Oxley and the European Union 8th Directive are external mechanisms that seek to ensure ethical corporate governance, but there are internal mechanisms as well.
  ➢ One way to ensure appropriate controls within the organization is to utilize a framework advocated by the Committee of Sponsoring Organizations (COSO).
  ▪ COSO is a voluntary collaboration designed to improve financial reporting through a combination of controls and governance standards called the Internal Control—Integrated Framework.
  ▪ It was established in 1985 by five of the major professional accounting and finance associations, originally to study fraudulent financial reporting and later to develop standards for publicly held companies.
COSO describes “control” as encompassing “those elements of an organization that, taken together, support people in the achievement of the organization’s objectives.”

The elements that comprise the control structure are also the essential elements of culture. They include:

- **Control environment** —the tone or culture of a firm: “the control environment sets the tone of an organization, influencing the control consciousness of its people.”
- **Risk assessment** —risks that may hinder the achievement of corporate objectives.
- **Control activities** —policies and procedures that support the control environment.
- **Information and communications** —directed at supporting the control environment through fair and truthful transmission of information.
- **Ongoing monitoring** —to provide assessment capabilities and to uncover vulnerabilities.

**Control environment** refers to cultural issues such as integrity, ethical values, competence, philosophy, operating style.

COSO is one of the first efforts to address corporate culture in a quasiregulatory framework in recognition of its significant impact on the satisfaction of organizational objectives.

Control environment can also refer to more concrete elements (that can better be addressed in an audit) such as the division of authority, reporting structures, roles and responsibilities, the presence of a code of conduct, and a reporting structure.
TABLE 10.1 - COSO DEFINITION OF INTERNAL CONTROL

Internal control is a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

**Key Concepts**

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is affected by people. It’s not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

THE INTERNAL CONTROL ENVIRONMENT

- The COSO standards for internal controls moved audit, compliance, and governance from a numbers orientation to concern for the organizational environment.
- In recognition of the interplay between the COSO control environment and the Sarbanes-Oxley requirements, it is critical to influence the culture in which the control environment develops in order to impact both sectors of this environment described above.
  - All the controls one could implement have little value if there is no unified corporate culture to support it or mission to guide it.
THE INTERNAL CONTROL ENVIRONMENT

- More recently, COSO developed a new system, Enterprise Risk Management—Integrated Framework, to serve as a framework for management to evaluate and improve their firms’ prevention, detection, and management of risk.
  - This system expands on the prior framework in that it intentionally includes “objective setting” as one of its interrelated components, recognizing that both the culture and the propensity toward risk are determined by the firm’s overarching mission and objectives.
  - Enterprise risk management assists an organization or its governing body in resolving ethical dilemmas based on the firm’s mission, its culture, and its appetite and tolerance for risk.

LEGAL DUTIES OF BOARD MEMBERS

- The law imposes three clear duties on board members, the duties of care, good faith, and loyalty.
- The duty of care involves the exercise of reasonable care by a board member to ensure that the corporate executives with whom she or he works carry out their management responsibilities and comply with the law in the best interests of the corporation.
  - Directors are permitted to rely on information and opinions only if they are prepared or presented professionals the director believes to be reliable and competent in the matters presented.
  - Board members are directed to use their “business judgment as prudent caretakers.” The bottom line is that a director does not need to be an expert or actually run the company!
LEGAL DUTIES OF BOARD MEMBERS

• The **duty of good faith** is one of obedience, which requires board members to be faithful to the organization’s mission.
  - In other words, they are not permitted to act in a way that is inconsistent with the central goals of the organization.
  - Their decisions must always be in line with organizational purposes and direction, strive towards corporate objectives, and avoid taking the organization in any other direction.

LEGAL DUTIES OF BOARD MEMBERS

• The **duty of loyalty** requires faithfulness—a board member must give undivided allegiance when making decisions affecting the organization.
  - This means that conflicts of interest are always to be resolved in favor of the corporation.
  - A board member may never use information obtained through her or his position as a board member for personal gain, but instead must act in the best interests of the organization.
• Board member conflicts of interest present issues of significant challenges, however, precisely because of the alignment of their personal interests with those of the corporation.
LEGAL DUTIES OF BOARD MEMBERS

• The Federal Sentencing Guidelines (FSG), promulgated by the United States Sentencing Commission and discretionary in nature offer boards some specifics regarding ways to mitigate eventual fines and sentences in carrying out these duties by paying attention to ethics and compliance.
  ➢ In particular, the board must work with executives to analyze the incentives for ethical behavior.
  ➢ It must also be truly knowledgeable about the content and operation of the ethics program.
    • “Knowledgeable” would involve a clear understanding of the process by which the program evolved, its objectives, its process and next steps, rather than simply the mere contents of a training session.

LEGAL DUTIES OF BOARD MEMBERS

• The FSG suggest that the board exercise “reasonable oversight” with respect to the implementation and effectiveness of the ethics/compliance program by ensuring that the program has:
  ➢ adequate resources,
  ➢ appropriate level of authority,
  ➢ and direct access to the board.
BEYOND THE LAW, THERE IS ETHICS

- One question we would expect the law to answer, but that instead remains somewhat unclear, is whom the board represents. Who are its primary stakeholders?
  - By law, the board of course has a fiduciary duty to the owners of the corporation—the stockholders.
  - However, many scholars, jurists, and commentators are not comfortable with this limited approach to board responsibility and instead contend that the board is the guardian of the firm’s social responsibility as well.

BEYOND THE LAW, THERE IS ETHICS

- Some executives may ask whether the board even has the legal right to question the ethics of its executives and others.
  - The board can prohibit actions to protect the long-term sustainability of the firm.
  - Unethical acts can negatively impact stakeholders such as consumers or employees, who can, in turn, negatively impact the firm, which could eventually lead to a firm’s demise.
  - It is in fact the board’s fiduciary duty to protect the firm and, by prohibiting unethical acts, it is doing just that.
BEYOND THE LAW, THERE IS ETHICS

➢ Though our rules and processes offer guidance in terms of corporate decision making from a teleological, utilitarian perspective, if corporate executives breach common principles of decency and respect for human dignity, society will exact a punishment, nonetheless.
➢ A board has an obligation to hold its executives to this higher standard of ethics rather than simply following the legal rules.

BEYOND THE LAW, THERE IS ETHICS

➢ Board members should also be critical in their inquiries about corporate vulnerabilities—what could drag the firm down and what could competitors do to help it along that path?
➢ Board members need to understand where the company is heading and whether it is realistic that it will get there.
➢ Failing in any of these areas creates pressures on the firm and on the board to take up the slack, to manage problems that do not have to exist, to be forced to make decisions that might not have had to be made if only the information systems were working as they should.
➢ It is the board members’ ultimate duty to provide oversight, which is impossible without knowing the answers to the above questions.
CONFLICTS OF INTEREST IN ACCOUNTING AND THE FINANCIAL MARKETS

- Conflicts of interest extend beyond the board room and executive suite throughout the financial arena. In fact, trust is an integral issue for all involved in the finance industry.
  - There is no real, tangible product to sell, nor is there the ability to “try before you buy.” Therefore, treating clients fairly and building a reputation for fair dealing may be a finance professional’s greatest assets.
  - Conflicts—real or perceived—can erode trust, and often exist as a result of varying interests of stakeholders.

CONFLICTS OF INTEREST IN ACCOUNTING AND THE FINANCIAL MARKETS

- In a standard business textbook, you might find the following definition of accounting: “the process by which any business keeps track of its financial activities by recording its debits and credits and balancing its accounts.”
  - Accounting offers us a system of rules and principles that govern the format and content of financial statements.
  - Accounting, by its very nature, is a system of principles applied to present the financial position of a business and the results of its operations and cash flows.
  - It is hoped that adherence to these principles will result in fair and accurate reporting of information.
• Linking public accounting activities to those conducted by investment banks and securities analysts creates tremendous conflicts between one component’s duty to audit and certify information with the other’s responsibility to provide guidance on future prospects of an investment.

• The ethical issues and potential for conflicts surrounding accounting practices go far beyond merely combining services.
  ➢ They may include underreporting income, falsifying documents, allowing or taking questionable deductions, illegally evading income taxes, and engaging in fraud.

• In order to prevent accountants from being put in these types of conflicts, the American Institute of CPAs publishes professional rules.

• In addition, accounting practices are governed by generally accepted accounting principles (GAAP) established by the Financial Accounting Standards Board that stipulate the methods by which accountants gather and report information.
CONFLICTS OF INTEREST IN ACCOUNTING AND THE FINANCIAL MARKETS

• However, the International Accounting Standards Committee, working with the U.S. SEC, is in the process of creating “convergence” between the International Financial Reporting Standards and the GAAP, with compliance required by 2009.

• Accountants are also governed by the American Institute of Certified Public Accountants’ (AICPA) Code of Professional Conduct.
  ➢ The code relies on the judgment of accounting professionals in carrying out their duties rather than stipulating specific rules.

• But can these standards keep pace with readily changing accounting and financing activities in newly emerging firms?

CONFLICTS OF INTEREST IN ACCOUNTING AND THE FINANCIAL MARKETS

• Scholar Kevin Bahr identifies a number of causes for conflicts in the financial markets that may or may not be resolved through simple rule-making:
  ➢ The financial relationship between public accounting firms and their audit clients.
  ➢ Conflicts between services offered by public accounting firms.
  ➢ The lack of independence and expertise of audit committees.
  ➢ Self-regulation of the accounting profession.
  ➢ Lack of shareholder activism.
  ➢ Short-term executive greed versus long-term shareholder wealth.
  ➢ Executive compensation schemes.
  ➢ Compensation schemes for security analysts.
EXECUTIVE COMPENSATION

- Few areas of corporate governance and finance have received as much public scrutiny in recent years as executive compensation.
- A *Fortune* cover exclaimed: “Inside the Great CEO Pay Heist,” and the article inside detailed how many top corporate executives now receive “gargantuan pay packages unlike any seen before.”
- In the words of *Fortune*’s headline: “Executive compensation has become highway robbery—we all know that.”

FIGURE 10.2 – CUMULATIVE % CHANGE IN ECONOMIC INDICATORS, FROM 1990
EXECUTIVE COMPENSATION

• It is relevant to note that CEO pay and the S&P 500 Index seem to follow similar trajectories.
  ➢ One might expect something along these lines since “pay for performance” is often based on stock price as one element of measurable performance.
  ➢ However, notice that actual corporate profits, not to mention worker pay, have not increased at the same rate as CEO pay.
  ➢ This lack of balance in the distribution of value has led to the perception of unfairness with regard to executive compensation.

EXECUTIVE COMPENSATION

• Skyrocketing executive compensation packages raise numerous ethical questions.
  ➢ Greed and avarice are the most apt descriptive terms for the moral character of such people from a virtue ethics perspective.
  ➢ Fundamental questions of distributive justice and fairness arise when these salaries are compared to the pay of average workers or to the billions of human beings who live in abject poverty on a global level.
Beyond issues of personal morality and economic fairness, excessive executive compensation practices also speak to significant ethical issues of corporate governance and finance. In theory, lofty compensation packages are thought to serve corporate interests in two ways.

- They provide an incentive for executive performance (a consequentialist justification).
- They serve as rewards for accomplishments (a deontological justification).
- In terms of ethical theory, they have a utilitarian function when they act as incentives for executives to produce greater overall results, and they are a matter of ethical principle when they compensate individuals on the basis of what they have earned and deserve.

In practice, reasonable doubts exist about both of these rationales.

- First, there is much less correlation between pay and performance than one would expect. At least in terms of stock performance, executives seem to reap large rewards regardless of business success.
- More to the point of governance, there are several reasons why excessive compensation may evidence a failure of corporate boards to fulfill their fiduciary duties.
  - First, the fact that in many cases there is no correlation between executive compensation and performance.
  - Second, there is also little evidence that the types of compensation packages described above are actually needed as incentives for performance.
The fiduciary duty of boards ought to involve approving high enough salaries to provide adequate incentive, but not more than what is needed.

Another crucial governance issue is the disincentives that compensation packages, and in particular the heavy reliance on stock options, provide.

- When executive compensation is tied to stock price, executives have a strong incentive to focus on short-term stock value rather than long-term corporate interests.

One of the fastest ways to increase stock price is through layoffs of employees. This may not always be in the best interests of the firms.

Further, a good case can be made that stock options have also been partially to blame for the corruption involving managed earnings.

- When huge amounts of compensation depend on quarterly earning reports, there is a strong incentive to manipulate those reports in order to achieve the money.
• Excessive executive compensation can involve a variety of conflicts of interests and cronyism.
  ➢ The board’s duties should include ensuring that executives are fairly and not excessively paid.
  ➢ They also have a responsibility to evaluate the executive’s performance.
  ➢ However, all too often, the executive being evaluated and paid also serves as chair of the board of directors.
    ▪ The board is often comprised of members hand-selected by the senior executives.
    ▪ In addition, the compensation board members receive is determined by the chief executive officer, creating yet another conflict of interest.

• The cronyism does not end at the boardroom door.
• One of the larger concerns to have arisen in recent years has been the cross-fertilization of boards.
  ➢ The concern spawned a Web site called www.theyrule.net, which allows searching for links between any two given companies.
  ➢ A search for a connection, for instance, between Coca-Cola and PepsiCo uncovers within seconds the fact that PepsiCo board member Robert Allen sits on the Bristol-Myers Squibb board alongside Coca-Cola board member James D. Robinson III.
  ➢ Though sitting on a board together does not necessarily mean Pepsi’s board member will gain access to Coke’s secret recipe, it does lend itself to the appearance of impropriety and give rise to a question of conflicts.
**EXECUTIVE COMPENSATION**

- Cronyism or basic occurrences of overlapping board members might occur simply because particular individuals are in high demand as a result of their expertise.
- However, where the overlap results in a failure of oversight and effective governance—the primary legal and ethical responsibility of board members—the implications can be significant to all stakeholders involved.

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**INSIDER TRADING**

- No discussion of the ethics of corporate governance and finance would be complete without consideration of the practice of **insider trading** by board members, executives, and other insiders.
- The definition of insider trading is trading by shareholders who hold private inside information that would materially impact the value of the stock and that allows them to benefit from buying or selling stock.
  - Illegal insider trading also occurs when corporate insiders provide “tips” to family members, friends, or others and those parties buy or sell the company’s stock based on that information.
  - “Private information” would include privileged information that has not yet been released to the public.
INSIDER TRADING

The Securities and Exchange Commission has treated the detection and prosecution of insider trading violations as one of its enforcement priorities because insider trading undermines investor confidence in the fairness and integrity of the securities markets.

Insider trading may also be based on a claim of unethical misappropriation of proprietary knowledge—knowledge only those in the firm should have, knowledge owned by the firm and not to be used by abusing one’s fiduciary responsibilities to the firm.

- The law surrounding insider trading therefore creates a responsibility to protect confidential information, proprietary information, and intellectual property.

- Misappropriation of confidential information undermines the trust necessary to the proper functioning of a firm and is unfair to others who buy the stock.

- One might make the argument that, in the long run, insider trading is not so bad since the inside information will be discovered shortly and the market will correct itself.
  - This contention does not take account of the hurt to those who completed the original transactions in a state of ignorance.

- Insider trading is considered patently unfair and unethical since it precludes fair pricing based on equal access to public information.

- If market participants know that one party may have an advantage over another via information that is not available to all players, pure price competition will not be possible and the faith upon which the market is based will be lost.
On the other hand, trading on inside information is not without its ethical defense.

- If someone has worked very hard to obtain a certain position in a firm and, by virtue of being in that position, the individual is privy to inside information, isn’t it just for that person to take advantage of the information since she or he has worked so hard to obtain the position?
- No legal rules exist other than traditional SEC rules on insider trading, but is there not something about this that simply feels “wrong?”

Can the SEC truly police all inappropriate transactions?

Is there a sufficient deterrent effect to discourage insider trading in our markets today? If not, what else can or should be done? Or, to the contrary, is this simply the nature of markets, and those who have found access to information should use it to the best of their abilities?

What might be the consequences of this latter, perhaps more Darwinian, approach to insider trading, and whose rights might be violated if we allow it.

**Review Questions:**
1. Discuss the professional duties and conflict of interests of important business professions.
2. Discuss the legal duties of board members.