Fair Trading

by

Meir Statman
Glenn Klimek Professor of Finance
Santa Clara University
Leavey School of Business
Santa Clara, CA 95053
mstatman@scu.edu

April 2005

Fair trading
Abstract

When we talk about ethics we often talk about fairness. What are the rules of fairness that govern financial trading?

Social norms, including rules of fairness, are rules of behavior that are enforced by the community and often make their way into law. Community rules of fairness in financial trading are important to all people since financial markets plays an important part in the economy but they are especially important to investors, both insiders and outsiders, to executives, to investment professionals, to students who plan to become executives or investment professionals, and to regulatory agencies, such as the SEC.

I use surveys to elicit rules of fairness from two segments of the community, investment professionals and students. I find that rules of fairness allow one trader to gain advantage over another with information obtained with research, skill or even luck, but they do not allow one trader to gain advantage over another with information, such as inside information, that other traders cannot obtain with research or skill. I find that rules of fairness place special burdens on traders who are well-off and traders who have sure information and that rules of fairness for trading stocks are different from rules of fairness for trading other goods, such as automobiles. I also find differences between the perception of rules of fairness by investment professionals and students.

Fair Trading

"Buffett's Reputation May Be Tested" is the title of a Wall Street Journal article by Jesse Eisinger (2005). Did Warren Buffett know about the role of General Re, one of Berkshire Hathaway's insurance units, in a transaction that helped AIG, another insurance company, distort its accounting? asked Eisinger. He noted that:

> Although he has always been mindful of being ethical, Berkshire Hathaway isn't a charity. Mr. Buffett made his fortune by acting in his economic interest when others were not. When investors were panicked or faddish, he was taking advantage.

And went on to ask:

> What are the ethics of conducting a transaction that isn't in the counterparty's economic interests?

When we talk about ethics we often talk about fairness. What are the rules of fairness that govern transactions that are not in the counterparty's economic interests? Was Buffett fair when he bought from investors who were panicked and sold to investors who were faddish? Does the judgment of fairness depend on whether Buffett was guided into his transactions by inside information or merely by smart analysis of public information? Does it depend on whether Buffett had sure information or only probabilistic information? Does it depend on the fact that Buffett is a very wealthy man? These are the kind of questions we seek to answer in this paper.

Social norms, including rules of fairness, are rules of behavior that are enforced by the community and often make their way into law. Community rules of fairness in financial trading are important to all people since financial markets plays an important part in the economy but they are especially important to investors, both insiders and

outsiders, to executives, to investment professionals, to students who plan to become executives or investment professionals, and to regulatory agencies, such as the SEC.

As Statman (2004) noted, rules of fairness in the financial markets are an outcome of a process that involves the entire community, not finance professionals alone, and many in the community hold beliefs that are radically different from those of finance professionals. Finance professionals who fail to understand and follow community rules of fairness take risks they would be wise to avoid.

People who violate rules of fairness that are enshrined in the law are punished according to the law, but people who violate rules of fairness that are not enshrined in the law do not escape punishment. Their punishment ranges from injury to their reputation to loss of career and social shunning.

Consider the story of Eric Corrigan and Thomas Chen, two senior Bank of America investment bankers. The two learned from Thomas Heath, a J.P. Morgan investment banker who was to take a position at Bank of America, that J.P. Morgan was advising Hibernia in merger talks with BancOne. Mr. Chen called a person he knew at BancOne to ask if there might be a role for Bank of America in the deal. Thomas (2005) wrote that sometime later Chen and Corrigan

> were summoned to a meeting … where their boss, visibly uncomfortable and flanked by bank lawyers, read them a statement. They were both dismissed and asked to leave the building immediately. The decision was final. Stunned, the bankers asked if they had broken any regulations. No, they were told. Nor had they traded on any inside information.

Thomas went on to note how changes the business and social environment affected the bankers' fate.

> In a different era, [acting on a tip from a rival banker] might well have been seen as an example of what hungry bankers do to secure an edge with a client and maybe even a better bonus -- not an inappropriate use of confidential information and cause for termination.
>
> But with regulatory scrutiny heightened after the collapse of Enron and other companies, corporations and their boards are adopting zero-tolerance policies. Increasingly, they are holding their employees to lofty standards of business and personal behavior.

And Thomas noted the severity of the punishment meted out to Chen and Corrigan.

> While Mr. Corrigan and Mr. Chen both realize that they may never work on Wall Street again, they said they were determined to at least make it clear that they were men to be trusted.
>
> "I just need to restore my integrity," Mr. Corrigan said. "I want to be able to look into my kids' eyes and tell them I didn't do anything wrong."

Sometime people violate rules of fairness when the benefits derive from such violations seem to exceed their costs. This is likely be the case of executives at AIG who used insurance instruments to mask the absence of adequate reserves. But at other times people violate rules because to fail to perceive the rules or understand them. This seems to be the case of the two Bank of America bankers who failed to perceive the change in rules as the boom of the late 1990s gave way to the bust of the early 2000s. Formal surveys of perceptions of fairness in the wider community are useful because they take finance professionals out of their cocoon, inform them of the perceptions of the wider community and alert them to charges in those perceptions.

I use surveys to elicit rules of fairness from two segments of the community, investment professionals and students. I find that rules of fairness allow one trader to gain advantage over another with information obtained with research, skill or even luck,

but they do not allow one trader to gain advantage over another with information, such as inside information, that other traders cannot obtain with research or skill. I find that rules of fairness place special burdens on traders who are well-off and traders who have sure information and that rules of fairness for trading stocks are different from rules of fairness for trading other goods, such as automobiles. I also find differences between the perception of rules of fairness by investment professionals and students.

Some transactions, such as those involving price gouging, are legal even if perceived as unfair. Other transactions, such as those based on inside information, are illegal. However, the street between fairness and the law is a two-way street, because the law affects perceptions of fairness while perceptions of fairness shape the law. Legislators change the law and judges modify their interpretation of the law when community rules of fairness change. For example, in 2002 the U.S. Supreme Court decided to prohibit executions of mentally retarded criminals, ruling that such executions constitute "cruel and unusual punishment." In reaching their decision, the Justices considered surveys indicating that most people consider such executions unfair. One survey, by Field Research Corporation, that found that 74% of the respondents disagreed with the statement, "Mentally retarded defendants should be given the death penalty when they commit capital crimes." More recently, in 2005, the U.S. Supreme Court used similar reasoning in its decision to prohibit the execution of minors.

Perceptions of the rules of fairness

I administered surveys to undergraduate and graduate students at a U.S. university and to investment professionals, mostly financial advisors, at two conferences.[1] Subjects

[1] Student surveys were conducted in May 2003. Investment professional surveys were conducted in October 2003 at an IMCA conference and in November 2003 at a Schwab conference.

read vignettes and were asked to rate the fairness of the behavior of the people described in them. Different surveys were administered to different subjects such that no subject answered more than one of any "parallel" questions, such as (2) and (3).

Subjects received the following instructions with the vignettes:

> In this survey, we are interested in your opinions about the behavior of people. We are not asking for your name or any other identifying information. All information is anonymous and will be kept in the strictest of confidence.
>
> Please follow the sequence of the questions. Do NOT skip ahead or skim through the rest of the survey. Please read each question carefully and circle the opinion that is closest to your own opinion.

One vignette presented to subjects the stylized facts of United States v. O'Hagan where the Supreme Court ruled against O'Hagan. James O'Hagan was a partner of Dorsey & Whitney, a law firm retained by Grand Met Company in July 1988 for help it with a potential tender offer for Pillsbury Company. O'Hagan did not work on the Grand Met offer but overheard it at the law firm. He bought call options and shares of Pillsbury in August 1988 and he sold then for a $4.3 million profit in October 1988 after news of the acquisition was announced.

I asked subjects to rate the behavior of "Paul Bond" who plays the role of James O'Hagan.

1. Paul Bond is a lawyer at the Brown & Long law firm. One day while standing outside his office at Brown & Long he overheard John Grand, another lawyer at the firm, talking with an associate about his work on a proposed purchase of the Pillow company by the Down company for $120 per share. Paul Bond had no role in the work on the proposed purchase of Pillow and Brown & Long represented only Down, not Pillow. Paul Bond bought 1,000 shares of Pillow for $70 per share. Please rate Paul's behavior as[2]:

[2] The 5% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 36% figure of students is different from 50% at the 0.01 level of statistical significance.

A) Completely Fair
B) Acceptable
C) Unfair
D) Very Unfair

Investment professionals:	Acceptable = 5%	Unfair = 95%	N = 240
Students:	Acceptable = 36%	Unfair = 64%	N = 206

The format of this vignette and the others follows that of Kahneman, Knetch and Thaler (1986) and, following them, I simplify our tabulation by combining the "Completely Fair" and "Acceptable" ratings into an "Acceptable" category and combining the "Very Unfair" and "Unfair" ratings into an "Unfair" category.

An overwhelming 95% majority of investment professionals rated Paul Bond's behavior as unfair while a smaller 64% majority of students rated it so. I offer three observations about these ratings. First, community rules of fairness prohibit insider trading if we assume that the perception of investment professionals and students represent the perceptions of the wider community. Second, the ruling of the Supreme Court in the case of U.S. v. O'Hagan is consistent with community rules of fairness and third, rules of fairness perceived by investment professionals in this case are much harsher than rules perceived by students. The last observation is especially important since it implies that students who join the ranks of investment professionals might perceive violations of insider trading regulations more leniently than such violations are perceived by investment professionals and the courts. Such students might find themselves in deep trouble if they follow their lenient attitude with action.

The 5% figure of investment professionals is different from the 36% figure of students at the 0.01 level of statistical significance.

Are rules of fairness in trading stocks different from rules of fairness in trading other goods? A comparison between perceptions of rules of fairness in stock trading and automobiles trading is useful because it reveals if rules of stock trading are unique. Such comparison also reveals the source of the difference in the perceptions of students and investment professionals. Students are likely to be as familiar with automobile markets as investment professionals but less familiar with financial markets than investment professionals. I find that the perceptions of students about rules of fairness in automobile markets are very similar to those of investment professionals, suggesting that differences between students and investment professionals in the perception of the rules of fairness in financial markets are likely due to differences in experience in financial market. I also find that rules of fairness in automobile markets are perceived as very different from those in financial markets. That is especially true when buyers and sellers of automobiles trade face to face, but it is also true when buyers and sellers of automobiles trade anonymously, as in financial markets.

Consider the following vignette about "Peter Jamison" who sold his car in a face-to-face transaction.

> 2. Peter Jamison brought his car for a routine change of transmission fluid and was told by the mechanic that the old fluid contained metal shavings, indicating that while the transmission is fine for now, it is very likely to fail in the next 10,000 miles. Fixing the transmission would cost $2,500. Peter decided to sell the car rather than fix the transmission. The buyer did not ask about any problems with the car and Peter did not offer any information about problems. Please rate Peter's behavior as[3]:

Investment professionals:	Acceptable = 30%	Unfair = 70%	N = 118
Students:	Acceptable = 26%	Unfair = 74%	N = 291

[3] The 30% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 26% figure of students is different from 50% at a statistically significant level. The 30% figure of investment professionals is not different from the 26% figure of students at a statistically significant level.

Peter Jamison did not disclose his "inside information" as he sold his car and investment professionals and students judged his behavior as unfair in approximately equal proportions, 70% of investment professionals and 74% of students.

A comparison between trading stocks and trading cars as depicted in this vignette is complicated by the fact that buyer and seller traded face-to-face while buyer and seller are anonymous to each other in the stock market. Perhaps investment professionals and students judged Peter Jamison's behavior in this car market vignette differently than they judged the behavior of Paul Bond in the earlier stock market vignette, because Peter Jamison, the seller in the car market vignette met the buyer face-to-face while Paul Bond, the seller in the stock market vignette, never met the buyers of the shares he sold and does not know their identities.

Consider a variation of the car vignette where buyer and seller are anonymous to each other, similar to the anonymity of buyers and sellers in the stock market. Now Peter Jamison sells his car to a dealer as a stock trader might sell his shares to a market maker. Peter Jamison in the car market, like Paul Bond in the stock market, does not know the identity of the ultimate buyer.

> 3. Peter Jamison brought his car for a routine change of transmission fluid and was told by the mechanic that the old fluid contained metal shavings, indicating that while the transmission is fine for now, it is very likely to fail in the next 10,000 miles. Fixing the transmission would cost $2,500. Peter decided to sell the car to a car dealer rather than fix the transmission. The dealer did not ask about any problems with the car and Peter did not offer any information about problems. Peter does not know who eventually bought the car from the dealer. Please rate Peter's behavior as[4]:

Investment professionals: Acceptable = 45% Unfair = 55% N = 122

[4] The 45% figure of investment professionals is not different from 50% at a statistically significant level. The 44% figure of students is not different from 50% at a statistically significant level. The 45% figure of investment professionals is not different from the 44% figure of students at a statistically significant level.

Students: Acceptable = 44% Unfair = 56% N = 89

I find, again, that investment professionals and students share perceptions of the rules of fairness in the car market. Fifty-five percent of investment professionals rated Peter Jamison's behavior in the anonymous car market as unfair, a proportion that is virtually identical to the 56% of students who rated him so.

Comparison of responses in the two car market vignettes reveals that both investment professionals and students judged Peter Jamison, the seller of the car, more harshly in the face-to-face vignette than in the anonymous vignette. Recall that 70% of investment professionals and 74% of students judged Peter Jamison's behavior unfair in the face-to-face trade but only 55% of investment professionals and 56% of students judged his behavior unfair in the anonymous trade.

Perceptions of the rules of fairness in an anonymous car market are different from perceptions of the rules of fairness in an anonymous stock market. While 55% of investment professionals judged a seller with inside information unfair in the anonymous car market, 95% judged seller with insider information unfair in the anonymous the stock market. The difference between the perceptions of the rules of fairness in the anonymous car market and the anonymous stock market among students is smaller but follows the same pattern. Fifty six percent of students judged the seller unfair in the anonymous car market while 64% judged the seller unfair in the anonymous stock market.

Some of the difference between the perceptions of investment professionals and students might be due to differences in their knowledge of the law. Investment professionals probably know better than students that the behavior of Paul Bond in the stock vignette is likely to be judged unlawful while the behavior of Peter Jamison in the

car vignette is not likely to be judged so. The relationship between rules of fairness and the law flows both ways such that rules of fairness that arise in the community are often enshrined into law, and the law bolsters rules of fairness in the community.

I can see the effect of differences in the knowledge of the law in differences between the perceptions of investment professionals and students in the Mike Miller vignette.

> 4. While at the San Francisco Giants baseball game, Mike Miller overheard a conversation between two people he knows from newspaper pictures as the President and Chief Financial Officer of Green Corporation about the surprisingly good sales of the Green Corporation. Later that week Mike bought 100 shares of Green Corporation stock at $20 a share. Please rate Mike's behavior as[5]:

Investment professionals:	Acceptable = 72%	Unfair = 28%	N = 240
Students:	Acceptable = 57%	Unfair = 43%	N = 100

Forty-three percent of students judged Mike Miller's behavior unfair but only 28% of investment professionals shared that judgment. Note that students judged the behavior of Mike Miller who had an informational advantage in this vignette *more* harshly than investment professionals, and recall that students judged the behavior of Paul Bond who had an informational advantage in an earlier vignette *less* harshly than investment professionals. The difference might be due to differences in the knowledge of the law. The Supreme Court ruled *against* James O'Hagan, portrayed here by Paul Bond, but a Court ruled *for* Barry Switzer portrayed here by Mike Miller. So the perceptions of investment professionals are closer to the law than the perceptions of students.

[5] The 72% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 57% figure of students is not different from 50% at a statistically significant level. The 72% figure of investment professionals is different from the 57% figure of students at the 0.01 level of statistical significance.

Barry Switzer, the famous football coach, was attending a sport event where both his son and that of the CEO of Texas Instrument Company (TIC) were competing. Switzer, who knew the CEO socially but not as a close friend, overheard the CEO tell his wife that TIC planned to merge with Phoenix Resources Company (Phoenix). He proceeded to buy shares of Phoenix and profited when the merger was made public. The court decided in favor of Switzer because it concluded that CEO did not intend to reveal the information to him. Barry Switzer, like Mike Miller was lucky and, overall, both investment professionals and students perceive an informational advantage gained by a "lucky break" as fair.

The results so far tell us that the community perceives stocks trading as a game of research and skill on a "level playing field" where traders have equal access to information and luck but where they devote different amounts of research to uncover information and have different levels of skill at interpreting it. Possession of inside information violates this rule of fairness since all outsiders, even those who apply the utmost research and skill, cannot uncover inside information. The prototypical fair trade is the trade by John Burr, a shareholder of the Beta Corporation, who relied only on his research and skill in the decision to sell his stock. John Burr's behavior is rated Acceptable by 99% of investment professionals and 94% of students.

> 5. The stock of the Beta Corporation went up in price from $30 last year to $50 recently. John Burr, a shareholder who owns 1,000 shares, analyzed Beta's financial prospects and thinks that the stock is worth no more than $40. John decided to sell his shares at the current $50 price. Please rate John's behavior as[6]:

[6] The 99% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 94% figure of students is different from 50% at the 0.01 level of statistical significance. The 99% figure of investment professionals is different from the 94% figure of students at the 0.01 level of statistical significance.

Investment professionals:	Acceptable = 99%	Unfair = 1%	N = 118
Students:	Acceptable = 94%	Unfair = 6%	N = 194

Some have argued that insider trading is perceived as unfair because insiders, such as corporate executives, steal inside information from corporations that rightfully own it. But large proportions of investment professionals and students frown on the use of inside information even when such information is used for the benefit of the corporation rather than for the benefit of its executives. Consider the variation of the John Burr vignette where John Burr is now the President of the Beta Corporation.

> 6. The stock of the Beta Corporation went up in price from $30 last year to $50 recently. John Burr, the President of Beta, analyzed Beta's financial prospects and concluded that it is worth no more than $40. John called a meeting of executives and they decided that Beta would sell new shares to the public at the current $50 price. Please rate John's behavior as[7]:

Investment professionals:	Acceptable = 64%	Unfair = 36%	N= 127
Students:	Acceptable = 48%	Unfair = 52%	N = 204

The Beta Corporation owns the information that John Burr, its president, uncovered through his analysis and he and the other executives of Beta used it to benefit the corporation, not themselves.[8] Fifty-two percent of students judged such trades unfair and so did 36% of investment professionals.

Inside information gives insiders advantages not available to outsiders. I find that insiders with sure information who trade considerable amounts are perceived as having greater advantage than insiders with probabilistic information and well-off insiders are

[7] The 64% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 48% figure of students is not different from 50% at a statistically significant level. The 64% figure of investment professionals is different from the 48% figure of students at the 0.01 level of statistical significance.

[8] Although John Burr and the other executives might benefit if they are also shareholders or if such sales increase their compensation. Also, John Burr and the other executive might be guilty of violating the prohibition against insider trading if they used inside information in their analysis, even if the entire benefit of the sale of stock goes to the corporation rather than to themselves. (I am grateful to Don Langevoort for this point).

perceived as having a greater advantage in life, even if not inside information, than less well-off insiders who trade small amounts. Community rules of fairness are especially harsh on insiders with sure information and on well-off insiders.

Consider the following pair of vignettes about Larry Wood who trades on inside information. In the first vignette Larry Wood is an executive who earns $150,000 per year and trades $50,000 worth of stock while in the second he is a summer intern who earns $10 per hour and trades $500 worth of stocks.

> 7. Larry Woods works as the director of marketing for USA Aircraft Company, earning $150,000 per year. This morning Larry heard that the company has just received a very large government contract and the good news would be announced tomorrow to all employees and the public. Two hours later, Larry purchased 1,000 shares of company stock at $50 per share. Please rate Larry's behavior as[9]:

Investment professionals:	Acceptable = 2%	Unfair = 98%	N = 122
Students:	Acceptable = 30%	Unfair = 70%	N = 194

> 8. Larry Woods works as a summer intern for USA Aircraft Company, earning $10 per hour. This morning Larry heard that the company has just received a very large government contract and the good news would be announced tomorrow to all employees and the public. Two hours later, Larry purchased 10 shares of company stock at $50 per share. Please rate Larry's behavior as[10]:

Investment professionals:	Acceptable = 11%	Unfair = 89%	N = 120
Students:	Acceptable = 46%	Unfair = 54%	N = 204

[9] The 2% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 30% figure of students is different from 50% at the 0.01 level of statistical significance. The 2% figure of investment professionals is different from the 30% figure of students at the 0.01 level of statistical significance.

[10] The 11% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 46% figure of students is not different from 50% at a statistically significant level. The 11% figure of investment professionals is different from the 46% figure of students at the 0.01 level of statistical significance.

Ninety-eight percent of investment professionals rated Larry Wood, the executive, as unfair but only 89% of them rated Larry Wood, the intern, as unfair.[11] The difference is even more pronounced when we focus on the "Very Unfair" rating. Eight-four percent of investment professionals judged Larry Wood, the executive, as Very Unfair but only 59% of them judged Larry Wood, the intern, as Very Unfair.

Students, like investment professionals, rated Larry Wood, the executive, more harshly than they judged Larry Wood the intern but, as before, students judged insider trading less harshly than investment professionals, perhaps because students are not as aware of the unlawfulness of Larry Wood's actions in both vignettes. Seventy percent of students rated Larry Wood, the executive, as unfair but only 54% of them rated Larry Wood, the intern, as unfair.[12]

Now consider the following pair of vignettes about Joe Ortiz, a biologist at Genomede. In the first vignette Joe Ortiz trades on the *probabilistic* inside information that a drug under development passed a Food and Drug Administration (FDA) test that increases the probability that it would ultimately be approved for use by patients. In the second vignette Joe Ortiz trades on *sure* inside information that a drug under development passed the last FDA test and is now approved for use by patients.

> 9. Genomede, a biotech company just received news from the Food and Drug Administration (FDA) that its experimental cancer drug passed one test of safety and effectiveness. The President of Genomede told the good news to the development team and added that it would be announced tomorrow to all employees and the public. Although passing this test does not necessarily mean that the drug would pass the following tests and ultimately be approved for use by patients, it does increase from 30% to 40% the likelihood that the drug would ultimately be approved. So while it is likely that the price of Genomede's stock would increase when the news is made public, such increase is not assured. Upon hearing the news, Joe

[11] The difference is statistically significant at the 0.01 level.
[12] The difference is statistically significant at the 0.01 level.

Ortiz, a biologist on the team, purchased 100 shares of the company stock at $50. Please rate Joe's behavior as[13]:

Investment professionals:	Acceptable = 9%	Unfair = 91%	N = 121
Students:	Acceptable = 55%	Unfair = 45%	N = 192

10. Genomede, a biotech company just received news from the Food and Drug Administration (FDA) that its experimental cancer drug passed the last test of safety and effectiveness. The President of Genomede told the good news to the development team and added that it would be announced tomorrow to all employees and the public. Passing this last test means that the drug is now approved for use by patients. The price of Genomede's stock is sure to increase when the news is made public. Upon hearing the news, Joe Ortiz, a biologist on the team, purchased 100 shares of the company stock at $50. Please rate Joe's behavior as:[14]

Investment professionals:	Acceptable = 3%	Unfair = 97%	N = 118
Students:	Acceptable = 37%	Unfair = 63%	N = 206

Ninety-seven percent of investment professionals rated the behavior of Joe Ortiz as unfair when he had sure information but only 91% rated his behavior as harshly when he had probalistic information.[15] Again, the difference is more pronounced when we focus on the "Very Unfair" rating. Eighty one percent of investment professionals rated the behavior of Joe Ortiz as Very Unfair when he had sure information while only 68% rated his behavior so when he had probabilistic information. And, again, while students are not as harsh as investment professionals in their judgment of insider trading, they rate Joe Ortiz more harshly when he uses sure information than when he uses probabilistic

[13] The 9% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 55% figure of students is not different from 50% at a statistically significant level. The 9% figure of investment professionals is different from the 55% figure of students at the 0.01 level of statistical significance.

[14] The 3% figure of investment professionals is different from 50% at the 0.01 level of statistical significance. The 37% figure of students is different from 50% at the 0.01 level of statistical significance. The 3% figure of investment professionals is different from the 37% figure of students at the 0.01 level of statistical significance.

[15] The difference is statistically significant at the 0.05 level.

information. Sixty three percent of students rated Joe Ortiz's behavior as unfair when he had sure information but only 45% of students rated him unfair when he had probabilistic information.[16]

Conclusion

I identify, through surveys, the rules of fairness in financial trading as perceived by investment professionals and students. I find that the prototypical fair trade in the stock market is one where all traders have equal access to information and equal chances for luck, but might differ in the amount of research they devote to uncovering information and the skill they apply to interpreting that information. Inside information gives insiders an advantage that cannot be overcome with research or skill and community rules of fairness require that insiders forego that advantage. Insiders with sure information have a greater advantage than insiders with probabilistic information and well-off insiders have a greater advantage in life, even if not in trading, than less well-off investors. Rules of fairness are especially strict on insiders with sure information and on well-off insiders. So while both investment professionals and students frown on summer interns who use inside information for small gains, they are harsh on well-off executives who use inside information for large gains.

Some might feel distaste for following community rules of fairness uncovered by surveys of the entire community. Shouldn't we follow rules of fairness that are based on fundamental rights? Unfortunately, rights conflict with other rights and not all agree on which rights are fundamental. Egalitarian liberals consider the right to food, shelter, education and health care as fundamental, even if the provision of this right requires income redistribution, while libertarian liberals consider income redistribution as a

[16] The difference is statistically significant at the 0.01 level.

violation of fundamental property rights. Personal rules of fairness would not help us where, for example, they permit us to trade on inside information because we believe that we have a fundamental right to consummate any trade with a willing counterparty. We should also know that we regularly follow intuitive surveys of community rules of fairness, often with little awareness of doing so. Students conduct informal surveys of fellow students and conclude that cheating is consistent with community rules of fairness because fellow students engage in it and employees of mutual funds conduct informal surveys of fellow employees and conclude that market timing is consistent with community rules of fairness because fellow employees engage in it. Formal surveys of perceptions of the rules of fairness in the wider community, such as presented here, are useful because they alert us to perceptions of people outside our own social and business circles and replace poor informal surveys with better formal ones.

References:

Eisinger, Jesse (2005). "Buffett's Reputation May Be Tested," *Wall Street Journal*, March 31: C1.

Kahneman, Daniel, Jack L. Knetsch and Richard H. Thaler (1986). "Fairness As A Constraint On Profit Seeking: Entitlements In The Market," *American Economic Review*, v76 (4), 728-741.

Labaton, Stephen and David Leonhardt (2002). "Whispers Inside. Thunder Outside." *The New York Times*, June 30: BU1 & 14.

Landon, Thomas (2005). "On Wall Street, A Rise in Dismissals Over Ethics," *New York Times*, March 29: A1.

Statman, Meir (2004). "Fairness Outside the Cocoon," Financial Analysts Journal, vol. 60, no. 6: 34-39.