

Taking Stock: Insider Trading in Halacha

Adapted from the writings of Dayan Yitzhak Grossman

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CNBC reports:

House Speaker Nancy Pelosi scoffed Wednesday at the idea of banning congressional lawmakers and their spouses from owning shares of individual companies, despite the possibilities for conflicts of interest between their legislative duties and personal finances. “No,” Pelosi, D-Calif., told reporters at a news conference where she was asked whether she would support such a prohibition. “We’re a free market economy,” she said. “They should be able to participate in that.”[1]

Some criticized Pelosi’s stance on the grounds that it is too easy for lawmakers to engage in insider trading:

It’s a ridiculous comment! She might as well have said “let them eat cake.” Sure, it’s a free-market economy. But your average schlub doesn’t get confidential briefings from government experts chock full of nonpublic information directly related to the price of stocks.[2]

Insider trading is a rather confusing and controversial legal concept, since it is difficult to articulate a coherent harm it entails:

There has long been “considerable academic debate” among business and legal scholars over whether or not insider trading should be illegal...Some legal analysis has questioned whether insider trading actually harms anyone in the legal sense, since some have questioned whether insider trading causes anyone to suffer an actual “loss,” and whether anyone who suffers a loss is owed an actual legal duty by the insiders in question...

Some economists and legal scholars (such as Henry Manne, Milton Friedman, Thomas Sowell, Daniel Fischel, and Frank H. Easterbrook) have argued that laws against insider trading should be repealed.[3]

Legal scholar Henry Manne was a prominent staunch opponent of the prohibition against insider trading, arguing that the practice causes no harm:

[I]t’s very clear that that person is in the stock market, an anonymous market, to sell the shares and doesn’t care who buys them. If there’s information out there, it may be an insider has it. It doesn’t make any difference. Once you make a decision to sell, you don’t lose anything when there’s an additional buyer in the market, because that person happens to have information. That’s absurd.[4]

What is the attitude of halacha to insider trading?[5] In this article, we consider the applicability of the halachos of fraud; in a follow-up article, we shall *iy”H* consider halachic perspectives on some other rationales for prohibiting insider trading.

Mekach ta'us

Halacha generally considers invalid a transaction in which a party was ignorant of material information that affects the transaction's desirability (*mekach ta'us*); whether the other party was aware of the information in question and attempted to take advantage of the ignorant party, or was also ignorant of the information, is irrelevant.

In at least some scenarios involving insider trading, the nonpublic information to which the outsider was not privy could theoretically be grounds for a claim of *mekach ta'us*, but as we have explained, *mekach ta'us* does not require asymmetry of information, and the insider's possession of nonpublic information is entirely irrelevant. Accordingly, if the outsider's ignorance of the information in question would be grounds for *mekach ta'us*, this would be the case *even if* the counterparty was similarly ignorant!

In practice, however, it seems that securities trading rules generally stipulate that all trades are absolutely irreversible (i.e., not subject to rescission),[6] and such a well-understood and universally accepted convention would presumably rule out any possibility of a claim of *mekach ta'us*. Although there is some dispute among the *poskim* as to whether a prevailing custom or formal communal enactment to ignore certain claims of *mekach ta'us* is binding,[7] it seems to this author that in the case of securities trading, where an entire category of transaction is highly regulated and governed by precisely specified, universally accepted rules, all authorities would agree that participants are bound by these rules, even where they diverge from classic halacha.

The prohibition of *ona'ah*

Even where a transaction is not considered a *mekach ta'us*, there is still a *lechat'chilah* prohibition against fraud (*ona'ah*) and an obligation to disclose any defect in an item being sold.[8] Here as well, however, insofar as these rules would apply to securities trading, they would extend far beyond the legal bans on insider trading, and would prohibit trading on nonpublic information *even by non-insiders*, such as an analyst whose research discovered a company's fraudulent accounting or undisclosed business troubles. And once again, in practice it seems to this author that a similar argument to the one made above about *mekach ta'us* applies to *ona'ah* as well. Although here too the *poskim* debate whether a practice that would be considered objectively fraudulent is permitted if it is the universal or general practice,[9] it seems that the prohibition of *ona'ah* would not apply to the securities markets given that it is universally understood that a party to a securities transaction has absolutely no duty to disclose any nonpublic information in his possession, even if such information could adversely affect the desirability of the transaction.

Given that the law does generally prohibit insider trading, however, it might follow that there is indeed an expectation that a party to a trade is not in possession of any material inside information, and it might therefore constitute *ona'ah* for an insider to trade on nonpublic information (in

addition to being illegal). But this is not necessarily so, because a party to a securities transaction is typically oblivious to the identity of his counterparty. Because he has no idea whether that person is an insider or not, perhaps he cannot be considered to have any expectations of him.

[1]Dan Managan. House Speaker Nancy Pelosi opposes banning Congress members from owning individual stocks: 'We're a free market economy.' CNBC.

<https://www.cnn.com/2021/12/15/house-speaker-nancy-pelosi-opposes-banning-stock-buys-by-congress-members.html> .

[2]Walter Shaub on Twitter.

<https://twitter.com/waltshaub/status/1471188793436815368> .

[3]Wikipedia contributors. Insider trading. In Wikipedia, The Free Encyclopedia.

https://en.wikipedia.org/w/index.php?title=Insider_trading&oldid=1061151790 .

[4]Larry Elder. Legalize Insider Trading. Capitalism Magazine. Sep. 24, 2004.

<https://web.archive.org/web/20041210094504/http://www.capmag.com/article.asp?ID=3933> .

[5]Rabbi Dr. Aaron Levine discusses this topic in his Case Studies In Jewish Business Ethics, from p. 163.

[6]Wikipedia contributors. Rescission (contract law). In Wikipedia, The Free Encyclopedia.

[https://en.wikipedia.org/w/index.php?title=Rescission_\(contract_law\)&oldid=1032134257](https://en.wikipedia.org/w/index.php?title=Rescission_(contract_law)&oldid=1032134257) .

[7]See Shulchan Aruch C.M. 232:19; Shu"t Radvaz *cheilek* 4 *siman* 1206 (136), cited in brief in Mishpat Shalom 232:7; Shu"t Mekor Baruch *siman* 55 end of p. 57b; Shu"t Knessess Yechezkel *siman* 85, cited in Pis'chei Teshuvah C.M. *siman* 227 s.k. 11; Shu"t Chinuch Bais Yehudah *siman* 108; Misgeres Hashulchan, cited in Mishpat Shalom 232:11; Shu"t Bais Shlomo C.M. *siman* 87 s.v. *Temol...aval* Moharashdam"; Shu"t Tshuras Shai (*kama*) *siman* 456 s.v. *Ve'efshar afilu minhag barur*; Ksoness Yosef *os aleph shresh* 2 *anaf* 1; Pis'chei Teshuvah C.M. *siman* 232 s.k. 6; Chochmas Shlomo C.M. 209:2; Shu"t Shem Aryeh O.C. *siman* 13; Shu"t Vehayah Ha'olam *siman* 23.

[8]Shulchan Aruch C.M. 228:6; Sma *ibid.* s.k. 7.

[9]See Sma *siman* 228 s.k. 16; Shulchan Aruch HaRav *Ona'ah se'if* 16; Shu"t Divrei Malkiel *cheilek* 3 *siman* 54; Minchas Yaakov *klal* 60 s.k. 1; Nachalas Tzvi Y.D. beginning of *siman* 97.