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NYT: Possibly Unfair, but Not Necessarily Fraudulent.

When someone has access to a service that is not equally available to others, the immediate response is often to say, "That's not fair!" And when the securities markets are involved, the first thought seems to be that any informational advantage is not only unfair but potentially fraudulent.

Of course, there are advantages everywhere. Airlines sell access to early boarding, and you can buy a pass at Universal Studios to skip the lines. Few seem troubled that someone who bundled millions of dollars in donations receives an invitation to an inaugural ball while common contributors might receive a token souvenir.

While we are accustomed to paying extra for things that were once free, like checked baggage on airlines, when it comes to the public markets for stocks, bonds and commodities, the reaction to those buying preferential access is to cry foul.

That became clear last week when New York's attorney general, Eric T. Schneiderman, announced an agreement with Thomson Reuters concerning a closely watched economic indicator. Thomson Reuters agreed that it would no longer sell access to the University of Michigan's consumer confidence index to high-frequency trading firms two seconds before other subscribers. Mr. Schneiderman described this as a step toward creating a "level playing field" in the markets by ending an "unfair business practice."

His office is investigating whether other firms are violating the law, particularly with regard to New York's broad Martin Act, in how they sell data to subscribers who can trade in advance of its public release. And Mr. Schneiderman is not the only one looking at disclosures of this type of information.

Senator Charles E. Grassley sent a letter to the University of Michigan asking questions about its arrangement "to allow preferential access" to the information. DealBook reported that the Securities and Exchange Commission was also investigating how Thomson Reuters released manufacturing data milliseconds before its public disclosure, giving high-frequency trading firms an opportunity to profit on it.

Although it is natural to think that having access to information that influences the markets before others is always wrong, the laws on fraud do not go that far. Instead, they focus on whether someone has been deceived, either through a misstatement or by a failure to disclose information.

The Martin Act, adopted in 1921, is considered one of the broadest antifraud laws available to police the securities markets. It does not require proof of intentional misconduct, and there is even a possibility that a misdemeanor violation could be proved without showing any intent — known as strict liability. That gives Mr. Schneiderman a powerful tool to go after companies like Thomson Reuters for disclosures that affect the market.

But the core of any violation is still about proving fraud, which includes not just false statements but also any "deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale" of securities. A 1926 decision by the New York Court of Appeals on the scope of the Martin Act stated that the law reaches acts “which do by their tendency to deceive or mislead the purchasing public.”

Is selling access to proprietary information to those willing to pay a premium a species of fraud when it allows traders to reap profits at the expense of those unwilling to pay the premium?

Thomson Reuters and others who selectively disclose information to subscribers are not hiding what they do. Indeed, it is the exact opposite — they tell the world that only those willing to pay will get the advantage of an early peek at the information.

There is a tiny universe of potential customers who would want access to financial data two seconds ahead of others. No individual would ever be able to take advantage of that time period, but high-frequency traders certainly can. As James B. Stewart reported, dropping the two-second advantage last week resulted in a steep drop in the amount of trading in the milliseconds before the broader release of the index.

Some informational advantages are fraudulent, as the recent spate of insider trading cases shows. Unlike companies that sell an informational advantage, however, the key to insider trading is keeping the information confidential and not letting anyone know you are using it to profit. It is the failure to publicly disclose the information before using it that brings about the violation, not just the fact that the information is confidential.

Still, it appears anomalous that someone at Thomson Reuters who used its confidential market information without permission to trade profitably would be guilty of insider trading, but the company can sell that same advantage to a select few willing to pay for it without violating the law. The difference is that insider trading requires proof of a breach of fiduciary duty, so that the proprietor of the information can do whatever it wishes so long as it does not deceive the investing public.

In a famous case in the 1980s, Carpenter v. United States, the Supreme Court upheld the conviction of a former Wall Street Journal reporter for trading on confidential information about companies before it was published. While the reporter breached his fiduciary duty, the court noted that The Journal had a proprietary interest in the information its reporters gathered, and could do with it as it saw fit.

Consumers of the information sold by media companies would not be subject to any claim of fraud because they are not trading on it in breach of a duty. When a company obtains the information through legitimate means, like the agreement Thomson Reuters has with the University of Michigan to distribute its index, then there is no violation of any duty by selling advance access to the data.

The S.E.C. does have a rule in place, Regulation FD, which requires public companies to disclose information to everyone at once and not just to select recipients. But this rule applies only to internal corporate information and not to the type of research data about the economy that is sold by companies.

The issue then is whether Mr. Schneiderman or the S.E.C. can police these types of arrangements by companies that sell information they obtain legally. It is notable that, even though the two-second advantage has stopped, Thomson Reuters continues to sell the information five minutes before its release to the general public, undermining the idea that any early disclosure is somehow fraudulent.

There is no broad mandate for the government to ensure that the markets are “fair” or that they offer a “level playing field” without any informational disparities, at least under the fraud laws.

While fraudulent transactions are certainly unfair, simply asserting that buying access to information in advance of others is somehow unfair does not necessarily make it illegal.

The issue may be more about how high-frequency trading firms can take advantage of information in just a few milliseconds to garner profits far beyond what might have been possible before computerized trading. If that is the case, then the focus should be on policing how these firms trade rather than cracking down on the sale of information to those willing to pay. Otherwise, perhaps the airlines should not be allowed to let so many people board ahead of me.