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Free The Insider Traders: Stop Treating Market Efficiency Like A Crime

Last week Manhattan U.S. Attorney Preet Bharara claimed another scalp in his crusade against "insider trading," a practice he once called "pervasive." Since 2009 Bharara' office has collected 79 insider trading convictions.

His most recent victory came against Mathew Martoma, formerly at SAC Capital. Martoma was the ninth SAC Capital employee convicted. Bharara reportedly has been after SAC founder Steve Cohen, so far without result. But Bharara bagged hedge fund billionaire Raj Rajaratnam, convicted in 2011 and sentenced to 11 years in prison. A decade ago Martha Stewart was convicted of obstruction of justice in an insider trading case.

Objectively, the insider trading ban makes no sense. It creates an arcane distinction between "non-public" and "public" information, and treats them differently. It presumes that every investor should possess equal information and never know any more than anyone else. It punishes traders for seeking to gain information known to some people. It inhibits people from acting on and markets from reacting to the latest and most accurate information. It effectively pushes everyone to base today's trades on yesterday's information in the name of fairness.

Martoma apparently got advance notice of the test results for an experimental drug from the doctor who chaired the monitoring committee. Martoma then recommended that SAC dump its stock in the two firms that were developing the pharmaceutical. The fund thereby avoided substantial losses.

If true, SAC gained an obvious advantage over other shareholders. But why should that be illegal? The doctor violated the confidence placed in him; he deserved censure and perhaps prosecution. In contrast, Martoma simply got out of the investment starting gate early. His actions hurt no one.

To the extent that SAC's sale began a market adjustment, Martoma actually reduced future stock price fluctuations. SAC avoided losses suffered by other shareholders, but it did not hurt the latter. They would have lost money nonetheless. Even the buyers of SAC's shares had no complaint: They wanted to purchase based on the information available to them. Their

understanding was incomplete, but not because of Martoma's actions. They would have purchased the shares from someone else had SAC not sold.

Of course, some forms of insider trading are properly criminalized—typically when accompanied by other illegal actions. For instance, fraudulently misrepresenting information to buyers/sellers, burglarizing a firm's office to steal data, or violating federal disclosure rules. However, the common anonymity of participants in stock market transactions limits the first. In most cases, it would be impossible to offer fraudulent assurances even if one wanted to. The other examples are equally rare.

The government has regularly expanded the legal definition of insider trading, yielding bizarre results and punishing people without warning. For instance, in 1985 an ambitious prosecutor with minimal concern for civil liberties by the name of Rudolph Giuliani indicted a *Wall Street Journal* reporter for leaking his "Heard on the Street" columns to a stockbroker before publication.

Doing so might have violated newspaper policy, but that was a problem for the *Journal*, not the U.S. Attorney. The information was gathered legally; the journalist had no fiduciary responsibility concerning the material; there was nothing proprietary about the scheduled columns. The case went to the Supreme Court, which deadlocked four-four, upholding the charge.

Other cases also have expanded Uncle Sam's reach. After Rajaratnam's arrest, the *New York Times* reported that "Switchboards at law firms have been lighting up in recent weeks as hedge fund managers and technology executives deluge lawyers with one question: What information is safe to share, in case the feds are listening?" Information is currency on Wall Street, widely and constantly traded. Punishing previously legitimate behavior after the fact unfairly penalizes individual defendants and disrupts national markets.

As applied, the insider trading laws push in only one direction: punishing action. Yet a smart investor also must know when not to buy and sell. It is virtually impossible to punish someone for not acting, even if he or she did so in reliance on inside information.

Imagine if Martoma had found out that the experimental drug was a great success. At his urging SAC could have made a big stock purchase, possibly triggering the same investigation. In fact, the SEC uses sophisticated computer software to identify "suspicious" trades. But what if the hedge fund had planned on selling and Martoma told his colleagues to do nothing?

The government probably wouldn't have noticed—there would have been no unusual trade to investigate. Even if it heard about his information-gathering, it would have been difficult to prove that but for the leak SAC would have sold. How do you to measure non-trades? Absent the unlikely discovery of a detailed paper trail of cancelled purchase or sale authorizations backed by an explicit explanation of why, this sort of insider trading would go undiscovered and unpunished. This implicit government enforcement bias against action is unlikely to improve investment decisions or market efficiency.

Moreover, it is impossible to equalize information. After the 2008 crash Securities and Exchange Commission Enforcement Director Robert Khuzami explained that prosecutions would restore "the level playing field that is fundamental to our capital markets." Does anyone believe that such markets ever will be a level playing field?

Wall Street professionals are immersed in the business and financial worlds. Even a part-time day trader knows more than the average person who invests haphazardly at best. With millions or billions of dollars at stake people will mount sophisticated intelligence operations: Hedge funds reportedly have tracked corporate jets in hopes of discovering merger deals. Is relying on this information really more fair than getting a tip from the secretary's nephew who works at the acquiring firm?

Even equal information is not enough. It must be interpreted. And people vary widely in their experiences and abilities as well as access to those better able to do so. Should having experts on speed-dial be viewed as a form of insider trading?

A better objective for regulators would be to encourage markets to adjust swiftly to all the available information. The 2008 financial crisis resulted far more from fraud, bad incentives, foolish policy, and inadequate accountability than a slanted playing field. And swifter responses to problems—such as the low market value of mortgage-backed securities—would have reduced losses and quickened recovery.

Speeding the process most helps those with the least information, since they typically have the least ability to play the system. The slower the adjustment, the larger and more abrupt the later price shifts, and the more people who will have made poor investment decisions along the way. The negative economic consequences will be worse.

Almost as bad as criminalizing insider trading is treating suspects as if they are terrorists or mobsters. For instance, the government employed wiretaps in the Rajaratnam case. And the SEC desires increased access to grand jury evidence developed in criminal prosecutions.

Fans of insider trading laws speak of the need to protect investor confidence. But is there really any small investor who believes that imprisoning Martoma makes him or her equal on Wall Street? How many people put more money in their mutual funds because of Bharara's war on insider trading?

In contrast, government prosecutors seeking to break new legal ground directly influence more sophisticated players. In the midst of the Rajaratnam case the TABB Group surveyed investment professionals and found growing wariness from the arrest of expert consultants: "There is an overwhelming belief that the recent insider trading probe has put a damper on investor confidence." Scaring professionals from doing their jobs is likely to distort investment decisions without adding to average investors' returns.

Enforcing insider trading laws does more to advance prosecutors' careers than protect investors' portfolios. Information will never be perfect or equal. However, adjustments to information can

be more or less smooth and speedy. Washington should stop criminalizing actions which ultimately, even if inadvertently, benefit the rest of us.