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It's Time To Legalize Insider Trading

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Prosecutions against so-called "insider trading" have become a growth industry. Manhattan U.S. attorney Preet Bharara calls insider trading "pervasive."

The government recently charged a gaggle of hedge fund consultants with violating the law. Unfortunately, in doing so the government reduced economic efficiency without improving market transparency.

Uncle Sam has a tough job. Many, if not most, people who trade individual stocks probably have attempted to use "inside information." But with limited resources, the feds focus on big money and high-profile cases.

Martha Stewart was one of the celebrity catches. In late 2009 hedge fund billionaire Raj Rajaratnam found himself in the dock. One of the strangest cases was *Wall Street Journal* reporter R. Foster Winans, who was prosecuted for trading on information that he gathered legally for his "Heard on the Street" column.

The objective of insider trading laws is counter-intuitive: prevent people from using and markets from adjusting to the most accurate and timely information. The rules target "non-public" information, a legal, not economic concept. As a result, we are supposed to make today's trades based on yesterday's information.

Unfortunately, keeping people ignorant is economic folly. We make more bad decisions, and markets take longer to adjust.

The financial crisis was exacerbated by inadequate information and bad assumptions. Had people recognized the true value of mortgage-backed securities and acted accordingly, losses would have been lower and the crisis would have ended more quickly.

Admittedly, insider trading sounds sinister. Yet it rarely involves fraud. Securities markets are large and impersonal. In most cases fraud is practically impossible. If I learn of an impending merger, I don't look for hundreds or thousands of shareholders to convince to sell by telling them there won't be a deal. Rather, I purchase thousands of shares from people already offering to sell--anonymously, for whatever reason, on a stock exchange. People who ask for no assurances and whom I never meet.

Moreover, markets routinely operate on asymmetric information. People not only get different data, but interpret it differently. Some of the variance is due to happenstance or luck. But a lot of the difference reflects diligence and expense. Big investors will always spend more money and devote more time than the rest of us to gather information.

Moreover, insider trading laws imbalance markets by effectively regulating only one-half of the trading equation. A good investor makes money by knowing when not to buy or sell as well as when to buy or sell. Many "insider" tips alert owners to hold their shares or not to buy other ones.

But even when the Feds treat investors like drug dealers--the government used wiretaps in the Rajaratnam case--it is virtually impossible to prove that inaction resulted from reliance on non-public information. Imagine trying to measure non-trades and prove that someone didn't sell after learning of an impending merger.

Thus, insider trading laws ignore many people who use non-public information in their investment decisions. This enforcement bias against buying or selling unbalances the market. You're entitled to rely on the best and most timely information so long as you do nothing. Such a rule is not likely to improve private investment decision-making or promote more efficient markets.

The feds claim insider trading laws ensure "fairness." After the 2008 crash Securities and Exchange Commission Enforcement

Director Robert Khuzami said prosecutions were intended to restore "the level playing field that is fundamental to our capital markets."

However, who believes that investment will ever occur on a level playing field? Professionals on Wall Street make money because of asymmetric information. Someone who spends all day immersed in the financial and commercial worlds--even an informal day trader who makes the market his occupation--will know more than those of us who do other work and invest some of our earnings on the side.

Serious investors go to extraordinary lengths to pick up hints of imminent deals. Hedge funds have even tracked corporate jets, whose routings might reveal executives heading off for merger talks. Information gleaned in this way is legal but, in principle, no different than a tip from someone's uncle who works at a hedge fund.

The beneficiary of inside information may not deserve to be so lucky, but then, neither does the big money lottery winner. Nor was it unfair that the seller/buyer lost. There simply is no victim of insider trading. The person on the other side of the transaction acted *based on his or her, not the insider's, information*. The other party would have acted even if the insider had not done so.

Moreover, what individuals see as unfair markets see as necessary. The sooner people act on accurate information the sooner the market will set the real price. Interfere with the adjustment process by prosecuting people for insider trading and the market will take longer to adjust.

More people will make more bad investment decisions. The eventual price shock will be bigger and more abrupt. More people will lose more money. And the negative economic consequences will be greater.

Of course, individuals and companies are entitled to keep proprietary information and punish those who violate that trust. But the offense should be civil, not criminal. And the punishment should fit the charge. In no case is the government justified in using intrusive enforcement measures developed to combat violent crime.

Yet in the Rajaratnam case the Feds deployed wiretaps as well as mass arrests. The SEC already uses sophisticated computer software to identify "suspicious" trades. Now the agency is pushing for greater access to grand-jury information from criminal prosecutions for use in civil actions.

Ironically, *not one investor* will benefit from the ongoing insider trading prosecutions. All those who "lost" voluntarily traded based on what they knew. Virtually all of the "inside" information was destined to become public.

Moreover, the government's zealous prosecutions are discouraging even innocent information-gathering. After the Rajaratnam 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?"

More people will lose more money if the government makes ignorance the new market standard. A survey last month of trading professional from the TABB Group found growing uneasiness resulting from the recent spate of expert consultant arrests: "There is an overwhelming belief that the recent insider trading probe has put a damper on investor confidence."

Laws against insider trading presume a world in which everyone can trade on perfect information. Such a world does not exist. The government should stop punishing investors seeking to act on the most accurate and timely information. After all, that's what the financial markets should be about.

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