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Doug Bandow: Where's the crime in insider trading?

Regulators should encourage markets to adjust swiftly to all available information.

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Manhattan U.S. attorney Preet Bharara claimed another scalp in his crusade against "insider trading," a practice he once called "pervasive." Last month, he won against Mathew Martoma, formerly at SAC Capital Advisors. Martoma was the ninth SAC employee convicted.

Another victory for Bharara was 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 a well-publicized insider trading case.

Objectively, the ban on insider trading makes no sense. It creates an arcane distinction between "non-public" and "public" information and treats them differently. It presumes that investors should possess equal information and never know any more than anyone else.

The rule punishes traders for seeking to learn information already known by some people. It inhibits investors from acting on and markets from reacting to the latest and most accurate information.

Martoma apparently received advance notice of the test results for an experimental Alzheimer's 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 medicine.

If true, SAC gained an 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's actions hurt no one.

SAC avoided losses suffered by other shareholders, but they would have lost nonetheless. Even the buyers of SAC's shares had no complaint: They wanted to purchase based on the information available to them. They would have acquired the shares from someone else had SAC not sold.

Of course, some forms of insider trading are properly criminalized – typically if accompanied by other illegal actions. For instance, fraudulently misrepresenting information to buyers and/or sellers. However, the anonymity of most participants in stock market transactions limits such cases. It usually would be impossible to offer fraudulent assurances even if one wanted to.

The government has regularly expanded the legal definition of insider trading, yielding bizarre outcomes and punishing people without warning. For instance, in 1985 the government 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 should have been 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.

Other cases also expanded Uncle Sam's reach. Punishing previously legitimate behavior after the fact unfairly penalizes defendants and disrupts national markets. Information is currency on Wall Street and is widely and constantly traded.

As applied, the insider-trading laws push in only one direction, punishing action. Yet a smart investor also knows 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. Thus, the government has an enforcement bias against action, whether buying or selling. That is unlikely to improve investment decisions or market efficiency.

Indeed, 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 level?

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. Nor is equal information enough. It must be interpreted. People obviously vary widely in their experiences and abilities as well as access to those better able to do so.

The best objective for regulators would be to encourage markets to adjust swiftly to all available information. The 2008 financial crisis resulted far more from fraud, bad incentives, foolish policy, and inadequate accountability than a slanted playing field. Swifter recognition of problems – such as the low market value of mortgage-backed securities – would have reduced losses and quickened recovery. Speeding the process would most help those with the least information, since they typically have the least ability to play the system.

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, however inadvertently, ultimately benefit the rest of us.

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