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Cato: Why is Insider Trading Illegal?

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The Cato Institute published an article this week advocating for a lift on all insider trading laws. The author, **Thomas A. Firey**, used former professional baseball player, **Doug DeCinces**, as an example of how draconian insider trading rules and associated punishments can be. DeCinces was convicted of 14 charges of insider trading last Friday, and faces up to 20 years for each charge. The retired third-baseman owned stock in a surgical supply firm, and when he learned from the firm's CEO (who also happened to be his neighbor) that Abbott Labs was acquiring the enterprise, DeCinces purchased more stock for himself, and furthermore shared news of the acquisition with friends. Ultimately he profited about $1.3 million.

Firey's argument against insider trading laws is not new, but it is compelling. When a person with more accurate information uses that information in the marketplace, its effect on the stock in question is to push it closer to its actual value without affecting the *ultimate* value of the asset.

The trouble with this argument is that by the time the ultimate value of the asset is determined, numerous stock trades will have been executed without the secret information, transactions that may or may not have occurred if they had been in possession of it.

Officially, a stock market is where companies sell equity to raise capital, which sounds very much like it should be as free and open a market as can be. In practice, the stock market is a giant off-track betting enterprise in which each company with listed stock is a horse. Traders bet on which horses are going to pick up speed, slow down, or maintain a steady pace in a never-ending race. Stock trading is essentially informed gambling, and most of it is executed by automated trading software that monitors various stocks to buy and sell based on programmed parameters. (For example, a simple programmed command may be to buy stocks in the energy sector with a beta of more than one when they dip below their 52-week moving average, and sell them when the stock is up 0.05%.) The trades are executed at lightning speed and often are based on tiny price fluctuations that, in total, can amount to large profits. Whether it is humans programming trading software, or your grandmother logged on to Scottrade, someone must make the decisions about which stocks to buy and sell, and that is where insider trading laws protect investors.

Insider trading rules were put in place after The Great Depression. Currently, some insider trading is legal, such as an employee buying stock in his employer's company. Those trades must be reported to the SEC and meet certain specifications. Illegal insider trading laws protect investors at large who are at a disadvantage because of an information gap. Theoretically all public information is available to all investors, and all investors can make decisions based on that information. When secret information that can materially affect a stock's value in the near future is used to an investor's advantage, that is illegal insider trading. But would it be, as Firey suggests, that the behavior of those who have privileged information will really push a stock toward a more realistic market value?

Imagine you are at the racetrack and are placing bets on horses. Someone whispers in your ear that the horse favored to win pulled a tendon earlier that day, and that only a few people know. You and a few others using that information to place your bet is unlikely to affect the odds appreciably, but may well affect your winnings greatly. You skip the favorite who will pay 3-to-2, and choose the second favorite paying 4-to-1 odds. If you had made the odd-makers' safe bet at $25 and won, you'd reap $12.50, or lost since the horse had a bad leg. But if you win with the second favorite, your winnings would be $75. In a similar fashion, DeCinces, in light of privileged information, increased his investment in the firm (which he may not otherwise have done) and invited a select group of friends to also get it on future profits. Likewise, a handful of people with the inside scoop are unlikely to affect the overall market price of a stock to the point of pushing it toward a more realistic market value. In fact, they are knowingly purchasing the stock at a discount.

Let' consider an example of a CEO who owns a good chunk of stock in his own company, and knowing that his quarterly numbers will be disappointing, dumps his stock just prior to the release of their financial statements. He would be acting on insider information, and the news that he was selling it would likely push the stock toward its true market value, but he will have sold prior to the downward curve, saving himself losses that are then suffered by stockholders who didn't have his privileged information.

In a way, the insider trading that is currently illegal is fraud due to timing. When a stock rises and falls, there are always winners and losers. The timing of a purchase at a discounted price or the sale of a stock at an inflated price can be injurious to other shareholders who are not privy to the ultimate market price and a boon to those who privately know the current market price is askew.

It is worth noting that insider trading laws only come into play when an investor makes a decision to buy or sell, and making a decision to do nothing has no repercussions. Being dissuaded from purchasing or selling a security with inside information, while technically illegal, will not land you in front of a judge.

The validity of insider trading laws and their effect on the markets is a separate consideration from the severity of the penalties for breaking them. Especially since the financial crisis, white collar crimes often receive <u>punishments</u> once reserved for the commission of violent crimes. It's hard to imagine a rational person who believes DeCinces deserves up to 280 years in prison for his actions, especially considering he was not a professional trader. **Bernie Madoff** only received 150 years (and restitution of $170 billion) for his Ponzi scheme.

Without insider trading laws, it’s conceivable that a great deal of capital will flee from the equities markets. Those not in the know, especially personal investors, will never see themselves as playing on a level playing field.