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Should Insider Trading Be Legalized?

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The Galleon charges may be just another headline.

Insider trading is back, big time.

On Friday, federal prosecutors and the SEC charged Raj Rajaratnam, the founder of New York hedge fund the **Galleon Group**, with insider trading in the stocks of several companies, including **Advanced Micro Devices** (AMD), **Google** (GOOG), and **Akamai** (AKAM). Prosecutors say he earned about $20 million in the process. Six others were also charged in the scheme.

This isn't your garden variety insider trading case. It involved an extensive, coordinated investigation by officials from both the FBI and the SEC, complete with government wiretaps. It suggests a level of aggression by law enforcement against insider traders not seen in decades.

It's a high-profile case with a $7 billion hedge fund and a perp walk. But most insider trading cases are brought solely by the SEC without the muscle of the US Attorney's office and the FBI behind it. The SEC can be commended for its efforts in the Rajaratnam case, but it won't answer the question of whether or not the agency is still the toothless cougar many believe it to be.

"The SEC has always been a relatively small agency with a relatively small budget," says Thomas Gorman, a securities attorney for Porter Wright Morris & Arthur and a former counsel in the SEC's enforcement division. And this is the agency with a mandate to ferret out and enforce cases of insider trading (among other financial misdeeds), which Gorman says is "difficult to detect and even more difficult to prosecute."

Direct evidence of insider trading, like the wiretapped conversations obtained against Rajaratnam, is extremely rare. As two SEC officials pointed out at a symposium some time ago, "there are no smoking guns or physical evidence that can be scientifically linked to a perpetrator," they said. "Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial."

Moreover, the SEC has just about 1,100 people responsible for ferreting out and enforcing violations among this country's more than 12,000 publicly traded companies, 10,000 investment advisers managing more than $38 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the close to $44 trillion worth of trading conducted each year on America's stock and option exchanges.

Seems like an impossible task. In that case, why not just legalize insider trading?

Amazingly enough, there are some who endorse this very idea.

Nobel Prize-winning economist Milton Friedman said, "You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that."

Dean emeritus Henry Manne of the George Mason University School of Law and the author of *Insider Trading and the Stock Market*, said in a radio interview that insider trading "helps to move the price of a share to its 'correct level'" and trades made using privileged information provide an "actual reflection of what's going on" with a particular stock.

And Donald Boudreaux, of the Future of Freedom Foundation wrote, "Perhaps the greatest benefit of insider trading is that it causes equity prices to disclose all relevant information as quickly as possible."

Gorman disagrees.

"I don't believe it would be appropriate to legalize insider trading," he says. "Putting information into the marketplace improves price discovery, but that information should be made public all at once so it gets absorbed into a stock's price immediately, rather than in dribs and drabs." Gorman argues that insider trading is unfair and causes dislocation in the markets. "If people perceive the market is an insider's game, they won't use those markets and then liquidity dries up," he says.

Minyanville Professor Kevin Depew, who writes frequently on market psychology, sees the issue from a different angle.

"Making insider trading legal would have no discernable impact on the markets," he says. "It's already considered an insider's game, so why would making insider trading unenforceable by legalizing it have any effect on investor psychology? Every day, there are countless trades being made using inside information as well as trades being made on the assumption that someone else has some sort of inside information. Insider trading is already, essentially, legal."

But in the eyes of the SEC commissioners, insider trading is still very much illegal. Recently, SEC Chairman Mary Schapiro was on Capitol Hill reassuring law makers that the agency is being revitalized and is redoubling its efforts vis-a-vis preventing criminal activity.

But Democratic Senator Jack Reed of Rhode Island, who sits on the Senate Banking Committee, pointed out that the SEC requested only a 1% increase in its operating budget for 2009.

With such a small enforcement presence over such a vast market, Gorman believes the SEC uses high-profile cases to help deter smaller fraudsters, and that's not the right approach. "Effective enforcement is the key to rejuvenating enforcement," he says. "Not big number, big headline enforcement."

And this brings us to why the SEC goes after big names like Mark Cuban, rather than the countless others engaged in activities far more harmful to the public at large.

“You get these enormous headlines -- Martha Stewart and **ImClone** (IMCL) and problems like that -- and you think, oh, boy, the securities policemen are really doing their job -- they're doing nothing,” Henry Manne said. “They’re making headlines. They’re not making enforcement of that law, because it’s really impossible to do.”

With the SEC boasting a national enforcement department that’s one-thirtieth the size of the NYPD, it’s painfully clear that Manne makes a more-than-valid point.

Last year, insider trading charges were brought by the SEC against Dallas entrepreneur Mark Cuban selling his 6.3% stake in **Mamma.com** (CNIC) after the company’s CEO, Guy Faure, informed him that the Internet search firm was planning a private stock offering which would dilute Cuban’s shares. Cuban promptly dumped his Mamma stock, avoiding losses of more than $750,000. The charges were later dismissed, prompting Cuban to respond by stating that the Commission is “infected by the misconduct of the staff of its enforcement division.”

A chastened SEC plans to appeal the ruling, prompting Cuban’s attorney, Stephen Best, to say, “This appeal is nothing more than the SEC’s desperate attempt to shock a heartbeat into a case that was dead on arrival. It's just one more example of wasting taxpayer money.”

Of course, if insider trading were ever to be legalized, there are still plenty of simple ways to break federal laws -- just ask the Cato Institute’s Gene Healy.

He reminds us that it’s a federal crime punishable by up to a year in jail to deal in the interstate transport of unlicensed dentures. Pretending to be a member of the 4-H Club when you’re not will get you six months. So will misappropriating the character "Woodsy Owl" or his associated slogan "Give a hoot, don't pollute." It's also a federal crime to disrupt a rodeo.

Note to Texas law enforcement authorities: If you see an outspoken Dallas billionaire wearing a Mavericks sweatshirt at a rodeo, keep an eye on him.

Mary Schapiro couldn’t get him. Maybe you can.