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Insider Trading and Whistleblowers: The Regulatory Conundrum

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Insider trading has been around for eons. It's recent emergence in the slightly more institutionalized form of an "expert network" says more about the perennial tension between investors' quest for information versus the public's desire for a level playing field than it does about the need for an "overhaul" of the hedge fund industry.

But is the release of inside information always "illegal?" The CIO at hedge fund Cornerstone Capital told Reuters last week that:

> "It is perfectly legal for me to pay someone for information on the industry as long as that expert is not violating any duty of confidentiality."

The Economist echoed this dilemma on Friday:

> "It can also be challenging to define what distinguishes insider information from diligent research. It is obviously illegal to buy information about a merger before it is announced. But is it also illegal to buy information about the number of customers going into a retailer, and trade using those data?"

Although they face certain controls, managers at publicly-traded companies are, of course, allowed to buy and sell their own stock as long as that decision is not based on any specific price-moving information. That's why *legal* insider trading is followed so closely by investors.

So an investment company's desire to level the playing field with management by gleaning background expertise from management (via expert networks) may not be, on its own, a bad thing.

Some point out that the release of secret information can be a benefit to society. On Friday, for example, The Telegraph's Tracy Corrigan wrote,

> "…defining insider trading too aggressively would, perversely, make markets less transparent. It is, after all, desirable for investors, journalists and analysts to take a critical view of company announcements and seek independent corroboration: a healthy dose of skepticism about Enron, for example, would have saved everyone a lot of trouble."

Corrigan is right to suggest that some measure of information leakage can likely protect investors. Proponents of short selling have been making this argument for years. When shorting was temporarily banned a couple of years ago, academics and practitioners lined up to make the case that short selling leads to more efficient markets. Without it, they said, those who smell a rat can do no more than simply avoid the stock and move on; look no further than the Madoff fiasco for an example of a situation where half the market alleged to know something was up, but had no option other than to ignore their gut simply because one can't "short" a hedge fund. And worse news for the olfactory-challenged, who end up throwing good money after bad stocks.

University of Missouri law professor Thomas Lambert picks up on this theme in the winter 2010 edition of the magazine "Regulation." In "A Middle Ground on Insider Trading," Lambert says that "some species of insider trading should be treated differently than others."

Specifically, he argues that "price-increasing" insider trading should remain "restricted", but that "price-decreasing" insider trading should be "deregulated."

Like The Telegraph's Corrigan, he also invokes the ghost of Enron as an example of where a little leakage of bad news (through insider trades) might have helped a lot:

> "Stock analysts, the other individuals who are well-positioned to identify and correct stock mis-pricing, also are less likely to correct overvaluation than undervaluation. Consider the optimism bias exhibited in the Enron debacle. In the autumn of 2001, just weeks before Enron's December 2, 2001 bankruptcy, each of the 15 largest Wall Street firms covering Enron's stock had buy recommendations in place. And as late as October 26, 2001 — after Enron's chief financial officer had been forced to resign, the SEC had initiated an investigation, and the Wall Street Journal had run several stories about Enron's earnings management problems — 10 of the 15 largest Wall Street firms covering Enron maintained buy recommendations, as did 15 of 17 top Wall Street analysts surveyed by Thompson Financial/First Call."

But, wait, why shouldn't we demand that a hypothetical Enron whistle blower simply go to the media with his or her concerns? That way, the public could learn what it needed to know and the insider would not have unfairly cashed in on their serendipity.

Lambert argues that, although corporate management can always be counted on to speaking positively about the company's prospects, they have little or no incentive to talk down those prospects. The manager could be demoted, fired or, worse yet, the company could experience the "last period" problem and go bankrupt *a la* Enron. In addition, by informing investors of bad news, they would unavoidably signal their competitors and customers and therefore potentially exacerbating the company's negative predicament; he calls this the "multiple audiences" problem.

He also points to basic behavioral biases that prevent corporate managers from publicly (or even personally) acknowledging bad news, as well as the continuing dearth of "sell" ratings vs. "buy" ratings issues wished to be raised by analysts.

Since mangers (analysts too!) are apparently quicker to highlight positive news and markedly slower to acknowledge negative news, Lambert writes that:

> "There is thus an asymmetry in the degree to which managers and market forces are able to correct the different species of mis-pricing: the primary options available to correct negative mis-pricing are not practically available when the mis-pricing is in the positive direction."

Lambert goes on to say that the resulting overvaluation of stocks, which is supported by existing management incentives and investment industry apparatus, is actually *more harmful* to society than the potential under-valuations that could occur if insider trading was allowed in "price decreasing" situations. Management of overvalued companies, he charges, tend to squander capital by embarking on misadventures such as expensive acquisitions. Conversely, overvaluation can also prevent good investments since CFO's may be more concerned about meeting Wall Street's inflated earnings expectations than about undertaking accretive R&D, advertising or maintenance.

But investors benefit when bad news is withheld as long as possible, right? So how is it bad that negative news remain strictly secret, as opposed to making its way out via falling stock prices? Lambert says that "overvaluation tends to be corrected eventually" and that since "shareholders possess neither actual nor apparent control over the events likely to reveal overvaluation," a bubble will build and investors will eventually have to pay the piper when it bursts.

Lambert's arguments are cogent and certainly challenge orthodoxy. Short-selling does keep management honest – and that's why management generally hate it.

But he largely avoids the larger moral question of allowing some investors to signal negative news by making self-enriching trades. In our mind, that's what fuels the public's disdain for insider trading, not its impact on the allocative efficiency of capital markets. Ergo, this is as much a morale and political debate as an economic one. (If you clicked on the link to Lambert's article, you may have noted that the magazine "Regulation" is published by the Cato Institute, which describes itself as an advocate of "individual liberty, free markets and peace.")

But in September, the SEC launched a whistle blower program that rewards people up to 30% of eventual monetary sanctions resulting from their tips. In a way, it's curious that the SEC encourages would-be snitches to report negative news when it involves illegal activities, yet (antithetically) obstructs the free flow of *non-illegal* negative news and therefore harm investors in the long run. In our view, Lambert is essentially suggesting that insider trading is one of the only ways management whistle blowers can protect investors. Perhaps the fact that they unfairly benefit is simply an appropriate, albeit socially distasteful, reward.