TIME

Why Is Insider Trading Even Illegal?

By Christopher Matthews – July 26th, 2013

Ever since the financial crisis, U.S. regulators have been hard at work putting away Wall Street financiers who play fast and loose with the law. The only problem is, those Wall Street crooks that the feds have been cracking down on aren't those who actually caused the financial crisis, but a different breed of white collar criminal: inside traders.

As Charles Gasparino explains in his new book on insider trading, it's largely coincidental that the fed's recent crackdown on the practice — which includes yesterday's indictment of the hedge fund SAC Capital – is taking place in the wake of the worst economic recession in several generations. But the coincidence does provide opportunity to ponder why — given the fact that insider trading isn't anywhere near as pernicious a crime as some other white collar shenanigans — the government spends so much time and energy trying to stop it.

In fact, there are large number of professional economists and legal theorists — albeit generally of the libertarian persuasion — who feel that insider trading shouldn't be illegal at all. Doug Bandow, a senior fellow at the Cato Institute, for example, writes:

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.

He goes on to argue that the goal of insider trading laws, which is to promote a fair stock market, is misguided. Every day stock market participants trade securities based on incomplete information. In nearly every transaction, one party has superior information than the other. Furthermore, it's only possible to enforce insider trading laws when a trader decides to buy or sell a security. But the decision to *not* trade a security is sometimes equally important. If your inside source at a company whose stock you don't own gives you a peak at a financial statement, and it's disappointing, you will decide not to buy that security. And that decision is illegal, but can never be proven. Writes Bandow, "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."

Finally, Bandow argues that insider trading laws prevent the market from reflecting all available information about securities. By preventing those who know more about a stock from acting on that information, you impede the natural tendency of markets to set a fair price.

These arguments are not new. Ever since 1934, when insider trading became illegal in the United States, theorists have argued about the merits of such restrictions. But what may come as a surprise to many is that even though insider trading has technically been illegal since the 1930′s, regulators have only been enforcing the law with vigor for the past 30 years. That changed radically in the 1980s, when several new laws were passed to stiffen penalties for insider trading, and regulators started bringing many more cases against Wall Street.

So why was there a sudden shift against insider trading in the 1980s, and what is the rationale behind these laws? While it's true that, as Bandow argues, insider trading deprives markets of some pertinent information, allowing insider trading would weaken other pillars of a modern securities market.

One such organ of modern financial system are market professionals like hedge fund, pension, and mutual fund managers. These are the people who spend significant time and resources digging up non-inside information about the economy and individual firms. For instance, big hedge funds often produce vast amounts of research concerning companies using publicly available data from the government or private institutions. This information helps make markets more efficient and helps to price assets more accurately. But if insider trading were legal, it's possible that all this work may not be worth it when competing with insiders and those able to get hold of insider information. If these market professionals leave the market as a result, it could lead to much less efficient markets.

Second, insider trading most certainly puts the average investor at a disadvantage. If the nonprofessional investor feels that he can't participate in the markets without getting ripped off, he'll also leave the markets. Just as with professional money managers, this will have the effect of reducing liquidity. Reduced liquidity in turn means that those who do invest will pay less for a stock because of the risk that they won't be able to sell it when they want to — and this in turn makes the cost of capital for firms more expensive and the economy less efficient overall.

Another effect of decreased liquidity is on so-called market makers: the folks who hold a large inventory of a particular security and will buy that security slightly cheaper than it will sell it. That price difference is called the "spread," and it represents the market maker's profits. Fewer participants in the market mean wider spreads, as market makers have to make up for decreased volume. Bigger spreads mean less efficient markets — as less capital is getting to those who will most efficiently make use of it.

The conclusion that researchers from the Federal Reserve Bank of Atlanta came to when looking at all these effects is that insider trading laws do indeed present a trade off. On one hand, insider trading laws distort the market by making it more difficult for prices to reflect all available information. On the other hand, a developed and modern securities market relies on the participation of different types of investors with different motivations and levels of expertise — and without insider trading laws many of these types of investors would stop participating.

And this explains why it takes so long for nations to develop insider trading laws. (Insider trading rules were laughably lenient in the U.K. until 1980, for example.) When an economy is young, it often doesn't have a developed financial services sector with people whose dedicated job is to make markets or trade for a living. Markets in such economies have few sources for information about the economy and the individual companies, and so it is important for inside information to be able to filter its way through to markets. But once an economy is mature, it can forgoe these sources of information in the name of more robust markets.

Ultimately, however, Congress didn't establish insider trading laws because of such refined economic theories. For better or worse, Congress doesn't set policy by soberly analyzing economic models. Often its actions simply reflect the emotional will of the American people. And Americans like fair play. With this in mind, it's easy to see why insider trading rules contain some of the contradictions Bandow emphasizes, and why we often see them most strictly enforced during times of financial excess — even when that excess isn't a result of insider trading.