What's Wrong About Insider Trading?

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Added to *cato.org* on May 17, 2010

This article appeared in Barron's *on May 15, 2010.*

Hedge-fund Billionaire Raj Rajaratname ended a good year in a bad situation. Last Christmas week he pleaded not guilty to running an insider-trading ring. It was the first insider-trading case to rely on wiretaps, and resulted in the arrest of another 20 people. Rajaratnam, reputedly worth about $1.5 billion, could spend 20 years or more in prison if convicted for a scheme that supposedly made at most $25 million in profit.

The government loves high-profile insider-trading cases, and it loves to provide smarmy details. One of the other defendants in the Rajaratnam case allegedly said in a taped phone conversation: "I'm dead if this leaks...I'll be like Martha f___ing Stewart."

Stewart, now back plying her trade as America's Decorator-in-Chief, may be the biggest "get" ever for the insider-trading cops. But there are many people on the list of those investigated (many, but not all of whom were convicted): stockbrokers, journalists, Wall Street kingpins, sports moguls, printers and others.

Few people ever ask the most basic question: Why is insider trading a crime?

Insider trading isn't fraud. In most cases those prosecuted never had contact with the alleged victims on the other side of their trades. Although the victims chose to trade without prompting, the legal issue is only whether the trade was based on inside information.

The law bizarrely affects only one-half of the trading equation. People make money by not trading as well as trading. But it is virtually impossible to prove that someone chose not to buy or sell stock because of a legally improper tip. So hundreds, maybe thousands, of people get away with insider "not trading" every year. Yet it isn't obvious that the operation of the financial markets is impaired in any way.

If there is a problem in the market about insider trading, it's that the market is biased by imposing criminal sanctions on only one side of the transaction. Inside information should lead roughly equal numbers of people to buy, sell and do nothing. The criminal law encourages people to do nothing. Whatever the impact, it isn't likely to be more efficient markets.

Insider-trading laws deny markets important information. The recent financial crisis was caused in large part by inadequate information. People didn't know the true value of mortgage-backed securities, leading to a financial house of cards that crashed down on federal agencies, investment houses, commercial banks and average investors.

The distinction between public and non-public information is legally decisive but economically unimportant. Perversely, the insider-trading laws seek to prevent people from trading on the most accurate and up-to-date information. The law seeks to force everyone to make today's decisions based on yesterday's data. It's a genuinely stupid thing to do.

The only plausible argument for ensuring that everyone trades on inadequate and outdated information is "fairness." The Securities and Exchange Commission's Enforcement Director, Robert Khuzami, says insider-trading prosecutions are aimed at restoring "the level playing field that is fundamental to our capital markets."

That is, just because your brother-in-law works at the accounting firm, you shouldn't be able to buy or sell based on his disclosure of a client company's dire financial straits until everyone knows it.

But Wall Street is built on metaphorical hillsides. The market is suffused with this sort of unfairness. Professional investors make money because of asymmetries of information. Someone working on Wall Street is almost always going to be better versed on financial issues than a casual investor. People make careers picking up hints and suggestions to use in trading.

However unfair it might seem to trade on inside information, it is unfair to no particular person.

Unless you committed fraud as part of the transaction, the person who bought your shares or sold his did so because he wanted to do so based on his information. Your "inside" information had no impact on his decision, especially in the impersonal markets through which most security transactions occur.

Acting on new information moves the market toward the right or "honest" price, as economist Donald J. Boudreaux puts it. Prosecuting people for insider trading slows the price-adjustment process. That means the price shock when the relevant news hits the market will be more abrupt and the losses will be greater for some people.

In some insider-trading cases there is a genuine victim: individuals or companies whose proprietary information was improperly disclosed. That should be punished, but as a civil offense based on the relevant contractual or fiduciary relationship. This kind of disclosure shouldn't be of concern to the feds, let alone be an offense serious enough to justify wiretaps and mass arrests.

Yet the SEC employs sophisticated computer software to identify a few "suspicious" trades out of hundreds of millions of transactions. Agency enforcement chief Khuzami wants greater access to grand-jury information and greater power to pressure defendants to turn in their confederates.

Insider trading shouldn't be a crime. There typically is no victim. To the contrary, most of us benefit when prices move more rapidly to the right level.

Unfortunately, prosecutors, regulators and politicians alike periodically demonize insider trading to justify their offices and budgets. But there is no reason to punish investors who trade on accurate information. In fact, that is precisely what the financial markets should encourage.