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The Fraud of Insider-Trading Law, Part 2

by Sheldon Richman

It is virtually unquestioned in America today that insider trading in the securities markets is a dastardly act. We must make a distinction here between trading by insiders and trading by insiders on the basis of nonpublic information. Insiders are legally allowed to buy and sell stocks. The Securities and Exchange Commission (SEC) requires insiders to disclose their trades, and the financial newspapers report such trading. Investors find this information a source of valuable clues about companies. (It is possible that even without the SEC requirement, shareholders would require their executives and directors to declare their trades.)

But what could be more immoral than someone's selling or buying stock on the basis of information he knows the other party lacks?

Put that way, maybe it doesn't seem so immoral after all. The idea that knowledge can ever be evenly distributed is one of those utopian pipe dreams the realization of which would require nothing less than secret police and gulags. Knowledge, like everything else about people, is most definitely *un*evenly "distributed." It is not distributed at all. It is acquired — by effort or luck. It's not as though there is a central knowledge-giver who spitefully shortchanges some of us. This leads to the first observation: if the law prohibits people from exploiting knowledge advantages, they have less incentive to ferret out valuable knowledge and bring it to market. Would that be good?

Those who seek to stamp out insider trading concede this point, so they object only when the knowledge is unavailable to the public. But the line between prohibited inside knowledge and permissible inside knowledge is far from clear. As law professor Daniel Fischel writes in *Payback,* although inside knowledge of specifics — an earnings report, a pending merger — is an illegal basis for insider trading, more general inside knowledge is not:

> Maybe the insider believes that a planned reorganization of a company's sales force is going better than expected or knows that a key executive is distracted by health or marital problems. Corporate insiders are permitted, even encouraged, to trade on this kind of informed hunch.

Why are stock transactions involving specific inside knowledge bad? The theory is that not only are the ignorant buyers and sellers taken advantage of, but — worse, perhaps — confidence in the securities markets themselves is sabotaged because potential participants, fearing they will be taken advantage of, will stay out of the market, depriving it of capital.

This is a serious charge. What's the truth?

Markets and prices

A good place to start when inquiring whether an act is a crime is to ask: who's the victim? Current law has two in mind: the specific buyers or sellers of stock shares who did *not* possess the inside information and "the market."

Let's dispose of the second one first. "The market" cannot be a victim. It's an abstraction, not a living, breathing being. You can only victimize — that is, violate the rights of — individuals. But what about the claim that insider trading erodes confidence in the market? Even if that were true, it would not turn the act into a crime.

But the assumption that insider trading erodes confidence in markets is false. On the contrary, confidence is increased by the realization that prices reflect up-to-date information. To explain this we must digress briefly to discuss the role of prices.

The price system does more than tell us what we must pay for goods and services. It produces information — in a highly concentrated and economic form — about supply and demand. We all use that information to guide our activities. For example, when a bad hurricane devastates a town and destroys homes, the new demand for plywood by suffering homeowners will bid up the price for the existing supply and attract new supply from other areas. (Unless socialistic laws prohibit "profiteering.") Whether or not I know about the new acute need for plywood, the higher prices will probably prompt me to postpone my plans to build a doghouse for Rover.

Note the social niceties of free pricing and the free movement of goods in response to price changes. Without making impossible interpersonal comparisons of subjective utility, most people would think that it's good that my doghouse will probably wait until after people rebuild their homes. The market's price system accomplishes this without a dictator issuing decrees or secret police shooting the uncooperative. Strangely, the market never gets credit from the intellectuals and "human rights" activists for this not inconsiderable achievement.

Of course, the contrast among most everyday alternatives is not so dramatic, but the principle is the same. The price system enables people to make decisions about scarce resources that take into account individual needs and knowledge spread throughout society, but without burdening them with an unmanageable amount of data.

Stock prices too are generated by supply and demand. But supply and demand for stocks are not disembodied concepts. They are generated, obviously enough, by suppliers and demanders — people with preferences, objectives, expectations, knowledge, and, therefore, plans. Part of what goes into an intention to buy or sell shares in a company is expectations about its future based on knowledge about its management, organization, and so on. These expectations are incorporated into the share price, and changes in expectations bring about changes in price. The more knowledgeable the participants, the more fully do prices perform their communications work. Nothing would undermine confidence in markets more than the belief that prices are out of date.

The Martha Stewart case

Look at Martha Stewart's ImClone stock sale. Regardless of what she knew, it is a fact that the Food and Drug Administration (FDA) was about to deny ImClone's application for the anti-cancer drug Erbitux. Obviously, the company and its stock would be worth more with FDA approval than without it.

Thus, in the time between the FDA's decision and its public announcement, ImClone's share price was unrealistically high. If shareholders with advance notice of the FDA's rejection sold their stock, they helped bring the price in line with the new set of facts.

The resulting price was a better price because it better reflected the revaluation. The direction of the price movement was also a signal to investors.

This leads to the question of whether particular buyers and sellers of stock are victims of insider trading. Again, let's look at the Stewart case, which is not about insider trading but relies on the theory. (See part one, *Freedom Daily,* September 2003.) No victim was named by the U.S. attorney. Stewart ordered her stock sold on December 27, 2001, after allegedly being told that the company's CEO was trying to sell his shares. (He was unable to sell them.) But she did not go out on the street, buttonhole a hapless pedestrian, and pitch the stock until he agreed to buy it. That's not how it works. She told her broker to sell, and the broker sold her shares to *someone already looking to buy the stock*.

This raises several interesting points. Anyone shopping for ImClone stock that day surely knew that a make-or-break decision from the FDA was due any time.

How can that buyer be described as a victim? Perhaps he wanted a long shot and was hedging with other stocks.

Or, since there was short-selling going on, he might have thought the stock would be a good deal in the longer run. (In fact, the stock price has come back because of a favorable Erbitux trial in Europe.)

Thus it is unlikely that a buyer of ImClone that day was naively shopping for stock. At any rate, for the government to assure the most clueless stock buyers that their knowledge is no worse

than anyone else's in the market is to set them up for disappointment and to discourage the market research that any investor should engage in. No one is done any favors when insider trading is outlawed.

The upshot is that the buyers were not victims of Stewart.

By the way, on the day she sold, 7.7 million ImClone shares were traded — five times the volume of the day before. The members of then-CEO Sam Waksal's family who were tipped off early about the FDA sold only 150,000 shares. Maybe the knowledge wasn't so "inside" after all.

Note also that sellers of the stock were improving things for any unsophisticated buyers. If dumping their shares depressed the price, the buyers who would have bought anyway suffered a smaller loss than they would have had the stock not been dumped.

Benefits of insider trading

Of course, a naive stock speculator might decide after the fact that because he lacked inside information he bought or sold too soon, or didn't buy or sell at all. But that was a risk he should have been aware of going in. In contrast, the long-term stockholder, such as the proverbial "little old lady," who is not buying and selling in response to day-to-day price changes, is unlikely to be harmed by insider trading. On the contrary, this seller will most likely benefit.

"The long-term trend of stock prices is upward, so that, all other things being equal, occasions for good news should exceed those of bad," Henry Manne writes in *Insider Trading and the Stock Market*. "Any undeserved risk to investors resulting from insider trading must, therefore, constitute a very small fraction of the total risk assumed by long-term investors."

Manne points out that insider trading is beneficial in another way. It's an appropriate method for corporations to compensate internal entrepreneurs for their work, because entrepreneurial insight is difficult to reward properly with bonuses or stock options. Fischel writes that insider trading (buying) can also be useful for letting executives "disclose" good news about the company without giving information away to competitors.

On the other hand, if stockholders dislike the practice, that will be reflected in lower stock prices for corporations that permit it. In the end, this is a matter for the competitive marketplace to sort out.

Insider trading, of course, is a separate issue from the use of proprietary information in violation of a contractual duty. If Stewart's broker violated his duty to his other clients, they may have grounds for a civil suit and Merrill Lynch would have grounds to fire him. But it would be no cause for an SEC action or criminal indictment. The offense would be breach of contract, not insider trading.

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