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COMMENTARY

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The Case for Insider Trading

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Insider-trading regulation had its primordial introduction in the muck of New Deal securities regulation, which was itself justified on the trumped-up theory that full disclosure was the best way to deal with corporate fraud and deception. Over the years, the benign-sounding idea of passive regulation in the form of full disclosure has morphed into a morass of active regulation. Full disclosure now wraps around -- and regulates -- corporate governance, accounting, takeovers, investment banking, financial analysts, corporate counsel, and, not least, insider trading.

Some history of insider-trading regulation is instructive in this regard. In 1934 Congress refused an early draft of the Securities and Exchange Act that contained a provision outlawing insider trading, perhaps because it would have covered members of Congress. But in 1961 the SEC, not to be denied, invented a new theory to force insiders either to "disclose or abstain from trading." In 1968 this unorthodox bit of lawmaking received judicial sanction, and subsequently Congress itself recognized fait accompli in what the SEC had ordained.

Prior to 1968, insider trading was very common, well-known, and generally accepted when it was thought about at all. When the time came, the corporate world was neither able nor inclined to mount a defense of the practice, while those who demanded its regulation were strident and successful in its demonization. The business community was as hoodwinked by these frightening arguments as was the public generally.

Since then, however, insider trading has been strongly, if by no means universally, defended in scholarly journals. There have been three primary economic arguments (not counting the show-stopper that the present law simply cannot be effectively enforced). The first and generally undisputed argument is that insider trading does little or no direct harm to any individual trading in the market, even when an insider is on the other side of the trades.

The second argument in favor of allowing insider trading is that it always (fraud aside) helps move the price of a corporation's shares to its "correct" level. Thus insider trading is one of the most important reasons we have an "efficient" stock market. While there have been arguments about the relative weight to be attributed to insider trading and to other devices also performing this function, the basic idea that insider trading pushes stock prices in the right direction is largely unquestioned today.

The third economic defense of insider trading has been that it is an efficient and highly desirable form of incentive compensation, especially for corporations dependent on innovation and new developments. This argument has come to the fore recently with the spate of scandals involving stock options. These are the closest substitute for insider trading in managerial compensation, but they suffer many disadvantages not found with insider trading. The strongest argument against insider trading as compensation is the difficulty of calibrating entitlement and rewards.

Critics of insider trading have responded to these arguments principally with two aggregate-harm theories, one psychological and the other economic. The first, the faraway favorite of the SEC, is the "market confidence" argument: If investors in the stock market know that insider trading is common, they will refuse to invest in such an "unfair" market. Thus investment and liquidity will be seriously diminished. But there is no evidence that publicity about insider trading ever caused a significant reduction in aggregate stock market activity. It is merely one of many scare arguments that the SEC and others have used over the years as a substitute for sound economics.

The more responsible aggregate-harm argument is the "adverse selection" theory. This argument is that specialists and other market makers, when faced with insider trading, will broaden their bid-ask spreads to cover the losses implicit in dealing with insiders. The larger spread in effect becomes a "tax" on all traders, thus impacting investment and liquidity. This is a plausible scenario, but it is of very questionable applicability and significance. Such an effect, while there is some confirming data, is certainly not large enough in aggregate to justify outlawing insider trading.

But there is still another justification for insider trading, and this one may explain why corporations did not regulate the practice themselves before the SEC got into the act. Management and the shareholders of large, publicly-held corporations have a strong common interest in the accurate pricing of the company's shares. If pricing is not reliable, investors will demand a higher return in order to be compensated for assuming this added risk. Thus, all other things being equal, the shares of a company with reliable pricing of its shares will sell for more than otherwise identical shares.

Lack of confidence in the reliability of a share's price, reflected in a higher risk premium, will have several negative effects. The company will have to pay more for new capital, boards of directors and the managers themselves will have less reliable feedback on managerial performance, managers' professional reputations will suffer, and the managers will be at greater risk of displacement either through a takeover or action of their own board of directors.

Like many well-functioning markets, the market for valuable information requires little attention or comprehension. The fact that insiders, who may not even be in managerial positions, profit from the system certainly does not mean that they necessarily understand or care about the economic importance of reliable pricing, or that their gain detracts from the benefits others receive from the system. The system would not work unless they profited, but there is no need for them to understand the larger picture.

No other device can approach knowledgeable trading by insiders for efficiently and accurately pricing endogenous developments in a company. Insiders, driven by self-interest and competition among themselves will trade until the correct price is reached. This will be true even when the new information involves trading on bad news. You do not need whistleblowers if you have insider trading.

If such trading is allowed, there are no delays or uncertainties about what has to be disclosed. There are no issues about when information must be published, or in what form. There is no need to regulate investment bankers, auditors, or stock analysts. The evaluation of new information will be done efficiently through a pure market process. Investors receive "virtual" full disclosure in the form of immediate and correct price adjustments.

This also helps us understand why stock exchanges, even before the SEC, required periodic financial disclosures to shareholders. Insider and other knowledgeable trading might keep the price of a company's shares at the right level, but the investing public would need confirmation of this. Periodic disclosure of financial statements confirmed to the investing public that the price level of shares, reached by trading, was reliable. Both exchanges and companies had an interest in this.

In time even the SEC noticed that periodic financial disclosures were not having much effect on stock prices. Their reaction was merely to require more frequent and more detailed disclosures. But the SEC never realized that insider trading was already the form of "disclosing" that maintained the efficiency of stock pricing. Instead, they outlawed it. Happily for us all, enforcement has not been too successful. Now it is time to reconsider the whole matter.

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