

# Should Insider Trading Be Legal?

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The government's historic crackdown on insider trading has shaken Wall Street. To date, authorities have filed charges against roughly 80 individuals, winning at least 78 of those cases through either a guilty plea or conviction at trial. Along the way, they've brought down hedge fund titan Raj Rajaratnam of the now defunct Galleon Group, and forced Steven Cohen's SAC Capital Advisors to end its business of managing money for outside investors.

The dragnet has also revived a debate over whether insider trading should even be illegal to begin with. While supporters of tougher enforcement say the ban helps to "level the playing field," critics argue that the costs of ridding markets of such illicit deal-making outweigh the benefits. Some go as far as to call it a victimless crime.

With that in mind, we invited two Wall Street experts to join us for a debate on the issue. Arguing in favor of decriminalization is [John Carney](#), a senior editor for CNBC.com and co-author of the site's [NetNet blog](#) covering high jinks on Wall Street. Arguing against the motion is [Matthew Yglesias](#), a business and economics correspondent for *Slate* and the author of *The Rent Is Too Damn High*. Here's what they had to say:

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Dear Matt,

When the government's great dragnet against insider trading reached a crescendo this summer with the indictment of SAC Capital, something quite surprising happened. Conventional wisdom shifted toward a view that had long been as disreputable as it was rare. [People began to wonder aloud](#) if the ban on insider trading was a mistake, a policy that should be repealed. This came as a shock to me. I've been [an advocate of repealing the ban on insider trading](#) ever since I first learned such a thing existed. But this was a heterodox position, something that earned me a reputation of someone defending the indefensible everywhere I went. First in law school, then when I was a practicing attorney, and finally as a journalist. But I never expected that this was an argument I might win.

So what happened? Two things I think. First, it became all too obvious that the official rationales for banning insider trading make no sense. The ban

doesn't create a level playing field or even meaningfully contribute to it. The phrase "fraud on the market" is gibberish: market quality is actually improved by insider trading because stock prices better reflect the undisclosed realities of corporate fortunes. There are no investors victimized by insider trading.

Take the allegation that a trader at SAC got insider information that a drug wasn't testing well and so sold some of the stock in the company, avoiding losses when the information eventually became public and the stock price dropped. No one who bought or sold the stock while SAC was in possession of this information would have done better if SAC hadn't had the information. In fact, buyers would have likely done worse since SAC's sales may have depressed the price a bit. It was victimless: so why is it a crime?

The second thing that happened was that people began to realize that the pursuit of insider trading had dramatically changed over the last few years. The government now employs legal tools — such as secret wiretaps — [developed to defeat the Mafia or stop terrorists](#) in an effort to catch people trading on nonpublic information. This strikes a lot of people as unreasonable in light of the benign nature of insider trading. In the United States we might tolerate a surveillance state narrowly tailored to catch mobsters, drug kingpins and terrorists — but anything much beyond that strikes us as government overreach. It's the NSA scandal in miniature. Of course, the government is headed in the opposite direction. New York's chief federal prosecutor, for example, is convinced that he's performing a great public service by pursuing alleged insider traders. So I don't expect the law to change any time soon. But perhaps it's not too much to hope that the government can someday be talked down from its current insider trading mania to regard it as something best left to civil authorities such as the Securities and Exchange Commission.

So, what do you say? Are you going to join the rest of us in the great crusade to decriminalize insider trading?

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Dear John,

When I was young and irresponsible, I was an insider trading legalizer myself. It seemed like a bold and contrarian stance of the best possible kind. A little bit of a right-wing deregulatory impulse, but also an element of populism to boot.

After all, the basic premise of insider trading bans as a consumer protection really is kind of fishy. The best way to avoid losing money playing blackjack isn't to look for the most honest casino in town, it's to not gamble. By the same token, the idea of a "fair" stock market in which it would make sense for middle class investors to pick stocks and trade is fantastical. What the mass of savers and investors need to know is that you shouldn't overtrade, shouldn't try to beat the market, and shouldn't pick stocks. Find yourself a nice low-fee diversified passive mutual fund or ETF and forget about what the insiders do and don't know.

On the other hand, I don't think the argument that allowing insider trading would improve market efficiency by putting more information to work makes much sense. As Jie Hue and Thomas Noe write in [their analysis of the issue for the Atlanta Federal Reserve](#), the existence of a sophisticated securities analysis industry in the United States means we don't really face the problem of a major informational gap. Just look at this year's Nobel Prize winners in economics. Eugene Fama has shown that U.S. equities markets are essentially "efficient" in an informational sense as is. His co-winner, Robert Shiller, has done an enormous amount to demonstrate that this kind of efficiency hardly precludes periodic manias and panics and that asset prices fluctuate much more dramatically than the fundamentals. But the substantial holes poked in the theory of the stock market as efficient point to herd psychology as the key flaw, not hidden information that insider trading would reveal.

The real impact of legalizing insider trading, in this instance, would be twofold. On the one hand, firms that don't want their insiders to trade on inside information would need to invest in their own monitoring and enforcement mechanisms of firm-level rules. On the other hand, firms that didn't bother to invest in halting insider trading could construe permissive insider trading rules as a form of additional compensation to employees.

The first impact hardly seems desirable. Since firms couldn't level the same kind of sanctions as the government, the monitoring would need to be much more intensive and expensive to produce equivalent deterrence, leading to a huge waste of social resources. And the second impact seems potentially disastrous. The last thing the American economy needs is a dynamic in which managers of major corporations have even more financial incentive to spend their time thinking about ways to game the stock market rather than manage their enterprises for the long term.

There are some good questions to be asked about the overall role of surveillance in American law enforcement that would, of course, have

important implications for insider trading cases as well as other kinds of criminal activity. But the fundamental social goal of securities law is to have well-managed, well-capitalized enterprises and the ban on insider trading serves those goals perfectly well as it stands.

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Dear Matt,

I think you may still be younger and more irresponsible than you reckon. Or, at least, your views may be far closer than you think to those of us who advocate decriminalizing insider trading.

Let's start with your first point about the problem of private enforcement of insider trading rules. I agree with you that there are often gains from centralization and professionalization of protective services. It's pretty easy to see, for example, that while it might create a lot of great incentives for homes to engage in fire-proofing, having every household responsible for its own fire-fighting would be socially costly (even if we ignore the negative externalities of things like your neighbor's house catching fire). Dedicated fire departments, with trained fire fighters, are a good idea.

This is likely the case with policing insider trading. The SEC and the self-regulating market organizations have a lot of experience and expertise here. Being able to levy fines is a powerful tool for controlling behavior. A corporation would have a much harder time monitoring and enforcing rules against insider trading without potential government sanction.

Importantly, however, this describes a rationale for an optional ban on insider trading rather than a mandatory one. That is, a rule against insider trading that corporations could opt-into, thereby gaining the benefits of government assisted enforcement. It's not a rationale for a blanket ban that applies to corporations that would rather permit insider trading.

Your second point is mysterious to me. If we had an opt-in rule, why would anything disastrous occur? If permitting insider trading truly created incentives that undermined corporate performance over the long term, then shareholders would discount the shares for that. If shareholders disagree with you about the effects of insider trading on corporate performance, then we might not see it discounted. How would you know in advance which is preferable? Most likely, in some sectors and some companies where cash is hard to come by, it would make sense to compensate through insider trading. And in others, it wouldn't. This is the virtue of an optional

insider trading regime: it recognizes the heterogeneity of corporate economics.

Surely this is a better path toward well-functioning capital enterprises than a one-size-fits-all ban on insider trading.

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Dear John,

The opt-in suggestion is intriguing.

From time-to-time I'm reminded of a seminar I took in college taught by the late great libertarian philosopher Robert Nozick. He observed that many regulatory functions that normal people think are necessary for the government to undertake — food safety, for example — could be easily discharged by the private sector. Given the choice between a certified safe can of beans and an uncertified can of beans, surely consumers would prefer the safe one. So a sensible canning firm would want to contract with a credible food inspection service to certify its beans. And as the long-term value of the food inspection service's franchise would rest on its credibility in the marketplace, the inspectors would have reason to judge food vendors in a harsh and credible manner.

Bye bye FDA, hello libertopia. And if it works for beans, why not for insider trading?

Sensible people, I think, shy away from this kind of thinking. It's easy to sketch out a diagram about reputational effects and consumer preferences and how it all works out in the end. But then it's easy to remember the case of the bond ratings agencies, who actually do operate on this principle, and who at the peak of the housing bubble were all-too-happy to offer AAA ratings to mortgage backed securities that turned out to have major risks.

And when it comes to beans, one of the virtues of the present regulatory system is that it actually works just fine. People buy their cans and don't get poisoned. The only real motivation for the hypothetical privatization of food safety is to demonstrate to undergraduates that ideologically rigorous libertarianism needn't necessarily entail as many upheavals of everyday life as one might think. But from my viewpoint it's a solution in search of a problem. And the idea of allowing opt-in or opt-out from insider trading rules strikes me as much the same. What problem are we trying to solve by legalizing insider trading? As a journalist, I agree that it'd be kind of fascinating to see what would happen if we did it — I'd be curious. But

again, it seems to me that if you want to find a problem with contemporary American equity markets it's that they offer *excessively strong* incentives for managers to sweat short-term price trends and quarterly earnings data. I'm not sure I have a regulatory fix for that, but I'm not going to embrace a step in the other direction.

Meanwhile, John, a question for you: How far would you take this logic? After all, the ban on insider trading is hardly the only rule of corporate governance in America. Should we just make it all opt-in? Establish a board with outside directors if shareholders demand it, but not otherwise? Release quarterly earnings if you like, but skip it if you don't feel like it? In other words, is the ban on insider trading a particular bugaboo or just step one to a radical rethink of securities law and corporate governance?

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Matt,

Let me admit that I admire your basically conservative instinct not to overturn laws just because they seem to make no sense. As Robert Frost taught us, sometimes it is better to mend walls even when we don't really understand why they're there anymore.

The problem is that the criminalization of insider trading isn't some harmless legal rule. It's very, very harmful. We're sending people to jail for years, even decades, based on legal theories of "fraud on the market" that you and I agree don't make any sense. Our courts are authorizing invasions of privacy, including open-ended wire-tapping, in pursuit of those the Justice Department suspects of insider trading. We've made a pariah out of one of the most successful traders of all time, Steve Cohen, and chased every outside investor out of his firm, SAC Capital. There are real human costs inflicted by the ban on insider trading.

The pursuit of insider trading is also diverting resources away from the pursuit of more serious financial wrongdoing. But don't take my word for it. Here's what [Judge Jed Rakoff recently wrote](#) in *The New York Review of Books*:

**As for the Department of Justice proper, a decision was made in 2009 to spread the investigation of financial fraud cases among numerous U.S. Attorney's Offices, many of which had little or no previous experience in investigating and prosecuting sophisticated financial frauds. This was in connection with the president's creation of a special task force to investigate the crisis, from which remarkably little has been heard in the intervening four-plus years. At the same time, the U.S. Attorney's Office with the greatest expertise in these kinds of cases, the Southern District of New York, was just embarking**

on its prosecution of insider-trading cases arising from the Raj Rajaratnam tapes, which soon proved a gold mine of prosecutable cases that absorbed a huge amount of the attention of the securities fraud unit of that office.

While I want to stress again that I have no inside information, as a former chief of that unit I would venture to guess that the cases involving the financial crisis were parceled out to assistant U.S. attorneys who were also responsible for insider-trading cases. Which do you think an assistant would devote most of her attention to: an insider-trading case that was already nearly ready to go to indictment and that might lead to a high-visibility trial, or a financial crisis case that was just getting started, would take years to complete, and had no guarantee of even leading to an indictment? Of course, she would put her energy into the insider-trading case, and if she was lucky, it would go to trial, she would win, and, in some cases, she would then take a job with a large law firm. And in the process, the financial fraud case would get lost in the shuffle.

In short, a focus on quite different priorities is, I submit, one of the reasons the financial fraud cases have not been brought, especially cases against high-level individuals that would take many years, many investigators, and a great deal of expertise to investigate.

Perhaps we could have a kinder, gentler insider trading ban that wouldn't be abused. But I don't see how we get there. Right now the only option I see available is decriminalization.

Which brings me to the answer to the question at the end of your last missive. If any of those rules were as damaging as the insider trading ban, then yes I'd be in favor of ditching them too. For the most part, however, they're either relatively harmless, superfluous or both.

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John,

As our debate neared its conclusion I found myself at the American Economic Association's annual meeting where Paul Brockman, Jiri Tresi, and Emre Unlu are presenting a paper that seems quite relevant to our debate. In ["The Impact of Insider Trading Laws on Dividend Payout Policy"](#) they examine an international sample of firms across 24 countries and find that insider trading laws seem to have a substantial impact on dividends. Specifically, where insider trading laws are weak we see firms with "a higher propensity of paying dividends, larger dividend amounts, and greater dividend smoothing" than in countries with stricter ones. This is because, it seems, the payment of a relatively high and stable dividend is a way for firm managers to credibly signal to shareholders that they're not getting ripped off in the absence of a sound legal framework.

This is perhaps a good way of thinking about the fundamental issue that divides us. When I look at the contemporary United States, I'm much more inclined to worry that we are seeing systematically too little capital investment than to worry that owners of corporate stock have too little cash in their pockets. Business investment could create jobs and raise productivity, while stock ownership is overwhelmingly concentrated in the hands of the most prosperous Americans.

Weakening insider trading protections will shift us into a lower-trust equilibrium in corporate governance where we see less investment and more cash flushing out to people who don't really need it. A bad recipe.

Your suggestion that vigorous enforcement of insider trading laws is crowding out more worthy investigations is an intriguing one. Certainly even in my role as designated basher of insider trading, I wouldn't try to make the case that this should be our absolute top priority. That said, there are an awful lot of questions one can raise about priority-setting in the federal law enforcement context. We have federal resources dedicated to hassling medical marijuana dispensaries in California, to policing the size of shampoo bottles that people bring onto airplanes, and into deporting otherwise law-abiding people for the "crime" of moving here from Mexico to roll burritos at Chipotle. Obviously, to debate marijuana legalization or airport security or immigration reform would take us far outside the scope of this exercise.

But my point is that to the extent that we're really worried about resource constraints here, insider trading enforcement is hardly the only place to look. More broadly, when you look at the scale of the economic losses associated with the financial crisis and the ensuing recession — literally trillions of dollars in unrecoverable lost output — it's obvious that any genuinely useful regulatory efforts would more than "pay for themselves." Where I think we can agree is that as a purely political matter the Obama administration has developed a bad habit of acting as if vigorous insider trading enforcement is a way of striking at the heart of the issues that led to the crisis. That's at best political theater aimed at garnering a little undeserved populist credibility. It's bad, and the press shouldn't let them get away with it. But it's not a reason to legalize insider trading any more than the existence of unsolved murders would be a reason for a state to legalize car theft. America's market regulators and federal prosecutors likewise need to be able to walk and chew gum at the same time.