

The Insider: Parasite or Legitimate Profit-Maker?

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In the lore of finance and investing, the insider takes his place alongside embezzlers, frauds, and all other varieties of scam artists. He uses privileged knowledge gained from executive friends told over a cup of tea or a game of golf to earn enormous profits in the stock market. Surely, this kind of activity should be universally condemned as unfair and unethical. After all, one person, solely by virtue of personal connections or occupation, gains an advantage that the average investor does not have. Should not everyone have an equal opportunity to earn money in the stock market?

For India, along with most of the industrialised countries, the answer is yes. Insider trading was outlawed in 1992 when the stock market was liberalised and the Securities and Exchange Board of India (SEBI) was given the mandate to investigate instances of alleged insider trading.

It is a well-known fact that insider trading, and many other forms of corrupt dealing, are very common in the securities markets in India. According to one author, "Price-rigging and insider trading have become a way of life in the Indian stock market (Sivakumar)." And the former president of the Bombay Stock Exchange is quoted as saying, "that there is no other kind of trading in India, but the insider variety (Dalal)." Important steps have been taken towards reform and the purpose of this paper is not to downplay many of the problems that exist in the markets in India. However, I believe the facts will show that insider trading does not belong in the same category as outright fraud or theft and that the negative effects of insider trading have been exaggerated. Furthermore, many of the fundamental problems plaguing the Indian markets are unrelated to insider trading and require reforms unrelated to insider trading laws.

Why do the Laws Exist?

Insider trading laws exist for reasons of both equity and efficiency. In regards to equity, the government wants to ensure that everyone involved in the stock market has equal information and that any information available to one active participant in the market is available to all participants. In other words, no one has an unfair advantage in the market. There is also a justification for insider trading laws based on efficiency considerations. Basic microeconomic theory holds that a commodity (i.e. a stock or an options contract) is priced efficiently if all information known or knowable is incorporated in the price. In other words, in an efficient market, if Intel invents a new, revolutionary microchip that will cause profits to triple next year, the price of the stock should immediately rise by three times as all market participants learn of this fact simultaneously. If there is unequal access to information (imperfect information in economics terms) then the market is said to be inefficient.

A quantitative study on the effects of insider trading on market efficiency has been completed by Utpal Bhattacharya and Hazem Daouk. They argue that, based on data collected in all 103 countries that have stock exchanges, the enforcement of insider trading laws increases market liquidity and decreases the cost of equity. The study attempts to control for factors such as the quality of legal institutions, level of international integration, foreign exchange risk, and others. In all tests, they find a positive relationship between enforcement and liquidity and a negative relationship between enforcement and cost of equity (Bhattacharya).

Are these results to be believed? Since countries that have insider trading laws have more advanced economies and more transparent markets, the correlation that does exist is not surprising. The only issue, and one that requires further research, is whether other factors such as these are adequately taken into consideration. Market transparency and investor confidence, irrespective of insider trading laws or enforcement, are extremely difficult to quantify.

One objection to the two justifications for insider trading laws is that the government, by enforcing insider-trading laws, is expected to enforce an unattainable ideal on the stock market. Perfect information is an abstraction that exists only in elementary microeconomics textbooks and not in the real world markets. In fact, as information technology has progressed so rapidly, information can travel much faster and be available to more people than ever before. It could be argued that technology has done more to ensure an efficiently operating securities market than government regulations have. According to Ajay Shah and Susan Thomas, the introduction of computerisation into the Bombay Stock Exchange has increased both liquidity and efficiency in that stock exchange (A Shah--Automation). Insider trading laws can hardly be credited with a similar improvement in efficiency. Insofar as insider-trading laws encourage the free distribution of stock-related information, they help to ensure more efficient pricing of stocks. However, when insider-trading laws discourage investors from buying or selling based on inside information, they only result in stocks being priced in a manner inconsistent with all available information. If insiders are allowed to act on the information they possess, it will also lead to more efficient pricing, as the buying and selling resulting from the information will be reflected in the overall price of the stock.

The argument in favour of insider trading laws also ignores the issue of use of information. Even if everyone has equal access to information, there is no guarantee that they will all use this information in the same way. Information must be analysed and different people have different opinions on what the best analysis of stock-related information is. For instance, although it is generally true that when two companies merge, the stock of the resulting company is worth more than the combined value of the individual stocks, it is not always the case. So an insider who knows in advance of a proposed merger cannot mindlessly purchase shares of the two companies hoping to earn an easy profit. He must examine whether the merger is sound and what the market's perception of the merger is and act accordingly. So the possession of inside information by itself is not as valuable as it appears to be at first.

Another argument is that it is not the government's job to ensure everyone is equal and has equal access to information. In fact, even with all of the insider trading laws that so many countries have, inequality of information still exists. Investors who are too busy to read the financial section of the newspaper or to follow the latest information about the companies they invest in voluntarily allow information inequality to exist. Since so much inequality of information exists even when the government attempts to narrow the knowledge gap, equal access to information is a utopian goal.

The Law

India's current insider trading regulations prohibit any "insider" from either acting on non-public information or from disclosing this information to any other person. The original law was passed in 1992 and SEBI passed a series of regulations to broaden the scope of the law in 2002.

A quick survey of enforcement of insider trading laws around the world will reveal that these laws are very rarely used. In Australia, there have been only six successful insider-trading

prosecutions since 1992 (P Shah). The Netherlands, similarly, has also had only one successful prosecution in the past ten years and Japan has yet to even use its insider trading laws (Newkirk). Additionally, Germany did not even have a law against insider trading until it was required to pass one by the European Union in 1994 (P Shah). Of the 87 countries that prohibit insider trading, only 38 have prosecuted any insider trading case (Bhattacharya). India appears to follow in the footsteps of these countries as from 1996 to 2000, SEBI brought only fourteen new insider trading cases (www.sebi.com). Furthermore, India, at the time of this writing, has yet to punish anyone for insider trading violations.

Alternatives

There are some cases in which insider trading may involve a breach of contract and in these cases, the aggrieved party can pursue a civil action. However, many cases of insider trading involve no direct violation of trust or contract and therefore, they should not be considered a legal matter. Even when laws against insider trading exist, the facts stated above should cast serious doubt on the alleged necessity of the laws.

According to Arturo Bris, if a country has insider-trading laws that are weak or rarely enforced, the situation is worse than having no insider trading rules at all. Insider trading laws increase the potential profits of those who choose to break the law. The reason for the higher profitability of insider trading among countries where there are laws against the practise is that the market reacts more strongly to public announcements when insider trading is illegal since there are less people willing to act on inside information prior to public disclosure. This means that the few people who are willing to take the risk to trade based on inside information can earn larger profits and the net result is that the profitability of insider trading is increased rather than decreased (Bris). Therefore, when a nation fails to enforce its insider trading laws, insider trading becomes more profitable and there is no appreciable decline in insider trading activity.

The facts stated above clearly establish that India is one of many countries that rarely enforces the insider trading laws that exist on the law books. Therefore, according to Bris's analysis, insider trading is a very profitable venture in India with little chance of facing punishment. The two choices that India faces are to strengthen the existing laws against insider trading or to do away with the laws altogether.

The United States is an oft-cited example of a country that has been very successful in countering insider trading with its combination of tough laws and vigorous enforcement. Again referring to Bris's paper, the level of profitability of insider trading in the United States is comparatively low. Some of this can be attributed to liberal, transparent markets and the rapid dissemination of financial information in that country, but its insider trading laws are also relevant. Nevertheless, insider trading is still a profitable venture and therefore its existence, even in the United States, is guaranteed. Another important issue that is outside the scope of this paper is the cost-effectiveness of enforcing insider-trading laws. The normative benefits of insider trading laws must be weighed against their costs. So even if one supports insider trading laws in theory, it is important to ask whether the money that would go to SEBI to make it as powerful as the SEC (Securities and Exchange Commission, USA) could not be spent more wisely elsewhere. Equally important is the fact that insider-trading laws have costs in regard to the efficiency of the stock market.

In most serious insider trading cases, private contracts can be a more effective way of preventing harm to ordinary investors and deterring the worst abuses in the stock market while freeing other investors from the possibility of frivolous or vindictive criminal investigations. A

few examples should suffice to show the potential for private, rather than government, regulation:

- A corporate officer buys shares of his company's stock in advance of a business deal announcement that is sure to send the stock price up. This officer could be disciplined by the stockholders as well as the company itself for bringing the company into disrepute.
- An outside investor trades based on information he gained from a company insider. In this case, every company and every stockholder has an interest in confidentiality so whoever revealed the information in question could be in violation of company rules.
- An options trader with advance knowledge of a company's losses buys an option to sell the company's stock in the near future. The broker he deals with is directly hurt by this action since he must buy the stock after the company's losses become public and the stock price goes down at a higher than normal price. In this case, the options market could have its own rules against insider trading and brokers and buyers could also sign a contract stipulating that they have no inside information prior to a transaction.

One famous, but controversial, insider trading case that deserves additional attention is the Hindustan Level Limited (HLL) case. Shortly before HLL announced that it was merging with Brooke Bond Lipton Limited, HLL purchased 8,00,000 shares of that company from Unit Trust of India (UTI). There is much controversy over whether this was a true case of insider trading or whether HLL failed to realise any profits from the purchase by buying at a premium. HLL defends itself by claiming that the stock was purchased at Rs 350 per share, a 10% premium over the market price (Ghosh). The important point is to show that insider trading laws were used, in this case, to prosecute a questionable case while more blatant forms of insider trading occur almost daily in India. In the case of HLL, the party that was directly harmed was UTI and therefore, UTI could have brought a civil case against HLL seeking damages for breach of contract if HLL and UTI signed a contract forbidding insider trading. The fact that the government pursued a criminal investigation against HLL in this case shows that the use of insider trading laws is less efficient than the use of traditional torts in civil law.

Another, less clear-cut case, is that of Hitech Drilling Services India (HDSI). Aban Lloyd Chiles Offshore Limited made a bid to buy shares of HDSI from Tata, with the deal to be publicly announced on March 18, 2001. In the days leading up to March 18, SEBI observed unusually active trading of HDSI stock on the Bombay Stock Exchange and the price of HDSI stock rose from an average of Rs 35 in January and February to Rs 50.70 on March 16. So far, no action has been taken against anyone in this case. Similar patterns of price increases prior to a public announcement of a merger have been observed in the UTI Bank-Global Trust Bank merger. So despite the efforts of the Indian authorities to combat insider trading, the practise remains extremely common.

According to Michael Adams, a professor at the University of Technology, Sydney, about 5% of trades in Australia could be defined as "insider" trades by that country's strict laws. In February 2002, India amended its insider trading laws so that the new law is ten times as long as the original. Insider trading has been defined much more broadly so that more transactions in the stock market will be considered illegal (P Shah). Unequal access to information is a simple reality in the stock market and yet countries like Australia, India, and the US continue to attempt to impose this ideal on the market, criminalising many stock traders in the process. At the same time, these laws, due to the burden of proof that must be shown in a criminal case, are largely ineffective. Relying solely on private contracts and civil suits would ensure that only cases involving an egregious abuse of trust or fraud would be punished and milder forms of insider trading would be allowed. Without insider trading laws, "if a director, or some such

person misuses [insider] information, then the company itself can bring an action to recover any damages caused, obviously any profits made, and can have the power to dismiss the individual."

One important fact to realise is that if an "insider," acting on knowledge not available to the general public, either buys or sells shares of a stock, no other market participants are harmed directly. If insider trading rules are abided by everyone and all stock buyers and sellers have equal and simultaneous access to information, then when a piece of news is released, everyone acts on that news at the same time, and the profits reaped by all buyers or sellers are miniscule. By contrast, if an insider acts before the general public, the stock will still eventually reach the same price it would if there were no insiders trading in the stock. In other words, insider-trading laws are a way to ensure that gains from stock news are distributed equitably.

Another important scenario that should be addressed is that of market manipulation. That is, spreading false information about a stock in order to generate a speculative bubble or a sell-off and profit from the results. This is clearly in a category quite different from insider trading, because this is not the use of inside information but instead it is the creation of misinformation. It is also a much more serious problem as it poses a threat to the integrity of the stock market. Fraud, embezzlement, and other such actions are in a quite different category than insider trading since they directly harm others.

Transparency

It is undeniable that there are serious problems in India's stock market and there is a real need to enact reforms that will lead to a more transparent and more efficient capital market. The question is whether insider-trading laws are a part of the reform package that must be put in place to strengthen India's capital market or whether they are a needless hindrance to the operation of the stock market.

At first, insider trading appears to be counter to the notion of a transparent market. If market participants are trading based on information the general trading public does not possess, then this appears to be a step away from a transparent market. However, as is always the case in economics, we must compare the scenario in which insider trading takes place to the scenario where insider trading is forbidden and much more rare. In the second case, there is not perfect information but rather equal access to information. This distinction is important because it means then that the price of a stock does not reflect all that is known or knowable about it. The stock price is not sensitive to inside information so there is a consequent loss of efficiency in the pricing of stocks.

Additionally, a point that must be stressed is that most varieties of insider trading do not, as is often claimed, result in loss of confidence in the market. If it is well known to investors that there is a group of insiders who trade on information prior to its general release, why exactly would investors wish to not invest in that stock? On the other hand, when market manipulation is allowed to occur, there is a serious loss of confidence in the market as investors feel that they can never be sure that the market price of a stock is fair. According to Ajay Shah, "Manipulation is intrinsically about making market prices move *away* from their fair values; manipulators *reduce* market efficiency. Insider trading brings prices *closer* to their fair values; insiders *enhance* market efficiency (A Shah, Why forbid?)." So there is a non-trivial distinction between market manipulation and insider trading and it is inaccurate to equate the two.

Given the fact that the Indian stock market has many problems related to efficiency, such as the lack of transparency and the existence of market manipulation, what can be done to reform the stock market? One viable area of reform is the elimination of restrictions on short selling. Short selling is an important moderator of price fluctuations and since India restricts its practise to such an extent, it is clear that government regulations are at least part of the problem (Varma, 21). Another action that can be taken against market manipulation is the creation of anonymous stock trading systems, so that a group of manipulators cannot be sure whether the rest of the participants are fulfilling their part of the agreement. Like a member country of OPEC (Organisation of Petroleum Exporting Countries) that sells more oil than it should, there is a strong incentive for a member of a market manipulation cartel to short-sell a stock that the others are buying since he knows it is overvalued (A Shah, Manipulation).

Conclusion

Insider trading laws cannot be justified on economic grounds. One of the most common claims made about insider trading laws is that they improve market efficiency, but as argued above, insider trading laws can only help to improve information *equality*, not information *availability*. If we compare a country that has insider trading laws with a country that has no such laws, the country with insider trading laws has a more equitable market, but a less efficient one. The existence of insider trading laws cannot move a market closer to perfect information because it does not improve information availability. A country with no insider trading laws, however, will only punish insider trading when there is a specific aggrieved party who is the victim of fraud or a breach of contract. The rest of the insider transactions that take place improve market efficiency by bringing prices closer to the price that would prevail under perfect information. If India were to abolish its insider trading laws, it would improve the efficiency of its financial markets.

So why not prohibit insider trading on the basis of fairness? If someone believes in fairness strongly enough, then any cost of insider trading laws can be justified. However, the situation in financial markets around the world governed by insider trading laws is very far from fair. Even in richer countries with more transparent markets, insider trading is quite common and even accepted in some situations. A law that prohibits an activity as common and accepted as insider trading can hardly be described as fair. Furthermore, when so few insider trading cases are investigated by SEBI, this results in a situation of selective enforcement and makes those willing to violate the law even more wealthy. Laws, in a free society, should not seek to force people to change the way they conduct their everyday affairs but, instead, should "seek to enable [the people] to continue doing what they do within the framework of a set of rules that promote the common good without altering the basic rhythms of society (Chakraverti, 108)." The case for insider trading laws therefore falls even on fairness grounds.

It is often claimed that insider trading reduces investor confidence in the market. Supporters of this claim argue that one of the reasons there is so much foreign investment in the United States is that country's strict enforcement of insider trading laws. If confidence in the market really does decrease when insider trading exists, than deregulation of financial markets is the most effective way to increase investor confidence. Stock exchanges that have private rules forbidding insider trading will attract more investors and corporations will wish to have their stocks listed on these exchanges. The free-market can provide for sensible insider trading rules without government intervention.

A cynic might argue that insider-trading laws exist to cater to rich investors who trade on inside information frequently and do not want anyone else to join them and lessen their profits. A more benign and more realistic proposal is that insider-trading laws exist because its premise of

greater fairness and market efficiency is accepted by most countries. Nobody wants to stand for unfairness or appear to be favouring rich investment bankers over investors of more modest means. Insider trading laws are another manifestation of the do-good syndrome behind so much of modern legislation. The laws fail to achieve their stated objective and, in fact, have consequences quite contrary to the intentions of the legislators who passed the law.

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