Inside Insider Trading

by Elisabeth
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On his Twitter page, where he goes by the username FinanceDarkSide, Utpal Bhattacharya tweets this: “The price of capitalism is eternal vigilance.”

It’s not that Bhattacharya disapproves of capitalism. On the contrary, as an associate professor of finance at the Indiana University Kelley School of Business in Bloomington, Bhattacharya, whose research focuses primarily on insider trading, says, “Market economies, though deeply flawed, are the best system.” But that system, he says, has a tendency to inspire behavior among the financial elite that is self-destructive and inexplicable.

According to Bhattacharya, insider trading (the illegal buying and selling of shares based on company-owned information) is often done for reasons other than money. “Critics ask me, ‘Then why do they do it?’” he says. “But I can’t answer that.”

Bhattacharya explains that the standard economic assumption that all decisions come down to rational, wealth-seeking behavior fails to explain the motivations of rich people who stake their reputations on comparatively small gains. Martha Stewart, for example, was charged in civil court with making a $45,000 profit from insider trading, at a time when her net worth was more than $1 billion.

“If you take the narrow economic view, you should have only poor people committing crimes because the benefit is great and the cost is very low. They don’t have the reputation or the future income to lose,” says Bhattacharya.

So how do you explain white-collar crime?

Utpal Bhattacharya
Photo courtesy of the Kelley School of Business at IU Bloomington

After conducting a study of CEOs convicted of insider trading,

Bhattacharya is more perplexed than ever. His research demonstrated that executives who engaged in insider trading actually had higher salaries than those who did not. The findings overturned his economics-based hypothesis that insider trading was a means for lower-earning CEOs to catch up to their peers.

"It does make me question that basic assumption of 'money-money-money,'" he says. "But it's good to keep questioning your assumptions as you grow in your research."

If pressed, Bhattacharya conjectures that the insider-trading phenomenon comes down to "hubris" among high-ranking executives. "They think they can get away with it," he says.

Talk is cheap

The CEO study was not the first of Bhattacharya's investigations to overturn commonly held assumptions about insider trading. His 2002 Journal of Finance article, "The World Price of Insider Trading," written with Cornell University Professor Hazem Daouk, demonstrated that passing a law against insider trading actually did nothing to improve a country's stock market values.

"That was the biggest research finding of my life," Bhattacharya says. "Moralists and politicians would say, 'Oh, insider trading is terrible, there should be a law.' But I wanted a dollars-and-cents answer. Does it matter for shareholders? The finding was that when a country makes insider trading illegal, nothing happens to share prices."

Bhattacharya looked into the insider-trading laws of all 103 countries that have stock markets (a process that took years of cold calls to national agencies, as no such information had previously been compiled). What he discovered was that while most countries had banned insider trading, very few had prosecuted anyone for it. The markets, he says, made a very clear distinction between "talking the talk and walking the walk."

"Markets realize that talk is cheap. It's only when a country prosecutes a person for the first time that share prices go up. So, it's not the law, stupid, it's the enforcement that counts," he says. Further analysis revealed that keeping ineffectual laws on the books actually hurts a country's economy. A second paper, "When No Law is Better Than a Good Law," also with Daouk, looked at such cases. It was published in the Review of Finance in 2009.

"When a country institutes a law but does not enforce it, share prices actually go down," Bhattacharya reports. He makes a comparison to gun laws to illustrate how a law without enforcement creates a huge disadvantage.

"If you have a law against guns but you don't enforce it, good guys will not have guns, bad guys will have guns. So you wind up in a society where a good guy is actually worse off than in the Wild West," he says. Markets detect this disadvantage, and the result is costly for the country as a whole.

Taking apart Ponzis

The lack of alignment between policy and practice also offers insight into another financial crime of interest to Bhattacharya: Ponzi schemes. These large-scale swindles, named after famed fraudster Charles Ponzi, rely on ever-expanding circles of investors to pay off previous investors and maintain an appearance of profitability.

"Traditional economic theory finds it very difficult to explain Ponzi schemes," Bhattacharya says. Investors often suspect such ventures are not legitimate due to the high rate of return and unusual predictability of profits. It's also common knowledge that these schemes always collapse eventually, either underneath their own weight or because of detection by governmental authorities. Reason would suggest, then, that people would refuse to participate for fear of being in the last, unprofitable round of investors.

But Bhattacharya says there is "a very rational reason for taking part." It has to do with the government's response once the fraud is uncovered. If the government claims that it will never bail out Ponzi victims but eventually does so after a Ponzi scheme explodes, then people are better off participating than not participating. Russia's response to the $1.5 billion MMM scandal in 1994 was an example of such a situation.

"What exactly does a bailout mean? It means a transfer of money from people who did not take part to people who did take part," Bhattacharya explains. "This is the calculus: If I do not take part, the government is going to take some of my money to bail out the people who did." Participating has at least the potential of financial reward, whereas not participating leads to certain financial loss. "Bailouts encourage Ponzi schemes," Bhattacharya concludes.

His theory garnered a good deal of attention following the uncovering of Bernie Madoff's investment fraud, landing Bhattacharya an opinion article in *The New York Times* economics blog. He opined that the government bailouts in 1998–99 would lead to more Madoffs in the future. Other aspects of his research on white-collar crime have frequently been featured in *The Economist*, the *Financial Times*, and *Money Magazine*.

Go-to guy

At present, Bhattacharya is among the go-to academics for media covering the case against billionaire Raj Rajaratnam, co-founder of the Galleon Group hedge fund, who is charged with masterminding the largest insider-trading scheme ever brought to court.

"There was a whole network of people involved from the top of the top in a few American companies," Bhattacharya says of the case. "The quid pro quo was this: 'Give me information about what your firm's going to do, and you'll own a share of my hedge fund, or I will give you cold cash, so we'll all benefit.'"

The first case to use court-authorized wiretaps, the Galleon case is also unusual because the defense ultimately lost money. Bhattacharya says he's never seen a conviction based on insider trades that resulted in a financial loss.

Bhattacharya argues that insider trading is not necessarily bad. In fact, it improves what is known as "market efficiency" — the degree to which the market reflects the true value of investments.

"If a CEO trades his own shares, and people see that someone's buying a lot, they will guess that someone has good news. The price starts reflecting the CEO's information," Bhattacharya says. "If, instead, you stop this guy from trading, prices will not reflect the truth."

Bhattacharya's first major paper illustrated this principle by examining the Mexican stock market and its failure to respond to news announcements from corporations. In "When an Event Is Not an Event: The Curious Case of an Emerging Market" (*Journal of Financial Economics*, 2000), he demonstrated that while changes in stock value commensurate with company events were occurring, they took place prior to the public announcements.

"Whether it was firing people, mergers, or acquisitions, the prices would change before the press release. We investigated further and found that insider trading was so rampant that all this information came out before the release, and nothing happened on the day of the release," Bhattacharya says.

Lord of the Flies vs. *1984*

Economic arguments against insider trading are subtle, Bhattacharya says: "Investments are distorted or outsiders who would like to analyze the company are crowded out." But he is not convinced by these explanations.

"I've always had this huge tension in my life regarding insider trading," he admits. "There are two diametrically opposing points of views, and I sympathize with both of them. There's the legal argument that says inside information is property, and some guy is stealing the property, so that's immoral and unfair. But the contrary argument is that it's his firm, it's his information, and he can profit from it. Besides, it makes the market more informationally efficient.

"Insider trading is a very, very narrow thing, but it encapsulates all the tensions of the financial system." Bhattacharya continues, saying it's never clear where the line is between too much and too little regulation.

"You have the *Lord of the Flies* extreme on one hand, where individuals without an authority figure explode into violence and chaos," he says. "On the other hand, there's *1984*, where you see how authorities abuse individuals. I take the view that there is no solution to this tension. All we can do is fumble along as best we can."

Although he personally feels ambivalent about insider trading, Bhattacharya acknowledges that if nearly all countries ban it, it must be because "no one likes insider trading." He is willing, then, to categorize the practice as one of the few financial activities that he believes is best kept under legal constraints.

"Because market economies are flawed, we should have regulations," he concludes. "But because governments are even more flawed, we should have few regulations." And above all, any regulations must be "vigorously enforced."

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