Insider Trading Shakes Investor Trust In Market (Public Equity)

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Frank Islam, Chairman and CEO of FI Investment Group. , *April 12, 2011*

If ordinary investors feel that the system is gamed by insiders, who don't play by the rules, the economy will be in real trouble.

Since the 1980s, the issue of insider trading has rocked the Wall Street every few years, with a top executive of a company or a reputed individual getting caught while trading with what's called 'non-public information.'

What usually occurs at the end of these periodic scandals is a loss of public confidence in the financial system and, for the individuals involved, a loss of reputation and occasional jail terms, if found guilty.

Now, more than six years after celebrity entrepreneur and media personality Martha Stewart served a five-month jail sentence, arguably the most high profile American to be convicted in an insider trading-related investigation, two separate scandals have shaken this country's investing community.

The first one has already wrecked the careers and sullied the names of a few highly accomplished Americans of South Asian origin. The second one, even though not as egregious on the surface, has attracted headlines because it involved the most famous name in investment, Berkshire Hathaway.

The first one began when the U.S. Securities and Exchanges Commission, the agency responsible for overseeing the securities market, probed the Galleon Group, a hedge fund management firm based in New York. Its Colombo-born founder, billionaire Raj Rajaratnam, was arrested in October, 2009, by the FBI, prompting investors to desert Galleon and resulting in its collapse.

The SEC accused Rajaratnam and his colleagues of "widespread and repeated insider trading at several hedge funds, including Galleon." According to the agency, the "inside information concerned market moving events such as quarterly earnings announcements, takeovers, and material contracts" and their "scheme generated over $33 million in illicit profits or losses avoided."

More drama ensued on March 1, when the SEC filed civil charges against former McKinsey managing director Rajat Gupta in a related investigation. The agency said that Gupta had repeatedly shared non-public information about the companies on whose boards he sat – including Goldman Sachs and Proctor & Gamble – with Rajaratnam, in whose company the Indian American had investments.

Gupta denied the charges and on March 18, filed a lawsuit against the SEC claiming that, by not bringing the case before a jury, the agency was denying him his rights. Many in the legal community believe that the government initiated 'administrative proceeding' against Gupta – where preponderance of evidence is less – because its case against him is relatively weak.

Nevertheless, Kolkata-born Gupta was forced to leave the boards of several companies and non-profits. If proven guilty, besides paying a hefty fine, he may not be able to have any public association with the Wall Street.

Half a world away, in India, charges against Gupta has bewildered the country's corporate sector, where he was a rock star. Gupta was one of the first Indian immigrants to make it big in the meritorious world of international management consultancy and many Indians had been closely following his rise in the American corporate hierarchy.

While the trial of Rajaratnam was moving toward a denouement, news came from Omaha, Nebraska, a few days ago that a top Berkshire executive has resigned after it was revealed that he had recommended the takeover of Lubrizol days after he invested $10 million in the chemical company.

On paper, Berkshire's $9 billion acquisition of Lubrizol resulted in an approximately $3 million profit for David Sokol.

Even though Sokol has not, seemingly, broken any securities law, the conflict of interest in his action was grave. It received all the more scrutiny because it happened in Warren Buffett's company, and Sokol was one of several Berkshire executives being talked about as a potential successor to the Oracle of Omaha.

In the world of investments, the name Berkshire Hathaway Inc. is gold-standard. Under the leadership of Buffett, the company has been consistently earning high returns for its shareholders over the decades, whether it was rain or shine, boom or bust. Since 1964, it has earned a whopping 490,409 per cent in per-share book value. In the past decade, which witnessed two recessions, Berkshire reported a 76 per cent total return.

The high ethical standard, preached and practised by Buffett, was also part of Berkshire's appeal. That is also one of the reasons that the Sokol episode created ripples on both Wall Street and Main Street. "Say it ain't so, Warren," the Wall Street Journal's Jason Zweig articulated the dismay of much of the world.

That these insider trading allegations have come at a time when the effects of a recession are still lingering doesn't do any good for the image of America's corporate executives. Already, there is a very deeply entrenched perception in the United States and the world over that the country's financial system is heavily rigged in favour of the rich.

The federal bailout of a number of large corporations in recent years, and the fact that some of these companies had paid huge retention bonuses to its top executives while accepting the taxpayers' money, haven't resonated well with the general public.

Now, there are some free-marketers who say that insider trading should not be illegal. Most notably, the late Milton Friedman of the University of Chicago famously argued that the public will be better served if those with confidential information are allowed to trade in stocks freely. There is also a contention that if insider trading is permitted, it may result in lowering corporate executive salaries, ultimately helping investors.

But these academic arguments fail to address the core issue: Insider trading gives unfair competitive advantage to a select few over a majority of investors. An ordinary investor would hate to put his money in the stock market in an investment climate where a few are allowed to buy and trade, based on insider information.

Ultimately, investing is all about trust. If ordinary investors feel that the system is gamed by insiders, who don't play by the rules, the economy will be in real trouble.

That is precisely why the message the Galleon and Sokol episodes send to general investors is awful.

As the Journal personal finance columnist Zweig wrote, “If even Mr Buffett can fail to appreciate a potential conflict of interest under his very nose, then ordinary investors need to realize just how pervasive and insidious conflicts are throughout the financial world.”

Frank Islam, Chairman and CEO of FI Investment Group, is a columnist based in Washington, D.C. He is the co-author of the book Renewing the American Dream: A Citizen’s Guide, which was released last summer. He is also a member of the advisory committee of the U.S. Export-Import Bank and the Department of Commerce Industry Trade Advisory Committee (ITAC).