

Why the stock market isn't fair

By [Eleanor Bloxham](#)

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Differential access to information and sophisticated technology have contributed to the sad reality that the capital markets are simply not fair to all investors.



The fairness of the capital markets has been increasingly in the spotlight since the flash crash on May 6, when the Dow Jones Industrial Average lost \$1 trillion in market value in a matter of minutes.

And now the US is reeling from a sweeping insider trading investigation by the FBI. So far, it's touched on dozens of financial firms, from hedge funds like SAC Capital and Citadel to mutual funds including Janus (JNS) and Wellington to banks like Goldman Sachs (GS). "Illegal insider trading is rampant and may even be on the rise," Preet Bharara, the Manhattan U.S. Attorney, said [in an October speech](#).

Hedge funds, which have been viewed as under-regulated for the past decade, were the initial focus of FBI raids. When SEC Chief William Donaldson resigned in the summer of 2005, he ended his quest to bring hedge funds into the regulatory fold. Now, the recently passed Dodd Frank Act seeks to bring hedge funds under greater regulatory scrutiny.

Regulatory structures matter, because they tend to either draw or repel certain kinds of people. Ten years ago, I had the occasion to speak to a number of hedge fund complexes as the industry was growing. It drew mutual fund managers with independent streaks who simply wanted to opt out of the regulatory constraints imposed by the Investment Company Act. Being naïve, I was astounded to learn that many funds didn't actually hedge anything, they simply picked up their mutual fund marbles and moved them to the hedge fund milieu.

I remember the conversations about their investment approaches and [heard their disdain](#) when I invoked the words Regulation FD or Fair Disclosure, which requires issuers to provide the same information (if it's material) to all investors at the same time. It was newly minted at the time having been promulgated in August of 2000.

The importance of Regulation FD

Regulation FD, I think, is important to understanding insider trading because insider trading is an example of an activity that requires two parties – a speaker and a listener who then acts on the information he receives.

Regulation FD is important for many reasons, but is significant, in this context, in that it puts the onus on not just the listener who acts on insider information, but also on the speaker who provides that information.

Although insider trading rules also pertain to the provider of information, that is not what people tend to think about, particularly if they are not working at the firm in question.

There have been a number of occasions, just this year, when these issues have arisen in my own business conversations, emphasizing the importance of both speaker and listener awareness and demonstrating the minefields that exist in daily business life.

In one case, a group of consultants were considering selling their perspectives to selected potential buyers including investors. The perspectives were to be based in part on information proprietary to other corporate customers. While what was being proposed was not intended to provide proprietary information per se, the information *derived* from proprietary information could have a similar impact — providing nonpublic, material clues concerning the operations of those companies. On this basis the strategy was rejected.

What was clear from those conversations, however, was that in the midst of the business strategy discussions, it's relatively easy for individuals without knowledge of the intention of the law to meet its spirit and be unaware of the implications.

In another instance, I was discussing my review of a company's public documents. While I would be providing information and my views on the public documents to a major shareholder and former executive, I consciously did not relay internal conversations (that went to the culture of the firm) because those conversations were both private and confidential. However, another reason I didn't provide this information was that, once I told him, he would be in jeopardy — unable to freely sell his shares or buy additional shares because he now had (unwished for) inside information.

Providing inside information, as innocuous as that side of it may seem, is like spreading a virus. You may be giving something to someone they would rather *not* have.

Legalists will be quick to point out that the information has to be material. But there's the rub. What is material enough to cause a significant information advantage? I don't think I can easily be the judge of that, as one piece of evidence may tip the balance — or matter greatly to an idiosyncratic investor.

What's technology got to do with it?

Trust in capital markets is based on the idea that capital markets will be fair. And that fairness is based on equal access to information.

Technology has brought many changes to the lives of individuals. Through the Internet and social networks, it has fundamentally re-shaped the way in which people think about and experience the notions of public and private. Earlier generations would never have thought of making certain issues public; privacy was highly valued. Today, life histories of everyday people are made public on the Internet, never to be erased.

But in the markets, the notion of what is public and what is private and what can and cannot be shared is rooted in the legal constructs of the securities laws surrounding insider trading and Regulation FD. The definition of when the line is crossed is important to recognize: how many people must know – when is information considered public?

“Expert networks”, as sources of information, have always existed, alumni networks being just one example. Technology, however, has made it possible for loose networks of people, relatively or very unknown to each other, to come together to share information. Expert networks of consultants using technology infrastructures are the part of the focus of the current probes.

The same technology that makes new networks possible makes their activities much more discoverable by law enforcement.

Enforcement Matters

Recent research by Lauren Cohen of the Harvard Business School and his colleagues suggests that Regulation FD has had a beneficial impact on limiting the impact of school ties and alumni networks in certain areas of the capital markets but not others.

Comparing pre- and post-Regulation FD and US and UK information, [their research shows](#) that in the US, after Regulation FD, the advantage of alumni networks to sell side analysts has been eliminated (while in the UK and the US pre-Reg FD those advantages remain). This suggests, strongly, that Regulation FD has worked very well in the analyst arena in curbing the advantage of insider information.

But in the current insider trading probes, subpoenas are being issued to mutual funds. Interestingly enough, Cohen’s results for analysts – and the elimination of information advantage — do not hold true for mutual funds. [Professor Cohen says](#), “there has been no change” in the results pre or post Regulation FD for mutual fund managers.

Why the difference? Why would Regulation FD have had a positive impact on squelching insider information for analysts but not mutual fund managers? Cohen says it’s because Regulation FD has heretofore been targeted at analysts, but not mutual funds. Until now, significant cases have not been brought against mutual funds although the law applies equally in each case.

This may be because it was easier for enforcers to learn about meetings between management and analysts. As the research shows, and as applies to all legal constructs, it is not just the law but enforcement of the law that builds the context that changes behavior.

Clearly, insider trading can impact each of us in ways we would not ordinarily imagine. For those who are privy to a great deal of inside information while sitting on boards or consulting to companies, the need to consider issues of confidentiality and prudence – and the impacts on the capital market system have never been more important than now.

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