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## The Ultimate Insiders

By Richard W. Rahn

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*Is Congress making money off advance economic knowledge?*

Stock or commodity trading on "inside information" has been illegal since the early 1960s. Yet there is one group that frequently has access to nonpublic information that can greatly affect stock prices, to the extent of making or breaking a company or even an industry, and these "insiders" are considered exempt from prosecution by the Securities and Exchange Commission (SEC). The insiders I refer to are members of Congress and their staffs. They have prior knowledge about which companies or industries will or will not be "bailed out," have their taxes raised or lowered, be subject to costly new regulations or exempted from such regulations, receive government contracts, etc. However, because the members of Congress and their staffs do not obtain their information from employees of the companies affected, they are not considered insiders.

There have been a number of recent news stories about how the average member of Congress showed an increase in net wealth over the past couple of years, while the average American was losing net wealth. The obvious conclusion is that members of Congress knew things the rest of us did not and acted on this knowledge to their own advantage - no surprise. A new study that empirically demonstrates this, "Capitalizing on Capitol Hill: Informed Trading by Hedge Fund Managers," has just been published by the Social Science Research Network. The authors of the study, Jiekun Huang and Meng Gao, found that hedge funds connected with lobbyists, relative to non-connected ones, outperform by 1.6 percent to 2.5 percent per month in politically sensitive stocks compared to nonpolitical stocks. These results suggest that hedge-fund managers exploit private information, which can be an important source of their superior performance.

We are in the process of finding out what actually was in the 2,000-page-plus health care bill and financial "reform" bill. Those bills have many winners and losers - which previously were known only to the lobbyists and the members of Congress and their staffs who put in the specific deals. This is why House Speaker Nancy Pelosi famously said, "We have to pass the bill so that you can find out what is in it." It will never be known who gained financially from the inside

information that was acted on as these bills were being passed, but you can bet the gain was in the hundreds of millions of dollars.

A bill was introduced early in this current Congress (H.R. 682: Stop Trading on Congressional Knowledge Act) which would prohibit the sale and purchase of securities or commodities' futures based on knowledge gained from a member of Congress, an employee of Congress or other federal employees. The proposed legislation is so broad and at points so vague as to be unenforceable in a consistent manner.

This proposed act makes the same mistake that the SEC often makes in dealing with "inside information," in that there is an underlying assumption that the uncontrolled dispersal of information about the health or prospects of companies is bad and that known information can be controlled.

The recent release of highly classified information from Pentagon sources by WikiLeaks again shows the near impossibility of controlling even the most sensitive information. Time and time again, the U.S. government has shown that it cannot protect sensitive information, from atomic secrets to sensitive financial data held by the Internal Revenue Service. Those who tell us that any information is safe when held by the U.S. government are both supremely arrogant and ignorant of history, including the news of recent weeks.

The SEC has a long history of not knowing what it should have known (e.g., Enron, Bernard Madoff) and at the same time trying to stop the dispersal of information about companies that is necessary for markets to operate properly. The SEC is in the process of trying to find ways to criminalize those who (outside a firm) find better ways of doing research or modeling what they think is going on in a firm, even though they have received no direct, nonpublic information from real insiders. This approach eventually could kill the whole field of securities analysis. Only government employees at the SEC could dream up a scheme to try to keep everyone ignorant and call it "progress."

Professor Henry Manne, dean emeritus of the George Mason University Law School and arguably the nation's greatest scholar on "insider trading" issues, observes that the decades of failure at the SEC show that enforcement of insider-trader laws is not feasible and often is counterproductive. Also, there has never been a clear definition of insider trading either from Congress or the SEC. Mr. Manne says it is time to "rethink any current policies based on a view of pricing in which we exclude the best-informed traders." Because insider or informed "trading clearly makes the market process work more efficiently, it aids capital allocation decisions and informs business executives through market-price feedback of the best predictions about the value of new plans."

Outsiders are best served in making their buy and sell decisions when all of the information about a company is incorporated in its market price, even if comes from insiders. As for Congress and their staffs, given that a prohibition of the use of inside information is nearly impossible, the effort should focus on more transparency. This, in part, would mean legislation being passed in small, understandable increments so that outsiders would be able to determine who benefits or loses when the legislation or regulation is proposed.

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