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When Regulators Break Their Own Rules

BY RICHARD W. RAHN

OFFICIALS LOOK THE OTHER WAY WHEN INSIDER TRADERS ARE THEIR OWN

Do you think people in government are more or less honest than those in the private sector?

A major function of most regulatory agencies is to keep those in the private sector honest and from abusing power. Yet we know that those in government often abuse the power that has been entrusted to them. The American Founders were well aware of the problem. As Thomas Jefferson warned: "The two enemies of the people are criminals and government, so let us tie the second down with the chains of the Constitution so the second will not become the legalized version of the first."

As the size of government has grown, and particularly the bureaucratic state, the chains of the Constitution have been loosened, and predictably the abuse of power has also grown — the Internal Revenue Service (IRS) being Exhibit A. Politicians and government bureaucrats have never-ending demands for more information about the assets and activities of the governed — all made in the name of protecting us. These demands are made with solemn assurances that the information will be kept confidential and not abused. As the Edward Snowden and Lois Lerner cases and endless others show, one can have no confidence that any piece of information the government has will be kept confidential and not abused.

The government aggressively prosecutes people in the private sector for acting upon so-called insider information (e.g., information that is not available to all potentially interested parties). Many government regulators, in the normal course of their activities, obtain information about private companies that is not available to the public. This information can be very valuable to an investor. For instance, government officials know which companies will or will not be charged for some alleged wrongdoing before the information is made public. Government officials also know who will or will not receive certain government contracts before the companies are notified and the information is made public. There are numerous laws against government officials revealing such information but, as has been seen with the IRS, laws saying it is illegal to reveal information are not always obeyed. The operative question is how often are such laws broken?

A new study by professors David Reeb (National University of Singapore), Yuzhao Zhang (Oklahoma State University) and Wanli Zhao (Southern Illinois University), published in the August issue of the Journal of Law and Economics, shows that "the presumed protectors of the shareholders and the general public interests appear to be using their positions to their advantage." Only those who have never been around government will be shocked by this revelation, but it is helpful to have the evidence from a well-done study.

In describing their evidence, Mr. Zhao stated: "There is more insider trading within regulated firms than with unregulated firms. There is very, very strong indirect evidence that this is due to people involved in the regulatory agencies." The researchers looked at firms in the financial, pharmaceutical and utility industries. As an example, Mr. Zhao said: "A pharmaceutical firm has a new drug awaiting Food and Drug Administration approval, and presumably no one inside or outside the company knows for sure what the FDA verdict will be. But, in a couple of days before the decision is released, there is an obvious spike in trading of the company's stock. It is apparent someone is aware of what the decision will be."

In conclusion, the authors noted: "officers and directors of public firms must disclose their trading activities, compensation and external contracts with related parties under U.S. security regulations. Interestingly, there are no requirements for disclosures by regulators who have access to material, nonpublic information." A few years back, there was a series of press articles about how members of Congress and their staffs had done unusually well in the stock market, presumably because they had access to information that the public did not have.

There are two classes of people in America, with different rules for each: One is the political-government class; the other is Americans who earn their living in the private sector. The fact is, insider trading by people in government is pure corruption, while insider trading by private parties may arguably result in better price discovery. Yet, the former is largely legal, and the latter totally criminalized.

Private business people are prohibited from making false claims about their products. Yet, politicians routinely lie about the programs (their products) they create. If President Obama, Nancy Pelosi and Harry Reid had been selling private insurance with the claim "you can keep your doctor," and it turned out not to be true, they would be in trouble with the law for consumer fraud. The consumer fraud these politicians sold was far larger than any private-sector business person has ever done.

To repeat, Jefferson warned that without adequate constitutional constraints, too many in government would engage in legalized criminality. The evidence shows the constraints have been broken.

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