Mimosa Investment Management

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Trading On The Inside

When something sounds too good to be true, it usually is. Some traders and investment operatives historically have searched for any piece of corporate information that few others, if any, possess. The end game for these is enrichment through the use of material, inside information via trading practices. In the US these practices clearly violate the law and have for many years.

History of Inside Trading

The buying and selling of securities has long been assumed to occur fairly and transparently. Then around the time of the Great Depression, the US Congress felt compelled to strengthen the laws, thus producing the 1933 and 1934 Securities Exchange Acts. More specifically the law's section 10b and its companion Rule 10b5 speak to the illegality of action as a result of using material information, unknown to the general public.

Then, in 2000 the SEC added regulation 10b 5-1 to clarify the law since courts were inconsistent regarding insider trading. The "manipulative and deceptive devices" occur when someone is in possession of inside information and made an actual purchase or sale. "Such action breaches a duty of trust or confidence owed to the issuer of that security or to the shareholders of that issuer."

The Second Circuit Court of Appeals in 1968 ruled against executives of Texas Gulf Sulphur, Co. Their crime: trading personally in TGS stock and /or calls based upon their personal knowledge of certain drilling outcomes that were deemed to be material and undisclosed to the public.

One would think smart investors would know the simple lessons of the rule, lessons of the TGS case. Fast forward to today.

Herbalife and KPMG

The main KPMG partner working on the Herbalife audits has admitted leaking information to a golf buddy for cash. "I regret my actions in leaking non-public data to a third party." stated the partner, David London, who went on to state that KPMG was not complicit in his actions. (WSJ April 10, 2013) Nonetheless, KPMG on April 8 of this year resigned as auditor for Herbalife. Crimes such as this happen even today, regardless of the strong lessons of the past. Not only does this case represent a setback for another accounting giant, it points out that the lessons learned in the audit failures of the financial crisis have waned in importance.

In another action the SEC has recently charged the Rajaratnam brothers of Galleon Management hedge fund infamy. Their crimes generated over sixty million in ill-gotten gains. Eleven years in prison and a 10 million dollar fine ended this saga for brother, Raj.

Role of the SEC

Insider trading continues to be front and center in the SEC's enforcement. In 2013 the SEC has brought fifty-eight inside cases against 131 individuals and entities. According to the SEC in the last three year period, actions against these illegal acts exceed any three year period in history. Sigma Capital hedge funds represent the most recent transgression generating a 14 million dollar SEC fine. The crimes included insider trading in the stocks of Dell and Nvidia.

Social Media

The SEC this month ruled that social media (Facebook, etc.) can report on material corporate news. The only catch is that investors must be told which media can be used for these corporate news events. Will this development weaken the prospects of fair and timely release of material information? The implication is that all investors can equally access social media sites. There is no doubt but that much rule making and court cases will be in order.

Trust but Verify

It is incumbent that investors must be vigilant in digesting corporate news. However it often is hard to impossible to distinguish when insider trading occurs, until after the fact. There is little doubt that inside operatives know full well that their acts violate the law, and are only remorseful when caught. There is no substitute for a healthy trust in investment advice, once verified.