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Insider Trading and the Agricultural Futures Market

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by

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Concerns regarding possible insider trading by futures market participants have arisen on a number of occasions in connection with the agricultural futures markets (e.g., Russian wheat sales in the 70s and the cattle markets in 1980). It is particularly appropriate to discuss this topic here at Iowa State since one of the most vociferous opponents of insider trading in futures, Congressman Neil Smith, represents Ames. Due primarily to Congressman Smith's concerns regarding insider trading in the live cattle futures market, Congress in its 1982 reauthorization of the Commodity Futures Trading Commission (CFTC or Commission) mandated that the Commission study the nature, extent and effects of futures trading by individuals in possession of material, nonpublic information (CFTC, 1984). In addition, each of the shadow studies of the futures markets addressed insider trading--Fischel and Grossman in "Customer Protection in Futures and Securities Markets" (1984) and Johnson in "A Comparison of Federal Regulation in the Futures and Securities Markets" (1984). This short presentation will summarize these studies and provide my own conclusions regarding insider trading.

In futures markets, insider trading in the broadest sense could be defined as trading by any individual with "superior" information (Fischel and Grossman) or "special" knowledge (Johnson). Under such broad definitions, all traders, be they hedgers or speculators, could be considered insiders. The CFTC's study viewed a narrower set of traders as insiders. This government report considered trading while in the possession of material, nonpublic information to be insider trading.

Information was considered to be material if a reasonable market participant would consider it important and to be nonpublic if its dissemination was selective and not generally available despite the financial resources of the trader. The scope of this definition was further narrowed by not including futures trading based on information regarding that trader's own futures or cash market transactions. This provision exempted hedging activity which is insider trading in the broad sense.

Given the current regulatory emphasis of the SEC and the publicity surrounding its prosecution of insider trading by securities market participants such as Paul Thayer and his broker Billy Bob Harris, any referral to futures market activity as "insider trading" is a pejorative description. Although insider trading in futures markets is considered by some to be comparable to insider trading in the securities market, there are substantial differences. In securities, a corporate officer, trading the stock of his company, is engaging in transactions with current or future shareholders to which a fiduciary obligation exists. If these transactions have been undertaken on the basis of information obtained by the officer due to his position in the corporation but not available to others, such transactions constitute insider trading. Insider trading in futures markets differs, primarily, due to the nature of the instrument traded. As Johnson notes, in securities markets a nexus exists between the instrument traded and the insider. Ownership of stock establishes an individual as a principal and a corporate officer as his or her agent. As an agent of the principal, the officer

has a fiduciary duty to the principal and insider trading constitutes a breach of this duty. Generally, in futures markets no such nexus exists (except between a broker and customer) and, hence, no fiduciary duty is breached by the insider's trading.

A second distinction sometimes made between insider trading in these two markets is the difference in the availability of inside information. In securities most of the material information regarding the value of a stock originates from the issuing company. Hence, the company is an informational monopolist and employees of the company may have ready access to the market power this information can provide. Conversely, as Johnson has noted, the set of material information in futures markets is much smaller. In futures markets, information regarding the value of a commodity originates from numerous sources. This wide dispersion of information creates uncertainty regarding the value of a particular piece of information thus reducing the set of material information available to the employees of individual firms. Nevertheless, as the CFTC report noted, material nonpublic information does exist in futures markets be it specific to a firm, such as a large export sale; the commodity generally, such as a USDA crop report; or the rules of a futures market, such as a change in margins or an order for trading for liquidation only.

The principal criticism of insider trading is that it is unfair or inequitable since it permits above average returns to certain classes of traders to the detriment of noninsiders. This perception of an unfair trading environment could reduce the

confidence that certain groups of traders may have in the market and result in a reduction of their trading relative to that absent insider trading. This decreased activity may adversely affect the economic functions of futures due to the loss of liquidity. However, even absent adverse economic effects, some insider trading opponents argue that this trading violates the general ethical standards of our society and, hence, it should be prohibited.

Juxtaposed to these potentially harmful effects are the potential benefits of insider trading. If it is assumed that insider trading transmits information to other traders, the CFTC report notes, then such trading should increase the informational efficiency of the markets. This increased informational efficiency should enhance the markets' pricing functions, reduce futures price variance and reduce hedging costs. Fischel and Grossman suggest that the opportunity for insider trading provides an incentive to search for information. Participation in the markets by these traders, therefore, should increase the amount of information aggregated by futures prices. Johnson also states that insider trading enhances the pricing functions of futures and, thereby, facilitates hedging.

In addition to its theoretic discussion, the CFTC conducted two empirical examinations of the extent of insider trading in the agricultural futures markets. First, it surveyed large businesses to assess the private disincentives for insider trading. Of 81 responses received from some of the largest grain and soybean concerns in the U.S., 76% reportedly had a written or

unwritten policy restricting or prohibiting futures trading. In contrast, of 84 large livestock concerns responding to the survey, only 33% had such a policy. The discrepancy between these two industries was thought to be due to the high number of private firms in livestock relative to grain and soybeans and their smaller size. The CFTC also attempted to estimate the percentage of open interest controlled by reportable noncommercial traders with potential access to material nonpublic information. This analysis found that only 3.7% of the long and 1.3% of the short grain open interest and .7% of the long and .8% of the short livestock open interest were held by these potential insiders.

Ultimately, none of these studies advocated a public prohibition on insider trading. The CFTC felt that theoretical analyses yielded inconclusive results on the effects of insider trading; however, given the lack of significant evidence regarding the presence of such trading, the Commission decided to make no recommendation to Congress regarding futures trading on nonpublic information. The Commission did, however, recommend restrictions on futures exchange employees and proposed the institution of standards for timing trades. Fischel and Grossman suggest that if insider trading is inhibiting market performance, then competition between futures exchanges will lead to the exchanges adoption of appropriate restrictions. Finally, Johnson notes that futures market insider trading is fundamentally different from that in security markets and the enhancement of

futures market pricing through insider trading is more important than equity considerations.

Overall, I think a number of conclusions can be drawn regarding insider trading in the agricultural futures markets.

(1) Any overall ban on insider trading in futures markets would require a major redefinition of the markets' hedging function since all hedging is insider trading by definition. Therefore, absent such a redefinition, any consideration of insider trading must be restricted to speculative trading.

(2) Futures market insider trading is substantially different from that in securities.

(3) There is little evidence of speculative insider trading in the agricultural futures markets or futures in general for that matter.

(4) Regardless of evidence on its existence, a prohibition on speculative insider trading may be advisable if such trading is thought to deter market performance or to violate the ethical standards of our society. Although there is some evidence that insider trading enhances market performance due to increased pricing efficiency (see Conklin, Freidman et al.), there is little evidence that it adversely affects performance by detering trading of potential futures market participants. Furthermore, it seems fallacious to suggest that potential participants will enter the market with a speculative insider trading prohibition. If these individuals are deferring market participation because they consider the markets unfair, this deferral will probably continue with a speculative insider trading prohibition since the

markets' principal informational inequities will be maintained due to the presence of commercial traders. Overall, there is insufficient evidence to suggest that insider trading deters market performance and, in fact, a prohibition on such trading may be detrimental to the markets.

The second alternative is to advocate such a prohibition on ethical grounds. That is, if one of our social standards is fair markets and insider trading is unfair, then a prohibition on this trading may be socially desirable. However, as just stated, a speculative insider trading prohibition will not result in fair markets, i.e., informational parity among all futures market participants. Furthermore, it can be argued that such a prohibition is ethically questionable if it reduces the performance of the market, presumably resulting in waste and a less efficient use of society's resources. Although any decision on the merits of an insider trading prohibition on an ethical basis is necessarily subjective, it would seem that the role of futures markets in the economy and the effect of insider trading on its performance in the role must take precedence over the dubious standard of informational parity among futures market speculators.

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