Insider Trading and Investors: Avoiding the Stigma of Misconduct

By Henrich Greve

Wall Street Journal reports that the hedge fund SAC Capital Advisors LP is losing investors at a rapid pace, with 1.7 billion dollar (one quarter of the total outside investments) at risk of being withdrawn. In a regular mutual fund, such a wave of withdrawals would have been disastrous because funds lose money when selling large amounts of stock in a short period of time. SAC can handle the situation because it has rules limiting withdrawal speed (normal for hedge funds) plus it is backed by 9 billion dollar of money invested by its fund manager and employees. So this is a serious situation but not a meltdown.

How did it happen? The fund got caught up in an insider trading investigation involving 6 of its former employees. The investigation may lead to civil charges, possibly leading to payouts to the government. The firm has said it cooperates with the investigation and will arrange any payouts so that its outside investors are not affected. Clearly this is not enough reassurance for all the investors, and now some are escaping and others are on the fence.

It is common that investors flee funds that have scandals. Often the scandals involve misconduct that is costly for investors, such as when funds make deals that favour some investors over others. But this scandal comes with a twist: insider trading is an illegal use of information, and it can be very profitable. If the insider trading occurred on investments held by this hedge fund, it would have been profitable for the clients who are now escaping. Indeed, SAC Capital has had very high performance.

Do the investors understand this? Absolutely. Investors in hedge funds are themselves fund management firms who know the rules very well, and also know how various kinds of misconduct would affect their balance sheets. So the investors are not worried that they have been robbed, but they are concerned with preserving their own reputation.

How reputations are brought down by misconduct, and can be recovered afterwards is a topic of research that interests me and coauthors Takako Fujiwara-Greve and Stefan Jonsson. In a paper in ***Administrative Science Quarterly***, we found that reputation loss extends beyond the firm that actually was responsible for misconduct. A scandal in the large Swedish insurance firm Skandia led to investors escaping from mutual funds owned by other insurance firms, as if all investments connected with insurance had somehow become tainted. Also, other large firms saw investors escape from their mutual funds, as if all investments connected with large firms had somehow become tainted.

In **ongoing work**, we are exploring how reputations can be regained. The answer seems to be, slowly. In fact, the movement of investors out of and into the Skandia funds after the scandal is most consistent with a model of current investors leaving when the scandal hits, and never coming back, while new investors who were not paying attention to Skandia (because they were not its customers) gradually trickle back.

So what does this mean for SAC? It needs to be patient because the outside investors are not likely to come back very soon, as we found for Skandia. Their decision to withdraw makes perfect sense because reputation losses do spread beyond the original firm, as we found for Skandia. The outside investors can find another place to put their money. But I am personally curious about whether any of the money now being withdrawn is profits from the inside trading that triggered the withdrawal.

Fujiwara-Greve, Takako, Greve, Henrich R. and Jonsson, Stefan, Asymmetry of Reputation Loss and Recovery under Endogenous Relationships: Theory and Evidence (August 23, 2012).

Jonsson, Stefan, Henrich R. Greve, and Takako Fujiwara-Greve. 2009. “Undeserved Loss: Legitimacy loss by innocent organizations in response to reported corporate deviance.” Administrative Science Quarterly, 54 (June): 195-228.

Strasburg, Jenny, and Juliet Chung. 2013. Investors Exit Fund Dogged by Probe. Wall Street Journal, February 15, 2013.

Here is an earlier blog post involving insider trading and Rajat Gupta of Galleon.

Find article at
https://knowledge.insead.edu/entrepreneurship/insider-trading-and-investors-avoiding-stigma-misconduct

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