

Why Not?

Don't Sell Us Short

Ian Ayres and Barry Nalebuff, 02.02.04, 12:00 AM ET

Why don't firms use their inside information to sell rivals short when they have information that won't be good news for their rivals?

One of the great puzzles of the securities market: why firms don't trade on inside information. What we have in mind is not illegal or even unethical--but it is a big profit opportunity.

Before you get all worked up, the key word here is firms, not individuals. Companies should be able to make money on information that they generate. Sometimes they do. For example, a company which has inside information that it is about to make a takeover bid for Acme Corp. is allowed to buy stock in Acme prior to its public announcement of the bid. If Acme is trading at \$20 and jumps to \$28 when the \$30 tender is announced, the acquirer saves \$8 on each of the shares bought early.

The puzzle is why firms don't use their inside information to sell rivals short when they have information that won't be good news for their rivals. The following example illustrates our point.

On June 14, 1999 Wal-Mart made the surprise announcement that it would be entering the U.K. market. Its entry was accomplished via the acquisition of the supermarket chain Asda. Competing with Wal-Mart is not good news, and on the day of the announcement the stocks of rival grocers and retailers Tesco, Sainsbury, Kingfisher, Boots and Storehouse fell 5% to 8%. Only Safeway Plc. rose (on the expectation that it would be the next takeover target).

Even taking account of Safeway's small gain, the market capitalization of these U.K. retailers fell by some \$3 billion. It isn't realistic that Wal-Mart could have taken the full \$3 billion for itself. But by selling rivals short and buying puts, it might have been able to capture 2% to 5% of the market shift--\$60 million to \$150 million. That's real money.

The Wal-Mart example isn't unique. If United Airlines decides to start a price war, it won't be good for other airline stocks. JetBlue's entry into the Atlanta market wasn't good news for Delta. (And its recent exit was good news for Delta.) Indeed, more than a century ago Jay Gould used this strategy when he sold Western Union stock short before starting his rival telegraph companies.

There are other profit opportunities from informed trading. On Nov. 10, 1998 Intel said demand for its chips was much higher than expected. Its share price went up 5%, for a rise in market value of \$7 billion. While Intel can't use private information to trade its own stock (that's illegal), it could buy a basket of other stocks in the industry. After Intel's announcement, the stocks in the Philadelphia Semiconductor Index rose by 5%, or almost \$4.5 billion, in market cap. Even 2% of that gain would be a quick \$90 million.

Why then don't firms today take advantage--like Jay Gould did--of these trading opportunities? Several explanations come to mind, none of them satisfactory.

The first is that financial officers think such trading is illegal. But they are confusing firms trading on their own stock versus firms trading on other firms' stock. When economists Robert Hansen and John Lott asked the Securities & Exchange Commission if it would be legal for Company A to trade in Company B's shares on the basis of information generated by Company A: "All [eight securities lawyers] said that 1) it is legal to trade rivals' stock; 2) even at its most imperious, the SEC has never suggested that this is illegal; and 3) they had never heard of such a case being brought, or even episodes of such trading questioned."

A second reply is that the firm has other bigger fish to fry. On the day that Wal-Mart announces its \$10.8 billion takeover bid for Asda, does it also want to commit \$2 billion to engage in stock trading for a measly \$100 million? This would be a distraction to the board. It is only 1% of the Asda deal, so it's a rounding error. But that type of thinking says why not pay \$11 billion rather than \$10.8 billion--it's all the same. Wal-Mart buyers care about every penny, and that \$100 million goes straight to pretax income.

As for the distraction, our view is that Wal-Mart could authorize Bear Stearns to do all the trading for it, even take all the risk of loss, in return for keeping half of the gains.

We've heard it said that such gains wouldn't be of much value, as one-time events don't get reflected in the stock price. Well, they could offset any one-time losses. Or they could be used to build sales in a way that would generate long-term value.

Perhaps the most credible explanation is that selling rivals short seems distasteful. It's unmanlike. United (UAL Corp.) doesn't want to make money selling American (AMR Corp.) short because it realizes that next time around American can return the favor. Next thing you know, price wars are more likely as the profits from selling rivals short take away some of the sting.

Or perhaps it is being done and people keep it quiet. Let us know.