

WORKING PAPERS IN ECONOMICS

Assessing Insider Trading

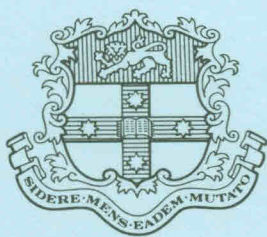
by

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Assessing Insider Trading

1. Introduction

The role of "insider trading" in securities markets has attracted much attention in recent months as a result of major investigations in the United States, serious questioning in the United Kingdom about circumstances surrounding the acquisition by Guinness of The Distillers Company and the publication of a consultative paper by the National Companies and Securities Commission (NCSC) in Australia. But the meaning and significance of insider trading is much less certain than expressions of concern and claims for its frequency would suggest. For example, the connections between the dissemination of information and the efficiency of securities markets bear heavily upon judgements about the significance of insider trading. No less important is the precise meaning of insider trading.

The purpose of this paper is an examination of the meaning of, and the evidence about, insider trading and to relate that to material in the consultative paper offered by the NCSC (18). This treatment should permit a comparison of the various approaches to the interpreting those actions taken by participants in securities markets which could be viewed as insider trading.

The next section of the paper is devoted to an analysis of meanings attached to the concept of insider trading. This defining of terms is linked to assessments of markets performance, essentially the efficient market hypothesis. The third section offers an extensive treatment of major themes revealed in the consultative paper prepared for the NCSC. It is supported by the subsequent section which treats issues about insider trading mentioned in the Campbell Committee's Final Report. It was a suggestion from that Committee which inspired the work initiated by the NCSC. These three sections provide the basis for examining the role of information in relation to its accessibility, the relationship between information and financial advantage and then market efficiency.

2. Insider Trading

Defining insider trading is no simple task. Two distinct approaches to its definition of the term may be identified. One approach, which may be thought of as reflecting property rights in information, rests upon the existence of fiduciary relationships. The other approach reflects a principle of equality of access to information about securities. That means having all participants, actual and potential, given the same opportunity to gain information on any one security traded in a market.

The first approach leads to a definition of insider trading as the use of information, not publicly available, by a participant in a securities transaction whose access to that information is derived directly or indirectly from a fiduciary relationship and giving the participant and associates a financial advantage over others. The advantage may be secured from trading in the securities of the company in which the fiduciary relationship is established, or in other companies whose market values may be influenced if confidential information held by the initial company were acted upon. The latter aspect finds its most common expression in mergers and takeovers.

According to this definition the owners have a property interest in the information held by the company so that those breaching a fiduciary relationship might gain at the expense of the owners, namely shareholders. That qualified statement reflects the possibility of some part of the reward to senior officers being in use of information for financial gain and thus an incentive payment for increasing the wealth of shareholders. But even with that qualification the use of insider information does not necessarily undermine the gains in wealth enjoyed by shareholders (4). Only those shareholders who sold at the time when trading on the basis of inside information was being pursued might be said to have "lost" wealth; an interpretation resting upon a rise in the price of the security. When the prospect is for a fall in price the only loss of wealth resulting from insider trading is experienced by those buying shares in the company prior to the information becoming public. Where confidential information is extracted without the co-operation

of those holding positions of trust in the company, then such actions are plainly theft.

The second approach emphasizing equality of access to information about a company by all participants in a securities market sets aside the property concept. Information is not perceived as the property of the company being a legal entity, or as contributing to the wealth of the owners, being the shareholders. In effect the provision of equal access amounts to declaring all information a "free good" to market participants regardless of costs for its generation. The costs of that free information may be exaggerated where the company requires information on its activities for management and audit purposes as well as for meeting reporting standards. Such provisions are clearly different from the costs of information developed by a company about other companies in which it has competitive concerns or sees opportunities for acquisition.

With this approach the definition of insider trading is the use of information, not publicly available, by a participant in a securities transaction to the financial advantage of that participant and associates over other participants. The breadth of this definition implies restraining use of any confidential information from whatever the source.

The theoretical assumptions of this position would appear to lead to equitable and efficient market outcomes. Availability of information would be absorbed by participants and understood for all price implications so that buyers and sellers would not gain or lose beyond general market movements. There is no explanation for the adjustment process incorporated in this approach; recognition and correct use of the new information is to take place instantly.

Comparison between the two definitions shows the huge difference between them. The economic or property approach is about using information, developed within fiduciary relationships of a company, to financial advantage. The "free good" approach requires equal access to all information about all securities for all participants, actual and potential, in the market. The former acknowledges the connection between information and the wealth of

shareholders whereas the latter denies its existence or, at the very least, its primacy for the workings of securities markets.

But this analysis of insider information and its use must go further. The use of inside information is only visible when trade in securities takes place. Yet any person holding such information, however defined, has two choices; whether to act on that information by trading or simply holding, that is not trading. There is no way in which penalties for supposedly using inside information can be applied when the decision is not to trade. There is asymmetry in the availability of evidence about the influence of insider information on securities trading. Prohibitions on the use of this information can only be partial.

The use of information is central to the efficient working of the capital market (9). In this context the concept of efficiency relates to the prices and values associated with all securities. An efficient capital market is one in which prices are accurate signals for allocating financial capital to physical assets, such as buildings plant and equipment. This means, in turn, that the returns or rewards on securities offered in capital markets will reflect a general level in the market adjusted for the risk associated with each security. That return on individual securities is best conceived as a normal return. This does not mean that actual returns do not vary around that normal return; any departures are random without persistent bias, positive or negative, around the norm. This concept is what is meant by the Efficient (Capital) Markets Hypothesis (8, Chapter 5).

Put at its strongest, this hypothesis denies the possibility of an individual participant being able to earn consistently positive abnormal returns after taking into account transactions costs of securities trading. But that interpretation rests upon all information, public and private, being available to market participants (12). A less demanding view, referred to as the "semi-strong form" of the hypothesis, rests upon the market reacting to all public information. With this interpretation there is scope for earning positive abnormal returns at least for a brief period when private information is acted upon. The third or "weak-form" of the

hypothesis is of no interest for this assessment of insider information because it is about participants being aware only of the historical behaviour of prices. The contrast between performances with the "strong" and "semi-strong" versions of the efficient markets hypothesis is the setting for examining the use of private, or inside, information.

The economic or property approach to defining insider trading leads to the judgement that use of inside information means a rapid adjustment of securities prices to new equilibria. Rewards to the users of inside information, being positive abnormal returns, are a cost associated with the rapid transmission into market prices and values of "new" information.

The equal access approach denies the role of the insider and rejects the gains for the workings of an efficient market. All information influencing market decisions should be available so that all participants are informed with equal possibilities for adapting their portfolios of securities. The initial response to this interpretation is to claim support for the approach in terms of the definition of the strong form of the efficient markets hypothesis. Reflection would point to the absence of any explanation how participants would transform all the information into new prices. In short, would there still be scope for some to earn positive abnormal returns?

This question is not just about the efficacy of the efficient markets hypothesis. It is central to an understanding of the complaints against insider trading. Hence the consultative paper offered by the NCSC provides a timely opportunity to reflect on, not only the significance of insider trading, but also the theoretical basis for prohibitions on preferred access and use of confidential information.

3. The Consultative Paper

This paper comes in three parts. First, there is a brief preface offered by the NCSC. This explains the origins of the consultative paper in deliberations of the Ministerial Council for Companies and Securities during 1983. The reason for delay in completion of the paper is explained. A very brief listing of the significant elements in the draft legislation and, by implication, the discussion paper is offered. But in the bureaucratic fashion of the day these are shown as "dot points" rather than numbered for easy cross-reference.

The second part is a discussion paper prepared by the NCSC's consultant, Dr Philip Anisman, with advice and suggestions from a number of people whose names are listed in the notes to the paper. This paper is lengthy being 129 pages supported by notes which comprise another 132 pages!

The third segment in the consultative document is a discussion draft of proposed legislation stemming directly from the work contained in the discussion paper. This was also prepared by Dr Anisman. Apart from a couple of introductory pages it is a detailed proposal for new legislation. Hence the stage is set for implementation of additional provisions about insider trading. In the preface a claim is made how an unidentified leading academic views this material as, "... a work of major importance and it deserves to be carefully considered with a view to prompt legislative action." (18,p.vi). The NCSC simply wishes public comment before, "forming a concluded view" (18,p.ix).

In the light of these two claims the consultative paper deserves close scrutiny for not only the material advanced but also the basis of proposals to change legislation. The discussion paper recognises the existence of legislation on insider trading. But it then goes on to claim that insider trading persists in a number of countries including Australia. The footnote to this claim does not reveal convincing sources of proof about the continuing problem with insider trading in Australia. The brevity of this treatment is

rather surprising in view of the claim advanced in the subtitle to the consultative paper as being an outline of issues.

There is no explanation of the shortcomings with existing legislation on insider trading. Two sentences on the first page of the discussion paper state a position but no elaboration was thought necessary:

"As a result insider trading has been the subject of numerous studies and investigations by governmental, self-regulatory and private bodies, (7) and is now prohibited in most western countries, including Australia.(8) It is generally accepted, however, that insider trading still frequently occurs and recent proceedings in the United States, Canada and Australia suggest that it is widespread.(9)"*

The initiative for proposals to strengthen existing legislative provisions appears to rest upon a recommendation from the Committee of the Inquiry into the Australian Financial System, familiarly known as the Campbell Committee suggested the need for a review of insider trading provisions with the aim of strengthening them. The NCSC took up the proposal with this consultative paper.

These two aspects - the assertion about the continued existence of insider trading in Australia and the suggestion from the Campbell Committee - constitute the grounds for offering new legislative proposals. It is very difficult to reconcile this position with the claim that the consultative paper offers an outline of the alternatives.

What the discussion paper does not address in any way are some practical questions. While bearing in mind that this paper was completed in March 1986, recent experiences with insider trading disclosures in the United States and the United Kingdom would not suggest some existing legislation, admittedly in countries other than Australia, to be grossly deficient. This reinforces the query about the failure to test the existing legislation before embarking on new

* The bracketed numbers in this quotation refer to notes in the discussion paper and are not references listed in this paper.

measures; a view common to submissions to the NCSC on the consultative paper (1,2,14).

Nevertheless there is a much more testing issue. Is the problem really a weakness in existing legislative provisions or is the real challenge to be found in implementation? This matter is not addressed and it should have been. It is necessary to show whether or not the administration of insider trading provisions can secure information revealing insider gains. Only then when such information has been tested in judicial procedures can a claim be advanced for strengthening or replacing existing legislation.

Omissions from the analysis conveyed in the consultative paper should not be set aside lightly. Until they are addressed, proceeding with further legislation would be misguided. It is essential to know what are the existing limitations on gaining access to information about insider trading. Are they practical ones of collecting information and supervision or do they rest on legislative weakness? In this context it is well to note that accounting and recording procedures of activity on trading floors of stock exchanges are available to the NCSC so allowing ready access to information on trades which, in turn, may be traced to buyers and sellers as well as to their brokers.

The quotation from Montaigne at the beginning of the discussion paper may be revealing of preconceptions about markets and their behaviour, "... no profit can be made except at another's expense, ..." (17, p.48). While the brief essay from which this quote is taken may be amusing, it could hardly reflect much of the thinking about markets developed over recent centuries since its publication was in 1580. Nor could it capture anything of the understanding of wealth effects stemming from changes in security prices. In the context of game theory and its applications, the assumption is of a zero-sum game, and so ignores the possibility of a positive sum game where all participants may benefit.

The main focus of any critique of the NCSC document must be about the links between information and market efficiency; a theme

explained in the preceding section as most important to any assessment of the effects of insider trading. Thus defining information to include not only fact but also intention, motivation and so forth is a sweeping view with important implications (18, p132). On that matter activities influenced by tax provisions and portfolio management may also be applicable to any assessment of the motivation of perceived insider trading. Another worry would be the possible handicaps imposed on stockbrokers as agents in securities transactions for clients in no way linked to inside information but about which a broker has become privy. The effect could be to restrict clients' access to the stockmarket as well as inhibit a broker offering advice to clients. A number of practical matters of this nature are spelt out in a commentary from the Australian Associated Stock Exchanges (1).

4. The Campbell Committee and Insider Trading

The Campbell Committee suggested that the National Companies and Securities Commission ".....should, as a matter of priority, review the insider trading provisions of the Securities Industry Act, with a view to strengthening them". (5,21.123) This conclusion reflected a series of statements which may be summarised as follows:

- (a) a securities market can operate freely and fairly only with all participants having equal access to information;
- (b) investor confidence depends upon the prevention of improper use of information; and,
- (c) any efficiency gains from the rapid dissemination of information from pricing changes reflecting insider trading are outweighed by equity considerations (fairness) and likely adverse impacts on investor confidence.

It is well to note that the Campbell Committee dealt with insider trading under provisions related to investor protection. These views on insider trading may be compared with the comments and suggestions made when treating the efficiency and structure of securities markets in the later Chapter 33. In what was a lengthy assessment of these markets the Committee made the following suggestion with an additional comment, "....the matter of a 'Second

Board' seems worthy of consideration by the NCSC. If adopted, the principle of caveat emptor might assume greater importance."

(5,33.147) This commentary was in the context of a discussion about broadening the scope of smaller and newer companies for access to funding through securities markets, especially the stockmarket.

The two perspectives are in marked contrast. When treating investor protection the Committee held principles of equal access to information, thus reflecting concerns with fairness, or equity, as foremost in any assessment of working relationships. When structural and efficiency aspects of securities markets were being reviewed, a much different slant emerges; buyers should be aware of potential pitfalls with the purchase of equity in companies listed on "second boards". That comment was directed not just to the risks associated with the activities of smaller and newer companies but also to the reduction information arising from a more modest prospectus than necessary for main listing and less onerous reporting requirements. With remarks about *caveat emptor* and modest requirements for informing market participants a much different slant on behaviour is offered.

A comparison of the stance adopted by the Campbell Committee when treating investor protection in the stockmarket with that taken when assessing market efficiency suggests no easy reconciliation. An explanation for these apparently perverse offerings from the Campbell Committee in respect of the stockmarket is not obvious. There is no internal evidence from the Final Report that the Campbell Committee paid much attention to the range of studies on insider trading available, most of all the 1974 study by Jaffe (15). What is obvious is the quite brief treatment given to insider trading; the entire commentary is less than a page of Chapter 21 in what is a massive document. An interpretation could be that the Campbell Committee devoted very little time to the topic resting its position on the "commonsense" of existing views. Yet the Campbell Committee explored at some length the workings of the stockmarket elsewhere in its Final Report, even though most of its efforts may have been concentrated in the closing weeks of its activities. It is as if the sketchy material on investor protection in Chapter 21 was treated quite independently of the more comprehensive assessment of efficiency in

Chapter 33. The Campbell Committee did not have a comprehensive view of how capital markets work nor did it set out an analytical framework to support its assessments.

The significance of the suggestion about the NCSC pursuing further the issues about insider trading lies in the paucity of evidence and analysis drawn upon by the Campbell Committee. It did not pursue a comprehensive assessment before advancing its suggestion as a recommendation. Nevertheless the NCSC used that proposal from the Campbell Committee to initiate work on the consultative paper. But that paper in turn reflects the same failings as the report from the Campbell Committee, namely a lack of analysis about the role and significance of insider trading, no empirical appraisals of the Australian market and a simple perception of issues in a most complicated situation reflecting the one principle of equality of access.

5. Information and Insider Trading

The NCSC discussion paper treats issues related to the connexion between efficiency and information. It reviews, perhaps too briefly, the question of whether or not efficiency of stockmarkets may be enhanced by the activities of insiders. The actions of insiders as buyers or sellers convey information quickly to the market so that all participants are promptly informed by new price signals. An important element in the argument for the positive contribution of insiders is that costs of gaining access to information - search costs - are minimised for all participants. The discussion paper rejects such arguments in favour of prompt disclosure because "... material developments on a timely basis as they occur would ensure that their full implications are reflected in the market price more quickly..."(18, p.8). But this judgement sets aside questions about the speed of response to new information and how it would occur; a matter referred to at the end of Section 2.

It may be helpful to examine evidence from the many extensive analyses of insider trading pursued in the United States. In that country the Securities and Exchange Commission (SEC) requires persons associated with companies to report share transactions. This

information on persons defined as "insiders" is available for analysis. Empirical work based on this data is comprehensive. The main purpose of that use of public information is two-fold; to analyse any gains enjoyed by insiders, as defined by the SEC, and test whether or not the availability of that information allows others to trade with equal or some advantage in the market.

Much of this work is of relatively long-standing, and was summarised in the 1974 survey by Jaffe (15). It is unfortunate that the discussion paper gives little recognition to the implications of many studies of the U.S. experience. A revealing and, in many respects, challenging analysis for the purposes of the NCSC study was the 1983 study by Seyhun (20). The results of that work were:

- (a) An outsider adopting a trading strategy of buying when the knowledge of insider buying became available from SEC data and selling or shorting when an insider sells would yield abnormal positive returns; and,
- (b) there appeared to be different experiences for smaller than larger firms with respect to trading opportunities.

Interpreting these results may not be straightforward owing to problems about measuring market returns for the smaller firms. This reservation had been noted earlier in work provided by Banz (3).

However, Seyhun later changed his judgement on this matter, (21). His later results denied the scope for earning positive abnormal returns from using information about the trading activities of insiders. The one qualification was the scope for trading on the basis of knowledge of insiders' trading activities before that information. This revised conclusion depends heavily upon costs of securities transactions being brokers' fees and bid-ask spreads.

Much attention has been given in this type of empirical work to the complicated links between the provision of information by a variety of means and insider trading. In view of the major emphasis given in the discussion paper to the availability of public

information, it is a matter for regret that the many subtle analyses developed during the 1980s were not treated.

One study reported early in 1985, examined the relationship between insider trading and management forecasts (19). The results of Penman's work point to some gains by insiders. However, they do not appear to take advantage of all the information available to them when trading on the stockmarket. An important point in his conclusion was, "... even if insider trades do capture insiders' information, they are likely to be quite noisy signals due to trading for other than informational reasons."(19, p.16). This aspect must be considered for its implications about the identification of just what is and what is not insider trading. Those with access to insider information will trade for a number of reasons such as liquidity and portfolio needs as well as tax influences. These features are noted frequently in commentaries on traders' activities whether they be insider, speculator or the ordinary participant.

At about the same time as the Penman study was available in 1985 another paper was reporting on a somewhat similar theme. This work by Givoly and Palmon was about the exploitation of insider information.(11) Apart from the excellent summary of issues at the beginning of the paper conveying much information on previous studies concisely, the study aimed at sorting out the extent to which abnormal positive returns are a reflection of the information available to insiders or the public disclosure of the specific news on which they acted, or were thought to have acted. On the basis of a very carefully developed methodology, devised to minimise the effects of extraneous influences, the two authors reach some important conclusions:

- (a) Insiders' superior performance, represented by abnormal positive returns compared with the market return, is a reflection of market perceptions that they have superior knowledge to which investors respond;
- (b) The basis for this claim is that the abnormal return to insider transactions lasts well beyond a typical period of reaction to the disclosure of specific news about a company; and,

- (c) Insider activities are seen as "leading indicators" in the stockmarket so that other participants follow the lead initiated by insiders.

It should be noted that these results point to a market taking time to adapt to new information and thus being less efficient, in the sense of response to the availability of new information, than is often claimed.

These results from Givoly and Palmon challenge some preconceptions about the deleterious impacts of insider trading. It is commonplace to reject any benefits of insider trading on the grounds of undermining investor confidence. This position was expressed by the Campbell Committee when stating "...the view that insider trading allows prices to adjust more quickly to the underlying value of particular investments. However, these 'advantages' are decisively outweighed by considerations of equity and likely adverse effects on investor confidence in the market as a whole." (5,21,118). What the Givoly and Palmon analyses show is quite the opposite. Far from undermining investor confidence the activities of some insiders may sustain confidence in the stockmarket and the particular securities concerned.

These results point to testing questions about the nature of efficient markets directed mainly to the nature of expectations held by participants. The equilibrium condition for the efficient markets hypothesis rests upon the existence of homogeneous expectations amongst participants. The introduction of new information disturbs those expectations which must mean the creation of circumstances for earning positive abnormal returns. Outside a theoretical construction it would be bizarre to expect instant recognition of all the implications of new information by all participants. The Givoly and Palmon results point to an explanation of the adjustment process from one equilibrium to another; leadership is sought from a hierarchy of participants.

Similar studies have been pursued in an effort to determine what association exists between insider trading and information

announcements. While the Givoly and Palmon study is most helpful, the work pursued by Elliott, Morse and Richardson is directed specifically to the question of whether or not insiders work on information available prior to public announcement.(7) One important conclusion from their work was that only a small portion of the trading conducted by insiders was related to information later made public.

Other conclusions are of interest for their bearing upon claims about the impact of insider trading:

- (a) insider sales are less than normal prior to announcements of mergers and substantial increases in earnings;
- (b) insider trading may be related to other considerations such as portfolio diversification and taxes; and,
- (c) the nature of the use of information is complicated requiring careful interpretation.

This result confirms points made earlier; detection of the influence of inside information on trading behaviour is not an easy task.

The first of these three points bears directly on the asymmetry in use of inside information for trading purposes to which attention was drawn earlier. But this conclusion does not suggest that advantage is taken of information on successful outcomes to buy securities likely to rise in value, quite the opposite. Insiders rest, by and large, with their existing securities in the company anticipating the gains in wealth to be verified when the market reacts to public announcements. The second matter is one referred to already; those comments on the variety of reasons why participants with access to confidential information trade in securities are reinforced by this result. The third point really bears upon just how is information interpreted and the difficulty of what is meant by using apparently relevant information.

The main purpose of this reference to the many analyses of trading information held by the SEC in the United States is to show that, despite the availability of that information on insiders' activities, it is difficult to reach strong conclusions on the extent

to which abnormal positive gains reflect inside knowledge. Insiders are not necessarily representative investors anyway, a feature recognised only recently.

The implications for the consultative paper offered by the NCSC are clear. First, the failure to examine the available evidence has meant the provision of a discussion paper which does not address the many complications associated with assessing the extent and impact of insider trading. Secondly, the omission of any significant review of the issues boils down to assuming a problem to exist which cannot be dealt with under existing legislation. Thirdly, despite the wealth of information held by the SEC on the United States position no attempt has been made to explain the practical difficulties of securing evidence for prosecuting insider trading.

6. Information and Access

Access to information is at the core of the proposals advanced in the discussion paper and then embodied in the draft legislation. The main ideas conveyed in the consultative paper (18, pp.12-13) appear to be:

- (a) Public investors should have an equal opportunity to obtain and evaluate relevant information when determining their course of conduct with respect to securities;
- (b) Information obtained in ways which enable a person to engage in essentially riskless transactions in securities, perhaps best termed "riskless arbitrage", should mean that persons with such access are prohibited from trading in those securities; and,
- (c) Any principles for organising market participation and supervising market participants can only be understood in practice - "that more concrete context."

In order to foster the equal opportunity approach the discussion paper and its associated draft legislation offers a structure of insider relationships dealing with all those associated with companies and others who may gain information from those people. Some 100 of the 129 pages in the discussion paper is taken up with spelling out the relationships, this being what is meant by a, "....

more concrete context". While this description may well apply to the style of the consultative paper, the draft legislation is opaque on the boundary of public and insider information. What is a reasonable time for information, "...to be generally disseminated to investors...."? This is no idle query because the informed public investor, not being an insider as defined by the draft legislation, would be in a position to act promptly not being restricted by any provision about reasonable time for dissemination.

This notion of equal opportunity conveys the idea of equal access to all information. How would awareness of this opportunity be conveyed? Should it be preceded by an announcement that relevant information will be available to all and sundry at a specified time and place. That declaration of an impending relevant announcement could readily influence trading even if only by widening bid-ask spreads. But what is contained in (a) above goes further in terms of conduct with respect to securities. Given the listing of some Australian shares in foreign stockmarkets it would be impossible to offer equal opportunity to conduct securities transactions at all times. As integration of national stockmarkets increases such difficulties must grow with more and more trading across time zones. However, the long experience of trading in shares listed in Australia and London removes any suggestion of novelty in this matter. Yet no heed was taken of this experience in the preparation of the discussion paper and the accompanying draft legislation.

There are other practical considerations. For example, companies brief fund managers, stockbrokers and others on their activities. Those briefings would seem to fall into a category of material information not generally disseminated. They offer the prospect of some public investors gaining an advantage by being in association with persons having material information. Should these briefings be prohibited? Attendance at such meetings would become a hinderance to fund managers were it to define an association for purposes of insider trading. It would be much more lucrative to await a formal statement to be acted on without restraint.

Other possibilities may be entertained. Stockbrokers could inadvertently become acquainted with insider information because of

the ways in which orders were placed. Would this preclude the brokers from offering advice on these securities to clients seeking advice in general or with particular reference to the securities concerned. Where a broker acts as principal, rather than agent on behalf of clients, which is of increasing significance in an era of market makers, the broking firm would be inhibited in this function. The effect of widely defining information for insider trading purposes would be in all likelihood, the segmentation of the broking industry with some firms specialising in institutional and corporate clients, others as market makers and others dealing with individual clients and small companies.

The second theme conveyed under (b) in the opening paragraph of this section is about engaging in essentially riskless transactions. In the light of U.S. experience with insiders this bold claim cannot be justified. In one work, to which reference has already been made, the point is stated; "When significant insider trading has been observed, the direction has not always been consistent with a profitable trading strategy" (7,p.535). Assuming that no participant with access to inside information is a dolt, this points up the importance of interpretation of any information prior to determining a trading strategy.

Problems abound for implementing provisions about restraining use of inside information. Does not this pose most difficult tasks for market supervision? A brief re-iteration of the main issue may help clarify the extent of the difficulty. Information would have to be posted, with defined insiders not able to trade the relevant securities for, say, a couple of days. But alert "outsiders" would be able to trade immediately. Such a provision as proposed would have only one real effect; *it would change the order of those first able to act on the new information.*

Whose interest is then best served by changing the ranking order of those acting on ready access to information? This question is reasonable in the context of support for legislation (6). Whether or not changing the ranking order would reduce the potential for earning abnormal positive returns remains conjectural. But on the evidence thrown up from various U.S. studies the prospect for

positive abnormal returns being earned, if only for a brief period, is real. Moreover, theoretical insights available from a spelling out of how adjustments take place in efficient capital markets suggest the availability of those short-term rewards.

7. Information and Financial Advantage

Controversy surrounds the notion of insider trading. The definitions of insider trading provided at the beginning of this paper appear to be about gaining a financial advantage as a result of having access to privileged information. Certainly it is the basis of the economic or property approach to defining insider trading. This means using confidential information about the activities generated from within the company concerned to trade in shares of that company or other companies. Such trades are said to confer financial rewards on those initiating sales or purchases over the other party to the trade as purchaser or seller.

The difficulty with this position is to determine whether or not this other party would have acted any differently if insiders were not permitted to trade before the disclosure of privileged information. The essential question is whether or not the timing of a purchase or sale by the other party would have been changed by the absence of an insider. In as much as the decision to buy or sell precedes the actual trade, then timing is not influenced by the activities of insiders. Manne's initial contribution on this issue has been challenged but not obviously rebutted in the lengthy debates since it was advanced more than two decades ago (16). Critics of this perception of insider trading are cautious in advising more comprehensive legislation.

The issue may be pressed further. Should there be a lapse of time between the date on which an insider could have traded, but is prohibited from doing so, and the date on which the information is generally disseminated, then more "other parties" may have engaged in transactions at values different from the new equilibrium set of values and prices fully reflecting new information. There may be opportunity costs to some participants because of prohibitions on the

use of confidential information. This has been overlooked completely in the NCSC consultative paper and most other commentaries.

The significance of the insider transaction seems to rest upon the conferring of a financial advantage. That has clearly been the interpretation applied in the United States. But that approach does not find acceptance in the NCSC consultative paper where the determination of the United States Supreme Court in the Dirks case is criticised (18,p.21) This case was about the actions taken by Raymond Dirks, an investment analyst, when he was informed of a major fraud which he verified before advising the regulatory authorities and his investment clients. The informants from within the company were not motivated by personal gain. Thus a breach of insider trading provisions did not take place. However, the proposals in the consultative paper reject this requirement about financial benefit stemming from insider information in favour of the broader provision which treats preferred access to information as a breach regardless of financial benefit. In its submission to the NCSC on the consultative paper, the Australian Associated Stock Exchanges (AASE) criticise this rejection of the U.S. Supreme Court determination because the broader interpretation incorporated in the draft legislation would, "... impose prohibitions which will interrupt the practical and efficient operation of the securities markets for the sake of prohibiting conduct which is deemed to be improper solely because purity of principle requires it." (1,p.4). That submission goes on to claim, "... community opinion would be on the side of Mr Dirks, and activities in which he engaged ought not to be prohibited." (1,p.5).

This response from the AASE helps clarify the extent of the commitment in the consultative paper to a single-minded pursuit of the second approach to defining insider activities, namely the requirement of equal access to information regardless of any other issues. Nevertheless, once the possibilities of there being a significant lapse in time between the generation of information and its public dissemination are admitted, then some market participants may be placed at a disadvantage. The "purity of principle" so delightfully noted by the AASE would then require not only general dissemination of information held confidential but also disclosure

following immediately on its generation. That would be a real test for market supervision!

Confidential information about a company need not be the exclusive province of that company and its directors and officers. Other groups in the economy may pursue investigations to develop a comprehensive assessment of the potential earnings and activities of any one company. The body of knowledge would not be in the public arena and hence would be deemed confidential to the company, bank, broking house or other type of institution sponsoring the work. It could be an individual or partnership, formal or informal. That information would be the property of the group concerned. It might lead to financial advantages accruing to the group but those gains would not reflect access to any fiduciary relationship bearing upon the target shares of one or more companies.

The consultative document sponsored by the NCSC does not recognise this distinction between confidential information held by a company about itself and that generated by another group about the same company. The draft legislation proposes that any information not in the public arena which bears upon past, existing or *intended* business or professional relationships, would constitute inside information (18,p.133). Apart from considerations of academic curiosity, the pursuit of information will be a reflection of some intent. Argument in the discussion paper appears to ignore the role for information generated independently of the existence of any fiduciary relationship because the reasoning conveyed in rebuttal of the efficiency arguments for insider trading is couched solely in terms of the company concerned making public the relevant information (18,p.8). No attention is paid to independently-generated information.

8. Information and Markets

Emphasis on the link between information and market efficiency is now embedded completely in assessments of market performance. It permeates virtually all discussions on the supervision and regulation of markets, not least in the financial services sphere (10). Hence it is essential to understand the theoretical basis for analysing

market efficiency, especially as it applies to the financial sector, spelt out in Section 2.

Within that context it is assumed that participants in the market not only use all available information *but also use it correctly*. References to empirical studies and their results in earlier sections of this paper offer some insights about the extent to which markets perform efficiently in terms of prices as signals to market participants and the speed of response to new information reflected in price changes.

At issue in this approach to the analysis of markets is whether or not the information available to participants is used fully by them. If that information is not absorbed fully and accurately or it takes time for it to be reflected in price changes then the market is not fully efficient; it may then be possible for some participants to earn returns higher than would be the case in a market which met conditions for strong efficiency.

Adjustment is about the adaptation of expectations to new information for the attaining of a new equilibrium. The proposals for dealing with confidential information conveyed in the consultative paper rest upon only one approach to defining insider trading. In every respect they reflect the strong measure of market efficiency in its entirety. What is readily lost from sight are the assumptions underlying strong efficiency; homogeneous expectations and instant recognition and response to new information. That strong concept defines equilibrium.

In the light of these restrictions it is hardly surprising that some reviews of the efficient market hypothesis question its dominant role in appraising the behaviour of financial markets. For example, the possibility of uninformed participants not being able to recognise effectively their trading opportunities (13). What such a concern does not admit is the likelihood of those participants being in a relatively weak position whatever provisions are made for restricting use of insider information. What recognition of this category of participant means is that others may be able to gain at the expense of the misinformed, a hardly surprising revelation. It

confirms the existence of a hierarchy of participants earlier mentioned when examining the results of work by Givoly and Palmon (11). The lack of homogeneity amongst participants says something about lagged price adjustment in securities markets but little if anything about the influence of insider trading.

Thus arguments about insider trading and the availability of all information to participants in securities markets are really discussions about the feasibility or applicability of the efficient markets hypothesis. This may be imperfectly understood, perhaps not at all. Once the strong form of the efficient market hypothesis is eliminated, some explanation of the price adjustment process is required. Those not condemning insider trading see the use of private information as the means of rapid adaptation of the prices of relevant securities.

An implicit assumption underlying their stance is that rapid adjustment of prices is the *optimal* adjustment procedure in securities markets. Yet that approach is a restricted one, confined entirely to securities prices. Recall how in the second section attention was drawn to "gains" and "losses" being associated with actual trades. An essential element in any assessment of an optimal pattern of adjustment would be exposure of the minimal proportion of the shares outstanding to gains or losses before a new equilibrium was reached. The time span of the adjustment then does not loom so large as the relative scale of share trading. Hence the familiar graphical displays of price adjustment shown in the finance literature are not complete statements on optimal adjustment (8, Chapter 5).

This element is missing from the strong version of the efficient market hypothesis for good reason; it is assumed away by reason of instantaneous adaptation of expectations, correctly applied by all participants and revealed in instantaneous new prices. Again as noted in the fifth section, once this theoretical construct is abandoned, the adjustment process comes to the fore. Deficiencies in the explanation of the adjustment process are a reflection of weakness in the efficient market hypothesis about the assimilation of relevant information.

9. Final Comment

Exploration of issues bearing upon insider trading in securities markets is most revealing in regard to the many complications besetting any attempt to regulate or prohibit the practice. Moreover attention has been directed in this paper to questions about information reflecting the accurate knowledge of those generating it. Deliberate transmission of misinformation is a separate matter to be treated as misrepresentation or worse.

The main immediate conclusion is the inadequacies of the proposals advanced in the consultative paper offered by the NCSC. The proposals requiring equal opportunity of access to relevant information would not eliminate the earning of positive abnormal returns, only the ordering of those first able to act for gaining such returns would be changed.

These are many other repercussions. Spreading the net of material or relevant information so widely imposes restraints on many participants, even those having no links to companies whose shares are the objects for analysis and potential trading. Failure to examine the evidence on insider trading from the United States has restricted perceptions of markets participation and hierarchies of participants.

However, the basis of the economic analysis of securities trading, embodied in the efficient market hypothesis, is not as secure as some of its proponents would claim. The shortcomings do not impair the great bulk of empirical analyses of market performance but should give pause to advancing propositions about market adjustment, most of all with respect to hints of optimal outcomes.

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