WORKING PAPERS IN ECONOMICS

INSIDER INFORMATION AND MARKET ADJUSTMENT

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W.P. Hogan

No. 118 November 1988

DEPARTMENT OF ECONOMICS

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Insider Information and Market Adjustment

I. Introduction*

This contribution has two purposes. First, an examination of the meaning of, and the evidence about, insider information and its uses. Secondly, a searching out of the implications of various analyses on the use made of insider information for the workings of markets in securities. Some issues on the relationships between securities markets, other means of financial intermediation and outlays on goods and services will also be treated.

Analyses of recent proposals for additional legislation in Australia on insider trading is not the province of this paper. The implications of these proposals sponsored by the National Companies and Securities Commission(NCSC) have been examined elsewhere.(1,15,16) Hence this contribution draws upon but is not directed to specific issues bearing upon the conduct of securities markets and their participants in Australia.

The perspective illuminating this paper is Hayek's analysis of the links between information and price setting.(14) What Hayek drew attention to, even if sufficient heed has still to be taken of his contribution, was the inability of any one person to know everything bearing upon the use of resources at any one time. Hence the market reflects the interaction of many participants each with knowledge of particular conditions of time and place. Accordingly there will always be some having rare or unique opportunities relative to most others. Experiences of markets reflect this point and are exemplified by propositions such as "learning by doing". The function of markets is to transmit information through prices on the relative demand for items. The more prompt the transmission the more effective is any one market in guiding the efficient use of resources.

The next section of the paper is devoted to an analysis of meanings attached to the concept of insider information. This defining

* Assistance with data and sources provided by Alison Harvie is gratefully acknowledged.

of terms is linked to assessments of market performance, essentially the efficient market hypothesis. The third part examines the empirical evidence, mainly drawn from the United States, and some related practical matters. This is followed by an assessment of the connections between pricing behaviour and equilibrium prices in securities markets. The final section of the paper examines the relationship between access to and pricing in securities markets, and other forms of financial intermediation.

II. The Concept of Inside Information

Two distinct approaches to the defining of inside information may be identified. The first which is best understood as reflecting property rights in information, is directed to the workings of securities markets. 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. This is an equity or fairness approach to determining how privileged information may be used.

The first approach means defining inside information as information, not publicly available, whose use by a participant in a securities transaction 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. The use of insider information does not necessarily undermine wealth enjoyed by shareholders.(3) 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. These "losses" may best be interpreted as the adjustment costs of adapting to a new equilibrium price for the particular security involved in transactions. It is not obvious that these "losses" represent a real loss to the participant on the other side of the transaction to the one using priviledged or inside information. The decision to sell or buy by that other participant would have been taken on the basis of information and circumstances prior to and independent of an action determined by the insider.

The crux of the property approach is that the firm possessing the privileged information may determine how that information is used; in effect to establish its use in securities or other markets. Rules on the use of that information may be imposed by directors and management allowing trading in securities within specific requirements or without restraint. The essence of this approach is that the nature of fiduciary relationships within the firm is determined by the directors and management; they in turn are answerable to the owners, the shareholders, for their actions.[1]

The efficiency of securities markets is enhanced by the prompt use of inside information. In this way signals are conveyed rapidly as prices respond to buy or sell offers. Adjustment to a new market equilibrium is fostered and not delayed.

The second approach emphasising 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. Admittedly 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 laid down by supervisory authorities. Such provisions are clearly different from the costs of

1. This interpretation encompasses propositions advanced by Manne which see the gains from insider trading accruing to directors and management as being part of their remunerations.(19)

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 any 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 and however it was devised.

The theoretical assumptions of this position would appear to lead to equitable and efficient market outcomes. Readily available 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. <u>There is no explanation for the adjustment process incorporated in this approach; recognition and then correct and complete use of the new information is assumed to take place instantly.</u>

Comparison of 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" or equal access approach requires all information about all securities to be available to 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.

Information is central to the efficient working of the capital market.(7) In this context the concept of efficiency relates to the prices and values associated with all securities. An efficient capital market is said to be 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; only that any departures are random without persistent bias, positive or negative, around the norm. This concept underlies what is meant by the Efficient Capital Markets Hypothesis.(6, 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. That interpretation rests upon all information, public and private, being available to market participants. A less demanding view, referred to as the "semi-strong form" of the hypothesis, refers to the efficiency of market reactions to all public information; again meaning the inability to earn consistently positive abnormal returns. 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 privileged, or inside, information.

The efficiency 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 any role for the insider and therefore rejects any gains contributing to a more efficient market. All information influencing market decisions should be available so enabling all participants to have 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 the use of inside information.

III. Empirical Findings

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. An understanding of the issues may be helped by an examination of the 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 having fiduciary responsibilities in companies or large shareholders to report share transactions. This information on persons defined as "insiders" is available relatively soon after transactions take place.[2] Empirical work based on this data is comprehensive. The main purpose for assessing this public information is two-fold; to establish the basis for analysing 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; the earlier studies were summarised in the 1974 survey by Jaffe.(17) This was followed soon after by another study confirming the role and significance of inside information in the workings of efficient markets.(8) Attention is given in this type of empirical work to the complicated links between the provision of information by a variety of means and its uses.

One study reported early in 1985, examined the relationship between insider trading and management forecasts.(20) 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,

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2. Should insiders use dummies or nominees for trading in shares to disguise their participation then the reported transactions would not reflect fully the extent of their activities.

".... even if insider trades do capture insiders' information, they are likely to be quite noisy signals due to trading for other than informational reasons".(20, 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.

The difficulty for interpreting the basis of trading by those with access to inside information is illustrated further by the results of a Swedish study of such trading in 1982. This study concludes that market returns on shares sold were higher than those on shares bought! (22, p.127) This evidence would suggest that influences other than access to confidential information dictated decisions about trading in securities.

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. (10) Apart from the excellent summary of issues at the beginning of the paper conveying much information on previous analyses 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 responsiveness to availability of new information, than is often claimed.

This work of Givoly and Palmon challenges 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. 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; their activities may be akin to specialist market-makers in a limited range of securities.

These results point to testing questions about the qualities 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 means 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.(4) 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. Others bear 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 no 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 earlier 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 information is interpreted and the difficulty of what is meant by using apparently relevant information.

The many analyses of trading information show how difficult it is, despite the availability of that information on certain defined insiders' activities, to reach strong conclusions on the extent to which abnormal positive gains reflect privileged knowledge. Insiders are not necessarily representative investors anyway, a feature recognised only recently. Within the very broad category of public investors not having access to privileged information, there may well be sub-groups with trading performances at least equal to those of perceived insiders. This must be the important, if not the only, rationale for the growth of various managed funds. Moreover, recognition of different groupings of participants is important for an understanding of the incidence of transactions costs in securities markets.(18)

IV. Prices and Market Adjustment

Emphasis on the link between information and market efficiency is now embedded in assessments of market performance. It permeates virtually all discussions on the supervision and regulation of markets, not least in the financial services sphere.(9) 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 at all times.

Adjustment is about the adaptation of expectations to new information for the attaining of a new equilibrium. The equal access or fairness concept is the polar case; the adjustment process collapses to a "once off" price change. It reflects the strong measure of market efficiency in its entirety. Readily lost from sight are the assumptions underlying strong efficiency; homogeneous expectations and instant recognition and response to new information. That strong concept attempts to define equilibrium, no more than that. That is independent of the separate theoretical concern questioning whether there is any basis for testing the efficient market hypothesis.(12)

In the light of these restrictions it is hardly surprising that some reviews of the efficient market hypothesis question its dominant focus for 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 enlighten is the likelihood of those participants being in a relatively weak position whatever provisions are made for restricting use of insider information. Recognition of this category of participant means that others may be able to gain at the expense of the misinformed, a hardly surprising revelation. It reflects the existence of a hierarchy of participants earlier mentioned when examining the results of work by Givoly and Palmon. The lack of homogeneity amongst participants says something about the reasons for lagged price adjustments in securities markets and thus the relative efficiency of those markets but little, if anything, about the influence of insider trading.

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 perspective may be imperfectly understood, perhaps not at all. Once the strong form of the efficient market hypothesis is set aside some explanation of the price adjustment process is required. Those not condemning insider trading see the use of privileged information as the means of rapid adaptation of the prices of relevant securities. Those prospecting the claims for equal access ignore the adjustment process, a purity of principle single-minded in its rejection of long-standing evidence on market responses amongst participants.

How would awareness of this equal opportunity be conveyed? Should it be 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. Such widening raises transactions costs to market participants. But a requirement for all public investors to have equal opportunities to obtain and evaluate relevant information goes further in terms of conduct with respect to trading in 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 and between locations. Any number of practical difficulties of this nature have been documented.(1)

A similar situation arises with provision of information to organisations which rank or "rate" the quality of the various types of financial instrument issued by companies. These organisations often seek privileged information about the commitments and relative distribution of activities in which the company is engaged. Hence they may receive information not in the public arena or well in advance of public disclosure. Yet determinations by these ratings organisations, when made public, may bring revisions to market prices for the company's shares and public debt. But such access is compatible with the economic or property interpretation because it would reflect a decision to release confidential information in order to maintain the best posture possible for the company.

Problems abound for implementing provisions about restraining use of inside information. A brief reiteration of the main issue may help clarify the extent of difficulties. 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, or something akin to it, would have only one real effect; <u>it would change the order of those first able to act on the new information.</u>

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 implicit 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. Hence Manne's critique of the alleged losses associated with insider trading may be extended further than he envisaged in his 1966 contribution.(19)

Nevertheless, the adjustment process is more complicated than just the price response. An optimal adjustment path is rarely considered. There is an implicit assumption that rapid adjustment of prices is the optimal procedure in securities markets. Yet that approach is confined entirely to prices movements. 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 adjustment should account for relative scale of share trading as well as price changes.

Whose interest is then best served by changing the ranking order of those acting on ready access to information? 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.

This situation is significant for the existence of asymmetric information. Much depends upon the extent to which each participant in the securities market is aware of the conditions known to all other participants. Where participants possess similar knowledge then they may expect a stable array of transactions costs with share prices reflecting risk premiums appropriate to each security on offer. However this is not the case being treated here. This is a much less certain situation. Expressed in general terms each agent is not certain what other agents know, all the more so if each agent is not sure that every other agent knows what that agent knows. Such a position hampers the derivation of an expression of probable outcomes with effects on the pricing of services offered, in this case bid-ask spreads.(21) Perceptions of the appropriate risk premium may be misplaced leading to a rise in transactions costs for most participants.

The obvious beneficiaries of changing the ranking order would be the active participants in the securities market, the brokers and the fund managers. With the brokers it would be those trading on their own behalf as principal rather than agent on behalf of clients. Knowledge of an impending announcement, combined with access to markets in which trades in relevant shares take place outside the ordinary hours of trading in the "home" exchange, would offer a preferred access to trade when compared with the ordinary participant tied to one location and time zone.

V. Securities Markets and Financial Intermediation

The analysis of the use of insider or privileged information has been confined to the workings of securities markets and their participants. Objections to the use of such information are based upon the financial rewards accruing to those having preferred access to information and the capacity to use that information when trading in securities. However, the empirical evidence does not suggest prompt responses of prices to the exercise of this information. Therefore the real objection to the use of inside information lies not in the apparent gains to those with preferred access but in the failure of insider trading to bring that prompt adjustment to prices which adherents claim to be its justification.

Control on the use of this information reflected in an equal access interpretation is no less fraught with difficulty. The interests of those actively involved in trading in securities, though not having a fiduciary responsibility to the firms whose shares are being traded, would be served through restraint on use of inside information. Their standing relative to those with access to insider information would be enhanced. They would be best placed to gain from equal access to information, most of all when dealing as principal.

Taken together these features suggest that the insider controversy is really about a shuffling of the ranking order for ready access to information. It confirms a hierarchy of participants in securities which is sustained by the abundant empirical evidence. In effect provisions on equal access would do little to alter the workings of hierarchies.

The implications of the formal analysis point to the maintenance of significant bid-ask spreads to moderate the exposure of brokers when acting as principal dealers or in the terminologies of many exchanges, specialists and market makers. In this way they hedge potential loss arising from trading by users of inside information or from agents being other participants who may gain from more prompt access to newly released information. Brokers' stance on bid-ask spreads could be reinforced further by the actions of their major competitors and clients, the fund managers, who would seek net sales prices on their transactions leaving the brokers to secure commissions from the other party to each transaction.[3]

Yet other empirical evidence does not suggest that a concern with priorities of access to and use of information is of great importance. This evidence points to much time being taken to absorb the implications of information for the efficient pricing of shares. Uncertainty pervades markets for individual shares.

In these circumstances the primary function of the stockmarket should be recalled; as a main element in the capital market its purpose is to guide the allocation of financial resources for the application of physical resources to real investment. Hence activities which do not moderate uncertainty in the pricing of shares or shorten the adjustment process will sustain if not generate further misallocation of physical resources.

The significance of this position should not be lost. Companies listed on stock exchanges have choices in the ways funds are generated for expansion of their activities. If banks have functional uniqueness, as distinct from qualities conferred by legislation, it is in the offering of services to borrowers on a confidential basis reflecting inside knowledge of activities and prospects of their clients and subject to oversight and, in the extreme, management supervision.(2,5) The theory and the evidence suggests that the unique characteristic of the non-marketable bank loan lies in the insider relationship between bank and borrower which preserves confidential information about the borrowing company from dissemination in the public arena.(5,11) Within a bank holding company this provision of inside debt may be complemented by equity funding through subsidiary companies being investment houses. The ties between inside debt and equity financing are most explicit in the management buy-out.

3. The fund managers are clients of brokers for sale or purchase of listed securities. Where the broker acts as principal, rather than agent on behalf of clients, then the broker is competing with the funds in terms of market returns on assets. This feature is independent of a position which may arise with an incorporated broking firm whose owners are also fund managers.

Substitution possibilities between sources of funding in Australia are depicted in Table 1. The estimates are for new liabilities incurred each year between 1975-76 and 1985-86 by corporate trading enterprises other than ones owned by government. The categories shown do not cover all forms of liability but amount to about 80 per cent of the total in each year. The notable feature is the variability of sources of new liabilities though in most years new capital raisings in the stockmarket - Column 1 - are a small proportion of total funding. The relatively modest contribution from banks in most years may be explained in two ways; first, the quantitative restraints on direct bank lending in most years covered and secondly, bank financing other than by loan is shown under Column 3. The sharp rise in bank loans during the last two years shown is a reflection of the abandonment of quantitative restraints, the removal of exchange controls on capital transactions in December, 1983 and the entry of new banks during 1985 and 1986.

Table 1: New Liabilities Incurred by Corporate Trading Enterprises in Australia (Percentage of Total Incurred)

Year	Ordinary & Preference Shares (1)	Commercial Bank Loans (2)	Other Loans from Financial Intermediaries (3)	Foreign Commitments (4)
1975-76	12.78	12.33	49.95	5.54
1976-77	16.61	-1.83	41.18	31.56
1977-78	19.13	10.14	32.49	10.67
1978-79	14.06	7.78	39.79	19.73
1979.80	28.77	12.73	28.47	6.46
1980-81	32.91	4.45	26.50	23.05
1981-82	10.61	4.81	22.36	42.82
1982-83	10.52	3.62	17.38	48.51
1983-84	25.92	-6.00	31.57	23.45
1984-85	17.59	30.54	20.77	7.76
1985-86	33.92	23.28	6.80	14.85

Source: Reserve Bank of Australia, Bulletin Supplement, Financial Flows; July 1986 and July 1987, Table 3.25.

Note: Column 1 - This series reflects new capital raisings by companies listed on the Australian Stock Exchange.

Column 2 - These loans are confined to what in Australian terminology are called "trading bank advances".

Column 3 - This category covers all financing other than that recorded in Column 2 by financial intermediaries. Bank financing of bills of exchange is included here.

Column 4 - All liabilities incurred with companies, individuals and institutions in the rest of the world.

These features go much of the way to explain the huge increase in direct lending to corporate trading enterprises in the last two years shown in Table 1. The banks increased rapidly their intermediation with the rest of the world. With this development went changes in the techniques of funding so that measures devised to circumvent quantitative restraints on bank lending in earlier years were reduced in significance. Such influences help explain the declining contributions from the two categories of funding shown in Columns 3 and 4.

Hence the stockmarket is one centre for financial intermediation having functions not exclusive in the capital market. Inhibitions on its main purpose, being the efficient pricing of securities in which it trades, will foster searches for other means for the funding of real outlays. The holding of inside information is not the exclusive preserve of participants in the stockmarkets. Measures applied in those markets to regulate the use of confidential information may do little, if anything, to improve their efficiency but may well encourage companies to secure funds in other places.

6. Commentary

The appraisal of issues bearing upon the concept of insider trading is part of a much broader challenge to the analysis of the efficiency of markets and the organisations working within then. There is not common agreement on the meaning of the concept because of much different perceptions of the role of information in markets. Where information is seen as the property of the company generating it then the benefits of that information should accrue to the owners of that information and their agents, the directors and management of the company. How the company chooses to use that information is their responsibility circumscribed as this must be by needs to raise new capital through equity and debt issues or similar borrowings.

Where all participants in markets for financial assets and liabilities are seen as having equal claims for access to information about the condition of firms, the prior claim of owners and their agents on the information held by companies is rejected. All participants in markets for financial instruments have the potential to be owners, as shareholders in any publicly listed company, and hence are held to require all available information on which to base their portfolio decisions. This perception is impossible of achievement in the Hayekian view of markets.

The startling feature of the controversy about insider trading is the lack of attention to empirical evidence about what takes place in financial markets. The great bulk of the evidence does not suggest the consistent extraction of positive abnormal returns by those having access to privileged information. Nor does it suggest that exercise of inside information brings a rapid adjustment of prices to some new equilibrium. Instead there appear to be categories or hierarchies of participants in stockmarkets rather than two groups, those having access to privileged information and the rest. Quite apart from the theoretical perceptions advanced by Manne which queried the strictures and formal restraints against insider trading, the empirical studies do not reveal a <u>systematic basis</u> for rejecting the use of privileged information. The practical handicaps to comprehensive policing are immense and, in all likelihood, most costly. The result would be to raise the cost of participation in stockmarkets so stimulating the funding of new liabilities through other forms of intermediation.

The implications of the analysis point to those immediately associated with the stockmarket as being the beneficiaries of measures to change the ordering of access to inside information. But their priority of access would be challenged by fund managers whose concerns are no less than the brokers as principals in containing exposure to risk. Hence much of the controversy rests upon practical implications of how disequilibrium is removed from securities markets. The empirical evidence points to a more complicated and drawn out process than theoretical constructions allow. Instantaneous adjustment is a will o' the wisp.

14 November, 1988 W.P. Hogan.

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