Is the law effective in protecting markets from insider trading?

Dr Georgios I Zekos*

Introduction

Insider trading is a term of art commonly meaning, or referring to, illegitimate trading by someone, whether or not the person is a true corporate insider, possessing material, nonpublic information about publicly traded securities. In other words, insider trading is buying or selling shares or any other kind of securities while in possession of unpublished information about the issuer or the trading of these shares. Insider trading involves persons in positions of power who use nonpublic information that is gained from their corporate standing to serve their own financial interests or, at times, the financial interests of their clients, family, or friends. Insider trading is most frequently done in order to amass profits by trading in advance of takeover announcements. Information is “material” if it would be important for an investor to have in deciding whether to sell or purchase a security. Criminalizing insider trading is central to the policies of promoting investor confidence and the fundamental fairness to market participants and the uprightness of the securities market depends on investor confidence. Without investor confidence investors would decline to take part in the markets at all. It could be argued that a transaction with an insider trader results in an investor trading at the wrong price and the price at which an investor trades does not reflect the undisclosed information inducing an investor to make an ill-advised transaction. Does insider trading deter small investors from participating because they would feel the playing field is not level? The ideal is a market in which prices provide accurate signals for resource allocation.

An effective securities regulatory framework offers a vision to the investor of fairness in the market place. This should be accomplished through increased disclosure, additional monitoring of requirements for investment businesses and effective and vigorous prosecution of securities law violations. Moreover, this vision should be based upon positive macro and micro economic factors of a strong economy functioning in a changeable international market. Can state regulations by themselves sustain a healthy securities market? The relations between those who finance industry and those who manage it should be harmonious. There is a conflict between harmonious relations and the objective or equal information for all. The traditional rationale articulated for insider

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2 United States v. O’Hagan, 521 U.S. 642

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trading regulation and other securities law is that such rules promote confidence in markets. Scholars have argued that permitting trade on the basis of inside information creates desirable incentives and improves economic efficiency.4

Professor Roberta Romano5 has called for the introduction for a system of competitive federalism for securities regulation. In accordance with Romano’s view a public corporation’s coverage under the national securities laws must be optional rather than mandatory and the securities transactions of a corporation that chooses not to be covered by the federal securities laws are to be regulated by the corporation’s selected domicile for securities regulation. On the one hand, regulatory competition might sound as a good idea because the choice of investments includes variation in legal regimes. Firms will find that they can obtain a lower cost of capital by choosing the regime that investors prefer. Hence, promoters will select the regime that maximises the joint interests of promoters and investors. On the other hand, the competitive federalism does not eliminate the possibility of mandatory rules and practises to be endorsed within the competitive securities regimes. The detection of manipulation of prices, fraud and insider trading might become more difficult to be detected. It has to be taken into account that the existence of competition or competition rules does not mean that there is not either abuse of a dominant position or abuse of the competition rules themselves. In a competitive regulatory regime undesirable mandatory policies cannot be maintained over time because firms will migrate to a regulatory regime that does not impose such mandates. However, an easy migration from a regulatory regime to a less strict regulatory system does not secure the investors position taking into account the volatility and the characteristics of the securities market. Litigation in a changeable legal regime might be a burden for individual investors. Competition would not eliminate merit regulation but rather would preserve it. Investors will choose the regime that protects their financial interests. In fact, the commercial demands of a national market would press toward

4 What kind of relationships trigger liability for insider trading based on the Misappropriation Theory? The Misappropriation Theory has failed to define what kinds of relationships trigger liability for insider trading. The courts have failed to distinguish the legal basis for the fiduciary duty analysis. There is a need to articulate, in detail, the parameters of the fiduciary duties that give rise to Rule 10b-5 liability under the Misappropriation Theory. Recently, the SEC promulgated Rule 10b5-2 setting forth three situations in which a person owes a duty of trust or confidence under the Misappropriation Theory. Insider trading prosecutions have shifted to lower level corporate fiduciaries and their friends and families. Insider trading legislation is necessary as part of a well-functioning corporate governance regime since small investors will otherwise be unprotected. Whereas Rule 10b-5 imposes a duty to disclose on managers, it does not necessarily impose a similar duty on outside shareholders who do not owe a fiduciary duty to smaller shareholders. While European law seems to rely on a narrower definition of inside information, it seems to be wider in its coverage of company outsiders who may be liable as “tippees”, which would also impose a liability on a dominant shareholder who learns adverse information about the company through indirect sources. Consequently, while European law seems to be unduly narrow with respect to what constitutes inside information, it is arguably more comprehensive with respect to who is an insider. Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) replaces Council Directive 89/592/EEC. Official Journal L 096 , 12/04/2003 P. 0016 – 0025. Bhattacharya, U, Daouk, H.,2002. The world price of insider trading. Journal of Finance 57, 75 – 108. Bhattacharya, S, Nicodano, G.,2001. Insider trading, investment, and liquidity: A welfare analysis. Journal of Finance 56, pp.1141 –1156.


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uniformity despite the inconsequential effect of variety. Does insider trading lead to more accurate prices rather than any strict regulation against it?

According to Carlton and Fischel\(^6\) insider trading is efficient and public regulation is inefficient. Besides, Georgakopoulos\(^7\) argues the opposite. Are differences in specific legal elements of countries’ insider trading laws associated with differences in the structure and performance of their stock markets? Deterrent elements of formal insider trading laws matter to stock market development. Are laws of insider trading effective in discouraging insiders from trading on non-public information? The aim of this analysis will be to examine the effectiveness of the legal regulation.

The Role of the Security Market

The primary purpose of a security market is to facilitate the transfer of savings from surplus units wishing to invest to deficit units wishing to borrow and desired changes in the asset structure of investors. One of the most important economic advantages of equity financing is that funds obtained by issuing stock are credits of unlimited duration, while the individual investor’s commitment is not long term. A liquid market is one that enables an investor to dispose of his shares without undue delay and without unreasonable loss as well. Frequent sales, ease of transaction prices and reasonably stable price fluctuations over time are characterizing a stock market. A liquid market has to be both active and stable. Hence, public confidence creates willingness to purchase shares, while public distrust creates reluctance to invest in security markets, mostly by small investors. A certain degree of volatility is unavoidable because stock price fluctuation indices changing values across economic activities so resources can be better allocated. Besides, excessive volatility diminishes and impedes resource allocation.\(^8\) Legal rules have not managed to eliminate market volatility, which means that the fundamental role belongs to economic factors rather than law. Can insider trading raise price volatility in the long run and reduce economic efficiency? Access to inside information is more valuable when there is a big rise or a big fall in prices. Insiders choose riskier projects than they otherwise would and manipulate the timing and content of the information release in a way that generate more volatility than it otherwise would. Further insider trading is found to be associated with higher market volatility, volatility of monetary and fiscal policies and maturity of the stock market.\(^9\) Consequently, economic factors are those influencing insider trading rather than the legal order.

The Market Price and Insider Trading

\(^{8}\) R Shiller, 1981, Do stock prices move too much to be justified by changes in subsequent dividend?, American Economic Review No 3 421-36.

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Economists believe that insider trading ensures that the market price of affected securities moves in the appropriate direction. Subsequently, a securities market with active insiders ensures accuracy in the pricing of the securities so traded. Insider trading moves prices towards a level, which correctly reflects the actual position of a company at a given point in time. Individuals may be less likely to seek to acquire corporate information if a prohibition against insider trading may prevent them from making use of it. In many cases the disclosure of any information would have occurred regardless of any related insider trading. It is therefore unclear whether permitting insider trading per se would be likely to have much effect on the accuracy of share values.

Price pressure is the key to the argument that insider trading improves the efficiency of the securities market. Insider trading in shares is often accompanied by a significant change in its market price, which indicates price pressure. On the other hand if the demand is perfectly elastic, insider buying or selling is incapable of shifting prices. The rise of stock prices preceded on announcement of a merger or tender offer of a premium price resulted not only from insider trading but also from the market’s anticipation of the upcoming bid and incorporation of the information into share prices. Abnormal prices built up by the participant’s overestimation of the value of the assets of the company. Insider trading moves prices because outsiders decode information from the fact of the trading itself. It could be argued that the mechanism of economy moves the prices to the correct level rather than any regulatory law.

Accurate pricing can be set by the market if all information relating to the security has been publicly disclosed. This benefits society by improving the economy’s allocation of capital investment and by decreasing the volatility of security prices. The market reacts fairly quickly when insiders buy securities, but the initial price effect is small when insiders sell. The price effects of insider trading induce shareholders to make poorly advised transactions. Price or volume changes resulting from insider trading will hardly ever be of sufficient magnitude to encourage investors to trade. The publicity given to scandals put all investors on notice that insider trading is a common securities violation, which means that insider trading does not threaten the confidence of investors in the securities markets. Moreover, regardless of all legal rules insider trading still happens and this knowledge drives prices to the right level.

It could be argued that insider trading becomes a source of injury to the firm if it creates incentives for managers to hold-up the transmission of information to superiors. Even if

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the period of delay by any one manager is short, the net delay produced by successive trading managers may be substantial.\textsuperscript{14} Hence, insider trading may create incentives for management to modify firm plans in order to increase the likelihood and magnitude of trading profits\textsuperscript{15} or encouraging over-investment in industries or activities that generate opportunities for insider trading.\textsuperscript{16} Managers may follow policies that increase fluctuations in the price of the firm’s stock maximizing the value of their services to the firm\textsuperscript{17}. Manipulation of stock prices, as a form of fraud, harms both society and individuals by decreasing the accuracy of pricing by the market. However it could be argued that extensive insider trading allows information to become more quickly public which leads to accurate pricing across the board. Reputational injury is translated into direct financial injury, by rising the firm’s cost of capital, if investors demand a premium (by paying less) when buying stock in a firm whose managers are known for insider trading.

**The Role of Speculation**

In a highly speculative market it is more difficult to ascertain the intrinsic value of a share. Even parties with inside information cannot predict stock prices with certainty as supply and demand determines stock prices.

Classical economists argue that speculation plays an important role in a free market because speculation creates liquidity by establishing an active and broad market and reduces inter-temporal differences in price. Speculation\textsuperscript{18} promotes allocational efficiency by stabilizing prices at normal levels, which are related to the intrinsic values. Speculators tend to stabilize a commodity market by buying when the price is low and selling when the price is high. Trading of speculators drives prices toward the intrinsic values of the shares and consequently promotes fair price determination. Moreover, insiders through their trading activities channel new information to the market and therefore increase the likelihood of fair price determination. Consequently, speculation promotes both allocational efficiency and promotional efficiency and liquidity in the stock market.

Keynes\textsuperscript{19} believed that speculation not only causes instability but also distort prices and fails to reflect the intrinsic value of shares. According to Keynes increased public

\textsuperscript{18} V Madrical “ Non-fundamental speculation” 1996 Journal of Finance 553
\textsuperscript{19} J Keynes “ The general theory of Employment, Interest and Money” 1936

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participation means that mass psychology influences stock prices and their fluctuation. The task of speculators for a quick profit depends upon the influence of speculation upon mass psychology rather than future changes of underlying factors in the market. Accordingly, share prices reflect mass psychology rather than providing information in the market for allocational and promotional purposes. However, informed insider speculators can forecast future prices and make profits speculating when they are able to use their inside information to their advantage. It is supposed that the public is not reacting irrationally by mass psychology. Hence, in time of crisis irrational mass psychology becomes important. What about a short-term crisis, which is created technically? It is assumed that speculators can foresee the normal price of shares, which narrows the range of fluctuations. It could be argued that a stock market considered safe from insider trading is the arena for mass insider trading gains by technical financial crisis. Outsiders can easily follow their market behaviour and so a public speculative demand may destabilize prices further. In the long run the efficient operation of capital markets and a properly functioning economy is the best protection for investors. In the short run basically organized markets stimulate investors towards investment and quick profit. Can any legislator deal with speculation effectively rather than leaving the market to deal with and solve the problem? The author considers that basic legal rules are the basis for a normal running of a stock exchange and a properly running economy is the axis for a proper functioning of a stock exchange, which can absorb a normal level of insider trading.

The Role of Information

Research has shown a positive, moderate relationship between public information and trading volume, but an insignificant relationship with price volatility. Thus, investors seem not to be affected by public information in contrast with a reaction under heavy speculation. On the other hand in efficient markets, stock price reaction is expected to occur at the time information becomes public. Practice has shown that insider selling does in fact increase significantly as the bankruptcy announcement approached. Insiders, using unpublished information to their advantage, have been able to generate abnormal returns trading in their shares. Besides, non insiders may be able to participate in these profits by using the information. Additionally, most of the time the expertise and knowledge of the insider leads to a better evaluation of the information, which drives insiders to have a better use of the information rather than the unpublished information, because an expert can evaluate with precision the real status of a company using the published fingers in combination with the status of the specific market. Furthermore, uninformed outsiders can earn significant abnormal profits by imitating insiders. Outsiders can purchase or sell following an insider’s stock purchases.

21 T Cosnell “ Bankruptcy and insider trading” 1992 The Journal of Finance 349

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Trading by investors who possess superior information imposes significant liquidity costs on other market participants due to adverse selection. According to Huffman, the value of trade, as well as the price of capital, can be highly correlated with a measure of the information content of prices. Can any regulation measure the quality of information and enforce the quality on information? The stock market detects the possibility of informed trading and impounds this information into the stock price. It could be said that the market mechanism detects insider information and absorbs it rather than any law. If participants know the probability that insider trading will affect the price of shares, they will adjust their behaviour to avoid overpaying. Information such as the intention to bid for control of a target firm is not reflected in the market price of the target shares until an action occurs that causes many traders to infer that information. Unusual trading volume attracts attention from securities traders and of course public statements provide direct information about potential bids.

While insider trading reduces the risk created by inaccurate stock pricing, it increases the risk to the insider who receives trading rights in place of other apparently more secure forms of compensation distorting the flow of information to investors. This is because insiders time the flow of information to make the most of trading gains and discouraging the flow of information within a firm. Information sharing increases the number of insiders who trade on non-public information; increased trading affect share price and consequently diminishes profits to each insider, affects resource allocation within a company because managers are encouraged to decide on those projects that maximize prospective trading gains. It could be said that in limited circumstances allowing managers to trade may better impound information about hidden managerial action. Risky projects offer more potential trading profits than safe projects and the insider is able to trade before knowledge of the project’s outcome reaches the public distracting executives from other firm business and distorting managerial behaviour.


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It could be said that insider trading violates procedural equality and fairness of opportunity. Insiders can make abnormal profits in the stock market. Outsiders who mimic the information of insider trades can earn abnormal profits as well. Insider trading can lead to more informative prices. Insider selling is more active when there are stock price run-ups and it then correct prices significantly. Hence, insider trading conveys more information to the market, which means more pragmatic share prices.

**Management and Insider Trading**

Professor Henry Manne argued that insider trading contributes to greater efficiency in stock market pricing because information becomes embedded in stock prices more quickly than it would if insiders waited until such information was ripe for disclosure. Further, the profits made by insiders on such trades are an appropriate reward for their labor. Additionally, Manne argued that insider trading is an efficient way of compensating managers for having produced information which means that the company benefits directly and society ultimately because managers have a greater incentive to produce additional information of value to the company. First, allowing such trading would encourage insiders to manipulate corporate decision-making and withhold information from the market. In contrast, prohibiting insider trading removes an impediment to the prompt release of information and promotes economic efficiency by assuring that share prices reflect their true value. Such informational efficiency assures that capital is allocated efficiently. Also, permitting insider trading would discourage research and analysis because the public information available to an analyst would not reflect all of the facts upon which trading is occurring. Stock-based compensation might

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provide incentives for managers to increase the short-term stock price through earnings management. Once a company’s shares become overvalued, it is in the managers’ interests to keep them that way, or to promote even more overvaluation, in the hope of cashing in before the bubble bursts.\textsuperscript{32} One way to get increased levels of managerial ownership is to award managers options or stock grants. However, stock-based compensation leads managers to focus on short-term stock prices rather than the long-term interests of shareholders, in this manner introducing incentives for earnings management. Henry G Manne\textsuperscript{33} in a comeback considers that “\textit{Stock trading by any informed individuals can produce information that may be extremely valuable to managers of publicly-held companies.}” In other words, insider trading could be considered by managers for the better management of a company and so insider trading could be regarded as part of corporate governance. The author considers that insider trading cannot become an instrument in the hands of managers to manipulate the money of investors for completely unethical gains of ownership, but an ethical use of information in advantage of the investors and so bringing gains for them as well will be productive. On the other hand, investors must know that the top management of companies always will have more information and knowledge and will use it to their advantage and so the fundamental criterion for investment should be the macro perspectives of the company rather than short term gains.

Market efficiency, share price accuracy and financial liquidity are interrelated: the more accurate share prices are and the more liquid trading is, the more efficient the market is.\textsuperscript{34} Securities regulation believed to be a field designed to protect the common investor and to attain efficient financial markets so as to improve the allocation of resources in the economy.\textsuperscript{35} On the other hand, restrictions on insider trading protect analysts from competition from insiders that would undercut the ability of analysts to regain their investment in information, and so drive analysts out of the market.


\textsuperscript{34} Ken Nyholm, \textit{Estimating the Probability of Informed Trading}, 25 J. FIN. RES. 485, 504 (2002) (noting that low volume stocks are found to be much slower than high volume stocks in adapting quotes to new full-information levels).

\textsuperscript{35} Robert M. Bushman, Joseph D. Piotroski, & Abbie J. Smith, \textit{What Determines Corporate Transparency?}, 42 J. ACCT. RES. 207, 208 (2004) (noting that, although information costs play a central role in financial theories concerning economic development and efficiency, little research considers how and why information systems, per se, vary around the world).

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advantage. With deregulated insider trading, corporate executives and other managers have the incentive to manipulate earnings statements, press releases, and the like to influence the stock price. The inducement to manipulate information and create it artificially is potentially serious to the correctness of the stockholder estimating the accurate value of a company at any given time, particularly when it is unfeasible for the stockholder to estimate any likelihood of malfeasance. Current insider trading restrictions rely on distinctions that are problematical to draw, difficult to enforce, and normatively unproductive. If substitute trading becomes popular, a material misrepresentation by a corporation or its officers may affect the stock price of other companies. A person who makes a misstatement about one firm and then profits from trading on another firm does not face liability under insider trading.

**Allowing or prohibiting insider trading**

By allowing insider trading the information possessed by insiders can be impounded in the prices of securities by increasing the efficiency of capital markets. Moreover, insider trading can improve the interests between outside claimants and management by allowing managers to profit from the appreciation in firm value engendered by their efforts. The production of information by outside analysts is discouraged, thus reducing the net informational efficiency of stock markets and the raising of external finance is more costly for outside investors decreasing the equilibrium level of managerial effort. Permitting insider trading leads managers to take positions in the firm’s stocks increasing the informativeness of prices and the welfare of shareholders and so insider trading opportunities encourage managers to increase project risk.

Furthermore, insider trading improves managerial motivation and greater effort put into the production process. The positive relationship between effort and information implies a positive relationship between private information and firm value. When insider trading is permitted, market participants can infer the manager’s private information from market prices and so better infer firm value. Are all gains and losses from insider trading absorbed by insider managers and shareholders? Insider trading increases shareholder’s ability to choose more efficient investment portfolios inducing managers to increase their stake in the firm beyond that obtained through their compensation contract. Corporate insiders utilize private information to strategically trade their own stocks for personal gain and so insiders of firms that file for bankruptcy protection sell their own shareholdings before stock prices fall and buy after prices have fallen. Insiders are able to trade profitably around major corporate events.

Would the stock market collapse in the absence of intensive oversight ensuring market integrity and that necessary capital would not be entrusted to it? Extensive insider trading involves the theft of valuable corporate property from its rightful owner. Insider trading legislation is an important factor for regulating the relationship between a company and

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its major shareholders. In an environment where insider trading is not regulated, dominant shareholders and managers could conspire and communicate information privately. If insider trading is not regulated, then the incentives of the large shareholder are aligned with those of management, at the expense of small shareholders. Mandatory disclosure aligns the incentives of dominant shareholders with those of small shareholders at the expense of management. Stockholders can benefit from insider trading through adjusting the managerial compensation contract. Stock prices may be less informative if insider trading is legal since analysts engage less in information acquisition.

Prohibiting insider trading is justified on fairness or equity grounds. Insider trading is trading in securities while in possession of material non-public information. Virtually anyone who possessed non-public information was required either to disclose it before trading or abstain from trading in the affected company’s securities. Liability could be imposed only if the defendant was subject to a duty to disclose prior to trading and insider traders were no longer liable merely because they had more information than other investors in the marketplace. (Creation of fiduciary duty elements substantially narrowed the scope of the disclosure or abstain rule, but it is not limited to true insiders, such as officers, directors and controlling shareholders, but also picks up corporate outsiders).

**Effectiveness of insider trading laws**

The prohibition in fact evolved through a series of judicial decisions in a process more closely akin to common law adjudication rather than statutory interpretation.\(^{37}\)

The regulation of insider trading prohibits insiders from using inside information in securities transaction decisions which means preventing non-public information from circulating in the stock markets. Information is an intangible good and so no physical barrier can prevent it from flowing and circulating. Hence, information can be embodied in a piece of paper such as a note or a memorandum and any insider might refrain from doing so because they would be under greater scrutiny. Even if the insider refrains from trading on inside information, nothing prevents them from communicating it to a third party. The moment the insider has access to the information, there is no way to recognize whether they have communicated what they know to a third party insofar as they did not send out the information in its materialized expression.

Law cannot prevent the insider "first accessing person" from communicating no public information to a third party except by prohibiting this person from accessing the information. In a corporation, more than a few people have access to inside information and some individuals are not directly employed by the corporation working on a temporary basis for the corporation and yet have access to inside information\(^{38}\)

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Therefore, as the number of people accessing confidential information increases, the number of third parties with potential access to information increases as well. Third parties communicate the not-directly-acquired information to other parties who in turn communicate this information to other parties. People may communicate the information even without knowing they are doing so. Moreover, the network by which the information circulates may become very intricate and the higher the degree of complexity of the network, the greater the trouble for the regulator to prevent the information from circulating. A large variety of individuals may come across inside information more or less incidentally.

Tracing back the information to its source becomes very difficult and this is essential if the regulatory authority wants to abolish illegal insider trading and prevent individuals from trading on the basis of inside information. Therefore, the efficacy of a regulation relies upon its success to prevent insider from communicating inside information to third parties attacking the problem at its source. Complex network distorts the information and the information progressing through the network is going to be subject to transformations and so be different from its original form. Taking into account the use of cyberspace by complex networks to circulate and distort information, the law has to identify what the inside information is on and what the potential offender has based their deal which makes it less effectiveness and less pragmatic.

Regulatory authorities (such as the SEC) use a multi-pronged strategy to detect and prosecute illegal insider trading. The intangible nature of inside information means that we have to rely often only on circumstantial evidence to detect and prosecute illegal insider trading. The use of circumstantial evidence poses several problems that undermine the effectiveness of the regulation itself. The insiders possessing the most truthful information are going to adjust strategically their behaviour to avoid investigations. Knowing that the regulator's rule to generate an investigation is based on price movement during a trading day higher than a certain threshold, insiders possessing confidential information, being the most able to make more precise estimates regarding future stock prices, are also going to be the most able to foresee when the regulator is going to suspect that non-public information has been circulating and insider trading took

Section 10(b) of the Securities Exchange Act of 1934 and the Securities Exchange Commission 10b-5 were not directly employed by the corporation where the confidential information had been produced.

39 SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984): George Platt, Phoenix's CEO and, therefore, an insider in regard to Phoenix, discussing with his wife about a recent business trip to New York at a track meet, inadvertently communicated inside information to Coach Switzer who laid down a on a row of bleachers behind them; inside information that he later used to buy a substantial number of Phoenix shares and tipped off a number of his friends.

place. Insiders with true confidential information are going to sensibly adapt their trading strategy in order to avoid the stock prices reaching the threshold above which the regulator will begin investigating insiders’ transactions. As a result, people with less accurate information – being less capable to calculate the magnitude of the stock price changes resulting from their transactions – will be expected to generate the investigations and be prosecuted on the basis of circumstantial evidence. When the regulation of insider trading relies on statistical evidence to discover and prosecute insider trading, the individuals who are going to be prosecuted are people who have traded on the basis of immaterial information. Insider trading regulation cannot be effective and does not discourage insiders in possession of non-public material information from trading since the quality of information they possess makes it doubtful they will be detected and prosecuted.

Insider trading does not inevitably imply that a securities transaction occurs. If a person in possession of inside information decides to cancel a securities transaction, that is, not buy or sell stocks, technically, they are also liable for illegal insider trading since their decision was made on the basis of inside information. If a party either has avoided a loss or has realized a profit by not realizing a securities transaction and their decision was determined by having non-public material information, they have committed insider trading which cannot be detected for the reason that such activity merely does not involve stock price changes per se. Information as well as inside information do not have any objective predictive power or objective value and so holding specific information concerning a specific corporate event does not give a party the capacity to predict with assurance the direction or amount of future stock price changes.

When parties use information (public or not) in profit-seeking decisions, the success of their decisions depends on the direction and magnitude of price changes while the latter depends on whether or not market people interpreted the same information as they did. Whereas insiders have theoretically an informational advantage by holding information not yet accessible by the public when they are making their decision, the success of their expectations is at last conditional upon the other market participants' interpretations concerning the information and resulting expectations once the non-public information has been disclosed to them and so market participants might not react in the expected way which means that the insider may realize a loss. It could be said that the fact that information is a subjective concept and the outcome of insider's decision depends on other market participants' interpretation and resulting decisions is a barrier to the usefulness of the regulation of insider trading. At the same time as the insider has broken the law, the regulator will not detect insider trading because insider's expectations regarding the reaction of market participants to the disclosure of the information were inaccurate.

Has the regulation of insider trading contributed to the success of the securities markets by restoring the investor confidence by guaranteeing that they are not going to be "cheated by insiders"?
The prohibition of insider trading will increase liquidity and decrease the cost of equity.\(^{41}\) In the presence of insiders uninformed market participants facing the insecurity of trading with insiders will be reluctant to invest on the market because they realize that they could be better off not trading which means the liquidity of the market will decrease because there are fewer participants on the market. Hence, countries enforcing insider trading laws benefit from greater level of liquidity and lower costs of equity than countries not enforcing insider trading laws or not having insider trading laws.\(^{42}\) The insider trading law does not consider the possibility that an inside trader may profit from inside information by not trading. Fairness and confidence considered by the Japanese Securities Exchange Committee to investigate the regulation of insider trading is fundamental to the successful operation of the securities markets. In order to ensure such fairness and confidence insider trading had to be regulated. Investors compete for information within the stock market and possession of inside information clearly creates an anti-competitive effect.\(^{43}\) The Japanese markets are considered as an 'insider’s heaven' but Japan had to amend its securities laws to avoid conflict with foreigners.\(^{44}\)

By increasing the market liquidity, the regulation has given the capacity to strategic insiders to better hide their informed trades. In liquid markets, insiders' trades become noisier and do not show up as fast as in illiquid markets where volumes are small and unusual trades show up very quickly.\(^{45}\) It could be said that the regulation of insider trading creates the misapprehension that there is no insider trading and so investors are going to take part more, believing that insiders are not going to take advantage of it. Liquidity of the stocks means that insiders' informed trades are going to be diluted among investors' transactions and will not show up as evidently as they would if stocks were illiquid. Informed trades among the large volume of transactions cannot be realized on the markets and neither are they able to observe abnormal volume or price changes. The more liquid the markets are, the more unsuccessful the use of circumstantial evidence to detect illegal insider trading is.

Insiders abstain from trading around key corporate events for the reason that their transactions around those events are under greater scrutiny. But they can still make transactions based on non-public information around other corporate events as they keep realizing abnormal profits. When insiders trade securities in their own companies, they are able to earn unusual profits meaning that not all available information is reflected in security prices, because, if it were, insiders would not be able to earn abnormal returns.\(^{46}\)

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\(^{42}\) Utpal Bhattacharya and Hazem Daouk, The World Price of Insider Trading, 57 J. Fin. 75 (2002).


It is argued that insider trading is the most profitable during the period with higher enforcement and sanctions.\(^{47}\) Insiders shift to a strategy of bailing out before bad news rather than buying on good news. There is no evidence to imply that increased regulations deterred insiders from trading. According to J. Carr Bettis, William A. Ducan, and W. Ken Harmon "the legal and regulatory prohibitions have not been completely effective in preventing insiders from trading using their inside information."\(^{48}\) Additionally, Arshadi and Eyssell\(^ {49}\) say that insider-trading regulation is overall ineffective in preventing trading on the basis of inside information. Insiders possess confidential information regarding the future price of their companies' securities but top executives and officers have more information regarding their companies' future situation than other insiders.\(^ {50}\) Hence, regardless of the increase in the level and enforcement of insider-trading prohibitions, insiders continue to trade on the basis of inside information which means that law must be accompanied with economic factors in order to financially deter insiders to trade rather than merely legally. Regulations change the nature of insider trading and so they trade more on inside information not related to major corporate events or at times other than those subject to strict scrutiny by regulators. In other words, the bulk of insider trading is not derived so much from registered insiders whose transactions are under great scrutiny by the regulatory authorities but from unregistered insiders (outside-insiders).

Due to the intangible nature of the information, insiders have a variety of ways to avoid the regulation of insider trading. Despite that, the regulation of insider trading does not eradicate insider trading, although there may be some benefits such as increasing investors’ confidence, increasing market liquidity, or reducing the cost of capital that result from such regulation.

The modern federal insider trading prohibition proscribes a corporation’s officers and directors from trading on the basis of material non-public information about their company, but it also includes a far broader net. It is said that insider trading causes an expanse of bid-ask spread in order to cover the greater cost of doing business and so passing along the cost of insiders’ trading to all outside investors with whom they deal, the so-called “insider trading tax.”\(^ {51}\)

\(^{50}\) H. Nejat Seyhun and Michael Bradley, Corporate Bankruptcy and Insider Trading, 70 J. Bus. 189 (1997).
Insider trading drives the price of a stock in the correct direction through the so-called “derivative” trading that occurs after some form of market “signalling” and so insider trading quickly incorporates the impact of non-public information into the market price. It could be said that insider trading brings information to the market and so the jobs of corporate managers, executives, officers and shareholders are much more simplified with a free and open information market for all possible participants and so leading to more efficiently working market and self regulating of prices which means the accuracy of the stock’s price. Significant stock price manipulation is exceptionally difficult to manage, and, paradoxically, it may in fact improve the functioning of the market. The share price impacted by informed trading transmits valuable information to top managers and large shareholder and so causing a reaction which stabilizes prices to the real value level.

Conclusion

A basic legal framework is needed for a market in order to function properly. An effective regime against insider trading cannot exist without a means of monitoring the market to ensure that all participants follow the rules. Insider trading can be used to serve the best interests of shareholders and the economy at large. The economic contribution of insider trading balances a natural level of insider trading based on investor relations and public relations rather than an extensive fraud. No legal rule can achieve the economic results mentioned above of having more accurate prices rather than leaving the market to deal with insider trading. Extensive insider trading is not absorbable from the market with positive effects leads to the collapse of the market. Finally, law by itself is unable to prohibit all forms of insider trading but it has to be accepted that law, when it is really enforced, offers considerable protection to investors from a big scale of traditional forms of insider trading. Law enclosing economic means in its context can be more effective rather than present regulations based only on abstract terminology and definitions.

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52 James D. Cox, Insider Trading and Contracting: A Critical Response to the “Chicago School”, 1986 DUKE L.J. 628, 646 (arguing that insider trading is a “noisy” device for communicating the stock value).