Logistics of Information is the antidote against insider trading

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Introduction

Insider trading is the exploit of material, non-public information, about a company in a securities transaction. Insiders are defined as any person who has access or has been given access to inside information. Thus, Insider trading is buying or selling shares or any other kind of securities while in possession of unpublished information about the issuer or the trading of these shares.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 non-public 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. The American legislation introduces a division within the class of insiders by differentiating registered (inside) insiders from (unregistered) outside insiders (tippees). Registered insiders or corporate insiders are defined by the Section 16 of the Securities Exchange Act of 1934 as every director and officer of the company in addition to any owners of more than 10% of the company's equity. They are required by the Section 16(a) to report periodically all their trade in equity securities to the SEC. Besides, under Chinese law, a holder of more than 5% of shares of a listed company is measured as an insider who has to comply with particular obligations, such as prevention from short-swing transactions. Unregistered insiders or outside-insiders are in control of material non-public information but are not required to report their transactions to the SEC. Unregistered insiders' acquisition of inside information can be through the course of their work (investment bankers, lawyers, accountants, financial printers) or indirect by the intermediary of registered insiders (tippees).

The regulation of insider trading prohibits insiders from using inside information in securities transactions and the central goal of the regulator is to preclude non-public information from circulating in the stock markets. In other words there is a need to achieve the establishment of the best way of circulating the information from its initiating source to the market. Specifically; inside information is all information of a defined character which has not been made public, relating directly or indirectly, to one or more issuers of stocks or to one or more financial instruments. Information which could have a major consequence on the development and forming of the prices of a regulated market, as such, could be regarded as information which ultimately relates to one or more issuers of financial stocks or to one or more related derivative financial instruments. Thus, the main weapon in the hands of swindlers involved with extensive insider trading/dealing is

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1 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) Official Journal L 096, 12/04/2003 P. 0016 – 0025. Article 1 “Inside information” shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments”.

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information. Therefore, management of information could be the weapon against insiders.

Logistics was defined as a function that was minimizing total distribution costs and logistics costs or maximizing profits, while achieving desired levels of service performance. To that extent logistics is directed towards maximizing local flexibility inside the company and customer service issues. In other words logistics has been implemented as a part of the strategic level decision-making process. Logistics is the science dealing with the planning, organisation, control and automation of the material and information flow. So, the logistics combine machines, information technology, and factory organisation and economy. E-logistics are designed to fit into the new, electronic economy and the cyberspace transactions. Only by linking all logistics activities directly to the organisation’s strategic plan can logistics manager work effectively to support their organisation’s strategy for achieving competitive advantage. The revolution in information technology provides the opportunity for logistics to utilise transaction based and decision support systems as a source of competitive differentiation and increased market share. Thus, a company can develop its own logistics system regarding the management and flow of information regarding financial securities as well. Has law managed to effectively regulate and eradicate insider trading? Can logistics be the antidote against insider trading?

The present article will compare insider trading in US, Chinese and EU law in order to find out which is the key point causing and fuelling the development of insider trading. The role of cyberspace in insider trading will be examined. The relation of market and insider trading will be analysed as well. Afterwards the potential role of logistics as the antidote against insider trading will be analysed.

**Insider trading in US, Chinese and EU law**

Any person in possession of material, non-public information about a company has either to reveal that information to the marketplace or abstain from trading in that company’s shares. Thus, a person violates Rule 10b-5 when he takes advantage of his access to material, non-public information for trading purposes knowing that the investing public remain uninformed of it. This rule protects the reasonable expectation of the marketplace that all investors enjoy somewhat equal access to material information. In *Chiarella v. United States*, the U.S. Supreme Court rejected this “equal access” rule which remains the law today and so under Rule 10b-5, a duty either to disclose information or abstain from trading arises *only* from a particular fiduciary relationship or analogous relationship of trust and confidence. In classical theory an individual cannot be held liable for insider

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2 See G Zekeos, Economics, Finance and Law on MNEs, NOVA Publishers NY 2007 forthcoming

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trading in a particular company’s stock unless the individual owes a fiduciary duty to that company’s shareholders. Hence, to be liable under the classical theory, a party must be an insider or tippee of an insider of the traded company. The particular fiduciary duty required by Chiarella could be one owed not only to a company’s shareholders, but also to a source of information and so an individual who steals information and uses it for trading purposes, in breach of a fiduciary duty to the information source, also should be liable under section 10(b). In United States v. Newman held the 10b-5 insider trading convictions of employees of an investment banking company who misappropriated information from the company for trading use. On the other hand, in United States v. Bryan the court held that the theory would hold misappropriators liable absent deception, despite the detail that deception is a requirement for section 10(b) liability. The U.S. Supreme Court in United States v. O'Hagan settled circuit split by clearly adopting the misappropriation theory. According to the Supreme Court the misappropriation theory satisfies section 10(b)’s requirement of deception. Whereas the classical theory applies to people who violate a fiduciary duty to the shareholders of the traded company, the misappropriation theory applies to people who breach a duty to the source of the information.

An individual can be held liable for insider trading under Rule 10b-5 even if that individual does not personally trade in shares. Where a tippee collect information from a company insider, the tippee takes over the insider’s duty either to disclose that information to the company’s shareholders or to refrain from trading and tipping only if two requirements are met: (1) the insider breached a fiduciary duty to the shareholders by disclosing the information to the tippee, and (2) the tippee knew, or should have known, that such a breach took place. An insider’s disclosure to a tippee represents a breach of duty only when the insider makes the disclosure for an unsuitable rationale. Thus, tippers are protected from liability for disclosure to analysts, given that these analysts serve the valuable purpose of collecting and analyzing information. In SEC v. Maxwell, the U.S. District Court for the Southern District of Ohio held that the SEC produced inadequate evidence to ascertain that a company insider’s disclosure to his barber created a personal benefit. A tipper and a trading tippee are both liable for insider trading when, without disclosing the information to the shareholders of the traded company, the tipper breaks a fiduciary duty to the shareholders by spreading the information to the tippee to

10 Yun, 327 F.3d at 1274–75 (applying an intent-to-benefit test), SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) (applying an actual-benefit test).
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obtain a personal advantage, and the tippee knows, or should know, that the breach took place. In *SEC v. Willis*\(^\text{12}\), the U.S. District Court for the Southern District of New York unambiguously noted in dicta that the misappropriation theory does not entail a showing of a benefit to the tipper. On the other hand, in *SEC v. Yun*\(^\text{13}\), the Eleventh Circuit held that in misappropriation cases, the tipper and tippee are not liable except the tipper seeks to benefit from the tip. The spreading of information could be minimized if courts could not impose a requirement that the tipper intended to benefit personally from the tip\(^\text{14}\).

China made a centralized securities supervisory system with the implementation of the Securities Law of the PRC in July 1999. Contrasting the U.S. where the regulation of insider trading has been established by case laws, China has adopted the codification method to regulate insider trading. Moreover, EU has decided to issue Directive 2003/6/EC\(^\text{15}\) regarding insider trading, using the terminology insider dealing, and connected with market manipulation instead of a Regulation directly applicable to all member states achieving a further harmonization in avoiding differentiations based on national law idiosyncrasies. Market abuse consists of insider dealing and market manipulation. Insider dealing and market manipulation preclude full and accurate market transparency, which is a requirement for trading for all economic players in integrated financial markets. The goal of legislation against insider dealing is the same as that of legislation against market manipulation making certain the integrity of Community financial markets and so boosting investor confidence in those markets. Market manipulation and insider trading are interrelated and based on circulation of information and so logistics of information could be the key to neutralize people from taking advantage of their privilege to govern information within a company.

The Chinese Securities Law (2006) is the key regulation with respect to supervising stock markets\(^\text{16}\). Article 73 prohibits individuals who possess inside information from using such information to trade securities. Additionally, Article 74\(^\text{17}\) provides a list of

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\(^{14}\) David T. Cohen, Old rule, new theory: revising the personal benefit requirement for tipper/tippee liability under the misappropriation theory of insider trading, 2006 *Boston College Law Review* Vol. 47:547


\(^{16}\) The Chinese Securities Law was effective on July 1, 1999 and significant changes were made on October 27, 2005, which took effective on January 1, 2006.

\(^{17}\) Article 74 includes following insiders: (1) Directors, supervisors, and senior officers of an issuer; (2) Holders of more than 5 percent shares of a company as well as the directors, supervisors, and senior officers thereof, or the de facto controller of a company as well as the directors, supervisors, and senior officers thereof; (3) Companies controlled by an issuer as well as the directors, supervisors, and senior officers thereof; (4) The person of the Company who may take advantage of their positions to obtain any inside information of the company; (5) The staff of securities supervisory agencies and other persons who administer the issuance and trading of securities pursuant to their statutory functions and duties; (6) The person of the sponsor, securities companies engaging in underwriting, stock exchanges, © Dr Georgious I Zekos

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individuals who are considered to be “insiders” and so making easier the detection of the source of information. In line directive 2004/72/EC\textsuperscript{18} Article 5 provides that Member States shall ensure Lists of insiders in compliance with directive 2003/6/EC making in a way more achievable a kind of detection of the source of information as well. Besides, Chinese law is more specific concerning the people responsible for company information. Moreover, Article 75 of Chinese Securities Law (2006) in the main defines what constitutes “inside information”, as well as records particular events that should be considered as inside information\textsuperscript{19}. So, materialization of the information makes easier the detection of the parties holding initially this information. In line directives 2003/6/EC and 2003/124/EC\textsuperscript{20} outline what could be considered as inside information producing materialization of the information but not with an absolute precision allowing people to bypass the definitions.

China has introduced a hierarchical regulatory framework on insider trading and the key assignment remains to make certain the constancy between enforcement and the letter

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\textsuperscript{18} COMMISSION DIRECTIVE 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions, L 162/70, 30.4.2004. Article 1 Inside information 1. For the purposes of applying point 1 of Article 1 of Directive 2003/6/EC, information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so and if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments. 2. For the purposes of applying point 1 of Article 1 of Directive 2003/6/EC, ‘information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments’ shall mean information a reasonable investor would be likely to use as part of the basis of his investment decisions.

\textsuperscript{19} Non-public information that have material impact on company’s business, finance and stock price is treated as “inside information” under Article 75: (1) The material events provided by paragraph 2 of Article 67 of the Chinese Securities Law (2006); (2) Company’s plan of dividends’ distribution or capital increment; (3) Any major changes in the company’s equity structure; (4) Any major change in company’s debt guaranty; (5) The value of one time mortgaged, sold or written-off assets are more than 30 percent of assets that involved in the business of the company; (6) Any director, supervisor or senior officer of the company may be liable for any major damage and compensation in accordance with law; (7) Acquisition proposals of a listed company; and (8) Any other significant information that has a marked effect on the trading prices of securities recognized by the securities regulatory authority under the State Council. Article 67 provides a list of “material events”, which includes: (1) A significant change in the business guidelines or business scope of the company; (2) A decision of the company regarding any significant investment or asset purchase; (3) An important contract entered by the company, which may significantly affect company’s assets, debts, rights, or its business developments; (4) The incurrence of any major debts in the company or default on any major debt that is due; (5) The incurrence of any major deficit or major loss in the company; (6) A significant change in the external conditions for the business operation of the company; (7) A change of directors, no less than one-third of supervisors or officers of the company; (8) A considerable change in the holdings of shareholders or de facto controllers, each of whom holds or controls no less than 5 percent of the company’s shares; (9) A decision of the company on capital decrease, merger, division, dissolution, or application for bankruptcy; (10) Any major litigation in which the company is involved, or where the resolutions of the shareholders’ general meeting or the board of directors have been cancelled or announced invalid; (11) Where the company is involved in any crime, which has been investigated into by the judicial agencies or where any director, supervisor or senior officer of the company is subject to compulsory measures imposed by the judicial agencies; or (12) Any other matter as prescribed by the securities regulatory authority under the State Council.


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and the character of the law\textsuperscript{21}. China’s stock markets were established to develop the economic performance of the state sector so as to reduce the Chinese government from continuing requirement to subsidize the troubled state owned enterprises (SOEs). Government intervention and state dominated ownership lead to many exceptional practices and regulations of China’s stock markets\textsuperscript{22}. To make sure state monitoring of the stock markets, nearly 2/3 of the total shares of Chinese listed companies cannot be traded on the stock markets\textsuperscript{23}.

Stock markets should play a crucial role in the formation of capital allocating resources through competition driven by the supply and demand of capital resources. Capital flows towards the most profitable companies until stability is reached between supply and demand. Consequently, a country can obtain the maximum benefits from its resources. A healthy, diversified stock market presents investors greater investment opportunities and leaves a country’s capital resources un-constricted. It is very problematical for investors to gain control of Chinese listed companies by a tender offer, which is a common means to change control in the U.S market and so change-in-control transactions are unusual and hostile takeovers yet unheard of in the PRC.

China has introduced a share classification system that listed companies have classified their shares into three parts based on the ownership: state shares, legal person shares and public shares instead of common shares and preferred shares, holding the philosophy that “all shares are equal”\textsuperscript{24}. State shares and legal person shares cannot be traded on the stock markets creating inequality among shareholders and so distorting the fair pricing function of a competent stock market creating diverse prices for securities of the same equity.

As mentioned above, main theories that have been used to rationalize a prohibition on insider trading include: (1) the equal access theory; (2) the fiduciary duty theory; and (3) the misappropriation theory. The equal access theory was extended from “a corporate insider”\textsuperscript{25} to “anyone” by the landmark case of SEC v. Texas Gulf Sulphur\textsuperscript{26}. In Chiarella

\textsuperscript{21} The laws refer to the laws issued by the China National People’s Congress and its standing committee; the administrative regulations refer to the regulations issued by the China State Council; the department rules refer to the rules issued by the ministries and departments under China State Council. See articles 62, 67, 89 and 90 of the Constitution of the People’s Republic of China, promulgated by China National People’s Congress on December 4, 1982.


\textsuperscript{24} Friedman, William I (2002), One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market, 27 Brook Journal of International Law 477. The division between common shares and preferred shares arises as a result of the investors’ dividend expectations, voting rights and priority in liquidation. Shareholders of each class of shares are entitled to equal rights and equal benefits, irrespective of their origin and citizenship.


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v. United States 27 the Supreme Court removed equal access theory by the fiduciary duty theory and duty does not occur from mere possession of non-public material information. There must be a fiduciary or other analogous relationship of trust and confidence between the trader with inside information and the plaintiff and so the scope of insider trading was considerably narrowed. The receiver of material, non-public information must refrain or disclose if the provider of the information breached his or her fiduciary duty to shareholders by benefiting from the tip 28. China 29 chooses an insider trading theory premised on the notion of equal access theory and does not accept the fiduciary duty theory. Prior to the revision of Chinese Company Law (2006), the norm of fiduciary duty did not exist in the Chinese legal system 30. The SEC has promulgated Rule 14e-3 in the tender offer context on the basis of the equal access theory 31. Moreover, Rule 14e-3, adopted pursuant to the SEC’s statutory power to “prescribe means reasonably designed to prevent” fraud in connection with a tender offer, disallows anyone with knowledge of a forthcoming tender offer from trading on that information prior to public disclosure of the offer. The rule closes the ambiguity left by Chiarella and Dirks, but only with respect to inside information related to tender offers because the rule does not prohibit trading by outsiders on the basis of non-public information that is not related to a forthcoming tender offer.

Insider trading in which the insider has stated up front that he/she trade on the basis of material, non-public information cannot violate Rule 10b-5 32. Professor Prakash 33 says that Rule 10b-5 prohibits only intentional misrepresentations, not mere breaches of fiduciary duty. Section 10(b) and Rule 10b-5 do not forbid mere breaches of fiduciary duty and controlling shareholders who breached a fiduciary duty to minority shareholders by offering insufficient consideration in a short-form merger would not, lacking

26 SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). “anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed.”
29 Article 76 of the Chinese Securities Law (2006): “prior to the public disclosure of inside information, a person who has knowledge of inside information on securities trading or a person who illegally obtains such information cannot purchase or sell such securities, divulge such information, or counsel another to purchase or sell such securities.”
30 Article 148, the Chinese Company Law (2006) for the first time introduces the concept of fiduciary duty by stating: “The directors, supervisors and senior officers shall comply with the laws, administrative regulations, and articles of association. They shall bear the obligations of fiduciary and diligence to the company. No director, supervisor or senior officer may take any bribe or other illegal gains by taking the advantage of his powers, or encroach on the property of the company.”
31 Huang, Hui (2005), The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform, 17 Australian Journal of Corporate Law 281, at 317. Rule 14e-3 places a duty on anyone who obtains inside information about a tender offer to disclose or abstain from trading. The equal access theory was reasserted in this rule with respect to tender offers.
33 Saikrishna Prakash, Our Dysfunctional Insider Trading Regime, 99 COLUM. L. REV. 1491 (1999). at 1510 (“O’Hagan correctly reaffirms that a breach of fiduciary duty is simply not enough for misappropriation or Rule 10b-5 liability; a deception is necessary.”) Basic Inc v. Levinson, 485 U.S. 224, 240 (1988) (“[M]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information.”); “Proposed Rules on Selective Disclosure and Insider Trading,” S.E.C. Release No. 33-7787 (“[I]nsider trading law has developed on a case by- case basis under the antifraud provisions of the federal securities laws, primarily Section 10(b) of the Exchange Act and Rule 10b-5.”);
deception, contravene Rule 10b-5\(^{34}\). As a consequence, insider trading that engages simply a breach of fiduciary duty to a trading partner or information source, but does not include dishonest fidelity to that person, basically cannot violate Rule 10b-5\(^{35}\). Rule 10b-5 prohibits an insider from executing a “pre-planned” trade that was “altered or deviated from” after the insider acquired material non-public information\(^{36}\). Insiders can basically make pre-planned trades when they do not have material non-public information, and then, once they gain material non-public information, either keep a pre-planned trade if it is profitable or abandon it otherwise\(^{37}\).

Can fiduciary duties be altered via contract? A corporate agent’s fiduciary duty is eventually owed to the corporation itself, not to individual shareholders\(^{38}\). Where an

\(^{34}\) Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), The Court explained: The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Larry E. Ribstein, *Fiduciary Duty in Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 541 (1997) (characterizing fiduciary duties as “a hypothetical bargain—that is, contract terms the parties themselves would have agreed to in the absence of transaction costs”); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 629 (1995) (“The rules of trust fiduciary law mean to capture the likely understanding of the parties to the trust deal...”); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (urging that there is nothing special about fiduciary obligations and positing that fiduciary obligations arise from “contractual” (and thus consensual) relations);

\(^{35}\) Sairkrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491 (1999) at 1510 (“Properly understood, [O’Hagan] indicates that classical insiders may avoid Rule 10b-5 liability even when they trade on material, non-public information on an anonymous exchange, so long as they do not deceive their shareholders.”); Jensen v. Kimble, 1 F.3d 1073 (10th Cir. 1993) and McCormick v. Fund American Companies Inc., 26 F.3d 869 (9th Cir. 1994)); Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023, 2055 n. 141 (2005) (arguing that Prakash’s position “is incorrect in that there is no case that follows Prakash’s analysis in the case of classic insider trading (i.e., where the source of the information is the issuer of the securities)’’); Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 568 n. 141 (2002) (noting Prakash’s position and responding that “it is doubtful that courts would accept a one-time blanket statement of an intent to trade as equivalent to the disclosure of the actual material non-public information upon which insiders seek to trade”); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and “Negative” Property Rights in Information*, 87 VA. L. REV. 1229, 1262 n. 108 (2001) (“A proper reading of O’Hagan implies a key distinction between inside information in the classic sense—information originating from the affected firm used by one of its insiders—and a different type of inside information—information generated by outsiders who are not employees of the affected firm. While the prohibition on trading involving classic inside information is clearly mandatory, and cannot be contracted around, the prohibition on trading involving information generated by outsiders is subject to contracting like any other property interest.”); Stephen M. Bainbridge, 52 SMU L. REV. 1589, 1647-48 (1999) (acknowledging that O’Hagan’s reasoning would seem to suggest that candid classical insider trading does not violate Rule 10b-5, but predicting that the Supreme Court would eschew such a position); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 436 n. 271 (1999) (rejecting the insidious suggestion that a prior disclosure of an intention to trade on material nonpublic information or ‘candid insider trading’ should be countenanced as an exception’).

\(^{36}\) 17 C.F.R. § 240.10b5-1(c)(1)(i)(C). The SEC has also expressly articulated one logical corollary of Rule 10b5-1, namely that “a person acting in good faith may modify a prior contract, instruction, or plan before becoming aware of material nonpublic information. In that case, a purchase or sale that complies with the modified contract, instruction, [sic] or plan will be considered pursuant to a new contract, instruction, or plan.” 65 FR 51716, 51728 n.111.

\(^{37}\) Jesse Fried, *Insider Abstention*, 113 Yale L.J. 455, 487-89 (Nov. 2003), at 490-91 (explaining that in this situation insiders can make above-market returns using material nonpublic information, because the gains to preplanned advantageous trades are no longer symmetrically offset by the losses associated with irrevocable, disadvantageous preplanned trades). at 491 ("But there seems to be little cost (in terms of inconvenience to insiders) to requiring insiders wishing to avail themselves of the safe harbor through the use of prearranged trading plans to wait until they are unaware of material nonpublic information before canceling their trading plans.").

\(^{38}\) CHARLES R. T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 260 (3d ed. 1999) (“Normally, directors owe fiduciary duties to the corporation, not to individual shareholders.”). Gearhart Indus., Inc. v. Smith Int’l, Inc., 741 F.2d 707, 721 (5th Cir. 1984) (observing that ‘directors’ duties of loyalty and care run to the corporation, not to individual shareholders or

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agent’s action might disadvantage an individual shareholder but would benefit the corporation as a whole, the agent’s fiduciary duties should not prohibit him from taking that action. In the U.S., the misappropriation theory was upheld by the Supreme Court in the *O’Hagan* case extending liability to those who trade on the basis of “inside information” misappropriated from a third party in breach of fiduciary duty or analogous relationship of trust and confidence, whether or not the trader owns an autonomous fiduciary duty of reveal to whom he deals with. Both the U.S. and China disallow illegal insider trading by traditional corporate insiders and extends liability to those who have misappropriated information. Misappropriation theory can also be established in Chinese law. According to Article 76, there is no prerequisite of a trust or confidence relationship between the misappropriator and the source of the information and so the extent of liability under Chinese law is much wider than that of the U.S. regulation, mainly because of the underdeveloped fiduciary duty doctrine in China’s legal system.

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 include 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.

Three major methods to detect illegal insider trading established both in the U.S. and China: (1) Referrals from the stock exchanges; (2) Investigations by the regulators; and

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40 Article 76 of the Chinese Securities Law (2006) requires: “a person who illegally obtains inside information on securities trading...cannot purchase or sell such securities, divulge such information, or counsel another person to purchase or sell such securities.”

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(3) Informants. Advanced technologies play a crucial role of monitoring day-to-day market transactions and so it can be used as a feedback for logistics of information applied by the stock exchange as well. The short analysis shows that the whole effort of law\(^{41}\) is to manage the circulation of information from the company towards the market in a way to avoid the time advantage that insiders have over outsiders in order to buy or sell financial securities.

Are laws effective in discouraging insiders from trading on non-public information? This author has argued that alone insider trading laws are ineffective and are unsuccessful in deterring insiders from trading on non-public information\(^{42}\). So, economics supplementing law are essential to combat insider trading.

**Cyberspace and Insider trading**

Law continues to develop to accommodate technological innovation\(^{43}\). The applying and borrowing from existing law and legal frameworks in new contexts doctrine could apply in securities\(^{44}\). The translation of traditional laws and regulations in new contexts leads at times to uncertain outcomes\(^{45}\). Technological innovations have presented challenges to existing legal frameworks leading to variations being made in such frameworks in order to apply such frameworks in new or modified business surroundings\(^{46}\). Cyberspace has enabled Internet security offerings, which tender prospective opportunities for fundraising not achievable in the past. It has to be taken into consideration that information is still the basis for insider trading in the cyberspace era. The new phenomenon will be the development of electronic insider trading concerning electronic purchase of securities based on electronic inside information. Inside information can be obtained by intercepting electronic files of companies using electronic transfer of data towards either the SEC or the stock exchange or among departments of the same company during exchange of information among managers. Cyberspace has had a


\(^{42}\) G. Zekos, Is the law effective in protecting markets from insider trading? Hertfordshire Law Journal 3( 2), 2-17, ISSN 1479-4195 Online / ISSN 1479-4209 CDRom. http://perseus.herts.ac.uk/uhinfo/index.cfm?9F83EBC7-9E3C-9BBF-60B2-C124DD4D5B91 p 17 “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”.


\(^{44}\) Alan Watson, Aspects of the Reception of Law, 44 AM. J. COMP. L. 335, 335 (1996) (“In most places at most times borrowing is the most fruitful source of legal change.

\(^{45}\) Donald C. Langevoort, Information Technology and the Structure of Securities Regulation, 98 HARV. L. REV. 747, 747 (1985) (discussing the influence of information technology on securities markets); at 749 (“The advent of the new technology suggests that we re-examine the current structure of securities regulation.”).

\(^{46}\) Olufunmilayo B. Arewa, Securities Regulation in the Knowledge Economy: Adopting Accounting and Disclosure Frameworks for a New Intangibles Age, 54 BUFF. L. REV. 254 (characterizing changing business practices with respect to technology, brands and other intangibles as constituting a Kuhnian paradigm shift in business worldview and practice to an intangibles paradigm).

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predominantly dynamic influence because of its operation as a medium by which information can be transmitted.\textsuperscript{47} Thus, cyberspace is the instrument that could be used for the employment of e-logistics of information both by companies and the stock exchange creating an electronic networking of logistics of information and so eliminating the time advantage of every insider who could be a potential direct or indirect player in insider trading.

Cyberspace has changed both the character of information promptly available to the public as well as brought greater simplicity of access to information\textsuperscript{48}. The introduction of cyberspace is accompanied by a considerable cultural shift evident in new business practices, forms of crime and creative personal uses of the new technology\textsuperscript{49}. Cyberspace’s prospective reach has noteworthy implications for the accommodation between law and technology.

The economic collapse following the 1929 Crash and the extremes of the New Era that preceded it were key factors inspiring the new securities laws.\textsuperscript{50} The SEC has enacted regulations that successfully translate the fundamental goals of the Securities Act with respect to investor protection and the maintenance of fair and honest securities markets into varied circumstances of business practice, including cyberspace\textsuperscript{51}. Moreover, the Securities Act involves disclosure of specific types of material information to investors in securities offerings and the securities regulation outline as a whole replaces the attitude of \textit{caveat emptor} with one of full disclosure with the objective of achieving high ethical

\textsuperscript{47} Jill E. Fisch, \textit{Can Internet Offerings Bridge the Small Business Capital Barrier?}, 2 J. SMALL & EMERGING BUS. L. 57, 69-70 (1998) (“\textit{The Internet offers new methods for offering and selling securities. Businesses can distribute financial information and solicit investors through the Internet more quickly and at lower cost than was previously possible through paper-based communications.}"

\textsuperscript{48} Robert A. Prentice, \textit{The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5}, 47 EMORY L.J. 1, 2 (1998) (noting that financial information online supplements company corporate communications and investor relations); Donald C. Langevoort, \textit{Toward More Effective Risk Disclosure for Technology-Enhancing Investing}, 75 WASH. U. L.Q. 753, 754 (1997) (“Technology has changed, and will continue to change, the institutional ecology of the capital marketplace … [and] permits those who want to influence investment decisions to produce and disseminate information quickly and at increasingly lower costs.”).

\textsuperscript{49} Paul D. Cohen, \textit{Securities Trading via the Internet}, 4 STAN. J. L. BUS. & FIN. 1, 1 (1999) at 5 (“While the Internet provides innovative alternatives for the securities industry and securities markets, individuals can also use it for illegitimate purposes. Since 1990, the SEC has detected and prosecuted several incidents of securities fraud perpetrated over the Internet. The open forums of ‘securities chat-rooms’ also provide new means for individuals to improperly influence the price of securities.”).

\textsuperscript{50} Stuart R. Cohn, \textit{Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions}, 38 FLA. L. REV. 1, 1 (1986) (noting that the Securities Act was “born out of congressional reaction to fraudulent and abusive sales tactics during the market heydays of the 1920’s”); Joel Seligman, \textit{The Historical Need for a Mandatory Corporate Disclosure System}, 9 J. CORP. L. 1, 27-34 (1983) (discussing the congressional hearings leading to passage of the Securities Act and Exchange Act and incidents of fraud depicted in such testimony); Peter V. Letsou, \textit{The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis}, 45 EMORY L.J. 95, 120 (1996) (“In adopting the 1933 Act, Congress was clearly responding to the then-recent crisis in public securities markets—the stock market crash of 1929. This is made plain by the debates leading up to the adoption of the 1933 Act, which made repeated references to the frauds and manipulations in public markets that were thought to have precipitated the 1929 crash.”)


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business standards in the securities industry. The Securities Act protects investors by providing them with unambiguous and adequate disclosure concerning securities they purchased. SEC regulatory reaction to concerns about capital raising needs have highlighted the tension between the objective of investor protection and the encouragement of entrepreneurial capital formation.

The SEC’s EDGAR electronic filing disclosure database is accessible on the Internet. Moreover, the SEC has dynamically enforced securities regulation online and focused on the Internet in relation to fraud and market manipulation. Furthermore, a network of logistics of information has to be built among the stock exchange-SEC and the companies circulating information concerning financial securities or any other information falling into the context of inside information as it is specified above. The SEC has translated Rule 10b-5 from “real” space to cyberspace by plainly stating that it applies equally to paper and electronic communications. Cyberspace, the setting up of corporate Web pages, and the increasing corporate use of e-mail are developments which permit special attention because they intensify the traditional difficulties and as a result multiply the opportunities for liability-creating communications.

The Role of Insider Trading in the Market

On the one hand, Insider trading permits private information to be promptly incorporated into stock prices, in so doing leading to more efficient stock prices. On the other hand, allowing insiders to trade at the expense of uninformed outsiders reduces investor confidence and impairs the integrity of capital markets. Insider trading restrictions are

52 James D. Cox, The Fundamentals of an Electronic-Based Securities Act, 75 WASH. U. L.Q. 857, 858 (1997) (suggesting that most troubling issues concerning the Securities Act result from its transactional focus). Alan R. Palmiter, Toward Disclosure Choice in Securities Offerings, 1999 COLUM. BUS. L. REV. 1, 18 (noting that public investors are unlikely to read and understand mandatory disclosure documents, leading to such disclosure being justified as “a way for market intermediaries to receive standardized and certified information”)

53 Donald C. Langevoort, Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities, 2 J. SMALL & EMERGING BUS. L. 1, 2 (1998) (“Since the 1970s, the SEC has taken the special capital raising needs of small and unseasoned issuers fairly seriously.”). Stephen J. Choi, Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation, 2 J. SMALL & EMERGING BUS. L. 27, 29 (1998) (“For the amount of money they raise, however, small companies bear a disproportionately greater cost from regulations designed to protect investors.”). Theresa A. Gabaldon, Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Businesses, 2 J. SMALL & EMERGING BUS. L. 259, 265 (1998) (noting that the price of the mandatory disclosure scheme may be so steep as to bar access of some entrepreneurs to capital).

54 Paul G. Mahoney, Technology, Property Rights in Information, and Securities Regulation, 75 WASH. U. L.Q. 815, 835-36 (1997) (noting that the SEC has devoted much money and effort to the development of the Electronic Data Gathering, Analysis and Retrieval (EDGAR) system, which requires electronic securities filings that can be retrieved on the SEC’s website or through commercial providers).

55 Press Release, SEC, SEC Continues Internet Fraud Crackdown (Feb. 25, 1999), http://www.sec.gov/news/headlines/spamcase.htm (discussing the SEC’s continuing nationwide sweep targeting Internet fraud and announcing four enforcement actions against 13 individuals and companies); Securities and Exchange Commission, Internet Fraud: How to Avoid Internet Investment Scams http://www.sec.gov/investor/pubs/cyberfraud.htm (giving an overview of Internet securities fraud directed to investors and suggesting ways to spot Internet fraud and what the SEC is doing to fight Internet investment scams).


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intended to diminish the adverse selection problem facing uninformed investors by limiting the occurrence of private information trading. The enforcement of insider trading laws has a sound influence on the cost of capital. Insider trading returns increase after enforcing insider trading laws. Moreover, Insider trading laws are associated with a considerable change in the informational environment surrounding acquisition announcements.

While the aim of securities laws is to ensure the correct pricing of securities by requiring dissemination to the market of information regarding the true value of securities, the insider trading prohibition plainly prohibits particular types of trading on the basis of material, non-public information, in this manner preventing such trades from informing the market regarding the true value of the securities at issue. It is vitally unjust for some traders to have an informational advantage over others, predominantly when the advantaged traders are corporate insiders who are supposed to be acting as agents for those who lack the informational lead. Insider trading discourages investment in the, seemingly, manipulated stock market, in this manner reducing the liquidity of capital markets. Moreover, Insider trading encourages insiders to postpone disclosures and to make management decisions that intensify share price volatility but do not maximize company value increasing the “bid-ask” spread of stock specialists, who methodically lose on trades with insiders (whom they cannot identify ex ante) and will tend to “insure” against such losses by charging a small premium on each trade. On the other hand,

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59 Bris, Arturo, 2005, Do Insider Trading Laws Work?, European Financial Management 11, no. 3 (June)


61 STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 519 (2002). at 605 (“The basic function of a securities fraud regime is to ensure timely disclosure of accurate information to investors. Yet, it seems indisputable that the insider trading prohibition does not lead to increased disclosure.”).

62 Jeffrey M. Laderman et al., The Epidemic of Insider Trading, BUS. WK., April 29, 1995, at 78 (quoting SEC Chairman Arthur Levitt as stating, “If the investor thinks he’s not getting a fair shake, he’s not going to invest, and that’s going to hurt capital markets in the long run.”); Lawrence M. Ausubel, Insider Trading in a Rational Expectations Economy, 80 AM. ECON. REV. 1022, 1022-23 (1990) (asserting that insider trading deters potential investors from securities markets, as outsiders want to avoid dilution of their investment returns); Louis Loss, The Fiduciary Concept as Applied to Trading by Corporate “Insiders” in the United States, 33 MOD. L. REV. 34, 36 (1970) (arguing that insider trading constitutes a “grievous insult to the market in the sense that the very preservation of any capital market depends on liquidity, which rests in turn on the investor’s confidence that current quotations accurately reflect the objective value of his investment”);

63 Robert J. Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 80 MICH. L. REV. 1051, 1054-55 (1982) (arguing that, if insider trading were permitted, “subordinates would stall the upward flow of critical information to maximize their opportunities for financial gain,” resulting in an “impair[ment] [of] corporate decision-making at all hierarchical levels”). Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 VA. L. REV. 117, 149 (1982) (noting that if insider trading is permitted “an insider can profit from a decrease in the firm’s stock price as well as in increase; the temptation of profit might actually encourage an insider to act against the corporation’s interest”); Jack L. Treynor, Securities Law and Public Policy, 50 FIN. ANALYSTS J. 10, 10 (1994) (“[Informed] trades can damage © Dr Georgious I Zekos

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insider trading cannot be “unfair” to investors if they know in advance that it takes place and even so choose to engage in the allegedly unfair trades. As mentioned earlier, Insider trading increases stock market efficiency—the degree to which stock prices reflect true value—which helps ensure effective resource allocation. Therefore, Insider trading drives the price of a stock in the right direction. Insiders put across important information to the marketplace. Assuming insiders’ trades by some means become public, other rational investors will follow their lead, which will cause stock prices to reproduce more correctly the underlying value of the company. More competent stock prices, then, will lead to a more resourceful distribution of productive resources all over the economy. The interaction of the labor and capital markets will guarantee that companies will approve insider trading policies that are, on the whole, value maximizing. According to Henry G. Manne insider trading lowers the cost of managerial decision making by providing managers with important information that they could not otherwise cost-effectively get hold of. In other words, insider trading engenders effective “prices” to guide resource allocation within companies.

Prices may be imprecise because of non-public information and because stock prices reflect expected future cash flows, and traders’ expectations are based on publicly available information concerning a firm’s future diagnosis. Moreover, investors’ mis-assessment of public information, speculative trading and liquidity crunches lead to stock price imprecision. Mispricing created by a liquidity crisis will be corrected by an information movement that freezes the speculative trading causing the liquidity crisis. In a market economy, decision makers look to prices in determining how to distribute resources to their most valued uses. Inaccurate securities prices are generally considered

the dealer, perhaps fatalistically. That’s a valid reason for discouraging trading on so-called ‘inside’ information, quite apart from whether such trading entails misappropriation of corporate property or wire fraud.”; John C. Coffee, Jr., Is Selective Disclosure Now Lawful?, N.Y. L.J., July 31, 1997, at 5 (“[T]he more that the law successfully prohibits the use of non-public value information, the more that the market maker can (and will be forced by competitive pressure to) narrow the bid-ask spread.”); 

Kenneth Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEGAL STUD. 801, 807-09 (1980) (observing that if the existence of insider trading is known, outsiders will not be disadvantaged because the price they pay will reflect the risk of insider trading); Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 HOFSTRA L. REV. 9, 32 (1984) (defending use of insider trading law to protect rights to information but arguing that “property owners” – i.e., the corporations to whom the right to inside information is allocated – should be “permitted to contract as to the use of the information they own.”); Sugato Chakravarty & John J. McConnell, Does Insider Trading Really Move Stock Prices?, 34 J. FIN. & QUANTITATIVE ANALYSIS 191 (1999) (presenting data suggesting that informed trading by insiders has the same price affect as uninformed trading by outsiders); James D. Cox, Insider Trading and Contracting: A Critical Response to the “Chicago School”, 1986 DUKE L. J. 628, 646 (asserting that insider trading is a noisy device for communicating stock value).


R. H. Coase, The Nature of the Firm, 4 ECONOMICA (n.s.) 386, 389 (1937) (arguing that “the distinguishing mark of the firm is the suppression of the price mechanism”)


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to be unattractive because they result in an unsuitable channelling of investment capital\textsuperscript{70}. Consequently, the development of logistics of information concerning securities not only will achieve the adjustment of stock price but also will keep a balance avoiding sudden up and down of stock price allowing enormous insider trading to take place.

Crashes make public information as they are driven by primarily sidelined informed investors going back into the market\textsuperscript{71}. There is a pattern of insiders selling intensity preceding crashes. Selling by insiders discloses unpleasant news to the market and causes prices to plunge\textsuperscript{72}. The absence of selling by insiders can disclose even worse information and so motivate prices to go down even more speedily than if there had been slight selling by insiders. Insider sales are extensively associated with crashes\textsuperscript{73}. Insider selling that is encouraged by private information is subjugated by portfolio rebalancing for diversification rationale\textsuperscript{74}. Uninformed investors can only assume that insiders are in control of bad news but not how bad the news really is resulting in a severe change in outside investors beliefs and perceived point of uncertainty. According to Jose M. Marin \textit{and} Jacques Olivier\textsuperscript{75} “stocks purchased by insiders earn positive abnormal returns but stocks sold by insiders do not exhibit negative abnormal returns”.

Earnings manipulation is a key mechanism that managers could use to increase stock price\textsuperscript{76}. Managers exaggerate earnings more in quarters that go before high insider selling activities and stock price run ups of individual corporations during the bubble period are associated with both earnings management and insider trading activities during the bubble\textsuperscript{77}. Furthermore, the stock price declines of specific companies during the following correction period are associated with both earnings management and insider trading activities during the bubble\textsuperscript{78}. Financial restatements are associated with a decrease in company value, a decline in future earnings hope and an increase in the cost

\textsuperscript{70} David J. Schulte, \textit{The Debatable Case for Securities Disclosure Regulation}, 13 J. CORP. L. 535, 539-42 (1988) (arguing that securities prices are important because of their effect on allocative efficiency); John Coffee, \textit{Market Failure and the Economic Case for a Mandatory Disclosure System}, 70 VA. L. REV. 717, 734 (1984) (observing that securities prices are important “not so much because of their distributive consequences on investors but because of their effect on allocative efficiency”); Merritt Fox, \textit{Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis}, 70 VA. L. REV. 1005, 1015 (1984) (noting benefits of accurate prices in efficient market);


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of equity capital. The negative valuation impact of financial restatements encourage company insiders, who possess advance knowledge about the timing, possibility and harshness of financial restatements, to trade shares in a model that avoids the negative influence of financial restatements on their personal investment in the restating companies. Insiders take advantage of outsiders by trading on proceeding knowledge of particular company events or privileged understanding of positive company features, such as R&D.

Managers tend to be steadily optimistic in their interpretation of their company’s business and will be less likely to correct over-pricing than under-pricing. Managers highlight price-enhancing information whereas suppressing price-decreasing information. If managers think the un-revealed bad news will result in firm insolvency or in their being fired or demoted, then managers may choose that the costs to them of misleading disclosures (or omissions) are less than the costs to them of candor. Consequently, managers sacrifice candor when managers possess price-decreasing information, while they almost definitely would not do so if the undisclosed news were price-enhancing. There is unevenness in the degree to which managers and market forces are able to correct the various types of mispricing. Besides, the logistics of information of a

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80 Piotroski, J. D., D. T., Roulstone, 2005. Do insider trades reflect both contrarian beliefs and superior knowledge about future cash flow realizations?, Journal of Accounting and Economics 39, 55-81. Michael C. Jensen, Agency Costs of Overvalued Equity, 34 FIN. MGMT. 5, 5-6 (2005) (“To my knowledge, with the exception of Warren Buffett (who hints at these forces in his 1988 letter to Berkshire shareholders) no leaders in the business or financial community have recognized the dangers of overvalued equity.”).

81 Donald Langevoort, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms), 146 U. PA. L. REV. 101, 106 (1997) (noting that, according to conventional economic analysis, “the interests of the company’s highest executives are usually (albeit not always) fairly closely aligned with the ongoing interests of the firm, so that the question of why senior managers would engage in secondary-market deception remains an interesting one”);

82 Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. ILL. L. REV. 691, 724-27 (summarizing data showing that fraud on the market generally occurs when agents are afraid they are in their last period of employment). Jane E. Dutton, et al., Reading the Wind: How Idle Managers Assess the Context for Selling Issues to Top Managers, 18 STRATEGIC MGMT. J. 407, 407 (1997) (“It is often middle managers rather than the top managers who have their hands on the ‘pulse of the organization.’”). MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 118 (1987) (“Ideas relating to the…financial decisions of top management…are likely to be processed as they make their way toward the top managers of a firm.”);


84 Roni Michaely & Kent L. Womack, Conflict of Interest and the Credibility of Underwrite Analyst Recommendations, 12 REV. FIN. STUD. 653, 671-78 (1999) (providing empirical evidence suggesting that market has failed to discount excessive analyst optimism).

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company could foresee any mismanagement and so could keep the circulation of information in a certain degree avoiding sudden bad news.

While insider trading contributes to the timely and precise incorporation of private information into stock prices\textsuperscript{85}, insider trading crowds out private information collection available to outside investors thus preventing the profits available to outside investors. By escalating information asymmetries, insider trading discourages investment, slows down stock market participation and liquidity and gives rise to further adverse selection problems and ineffective corporate behaviour.

There is a positive connection between the information environment, insider trading and insider trading laws enforcement. According to Nuno Fernandes, and Miguel A. Ferreira\textsuperscript{86} “The enforcement of insider trading laws leads to an actual deterioration in stock price informativeness in countries that rank low on these criteria. Our evidence also suggests that stock price informativeness declines the most in countries where insider trading is more common.” There is a substitute relation between insiders’ and analysts’ activities but analysts do not have important private information\textsuperscript{87}. On the other hand, the value of the information environment cannot be inferred just by looking at analyst reporting\textsuperscript{88}. Transparency prevents insiders from hiding bad news permitting for unconstrained firm-specific return variation. Analysts cannot separate whether price changes are caused by noise traders, or by insiders, and so when insiders are allowed to trade they beat the analysts because analysts follow prices and react to information\textsuperscript{89}. Lacking incentives to hold back information, insiders will disclose and when the information is disclosed, insiders and analysts compete to capture the value of the information\textsuperscript{90}. Limited insider trading moderates the expected return of analysts, but

\begin{thebibliography}{99}
\bibitem{87} Nuno Fernandes Miguel A. Ferreira, Insider Trading Laws and Stock Price Informativeness, 2006 \url{www.ssrn.com}
p28.
\bibitem{90} Jeffrey F. Jaffe, Special Information and Insider Trading, 47 J. BUS. 410 (1974) (suggesting that investors can profit from prompt use of the \textit{Official Summary}’s information), Halbert Kerr, The Battle of Insider Trading vs. Market Efficiency, 6 J. PORT. MGT. 47 (1980) (posing that knowledgeable investors have largely eliminated the opportunity to earn excess return by using the information contained in the \textit{Official Summary}), Goldie & Ambachtsheer, \textit{Are Some Insiders More ‘Inside’ Than Others? Comment}, 10 J. PORT. MGT. 75 (1983) (pointing out that after correcting for methodological problems, Kerr’s results show that outsiders can use the \textit{Official Summary} to earn excess returns).
\end{thebibliography}
leaves them a satisfactory return to remain operative. Enhancement in financial statement informativeness and analyst following leads to a weaker association between insider trade and consequent returns. Managers with large pre-existing positions in company stock and new grants of equity incentives are associated with stock sales related with portfolio rebalancing rather than the utilization of private information.

Insiders buy their own stock when the price is falling and the security exhibits low valuation ratios and sell their own stock when the price is increasing and valuation ratios are large. The returns associated with insider trading are principally generated by insiders trading against mispricing. According to Richard W. Sias and David A. Whidbee, “insider trading is inversely related to net institutional demand and that the inverse relation between institutions and insiders (or, equivalently, the positive relation between insiders and individual investors) cannot be explained by institutional investors’ and insiders’ attraction to opposite security characteristics or individual investors following insiders... Insider behavior is better described as trading against “institutional investor sentiment” rather than trading against “market sentiment.” Thus, insiders purchase following increases after initial enforcement of insider trading regulation). Ranga Narayanan, Insider Trading and the Voluntary Disclosure of Information by Firms, 24 J. BANKING & FIN. 395 (2000) (finding that stringent enforcement of insider trading regulations induces more disclosure by firms). Rezaul Kabir & Theo Vermaelen, Insider Trading Restrictions and the Stock Market: Evidence from the Amsterdam Stock Exchange, 40 EURO. ECON. REV. 1591 (1996) (examining the effect of introducing insider trading restrictions, since 1987, on the behavior of the Amsterdam Stock Exchange and finding that stocks became less liquid and also finding some evidence that the stock market adjusted more slowly to positive earnings news). Utpal Bhattacharya & Hazem Daouk, The World Price of Insider Trading, 57 J. FIN. 75 (2002) (finding that initial enforcement of insider trading laws is associated with a significant decrease in country-level equity cost of capital).

91 Darren T. Roulstone, Analyst Following and Market Liquidity, 20 CONTEMP. ACCT. RES. 551 (2003) (arguing that since analysts provide public information, increased analysts’ coverage has a positive association with liquidity). Jhinyoung Shin, The Optimal Regulation of Insider Trading, 5 J. FIN. INTERMEDIATION 49 (1996) (considering the optimal enforcement efforts and costs in a model including insiders, informed market professional, and liquidity traders, and concluding that tolerating some insider trading can be an optimal regulation policy). Patricia C. O’Brien, Forecast Accuracy of Individual Analysts in Nine Industries, 28 J. ACCT. RES. 286, 303-304 (1990) (suggesting—based on the results of an empirical study of analysts’ forecast accuracy—that analysts compete over the timely incorporation of new information); John Jacob, Thomas Z. Lys, & Margaret A. Neale, Expertise in Forecasting Performance of Security Analysts, 28 J. ACCT. & ECON. 51, 79 (1999) (hypothesizing, in light of the study’s results, that competition among analysts seems to cause underperformers to be replaced). Richard Frankel & Xu Li, Characteristics of a Firm’s Information Environment and the Information Asymmetry Between Insiders and Outsiders, 37 J. ACCT. & ECON. 229, 232 (2004) (noting that outside investors in firms with greater analyst coverage face less information asymmetries). Brett Trueman, The Impact of Analyst Following on Stock Prices and the Implications for Firms’ Disclosure Policies, 11 J. ACCT., AUDITING & FIN. 333 (1996) (showing that there is a positive relation between the number of analysts following a firm and the firm’s expected share price, and that this relation is a direct consequence of market participants’ inability to observe the number of informed traders in the market). William L. Cary, Corporate Standards and Legal Rules, 50 CAL. L. REV. 408, 415 (1962) (arguing that insider trading “infects the integrity of the market”); Manuel F. Cohen, Disclosure – The SEC and the Press, FIN. ANALYSTS J., July-Aug. 1968, at 21, 22 (arguing that “the problem of ‘inside information’ is one that has a tremendous impact on public confidence in the fairness of the securities markets”).


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outruns those they sell and insiders profit most when they trade against institutional investors.

Share price accuracy and financial liquidity are the two key determinants of market efficiency and so the more precise share prices are and the more liquid trading is, the more efficient the market is.⁹⁵ Markets are effective when prices precisely reflect all available information about the assets traded and so getting efficient pricing is crucial for achieving resourceful allocation of resources in the economy.⁹⁶

Given unimportant doubt in the marketplace concerning the company’s value, there is little scope for the insider to profit, even if the insider has ideal information about the fundamental value of the company. On the other hand, if there is immense doubt about the value of the company, then ideal information held by the insider would be rather profitable. The higher the accuracy of the insider’s information and the lower the accuracy of outsiders’ beliefs about company value, the more the insider can earn from his/her trades.⁹⁷ As much as insider trades signal company value to other market contestans, they influence the stock price. Managers sell their stockholdings at inflated prices as a drive for earnings manipulation.⁹⁸


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Elevated prior discrepancy of the stock price and higher precision of insider information both enhance informational asymmetry. Even though an insider’s particular private information at a point in time cannot be observed by analysts and outside traders, whether trade takes place, the direction of trade, the value of trade, and, consequently, trading profits are recognisably becoming part of the information environment. Securities regulations should diminish the cost of gathering, verifying, and pricing information. Research and development (R&D) activities enhance the information asymmetry between insiders and investors, in this manner permitting insiders at companies with high R&D spending to reap higher profits from their trading than insiders at other companies. An element of insider trades is driven by insiders’ informational advantage over other market contestants. In view of the fact that insider trades precede abnormal returns existing financial reporting practices and other information disclosures do not totally eliminate insiders’ information advantage. Furthermore, modern communication methods make it possible for financial market professionals and private investors to have more equal access to financial information, but also increase the risk of the spread of false or misleading information.

The short analysis indicates a discrepancy regarding the role and contribution of insider trading in the efficiency of the capital market. Insider trading might bring information quicker in the market but the miss-allocation of the capital caused in the mean time causes an inefficient allocation of resources in the economy generating problems of demand. This author thinks that enormous insider trading in the short run causes the collapse of the market in undeveloped economies and an unbalance of strong economies. On the other hand, small scale of insider trading in the long run based on the detection of

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99 Mark H. Lang & Russell J. Lundholm, *Corporate Disclosure Policy and Analyst Behavior*, 71 ACCT. REV. 467 (1999) (“[F]irms with more informative disclosure policies have a larger analyst following, more accurate analyst earnings forecasts, less dispersion among individual analyst forecasts and less volatility in forecast revisions.”); Christine Botosan & Mary Stanford-Harris, *Motivations for Changes in Disclosure Frequency and Its Consequences: An Examination of Voluntary Quarterly Segment Disclosures*, 38 J. ACCT. RES. (2000) (increased voluntary disclosure leads to increased analysts following); Mark H. Lang, Karl V. Lins, & Darius P. Miller, *ADRs, Analysts, and Accuracy: Does Cross Listing in the U.S. Improve a Firm’s Information Environment and Increase Market Value?*, 41 J. ACCT. RES. 317 (2003) (finding “that firms that cross-list on U.S. exchanges have greater analyst coverage and increased forecast accuracy relative to firms that are not cross listed” and “that firms that have more analyst coverage and higher forecast accuracy have a higher valuation”); Ole-Kristian Hope, *Disclosure Practices, Enforcement of Accounting Standards and Analysts’ Forecast Accuracy: An International Study*, 41 J. ACCT. RES. 235 (2003) (finding that “firm-level disclosures are positively related to forecast accuracy, suggesting that such disclosures provide useful information to analysts” and that strong enforcement of accounting standards is associated with higher forecast accuracy); Douglas W. Diamond, *Optimal Release of Information by Firms*, 48 J. FIN. 1071 (1985) (demonstrating that when the cost of releasing information to the firm is lower than the aggregate expenditure incurred by investors to acquire the information independently, welfare is enhanced if the firm discloses the information). Michael Fishman & Kathleen Hagerty, *The Optimal Discretion to Allow in Disclosure*, 105 Q.J. ECON. 427 (1990) (showing that limiting discretion on the form of disclosure (e.g., mandating the use of accepted accounting principles) leads to more informative disclosure). Donal Byard & Kenneth Shaw, *Corporate Disclosure Quality and Properties of Analysts’ Information Environment*, 18 J. ACCT., AUDITING & FIN. 355 (2003) (finding—based a study that examined how the quality of corporate disclosures impacts the precision of information that financial analysts incorporate into their forecasts of annual earnings—that higher quality disclosures increase the precision of analysts’ common and idiosyncratic information);


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information due to public relations/education and research could be the fuel in the engine of the stock exchange.

**Logistics the antidote against insider trading**

Logistics manage the interrelationship of all the factors, which affect the flow of both information and goods necessary to fill orders. The central element of the global logistic design and controlling system is the assessment of what kind of logistic tasks have to be solved in an autonomic way by virtual co-operating companies and what kind of tasks belongs to the capability of the virtual logistic centre. The development of just-in-time (JIT) concept is the key factor characterising logistics which could be applicable in a logistics of information demand. The possibility of adapting to changes in the environment concerns the possibility of choosing different lines of action in terms of disintermediation, multiple marketing channels, composite supply chain channels and/or multiple logistics channels, ordering channels or distribution flows\(^1\). Thus, logistics can be used to control information flow within a company and the distribution of information to the public.

The nature of the good (information) that law attempts to control causes problems of effectiveness. Information is an intangible good and so no physical barrier can stop it from flowing and circulating\(^2\). As long as information has been embodied in a piece of paper such as a note or a memorandum, the insider who has entrée to the materialized information and could trade on it is going to abstain from doing so because he/she would be under scrutiny. Although the insider refrains from trading on inside information, nothing prohibits him/her from communicating it to a third party.

Once the insider has access to the information, there is no way to identify whether he/she has communicated what he/she knows to a third party insofar as he/she did not broadcast the information in its materialized feature. There is always a first person who has entrée to the information and law cannot prevent this person from communicating this information to a third party apart from prohibiting this person from accessing the information, which is impracticable because that would imply prohibiting him/her from performing his/her job. As the number of persons accessing confidential information increases, the amount of third parties with access to information multiplies as well\(^3\).

Third parties can convey the indirectly acquired information to other people who themselves can convey this information to other parties. Occasionally, people\(^4\) may

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communicate the information even without knowing they are doing so. The network by which the information circulates can turn out to be very layered and the higher the degree of complexity of the network, the greater the problem for the regulator to preclude the information from circulating. In addition law will have difficulty tracing back the information to its source. The effectiveness of a regulation relies upon its success to preclude first accessing persons from communicating inside information to third parties. On the other hand, the instantaneous circulation of the information to the public will eliminate the time advantage of any insider to make profitable use of inside information. The role of logistics of information will be focused on circulating safely in time the information either among managers within the company or to the public and the stock exchange.

The information progressing through the network is going to be a matter subject to the alteration and law has to discover what the inside information is on which the prospective malefactor has based his/her deal. There is an inefficacy of the mechanism of detection for illegal insider trading. SEC lacks hard evidence due to the intangible nature of inside information and it relies repeatedly only on circumstantial evidence to discover and prosecute illegal insider trading. When the rule used by the regulator to find out and prosecute insiders becomes known to insiders, the insiders possessing the most truthful information adjust strategically their behaviour to evade investigations. Insiders with more truthful confidential information adjust their trading strategy in order to evade the stock prices reaching the threshold above which the regulator will begin investigating insiders’ dealings. Individuals with less truthful information – being less capable to foretell the scale of the stock price changes resulting from their dealings – will be more possible to trigger the investigations and be prosecuted on the basis of circumstantial evidence. When law relies on statistical evidence to discover and prosecute insider trading, as it is mostly the case today, the number of people who are prosecuted will consist basically of parties who have traded on the basis of inaccurate information.

Insider trading can take a passive or an active form. An insider trading takes place when a person has used of information not available to the public to make a decision regarding a securities deal. If a person in possession of inside information decides to abandon a securities deal, that is, not buy or sell shares, technically, he/she is liable for illegal insider trading since his/her decision was made on the basis of inside information. Since

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 significant number of Phoenix shares and tipped off a number of his friends.


there is no trading involved and so stock price change per se even though there is
decision, this type of insider trading cannot be detected.

Inside information does not have any objective predictive power or objective value and
so information is always subject to individuals' subjective interpretations, which vary
with parties' understanding and knowledge. While insiders have technically an
information advantage by holding information not yet available to the public when they
are making their decision, the triumph of their prospect is conditional upon the other
market parties' interpretations regarding the information but market participants might
not react in the expected way. Consequently, information is a subjective concept and the
result of insider's decision depends on other market parties' interpretation and resulting
decisions is an obstacle to the efficacy of the regulation of insider trading. Thus, while
the insider has broken the law, the regulator will not collect any sign that could help him
to conclude that insider trading has occurred.

This concise examination shows that due to the character of the information and the
network of people that could be involved in circulation of inside information shows that
the antidote could be a mechanism for the prevention of inside information getting out of
the company undetected or in case of a leak the quick-even instantaneous -revelation of
the inside information to the public. This author thinks that the establishment of logistics
of information in the company in relation and in connection with the establishment of
logistics of information in the stock exchange and the SEC creating a networking of
logistics of information will be the antidote against insider trading and market
manipulation concerning the governance of information which is the basis and the
weapon of insider trading. The development of a network of logistics of information will
make possible the just in time arrival of information to the market eradicating in nearly
an absolute degree the time advantage of any person wanting to get involved in insider
trading. Logistics of information will govern the informational picture of the company.
Additionally logistics of information should achieve the goal that information will reach
on the right time and the right speed the market in order to formulate the right price of the
stock. Governance of information via logistics of information will manage to offer
information just in time to the market in order to achieve the right stock price
representing the real value of the company based on the real informational picture.

**Conclusion**

The regulation of insider trading has contributed to the success of the securities markets
by restoring the investor confidence by promising that they are not going to be "cheated
by insiders". Prohibiting insider trading enhances liquidity and decreases the cost of
equity\(^\text{107}\). As a consequence of the intangible nature of the information, insiders have
a large variety of ways to avoid the regulation of insider trading. Notwithstanding that the

\(^{107}\text{Lawrence R. Glosten, Insider Trading, Liquidity and the Role of the Monopolist, 62 bJ. Bus. 211 (1989); Utpal
Bhattacharya and Hazem Daouk, The World Price of Insider Trading, 57 J. Fin. 75 (2002).}

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regulation of insider trading does not abolish insider trading, there are some profit such as increasing investors’ confidence, increasing market liquidity, or reducing the cost of capital that result from such regulation. The achievement of absolute honesty and equal knowledge is utopia. An advantage in informational knowledge based on better analysis of information is the engine for the development of the stock exchange and in general market development. Logistics will add to information dissemination undercutting the time advantage of people wanted to get involved in insider trading. The establishment of effective network of logistics of information among companies and stock exchange-SEC is the antidote against insider trading. In tandem the company as a legal person should be liable and responsible for the effective run of the logistics of information regarding inside information causing market abuse (insider trading/dealing and market manipulation) as analysed above. Additionally, SEC and the stock exchange could be liable as well for the effective run of the network of logistics of information among the whole system of selling and buying stocks.