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Securities Regulation and Virtual Crime in Financial Markets

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Introduction

In late 1995, a French company called Accor was set to buy a U.S. company and word got out about the deal. The hot tip carried like a winter cold through nine people. Each one of them is potentially liable for the crime of “insider trading.” The Securities and Exchange Commission (SEC) promotes “fair” stock markets and any player possessing an information edge creates a problem: they are a threat to the integrity of broad securities trading. It does not matter whether that player accidentally overhears the tip in a cab or picks up a document in corporate headquarters. The lawful response to the threat is to ban their participation in the stock market.

If insider trading liability (and securities regulation more broadly) is founded on sound legal and economic principles, then that suggests pervasive and intractable crime in financial markets. James Stewart, Pulitzer Prize-winning author of *Den of Thieves*, reported that “financial crime was commonplace on Wall Street in the Eighties.”¹ To the extent that overly broad fraud prevention regulations trap people in complexity, or allow them to become political and media targets, there is virtual crime. I suggest in this paper that the alleged financial crime wave of the Eighties and by implication, many of the securities violations in the Nineties reported by the SEC are not crimes at all. They are crimes in name only, responses to threats to securities markets that either do not exist or are exaggerated.

Today’s panel is “Black Hole Economics: Throwing Good Money After Bad Regulations.” The theme is that when government pursues wrongheaded objectives, it sometimes creates more serious problems than those it was trying to solve do. In many cases, that leads to a vicious circle of even more regulations and increased public spending. In this paper, I argue that market controls lead to more regulations and an increase in the intensity of the enforcement of those regulations, leading to greater budgets, yes, but more important, to unforeseeable market distortions.

Specifically, the wrongheaded insider trading laws are part of the control valve on the flow information between investor and firm. Related laws vary the flow of information too, such as those against stock parking, manipulation. Other laws and administrative edicts promote disclosure and transparency. These interventions, though wholesome sounding, create micro-level

inefficiencies (some firms will lose access to capital, for example) and macro-level hazards (contributing to bubble economies by inducing ignorant public investment).

What goes down the black hole is partly the energy and effort spent chasing phantoms, but also the money and wealth lost when real risks are distorted in securities markets. The case against Michael Milken is instructive: did his banishment from the securities industry enhance capital formation or did it make market participants rest easier?

Part 1: The Virtual Crime of Insider Trading

Corporate managers who engage in self-dealing and confidence men who bribe and swindle should not be confused with financial innovators who discover knowledge and market savvy analysts who take quick advantage of profit opportunities. Perhaps the most dangerous aspect of the vague set of restrictions on so-called “insider abuse” is that it confuses plain securities fraud and property theft with the legitimate use of knowledge that is created within and made useful by a firm. In the confusion, the SEC and other policing agencies have self-expanded their role, acting as federal law enforcement officials governing the proper uses of corporate property. They have treated as criminals those who use nothing more than insight to outmaneuver competitors.

SEC enforcement techniques over the last two decades have helped to obfuscate the distinction between economically legitimate versus criminal action. They first “marinate” their prey by continually releasing press announcements on new investigations of executives (at companies such as Accor and Lotus in the 1990s) and then fry “big fish” in highly publicized cases (such as Ivan Boesky and Michael Milken in the 1980s). Popular books about the Eighties drew the spurious correlation between enforcement intensity and the gravity of securities law violations. In turn, public prejudices were reinforced about corporate managers, businessmen and financiers. Market integrity is fleeting, under the SEC worldview, and hypersensitive to the lure of easy money and profit. To accept popular accounts that tend to take the SEC’s complaints at face value is to accept that securities markets by their nature are somewhat corrupt.

¹ *Den of Thieves*, jacket, and page__

Capitalistic rivalry is often high-pitched conflict and the financial world is dependent on trust and reputation for its smooth functioning. Thus business, like many types of communities, and despite its hardball tactics, ultimately relies on self-regulating principles. Counterparties are sovereign in the sense that they dictate terms of trade. They can buy and sell features of trade, such as risk management, in the course of trade. In many contexts, counterparties can contract out to third parties and purchase more risk management services, such as monitoring for compliance. The SEC is one such third party whose risk management service (identifying securities frauds, which is one of several) is a legitimate specialization. By stepping beyond fraud into the stream where trade information flows between counterparties, they dam up the information trade. The artificial raising or lowering of costs of doing business is the first stage of malinvestment. When real risks are distorted because of extensive malinvestment, conscientious self-governance is weakened.

Simply put regulation crowds out reputation.² Into that vacuum is the need for more risk management. Thus the vicious circle: controls on information have unintended consequences on the trade in information and that in turn lead to more controls to ostensibly better modulate the information. Extending regulation requires the right tool, namely, wider, discretionary power perhaps paid for by public spending or by cost impositions on the regulated industries.

In a typical case of insider trading, someone violates an employment contract by telling outsiders confidential information. They have committed “fraud-on-the-source” of information in the legal jargon. If the SEC or its equivalent were limited to enforcing employment contracts—searching out and arresting individuals that exchanged their employer’s property for suitcases full of cash and for those who supplied that cash—then there would be no controversy. The Ivan Boesky case is instructive because he legitimately sought and found information about the intentions of acquirers in future takeovers. But also (as the evidence indicates) he paid for private client information by bribing Martin Siegel of Kidder Peabody and Dennis Levine of Drexel Burnham Lambert.

Siegel and Levine inappropriately used corporate property (and had they been authorized to use it, there would be a different story). Ivan Boesky bought information that was not authorized and therefore was required to give up the gains and accept punishment. The general public views both

Boesky activities (the legitimate arbitrage during takeovers and bribery of employees) as morally tainted. Boesky made a deal with prosecutors that lead ultimately to prison time and conclusively ended his career. That deal sealed the public perception that Boesky’s underlying business was corrupt by nature when it was in fact one part standard business practice and one part crime. The fine distinction between the two was lost on the general public and the Congress when hostile takeovers and debt financing was almost regulated into oblivion (see part 2 for more details).

Neither the SEC nor the Congress is content to limit the scope of potential abuses to definable and understandable actions such as bribery. That would be too narrow. To protect investors, they go after anyone who, broadly speaking, abuses their advantage. This is where the agency crosses the line, because there is no reason to exclude people from the market for the reason that they affect the market from an advantageous trading position. It is one thing to exclude, for instance, Levine and Siegel from participating in securities markets. They are proven thieves and would have difficulty in a reputation-based industry with or without SEC sanctions. It’s another to exclude them or people in their positions because they move the market with special insight. There could be times when an investment bank and its employees receive authorization to purchase stock in potential targets of their clients. And it’s another thing to exclude an arbitrageur (like Boesky, but with no felony criminal record or intent) because by they use special information to make profits. In hostile and friendly takeovers, special information affects the balance of economic power between acquirer and target.

Perfect Competition

What is the rationale for constraining trading in securities by insiders who clearly have an information advantage? The SEC’s goal has been explicit from the beginning: following the scandals of the 1930s, their role was to “restore legitimacy to Wall Street’s essential function of channeling investment capital into enterprise.”³ The core principle, developed over time, is that anyone who participates in the stock market should have an equal opportunity to trade with others. As one SEC commissioner put it (in 1988), they intend to enforce “equal opportunity in

² Alan Greenspan, From *Capitalism: the Unknown Ideal*, 1960

³ Roe, *Stong Managers, Weak Owners*, page 35, quoting Thomas K McCraw in *The Public and Private Spheres in Historical Perspective*, in *Public-Private Partnerships* 31, (Harvey Brooks, et al, eds) 1984

information.”⁴ To make a true market, all players should be equal “outsiders” and there should be no “insiders.” Whether the market is called a “level-playing field” or “fair trade” or “perfect competition” the point is the same. The perfect securities market is one where each market participant knows neither more nor less than any other participant. In short, a market works best when it is devoid of human characteristics, like knowledge, motive, energy, enthusiasm, disposition, alliances, camaraderie, and institutions. If any of those human factors are present, the market is imperfect.

The man on the street boils it down to this: players in the market who know more than others ruin the market for everybody else. This view of the world was nurtured in the populist 30s when anti-Wall Street hysteria was high. It was popular then to believe that people from big investment banks ruined markets for everybody else by virtue of their knowledge and “inside” position. The popularity of that belief has never slumped. In very broad terms, the absence of an equality of knowledge (or access to information) between parties to a trade (called “asymmetry” in the jargon) is viewed as a market defect. Such imbalances in information are often viewed as a moral affront. The conception of the market—any market—as suffering from a genetic disorder explains how corruption in financial markets could be so widespread. Profit-seeking insiders by their very nature will exacerbate the inherent inequalities of power and asymmetries of knowledge.

To be fair to the economics profession, not all schools of thought, or even economists within the different schools of thought, subscribe to this extreme form of perfectly competitive markets. Indeed, the New Palgrave essay on “Perfectly and Imperfectly Competitive Markets” by John Roberts states the following very early in the essay (the 4th and 5th sentences)⁵:

“[E]conomic theorists seem to be increasingly of the view that something like imperfect competition is the fundamental idea, in that perfect competition should be justified by deriving it from models where imperfectly competitive behavior is allowed and, in particular, agents recognize the full strategic options open to them and any monopoly power they have. This view has led to a large volume of work over the last twenty-five years that, for the most part, suggest that perfect competition corresponds to an extremely limiting case of a more general theory of markets.”

⁴ Bainbridge, Steven M., *Insider Trading Regulation: the Path Dependent Choice between Property Rights and Securities Fraud*, February 1999,

⁵ *The New Palgrave: A Dictionary of Economics*, 1987, “Perfectly and Imperfectly Competitive Markets”, John Roberts, (see paper back volume titled Allocation, Information and Markets, 1989).

In other words, market theory has been misconceived for the better part of a century. These statements reflect both the common sense of the economics profession (which over time will throw out poor theories) and a return to insights of the Austrian tradition of Mises and Hayek. The starting point of competitive market analysis in the Austrian tradition is that the individual, with unique knowledge and position, engages a discovery process. In this framework, ignorance, innovation and “asymmetry” are the rules and not the exceptions. Shifting patterns of wealth concentrations are the norm in dynamic markets, not evenly distributed endowments of wealth where liquidity is a constant state. The Austrian school disapproves of the theory of perfect markets because it abstracts away from the most important and interesting aspects of how markets work.

Perfect markets are the standard of evaluation in much of the journalistic account of the 1980s. The idea that financial markets are subject to pervasive “insider abuse” is evident in the writings of Dow Jones journalists Benjamin Stein and James Stewart and in the New York Times reportage of Connie Bruck and Kurt Eichenwald. It is also evident in the popular books of Rolling Stone columnist William Greider.

Both Stein and Stewart have law degrees and some legal experience. Stewart was once editor of American Lawyer. The legal profession (very broadly speaking) still embraces this theoretical framework despite trends in the economics profession noted above. Their books and articles are peppered with references to “monopoly power”, “unfair advantages”, “uncompetitive practices”, “inside knowledge”, “market movers” and “market manipulation” as if these things were instances of unambiguously malicious intent and subject to criminal sanctions. They criticize the actions of Milken and Boesky from the same impossible standard of market perfection and find no economic difference between shrewd competitive instincts and bribery. William Taylor, reviewing Stewart’s book in Harvard Business Review, called it a story of “crime without the context, excess without the economics.”⁶ I go further and call it “crime without crime.”

Fairness

⁶ William Taylor, Harvard Business Review, “Crime? Greed? Big Ideas? What Were the ‘80s About?”, Jan-Feb 1992, page 36.

Many of our lawmakers in Congress think that policies that dovetail with perfect competition models are appropriate. During the Eighties, Congress awarded the SEC wide discretion and ad-hoc rule making capabilities in 1984 and 1988 to take care of alleged problems in the takeover market. They intended to make the market fairer for the little guy and at the same time respond to constituencies that were affected by hostile takeovers. ‘Fair’, of course, can mean many different things, such as fair rules of play, which is reasonable. Insiders, by the nature of their position, are thought to not play fair. However, the Congress has never defined in law what is an unfair advantage and is never likely to do so. The appeal to fairness by the Congress has always had a specific policy implication: to protect wide participation in the market for securities (as against other types of investing or not investing at all).

Historically, the goal of attracting funds to the securities markets has always been more important than “fairness”. The Congress wanted to revive confidence in the market following the Wall Street scandals of the 1920s. In a recent story on insider trading in the *New York Times*, the record is forgotten and inaccuracy is perpetuated:

“Regulators are cracking down on insider trading not just to punish wrongdoers. They are also determined to create a level playing field, especially for the small investors.”⁷

This is not true, conceptually, and it misreads history. The SEC’s mandate to pursue all forms of insider abuse developed over time, especially in the 1960s and 1980s, and was never part of the original legislative design in 1934. Their goal is the “level playing field” to attract capital to securities markets and the wrongdoing is defined in reference to whatever unlevels the playing field. Fairness is the handmaiden of confidence and confidence is the handmaiden of cash flow to the securities industry.

The persistence of widespread insider trading is thought to unlevel the field in one way by affecting the confidence of the traditional specialist of the New York Stock Exchange. Such specialists would have to buy stocks lower and sell stocks higher (widen the bid-ask spread) to make up for the uncertainty they face when trading against potentially more informed buyers and sellers. The overall effect, according to the SEC, would be negative, since it would raise apprehension among the general trading public. Fewer people with savings would participate directly in the stock market. With less money channeled to the stock market, the public

company’s cost of raising money would go up. This is why insider trading and other means of “playing the inside game” is thought to ruin the market for everyone.

At the micro level, rules that even out the playing field are ill conceived. It is better to recognize that insider proximity is a special form of knowledge and that the anxiety and uncertainty that it produces on the outside can be priced like any other subjective factor. What is worse from the small investors’ point of view? Is it, one, *knowing* that you are trading against more informed and better-positioned rivals? Anytime you trade with a professional, you are likely to be in that position. Or is it, two, *not knowing* that there are material facts that you don’t know and cannot get in a position to know? Two, in my view, is a bigger pitfall to the small investor. There are greater dangers when they don’t know how ignorant they are. To allow small investors to cling to the illusion that insider advantages will be shaken out by persistent federal police action is to put the small investor in the position of being constantly outmaneuvered by better, more energetic competitors.

If markets can be made perfect, the SEC is right: ban insiders. If markets cannot be made perfect, then why not shape policies that recognize the chronic ignorance of investors? The materiality of different forms of information is as much in flux as prices. Many of the “little guys” choose to remain under-informed about trading counterparties. Some small investors might choose to trade against firm insiders (in a world where firms were allowed to permit its insiders to participate in the market). What is strikingly unfair is to perpetrate the notion that small investors benefit from rules that promote fairness. Rules banning insider participation do not work because they cannot work, but will serve the Congress and SEC’s purpose of attracting their capital.

At the macro level, the channeling of indiscriminate funds to investment capital is a serious malinvestment. The securities industry can and should promote its product, which is stock trading. But such federal protections for the capital market as a whole and stocks in particular can artificially divert investment savings from where it otherwise would go. The stock market boosterism can lead to mispriced financial asset values and create conditions for crisis.

⁷ *New York Times*, “Mr. Boesky Goes to Main Street,” Jonathan Fuerbringer, April 16, 1997, page C1, C6

Passive capital is notable for its agency consequences. Active investors, on the other hand, make executive management accountable for performance. System-wide passive investment is the road to massive unaccountability. To the extent that investors view market values and the liquidity that supports them as a form of entitlement, the politics that result dictate that Alan Greenspan cannot never let market confidence drop on his watch. That in turn can lead to further confidence measures and further mispricing of financial assets.⁸

Disclosure Rules and Shareholder Communication

The discretionary power of the SEC takes the form of disclosure rules. Like all other agencies, they like more of it, as if an increase in information is everywhere and always a good thing. Prior to the 1930s, investors attached importance to the reputation of the investment bank before buying new issues of stock. Thus, stock prospectuses were brief by modern standards. In the 1930s and 40s, Justices Brandeis and Douglas said that corporations should be forced to disclose information sufficient to help government identify and eliminate excess profits, whether or not investors regarded information as important. For decades, no one in government considered costs or benefits. Today, the general climate has shifted—profit is not the dirty word it was in the 1930s—and with increasing frequency, government agencies, including the SEC, consider costs imposed on companies.

Since markets became more sophisticated in the 1980s, the SEC’s disclosure rules are less defensible. The faults in the market model are more glaring than ever. For one, they fail to consider the ability of the average investor to assimilate minutiae. With the Internet, the delivery problem is nearly solved. That suggests it is time to focus on the demand side: not everybody wants or needs or can retain 400 page 10K reports. And some of the most successful investors (such as Warren Buffet) focus on a relatively small number of facts about the businesses they invest in. Two, they do not augment the abilities of aggressive and high-powered institutional investors to demand what they want from tight-lipped public corporations. The market power of large institutions is a fact of life, but an irrelevancy to the perfect competition models. Trade in information occurs whether the SEC demands that firms give it away for free or not. And three, stock valuations have grown more sensitive to portfolio considerations for a large class of

⁸ Jeff Scott, “Is the Market Too Big to Drop?”, February 1998, *The Free Market*, Ludwig von Mises Institute

investors who care less about fundamental analysis. Investor knowledge is contextual, and models of perfect competition assume that information is acontextual. More disclosure, for its own sake, does not lead to better valuation or investor protection against volatility.

Over the course of SEC history, at the same time they forced disclosure, ostensibly working to open communication, they also worked to restrain it. They attempted the impossible: to fine tune the price and quality of the supply of information sufficient to bring the knowledge and the power of the “little guy” up to that of the sophisticated market players. For years, they radically restricted shareholder communications (which has been liberalized in the 1990s) and they imposed high costs on efforts by shareholders to increase pressure on managers. The chronic complaint by various market professionals about investor-corporate communications is that there is too much information and too little. Both complaints are true. The issue is the quality of information.

The most effective shareholder communication is not the kind that the SEC focuses on, namely accounting disclosures. Accounting measures from inception were never intended for use by shareholders for the purpose of valuing companies, but were designed for creditors to value their loans in the event of a liquidation of assets. In many circumstances, the most effective shareholder communication is the kind of information targeted to select highly sophisticated investors.⁹

Consider the example of how unrestricted communication between two technology companies works to transfer important information. Fujitsu owns 44 percent of Amdahl reflecting a relationship that started in 1970.¹⁰ Fujitsu is great at basic research (semiconductor technology, optical fiber, and communications) and Amdahl is superb at the development of commercial applications for Fujitsu’s research. They are insiders to each other with respect to ongoing developments in their technology. Imagine an agency called the Technology Exchange Commission (TEC) that attempts to regulate the subtle, technical flow of information between Amdahl and Fujitsu. Instead of allowing proprietary information to pass through, such transmission is subject to regulatory intrusion and “fine-tuning.” Consider a simple intrusion in the name of national security: the effect of a ban on the export of encryption technology. That

⁹ Chew, *International*, page 197-223. Jerold Zimmerman, founding co-editor of the *Journal of Accounting and Economics*

¹⁰ Chew, *International*, page 64-5

would prevent them from securely protecting their communications via e-mail. The mutual knowledge developed under a system of government-defined disclosures and restraints would undoubtedly hinder both Fujitsu and Amdahl from making the wisest technology investment decisions or unduly expose them to theft.

The same applies to the SEC, where transfer of strategic and organizational knowledge between the corporate strategists and the institutional shareholders is restricted. Information must be funneled to the public, where the rule is either all must be informed at once or none at all. Management cannot give information selectively to anybody without going to jail.¹¹ (That is the effect of the insider trading law.) SEC rules contribute to the poisoning of the legal atmosphere of business. For example, CEOs in significant numbers report that they have been sued for statements made in meetings with stock analysts. The latest problem cited by Chairman Arthur Levitt (reported in various publications in April 1999) is the problem of selective disclosure. CEOs, prohibited from using information themselves, give it first to their favorite analysts. In return, they can receive favorable attention and delay contrary opinion that can boost the value of their stock holdings.

The mutual knowledge developed under such circumstances hardly helps investors and managers to make better investment decisions. Indeed, neither investor nor managers may be made better off. Investors will not all rise to a high level of sophistication and farsighted managers will be restrained from making the best decisions. For large scale companies that need to take huge technological risks, poorly informed outside investors force "dumbing down" (or risk aversion) leading to an under-investment in the company's capabilities. A move toward a wider, varied and targeted communication, including perhaps the signaling of the market by trading by insiders, would provide the means of crisis prevention (in the form of modulated pressure on management).

At the turn of the century, the presence of a J.P. Morgan banker on the board served this function. Such an arrangement facilitated monitoring of management performance and the evaluation of new projects. Such pressure increased the value of a company by 30 percent.¹² Following the

¹¹ Chew, *International*, page ____

¹² Mahoney, *The Exchange as Regulator*, page 14, figure from Bradford De Long

Depression, the swing into conservatism (inaugurated in part by the SEC) reduced the influence of long-term lenders on the strategic direction of enterprise. After the founder or heir disappeared, their replacement was investment institutions. Segmented financial institutions could not exercise decisive power over the firms that they could potentially serve. Thus, board of directors lost the single-minded investor viewpoint that acted as a defense against unfocused investment.¹³ In the absence of that focused communication, crisis intervention was made necessary. By the 1980s, the need to refocus the enterprise was met by Drexel Burnham Lambert and the buyout techniques that it sponsored (leveraged buyouts, friendly and hostile, using high yield debt instruments).

The Insider Trading Laws

Because the insider trading law has been so vague from the beginning—no one really ever defined insider trading—the scope of the regulation has been inconsistent. Defining the specific criminal behavior of insider trading, according to Congressman John Dingell, would be a “roadmap for fraud.”¹⁴ Any law that defined insider trading would be “underinclusive.” (Legally speaking it is a form of federal common law.¹⁵) There is not a lot of consistency in the laws from country to country. Nor is the legal concept of insider trading, such as it is, applicable to other types of markets for instruments traded on or off organized exchanges. Insider restrictions do not pertain to the bond, currency, futures, options and commodities markets, or to other asset markets such as real estate, employment, athletics or art. What is it that makes the stock market and our U.S. stock market in particular, special?

Before 1980, no one had ever been criminally prosecuted for insider trading. That year, the Supreme Court (4 of the 9 judges) suggested (in *Chiarella vs U.S.*) that insider trading laws should focus on fiduciaries of the firm. Market professionals and others, such as Chiarella, who worked as a printer of company information, are not in a position of duty and therefore cannot misappropriate information. (Chiarella was an employee, who had a contractual obligation to his own employer, but was under no fiduciary obligation to the shareholders of the company that had material printed in the shop where he worked.)

¹³ Donaldson, Gordon, “The Corporate Restructuring...” Journal of Applied Corporate Finance, Vol. 6, Num. 4, Winter 1994, page__

¹⁴ Fischel, page 59

¹⁵ Bainbridge, Steven M., *Insider Trading Regulation...*

Market professionals have the same standing since they are not trustees of the firm: they are not directors, managers or employees who have sworn an oath of confidence about company activity and intellectual property. After 1980, only such true insiders would be the objects of investigation. For a brief period, a bright line defined insider trading as crime only true insiders, that is, fiduciaries, could commit. After another period of congressional law making, uncertainty reigned again. And the most recent decision of the Supreme Court (*O'Hagan*) is also confusing to experts in the field.

One major source of complication arises from circular definitions. As the SEC would have it, a fiduciary is a person with insider-trading liability while insider-trading liability is defined as something that a fiduciary has. How can the printer have a liability if he is not a fiduciary? The SEC would not want to limit liability to only fiduciaries, unless they got to say who in fact is a fiduciary. Consider this analogy: An artist is thought to be a person who produces art while, circularly, art itself is something that is produced by an artist. How can an Elvis impersonator be an artist if he doesn't produce art? He produces only renditions of Elvis music. The ambitious art critic, who is also an Elvis fan, would not want to limit his reviews to only artists. Unless, of course, he got to define broadly who artists were, and that included Elvis impersonators. In order to do what he wants, and fulfill the needs of his editors to sell papers, he needs discretionary power to review whatever he wants in the art critic column.

The securities industry saw the opportunity that arose in the wake of the court's decision in 1980, and an interest group was born. Lobbying arms of the securities industry encouraged the beefing up of SEC enforcement in order to benefit from increased trading. If people on the inside of a firm are banned from taking advantage of the discoveries and knowledge created within the firm, if they cannot control the property which they have created, then the trading advantage does not go to the general trading public, the little guy. The securities market professionals are the next in line, and they will have the information advantage and will reap the gains.

Understanding this hierarchy of trading advantages is crucial. As Jonathan Macey has suggested, a ban on all insider trading is the equivalent of a rule requiring insiders to throw money out of a

window of the firm's corporate headquarters.¹⁶ Those who collect that money are the street professionals, not the passive and less-informed "little guy." The gains from the ban on insider trading go to the specialists who work at the stock exchange and the analysts at brokerage houses, in essence, anyone that obtains, assimilates and processes information about firms. Thus, the insider trading laws have sponsorship from a political constituency, the securities market professionals.¹⁷

Successful investing by single non-professional individuals is extremely difficult. One reason is that institutional trading dominates the market (more than two thirds of trading volume is institutional, though total ownership is still dominated by individuals). If you are going into the stock market, which is very easy to do, your investment strategy should not equate the freedom to enter the market and compete with the probability of achieving a return equal to the professionals or the Main Street insiders. Insiders (defined broadly) have a distinct advantage and will tend to earn 2 to 8 percent higher than the outsiders (depending on the time period and method of measurement).¹⁸ Outsiders, as amateurs, on average, should not play in the stock market against professionals or insiders unless they have a very high appetite for risk.

More generally, the freedom to buy is not the guarantee of a successful, moneymaking trade. Successful investing is clearly tilted toward those with means and opportunity and those that have had the foresight to put themselves near the action. The knowledge gained by professionals who invest time and effort is a perfectly legitimate basis for earning profits. Many people who invest casually know that they are too far away from the opportunities in the market that can fly by in mere moments of the trading day. Thus they participate in other ways, such as "buy and hold" investing through company-sponsored retirement investment plans or other employee-based stock purchase plans.

The main effect of eliminating insider trading restrictions would be to allow companies and the exchanges on which their shares are traded to experiment with rules of communication. They can rebalance the needs of investment efficiency and outside liquidity, and they can trade off the value of concentrated ownership against wider dispersion of shares.

¹⁶ Macey, *Insider Trading: Politics*, ...page 15, quoting Macey and Haddock.

¹⁷ What about the issue of floor traders versus their customers?

Innovative businesses are where scientific and practical knowledge is discovered, products are hatched and economic value is created. A company must achieve and preserve earning capacity—a company is nothing if it can’t ultimately generate revenues—and to do that it must be organized in such a way as to reward managers’ and employees’ performance with pay. And allowing risk-taking executives under very specific company guidelines, to participate in the market for the company’s stock can preserve the creation of wealth *by* the firm *within* the firm.

A century ago, having a J.P Morgan & Co banker as an underwriter of a firm’s securities signaled to the market buyers of bonds and stocks the firm’s new project was good. Thus, the Morgan stamp of approval lowered costs of new external capital. Insider trading in a modern context can function the same way. It can signal the approval of highly placed, sophisticated board members and executive management, allowing other participants to benefit from the insider’s superior evaluation of projects, thus lowering the cost of capital. Without such evaluation, a company might have to abandon complex internal investment initiatives, risk management programs and long-term technology projects. Allowing superior evaluation techniques to work fully is like having a Morgan banker. The information that flows between investor and executive management is “smarted up.” High level information, through various stages of digestion, can be fully consumed by all shareholders. This is particularly important in the context of panic selling, in Morgan’s time, where insiders are allowed to express their confidence in the future by stepping into the outside market for shares and buying.

Most people believe, mistakenly, that widespread insider trading implies widespread corruption, that it would be a disaster for firms and for the market if the blanket of protection were lifted. This is not a reasonable fear. A public company that wants to allow its insiders to trade, at worst, gives up some of the “outside” participation in the market for its stock. Some economists argue that there would be no change, pointing to Japan and Hong Kong, which are “insiders paradises” but where outsiders participate enthusiastically. But assume the worst. One result could be that fewer and better-informed people would trade in the stock rather than more and less-informed average investors. The cost of capital rises when there are fewer outside investors but falls from the actions of the selectively informed, lead investors who can signal approval to outside

¹⁸ Source?

investors. This is little different from J.P. Morgan a century ago, who gave up the lure of liquidity in order to exercise judgment and control over strategic direction.

Wider trading in a stock has always been assumed to be better trading, and people who watch nightly business reports are likely to be lulled into the sensibility that thin trading is somehow weak, unhealthy trading. Liquidity, of course, is critical in the formation and vitality of securities markets for junk bond and mortgage-backed products. However, beyond a certain point, its disadvantages can outweigh its advantages. The view that the widest possible trading is best serves the parochial interests of those who make markets in stocks and whose livelihoods depend on trading with an advantage over the “little guy.”

The advantage of wide liquid markets is that they make buying and selling easy. That is good for individual stock buying and portfolio management strategies. It makes risky investment decisions easily reversible. Liquidity can support asset value, but it is not the ultimate source of the value. Faking trades in a stock to boost its liquidity, and therefore its marketability, is illegal, and rightly so. But when the federal government boosts overall liquidity that ultimately trickles down to individual stocks, it is called market confidence. It has the same effect as faking trades.

The market itself is not liquid; the securities in the market are liquid to one degree or another. The mistake is thinking that value comes from top down rather than from bottom up. Peter Bernstein reminds us that somebody has to **hold** the security.¹⁹ Somebody has to do the research and homework. And the function of the security holders (as distinct from the buyers and sellers) is to exercise some judgment and influence the direction of the company they hold. The action of buying and selling conveys knowledge (about market expectations, for example) and creates knowledge (about prices, volumes, volatility, etc.). But the market isn't a hall of mirrors, with everybody watching what everyone else is doing to know what they themselves should be doing. There are fundamental facts of reality that must be discovered and disseminated. Such knowledge is set on the ground of something real: a company, a project, a person, or a product. The ultimate influence of holders on firm direction will depend on the proportion of their stake, the condition of the firm and several other factors.

So while the liquidity created in the market by the stock exchange professionals is a value-enhancing service, it is not a stand-in for knowledge about the real underlying conditions. The knowledge about market sentiment that is created by the actions of buying and selling is not all the relevant knowledge. Large groups of buyers and sellers can be ignorant or simply wrong. Some traders are able to read the changes in general market sentiment and understand popular misreading of facts. People who trade stocks in the market partake of market liquidity but by doing so, they do not reduce the need for somebody, somewhere, to do the homework, to study the firm, value it and judge its prospects. There is no inherent inferiority to the non-liquid markets that involve subtle, complex knowledge brought to bear in negotiations over assets like real estate, athletes or artist properties.

Wide liquid markets have important unintended consequences. If scattered shareholders cannot understand complexity and if managers cannot be rewarded for what shareholders cannot understand, firms must abandon some long-term technologically complex projects.²⁰ Under such circumstances, the less informed shareholders are harming the more informed (or potentially more informed) shareholders. If stock prices ultimately reflect expectations, then it makes sense from the shareholders point of view that the wisest and more informed expectations should drive those values, rather than the alternatives: the misinformed, the uninformed or the “irrationally exuberant.” When Warren Buffet buys undervalued firms and supports or installs good management, the value of the firms is realized. In this way he benefits other shareholders, which is why his trading is watched closely.

If insiders are allowed to buy stock based on a deeper understanding of the proprietary values inside a firm, they do not harm the non-insiders any more than sophisticated market specialists harm the less-informed “little guy.” The holders of a company’s stock who are not insiders benefit from the rise in the stock prices caused by better inside knowledge. In the case of a scientific discovery, the insider trading can convey information about the discovery without revealing the proprietary methods or content which constitutes the discovery. Insider trading, in this case, is a superior means of signaling the internal approval and potential success of a complex

¹⁹ Bernstein, “Dazzle...”, page 72

²⁰ Roe, page 9

research, development and investment project, since it does not give away the technical detail of the discovery.²¹

In sum, there are benefits created by the stock trading of more informed shareholders. The attempt to share information widely among all holders of the stock, even if technically possible, is cognitively impossible. Such attempts reduce firm value to the extent that complex information can not be assimilated among all shareholders. More informed stockholders, such as ace investor Warren Buffet, do not in principal harm less informed stockholders by their normal trading activity.

Another reason why it might be important to permit insider trading is related to the issue of compensation. A firm should preserve a wide array of compensation options for the employees. Insider trading opportunity—in the sense of an executive using the intangible knowledge or other property of the firm with permission and restrictions of its owners—is one way of rewarding employees. If shareholders and their directors are not free to give or take away permission to trade, or are too weak to form internal compliance mechanisms which delimit trading activity, then the shareholders must suffer by having to pay higher salaries and bonuses, by higher turnover of the company’s best people or by incurring costs borne from impermissible, unmonitored trading by its executives. The owners of the firm are the owners of the products, knowledge and information created in the firm, and they must be free to assign the rights to use that information in a way that respects critical fiduciary duties and without undermining the integrity, goodwill and survival of the business.

In the case of a scientific discovery, the discoverer will have to be compensated. When earnings from the discovery arrive, they will not be paid out in full to all shareholders. A large portion of earnings is likely to be retained to compensate the executive. By inside trading earlier (buying up outside stock), he would have created information for the market: he would have signaled other investors of the internal support that he has for the earnings possibilities of the discovery. By refraining from trading due to SEC restrictions, the company’s least interested and least loyal shareholders benefit. The insider restriction encourages more trading (of the uninformed variety) than there otherwise would be relative to all trading. The SEC thus furthers the interests of

²¹ Macey, *Insider Trading: Politics...* page 46

uninformed trading against the informed (and potentially active) shareholders, their board members and firm employees. That is what they mean by “leveling the playing field.”

Consider how the most uninformed traders benefit from the SEC rules. There are three classes of stockholders: those who are holding the stock, those who are buying the stock and those who are selling.²² For the first group, the long-term holders, insider trading is irrelevant. In the case of an insider trading on the news of a scientific discovery, the long-term holders will not care. To the extent they do care, they would just as likely prefer to allow insider trading (against the non-long-term holders). That would allow the insider to reap the benefits of the rise in stock, rather than having long-term shareholders pay the costs of his deserved compensation later in the form of reduced earnings for them and additional salary (or bonus) for him. Also, the long-term holders could suffer from the replacement cost of a new executive. People on the inside who sell on bad news or who buy on good news do not affect the position of the long-term holders. The outsiders' stock value either goes down or up earlier than it would have anyway.

Some buyers and sellers benefit from insider trading. Buyers benefit if the stock is heading down from rumors of bad news and they either refrain or buy at a lower price. Sellers benefit if the stock is heading up from rumors of good news and they hold instead of selling or sell at a higher price. Other buyers and sellers do not benefit. They must buy at a higher price if good information precedes their purchase and sellers must sell at a lower price if bad information has driven the price down. Insiders are not responsible for the loss of the sellers (assuming they have done nothing to cause the bad news). In principle, the outside buyers do not have a claim to same gains as the inside buyers. Nor do the outside sellers have the right to the same reduced loss of the insiders. These two narrow class of investors, the people who bought in as events turned for the worse, and the people who sold out as events turned for the better, are the investors which the SEC protects in order to keep wide and uninformed trading active.

Insider trading laws are economic protection laws. Taking away protections will have effects. But this is like the sugar lobby arguing that if you take the sugar price support away, the cost of sugar will go up. So be it. The funds now invested in the stock market by the general public would face higher costs. Therefore, it is likely that money would flow out of stocks and into other areas

(where it would have gone into before the SEC protections were in place). There are lots of opportunities for satisfaction: foreign stock markets, real estate, commodities, collectibles, education, Hawaiian vacations, bank savings, private partnership venture capital funds, junk bonds, leveraged buyout partnerships, whatever. So be it. The stock exchanges and the stock market as a whole must compete fairly—under the law, not in partnership with the law—for investor funds. What SEC rules do is create an artificial preference for stock investing, crowding out, at least in part, new forms of capital and new businesses. The role that the SEC plays is consistent with many other government agencies. In broad terms, agencies protect the industries that they regulate. They serve their respective industries, while claiming broad public benefits.

The SEC does not serve “the market as a whole” but rather protects the position of the specialists. They outmaneuver the “little guy” and they themselves tend to be outmaneuvered by insiders (whether such trading is within existing legal bounds or not). The insider trading ban does not serve the interest of the market as a whole since it tries to freeze out superior market competitors. When you exclude people because of their position, insight, knowledge or opportunities, the market as a whole is not protected but undermined. The SEC protects the ignorant, preserving the status of the underinformed, short-term buyers and sellers. Thus they promote ignorance, allowing this class of investors to ruin the market for everybody else. By fostering a market sentiment guided by whimsy rather than wits, or “irrational exuberance,” rather than grounded expectations, the SEC undermines the objectivity of public market values. Insiders, properly understood, would reduce investment risks in the market as a whole. Their banishment raises risks, particularly systematic risks.

Thus the Congress’s economic regulations have achieved the opposite of their intended effect. Like the subsidy and support provided by the federal banking agencies to S&Ls and banks, the SEC has sown seeds of its own industry’s destruction. And government-created bubbles, as we have seen in recent history in developed markets such as Japan and many emerging markets, pop fast and furious.

In theory, the SEC is not that mysterious. It controls business speech between investor and firm. It claims public ownership of the means of transmission. Its assignment to control information

²² Reisman, George, *Capitalism* page 395-6 and Jonathon Macey, *Insider Trading*

between shareholding investors and corporate managers is a failure by any reasonable measure. No one has ever known when financial news is public.²³ And recently they have had to tackle the problem of corporate managers calling their favorite analysts first. Having first banned the insider from benefiting from inside information, the insider simply gives the property to his preferred analyst.²⁴ Will every future investor-manager conversation require an SEC chaperone? Even under the technological advances of the Internet, the timing of release of information is still a hopeless quandary for regulators, which should suggest to them that the problem is conceptual, not technical.

The SEC forces the over-reporting of minutiae which is stale by the time it is reported and it causes under-reporting by restricting the subtle, complex flow of proprietary information. The huge growth and sophistication of market professionals ensure that relevant information is transformed into public market prices, but restrictions on shareholder communications squeeze the pipeline through which the most relevant information must flow. While the ideal of fairness purports to equalize all classes of investors at the high, informed level of trading, eliminating the uninformed traders from the market through disclosure, in fact it promotes the opposite. By removing informed traders and promoting uninformed traders, they work in the direction of a low, dumbed down, equal yet "perfect" level of uninformed trading. They create a level of security experienced by S&L depositors in their brighter days.

To summarize, the SEC is a regulatory agency that responds to a constituency. The stock exchange, the stock market makers and the investment bank trading units benefit from trading, and the more that trading is perceived to be fair, the more the general public will trade in stocks. Investment banks and the organized exchanges do not want the public to believe that the market could be uneven or rigged any more than food companies want the public to believe processed food is tainted. Thus, the Congress and the SEC have developed and enacted economic regulations; a protective blanket designed for economic effects, intended to keep as much of the general public's trading activity on the exchange floor. That keeps trading within the domain of

²³ see *New York Times*, Viewpoint column in Money and Business section, Ted Pincus, "When News is in the Timing" September 7, 1997

²⁴ "SEC Considers Tightening Company Disclosure Rules" Melody Peterson, *New York Times*, March 17, 1999, page C2.

the major exchange and the SEC's purview. Under the guise of protecting the interest of the public, it protects the competitive position of the industry that it ostensibly monitors.²⁵

Part 2: The Virtual Crime of Stock Parking

In takeovers, insider trading restrictions are paradoxical. The trading that occurs on the basis of new information takes place not inside the firm but outside it. A bidder of a targeted company is in competition with the incumbent managers. In preparing for a takeover, the bidder (say, a leveraged buyout firm such as Kohlberg Kravis and Roberts (KKR), working in conjunction with investment bankers at Drexel) has evaluated the company. The bidders are prospectors of potential values. The early stage of a takeover attempt is the act of discovering how a different course of management action could change the company's fortunes. Thus, an LBO firm like KKR is in the business of creating knowledge. The very act of casting a bid directly to the shareholders requires the employment of proprietary, material nonpublic information. KKR and Drexel, in this example, are the first to uncover the hidden value. They learn, for instance, how poorly a conglomerate is being managed or how new capital and organizational forms might be more suitable for a particular firm. They apply valuation techniques to price a competitive bid.

How do arbitrageurs fit in? Do they exploit or assist this process? Is their function to steal information or to make most effective use of an intangible asset? Arbitrageurs watch the market. They employ the rumors that they have heard or induced, suggestions that emanate from financial media, investment bank analysts, and of course, in rare cases, from bribed employees of law firms and investment banks. Arbitrageurs begin to buy up the target company's stock on the expectation of a takeover deal in order to get stock out of the hands of outsiders and closer to the hands of potential future insiders (the bidder).

The arbitrageur is middleman between the bidder and the existing shareholders. He trades on rumor with uninformed shareholders. Shareholders as a group cannot on practical grounds be uniformly informed of the value of a bidder's intended course of action. Thus, he hopes to get paid for moving the money from passive holders into his own active hands where in turn, he will make it available in large blocks to the bidder. In most cases, the more they know, the smoother

²⁵ Macey, "Agency Obsolescence..."

the deal will go. Arbitrageurs, remember, have been condemned for making takeovers go *too* smoothly, for actions which build economic value, not for gumming up the working of finance. Arbitrageur success at moving money earned them the reputation for being “in it only for the money.”

By using information, arbitrageurs fulfilled an important function. They assisted in concentrating the power of ownership in order to overcome the powerlessness of dispersed ownership (a collective action problem faced by widely dispersed shareholders). Such power was crucial to the successful implementation of a takeover. The source of that power was the exclusive use of information created by or for the bidder *or* the assigned use of that information by agents such as investment banks and arbitrageurs. The attempt to restrain arbitrageurs by expanding insider trading restrictions in the 1980s to protect the alleged abuses of shareholders was a deception. Congress wanted to throw a monkey wrench into the gears of takeovers, and the SEC obliged. To offer a less charitable interpretation, they were only in it for the power.

SEC insider trading policy for arbitrageurs is bizarre. They are tippees whose tippers willingly tip in order to fortify their bids. The long-term target company shareholders should welcome this activity on both efficiency and profitability grounds. When applying insider trading restriction to ostensible outsiders, the SEC built an absurdity into the law: for an arbitrageur, trading on the rumor of a bidder’s intention to buy a target company is legal, but trading on full information is illegal insider trading. The arbitrageur is acting illegally, in the vague words of the statute, using or employing information, obtained deceptively “in connection with the purchase or sale of any security.” The arbitrageur hasn’t committed classical insider trading (from the inside), but has “misappropriated” information, taken information and used it for profit. That is, in brief, the expanded theory of insider trading, called misappropriation. It is the use or employment of a “deceptive device...in connection with” a securities transaction. In fact it is another application of the “level playing field” ideal: if you possess a mere rumor, you don’t tip the balance of the market between bidder and target. But if you, the arbitrageur know for fact that a takeover is intended and likely, you will want to get in early and tip the “balance” in favor of the bidder who will buy the stock from you. Thus, the “level playing field” is upset.

What then, did Michael Milken and his junk bond market have to do with insider trading laws? Nothing. The charge of “insider trading” against Milken, who traded junk bonds primarily, is so vague as to be meaningless. Generally, it means that Milken had a great deal of control over the junk bond market, that he was in an “inside” position as a trader and allegedly “abused” that knowledge. Or more narrowly, it can mean that he dealt with other insiders such as Thomas Spiegel (Colombia Savings and Loan executive) and was involved in thrift industry “insider fraud and abuse.” These charges against him that had wide currency in the late 1980s and early 1990s are nearly incoherent.

Though its definitions of crimes are mutable, the SEC’s jurisdiction over the securities market is narrow. Thus, investigators could not examine Milken’s High Yield Bond Department in Beverly Hills except indirectly (for instance, by looking at the convertible bond traders, whose products could convert to stock). How did they get a foothold if not by insider trading in stocks?

Insider trading is not the only vague offense subject to wide differences of definition and application. There are others that can be drawn from the SEC’s conceptual framework of the market. As discussed above, you can’t have insider trading (you can’t have more informed buyers) because more informed buyers have too large an effect on the price. And by their definition of fairness, they want to make it illegal to have or to create an unfair advantage. Restrictions on stock manipulation serve a similar purpose: you can’t have one buyer or seller having too large an effect on the price (all participants have to affect the price roughly equally, and no one trader should “manipulate” it). Manipulation, of course, includes the possibility of fraud, and indeed some stock manipulation schemes are fraudulent. Another means of forcing the market to the ideal of perfect competition is to prohibit parking or warehousing.

Here’s how stock parking offends: a true perfect market can’t have one trader with too large a stake because that trader will have too large an effect on the price. Parking is a favor. Alan asks Bill to purchase and hold some shares of stock for a while until Alan repurchases it, without disclosing that Alan is the “true” owner because Alan alone exercises the trading decision. Bill is Alan’s warehouse or parking lot. Parking defeats the competitive ideal of wide, dispersed ownership by hiding (by failing to disclose) *concentrated ownership*. Stock parking accounts for the lion’s share of charges against Milken and Drexel.

The prohibition against stock parking is related to the ban on insider trading by arbitrageurs.

Consider this excerpt, from the 1996 edition of a business law and regulation textbook:

“On first examination, stock parking seems an innocuous and harmless practice to maintain confidentiality. In most situations, it is perfectly legal to withhold one's identity in an effort to maintain privacy. However, the securities laws require identification of stock holdings because they often signal future changes in corporate control. Therefore, parking becomes illegal when it is used to hide the identity of a potential takeover bidder from the corporation's management, other shareholders, and the stock market. Stock parkers have been prosecuted, even under criminal laws, with greater frequency because parking is a first step in some stock manipulation schemes. It may be unethical because obscuring the identity of someone accumulating a corporation's stock provides an unfair advantage in a takeover attempt. The Williams Act declared that takeovers should occur on a ‘level playing field’ without advantages held by the bidder or by incumbent management. Without this balance, the bidder or the managers could take an unfair advantage of shareholders' ignorance in a surprise takeover attempt.”²⁶

Stock holders, under the protection of the SEC, following the policies of the Congress, are prohibited from being surprised by an anonymous investor group that offers them a higher price for their stock. An investment bank or LBO firm that tips someone to anonymously accumulate stock “unlevels” the playing field. An investment bank, working for a buyout firm, with a 5% stake, can tip an arbitrageur to buy and hold another 5% stake is guilty of two “economic” crimes. The arbitrageur as tippee is an “inside trader” and the investment banker is a “stock parker.”

Buyout firms and takeover artists and their investment banks perform a vital function. The way that they do that is to accumulate large blocks of stock, sometimes without anonymity, but other times, with anonymity. Secrecy is achieved by requesting their associates or other friendly hands (anyone eager to sell) to “hold,” that is, park, the stock until the time is ripe for a bid. In the 1980s, investment banks raised money in the junk bond market and gave a perfectly legitimate competitive advantage to bidders. That advantage could be augmented by the means of parking. Essentially, that means creating large pool of funds that can be mobilized and consolidated very quickly. The SEC’s regulation prevented an economically rational action (parking large blocks of stock into friendly seller hands for a buyout attempt) in favor of economically irrational action (keeping the stock ownership widely dispersed, which raises the cost of the bid to the buyer) in the name of “fair” trade. The “level playing field” is defined as widely dispersed stock holding.

In their notions of fair trade and level playing, the underlying assumption is that takeovers are bad. (In passing, it's notable that the SEC was never explicitly given the power to regulate takeovers.) Laws against the means of putting together takeover finance packages raises the cost takeovers first and then over time raise the costs of crisis intervention and prevention. Stock parking restrictions and other state laws that were passed against the use of junk bonds were directed at Drexel because of their instrumental role in takeover finance.

Such laws transfer benefits from shareholders to managers by allowing managers to extend the unprofitable life of the company. Lost in discussion of level playing field is that buyout artists perform the vital function of rapidly redeploying the assets of uncompetitive firms. The longer that an offer stays open, generally, the more advantages accrue to the incumbent managers and the less the overall economy benefits. Stock parking restrictions raise the risk and cost of the bidder's offer by artificially extending the life of the offer. Stock parking rules, as noted in the textbook passage above, have the same intention of the Williams Act of 1968. That act was passed to stop the wave of weekend takeovers. It said, among other things, that cash offer deals must stay open 20 days and that accumulation of over 5 percent ownership must be disclosed. Parking restrictions serve a similar function. All stock that is controlled (or controllable) by the must be controlled as stated, not by surrogates (i.e. no stock can be “parked”). With the availability of junk bond funding in the 1980s (which had wide, deep and frequently anonymous participation), much of the “level playing field” intention of the Williams Act was rendered useless.

How, and in what manner, and on what “playing field” should companies, their management and their assets be bought and sold? Consider the previous wave of takeover activity. Nicholas Brady, working for Dillon Read, was considered one of the top mergers and acquisitions specialists of his generation. In the 1960s, he managed a restructuring program for General Mills, helping them to acquire forty-five companies in eight years. This was a case of a large, well-financed company taking over smaller ones. There were few leaks (Brady “didn't shoot his mouth off” according to a colleague), no need for speculative capital (high yield bonds), and subsequently little role for takeover arbitrageurs (to accumulate blocks of stock to facilitate the takeover transaction). These

²⁶ *Irwin's Legal & Regulatory Environment of Business* by F. William McCarty & John W. Bagby (3rd ed.1996) Richard D. Irwin, Co (see <http://www.smeal.psu.edu/mando/courses/blaw445/ch15ans.htm>)

takeover targets were small, dispersed and politically unorganized. They couldn't fend off the wide, deep and private cash reserves of General Mills working with Dillon Read.

But in the 1980s, as new forms of takeover developed with the help of junk bonds and takeover arbitrage began to grow, the functional importance of anonymity grew. Stock parking was a means of achieving that. The rules against stock parking reflect incumbent management's abhorrence of anonymous takeover pressure. The general threat of takeover by Drexel could not be relieved fully by the tools available at the Federal level. State law reacted to the pressure blatantly by passing laws favorable to home state constituents. At the federal level, the response to takeover pressure was subtle. It was thought prudent to restore the unwritten rules of buying and selling companies during Brady's generation: no use of “junk” debt to replace bank debt, no use of inside knowledge by arbitrageurs like Boesky to accumulate stock in friendly hands, and no stock parking by takeover artists. That is, in the 1980s, you can't use surrogate owners to achieve virtual anonymity. If you don't have the private cash reserves of a General Mills, you cannot form a capital reserve that serves a similar purpose.

The anger of the establishment toward hostile takeovers was conveyed in several ways. Junk bonds were an obvious lightning rod, as was insider trading (however vapoiously defined). So too was anonymity. Stock parking was one means of achieving anonymity. Drexel's “blind pools” of money that stood behind its “highly confident” letters was the primary means of enabling the fearsome, anonymous money raising. And the means of fighting anonymity, if you are a takeover target, is to get your state representative to introduce protective laws or lobby Congress to pressure the SEC to expand the bounds of an ill-defined infraction, stock parking.

The discovery of the technique of parking pointed journalists (with legal, not economic backgrounds) like James Stewart to the conclusion that “financial crime was commonplace on Wall Street in the Eighties.”²⁷ But there is an alternate explanation of the “commonplace” crime he reported. SEC Commissioner Edward Fleischman, appointed under Reagan, wrote an open letter to President Bush (shortly before he resigned in 1992) that was critical of the SEC's agenda. In that letter, he quoted another Commissioner from an earlier era, who opined that instead of

²⁷ *Den of Thieves*, page__

bright and clear lines, “uncertainty surrounding the limits of the law is desirable because the ‘crooks’ can never be sure when they have overstepped the bounds.”²⁸

²⁸ Fleischman, Edward H., “Dear Mr. President”, page 15, JACL _____

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