3-19-87 **REVIEW & OUTLOOK**

The SEC's Fight With Itself

Everyone is worried about where the Securities and Exchange Commission's "insider-trading" cases are headed. We've warned that the vague definition could be used to punish anyone who has more information than someone else, a recipe for market disaster. We're not alone. The people who best know the mind-set of the agency's lawyers are the SEC's economists. And they are going public with their horror over the SEC's enforcement strategy.

The Office of the Chief Economist last week presented the lawyers down the hall with a study titled, "Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?" The economists warned that busting arbitragers and bankers shouldn't be used to chill the legitimate market for information. Market anticipation of takeovers, reflected in price rises before tenders are announced, is almost entirely based on factors aside from illegal insider trading.

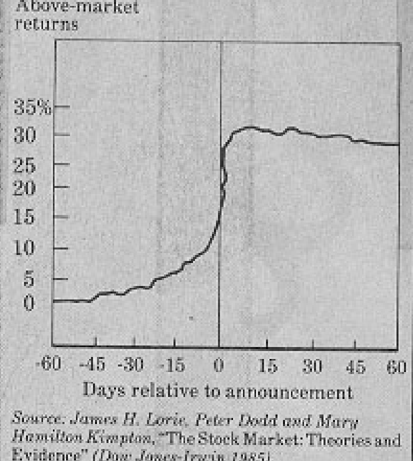
The study was aimed squarely at SEC legal chief Gary Lynch. In the name of "equal information," Mr. Lynch has said he'll go after insider trading until there is no more run-up in share price before the announcement of a tender offer. Gregg Jarrell, who was the SEC's chief economist until he recently left to teach at the University of Rochester, told us he warned Mr. Lynch that run-ups do not necessarily mean insider trading. "When Gary sees the price creep up, he sees evil," Mr. Jarrell says. "I see the ferreting out of valuable information as a sign of the efficient market."

Dormant conflicts within the SEC erupted with this study. The enforcement division managed to block publication of the study's planned appendix titled, "The Law of Insider Trading." Written by Jeffry Netter, a lawyer on the economics staff, the appendix began, "The legal definition of illegal insider trading is somewhat ambiguous." It went on to say that "what should be remembered at the outset is that most trades involving asymmetric information do not violate insider trading laws." This was too hot to handle because it showed that the SEC's flat-out attack on "nonpublic" information is legally groundless.

The study the SEC actually allowed to be made public supports the economists' view. The report identified three major causes of pre-bid trading. These are rumors reported on the Dow Jones ticker and in this newspaper, the size of the bidder's "foothold" acquisition and whether the takeover was hostile or friendly. A study of 172 big takeovers between 1981 and 1985 showed these factors led to a run-up before the formal bid of nearly 40% of the premium price.

This was not surprising. Consider the following:

Above-Market Returns on Shares Of Target Firms in Tender Offers



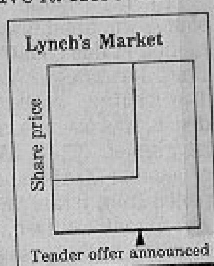
Source: James H. Lorie, Peter Dodd and Mary Hamilton Kimpton, "The Stock Market: Theories and Evidence" (Dow Jones-Irwin 1985).

This graph shows the average run-up before the public announcement of tender offers between 1962 and 1978. This ground-breaking study by efficient-market, random-walk economists at the University of Chicago jibes completely with the more recent findings of the SEC economists.

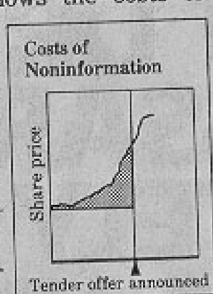
The following graphical bird's-eye view shows the mischief of Mr. Lynch's aggressive stance against information:

The Efficient Market. The price movements of a hypothetical stock shows how depressed share prices rise as traders learn that a family that owns a publicly traded company has begun to bicker, or see heavy trading on the computer tapes. By the time the raider reaches 5% and files its 13D with the SEC, the market understands something is going on. The price keeps rising until the bid succeeds or is dropped.

Gary Lynch's Market. Compare this with the market as Mr. Lynch would apparently have it. Here the enforcers at the SEC have accomplished the goal of takeover bids taking the market completely by surprise. Equal information means no information. No one learns any information before anyone else, even through legitimate research. The share price is flat up to the announcement of the tender offer. The 90-degree angle shows the perfect absence of market forces to point to the true value of shares.

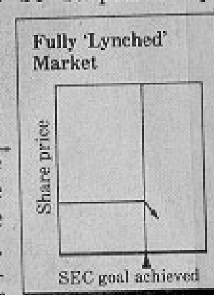


Costs of Noninformation. Overlaying the efficient market with Gary Lynch's market shows the costs to market efficiency if the SEC ever managed to end price run-ups. The shaded area measures the misallocated capital. The shares are really worth more, but no one—not arbitragers or pension-fund managers—knows it because the SEC makes knowing more than someone else an indictable offense.



The SEC economists concluded that trying to end the price run-up is dangerous. "Legitimate research gives some traders informational advantages and their earnings serve as compensation for their efforts," the report says. Their trading "aligns actual stock prices with their theoretically correct values, improving the allocation of scarce capital between competing uses."

Fully "Lynched" Market. If Mr. Lynch is serious about equal noninformation, he might be surprised by what he actually would get if the SEC completely chilled information gathering. Investors would flee the markets. We hope one irony won't be lost on Mr. Lynch—the downward slope of share prices would be completely vertical except that the information market would by then no longer be efficient enough to funnel even this valuable information very quickly into the market.



Mr. Lynch can assure the markets that his prosecutions won't go this far by supporting a definition of insider trading that protects all non-stolen information. Until he does, it's clear the SEC's economists have a better understanding of markets than do its lawyers.