The Efficient Market Hypothesis, Insider Trading and their relationship with today's stock markets

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The world's stock markets act as a trading place for securities. As with any market, the price of the commodity (in this case the share price) is central to the market's activities. The Efficient Market Hypothesis is an area of study directly related to the question as to how stock markets determine the price of securities traded thereon.

The information processing efficiency of a capital market refers to a stock market's ability to price stocks fairly and quickly. A recent example of the Irish Stock Market's ability to price stocks quickly was demonstrated on November 2005.

Eircom PLC (an Irish telecommunications company) had a share price hovering around the €2.10 value throughout the months of September and October 2005. At the close of trading of on 1 November its shares were valued at €2.10. On the morning of 2 November 2005 the Board of Directors of Eircom PLC publicly announced that it had received a formal takeover bid for Eircom PLC by Swisscom AG, a large player in the European telecommunications market. Within one hour of this public announcement the price of Eircom PLCs shares rose to €2.40. However, Eircom shares subsequently dropped by 36c, (15%), in one day when the Swiss Government announced that it would block any major international acquisitions by Swisscom whilst it remained a majority shareholder. What is evidenced here is the ability of the Irish Stock market to value quickly and, probably fairly, the impact of the Swisscom AG's initial bid and it's failure on the value of Eircom PLC's shares. (See Note 1).

There are three degrees of information processing efficiency, namely:

1. **Weak Form Efficiency Hypothesis** – This states that current share prices reflect all information available from past changes in the share price only.

2. **Semi-Strong Efficiency Hypothesis** – This states that current share prices reflect both:
- all relevant information available from past changes in the share price (per weak form efficiency), and
- all relevant knowledge pertaining to the share price that is publicly available

3. **Strong Form Efficiency Hypothesis** – This states that the current share prices reflect:
- all past information relating to share price movements, and
- all information that is publicly available, and
- specialist or insider knowledge relevant to the share price

So which form of market efficiency is displayed by today's capital markets?

Weak Form Efficiency
Chartists or technical analysts study past share price patterns in order to identify trends which enables future share price movements to be predicted accurately. Often

technical analysis is treated with a degree of scepticism, as there is little theoretical justification to the approach. However, statistical studies have shown that the degree of success enjoyed by such chartists far exceeds that which would be expected from a mere random approach to share valuation. Thus there must be some merit in its application. Nevertheless, in today's world with rapid advancement in telecommunication technology it is considered that share prices are capable of reflecting more than just past share price movements.

Semi-Strong Form Efficiency

Today, most investment banks/brokerages employ the services of investment analysts. The role of the investment analyst is to understand the dynamics of a particular industry and to be familiar with all the key listed companies in the industry of their expertise. This knowledge helps ensure that the investment banks/brokerages are made aware of, at the earliest possible moment the likely impact on share prices of announcements of any significant issues impacting on the industry or individual listed companies within an industry. The investment analyst's advice will then be relayed to the dealers/traders who will buy/sell shares, options and derivatives related thereto in their client's best interests.

Strong Form Efficiency

If strong form efficiency is considered to be displayed then it suggests that share prices also reflect inside information pertaining to the value of a particular share. Inside information is confidential information received which has not been announced publicly. Insider trading refers to the use of such information for personal gain. Insider trading is in its basic form is a criminal offence under Sections 108 to 115 of the Companies Act 1990, punishable by terms of imprisonment and/or fines.

Random acts of insider trading do occur in today's capital markets. A recent high profile case was that of Martha Stewart the so called 'Queen of America' who was investigated by The Securities and Exchange Commission, tried and subsequently found guilty of insider trading (in collusion with her Merill Lynch employed stockbroker). As a result of insider information, Ms Stewart netted $45,000 on a share sale in biotech company Imclone Incorporated. In 2004 Ms Stewart when found guilty received a $30,000 fine and five months in jail.

One of the most significant cases in Irish history relating to <u>alleged</u> insider trading has recently been heard in The High Court. The case centred around an allegation by Fyffes PLC of insider trading against a former director of Fyffes PLC, Mr Jim Flavin. Mr Flavin is the Managing Director of DCC PLC, a highly successful listed Irish industrial conglomerate. The case, estimated to have cost in the region of €15m to €20m to be heard, involved international experts on insider trading from the U.K. and U.S. The profit accruing to DCC PLC as a direct result of the alleged insider trading totalled €84m. Ms. Justice Laffoy ruled, in her judgement issued on 21 December 2005, that that the defendants <u>were not</u> in possession of price sensitive information at the time they sold their shares in Fyffes and as such "the dealing was not unlawful".

It is probably correct to conclude, despite some views to the contrary, that acts of insider trading are isolated events perpetrated by individuals motivated by personal greed and thus should not be considered typical of behaviour on the stock markets as a whole.

Conclusion of market efficiency and what it means to the investor

A consideration of the practicalities of stock market trading today coupled with a review of the research findings on the subject would suggest that today's capital markets display semi-strong form efficiency, in that, share prices reflect all or most publicly available information relating to a PLCs shares.

The implication of semi-strong form efficiency for the individual investor is that it is highly unlikely that one can spot a share being sold at a bargain price. This is because the markets will already have gained knowledge of, analysed this information and, the impact thereof will have quickly been reflected in the current price of that share.

In much the same manner, the likelihood of an individual investor being able to buy Eircom PLC shares for less that €2.40 following the public announcement of Swiscom AG's bid is highly unlikely as the market responded to the information almost simultaneously to the announcement.

However, an investor may take steps to help ensure that his/her investment reacts in a timely fashion to public announcements. Such an investor may employ the services of institutional investors to act on his/her behalf.

Notes
(Note1)Eircom PLCs share price can be monitored on www.ise.ie

Web Links
www.ise.ie
www.ft.com
www.courts.ie
www.newyorktimes.com