[Accounting Historians Journal](https://egrove.olemiss.edu/aah_journal)

Volume 20
Issue 2 *December 1993*

Article 4

1993

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The Accounting Historians Journal
Vol. 20, No. 2
December 1993

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INSIDER TRADING AND ACCOUNTING REFORM: THE COMSTOCK CASE

Abstract: This paper examines the hypothesis that major episodes of insider trading and business fraud promote accounting reforms. During the 1860s and 1870s, the markets for Comstock mining shares reeled from one scandal after another. Eventually these scandals emerged as a leading political issue in California. The frauds contributed significantly to the passage of accounting and financial reporting reforms in 1880. The Comstock episode has implications for modern day instances of insider trading.

Major corporate business frauds have often stimulated the development of modern financial accounting practices. Many fraudulent schemes have been associated with insider trading activities. The most important were the frauds of the 1920s that led to the reforms of the 1930s. Yet this was neither the first financial scandal, nor will it be the last. Daniel Drew, Jay Gould and Ivar Kreuger became legends as a result of their ingenious and ruthless intrigues, However, for shear audacity it is hard to surpass events in San Francisco's stock exchanges during the 1860s and 1870s. This paper describes how California's stock exchanges reeled from one insider trading scandal to another, and how the California legislature enacted financial accounting and disclosure reforms to protect the public.

The study of these early market abuses and the legislative response is especially relevant today because of the many insider trading and S&L scandals of the past few years. Naturally accountants worry about the impact of business frauds on the economy and on the accounting profession. Yet, in the long run that impact has not always been negative for the accounting

The authors wish to thank Dale L. Flesher and two anonymous referees for their valuable assistance.

profession. Flesher and Flesher [1986] showed the important contributions made by Ivar Kreuger to the development of modern financial reporting. Under similar circumstances, the FASB is currently crafting accounting reforms for the banking and savings industries. The study of San Francisco's nineteenth century stock exchanges supports the hypothesis that accounting reforms are a likely consequence of major business and securities frauds. An analysis of newspapers, corporate records, California statutes and an 1883 federal study of the Comstock are used to support the above hypothesis.

This study also provides evidence which can be used to assess the merits of insider trading. There has been a vigorous scholarly debate over insider trading since Manne defended the practice in 1966 [Manne 1966a and 1966b; Brudney, 1979; Carlton and Fischel, 1983; Manove, 1989; Moore, 1990; Shaw, 1990; Benabou and Laroque, 1992]. Manne argued that significant insider trading was a rare occurrence and that most opposition to insider trading was based on emotion rather than logic. In his view, inside trading was generally a victimless crime. He advocated inside trading as an effective means of encouraging and compensating managers for their entrepreneurial activities. Moore [1990] and Benabou and Laroque [1992] suggested that inside trading promotes harmful business practices. Of special interest to accountants is the motivation inside traders have to manipulate the stock market by making false reports about company operations. Manne [1966b, p. 149] doubted that insiders would lie very often about corporate affairs. However, on the Comstock, insiders misled shareholders at almost every opportunity.

COMSTOCK MINING CORPORATIONS

The corporate form of business was first used extensively on the West Coast in the early 1860s to finance the development of the then recently discovered gold and silver bonanzas of the Comstock Lode in Virginia City, Nevada. Corporations quickly became the normal form of business for Comstock mines. When California's first stock exchange was organized in 1862, it was for the purpose of trading Nevada mining shares [Paul, 1947, p. 298]. From the earliest days, the shares of the Comstock mining corporations were popular, but very risky, investments.

Because of its small size, the Comstock Lode could have been efficiently developed by a handful of companies. Instead, it

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was divided among thirty-five to forty separate corporations each with its own board of directors, president, accountant, mine superintendent, engineers, bookkeepers, timekeepers, shafts, hoisting machinery, and grand offices in San Francisco. This was a very inefficient system of management which was financed by the Comstock's extraordinarily rich ore and by frequent stockholder assessments.

STOCK SPECULATION

The nature of the Comstock Lode encouraged stock speculation. The district's gold and silver appeared to be randomly distributed along a narrow fault zone in *bonanza deposits* (i.e. isolated masses of extremely high grade ore). It was impossible to predict which corporation would discover the next bonanza. Yet for twenty years, one bonanza after another was discovered. Speculators purchased the stocks of apparently worthless mines and willingly paid assessments for years because they hoped to share in the next bonanza. The Comstock was more like a lottery than a business opportunity. This market was dominated by speculators; speculators are the one group that Manne [1966a, pp. 114-115] felt were sure to lose when trading with insiders. He compared it to gambling against someone who had loaded dice.

Lotteries, of course, need strong promotional campaigns. Mark Twain, a young Virginia City reporter in the early 1860s, claimed that he and other reporters were bribed to inflate the prices of mining shares. The following is Twain's colorful recollection [1871, p. 18]:

> If the rock was moderately promising, we followed the custom of the country, used strong adjectives and frothed at the mouth as if a very marvel in silver discoveries had transpired. If the mine was a "developed" one, and had no pay ore to show (and of course it hadn't), we praised the tunnel; said it was one of the most infatuating tunnels in the land; driveled and driveled about the tunnel till we ran entirely out of ecstasies—but never said a word about the rock.

While this story is amusing, it essentially involves bribing financial reporters to dupe the public into buying shares at inflated prices. This is a type of fraudulent behavior that Manne believed would rarely occur.

A VOLATILE STOCK MARKET

Stock prices of Comstock Companies gyrated wildly as new bonanzas were found and old ones were exhausted. For example, the stock of the Crown Point Mine rose from $3 per share on Nov. 19, 1870 to $1,825 per share on May 5, 1872. Between January and early May 1872, the market value of 150 mining corporations listed in San Francisco increased from $17 million to $81 million [Smith, 1943, pp. 129-133]. That bull market collapsed during May 1872. The next boom [Lord, 1959, p. 409] began late in 1874 and took the market to a value of over $262 million. However, share prices plummeted during the panic of January 1875. Mining stocks quickly recovered, but fell once more when Virginia City was destroyed by the great fire of October 1875. Soon prices rebounded, only to plunge in the summer of 1876. The last significant bull market occurred in 1878. After that the Comstock began a rapid decline from which it could not recover.

DECEPTION TOLERATED

During the 1860s and 1870s, many of the mines were controlled by stock manipulators (management rings) who devoted more effort to rigging the market and defrauding stockholders than to searching for ore. Comstock operating reports were often intentionally incomplete, misleading, inaccurate, or too late to be of value [Lord, 1959, p. 286 and pp. 316-319]. Because of these practices the mines were very poor investments for anyone, except for the members of the management rings.

Perhaps the shareholders tolerated deceptive financial reports because the lack of accurate information contributed to the volatility of the market and thereby increased the opportunities for speculation. Most Comstock shareholders were gamblers, not investors. For fifteen years, the stock market had been driven by the bonanza discoveries. Each new discovery initiated a frenzy of stock trading. Anyone could become wealthy by speculating in Comstocks, but very few speculators succeeded without inside information. It was a lottery which was exciting while it lasted.

Reform did not become an important public concern until after the last great bonanza had been discovered and the market for Comstock shares had begun its final decline. This occurred during the second half of the 1870s. Only a few small bonanzas and lower grade ore deposits were discovered after that date. For many years, the Comstock had contributed significantly to the wealth of California. When the value of the mines collapsed so did the wealth of many prominent Californians. As a result the public finally became interested in curbing insider trading and business fraud.

COMSTOCK ETHICS

The members of Comstock management rings did not hesitate to use inside information to take advantage of stockholders, and occasionally they betrayed each other. The best known example of deception within a management group occurred in 1870, and involved John P. Jones and William Sharon [Smith, 1943, pp. 128-131]. Sharon founded the Union Mill and Mining Company in 1867 and, within two years, he dominated the Comstock. Jones was working for Sharon when late in 1870 he discovered a large body of ore in the Crown Point Mine. Instead of notifying Sharon, Jones and an associate, Alvinza Hayward, quietly purchased a controlling interest in the mine. When Sharon learned what had happened, he considered battling for control of the board of trustees, but his chances did not look good [Lord, 1959, pp. 282-284]. Instead of fighting, Sharon sold his minority interest in the Crown Point to Jones and Hayward, and at the same time purchased all of the shares they held in the adjoining Belcher Mine.

Sharon gambled that the ore body would extend into the property of the Belcher. The gamble paid off. The new bonanza was one of the largest discoveries in Comstock history and roughly 55 percent of the ore body lay within the Belcher [Smith, 1943, p. 141]. Furthermore, Sharon purchased many additional shares of the Belcher Mining Company from the firm's treasury stock account. He paid only one dollar per share which was less than one percent of their fair market value! It was a common practice for mine directors to purchase treasury stock at bargain prices when the market began to rally [Smith, 1943, p. 130].

INSIDE INFORMATION

The *shut-down* was Virginia City's most distinctive form of insider trading. Whenever a new section of the lode was being explored, the miners were imprisoned underground. For many days, they would not be allowed to leave the mine and no visitors would be permitted to enter the mine. Thus, only the managers and their associates would possess inside information, thus enabling them to complete their stock deals before releasing the miners [*Gold Hill News*, Feb. 15, 1869].

The shut-down was first employed by the management of the Gould & Curry Mining Company in 1863 [*Territorial Enterprise*, Jan. 19, 1871]. This became quite a common practice in Virginia City. For example, the newspapers reported the following cases: the Hale & Norcross Mine in January, 1868 [*Territorial Enterprise*, Jan. 11, 1868]; the Imperial-Empire Mine in February, 1869, [*Gold Hill News*, Feb. 15, 17-19, 1869], and the Savage Mine in February, 1872 [*Gold Hill News*, Feb. 6 and 8, 1872]. On, January 19, 1871 the *Territorial Enterprise* reported that three mines, the Crown Point, the Ophir, and the Yellow Jacket, were shut-down at the same time.

Investors initially assumed that if a mine was shut-down a discovery had been made. As a result, stock prices would rise just because of the shut-down. Management rings observing this behavior, began to shut-down worthless mines to rig stock deals. In 1872, Alvinza Hayward and J. P. Jones shut-down the Savage Mine and began leaking false reports of a great new discovery. In San Francisco, the stock price soared from $62 to $725 a share, while underground the miners relaxed because there had been no discovery of any kind. Hayward and Jones reportedly unloaded their shares in the Savage on their *friends* [Smith, 1943, p. 88].

In order to benefit from inside information about the mines, the management rings had to conceal their stock trades. Complex systems of agents were developed to hide the identity of traders. The real names of the owners of mining shares were frequently not recorded in the stock ledgers. Leading investors developed spy systems to obtain information. However, the average investor did not have these sources. Under these conditions, the proper decision for the uninformed outsider was not to buy Comstock shares, but many continued to gamble in the market. Perhaps the government inaction was due, in part to the public's perception that outside investors were too foolish when they persisted in speculating despite knowing that the deck is stacked against them, and thus fools were unworthy of sympathy or governmental protection.

PRIVATE MILLS

Mines controlled by Sharon had all of their ore refined by the Union Mill and Mining Company, which was privately owned by Sharon and his close associates. The contracts which Sharon negotiated for himself provided very generous profits for the Union mills [Smith, 1943, p. 253]. Some mines controlled by Sharon even paid to have low-grade ore processed at a loss in order to maintain the profits of his mills. Perhaps because of the nature of these contracts, Sharon concealed his interest in both the mines and the mills.

Every management ring which could afford to construct ore mills followed Sharon's example. Many bonanzas failed to produce any dividends for investors because of this practice. For example, the stockholders of the Justice Mine had the misfortune of discovering a bonanza in 1875. However, milling charges increased more rapidly than revenues and as the value of the mine's production went up so did the assessments [*San Francisco Chronicle*, Apr. 8, 1879].

A FALSE ANNUAL REPORT

The leading management group of the 1870s was the Bonanza Firm, controlled by Mackay, Fair, Flood and O'Brien. Late in 1873 they discovered a bonanza within the Consolidated Virginia Mine which eventually yielded over $100 million in gold and silver. Throughout 1874, no one knew the extent of the big bonanza and most experts over estimated its size. However by the end of 1875, the bottom of the bonanza had been reached and the managers had sufficient data to estimate accurately the size of the ore deposit. Yet, in the 1875 annual report to the shareholders, the mine superintendent falsely claimed that the ore body below the 1,550 foot level was twice as large as it was known to be [Smith, 1943, pp. 194-195]. This could not have been an honest mistake, bad estimate or a clerical error. Perhaps this misstatement gave the superintendent and his associates time to unload their shares on unsuspecting investors.

THEFT

Occasionally a management ring would simply loot a mining corporation. This happened to the Justice Mining Company under the control of the firm of Schultz & Von Bargen during 1877. Their management style was akin to that of Blackbeard boarding a merchant ship. The stockholders brought legal action against Schultz & Von Bargen charging, among other things, that they had pilfered $500,000 of the mine's operating receipts and that an additional $250,000 had been stolen by the sale of an ore deposit. Unfortunately for the stockholders, Schultz maintained such poor accounting records that it was impossible to verify the $500,000 claim. Regarding the other allegation, George Schultz admitted that he had accepted a $250,000 personal fee to negotiate the sale for $1 of a Justice Mine ore deposit to the neighboring Alta Mining Company. The managers of the Alta testified that they believed that they were paying the $250,000 to the Justice Mining Company for the mineral rights. However, the judge ruled that it was clearly a bribe and, as such, it belonged to Schultz as personal income [*Daily Alta California*, Mar. 16, 1880].

SALTING

One venerable means of manipulating stock prices is to *salt* a worthless mine. All one needs to do is to buy several tons of rich ore from a producing mine and to scatter the ore within the property being promoted. Mark Twain tells how the North Ophir was salted with melted silver coins. As a result of this salting, it was the only Nevada mine ever to yield pure silver nuggets. The experts were quite puzzled by this odd kind of ore until someone discovered the letters "TED STATES OF" [Twain, 1871, pp. 21-23] stamped on one nugget. In January of 1880, the Lady Bryan Mine was salted and the superintendent John Kelly reported a discovery of $90 per ton ore [*Engineering and Mining Journal*, Feb. 7, 1880, p. 105]. The stock rose from less than $1 per share to $4 per share before the hoax was revealed.

One wonders how many California legislators supported reform in 1880 because they had purchased Lady Bryan stock at inflated prices or had invested in the Justice Mining Company.

REFORMS — SAN FRANCISCO BOARD OF BROKERS

The San Francisco Board of Brokers proposed market reforms in 1870. Prior to this proposal, the mining stock market had been depressed. The output of the Comstock declined from $13.7 million in 1867 to $7.5 million in 1869. There had been no significant discoveries for several years and the exhaustion of all the known deposits was clearly in sight by 1870 [Lord, 1959, pp. 263-264]. While the brokers could not stimulate the market by discovering a bonanza, they hoped to generate more business by reforming the market. On January 26, 1870, the San Francisco Board of Brokers established a three-man committee to develop solutions to the insider trading problem. This committee recommended that the state legislature require quarterly reports of work done at each mine, reports of cash receipts and disbursements, and a detailed report of wages paid. The committee also proposed that mine managers should be required to award milling contracts to the lowest bidder. However, the brokers did not energetically lobby for these reforms and they did not even adopt them as regulations for the exchange. As a consequence, no action came from these recommendations. Eventually, the discovery of the Crown Point bonanza late in 1870 brought investors back into the market without the need for reform.

REFORMS — THE ACT OF 1874

The California legislature in 1874 enacted Senate Bill 393 (The O'Connor Bill), "an Act for the better protection of the stockholders in corporations, formed under the laws of the state of California, for the purpose of carrying on and conducting the business of mining." The first section of this act [Thompson, 1918] required mining corporations to keep the books in accordance with the company's by-laws, but it did not specify what should be stated in the by-laws. Were there mines that did not keep any accounting records? The law also required the mines to prepare semiannual statements of all business and financial transactions, which was interpreted by the Comstock's leading mines as a statement of cash receipts and disbursements. Investors holding stock of at least $500 par value could demand the preparation of monthly balance sheets (probably cash flow statements which were often called *balance sheets* on the Comstock). The second section of this act obliged mine officers to permit major shareholders (those owning at least $500 par value) to enter and inspect the mine during all business hours. This section was designed to eliminate the shut-in [*San Francisco Bulletin*, Feb. 9, 1874] and it may have represented a delayed response to the successful 1872 Savage Mine hoax perpetrated by Jones and Hayward.

Other reforms were considered and rejected by the legislature. The Duffy Bill would have prohibited margin sales of mining shares [*Daily Alta California*, Feb. 14, 1874] and also would have prohibited sham sales of stock. The Gibbons Bill called for the prohibition of short sales of stock [*Daily Alta California*, Feb. 15, 1874]. These latter bills did not pass. The newspapers generally supported the 1874 reforms, but the support was restrained. Mine reform did not seem to be a big issue that year.

REFORMS — THE FELTON BILLS OF 1880

From 1876 through 1880, many San Francisco and Sacramento newspapers were obsessed with the Comstock share market. Hundreds of editorials were written on the subjects of insider trading and stock fraud. The pressure on the legislature must have been intense. The reforms of 1880 were almost certainly prompted by the crusade of the press.

In 1880, several bills, including some which were quite radical, were introduced in the California legislature. One bill would have prohibited assessments on shares and another would have prohibited all margin sales of stock. The legislature ultimately rejected those proposals and instead adopted several reform bills authored by assemblyman Charles Felton.

Assembly Bill 230 directed the mines to record the names of the "real owners" in the stock books. This prohibited parking transactions and should have made insider trades much more difficult to conceal. Another section of this act made it illegal to "sell, lease, mortgage, or otherwise dispose of" any portion of the firm's mining grounds without the approval of at least two-thirds of the voting stock. This section seems to be aimed directly at preventing a repetition of what happened at the Justice Mine.

Felton's Assembly Bill 249 amended the Mining Act of 1874. The Felton Act required mining corporations to keep a "complete" set of books and it now stated how these books should be maintained. The books were required to show the sources of all cash receipts and the object of all cash expenditures. Any shareholder was authorized to examine the books during normal business hours and he had the right to be accompanied by an expert (probably an accountant). Company officers were compelled to prepare monthly cash flow statements (called *balance sheets*) which would disclose the source of all cash receipts and to whom and for what purpose all disbursements were made.

The officers were also obliged to report the current balance of cash, bullion and all liabilities. There was no independent audit requirement, but the financial statement must be sworn to under oath by the president and the secretary (accountant). Investors wishing to examine this statement needed to visit the corporate offices. The mine superintendent was directed to file weekly statements of labor employed at the mine, of work done at the mine, of ore extracted, of ore milled, and of all ore discoveries. All stockholders had the right to examine these reports. Finally, every stockholder had the right to inspect the mine and to be accompanied by a mining expert [Thompson, pp. 156-158].

The accountants of the leading mines met at the offices of the Consolidated Virginia Mining company to discuss the Felton Acts and announced that they would obey all of the provisions, except for the disclosure of the real owners of the mines which they chose to ignore since there was no penalty for doing so [*Territorial Enterprise*, May 5, 1880]. The San Francisco Chronicle [May 5, 1880] reported that compliance with the Felton Acts was quite good and that firms which failed to comply did so through ignorance rather than through intent.

FINANCIAL REPORTING ON THE COMSTOCK LODE

The financial reports of four leading Comstock mines have been examined. These mines are the Hale & Norcross Silver Mining Company, the Savage Mining Company, the Consolidated Virginia Mining Company, and the California Mining Company. Generally, nineteenth century mining records are rare. Fortunately there are two libraries with excellent collections of Comstock business records, the Huntington Library and the University of Nevada-Reno Library. The examination revealed that the primary financial report on the Comstock was a statement of cash flows. Balance sheets were included in the early financial reports, but their importance declined during the 1870s. Comstock accountants lacked a clear understanding of what a balance sheet should be and they sometimes called the cash flow statements "balance sheets." There were no income statements and little evidence of accrual accounting practices such as depreciation or depletion.

The March 20, 1867 annual report of the Hale & Norcross Silver Mining Company [Hale & Norcross, 1867] consisted of a cash flow report and a statement of assets and liabilities. The cash flow statement summarized disbursements by objectives such as mining, assaying and freight. The statement of assets and liabilities was a balance sheet which used the expression "Excess of Assets over Liabilities" in place of an owners' equity section. The work in process inventory of partially processed ore was recorded as an asset at its net realizable value. In 1870, the mine's Statement of Receipts and Disbursements [*Hale & Norcross*, 1870] was much more detailed than it had been three years earlier, but there were no other significant changes.

The Savage Mining Company of Virginia City presented three primary financial statements [Savage, 1868] for the year ended July 11, 1868. These included a cash flow report, a statement of current assets and liabilities, and a statement of property, plant and equipment. The statement of current assets and liabilities disclosed the mine's working capital position. It would have provided information useful in assessing the need for stockholder assessments or the likelihood of dividends. It was balanced with the account Excess of Cash Assets over Liabilities. This firm's annual report also contained several auxiliary schedules detailing production of precious metals, operating costs, and the distribution of supply costs.

During the 1870s, the Consolidated Virginia Mining Company [Consolidated Virginia, 1876] and the California Mining Company [California, 1876-1878], were the Comstock's leading mines. These mines issued statements of cash disbursements and receipts, which were called *balance sheets*. The structure of their cash flow reports is very similar to the requirements of the subsequently enacted Felton Bills. It would certainly have been logical for Felton to have used the accounting and reporting practices of the leading companies as a model for his legislation. The annual reports also contained a statement listing company assets which included supply inventories and property, plant and equipment. Property, plant and equipment appear to be recorded at unamortized historical cost. These mines did not record the partially processed ore as an inventory as had the Savage Mine and the Hale and Norcross Mine.

The Felton Acts made the cash-based financial reports of the Comstock the standard for all California mining corporations. This very simple uniform system of reporting appears to have been followed by California mining corporations until the enactment of the federal income tax in 1913. During that period, California was one of the few important mining centers to possess standardized accounts and reports.

COST BOOK ORIGINS

The Comstock accounting system may have been adapted from the traditional cost book practices of Cornwall, England [Lawn, 1901 and Williams, 1891]. The Cornish cost book system was created in the reign of Edward I. This system combined features of partnerships and corporations. The fundamental financial statement of these firms was the statement of accounts, a cash flow report. Comstock reports are very similar to the Cornish cost book practices. The prime difference appears to be that the Comstock mines classified cash outflows by activity as well as by payee. The statement of accounts of a leading Cornish cost book mine [Lawn, 1901, pp. 134-146] classified disbursements only by payee. At the same time as the development of Comstock accounting, Cornish cost book practices were transplanted to Australia as the no-liability system of mine organization [Godden and Robertson].

INSIDER TRADING

Insider trading was legal during the 1800s. As a consequence, it was widely and openly practiced in the Comstock share markets. However, the insiders generally were not satisfied with the returns to be earned from employing their superior knowledge. They repeatedly defrauded investors by spreading false reports about the conditions at the mines. The untruthful information was spread by rumors, by managers expressing expert opinions, and in published annual reports.

An infamous case of deception by inside traders was the Savage Mine Deal of 1872. Hayward and Jones maintained a shut-in at the mine while untrue rumors of a great discovery circulated. The insiders knew that nothing had been discovered and they must have been aware of the rumors. Why did they continue to shut-in the mine? They did so to inflate the value of the shares which the insiders were selling. Anyone who purchased Savage Mine shares was defrauded. However, this was and continues to be a fairly safe form of fraud because of the difficulty in identifying the source of the false rumors.

The California legislature did not consider the prohibition of insider trading. Instead, the Felton laws were crafted to inhibit or prevent the specific frauds employed by the insiders. The legislature required weekly operating reports from the mine superintendents, and the stockholders were given the right to inspect the mines. The mandated cash flow reports permitted an assessment of the ability and honesty of the managers. Thus the outside investors were given the tools to become informed before buying or selling stock. If the outsiders still chose to remain uninformed, then only they were to blame.

There are many types of inside traders, including corporate directors, managers, lawyers, business reporters, investment bankers and assorted friends and relatives. On the Comstock, a ruthless parade of directors and managers enhanced their insider trading profits by withholding information and spreading false reports. This type of market fraud is less common today because S.E.C. rule 10b-5 requires insider traders to disclose material information or refrain from trading.

SUMMARY

The reform of California's stock markets in 1880 and the concurrent mandating of published financial statements was a political response to the brazen frauds associated with the Comstock Lode. During the 1860s and 1870s California's stock exchanges were rocked by one insider trading scandal after another. Those abuses met with public disfavor, but they were tolerated as long as gold and silver continued to pour from the mines. Eventually the last great bonanza was discovered and the production of bullion declined rapidly. When that decline was followed closely by hard times, the reform of the Comstock share markets became one of California's leading political issues. In 1880, the California legislature enacted significant financial accounting and disclosure reforms as a primary means of protecting the public. As a result of insider trading and frauds, the Comstock Lode earned a very unsavory reputation within the mining industry. On the other hand, California obtained a uniform system of mine reporting many decades before it would have, had it not been for these shady schemes.

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