INSIDERS ON THE FRONT PAGE

HOW FAR SHOULD THE NEW PENALTIES GO?

by LINDA ENGLISH

Few would dispute that insider trading exists in the Australian marketplace – but critics question the precision of recent research and the effectiveness of subsequent proposals for legislation.

A recently published study of insider trading in Australia, which concludes that the practice is a serious problem for the nation's securities industry, has attracted an unprecedented degree of favourable media attention. The study, by the academic lawyers Roman Tomasic and Brendan Pentony of Canberra College of Advanced Education, suggested that as many as 5 per cent of all trades may involve breaches of section 128 of the Securities Industry Code, particularly during takeover bids. (An article by Dr Tomasic and Mr Pentony, summarising the findings, was published in the March 1989 issue of *JASSA*.)

Coupled with the NCSC's crackdown on alleged illegal deals, the research has succeeded in bringing insider trading on to the front pages of Australian newspapers – and on to the agenda of two Federal Parliamentary inquiries – something that the NCSC-commissioned Anisman Report on the same subject failed conspicuously to do when it was published in 1986.

The researchers say they have undertaken "an empirical study of the attitudes and experiences of key players in the securities industry with a view to systematically collecting more reliable evidence than the largely impressionistic material that up till now, has served as the basis for policy debates in insider trading in Australia." The Tomasic-Pentony report, titled *Insider Trading in Australia*, is the product of lengthy, confidential, face-to-face interviews with 79 people closely involved with the securities industry and written reaponses from a further 20 market participants, It was presented in four parts: *Regulation and Law Enforcement, Extent and Effects, Business Ethics in Australia*, and *Summary and Recommendations*. The breadth of topics covered is indicated by the titles.

On the basis of the evidence garnered, Dr Tomasic and Mr Pentony have made a series of recommendations which include calls for increased public awareness of the illegality of insider trading, the raising of ethical standards in the industry, increased resources and political commitment to ensure that the law is enforced, more severe penalties, the redrafting of section 128 of the Securities Industry Code and reform of the prosecution process.

The fanfare notwithstanding, some people are beginning to question whether the study does more than present unsubstantiated opinions. Critics, from both academia and industry, say they are concerned that the findings may be based on "rumour, hunches and gossip" and that they cannot be verified by scientific testing. Another critic, also an academic lawyer, says that the Tomasic-Pentony recommendations do not go far enough and uses a United States comparison to suggest that a wrong conception of the harm done by insider

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trading is common in Australia. He is Professor James C. Cox, Professor of Law at Duke University and currently Senior Fulbright Fellow in the Faculty of Law, University of Sydney.

Mr Ron Coppel, executive director of the Australian Stock Exchange, has publicly questioned the importance of the study, charging that the researchers had provided only anecdotal and apocryphal evidence of the incidence of insider trading. "The reports quotes various people saying that insider trading is rampant," Mr Coppel said. "What the researchers do not seem to have done is question the basis on which the respondents formed their opinions. It is this apparently unquestioning acceptance of opinion based on rumour, hunches and gossip that I find is unsatisfactory.

"What the report has done successfully is to give the debate on insider trading a higher profile. That in itself is a good thing. But other than that, the report does not really contribute anything new."

Mr Coppel's point is not that insider trading does not exist: he concedes that it very well might. What he says, however, is that he does not believe Dr Tomasic and Mr Pentony have proved its existence empirically. The quality of the evidence provided is essentially dependent on the methodology used by the researchers. The quality of the research is important because, as Mr Coppel pointed out, it has a bearing not only on our opinion of the evidence tendered, but also on the weight we should give to the recommendations which flow from the evidence.

Dr Stephen Bishop of the chartered accountants Arthur Anderson and Co., formerly associate professor in Monash University's Department of Accounting and Finance, agrees with Mr Coppel that opinions are not necessarily evidence of fact. "The study proves that many people believe that insider trading occurs, but no-one appears to have provided any hard evidence of its existence," Dr Bishop said. "Before the researchers can claim to have proved that insider trading occurs they need to provide some form of documentary evidence such as an audit trail to verify what the respondents have said."

Mr John Zerby, a University of NSW econometrician, says that although Dr Tomasic and Mr Pentony may technically have provided empirical evidence, the relevance of their results is limited by weaknesses in their research methodology.

"Unscientific research of this nature has three main failings," he says. "It is impossible to replicate the experiment and get similar results, to make inferences from the sample results to the general population, and to evaluate the biases that may be present in the experimental design and interpretation of the results.

"The biggest problem with empirical studies that are not scientifically sound is that the only way the reader can accept the results is to appeal to the authority of the researchers. Alternatively, the reader accepts the results because they confirm his or her own preconceptions. Either way it is unsatisfactory because each research effort should stand on its own. The results should be capable of independent verification should proof be needed."

Accordingly, the recommendations should be viewed for what they are: a number of options based on selected opinions of a sample of informed market participants.

There is ample evidence that Australia has been complacent in its attitude towards securities fraud. What seems to be lacking is the political and economic will to rid securities markets of insider trading. It is doubtful that tinkering with the law can substitute for that level of commitment.

There is ample evidence that Australia has been complacent in its attitude towards securities fraud.

Despite their recommendations for the redrafting of various subsections of 128 of the Securities Industry Code, and that materiality be defined, the researchers admit that "surprisingly, there was also a widespread view, especially amongst lawyers, that the current insider trading laws did not need to be significantly reformed, but rather that they needed to be more vigorously enforced."

Some respondents recommended that the existing section 128 should be tested to the full in the courts before any substantive changes were contemplated. As the recent spate of insider trading prosecutions seems to indicate, this is an opinion which the National Companies and Securities Commission (NCSC) may share. It is also a strategy which Professor Bob Baxt of the Trade Practices Commission favours.

In recent trade practices cases, the courts appear to be falling more into line with the spirit of the legislation, rather than relying on a narrow interpretation of its letter (e.g. *Queensland Wire Ltd v BHP*).

Professor Baxt's argument is that redrafting should be undertaken only if the courts are found to interpret the law in a way that parliament finds unacceptable. Piecemeal amendments to the Income Tax Assessment Act had provided a salutory warning against redrafting in an interpretive vacuum.

According to Dr Tomasic and Mr Pentony, the universal view among respondents is that criminal sanctions are appropriate for dealing with insider trading. Imprisonment is regarded as the real deterrent, and there is strong support for the introduction of new and improved civil remedies to supplement the criminal law.

They recommend:

- increased maximum fines of at least $100,000 for each offence;
- the introduction of civil penalties such as disgorgement of profits and at least double damages; and
- the introduction of class actions to enable shareholders damaged by trading to obtain remedy.

Professor Cox argues that these recommendations do not go far enough to maximise the deterrent value of the law, or to encourage witnesses to come forward with information about insider trading.

In a recent paper ("The Economics of Insider Trading Regulation and Enforcement," Faculty of Law, Sydney University 1989), he points out that Australia lags far behind the US in the amount and sophistication of resources devoted to detecting insider trading at both stock exchange and government levels.

Of the US approach, he says; "Insider trading is an offence of stealth whose presence can only be detected initially inferentially. That is, the explanation for public prosecutions of insider trading are partly technological. The government's enforcement efforts are heavily dependent upon electronic market surveillance systems maintained by various American self-regulatory organisations. The organisations first monitor trading activity through sophisticated computers that can identify abnormal price or volume changes within seconds of their occurrence. Once such trading abnormality is detected, a review of wire releases occurs to determine whether the trading activity can be explained by market, industry or company-specific information. If nothing appears from a perusal of the various wire services available to the organisations, the subject company is contacted to determine if there is a corporate event not yet announced. The organisations also perform a retrospective review of trading in listed companies' stock for possible abuses before an announcement was made.

"Once suspect trading is identified, the self-regulatory organisation's investigators move into the second stage whereby the brokerage firms executing the suspect transactions are identified and later a profile of the trading customers is prepared. This information is screened through the Automated Search and Match System (ASAM) to determine the traders' relationship, if any, with the listed company. Once the investigators believe insider trading has occurred, they forward their evidence to the government prosecutors."

Australia lags far behind the US in the amount and sophistication of resources devoted to detecting insider trading.

ASAM's database includes names and general information about more than 500,000 corporate officers, directors, attorneys, accountants and other individuals having corporate contacts. The screening can also look for characteristics common to both a suspect trader and another person who appears within the ASAM database. For example, the investigator's suspicions are increased when the trader's *alma mater* or club affiliations match those of the issuer's executives.

Professor Cox agrees with the claims by regulators, reported in the Tomasic/Pentony study, that detection also relies on the willingness of witnesses to inform the authorities about suspicious trades. That sophisticated computer surveillance, analysis and investigation do not themselves guarantee that a suspicious trading pattern will be linked to the insider was illustrated by the Denis Levine case. In 1985 the Securities Exchange Commission received 11 different reports of questionable trading practices occurring through the Bank Leu. Levine was linked to these trades, and others going back to 1980, only after the SEC received a tip.

Reacting to the Levine experience, the US Congress has attempted to augment the detection and prosecution of insider trading by providing a bounty award of up to 10 per cent of the government recovery for those who assist in the detection of insider trading.

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Professor Cox argues that the weaknesses identified in the enforcement mechanisms of the Securities Industry Code arise from a poor articulation of the interest harmed by insider trading. The Tomasic/Pentony study reported a wide-spread belief that providing "fairer markets by promoting equal treatment and to stop illegal gains" was the primary purpose of insider trading laws. Incidental to ensuring "a level playing field" were considerations of investor protection, the encouragement of efficient capital raising, and "to enforce moral attitudes in the community."

Where Dr Tomasic and Mr Pentony accept the traditional reasons for sanctions against insider trading, Professor Cox offers a more rigorous analysis. He maintains that the only logical ground on which to pin insider trading sanctions is the notion of the company's property right in the information. Insider trading violates the property right, as the American case *Carpenter v United States* illustrates.

In *Carpenter* the conviction of Winans and his accomplices for mail fraud were upheld upon proof that they had misappropriated their advance knowledge of the content of the *Wall Street Journal's* "Heard on the Street" column, which Winans co-authored for the newspaper's publisher, Dow Jones and Company. The court emphasised the publisher's interest in both the confidentiality of the contents and timing of the release of the column's contents, thereby recognising Dow Jones' protectable property right in the information.

Similarly, in the context of takeovers, unauthorised use of confidental information which has the effect of driving up the price of the target company is a violation of the acquiring company's property rights in information regarding the pending takeover announcement and its valuation of the target. If the purchase of the target's stock subsequently forces the acquiring company to pay more than originally planned for the target, the acquiring company has grounds to sue the insider.

Professor Cox recognises that not all cases of insider trading result in tangible harm. He argues that the purpose of regulation should not be to proscribe only that for which tangible harm is possible. "Much like the crime of attempt, societal benefits arise from protecting the property interest from the threat of injury, whether or not actual injury results," he says.

With a focus on the harm to the information's creator – companies – rather than the investor, Australia may have considered a more rational and efficient enforcement scheme. Recent legislation enacted in New Zealand permits the corporation in whose shares the insider trades to recover up to treble the insider's profits. Australian legislation, however, allows contemporaneous traders, individual or collectively, to recover no more than the insider's trading profits.

Enforcement mechanisms are not the only factor relevant to deterring insider trading. The nature and extent of the penalties are also important.

Since 1984 the United States SEC has had the authority under the Insider Trading Sanctions Act to seek civil penalties up to treble the insider trading profits against persons who commit insider trading violations. This provision was recently extended to brokerage houses, investment advisory firms and other organisations who fail to take appropriate steps to prevent insider trading violations that their employees have been found to commit.

Importantly, the US government has an alternative route to imposing the treble-profit sanction on an employer. Instead of having to establish that the employer had knowledge of or was reckless in the face of another's violation, it can sanction the employer if it "knowingly or recklessly failed to establish, maintain or enforce" the policy and procedures "reasonably designed to prevent the misuse of material, nonpublic information" and if "such failure substantially contributed to or permitted the occurrence of" insider trading. In extending civil sanctions to employers, the Congress has increased the economic incentives for employers

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QUESTIONS ABOUT THE QUESTIONS

The value of empirical research is determined by how scientifically the observations have been collected and the experiment conducted. The hallmark of scientific empiricism is that the evidence presented can be independently verified by documented facts. The verification process requires the researchers to explain the methodology which they have adopted, and why that particular methodology was chosen; to present a summary of data collected; and to subject the data to various statistical tests to establish its significance.

Scientific studies are so formulated for three very important reasons:

- to permit another researcher to replicate the experiment and get very similar results;
- to ensure that inferences may be drawn from the sample results to the wider population. This involves selecting a statistically sound sample from the population, and applying various statistical analyses to the results; and
- to document the researcher's conscious or unconscious bias. Some bias is inevitable. The important point is that in explaining the research design and methodology the bias is communicated to the reader, who is then able to assess the results of the experiment.

The usual survey questionnaire which requires respondents to tick various responses set out by the researchers has one apparent disadvantage: it limits the repondents' choices because respondents have to choose a given response in answer to a particular question.

The great art in setting up this type of questionnaire is to ask the questions in such a way that does not, in fact, limit the responses. This partly explains why questionnaires often seem to repeat questions offering slightly different responses.

The advantage of the structured questionnaire is that the evidence can be collated and subjected to statistical analysis, which is essential if inferences are to be made about the population at large.

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It is usual for a copy of the questionnaire and a summary of the answers to be published to enable the reader to form an opinion about the quality of the survey itself and hence, the relevance of the results. An open-ended survey conducted in face-to-face interviews, such as that undertaken by Dr Tomasic and Mr Pentony, makes it impossible for the researchers to subject their results to any form of statistical analysis. Without the discipline of the tick-the-box type questionnaire there is no way to test for significances within and between groups of respondents. Similarly, we are given no information to indicate whether or not the sample chosen is representative of the population as a whole.

One major problem of the face-to-face interview technique combined with an open-ended survey is the amount of unconscious bias it permits. Not only is it possible for the interviewer to influence the responses of the interviewees, but it is also possible that the researchers themselves unconsciously emphasise certain responses when reporting and interpreting results. The problem is that the reader, with insufficient published evidence, is in no position to assess the presence of these potential biases.

Thus, the relevance of the Tomasic/Pentony study seems limited. We have no reason to deny its findings, but neither do we have strong reasons to believe them. This is because the researchers fail to give readers sufficient information on which to make informed opinions. We are uncertain how representative the opinions are of the total population, and we do not know how much bias there is in the results that are reported. Finally, no verifiable proof of the existence of insider trading has been provided. All we have is an indication that many people believe it happens. □ **Linda English**

- there is no comparison of performance to a representative benchmark;
- there exists no absolute level of performance;
- it is unstable across time; and
- it is based on inappropriate assumptions.

If the Sharpe Index is unsuitable, then what other options are there? Rather than try to modify an inappropriate measure, a new measure is required which satisfies the criteria outlined at the beginning of this paper.

One such possibility is a statistic which calculates the difference between each fund's return and the return on an appropriate efficient frontier for the fund's level of risk, where risk is measured by the semi-standard deviation of return. Such a model would not be too far removed from the Sharpe Index, since the efficient frontier can in many respects be viewed as an extension of the Capital Market Line, where there is no longer one optimal, efficient market portfolio, but an optimal combination of the various assets at each level of risk.

However, unlike the Sharp Index, such a measure would:

- measure risk using the semi-standard deviation of return;
- compare performance to a representative benchmark;
- possess an absolute value of 0, which corresponds to market performance, and is unaffected by both the frequency of calculation (i.e. monthly or quarterly data) and the time period which is being considered.

Rather than try to modify an inappropriate measure, a new measure is required which satisfies the criteria.

If the performance measurement industry in Australia is to maintain credibility at this critical point, when the demand for accurate assessment of investment performance is greater than ever before, then such options must be given serious consideration. □

NOTES

1. Sharpe W.F., 1966. *Mutual Fund Performance*, Journal of Business, XXXIX(1), January, pp119-138.
2. A fuller treatment of these qualities can be found in Prowse, R., 1989, *Measuring Investment Performance: Essential Qualities of a Performance Measure*, Quarterly Journal of the Institute of Actuaries of Australia, forthcoming.
3. This definition could quite easily be adapted to other investment situations, particularly where there is a particular objective to be met.
4. These studies form part of the unpublished honours thesis of Prowse, R., 1988, *An Evaluation of Investment Performance Measurement Methods for Australian Superannuation Funds.*
5. The Efficient Frontier and Capital Market Line shown in this diagram are not quite as some textbooks might suggest, because this figure is based on actual data.
6. Occupational Superannuation Standards Act 1987, Regulation 16(1)(b).
7. There is an absolute level in that value above zero represents a return above the risk-free rate; this is not really an appropriate benchmark. All funds would be expected to have a Sharpe Index exceeding 0, and an index value below this, for a reasonable period of time, should make the trustees do some serious questioning.

SETTING THE INSIDER PENALTIES

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to supervise their employees vigorously.

According to Professor Cox, the Australian Securities Industry Code contains some important deficiencies which erode the deterrent value of its proscription of insider trading. For instance, it depends too heavily on private actions to recover losses caused by insider trading.

"Because this civil remedy will never exceed more than the profits the insider wrongfully obtained, or the loss he has illegally avoided, the contemporaneous trader's remedy cannot be expected to be a sufficient disincentive for insider trading. The insider is hardly worse off by failing to trade on his confidential information than if he trades, and is reprimanded by a mere disgorgement of what he would have lost he had not traded."

The real deterrent to an insider must be the prospect of losing significantly more than his potential illicit gains, in addition to the stigma of jail and loss of professional status, Professor Cox says.

"Secondly, Australia's enforcement mechanism does not include the efficiencies concomitant with the ancilliary remedy available to American government prosecutions. The NCSC does not enjoy authority to undertake the type of ancillary remedy on behalf of investors as the SEC enjoys in its civil prosecutions. This obviates the need for a wasteful secondary action and further recognises the primacy of the issuer's action against insiders."

Australia's remedies against insider trading, together with the absence of class actions and contingency fee arrangements, act as a disincentive to civil actions for several reasons, the professor says:

- the amount of recoveries cannot exceed the insider's illicit trading profits, so the legal costs of the proceeding may overwhelm the plantiff's expected recovery;
- no single investor may have lost a sufficient amount to make individual litigation worthwhile, a problem exacerbated by the absence of class suit actions in Australia;
- investors faced with an uncertain or small recovery will be most reluctant to incur substantial lawyers' fees. This problem is overcome in America by the contingency fee device.

"Finally, America has enacted strong measures to stimulate various market professional organisations to undertake significant efforts to deter and detect insider trading. The benefits of this process can be seen as recognising that such employers may incur lower marginal costs either to deter or to detect insider trading than an additional enforcement effort from a centralised body. The legislation recognises that employing organisations have an important role to play in the regulation of insider trading."

In contrast, Professor Cox notes, Australia merely relies on "Chinese walls" to protect the trading activity of the business organisation. "Chinese walls" are designed to isolate trading departments from corporate advisory departments whose employees may have access to confidential information. "This response," he says, "provides no incentive for employer organisations to join the cause of reducing the incidence of insider trading with proactive surveillance and safety mechanisms." □