Insider trading scandals in other countries have focused attention on the adequacy of legislation in Australia. The Securities Institute of Australia formed a committee to review legislative changes proposed by the National Companies and Securities Commission.

The committee was chaired by Mr Brian France, managing director, Meares & Philips Ltd. Other members were Mr Rowan Ross, director, Bankers Trust Australia Ltd; Mr Wayne Lonergan, partner, Coopers & Lybrand; Mr Philip Weate, director, Potter Partners Ltd; Mr Jim Berry, manager, regulation and compliance, The Sydney Stock Exchange Ltd; Mr David Gonski, managing director, Westfield Capital Corporation. Here is their submission to the NCSC.

In a following article, Linda English examines the question of whether legislation against insider trading is necessarily more effective than self-regulation.

TRADING ON THE INSIDE

DOES PUNISHMENT FIT THE CRIME?

Whilst we believe that there is little evidence in Australia to suggest major insider problems, many examples can be found of small, sharp price movements immediately prior to disclosures, indicating to the Committee that certain participants do gain advantages through the use of "good information".

We regret that the NCSC and its Delegates have not been successful in pursuing such incidents. We believe that, on many occasions, incidents have been reported to the NCSC's Delegates which appeared to warrant investigation. On other occasions apparently blatant examples alluded to in the financial press do not appear to have been followed up.

We believe that the current legislation should be further tested and if found wanting the NCSC should move for its amendment. By placing the matter before the Courts, the market is "informed" of the behaviour that is considered unacceptable and the market players add to their store of knowledge of what is unethical. Failure to gain prosecution, through poor legislation, would motivate amendments whereas inaction breeds further inaction (see our later comments on plea bargaining).

We believe the suggested legislation is unworkable due to its complexity and does not give realistic guidance to the market as to the participants' required professional standards.

Whilst we are not convinced the current legislation is necessarily ineffective and would be happier reviewing insider trading after more judicial comment, we believe the draft legislation should be significantly simplified, broadly based, able to be easily interpreted, and by way of reinforcing professional industry ethics on all market participants.

Professor Anisman's discussion draft of anti-insider trading legislation and his accompanying paper were considered. We agreed to restrict our submission to the NCSC to particular aspects of the proposal which caused us concern, rather than attempting to discuss the proposal in all its aspects.

As the Securities Institute's expertise lay in the area of public markets, Professor Anisman's proposal, and insider trading generally, was considered only in relation to trading in listed securities. We believe that the Institute has a particular interest in protecting the integrity of Australian public securities markets and that our submission would carry most weight if restricted to the application of the proposal to these markets.

All members felt that Professor Anisman's approach was too complex, too far-reaching and that it would prohibit some conduct which the Committee regarded as acceptable for the efficient working of the market. While we agree that some types of insider dealing should clearly be prohibited, there is a broad spectrum of cases where the position is less clear.

The various definitions which Professor Anisman has adopted were considered. We believe the definitions were adequate in some cases, yet in others...
could cover an extremely wide area of conduct including morally acceptable conduct. We have therefore adopted a different approach.

A further objection to Professor Anisman’s approach was that he assumes that all insider trading creates riskless opportunities whereas this is not the case. The degree of risk borne by an “insider trader” will depend upon the certainty of his insider information and the certainty with which the market’s reaction to the information may be predicted. Professor Anisman’s extremely broad definition of “material information” would include information upon which it would be extremely risky to act and it is inappropriate that trading upon the basis of such information should be regarded as insider trading.

Insider trading legislation cannot address all cases where traders secure an advantage by reason of possession of information, both because it is unclear that an “advantage” has been obtained where the decision to trade was a risky one — notwithstanding possession of inside information — and because it is, in all but the clearest cases, difficult to prove all the elements of a breach (possession of confidential information, the materiality of the information and so forth).

It is sometimes sought to overcome evidentiary problems by deeming provisions. Such provisions make it all the more likely that innocent traders will be found to have breached the legislation. This would be undesirable on any view but is particularly so in the light of the severe penalties which Professor Anisman advocates. If deeming provisions are not included, insider trading legislation becomes almost impossible to enforce and consequently brings the law into disrepute.

The Committee consider that, in view of the difficulties of proof and of the highly subjective nature of the offence itself, it would be better to vest a broad discretion in the courts to take action in cases of unacceptable conduct.

A considerable body of the proposed legislation is concerned with the definition of who should be covered under the definition of an “insider”. It does not matter what the association is, it is the information that causes the damage rather than precisely how it is obtained or who obtains it.

Therefore, the legislation could be much simplified by preparing an appropriate definition of what falls under the heading of “confidential information” (i.e., information that is price-sensitive and confidential). Accordingly any person (broadly defined) who uses such confidential information should be caught by the legislation. We note that there is already considerable case law precedent on what comprises confidential information.

We note and agree with the comment made by Professor Anisman in particular that “insider trading is essentially a problem of non-disclosure”.

Accordingly, we agree as a generalisation that more disclosure is required. In particular the following should be encouraged: the introduction of quarterly reporting by all listed companies; the prompt release by companies of market sensitive information; the enforcement of existing disclosure requirements (e.g. AASE Listing Requirements, Securities Industry Code disclosures, etc); greater policing and enforcement of existing legislation; generally; continuing disclosure through existing channels (e.g. company visits, information to places etc).

We believe that monetary penalties . . . should be minor and that the threat of imprisonment should be the major disincentive. At a practical level even a short gaol sentence would effectively ‘ruin’ most professional operators.

The Committee believes that much of the so-called “insider” information is already available in the market place. In any event the Stock Exchange Listing Requirements already require disclosure of material new information.

Accordingly, efforts to maximise the distribution of information by more formal means could result in substantial levels of paper work, with minuscule real benefit, as the vast majority of investors do not pursue detailed research before making investment decisions (refer, in particular, to the recent NCSC survey on readership of prospectuses).

More formal regulation of information disclosure (e.g. by discouraging company visits) might also adversely effect the present flow of information to the market to the detriment of the efficient operation of the Australian capital markets generally.

For the insider trading legislation to be applied at a practical level a clear measure of materiality is required.

At first we considered that materiality should be defined as a percentage of the share prices at the time of purchase (adjusted for general market movements). For example, a realistic materiality guideline should be 10 per cent of the share price or 25 per cent (whichever is the greater), after having regard to the type of security and its normal market movements.

However, materiality clearly depends upon the circumstances, eg. 10 per cent rise in the price of a widely traded stock selling around $10 is very different from a 10 per cent rise in the price of a thinly traded stock selling at $10.

This problem could best be solved by defining materiality as the amount which a reasonable person would consider was material and the insider obtained a significant advantage. The concept of materiality could then be further elaborated on by NCSC practice notes.

The general thrust of the legislation should be to deter “high rollers”, especially in takeover situations. Accordingly, unless insider trading profits are material it is not worth the legislative and enforcement effort to eliminate them.

We believe that subsequent case law development will help define “what is materially price-sensitive”.

Because of the significant penalties involved the onus of proof must be clearly on the prosecution (“natural justice”).

We consider that law enforcement procedures generally are such that judges appear to be reluctant to impose gaol sentences if the legislation provides a reasonably significant monetary penalty as an alternative.

Accordingly, we believe that monetary penalties, over and above the disgorgement of any profits made, should be minor and that the threat of imprisonment should be the major disincentive. At a practical level even a short gaol sentence would effectively ‘ruin’ most professional operators.

We consider that there is a right to obtain specific damages. Accordingly there is no need for a pool of funds derived from successful prosecutions of insider trading, since common law remedies already exist.

As a matter of mechanics we also believe that the concept of a pool would not work at a practical level. In particular, in the event of a successful prosecution for insider trading it would be likely that a whole series of claims would arise from investors who, given the benefit of hindsight, would consider that they also suffered loss as a result of the alleged insider trading (even though the amount of shares involved in the insider trading event may have been immaterial to the number of shares traded during the
A different view — insider trading promotes market efficiency by allowing prices to adjust more quickly to the underlying value of a particular investment.

Recent events in the US have focused attention on insider trading in the securities markets. Spectacular profits earned by insiders, and the prominence of the offenders, have resulted in calls for increased regulation in the US.

The glare of unfavourable publicity over the Levine and Boesky scandals has put pressure on Wall Street and the American exchanges. The dispute into which the securities industry has fallen is forcing members of the industry to clean up their image by being seen to take active and effective measures to eliminate insider trading and other abuses.

Public opinion is forcing the industry to increase self-regulation to ward off increased government intervention. The SEC and the American exchanges cooperate closely to identify people who abuse the system. The exchanges run most of the compliance and monitoring systems, feeding the SEC with information which is then investigated further to provide grounds for prosecution.

In Australia, the situation differs markedly. Although insider trading prohibitions have been in place since the 1960s, no successful prosecutions have been brought. Australian Stock Exchanges seem reluctant to become involved actively in the insider trading debate. Also evident is a reluctance on the part of both government through the NCSC and the exchanges to make the necessary commitment to put in place an effective compliance and monitoring system.

In 1983 the NCSC announced that it proposed to review the existing law on insider trading “because of the importance of the statutory prohibition on insider trading in ensuring that the securities market operates freely and fairly and investor confidence is maintained.”

The announcement continued: “Although the egregious conduct of this nature is reputedly not uncommon the difficulties of detection and proof are such that successful prosecutions have been rare.”

Philip Anisman, then professor of law at Osgoode Hall Law School, York University, Toronto, was engaged to prepare an Issues Paper for the Working Party on Insider Trading of the NCSC. “Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives” was published in October 1986.

The stated aim of the NCSC working party was to examine the law of insider trading, prepare a discussion paper for publication which would canvass the general issues, and make recommendations to the Ministerial Council.

Of the twin difficulties of detection and proof identified by the NCSC, the Issues Paper seems to be concerned only with the question of proof. The Anisman proposals concentrate on tightening legal definitions and raising the stakes for offenders.

What of detection? Does the focus of the Issues Paper imply that solving the problems of proof will automatically solve those of detection? It would seem that questions of detection and enforcement are issues which should also be addressed.

The Issues Paper acknowledges some criticisms of the regulation of insider trading. “Critics have suggested the continued regulation of insider trading is both an inappropriate restriction on freedom and not a cost-effective method of allocating scarce public resources.”

The terms of reference set by the NCSC for the Working Party apparently preclude serious examination of such fundamental issues. The very fact that the working party is charged to examine only the law of insider trading narrowly prescribes the general issues deemed strictly relevant.

Economic theory suggests that the imposition of insider trading prohibitions inhibits efficiency and is likely to be detrimental to the market.

In the absence of a wider debate on the regulation of insider trading, the Issues Paper essentially accepts these implicit assumptions — the government should intervene to regulate insider trading — the optimal regulatory response to deter insider trading lies in the imposition of strengthened legal sanctions, and by implication, the problems of detection and enforcement will be solved as a result of the proposed redrafting.

I believe the terms of reference of the working party are too narrowly defined. Redrafting existing legislation without consideration of fundamental issues.

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means problems of detection are ignored and, more importantly, the rationale for government regulation remains assumed rather than debated and justified.

The NCSC has suggested that the statutory prohibition is important in ensuring that securities markets operate freely and fairly and investor confidence is maintained. The nexus between the legislation and maintenance of investor confidence is not demonstrated. The NCSC's confidence in this assertion, in the face of the singular lack of successful prosecutions, is not explained.

Exactly which investors does the government wish to protect? The object of regulation is undefined. We can only presume it is for the benefit of the small investor rather than the “professionals” — brokers, merchant bankers, fund managers. As Graeme Samuel has pointed out, the professionals would call for regulation if they felt in need of protection.

The public confidence argument implicitly assumes direct investment by the small investor is not only a desirable social and political goal but also an essential and achievable economic goal.

Logic suggests the costs to market confidence of some (unknown) amount of insider trading are not great. This is because investors tend to accept that some insider trading is inevitable and the trade itself results in the market becoming more informed. The high quality of insider information, as opposed to false or misleading information, would tend to reduce the outrage of investors.

The only relevant recent research into the structure and efficiency of securities markets in Australia of which I am aware was commissioned by the Campbell Committee. Patterns of share ownership showed indicated that small investors were turning from direct to indirect investment. However, the Campbell Report did not cite the incidence of insider trading (which had been well documented in the Rae Report) as being responsible for the changing investment pattern. Evidence suggested small investors had altered their investment portfolios to achieve optimal returns adjusted for risk.

The Campbell Report cited a number of advantages derived by individuals from investing in shares indirectly. It also noted the increased volume of “contractual” savings by captive savers for retirement through insurance companies and superannuation funds. Evidence such as the high yield on property trusts indicated that on a risk/return basis, investment in housing was more attractive in the 1970s than direct purchase of shares.

The committee examined the consequences of greater concentration of shareholdings among a few large institutions and concluded tentatively that there is no cause for concern about the effects of concentration levels on competition, the pattern of funds flow or the development of a two-tier pricing structure.

Do small investors need protection? The evidence presented in the Campbell Report tends to corroborate conclusions drawn from economic analysis that small investors do not need government protection. They appear to act in their own best economic interest and to base their investment decisions on rational grounds.


Proponents of regulation suspect the incidence of insider trading. They assume that existing institutional arrangements are inadequate to control the problem. Whether they realise it or not, those in favour of regulation are focusing on the absence of perfect information in the marketplace. They argue there is a demonstrable market failure which, they assume, can be corrected by government intervention. The question of whether perfect information is an achievable goal is itself debatable.

In proposing various forms of

It appears obvious that regulation of insider trading cannot be made effective purely by changing the law.

Fairness or equity in terms of the operation of markets is often taken to mean that “insiders” and “outsiders” alike should have equal access to information, giving them equal opportunity to profit or reduce losses.

The equality of opportunity argument rests on three assumptions: (i) it is physically possible to ensure all investors have access to the relevant information simultaneously; (ii) all investors have equal ability to analyse the information, and subsequently (iii) all investors have equal opportunity to trade on that information.

Clearly these assumptions are irrelevant in the impersonal market place. It is obvious that members of the securities industry, journalists, business people and institutional portfolio managers will be in a superior position than the small investor on all three counts. They will be most likely to hear the information first and be in a better position to act on it quickly. Practically, equality of opportunity is unachievable and consequently a highly suspect basis for regulation.

A review of the literature based on economic analysis concerned with the bases of regulation of insider trading tends to lead to the conclusion that there is little economic justification for the imposition of controls. On the contrary, economic theory suggests that the imposition of insider trading prohibitions inhibits efficiency and is, therefore, likely to be detrimental to the market.

Economic analysis directly related to insider trading has been propounded by the American lawyer-economists Henry Manne, writing in the Harvard Business Review (volume 44, 1966), and Denis W Carlton and Daniel R Fischel, in the government intervention, advocates of regulation often fail to consider that the observed outcome in the marketplace may represent the rational preferred efficient solution.

An alternative view is that the perceived outcome results from a logical and efficient assignment of the property rights to valuable information. Insider trading is condoned because, on a cost-benefit basis, it is not in the best interest of firms to eradicate it. Some economists have argued that consentual trading on insider information can be an integral element of efficient managerial compensation packages.

Information is neither a free nor a public good. In terms of securities markets, information is exploitable by investors only to the point at which it is fully impounded into prices. After that point it yields no further profit. Companies expend considerable resources to obtain information. Consequently, firms and their shareholders have a legitimate right to benefit from the information so obtained.

The decision of how best to assign the property rights to information falls to the managers hired to run the firm. Clearly the “insider” trades on a superior information-set with reduced risk in comparison with the uninformed investor with whom the trade is concluded. However this fact of itself does not necessarily imply that the property right to information is usurped, that market remedies are unavailable to protect the chosen assignments, or that shareholders disapprove of it. Carlton and Fischel argue that firms in effect assign the property rights to valuable information to managers and that shareholders condone
the assignment.

What may really happen in practice is that firms, through management and the board of directors, recognize the difficulties (costs) involved in assigning the property rights to information exclusively to shareholders. Casual observation suggests that there are occasions when management will go to great (costly) lengths to protect information. In such cases the perceived benefits of protecting the information must outweigh the costs of maintaining secrecy.

Most listed companies appear to have minimal formal provisions to discourage insider trading. It is conceivable that firms insert appropriate clauses in articles of association and/or employment contracts aimed at minimizing insider trading. It is also possible to write similar restrictions into contracts between a firm and outsiders which involve material confidential information (including profitable contracts). Firms need not be able to prohibit insider trading perfectly to benefit from the attempt.

Common law remedies exist to enforce contractual arrangements designed to preclude insider trading. Clearly, firms are not averse to pursuing legal redress when they perceive the benefits outweigh the costs of litigation, as recent court cases attempting to thwart takeovers indicate. Failure on the part of firms to investigate the possibilities of relying on contracts to control insider trading seems to indicate the benefit to shareholders is currently deemed less than costs likely to be borne by firms.

One reason for this could be that it is virtually impossible to ensure that the benefits of assigning property rights to information to shareholders accrue solely to the firm's shareholders as opposed to investors as a whole. The fact that externalities exist and information is not a public good could be seen as a ground to support government intervention so that the costs of control are shared by all recipients of the resulting benefit. Whether the government could police an alternative arrangement more efficiently than firms themselves is another matter.

Common sense tells us that if insider trading is perceived by shareholders as being detrimental to themselves we would expect firms to prohibit it, all other things being equal in an efficient capital market. This is so because the price of securities of firms seen to be actively prohibiting insider trading would be higher than the prices of equivalent firms indifferent to the issue.

Carlston and Fischel maintain the relevant question for firms is whether trading on confidential information is consensual. From the firm's viewpoint it should not make any difference whether or not the trader is an employee or that the shares traded are those of another firm (a takeover target).

In contrast with trading corporations, professional advisers and firms within the securities industry are known to go to considerable lengths to be seen to protect the integrity of clients' confidential information. It is obviously in the self-interest of such firms to do so. The benefits of maintaining confidentiality outweigh the costs of enforcing trading prohibitions and potential profits foregone. Whether these efforts are wholly successful is another question.

As societal values change over time it is conceivable that the relative costs and benefits to firms of the decision regarding the allocation of property rights to valuable information will alter.

The professionals would call for regulation if they felt in need of protection.

Recent US experience confirms this point. Both Levine and Boesky worked in the securities industry. In profiting on clients' confidential information they betrayed both their clients and the firms for which they worked. The pressure of public exposure has forced both client and employer firms to review policies relating to the assignment of property rights to valuable information and the ways in which these assignments can be protected.

US experience indicates that improved technology of market surveillance combined with an aggressive enforcement policy and attending publicity can act as a powerful deterrent. Making enforcement more effective is obviously costly in terms of monitoring, detecting and proving by litigation that illicit trading has taken place. It appears obvious that regulation of insider trading cannot be made effective purely by changing the law.

There appears to be little evidence to suggest that insider trading poses a problem to the efficient operation of securities markets. On the contrary, it could be argued that management and shareholders condone trading for logical (efficient) reasons.

It is debatable that individual investors would actually benefit directly from effective insider trading regulation (should it be achievable). The most likely beneficiaries would not be small investors but those first in line to receive and act on public information - brokers, analysts, journalists and professional investors.

The small investor is likely to benefit only if there is a good working relationship with the investor's broker. That relationship is often based on commercial considerations such as trading volume rather than friendship.

According to some theorists, the real beneficiaries of any government regulation are the bureaucrats who administer regulation and the professionals whose services are required to decipher it. Recognized long-term beneficiaries also include those working in the regulated industry as opposed to the public for whose benefit the regulation was ostensibly initiated.

Apart from the costs of monitoring, investigating and proving offences, all investors "pay" for insider trading regulation in the sense that the market is less informed. The classical economic argument was propounded by Henry Manne. Insider trading promotes market efficiency by allowing prices to adjust more quickly to the underlying value of a particular investment. Any regulation which delays disclosure of information impedes the efficiency of securities markets as pricing mechanisms.

Drawing on economic analysis, it would seem that insider trading does not pose a problem in terms of the operational or allocative efficiency of securities markets. Economic theory suggests the imposition of insider trading controls inhibits the efficiency of capital markets as pricing mechanisms.

Firms have both the ability and the incentive to reach optimal allocation of property rights to valuable information. That they do not invariably assign these rights to shareholders seems to be explained by the costs of detecting and proving illicit trading.

If the government decides to regulate it must assume these costs that firms, for the most part, have declined to bear. In order to justify the imposition of regulation the government needs to delineate exactly who benefits and who loses from regulation, and consider whether government intervention can achieve the regulatory objective more efficiently than market forces.

The direct costs of redrafting legislation are not great. But it is questionable whether changes to the statute without the requisite surveillance and enforcement policies will be sufficient to ensure the regulatory objectives are met. Costs of ensuring effective deterrence are significant, and should be justified by the government through a cost-benefit analysis.