The phenomenon of insider trading lends itself to extreme responses, ranging from exaggerated media portrayals of the “inside-trading-is-rife” variety to, on the other hand, overly defensive industry statements which seek to soft-pedal the issue by fudging the question – saying, for example, that everything is insider trading or that legitimate market activity such as market research might be jeopardised by over-zealous intervention by enforcement and regulatory authorities. Both of these extreme views are wrong-headed.

Insider trading is not the most serious problem facing the securities industry – ramping or price-fixing and warehousing are worse. Nor is it, however, of so little importance as not to be a matter of concern. It can seriously jeopardise markets and their integrity. The protection of the fairness and integrity of markets is, of course, essential to capitalism itself.

This paper is based on three reports which emerged from an 18-month research project involving interviews with key securities industry participants and advisers in Melbourne, Perth, Sydney and Canberra. The study arose against the background of often emotional and abstract debates about insider trading and its effects on the regulatory system and on the market itself. The Green Paper on insider trading by Phillip Anisman, which was commissioned by the NCSC, was eventually shelved because of the belief that there was insufficient evidence about industry attitudes to insider trading in Australia, and in fact, about the seriousness and extent of the problem. The policy dilemma provided an opportunity to inject some more concrete evidence into the debate.

One of the directions of the research was to investigate the perceived objectives of the regulation of insider trading. Most respondents felt that insider trading should continue to be treated as a criminal offence. The most common explanation for this attitude was that it was necessary to provide a level playing field and thereby to provide fair treatment to all investors and traders. However, this justification was often supplemented by the view that insider trading should also be seen as theft; as one broker said, insider trading was “like having your hand in somebody’s pocket”. He was not a typical broker but it was not uncommon for insider trading to be seen in terms of the theft of a company’s property.

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Whatever are the real objectives of insider-trading regulation, the almost invariable opinion was that the current system of regulation was not working. In almost two decades there has not been one successful prosecution for insider trading, despite the knowledge that insider trading is commonplace in Australia and has been for some time.

Criminal sanctions were favoured because insider trading was seen as "a type of stealing". Civil penalties alone were considered insufficient because of the need to make "people sit up and take note" and to add the stigma which imprisonment brings. However, according to some respondents, the value of criminal sanctions as a deterrent would not be very great because of the reluctance of judges to jail white-collar offenders. One regulator said: "The attitude of the judges makes the criminal process inappropriate. It is difficult to align an otherwise-respectable businessman with criminals." Another regulator supported that view with the observation that magistrates "just won't send prominent businessmen to jail". It is clear that judicial attitudes to securities-market fraud need to change, as they are doing in North America and Britain.

Other reasons for doubt about the value of applying criminal sanctions to insider trading suggested that there was an urgent need for reform, particularly of the penalties, which currently are up to five years' imprisonment and/or a $20,000 fine. The fine was almost universally regarded as being too low to be a real deterrent. One regulator described the fine as "a parking fee". Another said it was "a joke". Brokers felt the $20,000 fine to be "ludicrous — it is no threat", or "hopeless". A funds manager said: "A $20,000 fine is comic." Moreover, a regulator pointed out that the penalties would rarely be imposed because they were maximums. "Judges won't impose the jail sentence and the fines mean nothing to insider traders."

The US Senate in November 1988 passed a bill, already approved by the House of Representatives, to increase insider trading penalties to 10 years' jail for each violation and a maximum fine of US$1 million for individuals. Firms face fines of up to US$2.5 million for each violation. In Australia, according to our research, fines for insider trading need to be raised to at least $100,000 for each offence (the five-year maximum prison sentence is seen as sufficient, provided it is enforced). Some respondents thought that a $100,000 fine would still be low. There was a strong view that criminal penalties need to be supplemented by enhanced civil sanctions or remedies, such as the disgorgement of profits, substantial damages awarded and a revision of the law which provides a very poor civil right to damages. This provision has never been successfully used by litigants.

Increasing the severity of criminal sanctions and improving civil remedies will not, in themselves, lead to a better record of enforcement. These changes are needed to show that insider trading laws should be treated more seriously and that they have the support of government. But legislative changes need to be backed up with other institutional and political changes.

It is clear that the regulatory agencies have not had enough political support from government to convince them that insider trading laws should be seen as anything other than symbolic. However, means of ensuring that insider trading will be treated more seriously is to provide these agencies with the funds, staff and computer monitoring equipment to enable them to be more effective. This investment would be repaid by successful prosecutions. Another problem for the regulatory agencies has been finding the motivation to take on the prosecution of complex and time-consuming cases. A more effective enforcement effort would be ensured by the dedication of an expert prosecutorial authority such as the DPP to this area. This body has shown what can be done in the equally complex field of tax avoidance.

The paucity of insider trading prosecutions so far can be explained partly by problems of proof and detection. Unless witnesses are prepared to come forward and provide evidence, the prosecution of insider trading offences is unlikely to succeed. Part of this problem is the strength of peer-group pressures or what has been described as "the clubbishness of business people". "Finding reliable whistle-blowers is difficult," a regulator said. For this reason, many see insider trading as a "perfect" crime.

An American response to this problem has been to make provision for bounty hunters who would earn 10 per cent of the fine or settlement if they provide information which leads to a conviction. Another way to improve the likelihood of gaining evidence is to reverse the onus of proof once a prima facie case of insider trading has been established. We would argue for such a measure in Australia because of the cautious and uncooperative approach of professionals when dealing with insider trading investigations in which their clients might be involved.

Further, there is a need to clarify elements of the definition of insider trading in Section 128 of the Securities Industry Code — in particular, the test of materiality. We would suggest the introduction of a definition based on what a reasonably informed professional would regard as a material change. There is support for this, but little, if any, for a percentage-based test of materiality.

Ultimately, insider trading regulation and law enforcement need to be recognised as difficult and important. The agencies should be given far more political, economic and industry support than they presently have if the community is to begin to deal with this intractable and serious problem.

When analysing the results of the study, we were not surprised to find that Section 128 of the Securities Industry Code is not taken seriously. We expected to be told that; after all, the performance of the regulating agencies across the whole spectrum of law enforcement in Australia leaves much to be desired. The commitment of governments — State and Commonwealth — to law enforcement is at best lacklustre.

The more difficult task in the study was to attempt some measurement of the extent and effect of insider trading. We did not expect to be able to measure it precisely. As one merchant banker said, the people who do it do not talk about it. Nevertheless, we were able to conclude...
If Australia is to avoid a collapse into casino capitalism, insider trading (and other types of market abuse) must be taken seriously.

defences, is said to be so common as to be almost routine. The Takeovers Code, which exists to ensure a fair deal for all shareholders, was also said to be breached often.

Is insider trading worth worrying about? Only one person argued that the law should be repealed. Everybody else said that the practice was wrong for several reasons:
- it was unfair/immoral/unethical;
- it was dishonest and amounted to theft;
- it meant that the market was not being conducted on a level playing field;
- it destroyed confidence in the Australian market.

We asked whether it benefited anybody other than the insider trader? The best that could be said for it was that it is informationally efficient — it brings information to the market. If that is so, it does not say much for the state of the market. If a corrupt, illegal practice is necessary to help the market, there must be something seriously wrong. It was interesting to hear comments about the reaction of small investors to the market and to insider trading. We were told in many cases that they tend to view the market as a gambler: it has a casino image, according to many of the people we interviewed.

We had a special interest in testing the theories of a significant American academic, Professor Henry Manne. He argues in favour of insider trading because, he says, it accelerates the price to the proper level and it provides an incentive to company executives. Both strands of his argument were roundly rejected and that reaction is important for two reasons: theoretical models do not necessarily reflect marketplace realities and, even if they do, it is better that they are Australian rather than US-based.

This study of insider trading produced these conclusions:
- The law has fallen into disrepute. It is unenforceable and incomprehensible to those it should regulate.
- The enforcement agencies cannot properly do their job. They are starved of resources, do not have the sophisticated equipment they need and have effectively been abandoned by their political masters.
- Insider trading has the potential to destroy the market and, in the process, damage an important element of our economy.
- The risks posed by insider trading to Australia's international reputation. Unchecked, it could reduce us to the level of the markets in New Zealand and Hong Kong.
- Self-regulation by itself is not an option. It failed in the 60s and 70s and nobody in the market place takes it seriously.
- The stock exchanges must lift their game as far as compliance is concerned.

If Australia is to avoid a collapse into casino capitalism, insider trading (and other types of market abuse) must be taken seriously. Nobody has the perfect solution to deal with this problem and it is romantic to think that insider trading will ever be eliminated. We believe that some steps can be taken to curb its effect:

**Improve the enforcement effort** by devoting better resources to it, by developing, if necessary, sophisticated computer programs and by achieving an even closer combined effort between government agencies and ASX.

**Introduce effective deterrents** by tougher penalties (increasing the fine from $20,000 to at least $100,000); by innovative penalties such as profit disgorgement; by employing a tooth-and-claw prosecuting agency such as the DPP.

**Change the law** to make it comprehensible. Reverse the onus of proof so that once a prima facie case is made out, the defendant must prove it was not insider trading; bring it into the jurisdiction of the Federal Court; and...
volatility can be had by isolating the relevant factor in a more efficient market such as the stockmarket. It is suggested that the differences in volatility can be considered as a liquidity premium that is paid so an investment position can be easily adjusted.

REFERENCES

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define better concepts such as tippee liability and material price change.

Improve the performance of the stock exchanges in listing companies and monitoring the activities of persons associated with them; in enforcing the Listing Rules, especially in relation to the disclosure of information by listed companies; in monitoring the market for signs of insider trading.

Develop greater awareness of the illegality of insider trading. Directors need to understand the risks they run by trading; companies need to improve the security of price-sensitive information; and the shareholding public must understand that insider trading is illegal and that they are its victims.

Introduce a greater emphasis on ethical training. This is necessary in the stockbroking industry in particular and in tertiary business courses in general.

Recognise the international dimension of the securities market. The fate of Australia’s international capital raising is inexorably linked with the overseas perception of our market. It is therefore essential for Australia to pull its weight in the detection and prosecution of international securities market abuses.