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.
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.

It is this apparently unquestioning acceptance of opinion based on rumour, hunches and gossip that I find is unsatisfactory.
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.”

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 govern-
ment recovery for those who assist in the
detection of insider trading.

Professor Cox argues that the
weaknesses identified in the enforce-
ment 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 take-
overs, unauthorised use of confidential
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 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
Rather than try to modify an inappropriate measure, a new measure is required which satisfies the criteria.

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 Sharpe Index, such a measure would: 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.

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

3. This definition could quite easily be adapted to other investment situations, particularly where there is a particular objective to be met.
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.
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 prescription 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 disinheritment 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 ancillary 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 plaintiff’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.”