

Should Insider Dealing & Market Abuse remain Illegal?

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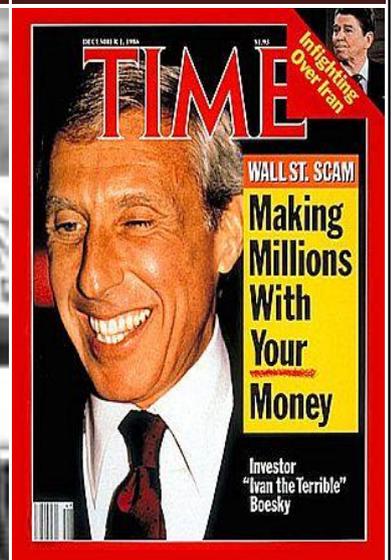


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Executive summary

This project considers whether Insider dealing and Market Abuse should remain illegal by looking at what activities fall under these terms, how they are regulated and the history of regulatory processes. It considers a number of arguments as to whether the existing legal situation is relevant and effective, taking into consideration prevailing academic thinking as well as interpreting real results. Eventually concluding that Market Abuse is almost entirely indefensible and that the arguments for legalising Insider Dealing are spurious and ill conceived.

Introduction

The financial services industry is a major contributor to the UK economy. It is a huge employer and millions of people are reliant on the instruments traded to establish and maintain their savings and pensions. As a sector it comprises banks, pension funds, insurance companies, stockbrokers and professional trade bodies. Whilst the recent financial crisis may have brought the actions of this industry into disrepute, there is a long history of illegal behaviour and malpractice dating back well before recent events. These activities can take a number of forms with Insider dealing perhaps tending to receive the greatest coverage in both real and fictitious media. The relevance, cost and effect of policing Insider dealing and what has become known as Market Abuse have been subject to much debate.

By way of introduction, the timeline below illustrates a history of Insider dealing and market abuse:



Up to the end of World War II the buying and selling of stocks and shares in a company on the basis of information known only to the company or its directors, officers and advisors was considered legitimate and widespread.

In 1973 The Stock Exchange and the Takeover Panel issued a joint statement calling for criminal sanctions. A number of subsequent attempts to pass legislation through Parliament were aborted, but on 23 June 1980, sections 69-73, Part V of the Companies Act 1980 came into force and made insider dealing a criminal offence in certain specified circumstances. These provisions were subsequently consolidated as the Company Securities (Insider Dealing) Act 1985, and amended by the Financial Services Act 1986.



Insider dealing has only been a criminal offence in the U.K. since 1980. Prior to the FSA assuming its responsibilities in 2001, the DTI and SFO dealt with Insider dealing. It achieved particular notoriety in the 1980's with the arrest and prosecution of several leading bankers, arbitrageurs, brokers and lawyers and was depicted in the film Wall Street where Michael Douglas won an Oscar for his portrayal of Gordon Gekko – said to be based on real life Insider dealer Ivan Boesky.



The Financial Services and Markets act (2000) heralded a new single regulator (FSA) with accordant powers to tackle Insider dealing and Market Abuse.



The Market Abuse Directive (MAD) came into force in 2005 setting out a code of market conduct – the standards that should be observed by anyone who uses the UK's key financial markets, whether they are trading in the UK or overseas. The FSA state that “The code brings transparency to all market users and lets everyone know what standards can be expected when dealing on UK markets.”

What is Inside information?

Inside information is information that relates to particular securities or a particular issuer of securities (and not to securities or securities issuers generally) and is specific or precise; has not been made public; and if it were made public, would be likely to have a significant effect on the price of the securities. As such, sensitive information of this kind would normally be released in an orderly fashion via the London Stock Exchanges Regulatory News Service in order to create a level playing field rather than one where a few privileged “insiders” have an advantage over others.

This kind of information is deemed to be “Price sensitive” i.e. it is Information that has the potential of influencing a particular company's share price. By its very nature it is information that tends to be known by senior company officials such as the board of Directors. As a result many people are in possession of inside information on a daily basis, possession of which is perfectly legitimate. The offence of Insider dealing only occurs depending on what they do with the information.

I have depicted the following scenarios involving price sensitive information to illustrate what may and may not constitute Insider dealing:

An example of legitimate use:



Sam, The Chief Executive of Rock-a-hoola Baby plc has been informed by his sales Director that they have won a multi-million dollar contract to supply Flux capacitors to XYZ Corp.



The Chief Executive realises that that the raw materials required to fulfil this order are in short supply and instructs his Procurement Director, Marv, to purchase as many Widgets as possible while the price is still cheap.

Altered Examples to show Insider dealing:



Upon hearing about the contract, the Chief Executive tells a neighbour that this will make the share price of Widget manufacturer SpamUlike rocket.



Marv tells a commodities broker that Rock-a-hoola Baby are buying as many Widgets as they can in order to fulfil the order and this will clear out SpamUlike's entire supply of Dilithium crystal – a key widget component.

What distinguishes the original example from the other two?



Well, firstly while Sam is definitely in possession of inside information about the order, his decision to purchase the widgets is based on his own estimation, skill and analysis of the widget market – something he

has an opinion about but not precise information. On the contrary, the subsequent examples deal with Sam and Marv imparting specific information that could have a significant effect on the price of the underlying shares of SpamUlike and the commodity price of Dilithium Crystal.

The CISI Workbook states that it is also an offence to encourage another person to deal in price-affected securities, or to disclose the information to another person (other than in the proper performance of employment) – which is exactly what the Chief Executive and his procurement Director are doing in the latter scenarios.

How is Insider dealing regulated?

The Financial Services Authority (FSA) had been the body responsible for regulating the financial services industry in the UK since 2000. Established in 2000 under the Financial services and markets act (FSMA), it is responsible for authorising and regulating financial services companies in the UK. In addition to expecting firms to adhere to high standards it also assesses the individuals within the industry and will

only allow them to fulfil a key role, or “controlled function”, if it is satisfied that they are “fit and proper” with honesty, integrity and a good reputation.

In order to exercise its power the FSA has 5 statutory objectives:

market confidence	Maintaining confidence in the financial system
public awareness	Promoting public understanding of the financial system
financial stability	Contributing to the protection and enhancement of the UK financial system
consumer protection	Securing the appropriate degree of protection for consumers
the reduction of financial crime	Reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The regulation of Insider dealing and market abuse are consistent with the objectives to maintain market confidence and reduce financial crime.

At the time of writing the FSA’s role is under review with the potential that this area will come under the remit of a proposed new unit, the Economic Crime Agency.

Whilst the decision to disband the FSA and start anew has not been based on their track record with regard to insider dealing (failings relating to the tripartite structure and prudential oversight being far more pertinent) there has been a great deal of criticism of their relatively low strike rate in this area.

However, we will see that it is not that easy to catch Insider dealers.

The problem with Catching Insiders

“If you want to draft a law that is enormously difficult to prosecute, someone can point at such a plethora of data as to why they purchased a share - pinpointing insider knowledge is impossible.”

Steven Francis, a partner at the law firm Reynolds Porter Chamberlain, speaking on the Today programme on Radio 4. (Francis, 2010)

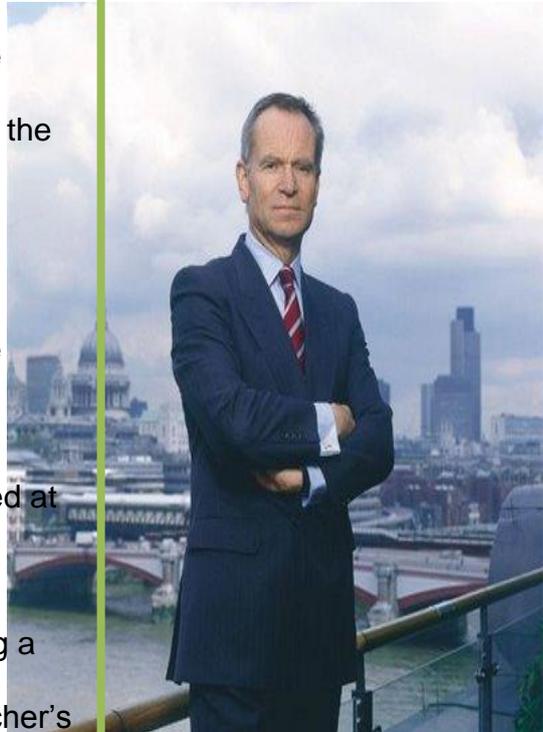
Traditionally Insider dealing has been difficult to prove as, by its very nature, evidence tends to be of a circumstantial nature and, whilst a transaction can be tracked, it is difficult to prove that its participants have acted illegally. Also as Steven Francis alluded to in the above quotation – there is so much information and data available to investors these days that they can explain their actions on a huge variety of reasons – examples being a share’s price graph, press speculation, bulletin board chatter, personal research or perhaps even intuition. Unless the authorities can prove that the transaction was down to specific and precise non-public information then they cannot establish a case for insider dealing. Indeed there have been a number of costly cases where the prosecution have been unable to do just that.

The following example shows how circumstantial claims alone are not enough to demonstrate wrong doing:



On 12 January 1994 the directors of Anglia Television received a takeover offer at 610 pence a share. On 13th January Jeffrey Archer bought 25,000 Anglia shares at 485 pence followed by another 25,000 the following Friday telling his brokers that he was buying them on behalf of someone else. On 18th January a takeover deal was confirmed at 637p, Lord Archer sold the shares 2 hours later making a profit of £77,219 – Lord Archer's Wife, Mary was a Director of Anglia Television.

The Department of Trade and Industry did an investigation but decided there was insufficient evidence to prove that the tip to buy had come from Mary to Jeffrey. Lady Archer said later: "I haven't checked my diary, but I didn't tell my husband or anybody about the takeover of Anglia, full stop."



The Market Abuse regime

Given the difficulties in achieving successful prosecutions and the increasingly complex nature of cases, it is no surprise that regulation has evolved over time to adapt. For example, the Financial services and markets act (2000) which established the FSA also made Insider dealing a civil offence requiring a lower burden of proof than the criminal offence covered by the criminal Justice act (1993) making it, in theory, easier for the authorities to gain a successful outcome. Similarly, it was considered that whilst in many cases there was no insider dealing the behaviour and activities of those involved still fell short of what might be deemed acceptable conduct by a “regular user”: As a result, it also introduced the offence of market abuse which was further supplemented by the Market Abuse Directive (MAD) in 2005.

It's a MAD world

Under MAD there are seven types of behaviour that constitute market abuse.

Offence

Example

Insider dealing	Previously covered
Improper disclosure	Passing on Insider information
Misuse of information	Acting on Inside information
Manipulating transactions	Buying shares to push up the market price
Manipulating devices	Buying shares and then spreading positive (false) rumours
Dissemination	Posting false information on a bulletin board such as a takeover bid
Distortion and misleading behaviour	Doing something to create a false impression as to the demand of or supply of an investment.

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These legislative changes covered a wider spread of activities and financial instruments as well as allowing the FSA greater flexibility over whether it chooses to pursue either criminal or civil proceedings in relation to Insider dealing.

The complex nature of Insider dealing and market abuse cases requires the FSA to work with other agencies including the Serious Organised Crime Agency, City of London Police and other police forces on searches, arrests and extradition; and internationally with other regulators and crime detection agencies.

Indeed, when addressing the American Bar Association, Margaret Cole of the FSA touched upon areas where UK regulation could be more effective by adopting techniques from international peers:

“We also, currently at least, lack the ability to plea bargain which the Americans have used to great effect. This, and the ability to enter into immunity agreements with witnesses in return for hard evidence, are areas which are under very active consideration as we believe the ability to gather sound evidence in this way may be a key to unlocking a number of difficulties, particularly in cases of systematic misuse of information by so-called "rings".

(Cole, The FSA's approach to Insider Dealing, 2007)

Unlocking the rings

Some of the most high profile cases of Insider dealing have come to light when one member of a ring gives evidence which implicates others by turning stool pigeon.

For example

The image is a collage centered on a background of scattered US dollar bills. It features several key elements:

- Top Left:** A TIME magazine cover from October 1983 featuring Ivan Boesky. The headline reads "WALL ST. SCAM Making Millions With Your Money" and identifies him as "Investor 'Ivan the Terrible' Boesky'".
- Top Center:** A blue callout box with white text: "Boesky's testimony helped to secure the successful prosecution and imprisonment of Michael Milken (known as the Junk bond king)".
- Top Right:** A yellow-bordered box containing a group photograph of four men in suits, including Michael Milken.
- Bottom Center:** A TIME magazine cover from February 29, 1984, titled "GERMANY: The Rush to Unity" and "PREDATOR'S FALL". The sub-headline reads: "The collapse of Drexel Burnham, the house that junk built, is only the latest of Wall Street's woes. So where are the tears?".
- Bottom Left:** A blue callout box with white text: "Ivan Boesky was estimated to have made in excess of \$200 million via insider dealing when he was prosecuted in the 1980's he agreed a plea bargain, limiting his penalty to \$100 million and 3.5 years imprisonment."
- Bottom Right:** A blue callout box with white text: "And the so called Guinness 4 in the U.K."

Blue curved arrows connect the callout boxes, indicating relationships between the information presented.

Is it worth it?

Legislative changes and a concerted international effort have certainly helped to improve the chances of the regulator gaining successful prosecutions but the relevance of any law and related penalties should be to establish whether it is acting as a sufficient deterrent to others.

The FSA actually measures what it terms “market cleanliness” by analysing the scale of share price movements in the two days ahead of regulatory announcements to identify abnormal activity.

Their 2009/2010 Annual report contains the following data which assesses announcements relating to takeovers.

Year	Announcements	APPM's	% ratio
2000	183	44	24.0
2002	147	37	25.1
2003	160	22	13.8
2004	102	33	32.4
2005	177	42	23.7
2006	199	57	28.6
2007	167	48	28.7
2008	181	53	29.3
2009	144	44	30.6

(The Financial Services Authority, 2010)

This table suggests that in the two days prior to a company takeover being announced that an average of 26.44% were preceded by suspicious trading activity over the course of the last ten years, with the recent trend being upwards.

Whilst this statistic is worryingly high it does not necessarily follow that all of this activity is based on specific, precise knowledge. Indeed much of this may be down to a response to rumours, a newspaper article, a bulletin board post or tweet and reflects investors trying to get on to a good thing rather than being in the know.

For the regulator, the issue is what is the source and cause of the rumour, how it was passed on and by whom. They expend a great deal of time and resource monitoring markets, individual share prices and announcements and also require firms to have systems and procedures to do likewise. This vast cost combined with the FSA's traditionally low strike rate has left the regulator open to criticism, adding to the ongoing debate as to whether Insider dealing should be deemed an illegal activity.

Arguments for and against

"You want more insider dealing, not less. You want to give people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that."

Milton Friedman (2003)

Make it legal

There are a number of arguments that say insider dealing leads to a more efficient market with share prices that more accurately reflect the underlying fundamentals of individual share prices. If you subscribe to Friedman's argument, making it illegal drives the behaviour underground and decreases public awareness, whilst an open transparent system would lead to greater information sharing. This is consistent with the Efficient Market Hypothesis espoused by Fama (1970) where rational investors make logical decisions. Behavioural Finance theory, on the other hand, rather undermines the Economists argument as Kahneman and Tversky found that investors develop a herd mentality and tend to over or under react to news – far from efficient price discovery and perhaps more like the "irrational exuberance" once described by Alan Greenspan.

Keep it Illegal

Arguments against tend to focus on the moral inequality of the privileged few getting away with it at the expense of the many, perhaps an open transparent system would allow greater access to all.

Margaret Cole of the FSA summarised “..a significant volume of academic material on the rationale for prohibiting insider dealing” when she highlighted the following:

It impairs allocative efficiency of the financial markets; reduces market liquidity/increases cost of capital. If a stock market is functioning efficiently, the share prices should reflect all available information and so provide reliable signals upon which investment decisions are based;

It jeopardises the development of fair and orderly markets and in doing so it undermines investor confidence. It can threaten to harm confidence by undermining investors' beliefs that the market is fair, leading them to withdraw their investment;

it is immoral by being inherently unfair on the basis of inequality of access to information;

it is contrary to good business ethics;

it damages companies and their shareholders/investors; and

More recent cases have emphasised the breach of fiduciary duty by employees using privileged information that belongs to a firm.

(Cole, 2007)

Conclusion

In all of my research for this project I have been unable to find any sort of argument for making many of the activities associated with Market abuse legal – in my opinion that is because they are pretty much indefensible. Insider dealing on the other hand has been the subject of debate for long periods of time – the fact that it has only relatively recently been made an illegal activity indicates, perhaps, that it has not always been viewed as being obviously wrong. Similarly, does the end justify the means? It is, after all, a very expensive burden for all concerned with a low rate of success. Why for example should dealing in financial markets be treated differently to dealing in property: As the law stands it is perfectly legal to buy or sell a house or land based on inside information, with the accepted view being that the parties involved do research beforehand. Furthermore, Economists have argued that making insider dealing illegal leads to inefficient markets, making everybody worse off.

My own view is that both market abuse and Insider dealing should remain illegal. The difficulty and expense of policing these activities cannot outweigh the morality of protecting the savings, investments and pensions of millions of everyday people. After all, Insider dealing is far from a victimless crime: In the financial markets for every buyer there is a seller; for every winning insider there may be a losing pension fund or investor. I think we should be grateful that the FSA and others are working towards fairer outcomes and whilst this has no doubt been a frustrating process, regulatory changes and a refined, multinational, approach are starting to deliver headline grabbing results. Similarly, the Economists' argument for making it legal is very similar to those raised by proponents for allowing unlimited short selling. In my

mind the Economic view is based on theory rather than reality as Investors and markets do not always act logically.

Word count: 3228

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