

INSIDER TRADING IN AUSTRALIA

PART 2

EXTENT AND EFFECTS

Dr. Roman Tomasic

and

Brendan Pentony

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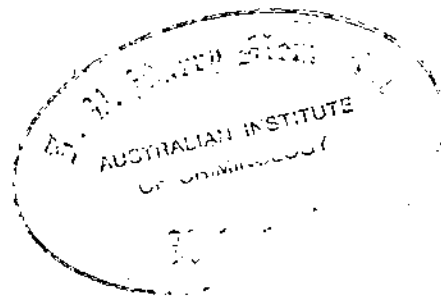
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THE EXTENT AND EFFECTS OF INSIDER TRADING IN AUSTRALIA



The second of three reports from a project financed by a grant from the Criminology Research Council. The research on which this report is based was carried out by

Dr Roman Tomasic
Principal Lecturer in Law
Canberra College of Advanced Education

and

Brendan Pentony
Senior Lecturer in Law
School of Management
Canberra College of Advanced Education

1. Introduction

This paper is part of a wider study of insider trading in Australia which has sought to raise the level of debate on this often emotional and controversial subject. The study arose in the context of increasing concerns in this country regarding the incidence and implications of insider trading and its possible impact upon the market for securities and for law enforcement. Following the publication of the Anisman Report by the NCSC in 1986 there was a widespread reaction that more evidence about the nature and extent of insider trading as a problem in Australia was called for. Of course, the publicity surrounding the enforcement of insider trading laws in the United States, and to a lesser extent in Britain, led many to believe that insider trading may also be a problem that faced our securities markets in this country. With the support of the Criminology Research Council and of most members of the Ministerial Council on Companies and Securities we decided that it was timely to seek to inject some more concrete evidence into the Australian insider trading debate, particularly as there have not been any successful prosecutions of such conduct.

The lack of case law in the country on this topic meant that at least one of the traditional responses available to legal researchers was not available to us. Such case analysis that we did undertake was limited to overseas cases and to the few unsuccessful prosecutions which had been launched. This was not a very promising approach to take with a view to obtaining a better understanding of insider trading in Australia. The other traditional approach to legal research was to engage in that fairly abstract and sterile debate concerning the policy issues surrounding the enforcement of insider trading which has particularly characterized the North American law review literature. Whilst we of course surveyed this fairly arid jurisprudence, we did not feel that it would be productive to seek to add to it without some more tangible evidence. For these reasons we decided to adopt what for many lawyers must be seen as a fairly unusual approach, namely, we decided to undertake 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 until this time has served as the basis for policy debates regarding insider trading in Australia.

The study is based upon interviews with officials and professionals in four Australian cities. These were Canberra,

Melbourne, Perth and Sydney. We also obtained mail responses from officials in other capital cities. Our research was assisted greatly by the support which we received from the relevant Attorney's General and Commissioners for Corporate Affairs and their staff in each jurisdiction other than Queensland, as well as from the Australian Stock Exchange branches in each city that we visited. The NCSC also proved to be most helpful during the course of this research. We were also able to obtain access to principals and staff in over twenty broking houses, as well as to at least a dozen partners undertaking corporate and takeover law work in the four largest law firms in each of the cities that we visited. The study also included merchant bankers, financial advisers, representatives of industry groups and financial journalists. Our interviews with each of these individuals often took up to two hours and sometimes even more. We were surprised by the willingness of these busy professionals to be so generous with their time and that of their colleagues. We often found that the person that we had arranged to interview also brought along one or two other colleagues to participate in the survey. This certainly served to enrich the study greatly, although it often had the effect of prolonging interviews quite considerably.

This paper is the second of three papers which will present the basic data drawn from this research project. The other paper nearing completion is concerned with business ethics and attitudes to insider trading. The first paper was concerned with the regulation and enforcement of insider trading laws. These reports are based upon about 2000 pages of questionnaire responses which we received. The questionnaire contained 66 questions and was open ended in design to allow us to explore related issues as they arose during the course of the interview. We had a core group of 30 questions that all interviewees were asked to answer and the remaining questions were designed for particular industry groups, such as brokers, lawyers and enforcement officials. The questionnaire was pre-tested with interviews in Canberra late in 1987, with the main body of interviews taking place in Perth during the first week of February 1988 and in Melbourne and Sydney during two weeks in May 1988. A number of other interviews of regulatory officials in Canberra, Melbourne and Sydney took place during the first half of 1988. Library research of legal issues is certainly much to be preferred over this kind of fairly arduous field work. On the whole, we spoke to, or received responses from, a total of 99 persons and conducted a total of 79 interviews in Australia. One of us also interviewed enforcement and stock exchange officials as well as insider trading researchers

in London, Toronto and Washington to obtain comparative insights for the Australian study. To our knowledge, this is the largest study of its kind undertaken to-date. This research has also proved that empirical research can provide invaluable insights into the operation and meaning of corporate and securities law in Australia, adding a vital dimension which is simply not available from the limited body of case law in this broad area.

In determining the appropriate legislative responses and enforcement strategies to deal with insider trading it is necessary to understand the extent to which it occurs and the effect of insider trading on the market, on individuals and, indeed, on the international reputation of Australia. These are the general issues with which this paper is concerned.

2. The Extent of Insider Trading in Australia

The necessary first step in this study was to attempt to gauge the extent to which insider trading occurs in Australia. A salutary warning in this process was the advice that "the people who do it do not talk about it" (FA16) and that "the people who are qualified to comment understand the severity of the law and tend to be quiet" (B51). Nevertheless, we asked a series of questions with a view to clarifying perceptions of market participants concerning the incidence of insider trading. We did recognise that gossip and rumours, of themselves, do not amount to insider trading and that there is a populist usage of the term which perhaps embraces all forms of sharp practice in the stock market. It should be emphasised, as it was to participants in the study, that the survey was about insider trading as described by section 128 of the Securities Industry Code.

2.1 Situations In Which Insider Trading Is More Likely

In trying to establish impressions about the extent of insider trading we first enquired about the circumstances under which it is likely to occur. We began by seeking to discover whether insider trading is more likely to occur in relation to particular types or classes of securities or markets (Q2).

Almost exclusively, brokers said that insider trading would take place in the market for shares and not in the options market. The range of opinions about which types of shares might be involved was very wide. According to one view it would depend on "what was flavour of the month" (B8). The most commonly identified group were mining, speculative, exploration and gold shares. Various explanations were put forward as to why mining stocks attract insider trading. One broker said that insider trading is most likely to occur in this broad area because "there are all sorts of people on the site" (B52). Other reasons were that this is "where there are things like drilling reports" (B48) and that "a leak from a geologist could create insider trading" (B52) or that "drillers and assayers know and word filters through" (B49).

Among the less specific opinions was one that insider trading is more likely in "new, up and coming super stocks which involve newer players" (B43). It was said to occur "in less professional areas where there are more opportunistic stocks" (B37). A Melbourne broker said that it is more likely in the "smaller less frequently researched stocks, rather than larger" (B44).

A point often referred to was the need to be able to move the price and in this respect gold mining stocks were said to be "most reactive to any information" (B9). Where the companies have lower capitalisation "insider trading will have greater effect on prices" (B47) and it is "easier to move prices in respect to these stocks" (B52). In entrepreneurial mining companies, often described as Western Australian cowboy companies, and perhaps in high technology companies we were told that "a lot of these stocks are tightly capitalised and likely to move quickly on a rumour" (B58).

The number of people in a company was also said to be a factor as "insider trading tends to occur more in smaller companies controlled by one or two people" (B51) or in second board stock "which is more tightly held by a small group of people" (B48). Another view was that "it is easier to rig tightly held stock" (B31).

There was no consensus about whether insider trading is more, or less, likely in regard to second board stock. There were those who said that second board companies have lower capitalisation, are more tightly controlled and are therefore more prone to insider trading. A number of other brokers expressed a contrary view saying that "the second board is too thinly traded to sustain insider trading" (B28). Despite their differences on this point most brokers shared an uncomplimentary opinion of second board companies.

In contrast, according to the financial advisers, the area of the market where insider trading is most likely to occur seems to be in the lower quality stocks, such as the speculative, mining and second board stocks. An interesting observation was that "originally insider trading was limited to tightly held stock but in the last two years vast amounts of money have been available and this leads to more insider trading" (FA6). Cross directorships, trading on rumours, stocks that respond to good news, and stocks where players are trading to enlarge their profits, were seen as situations which led to insider trading.

There was no common view among stock exchange officials on this matter. One reported that insider trading occurs "in illiquid stocks. The best weapon against insider trading is an efficient market" (R21). This view was endorsed by another official who said that "it is more likely to occur when there is a lack of liquidity in the market - in a thin market it is more easy to fulfill objectives" (R12). According to another, insider trading occurs in "situation stocks e.g., takeovers" (R26).

The other views which we were offered by members of this group were characterised by a lack of certainty. One official said that "I can't single out any - perhaps options and takeover situations" (R18). While another told us that "I cannot make an informed opinion. Probably in more volatile stocks. The second board is too thin" (R66). A very concise answer was that it is "not evident" (R71) where insider trading was more likely to occur.

The general view among the market observers was that insider trading is more likely to happen in lower quality stock. Only one of these addressed the issue of the type of securities involved and he said that insider trading occurs "in shares - the bigger market equals bigger chances. There used to be a fair amount on the second board but since the crash people have lost interest. It is more likely in entrepreneurial stocks - you don't hear about the big stocks. The community tends to know which companies are slack about insider trading. It is more likely to be entrepreneurial companies. It is very common in resource stocks especially at the release of results stage" (O5). Another line of thought was that insider trading occurs across the whole spectrum but, according to one respondent, "it is less likely in trading bank stock. It happens on a bulk scale in speculative stock. The second board is an invitation to misbehaviour" (O59). This theme was developed by another market observer who noted that "entrepreneurial companies are more prone and more visible". He went on to say that "insider trading occurs even in reputable companies and share dividend schemes using options are the likely methods" (O46). The views about the second board were as conflicting here as they were amongst other groups. On the one hand "the second board is not deep enough" (O64) and on the other "insider trading occurs in the second board but not exclusively" (O53). Also reflecting the views of other groups was the perception that the level of insider trading is related to the level of market activity (O25,65).

It was rare to find a lawyer saying that insider trading was likely to be found in industrial or in blue chip securities. The nearest exceptions to this were in respect to takeover stocks generally, although it seems likely that "insider trading will occur in relation to anything which is volatile" (L15). Generally, however, it was felt by the lawyers that we interviewed that insider trading would be most likely to occur in relation to speculative, volatile, mining, second board, or lower quality securities, or in respect of securities in smaller companies where there was a high level of ownership by a relatively small number of shareholders.

Turning to the regulatory officials insider trading was seen to exist firstly, in particular securities such as speculative, mining, takeover, high technology and low price/high volume stock. Gold stocks were often identified as being likely to be subject to insider trading activity. Secondly, many regulators also took the view that insider trading was prevalent "across the board" or "across the whole market" or "over the whole range of market activity" (R 1b, 19, 22, 68). There were also certain circumstances in which insider trading was likely to arise. As one official put it "insider trading is more likely to occur following new company flotations and reconstructions and relating to equity securities" (R69).

There is no doubt that insider trading occurs throughout the whole Australian securities market. However, it is clear that it is more apparent in certain specific areas. At different times, insider trading seems to be more prevalent in some areas of the market than others. This is largely a matter of opportunity and the market situation affecting particular securities. Thus, during the mineral boom of the late 1960s and early 1970s mining and exploration stock seemed to be particularly susceptible to the threat of insider trading. In contrast, during the early 1980s high technology and takeover stocks were most commonly seen to be associated with insider trading activity. Market conditions clearly seem to have had an impact upon the perceived incidence of insider trading. The apparent extent of insider trading was also seen to be particularly influenced by the volatility of the stock in question and the degree to which the ownership of securities is tightly held amongst a relatively narrow group of shareholders. Whilst this is not to suggest that insider trading does not occur in relation to the "blue chip" securities of large public companies, it is more likely to be successful in moving market prices at the other end of the market and hence it is probably more likely to occur at the latter end of the market, that is in lower quality stocks. However, as even large Australian public companies tend to have large parcels of their stock tightly held in a relatively few hands, the likelihood of insider trading occurring in this sector should not be discounted, especially in takeover situations. Thus, whilst it may be easier to pinpoint insider trading as most clearly occurring in a number of particular areas, this should not lead us to

conclude that it is not present throughout the entire market at different times.

2.2 Who Are The Likely Insider Traders?

We then asked whether there are particular groups of investors and/or traders who are more likely to be involved in insider trading (Q3). Perhaps consistently with their stated lack of awareness of the extent of insider trading, brokers varied considerably in their views about who is likely to engage in insider trading. The groups that they most often referred to were (in order) executives; entrepreneurs; directors; and promoters. A number of brokers thought that no particular group was more likely to engage in it. Others who were said to be likely insider traders included institutions, merchant banks, brokers, field staff, newer players, lower level staff, Jews and Chinese, speculators, banks, fund managers, professional investors and those driven by greed.

The most comprehensively stated view concerning the identity of insider traders which was expressed by a broker was that

"there are specialists - professional investors; entrepreneurs who make money without running any enterprises; some brokers especially the broker/director type. In lesser companies it is more likely to be the board rather than management; in larger companies it is the peripheral figures such as accountants and those who are not directly associated. Management in the larger companies is more cautious and more aware" (B47).

Persons closely associated with the companies were said to be the most likely to engage in insider trading. As one broker remarked, "people who are most likely to do it are fairly high up the corporate ladder" (B51). Another estimate was that it is "those associated with the management or control of the company" (B44) or, more specifically, "executives in companies that are described as entrepreneurial" (B30). Another opinion was that it is likely to be "anyone who has access to the books but they are often poor judges as to the effect [of insider trading] on the market" (B49). Also identified were "promoters of small companies and those associated with the promotion of companies" (B37).

Others took a contrary view - "it is not management" (B58) because "management has too much to lose" (B54). Another

broker suggested that "directors in tightly held situations could insider trade, but by and large they are very ethical" (B28). One opinion was that the range of persons is too broad to define precisely but "often, surprisingly, it is those who are close. People talk who should not" (B50). Another key issue which was seen as likely to be a factor in insider trading was that of greed. Brokers pointed to "less ethical persons turned on by money and under pressure to make it" (B51) or those who "are ignorant or driven by greed" (B32) as being more likely to engage in insider trading. One broker, searching for the right word to precisely identify the typical insider trader, used the term "yuppie" (B27).

It was suggested that "perhaps the privileged treatment of institutions amounts to insider trading" (B8), and in support of this view, the suggestion was made that insider traders included "institutional investors who will punt as they get the tips" (B51). But, on the other hand, "institutional investors are informed from a wide range of sources and it would be extremely rare for them to be engaged in insider trading" (B44). The obvious answer is that "it depends on who has the information" (B8) but as one broker pointed out "the information never comes from the ultimate source, it always comes via a second person" (B9).

It was in the context of this question that several of the interviewees referred to insider trading from off-shore and we followed up this issue with the brokers. A Melbourne broker described off-shore insider trading as a "real worry" (B37). Another broker told us that this form of insider trading is done "via an obscure broker" (B54). According to a broker from Sydney, this is "the smartest way to do it but it tends to limit you to the better class of stock" (B51). Another described it as "common in high volatility stock" and he said that it is done this way for tax reasons (B52). The tax aspect was also referred to in another answer but the respondent told us that "it is hard to know how common it is" (B48). A Sydney broker told us that when insider trading is done this way it is "safer", but he wondered how common this approach really was. To the same effect was the reply from a broker who described the practice of off-shore insider trading as a "sophisticated operation done on legal advice. It is hard to know how common it is. The risk is greater in Australia" (B58).

Turning to the views of the financial advisers, persons associated with the company, especially executives, were identified by them as being the group most likely to engage in insider trading. Brokers and their staff, some lawyers and accountants,

speculators, entrepreneurs and advisers were also mentioned. On the subject of off-shore insider trading, several financial advisers said that this was the most likely or most effective way of doing it. We were told by one of the merchant bankers that "only the majors are traded overseas and they are not susceptible to insider trading because these companies are more security conscious. Second line stocks are not done overseas" (FA62). A similar view was expressed by a banker who told us that "it does not happen in low grade stocks but big scams could be done overseas in the industrials". He told us that this is less widespread than is popularly believed and because doing it overseas could be risky, "the operation would stick out". He felt however that the preferred way would be to use an off-shore vehicle to trade in Australia (FA60). A Melbourne financial adviser told us that the way to conduct an off-shore operation was to "set up in New Zealand and get the New Zealand directors to trade in New Zealand". He also suggested that "Netherland Antilles and Monaco tax companies - where the directors are invisible - are perfect for insider trading" (FA41). Off-shore insider trading was said by one merchant banker to be "easier to mask" but it "would have to be done on a large scale". He said that he would be surprised if it doesn't happen (FA42).

There was a considerable variation in the stock exchange officials' views on this topic. Whilst one professed simply not to know (R26) another felt that "traders were more likely to insider trade" (R71). A more detailed response was that the more likely groups are "quasi-entrepreneurs who follow takeovers... Circumstances suggest that they have been given information. Management insider trades, but not directly as it is hard to decide who is an associate. It is more likely to be directors and persons associated with directors who insider trade" (R21). We were also told by the officials that "a determined insider trader would go off-shore. Brokers are not a problem because of Chinese Walls and stock exchange audits. There could be leaks in management" (R18). Another official said that "no history points to any group, but management has the real inside information" (R12). The most comprehensive answer came from an exchange official who said that

"I am absolutely certain that there is a group of investors who would love to do it but do not have the information - they need contacts in the companies. It is more likely to be opportunism - there is no Gekko. Off-shore is the place to engage in insider trading if you are serious about it" (R66).

This question also yielded a very wide range of opinions from the market observers. A fairly vague style of answer was exemplified by such views as that "there is no particular group, it is entirely personal" (O5) and that "it is done by greedy people all over the place" (O7). The majority view, however, was that it is done either by people associated with the market or close to companies or, according to some, by a combination of these groups. One journalist said that it is done by "people close to the company and by market people such as brokers and funds managers". He went on to say that

"senior management of broking firms could not care less about insider trading during the boom. The most dynamic people during that time were insider trading" (O46).

Merchant bankers, investment bankers, brokers and brokers' staff were all mentioned as being likely to engage in insider trading and according to one observer "merchant bank staff are subject to peer pressure to engage in insider trading" (O53). We were directed to one case where it appeared that the directors of a mining company had been very profitably engaged in insider trading (O64). On the topic of directors, we were told that the "vast majority of directors are as clean as a whistle but others would be prepared to exercise their opportunities" (O59) and that "controllers of smaller companies" are likely to be involved in insider trading (O65). Some of those in this group made the point that large companies are conscious of insider trading and take precautions to prevent it. As one explained, "in larger companies the use of share plans resulted in no insider trading by executives and employees" (O34).

We were interested to further test the hypothesis on the market observers that the best way to engage in insider trading is to do it off-shore. Those observers who were able to comment tended to agree that this was so. We were told by an ex-broker that "most insider trading is done off-shore", whilst another view was that "you don't have to do it this way but it is done via options and convertible bonds especially from Luxembourg" (O46). London was also identified as a good place from which to conduct insider trading.

In our enquiries of the lawyers on this point, what we received were more in the nature of educated guesses concerning who the insider traders are, than precise identities. It is often said that the

group most likely to be involved in insider trading is the management of corporations. The large law firm lawyers felt that this was less common than might be expected, particularly with large corporations. It might be said that this response is predictable from them in view of the fact that such corporations tend to constitute the client base of these firms. Be this as it may, their reasons were often compelling. Thus, one Perth lawyer explained that whilst "management is the obvious place to look, they know that they will be looked at most." (L14). This was confirmed by other lawyers. For example, another Perth lawyer stated emphatically that "I doubt that the management of larger companies is involved in insider trading" (L15). One reason for this was given by a Sydney lawyer when he observed that "company management is less likely to be involved in insider trading. It is unusual for company management to trade in their own stock as it was harder for them to get away with it" (L56). Another Sydney lawyer went on to contrast management with other groups when he told us that

"merchant bankers, investment banks and brokers were more likely to insider trade. Lawyers are not risk takers. Company management would not insider trade as they would be the first to be suspected and they already have significant holdings in the company" (L57).

Once again another well known Sydney takeover lawyer noted that

"insider trading is not typically done by management. To the extent that they do do it, insider trading is not a material concern. Insider trading is done by entrepreneurial types connected to management. I'm told that there is a good deal of insider trading in the broking industry" (L61).

This is not to imply that management is never involved in insider trading for, as another lawyer told us, "insider traders tend to be those with greater knowledge, especially directors" (L39). Another lawyer referred to "geologists and the less reputable entrepreneurs in Western Australia" (L14) as being most likely to be involved.

Of the occupational groups that it is most often suggested are involved in insider trading, it was the brokers who were most

often highlighted. To a lesser extent merchant bankers were also identified. Thus one Melbourne lawyer observed that

"some brokers are more likely to insider trade than others, especially those who achieved considerable prominence before the crash when they dealt with the entrepreneurial paper shufflers. They are all involved in moving market prices. There seems to be a very easy morality [amongst brokers] in the pricing of stock" (L36).

It was also reported that the "junior staff in merchant banks were more likely to be involved" (L56). Another Sydney lawyer went on to elaborate upon this theme when he observed that "insider traders are possibly found amongst merchant bankers and their friends. However, they often rationalize that [the information] is not price sensitive or material or they argue that anyone could put it together" (L55). Whilst it is easy to single out particular groups, it is important to note that insider trading is largely a product of opportunity and the assessment of the likelihood of apprehension. As one Sydney lawyer put it,

"there are groups of people who are known to be insider traders. However, there are not classes of people or of occupations who are more likely to be insider traders. You tend to find insider trading in relation to cash boxes and venture capital companies and where there are speculative capital markets" (L38).

One Perth lawyer suggested that even this was too narrow a population of likely insider traders when he disarmingly responded to the query as to whether there were particular groups of investors or traders involved in insider trading, by answering "human beings. Perth is a pretty greedy town. Everybody wants to be part of it" (L15).

The responses from the regulatory officials fell into two broad categories. Firstly, there were those who took what might be called the crime and opportunity perspective and thus argued that insider trading was not restricted to any particular group or that "all levels of persons are involved" (R1a). As another regulator saw it "there is no particular group; it is a matter of opportunity and personal integrity" (R68). Another felt that it was a matter of "whoever has the information" (R22). Others were prepared to

identify diffuse groups or networks of persons who were likely to insider trade. As one official put it

"the general public is not involved in insider trading, but there is a rogues' gallery of lawyers, accountants and ex-directors who insider trade" (R4).

One regulator observed that "networks of traders who help each other are known but are fluid. In this regard, Perth is probably different from Sydney or Melbourne" (R2). Other respondents in this group were able to identify more specific categories of persons who might be more likely than others to insider trade. Sometimes, these responses were apparently at cross purposes or contradictory. For example, whilst we were told that "management and lower level officers are most likely to insider trade" (R24), a more common response was that "directors do not insider trade, it is more likely to be their tippees" (R20). As another regulator saw it, "very few directors insider trade. Insider traders tend to be persons 'associated with' the company rather than insiders, e.g. brokers and merchant bankers" (R67). Some regulators were even more specific in identifying insider trading risk groups. Thus, for example, geologists, merchant bankers and financial advisers were identified by some. A good summary of the range of the insider trading risk group was identified by another regulator in the following terms

"Firstly, the promoters and financiers involved in the incorporation of a new company which intends to have a public float; secondly, directors and major shareholders of an existing company; thirdly, shareholders, underwriters, professional advisers and their respective employees, as well as other persons associated with the share market, including stock exchange employees" (R69).

As we have seen, identifying insider traders by reference to occupational categories most likely to be at risk, is by no means an easy matter. Whilst it is clear that some groups in the industry may have a greater opportunity to insider trade than others, opportunity alone is an insufficient indicator. Some groups such as directors of large public companies are seen as having too much to lose and as being too readily detectible to be likely to themselves directly engage in insider trading. However, directors and corporate executives are often perceived to be likely to pass on information to tippees, if they trade

at all. It seems that other factors apart from the opportunity to insider trade need to be considered in pinpointing risk groups. A critical factor is likely to be the personal integrity and the level of professionalism of a person faced with the opportunity to insider trade. Of course, the low risk of apprehension is another factor which is likely to be exploited by the more sophisticated market operators. Although it is clearly not necessary to go off-shore to insider trade, this is widely perceived to be an effective means of minimizing even further the low risk of apprehension. Perhaps brokers and merchant bankers are in the best positions to act in this way. In fact, these groups are generally seen as being most likely to engage in insider trading. They are seen to be in positions which give them considerable opportunity to so act. Linked to this is the relatively lower degree of professionalism amongst these groups when compared, for example, with accountants and lawyers. It should also be said that insider trading cuts across occupational boundaries in the form of the well developed networks for the transmission and exploitation of price sensitive information found in some sectors of the securities industry and in some locations. Perth was singled out as one such location, although this does not mean that similarly oriented networks do not exist in other Australian cities. Indeed, a Sydney fund manager for a large institutional investor stressed the importance of these socially based networks in Sydney and the disadvantages of being outside them. Those at the entrepreneurial end of the industry, as well as the more marginal members of the industry, such as geologists and tippees, were also frequently identified as common insider traders. However, in the final analysis, it is clear that, in varying degrees, insider trading is to be found throughout the entire Australian securities industry and amongst all groups who are involved with it.

2.3 Market Conditions and Insider Trading

Having looked at the type of stocks and the type of people involved in insider trading we were interested to find out whether insider trading is likely to occur in particular market conditions such as, for example, in a bull or bear market. (Q56) The overwhelming view within the broking group was that insider trading was more likely to occur during periods when the market is very active. This was seen to occur in two main types of

circumstances: in a bull market and when there are takeovers. Most brokers felt that takeovers were more likely to occur during bullish market conditions.

A bull market was said to be the most likely time for insider trading to occur because "there is more activity" (B50) and "more people are interested. It is hard to get people to buy [after October 1987]" (B58). A fairly realistic view was that in a bullish period "the enormous level of activity means a lower chance of detection" (B47). During this period "there are thriving takeovers and mining discoveries" (B43) and this means that "there are more opportunities" (B29). One broker advanced a more complex reason saying that "the ban on short selling results in little insider trading during a bear market" (B48). In the opinion of another "it all depends on the level of volatility in the market" (B52).

Special events were also seen as likely to contribute to the level of insider trading and these were identified by one broker as "during periods when there are takeovers and discoveries, special breakthroughs or sudden developments" (B31). A variation of this view was that insider trading is likely to occur "at the time of some extraordinary event like a takeover; less commonly following some outstanding discovery" (B44). Others felt that whilst insider trading is more likely in a bull market it was also "possible in a bear market" (B8) or "during fast moving commodity market activity eg gold, nickel booms and during exploration phases" (B28). The level of insider trading was also seen to "depend on the nature of the shares being sought such as during the nickel boom, and on the state of the economy" (B27). Another comment which is probably not at odds with the majority view was that insider trading "will occur in any market but it can be pinpointed more in a bear or drifting market" (B9).

The opinions of the financial advisers as to the type of market conditions in which insider trading is more likely to occur were generally consistent with each other. They identified markets with a high level of activity and periods when special events were occurring, such as takeovers and major reconstructions as being more likely to sustain insider trading. One fund manager thought that it was more likely to occur in "a bear market where assets have been undervalued" (FA6). A merchant banker summarised the conditions in which insider trading is likely to be found as "in a bull market when there is good news and in a bear market when there is bad news" (FA41).

On this question the stock exchange officials were once again unable to express a single community view. "It is more likely in an illiquid market" said one (R12). Another replied that "I cannot say whether it would be a bull or bear market. The reversal of performance of a company would allow employees to engage in insider trading" (R18). It is "when the market is uninformed" that insider trading occurs, according to another who also suggested that "the NCSC could improve disclosure by using its powers under Part X [of the Securities Industry Code]" (R21). Another opinion was that it is more likely to occur "during rights issues and during takeover activity" (R26). One ASX official explained that insider trading could be detected by focussing upon "sharp price variations and turnover unaccompanied by a report from the company" (R71).

Insider trading was seen to be most prevalent during periods of heightened market activity, such as in a bull market, takeover situations and in situations where major discoveries or innovations were known to have occurred. It was also evident however that insider trading could occur in a bear market, when there was bad news. The level of volatility in the market was also seen as important in encouraging persons to insider trade. Taking advantage of volatility in prices was particularly important if profits are to be made or losses to be avoided.

2.4 The Prevalence of Insider Trading

There were several key issues to be examined in the course of this project. Perhaps there was no one issue which was more fundamental than that of the extent to which insider trading takes place in Australia. As mentioned earlier in this report, we were at pains to emphasise that we were asking about insider trading in the sense referred to in section 128 of the Securities Industry Code. Our first question was to ask whether the participants in the study agreed with the commonly expressed view that insider trading is widespread (Q1).

Despite the comment of a prominent broker (who was the only broker to refuse to participate in the study) that "you don't expect brokers to tell you it goes on do you?" none of the brokers denied that insider trading took place. Most of them did not agree that it was widespread, while the remainder said that it ranged from being widespread in some areas to being rife. A typical response was that "insider trading exists but it is not widespread. It does

not occur on a wide scale" (B29). A Melbourne broker was, however, prepared to go further saying that "it is a fairly perfect market but there are isolated examples" (B44).

A common thread in the reaction to this question was the reference to information and its role in the operation of the market. The quality of the available information tends to vary and, as one broker pointed out, "gossip is not inside information" (B10). The risks associated with what people regard as "inside information" were alluded to by a Sydney broker who told us that "lots of people act on information believing it to be inside when it is not or does not affect the price" (B52). One broker who thought that insider trading was not as widespread as in the pre-Rae Report era, explained that there is

"not so much insider trading as deliberate spreading of rumours which if true would be price sensitive. Stocks move on these rumours" (B47).

Another, whose opinion was that insider trading is "blown out of all proportion", said that the "market often feeds on itself." (B54). A factor which might also contribute to the perception of widespread insider trading is the extent to which the market is subject to analysis and research. One broker asked whether brokers' reports amount to insider trading (B28) while another made the point that "good news is often anticipated by the market" (B31). The importance of information was summed up by the comment that "information drives the market" (B8). As one broker who believed that insider trading is rife pointed out,

"brokers need information to survive and sometimes it might be inside information" (B50).

The attitude of the industry to the availability of information is referred to throughout this report but it is appropriate to mention the very widely held view that company disclosures should take place much more regularly. It is also relevant to refer to the role of company briefings - "roadshows" and lunches - during which it appears that information that is at least price sensitive, if not "inside", is provided to brokers.

Those who do not believe that insider trading is widespread put forward a variety of reasons for their view. One broker "could think of only some odd examples some time ago" (B58). In the words of a senior Melbourne broker

"insider trading is not as serious as other abuses. There is no evidence that it is bad enough to justify the Anisman approach. Discount what politicians say" (B37).

This broker reflected a common view in saying that the "entrepreneurs' form of insider trading is more common". He argued that "laws do not abolish insider trading". One broker whose firm's high ethical standards are acknowledged by the industry said that, based on his firm's client base, insider trading was not widespread but he went on to say that he "does not deal with entrepreneurs" (B43). The attitude of brokers, especially those in Melbourne, to "new operators", "entrepreneurs", "newer players in the market" was uniformly critical and the impression was that such persons, whoever they might be, are capable of anything. Another factor which pointed away from widespread insider trading was the view that "there are always risks for insider traders - it is not always profitable to insider trade" (B31). Not all information will move the price and even if the "information is right, the timing is wrong" leading to the estimate that 90% of insider trading leads to a loss (B30).

Amongst those brokers who reported that insider trading was widespread, one Perth broker said that "it is dishonest to say that it was not" (B9). Another said that it was widespread throughout the world and that perhaps "as many as 5% of orders involve insider trading" (B30). There was a view that since the downturn of the market there has been a dampening of insider trading (B27). All of those brokers who said that insider trading was widespread were from the retail sector of the industry.

In contrast to the brokers, most of the financial advisers said that insider trading was widespread though there was some uncertainty about the precise extent of it. The strongest view was expressed by a Sydney funds manager who said

"if you are not an insider then you are on the outside.
Insider trading is very, very, extensive" (FA63).

Another funds manager said that it was "endemic to the market" (FA6) and he went on to say that "the majority of insider trading is in small volumes, less than \$100,000, and it is not possible to make enough money to make insider trading worthwhile". The "extensive inter-relationship between Australian companies" was said by another funds manager to support the view that insider trading is widespread (FA11). Several within this group thought

that insider trading was widespread but they were not as definite in their opinion. According to one accountant, "insider trading is pretty widespread at the bottom end of the market; mainly it is buying to prop up the price" (FA17). A very senior merchant banker made the point that

"it is impossible to know, but considering the ease with which it could be done then I would expect that insider trading is widespread" (FA60).

An accountant thought that insider trading is widespread because there is no way of effectively stopping it, but he also thought that there was more market rigging than insider trading (FA40). Another of the merchant bankers said that "it depends on the definition of insider trading. There is some which falls strictly within section 128. In terms of the Anisman definition - that is a person trading with information not available to others - there is a lot more" (FA41). The remainder, who did not agree that insider trading was widespread, put forward several views. "It is believed to be widespread but there is little evidence that it is" said a merchant banker (FA33). Another of the advisers explained that "in terms of the section 128 definition the amount of insider trading is limited. There may be some buying to support the market price" (FA16). An investment adviser told us that he "would be surprised if insider trading was high as a percentage of overall transactions. Most traffic goes through respectable brokers" (FA74).

While none of the stock exchange officials denied the existence of insider trading they did not accept the view that it is widespread. As one official put it, "insider trading is not as widespread as people would like to think" (R66). Another view was that

"those in Australia who say it is rife are talking without facts" (R18).

A similar position was that "a perception has been created by the press that there is widespread insider trading. But it is wrong to say we never see it" (R12).

As to the extent of insider trading one ASX official said that "it exists but I do not agree that it is widespread and have no knowledge of its extent" (R71). Another of the officials told us that "it defies any quantification. It is hard to differentiate gossip and real insider trading" (R21). A more definite assessment of the extent of insider trading was that "it is not very extensive in the

section 128 sense but there is no doubt that it happens. The Australian market is too small for the Boesky style operation; to do it on a large scale would affect the market" (R66). What appeared at first to be a typically bureaucratic response came from a senior official who told us that "the stock exchange is not directly aware of the conduct of clients but some unexplained movements lead to enquiries to the companies. The stock exchange is advised that there is not" but, he went on to say, "it would be naive to believe that it does not happen. In takeovers it is hard to believe that there is no insider trading" (R18).

None of the market observers rejected the possibility of insider trading occurring but there was some disparity in their assessment of its extent. The views of the financial journalists that we spoke to were fairly consistent. According to one, "based on anecdotal evidence, insider trading is common" (O5), while another said that it was "as extensive as it ever was" (O25). These were, however, relatively mild statements compared to what another journalist thought. A Sydney journalist who was able to back his opinion with examples of insider trading told us that "insider trading is rife - it is ingrained" (O64). His counterpart in Melbourne expressed similar views

"insider trading is rife. A large percentage of trading is insider trading. Institutions and brokers rely on what they call market information which is another form of insider trading. It is totally entrenched" (O46).

He also offered us examples to support his view. Another emphatic statement was that

"insider trading is very widespread. No one buys shares unless they have information" (O7).

A former broker observed that "insider trading is quite widespread" (O65).

The views of the people who were associated with the market seemed to vary according to how directly involved they were. One of them who is very closely associated through his link with a major company said that "maybe it happens in entrepreneurial stock. It is wrong to describe it as widespread" (O34). Another whose linkage was less direct said that "it is widespread but you cannot assess its extent" (O53). We were also told that "no doubt a fair amount has taken place over a long time but 'rife' is an unfortunate term to use" (O59).

Whilst it is frequently said that insider trading is widespread in Australia, lawyers generally felt that they were poorly placed to accurately assess the extent to which this practice occurred. Added to this is the reserve which lawyers have about being directly associated with any perceived illegality such as insider trading. Thus it was often said that lawyers in large law firms had too much to lose from being involved with insider trading activity and that they already had high status and well paying jobs which they would of course lose if they were to be found to be associated with criminal activity. However, this is not to say that some lawyers are not involved in insider trading activity. These seem to be found in firms other than the large law firms, or so it is said by partners in these large firms. Also, lawyers who have gone into business or whose law practice tends to be the base for their wider entrepreneurial activity, rather than being primarily concerned with the provision of legal advice, tend to be seen as more likely than other lawyers to insider trade, given the opportunity.

Generally, the corporate and securities lawyers in large law firms that we spoke to took the view that whilst they themselves had not seen much direct evidence of insider trading, they nevertheless felt that it occurred, although they did not know how extensive insider trading actually was. Only two of our interviewees did not think that insider trading was widespread. However, as another lawyer put it

"insider trading does not have to be widespread to be a matter of concern" (L39).

In Perth, insider trading activity seemed to be far more open to view than it was in Sydney or Melbourne. Thus we were told that "generally the passing of confidential information is prevalent in Perth" (L13). Another Perth lawyer told us that insider trading was extensive while the stock market was particularly active up to October 1987. This lawyer reported that there had been some very blatant examples of insider trading and that this could in part be attributed to the fact that

"Perth is an incredible networking place so that something can travel around society very quickly" (L15).

This perception was confirmed by a number of other interviewees in that city. However, this does not mean that insider trading is

not to be found in other cities; it may be that insider trading is just better concealed there. In Melbourne, for example, we were told that

"I suspect that insider trading is widespread, but not amongst lawyers. I would be surprised if insider trading was not extensive, especially in entrepreneurial companies. As market rigging and ramping are present a lot, so also is insider trading" (L36).

Another Melbourne lawyer, who actually defended the practice of insider trading, confirmed this when he reported that "there is no doubt that insider trading is out there and that it definitely goes on more than just a little" (L38). Similarly, a Sydney law firm partner observed that "insider trading does exist, and probably more than people want it to exist" (L55). However other Sydney lawyers that we interviewed did not believe that insider trading was as widespread as the press have often made it out to be.

The views of the government regulator interviewees included confident assertions that insider trading was "extremely widespread" (R1b), "it goes on all the time" (R4), "it is an art form in Western Australia" (R20), "is there any other form of trading?" (R1), and that "insider trading is common as a form of petty crime" (R67). On the other hand, there were some regulators who were somewhat more cautious in their responses. Others suspected that it was the case that insider trading was widespread, although they could not point to evidence of it to show how extensive it actually was. However, even these were prepared to take a more expansive view when pressed. Thus we were told that whilst there was no evidence as to how widespread insider trading actually was,

"the very nature of the market is such that insider trading goes on all day, every day".

This respondent went on to say "from my personal experience, there is an enormous incidence of insider trading" (R19). Another interviewee probably summarised many a regulatory view when he answered

"it is my strong belief that this is so; the pitiful record of company regulation means that there is a massive opportunity to make easy money" (R23).

In an attempt to establish more accurately the degree of insider trading we pursued this matter further and asked our interviewees whether they had heard of or seen any cases of insider trading over the past year (Q5).

While some brokers reported that they had not seen or heard of any cases of insider trading during this period, most reported that they had seen or heard of instances ranging from one to "hundreds to some degree" to a "hell of a lot". Others either suspected, guessed, read about or heard rumours of cases. The responses to this question illustrate how difficult it is to be sure that the conduct is actually insider trading. Those who suspected it, did so on the basis of price movements leading up to takeovers. Others suggested that it was "difficult to determine if it is inside information" that was being used. It was also pointed out that "this industry is prone to rumours - deals are based on rumours" (B58) some of which are "deliberately generated [from particular companies] and are wrong" (B52). One broker who had knowledge of several cases said that it was "nothing on a big scale. It was being done by people who were not aware of it being a breach of the law" (B50). The reaction to entrepreneurs was again illustrated by the observation that "some activities of the directors of entrepreneurial companies are so self serving as to be, if not insider trading technically, at least its equivalent" (B37).

Most of the financial advisers had either seen or heard of cases of insider trading over the past year. One of those who had not, said the cases of insider trading would be "easy to find if I looked" (FA6). One of those who had seen cases made the comment that

"I put evidence of classic insider trading to the NCSC in 1986 and they had neither the resources nor the time to follow it up" (FA41).

This person was highly critical of the performance of the NCSC. We raised this matter with the NCSC and their advice was that the report had been followed up but they were unable to establish a case. This incident illustrates a point raised by many others namely, that the NCSC creates a poor image with persons in the industry who pass information on to it. Perhaps there is a case for doing something to improve liaison with such persons.

Some of the Stock Exchange officials said that they had not come across any cases of insider trading (R12,26) and of those who had seen some cases, the scale ranged from "perhaps one" (R18) to "several at least" (R21). Another ASX official reported that he had

not come across any "definite cases but I have had suspicions" (R71).

The market observers reported that they had seen or heard of instances of insider trading in the last year. Those who were most definite about it said that they saw it "... during the bull market" (O25) or that it was seen "all the time involving brokers and institutions" (O46). One of our respondents from Perth told us "I can't say precisely, but it appears that a lot of well timed investment takes place" (O7). Another, who said that he had not seen any cases of insider trading, went on to say that "if I looked I could identify insider trading with 50% accuracy" (O65). Some concluded that there is insider trading because of price movements in the course of takeovers (O75,53). However there were those who said that they had not heard of insider traders "not even in gossip" (O34) or that what they had heard was "only innuendo" (O59).

Most lawyers reported that they had heard of particular instances of insider trading during the last year, although this was often at second hand and, at most, no more than a handful of instances were reported. One suspects that lawyers in large law firms would be far less likely than other groups to be directly involved in insider trading activity or be prepared to report the involvement of others where they have professional relationships with them. The regulators were not able to be any more informative in this regard than the lawyers. On the whole, very few cases of insider trading were identified by them. Most referred to no more than a couple of cases which they know about, and often these were based upon rumour or cases being investigated by the NCSC. One regulator was able to refer to five insider trading investigations which he knew of, although this was unusual. A common complaint was the "need for a vocal victim" (R1) to complain to the CAC before the regulators would know of insider trading. There were however many suspicions of the existence of insider trading based upon what were seen as unusual share price movements in particular stocks, although such movements could often be explained by a number of quite innocent factors.

The question of the precise incidence of insider trading is shrouded in myth, rumour and rhetoric. It will probably never be possible to definitively assess the level of insider trading which takes place below the surface. The very nature of this phenomenon makes this almost inevitable. The few cases which most industry

observers were prepared to acknowledge represent but the tip of the iceberg. Terminological confusions, help to further obscure this issue. It is clear that the legal use of price sensitive information is not all that far removed from the illegal use of such information. As many in the industry either cannot or are unwilling to make the fine distinctions which are often needed to distinguish between these two, it is easier to blur the issue or simply to pretend that insider trading is not a problem. There is also a natural hesitancy of professionals to make accusations of others, or at least to publicly make disparaging remarks about those that one does business with. Nevertheless, there were a sufficient number of persons from across all sectors of the industry who provided enough information to lead us to conclude that insider trading is far more widespread than many are prepared to acknowledge. Moreover, the practice of many Australian companies selectively briefing brokers and institutional investors in many cases seems to stray into the realms of proscribed insider trading in the sense that the brokers and institutions might at least be categorized as tippees. Whilst insider trading activity in Australia does not seem to be anywhere near the proportions of that perpetrated by the Boesky-Levine ring in the United States, it is still widespread enough to be of concern. In any event, we would agree with the view put to us that insider trading does not have to be widespread for it to be a matter of concern. For too long, it seems that insider trading has been allowed to continue unchecked, so that the relatively high level of this conduct has not been seen to be a matter of concern. If we are to follow this benign approach through to its logical conclusions, the only rational action is to repeal the laws in this area. Yet, there is a great reluctance to do just this because of the fear that insider trading could become even more widespread than it already is in Australia.

2.5 Is Insider Trading More Common Now?

We attempted to get some idea of the scope of insider trading by asking whether, in recent years, it has become more, or less, common (Q4). In this respect it was interesting to note how the benchmark was taken as the mining boom of the late 60's. There were frequent references to the anti-insider trading laws that were enacted following that period.

Most brokers said that there was now less insider trading than in earlier years. Many of the brokers that we interviewed had been in the industry during the mining boom in the late sixties and tended to make their comparisons with that period. A number qualified their views by saying that the level of insider trading will depend on market activity.

The most common reason given for saying that there was less insider trading now than in the recent past was that the market had responded positively to the introduction of the Securities Industry legislation. Typical of this school of thought was the explanation that "the industry is much cleaner now due to better regulation" (B37). Others said that "the effect of the laws" (B58), "better policing" and the fact that "people think twice now" (B48) have contributed to the reduced level of insider trading. The legislation has had "a frightening effect" (B44) and it has led to "heightened consciousness" (B55). An interesting observation from a Sydney broker was that insider trading is "less acceptable now; in the late 60's and early 70's it was regarded as normal". But, he went on to say, "the risks are higher now" (B47). One suggestion was that "perhaps some former insider traders have left the market". (B51)

Those who thought that insider trading was now more common attributed the increase to the larger volume of trading reflecting the earlier statement that "its frequency depends on the state of the market" (B52). The importance of information to the market was again referred to in comments such as "there is always information circulating, but when is it inside information?" (B52) and that information "drives the market". (B8)

The prevailing view among financial advisers was that insider trading is now less common than it was previously, and only a few expressed a contrary view. The explanations for the reduced incidence of insider trading varied. According to some, the legislation and the presence of the NCSC have contributed to the reduction while others said that directors, companies, bankers and brokers are now more aware of their responsibilities.

One of those who did not agree with the majority view explained that "insider trading has always existed but it is more talked about now" (FA11). According to one of the accountants, "insider trading involving directors is less common, but other investors are more involved now" (FA17). A merchant banker surmised that "a

higher volume market means that there is probably more insider trading" (FA62).

There were not many direct answers to this question from the ASX officials and no particular pattern emerged. One official said "I do not know. The pre-Rae period reflected less subtle forms of insider trading" (R12). One of those who said there was now less insider trading, pointed out that "it is less common, but it is more visible now" and he told us that "Australia is developing better forms of electronic surveillance than London or Toronto" (R66). We also learned that "regulation and surveillance are better than ever. The role of the press is important" (R18). Market activity was seen by some as being a factor in determining the level of insider trading. As one ASX official explained

"it depends on the level of market activity. In a bull market strains are intense and are hard to see; less experienced and less ethical people come into the market" (R21).

A more direct reply was that the level has "probably been unchanged during the past 10 years but it varies with the level of market activity" (R71).

The responses from the market observers suggested that the incidence of insider trading is about the same as in earlier years. There was some support for the view that insider trading will vary according to the level of market activity. Those who said that it was at the same level now offered a variety of explanations "it is more visible now - not necessarily more common. It is a feature of booms" (O46). Another remarked that "there is less as the volatile stocks have slowed down" (O34). A more detailed response was that

"people are more wary. A bull market gives better opportunities and the debate on insider trading may have slowed it down. In any case the market is much cleaner now" (O5).

The cleaning up of the market was reflected in another answer "there is less because of better policing" (O59). One view was that "insider trading has been around for years especially during bull markets" (O64) but a more hardnosed approach was to say that

"insider trading has always happened and it is always high" (O25).

Some of the younger partners in the law firms could not comment on the level of insider trading activity today as compared with the mineral boom of the late 1960's. However, two views of the relative extent of contemporary insider trading activity tended to prevail. The most prevalent of these was that insider trading was more common today due largely to the increased volume of stocks traded and to the increased interest in the market during the bull run of the mid 1980's. As one Melbourne lawyer put it

"insider trading goes on depending upon the volatility of the market. After the economic downturn in the early 1970's there was limited insider trading. After the October 1987 crash there will [no doubt] also be limited insider trading" (L36).

Similarly, another Melbourne law firm partner observed that "there has been a steady increase in insider trading. It has become more common except during the six months after October 1987" (L38). Another view which was expressed by a number of practitioners was that there has not really been a change in the level of insider trading, but only in its level of visibility. Thus one Perth lawyer told us "I suspect that Perth in 1970 was not that different from in 1987" (L15). A Melbourne lawyer observed the

"there is no difference in the level of insider trading from previous years, only in the level of people's awareness of it" (L39).

Similarly, a Sydney lawyer added "I suspect that nothing has changed. Insider trading is however more prevalent in a boom" (L56).

We also asked the governmental regulators that we interviewed, about changes in the relative extent of insider trading. In some respects, these individuals were in better positions to answer this question in view of their generally longer experience in watching the securities industry and markets. The senior regulators that we interviewed were usually somewhat older than the average takeover lawyer who is now a partner in the larger law firms. They were therefore usually able to provide us with a better historical picture of the development of insider trading in Australia in the last two decades. Whilst some thought that it was difficult to say whether insider trading was now more or less common, most suggested that there was probably more insider trading occurring in recent years. This was attributed to a

number of factors such as "the upsurge in speculative trading" (R1), the boom conditions of the 1980's and the bull market. It was also reported that

"there is more insider trading overall today, probably because the market is bigger" (R19).

However, many also saw the extent of insider trading as being related to the level of opportunity which existed at any one time. As one senior regulator saw it

"the motive remains constant, the question of greed versus the risk of being caught. There may be more opportunity to insider trade with the increase of takeover activity" (R22).

Another regulator made a similar observation when he told us that "insider trading is always a question of opportunity and there is always opportunity in a bull market" (R24). On the other hand, there were a few regulators who thought that the level of insider trading has not changed much. As one saw it

"insider trading has always been around since the mining boom of the 1970's" (R1a).

Another felt that "the level of insider trading has always been the same" (R2). However one regulator felt that the level of insider trading may actually have decreased since the passage of legislation criminalizing insider trading. He was however very much in a minority in taking this position. Most regulators felt that the level of insider trading had varied with market conditions and that these conditions had been such that the level of insider trading had actually increased.

On the whole, the brokers were very defensive about the present level of insider trading, although some would not have had the historical perspective to accurately make this kind of comparison. Although we spoke to many other brokers who had been through the late 1960's and early 1970's period, many of these seemed to be primarily concerned with improving the reputation of the broking profession. Few were prepared to admit that the "bad old days" had returned.

Although it is true that the introduction of Securities Industry legislation in the 1970's and the more high

profile activity of the NCSC has had some effect upon changing the behaviour of licensed industry professionals, we were also frequently told that these laws and regulatory structures were of little concern to many others in the industry. In any event, the bull run of the mid 1980's had increased market activity to such an extent that many believe that there has been a corresponding increase in the level of insider trading. Merchant bankers were more prepared to acknowledge this than were the brokers. Moreover, although the cruder examples of insider trading from the period of the nickel boom seem to have decreased, many believe that contemporary inside traders have simply become more sophisticated rather than having been deterred from such conduct. The public and the media has however also become increasingly aware of insider trading as a issue of concern. These concerns are not unfounded, as the views of regulators and securities lawyers, amongst others, suggest if anything, that the level of insider trading has at least remained constant, or what is more likely, that it has increased during the boom market conditions of the mid 1980's.

2.6 Takeovers and Insider Trading

It has often been said, and other research tends to show, that there is a distinct relationship between takeover activity and the level of insider trading. We asked the interviewees whether they could think of takeovers where they suspected that insider trading had taken place (Q30).

Most brokers at least suspect that insider trading is associated with takeover activity. According to one

"takeovers are a great example of insider trading. The majority of cases involve leaks. This is the easiest form of insider trading to prove" (B49).

Another said that takeovers are "most likely to be related to the time [that insider trading occurs] as they are the special events likely to move the price" (B52).

The basis for the widely held suspicion is the movement in prices prior to the announcement. One broker considered it "interesting that share prices lift pre-takeover" (B47). A Melbourne broker said that there was a link

"in just about every takeover because there are so many people involved. It is very rare that the price does not move and part of that movement comes from insider trading" (B29).

In the same vein was the response of a Sydney broker who said that there was a link "over the past two to three years based on pre-announcement price movements". (B50) According to him, "some merchant banks leak, especially on West Australian deals".

Those who did not identify insider trading with takeovers suggested that takeover targets are often identified in the course of market analysis. It was explained that

"in takeovers it is very difficult to control the flow of information. Broker recommendations of stocks that are later involved in a takeover arise from research, not inside information. Prices tend to move on rumours of takeovers" (B28).

A similar view was that the "targeting of a likely takeover can lead to insider trading. However I am not aware of persons associated with the companies exploiting their knowledge. There are cases of rumours being acted upon" (B8). Another broker was less certain about this relationship when he said that "it is hard to know - a number of factors can build up" (B30). Even though participants were not asked to do so, it was not uncommon for them to identify specific takeovers where they thought that there had been insider trading.

The views of financial advisers about the link between takeovers and insider trading ran strongly in favour of saying that it does exist. Some members of this group were able to say that they knew of cases while others suspected that there was a link. One of those who doubted the link explained that "people may be backing hunches" (FA62), while another said that "some corporations specialise in buying stakes in target companies" (FA11).

This question inspired a mixed reaction from the ASX officials. Two quite clearly doubted that there was such a link, whilst another who took a similar position explained that "where the bid is made on the floor of the exchange the trading creates an impression on others" (R66). Another ASX official replied that there was "one case a few years back and there was no reaction by the authorities" (R18) but in an earlier reply that person told

us that "in takeovers it is hard to believe that there is no insider trading".

In contrast, we found that the observer group strongly suspected that insider trading took place during takeovers. One member of this group said "it is frequent and it is demonstrated on graphs" (O7). An even more emphatic response was

"hell yes - just look at the price movements and turnover a month to two weeks prior to a takeover. The leaks are in the targets - clerks, lawyers, CACs, bankers and accountants" (O65).

On the subject of leaks another view was that "the leaks vary. Sometimes they come from the board but more often well below the board in the advisory groups where there is terrible chicanery" (O59). This was also in the mind of another market observer who believed that

"just about every one of them involves insider trading - there are sudden pre-bid price movements. There is a long chain in the lead up to a takeover" (O46).

One person was not quite so definite about the frequency of insider trading in takeovers saying "some are not insider trading but are curious. Warehousing cases referred to in the press involve insider trading" (O53). The sole dissenting voice said "there are no cases of which I am aware. Some takeovers involve research and opportunism" (O34).

Whilst the lawyers felt that there were instances of such a relationship occurring from time to time, they diverged widely on the extent to which they were associated. Most felt that there were not many circumstances where these events occurred together. However, sufficient respondents saw a relationship to lead us to conclude that there often were takeovers where insider trading also occurred. As one Perth lawyer put it

"insider trading occurs a lot in takeovers. The buzz goes around. If you look at any event in a company's life, then, a few days before the announcement is made its share price jumps" (L15).

This was a commonly held viewpoint both amongst lawyers and non-lawyer respondents. A Melbourne lawyer also confirmed this when he reported that "there are many that one can think of - just

look at the price rises before a takeover is announced" (L36). It seems that warehousing is more common in relation to takeovers, although this is often related to insider trading. As one Sydney lawyer explained "you often wonder about some large takeovers. Insider trading need not only occur in small corporations, but associate and warehousing questions are more common in takeovers" (L55). Another Sydney lawyer added "insider trading in takeovers is a relatively minor problem. Warehousing is the problem issue here..." (L57).

The balance of opinion among the regulators was that there clearly seemed to be a relationship, although there was once again a problem of hard evidence of insider trading being available. Whilst some regulators could not point to any particular takeovers where they suspected that insider trading occurred, most felt that there was at least considerable potential for insider trading in takeover situations. Some went so far as to tell us that "most major takeovers involve insider trading" (R24). Another regulator, also observed "yes, most shares acquired before a takeover announcement will involve insider trading. The insider traders will often hide behind press speculation" (R67). Similarly, another regulator remarked that "takeover activity goes with insider trading, and especially warehousing" (R1a). Others felt that there was "always the potential of insider trading in takeovers" (R19), which was confirmed by another regulator when he noted that "the potential for insider trading is very high in takeover situations" (R2). Furthermore, there is a perception that "the mere fact that a takeover is on is itself price sensitive information; this is an opportunity to make big money" (R1b). Other regulators felt that whilst insider trading in takeover situations was not very common there are nevertheless major examples of this relationship which had occurred in recent years (R3 & R1).

It is clear that there is often a connection between insider trading activity and takeovers. Those closest to the market, such as brokers and merchant bankers, were particularly certain of the existence of this relationship and most other groups on balance also saw a link. Only the ASX officials seemed to question the existence of this linkage. Their views need to be treated with caution in this regard in view of the preponderance of industry opinion to the contrary. Takeovers were pinpointed as likely insider trading situations due to the profits which could be made by buying shares ahead of a takeover as well as due to the long chain of advisers and other

persons who are involved in preparing the takeover. As we saw, it has almost become a commonplace of the industry for many leaks to occur prior to a takeover and for prices to rise prior to a takeover being announced. Entrepreneurial stocks seem to be particularly susceptible to insider trading in the context of a takeover.

2.7 The Seriousness of Insider Trading

We believed that another way of measuring the extent of insider trading may be to find out how seriously it was regarded in comparison to other forms of market abuse (Q59/62).

We found that insider trading is generally not regarded by brokers as serious or as significant as other forms of market conduct. We were told that "there is so little insider trading it is not a problem" (B44) and that "the interest in insider trading is disproportionate" (B37). According to other brokers, "insider trading is not as serious as it is made out to be" (B8) and "is not as significant in terms of [its effects upon market] confidence" (B52). A Melbourne broker told us that he could "think of many more examples of other forms of abuse than of insider trading" (B28).

Other forms of conduct were seen as being more significant, such as, market rigging which is "more serious and easier to do" (B10); manipulation by false rumours (B31); "floating shitbag (sic) companies" (B51); corporate fraud, churning of clients, staff malpractices, linked advisors, ramping, warehousing (B54), and

"other rorts such as loans to directors, asset purchases by directors in smaller listed companies. The public is being ripped off left right and centre by these rorts" (B29).

Perhaps the most representative comment was that

"within the industry we are laid back about insider trading. Warehousing, circumventing the Takeovers Code and the actions of the big players are serious matters. Insider trading is one of a number of imperfections in the market" (B49).

Those brokers who felt that insider trading was a problem were not unanimous about how serious it is. According to one firm "the concern over insider trading is not blown out of proportion" (B32).

It was seen as being "as important as any other form of abuse - it can disrupt the ideal market" (B9). In the same vein, insider trading was seen as being equally as serious as warehousing, price rigging and ramping and "although not the most serious, it could affect more people" (B47). Some said that warehousing involves a form of insider trading. The effect of insider trading on investors who "get out too early" makes it "more serious because of its longer term implications" (B27).

Only one of the financial advisers was prepared to describe insider trading as a serious problem. Most said that it was not a major problem. According to a merchant banker "insider trading is a lesser problem but it is more serious than warehousing" (FA16). Another view was that

"in terms of its frequency, insider trading is a small matter but it has the potential to destroy the market" (FA17).

A powerfully expressed view was that "insider trading is irrelevant compared to other scams such as warehousing. The Bond - Bell - SGIC rort will hurt shareholders a lot more than insider trading ever would" (FA41). Another view was that "insider trading is only one of the market illegalities" which were occurring (FA60).

None of the stock exchange officials ranked insider trading highly as a problem. One described it as "no more serious than other abuses. Insider trading was graphically described by one exchange official as

"the public scar of the industry and is certainly a problem. New systems being introduced will give a better audit trail and create less chances for abuse" (R21).

On the scale of market abuses one official observed that

"insider trading is comparatively minor. Ramping is much more serious for shareholders than insider trading as many shareholders are likely to suffer. Insider trading gets undue attention because of the public perception. We are very concerned about unenforced legislation or poorly written legislation" (R12).

Another official told us that "it is very hard to say how serious insider trading is. One hears of other sorts such as warehousing which are more visible" (R18). It is "not a serious problem" according to another ASX official (R26).

One official had "no knowledge" (R71) whilst another commented on other forms of abuse, "warehousing is rife but how can it be proved? As to price manipulation a very open market prevents it being common. I have not seen any instances; control on the trading floor is excellent" (R66).

Generally, insider trading was not seen by the lawyers as being the most important form of market abuse which they were aware of, although this was often a difficult assessment to make, for as one Perth lawyer put it

"it is hard to say how important insider trading is. Honesty is an important thing about securities markets. Emphasis should be placed upon making people tell the truth. Insider trading is in this category".

However he went on to say

"I would rank insider trading after market rigging in importance due to the difficulties of proof involved" (L15).

Other respondents echoed these sentiments to a large degree. For example, a Sydney lawyer said that he thought that "insider trading is very serious, but warehousing and price fixing are worse" (L39). Another Sydney lawyer added

"insider trading is near the top, but not at the top. But insider trading is a serious problem. However warehousing is a lot more important as a problem" (L55).

As a Perth lawyer also told us, "warehousing is not treated seriously" (L13). However insider trading co-exists with warehousing and price fixing for, as a Melbourne lawyer explained,

"insider trading is behind other forms of market abuse" (L36).

Perhaps ramping is now emerging as the most important securities market problem. This was certainly the view of many brokers. It was also the attitude of a number of lawyers, especially in Sydney. As one Sydney lawyer said "insider trading is substantially less significant than ramping" (L57). This was confirmed by another Sydney lawyer who told us that

"ramping is more important than insider trading. I suspect that too much ramping goes on and some additional regulatory activity is deserved here. Insider trading is in the middle in terms of importance. Warehousing is now under control, although it has to be watched" (L61).

Perhaps, if our Perth interviewees are also to be believed, warehousing is a greater problem in the West than it is in Sydney.

There is little doubt that insider trading is perceived as a significant problem in the Australian securities industry, although it is said that it is not as serious as other problems such as warehousing and price fixing. However, as the latter are often related to insider trading activity, it is unrealistic to isolate these forms of market abuse from each other. In any event, insider trading was seen by many to have a far more corrosive effect upon the market and upon the confidence of those who had sold shares to an insider trader. Insider trading was seen as serious then, not because of its relative extent, but because it could affect more people than other forms of securities market abuse. As one respondent put it, it was perhaps a small problem, but it could nevertheless destroy the market. It was not surprising therefore to hear a stock exchange official aptly describe it as the "public scar" of the securities industry. For reasons such as these, insider trading will continue to be seen as a problem which cannot be readily or realistically ignored.

2.8 Opportunities for Insider Trading

Insider trading has been described as an opportunistic crime. It is carried out when an opportunity presents itself and by persons who take advantage of the opportunity. The difficulties of quantifying the extent of insider trading and perhaps, in detecting it might be due to the opportunistic, random nature of the

practice. We were, therefore, interested to find out what opportunities existed for insider trading.

The first of our questions on this topic asked the interviewees about the frequency of conflicts of interest arising from access to price sensitive information (Q24). The detailed responses to this question were reported earlier in the paper *Insider Trading Regulation and Law Enforcement in Australia*.

The brokers told us that conflicts of interest were a constant factor in the industry or, at least, that they were very common. They were said to arise especially when a broker is engaged in corporate advisory work. We were told that these conflicts were usually resolved properly.

In the context of conflicts it is useful to refer, at this stage, to our discussions on the subject of the treatment of information gathered in the course of research, especially the information provided to brokers by listed companies. A Melbourne broker explained to us that, in his firm, "any research undertaken by the firm goes back to the company first" (B30). The same practice is followed by another Melbourne firm where "the research information is kept secret until it is checked with the company and then it is published" (B28). In one of the Perth firms there is a Chinese Wall between the research department and the dealers' room (B9).

We were interested in whether there is any house trading on the information collected in the course of research. Several brokers explained the position in their firms and at the same time described the process of gathering information. A Sydney broker told us that

"some companies refuse to see brokers; they rely on section 128 to avoid them. Others, with less market status, are anxious to see them to build up the share price. Of those who talk it is amazing what they say, but some companies do not tell the truth. There is a great deal of monitoring of companies these days. Here there is no house trading but some institutional analysts are not prevented from trading" (B52).

Another of the Sydney brokers explained the matter in these terms "what is price sensitive information? It depends on your personal view. A takeover scoop would be very rare. Major companies have people to deal with brokers. Information

provided by them is not price sensitive. I don't know about the extent of house trading on research information. In our firm house trading does not take place. The exchange could possibly provide the figures on house trading. Many brokers trade on the share index" (B50). We obtained another perspective on the practice from a senior broker who said that

"market research is done in the hope that it picks up price sensitive information. This is only ever done on a formal basis; it does not disclose inside information. The information is ultimately used by the firm to disseminate to its clients. The firm does not trade on this information but we will pass it on early to institutions. Trading on research information is common elsewhere especially in those stocks where a small amount could move the price (B47).

Another explanation of how research information is dealt with was provided by a broker who told us that

"research obtains price sensitive information but how often is it inside? At presentations the companies should be more guarded. Information that is not generally available to the public comes out. The information then goes to clients. In this firm advisers would not go out and buy shares; the house would buy shares and disclose to clients that it is selling as a principal. It is more likely in small firms for brokers to trade on research information" (B48).

An enigmatic statement was that "companies are always giving information but it is not insider trading. The research reports go to clients. Trading by the house before advising clients could go on but the information could be wrong or your interpretation wrong. Profit forecasts do not affect prices much. Some companies especially in the second board feed us bullshit" (B51). A member of the same firm told us that "market research information would be discussed with the analysts. It might be circulated internally within the firm. There would not be any house trading" (B58).

Another insight into industry practices came from a Sydney broker who asked "how often is information from research price sensitive?" and then went on to say that "high level executives do not give much away". He went on to ask "is it inside information or smart analysis?" In his firm, he told us, "there is no house

trading on this information - it goes to the client first. It would be stupid to breach trust. Not many brokers have the same degree of self control. This firm is always aware of surveillance and the potential danger to its business" (B54). Perhaps the frankest exposition of the treatment of information gathered from companies came from a broker who, before he cut short the interview to visit a company, told us that he sees companies

"at least once a week and gets superior information. Some managements talk freely and you get price sensitive information from them. With research information we either trade for the house or send it to institutions. We trade in big companies only if it is inside information from leaks from banks or advisers. It will be a problem with screen trading. All companies try to bull the price of their shares" (B49).

When we asked the financial advisers about the frequency of conflicts of interest, the overwhelming view was that it is a common event. There was little comment about the way in which such conflicts were resolved but it was interesting to note that the accountants made similar replies to the effect that "professionals don't find it a problem". The merchant bankers suggested that they can handle conflicts better than brokers.

The response to this question from the stock exchange officials suggested that they are not close enough to the daily workings of the market to be able to comment accurately. On the subject of the use of research, one official felt able to tell us that

"in section 128 terms brokers do engage in insider trading but some of the information could be found out by individuals".

He admitted having "some difficulty with the practice of trading first before passing on the information to clients. It is unwise and unethical" (R66).

From what the market observers told us, it seems that conflict of interest is ever present. When we asked about the treatment of price sensitive information gathered during research the answers were somewhat varied. One observer told us that he was "not able to say how often price sensitive information is given out by companies" (O59). Another of the group was of the opinion that

"brokers obtain price sensitive information but it is not devastatingly inside information. They probably trade on it and then pass it on to the client. Small investors are not treated as well. Some brokers are subsidiaries of the companies whose shares they are ramping" (O53).

A more definite response was that "research is used before it is made public" (O46). But even stronger was the explanation that

"analysts quite often get price sensitive information; boards tell them what they want to tell them; circulars are speculation, puffery, to get the price up. Larger companies are better scrutinised and much cleaner in insider trading terms. I would not be surprised if there is house trading nor if there was passing on to affiliates. This is consistent with the ethical standards in the broking world" (O64).

The most authoritative explanation came from the ex-broker who told us that

"talks with companies are directed at getting sensitive information. A skilful broker will get it wittingly or unwittingly. Brokers do house trade on it. They buy shares to provide them to persons who are acting on their recommendation" (O65).

The lawyers were able to appreciate the issue of conflicts better than other groups in the study. Their views were that conflicts of interest are a particular problem for those persons in company management who trade in shares. Brokers were also identified as a group for whom conflict situations were common but several lawyers pointed out that brokers tend not to be able to manage such situations well.

While the regulators consider that conflicts are not likely to arise in CAC's, they tended to take the view that conflicts would be common in the private sector for merchant bankers, advisers and within companies. One assessment was that "such conflict is probably quite frequent, it depends on the opportunities which arise" (R24).

Continuing on the theme of opportunities for insider trading, we tested the argument that is sometimes put that traders

deliberately build up their holdings in order to obtain price sensitive information to assist them in their trading (Q25).

The almost universal view amongst brokers was that traders would not seek a place on the board solely as a method of obtaining price sensitive information. The main reasons for such a view were that "it is an expensive way of doing it; a long way for a quick trade" as one broker put it (B50). Once on the board "your hands are tied", said another broker (B54). Those who did not dismiss the possibility said that "it could happen" (B48) and that "it is not common but it certainly happens" (B29) or that it might happen "in smaller companies" (B47).

The qualifications to some responses provide insights into the process of obtaining information. A Melbourne broker told us that "boards do not necessarily know everything; the information flow is controlled by CEO's and accountants. It is not an efficient way of obtaining information" (B28). Another broker warned that "you need to be sure of the information before building up" (B47). This cautionary note was expanded by a Sydney broker who explained that

"a lot of information is wrong. Banks get better information than brokers; auditors get better information; lower level people get information probably before the directors do" (B51).

The ease of obtaining price sensitive information was referred to by one broker who told us that "some brokers might take this approach but it is too expensive. Non-brokers can obtain information and do research without going on to the board" (B58). Just how easy this was, was demonstrated by the comment that "brokers can go to the company and get information" (B58).

This question also yielded some insights as to how insider trading is conducted. A Sydney broker told us that "most is unplanned, it depends on information falling into your lap" (B50). According to a Perth broker "it is easier to insider trade off the board [ie the board of directors]" (B10). Another view was that for insider trading "it is sometimes better not to go on to the board" (B31). A Perth broker expressed the opinion that "going onto the board does not give rise to an insider trading problem, it is more a long term proposition" (B8).

Some brokers took the opportunity to comment on the activities of institutions. According to one they "tend to throw their weight around" (B47) and "get better deals than individuals" (B54).

Another comment was that the institutions "get better deals in takeovers, such as side deals on assets or management of super funds" (B49).

The response from most of the financial advisers was that it is not common to build up holdings in a company merely in a effort to obtain access to price sensitive information. It was seen as either a very expensive way of obtaining information or as a means of achieving other goals such as the control of the company. Two financial advisers who said that it does happen said that it is done "to improve business networks" (FA11) or "in the lead up to a takeover" (FA41).

The majority view of the ASX officials was that this does not happen. The build up of holdings was said to be

"not primarily for this reason. Being able to control your investment is the primary reason. But, a person would be dumb not to use a position on the board or to ignore information" (R12).

Another told us what we had heard from a number of other respondents, namely, that "it is not practical and is too expensive. If you are on the board what good is that?" (R66). A response (received by mail) was that it is "not considered common. Question implies that directors have no integrity. Knowledge may be a disadvantage" (R71). But others thought differently. One told us that "it happens all the time; maybe it is part of the motive" (R21). Another of the ASX officials told us that it is "not unusual" to do this (R26).

In answer to this question we were given a wide range of views by the market observers. It was said to be "quite common" or "routine", that "it happens in second board and lower main board companies" and that "it often occurs". A different view was that "it is done mainly to get control and participate in the company" (O5). Another observer repeated the point that "it is a very expensive way of doing it. The board is the last place to do it" (O7). One observer told us that

"they don't really need to, they can use contacts as Boesky did" (O75).

Whilst some lawyers felt that "some people who have got onto major company boards have only paid lip service to insider trading controls" (L36), it was more commonly felt that this could

be a very expensive way of trying to obtain price sensitive information and that "there are usually better ways of getting price sensitive information and people don't start out with the intention of doing this" (L15). As a summary of the typical attitude received from the lawyer interviewees, a Sydney lawyer put it this way

"this is not a driving force as you have to be prepared to pay a great deal to get this information. Unless you are on the board you won't get price sensitive information, but the reasons for getting onto the board are not usually driven by personal gain" (L56).

Similarly, the regulators also felt that it was rare for such conduct to occur. This was because, as one regulator observed, "persons who insider trade can obtain the inside information without being on the board" (R3). However once on the board, certain additional constraints upon the traders are seen to operate

"...once a person is on the board he is an insider and the risks of being caught increase" (R67).

However it is always difficult to dissect the prime motives for investing in companies from other motives which no doubt also exist. One regulator pointed to this problem when he observed "I doubt that this is a prime motive for building shareholdings" (R22). Another regulator observed

"I do not think that this is common, although it is not possible to isolate intention to insider trade from other motives for building up shareholdings" (R2).

On the other hand, there were at least two regulators who believed that such conduct was common. There were also an even greater number who could not venture an opinion on this matter, as it was beyond their experience.

Our final question on this area was designed to find out whether there is pressure to obtain price sensitive information. We asked how important it is to have access to price sensitive information to succeed on the stock market (Q26). For the most part, brokers believed that it is possible to succeed without access to price sensitive information and that success comes from relying on fundamentals. We were told that "most people rely on fundamentals" (B29) and that "you can rely on fundamentals in industrials" (B52). A Sydney broker thought that "price sensitive

information is just a help. It is not vital" (B49), and another of his colleagues went so far as to say that "it is probably better not to rely on it" (B51). The view of another broker was that "you can succeed without inside information" (B27) and, suprisingly, we were also told that "inside information is not important at all" to success in the stock market (B28).

Price sensitive information was, however, seen as valuable particularly as fundamentals were seen as of more long term importance. As one broker explained

"price sensitive information is very important for making profits but over the long run you can succeed on fundamentals" (B54).

This view was supported by the observation that "in the longer term you can succeed without it. Short term it is not impossible to achieve above average success without it" (B43). The value of inside information was recognised in several comments. One broker said

"you can succeed by relying on fundamentals but inside information is better than fundamentals" (B48).

But on the other hand, "you cannot be successful without [price sensitive information] but it need not be inside" (B47). A final comment was that "inside information leads to more success but it is not absolutely necessary" (B50).

An interesting perspective was that "price sensitive information is important for the very competitive institutional business" (B58). A similar view was that

"one of the tenets of a broker's business is to have price sensitive information. Research is important for this" (B48).

The general impression seems to be that over the long term at least, analysis of the fundamentals will prove successful. Access to price sensitive information, but not necessarily inside information, would enhance the prospects of success. For quick profits it appears necessary to have access to price sensitive information.

The almost unanimous view of the financial advisers was that price sensitive information is not necessary for success. Good

research, astuteness, and relying on the fundamentals were mentioned as the factors for success. It was pointed out by some that price sensitive information is not necessarily inside information and that if a person has access to such information the chances of success are greater.

The general view among stock exchange officials, predictably, was that success is possible without price sensitive information. The route to success was explained to us in these terms

"success is certainly possible without insider trading. Brokers can be successful by knowing where to get stock, how to place it and by doing good research. Investors can succeed without insider trading" (R18).

Another view was that "you can succeed without it. The stock exchange runs not on facts but on fashion - there is always good value stock that is ignored. Success does not depend on insider trading" (R66). We were told that "investors succeed without it, but access would improve success". This view was endorsed by two other officials.

The most common view of the market observers was that success is possible without price sensitive information and that the approach of relying on fundamentals was the best method for success.

The general view that price sensitive information was not essential was also held by the lawyers that we spoke to. Usually there was some qualification or a rider put to this answer. For example, we were often told at the outset that you could succeed "without price sensitive information if you just look at fundamentals" (L13). Some interviewees went on to add that "you still may need extra information" (L57) or that you "have to know how to put it together ...as a lot of price sensitive information is staring you in the face" (L61). Another lawyer went on to add that "yes, you could succeed by looking at fundamentals and by keeping a keen eye on stocks and by analysis" (L36).

However, the notion of "success" is an ambiguous one and in any event the availability of price sensitive information is no guarantee of success as a lot of people find that their price sensitive information does not have the effect of moving the market in the way that they had expected (L55). However if you want to succeed as a professional trader, the lawyers that we

spoke to were a little more sanguine about the prospects of success. As one Sydney lawyer put it, somewhat colourfully,

"to the mug public or punter, price sensitive information is not at all important. But to industry insiders it is very important to get price sensitive information. However, getting price sensitive information is no guarantee that you will make money" (L56).

Similarly, a Perth lawyer answered that

"you could succeed without price sensitive information, but only if you are a good reader of the market. But, most people who do it for a living have their contacts" (L15).

One Melbourne lawyer was even more sceptical about the chances of success without price sensitive information when he observed that

"there are only two ways to succeed without price sensitive information. Firstly, if you are lucky, and secondly, if you deal only in blue chip stocks and you are an excellent analyst. One could not survive in the second board or lower first board companies without inside information and by resort to other practices such as price fixing" (L38).

On balance, the regulators took the theoretical view that it was possible to succeed without access to price sensitive information. However, many of these added a qualification, such as that "it depends upon the type of shares that you are buying" (R2) or that only "...in the long term", or that "the person who has inside information has a better chance of success than someone who is otherwise well informed" (R20) or provided that "you followed the market, and invested in funds or in sound companies" (R19). A good proportion of regulators were not so confident. As one regulator saw it

"I would consider insider trading to be a very important factor in achieving success beyond the norm on the stock market" (R69).

Another regulator felt that "the odds are against success without access to price sensitive information" (R1b). Thus whilst most regulators felt that success was theoretically possible without access to price sensitive information, some of these had serious qualifications and there were a good proportion who doubted that such success was possible, especially in the long term or in substantial terms.

It is evident that one of the more blatant opportunities for insider trading arises from the readiness of corporations, for a variety of reasons, to selectively divulge price sensitive information about their corporation to brokers, institutions and large shareholders. Often there may be good reasons from the corporate executives' point of view for doing this, but it is nevertheless grossly unfair and is contrary to the notions of a properly informed market. It has been all too convenient for brokers and others who receive such information to argue that the availability of this information does not guarantee a profit or that this information is often misleading. Moreover, attempts to rationalize efforts at obtaining such information as merely the product of good research, are just this, namely, rationalizations. There is clearly room for greater control of the release of corporate information to ensure that all investors are given an equal opportunity to take advantage of the market opportunities which this information creates. More direct means of obtaining price sensitive information, such as through the purchase of large holdings in corporations which might entitle one to Board membership are not available to many. Moreover, whilst it is believed that some entrepreneurs may be primarily motivated in this way, it seems that this is both an expensive and risky means of obtaining price sensitive information. It is obviously much safer to seek to obtain this information through selective briefings from a corporation than through Board membership.

At the same time, the market operates upon the basis of the comforting myth that so long as your market analysis is correct or that if you study fundamentals, you will be able to succeed. Brokers clearly have an interest in perpetuating this somewhat abstract or theoretical view of markets. Whilst it is true that this method is likely to bring success in the longer term, particularly with blue

chip stock, most interviewees grudgingly acknowledged that resort to inside information is superior to reliance upon fundamentals, particularly in the shorter term. In an over-analysed and competitive market, the temptation for financial intermediaries to obtain inside information is enormously attractive. Ironically, it is industry insiders, those who are arguably in the best positions to undertake analysis of fundamentals, who rely most upon inside information, rumour and herd instincts. Perhaps this is inevitable to a certain degree, but it seems that too much reliance may be being placed upon such short-cut methods for the market to be healthy and for the public to have confidence in it. Many in the industry seem to share this view. More timely disclosure of price sensitive information would reduce the premium value of that information and would reduce both the opportunity for and the scope of insider trading. Such disclosure would, as well, contribute positively to greater market efficiency.

2.9 Conclusions

At the start of this project we did not expect to be able to quantify the extent of insider trading. This was confirmed by the responses to our questions. We must reach the obvious conclusion that nobody in Australia can say, with any precision, how extensively insider trading is carried on.

We did not expect brokers to say anything different to what they told us. It would have been impossible for any of them to nominate with any certainty the extent of insider trading. It is no reflection on their truthfulness and candour to say that we would have expected them to paint the industry in its best light. We regard it as significant that none of them was prepared to deny that insider trading goes on. That fact is an inescapable conclusion in our view. Given the opportunities that are available and, even if we accept the argument that there are always "bad apples" in any profession, it is clear that the temptation to make substantial profits through insider trading is ever present and would be very difficult for some to resist.

An interesting feature of the information which we gathered was that the further we moved from the centre of the market the more often insider trading was said to be widespread. The brokers said that it was not widespread and it was not surprising that the exchange officials said the same. The financial advisers

thought that it was widespread as did the lawyers and the market observers. The regulators were inclined to say that it was very widespread. We found that most of the participants regarded insider trading in takeovers as commonplace and this confirms, to a degree beyond what we had expected, the widely held views about the link between takeovers and insider trading.

It appears, from what we were told that the level of insider trading is probably slightly lower than in the pre-prohibition period and that the main difference is that it is now less blatant. This is not altogether surprising in view of the widely held view that the legislation is moribund. It also reflects the reality of human nature that where there is a chance to make money it will be taken by some despite the law and despite the ethics of the matter. It was interesting to be told that insider trading is not a major problem. What made it so significant was that other forms of market abuse were quite readily identified. We were struck by the number of times that participants in the study referred to warehousing and, in particular, to price rigging which seems to be so commonly practised as to be almost legitimate by default. While we recognise that there could be an element of envy about "entrepreneurs" we could not fail but to note the strength of the disapproval of their activities. There was considerable variation in the opinions as to who engaged in insider trading and in which stocks this occurred. The weight of opinion leans strongly towards persons associated with companies and there was a discernible pattern in the responses that showed that brokers and other market-place professionals were also engaged in it to varying degrees.

Our impression is that insider trading is done on two levels - as an opportunity arises and in a calculated way. We also believe that it is conducted on two scales. At one end of the spectrum is "petty" insider trading, usually conducted by lower level staff and smaller investors. At the other extreme is trading which involves considerably larger sums. The key to the difference in scale is the amount of money required to make the investments. In the course of our discussions we learned that for a large player a profit of \$100,000 is regarded as unexceptional. We were shown figures that indicated that over a two day period an apparent insider trading operation yielded a profit of \$890,000 and there have been allegations of a profit of \$23 million from an off-shore insider trading operation. We think that these represent an unusual level of insider trading. We do not think that there is insider trading on a "Boesky" scale. The Australian market is too

small to sustain such an operation and none of our respondents even hinted at the existence of such a person in Australia.

The sector of the market in which insider trading is most likely to take place is the market for shares. There was some reference to options as a possible vehicle for insider trading. The general view of the participants in the study was that insider trading is more likely to occur in "lower quality" stock such as mining, resources, high technology and speculative stock generally. We think that this is a plausible assessment. This type of stock is more likely to react to good news and more likely to yield better profits through the more spectacular movement of its price. There were, however, many respondents who told us that insider trading is not confined to a particular type of share.

In the course of the project much of what we came across was logical, plausible or predictable. We were, however, surprised by two particular matters. The first of these was the ease of carrying out an insider trading operation. It seems that this can be done quite simply either by using a false name or through a nominee or tippee. Persons wishing to do so can rest easy in the knowledge that the risk of challenge, detection and ultimate prosecution is so low as to be virtually non-existent. Even if one is suspected of insider trading there will be a minimum of professional opprobrium. For the more determined insider trader the use of an off-shore medium is seen as a riskless way of operation. The places mentioned in this context were London, New Zealand, Luxembourg and Monaco. Nobody was able to say how common this mode of insider trading is.

The second surprise was the level of ignorance among many of the participants, especially brokers, about what constitutes insider trading. There is some evidence that when a broking firm discovers non-public price sensitive information in the course of visits to a company, it is common for the firm to use that information to trade on its own account before it is passed on to selected clients or to institutions that the firm would like to have as clients. When this matter was discussed with brokers we were surprised that many of them did not consider the possibility that what they did, as a matter of course, might bring them into conflict with the prohibition on insider trading. This matter further emphasised the point made by most interviewees that there must be something done to improve the disclosure practices of listed companies.

The level of ignorance which we detected is, perhaps, understandable given that section 128 is very complex and that there is no guidance about it from decisions of superior courts. It might also be explained by the reference to a lack of ethical training in the broking industry. We do not wish to have this observation interpreted as a denunciation of the ethical standards of all brokers. Nor do we wish to understate the pressure to make money that brokers must feel.

In respect of the extent of insider trading in Australia we can conclude with the following observations:

- the populist impression of insider trading which embraces rumours, gossip, guesses and uninformed tips is not necessarily always the type of insider trading that is referred to in section 128 of the Securities Industry Code. The impressions of the degree of insider trading are exaggerated by that factor.
- our study was undertaken after the 1987 crash and the responses to our questions about the extent of insider trading represent the base level of insider trading, that is, it is not enlarged by the higher level that could be expected during a bull market.
- insider trading occurs mainly, but not exclusively, in the lower level stocks.
- the persons most likely to engage in insider trading are those associated with the company but that does not mean that others more actively engaged in the market do not do it.
- while it is not amenable to precise measurement, it would be a reasonable estimate that the extent of insider trading ranges from "not uncommon" to "widespread". It is certainly not an occasional aberration.

3. The Effects of Insider Trading

If insider trading is perceived to be fairly widespread by informed observers, an obvious question to ask is what effect, if any, this practice might have. A more definitive study of insider trading might also have drawn upon data which gave some idea of the views and experiences of ordinary investors and traders, rather than just those of the industry professionals. However, as these professionals occupy key vantage points from which to make authoritative judgments, it is not unreasonable to expect that they would be able to give us a fairly good idea of the likely effects that insider trading may have.

3.1 Harmful Effects of Insider Trading

In considering the impact of insider trading an obvious enquiry is whether it has any beneficial or detrimental effects. We first asked whether it has any harmful effects (Q6).

Almost all of the brokers said that insider trading is harmful and the most commonly expressed view was that the harm was done to the market. Some said that small shareholders suffered. Some of those who expressed contrary views said that there were no losers because there were willing sellers. Amongst those who agreed that there was harm to the market there were various qualifications of that view. According to one broker, "in its rawest form insider trading dislocates the market. It upsets overseas investors. It is not to be commended" (B44). Similarly, a Sydney broker asserted that

"sophisticated insider trading done on a big scale erodes market confidence. Australia's image was damaged by insider trading in the mining boom. 'Innocent' insider trading has negligible effect" (B50).

A more specific statement was that "the harm is to confidence in the market place. It is necessary to protect smaller people - insider trading hurts small people" (B28). The similar though more strongly expressed opinion of a Melbourne broker was that

"it is a form of stealing. It damages the system, especially small people. The entrepreneurs steal from the weak" (B43).

A more equivocal view was that "the market would suffer if there was widespread insider trading because individuals would feel

manipulated. People don't like being ripped off. Insider trading involves risks - the inside trader could lose; the other party could lose or be taken advantage of perhaps. Maybe they would have sold anyway" (B31). A wider range of matters was referred to by another broker who told us that "insider trading harms the general public and keeps people out of the market and also harms institutions when they are on the wrong side of a deal. Overseas investors suffer" (B47).

A more detailed explanation was that

"the vast majority of shareholders suffer. There are new forms of regulation adding to the cost; they miss out on value; they should be able to share profits" (B32).

The damage arises according to one view because "there are winners and losers" (B10). A somewhat different assessment of the damage was that "there is more money lost by people acting on what they think is inside information than by those who sold" (B52).

Some brokers were more specific about where the harm is felt. Two retail brokers told us that it is "the small shareholder who suffers" (B9) and that it is "the man in the street who loses" (B30) though "the insider trader loses more often than not" (B30). The effect on small shareholders was reiterated in the explanation provided by a Melbourne broker who said that

"smaller shareholders are disadvantaged. The institutions are not. They are in a privileged position, in a favoured position and are getting all the information that is around - but are not necessarily insider trading" (B27).

Another similarly detailed view was that "harm is done to shareholders - they are given a bad impression of the market; it affects brokers' professional image; later shareholders are harmed and the market goes beyond true value" (B72). A Perth broker summed it up by saying that "in blatant cases the seller is disadvantaged" (B8).

Those who felt that no harm was caused by insider trading offered several views. In the words of one broker "there is a willing seller who would have sold anyway. It is caveat emptor in the market place" (B54). Another of the Sydney brokers expressed the

opinion that "there should not be any harmful effects; who is harmed? Everybody should have access to information" (B48). One broker saw it in terms of "a swings and roundabouts situation. There is some damage in blatant cases such as in pre-takeovers" (B58). One of the very senior brokers we spoke to described insider trading as

"... a victimless crime. In the equities market you cannot totally protect everybody. It has an unfortunate effect on the market" (B37).

Most of the financial advisers felt that insider trading is harmful and for the most part they identified the victim as the market. In more specific terms they said that investor confidence is eroded; the raising of capital is made more difficult; the efficiency of the market is destroyed; the perception of unfairness leads to disinvestment and that the international reputation of the Australian market suffers. One view was that the market does not suffer from insider trading because it is always in need of information (FA11). Other victims of insider trading were identified as the "Mums and Dads" investors, small traders, and those who do not have the information and trade in that state of ignorance. An interesting commentary was provided by a merchant banker who said that

"there is a level of insider trading which is immoral where a person trades where there has been a dramatic increase in the price. In a commercial sense the market would be much better if caveat emptor applied; the market is a good regulator" (FA41).

The fund manager who thought differently said that "there is not really any harm. Although the game is not played with fair rules I believe that people buy and sell shares at prices they find attractive" (FA6).

Except for one, all of the stock exchange officials believed that there was some harm associated with insider trading. There was some difference as to what or whom was harmed. Two said that the market suffers, one said that it was the seller who was the victim of insider trading while others mentioned persons who conduct the transaction without being properly informed. The dissenting view was that there is no harm "particularly in Australia as the market is so thin. The seller is not forced to sell. He sells at a price he thinks is fair" (R66).

There was a widespread view within the market observer group that insider trading is harmful and the words "unfair", "wrong", and "defrauds" were used in describing its effect. The views as to the victim of the harm fell into two categories - the market, and those who were on the other side of the transaction. An answer that perhaps summed up the views of the group was that "it distorts the market; it is unfair to small shareholders; it creates an unfair advantage and it destroys the level playing field" (O7). Another view strongly expressed was that

"it causes financial harm to those who do not know, such as the mug punter. A real loss is suffered by buyers when insiders are getting out. There should be tough rules and they should be prosecuted toughly" (O64).

The concept of a group of uninformed shareholders being taken advantage of was neatly summarised as "people on the outer ring of the market are disadvantaged" (O46). A more robust view was that "the real harm is that the game is not straight. We need an informed, honest market" (O65). Even less concerned with the effect on investors was the observer who said that "in some situations insider trading could undo a deal" (O34).

Whilst most lawyers agreed that there was harm caused by insider trading, they often also said that this was a question of perspective. As one Sydney lawyer put it

"it all depends upon where you stand. I've never been interested in little old ladies and orphans. There must however be a minimum level of regulation. It seems wrong when you hear of cases of insider trading. The law has a role to inhibit it but not to stop insider trading entirely" (L61).

In a similar vein, a Melbourne lawyer observed that "the degree of harm depends upon the circumstances of a particular stock. Insider trading can both advantage and disadvantage an individual" (L39). Most views fell into two groups. The most commonplace was that insider trading was harmful basically because of its unfairness to the person who does not have the inside information. As one Melbourne lawyer said "harm is caused to the person taken advantage of. It is unfair that some trade with better information than others" (L35). Another Melbourne lawyer added that

"technically, the little mums and dads could be harmed. It is just dishonest, insider trading is like fraud. The person who sells is harmed" (L55).

A Perth lawyer more emphatically observed that "undoubtedly insider trading causes harm. If it is a true case of insider trading, people profit at the expense of the uninformed. However, you often don't realize that you are a victim" (L14). A similarly strong view was taken by a Melbourne practitioner, who said that "insider trading distorts securities markets. Insider trading is a fraud. People should be fully informed or have the capacity to be so if they seek advice" (L36). As a Sydney lawyer explained

"if there is insider trading, the harm is that others trade on less than the same information. People must lose from insider trading as there is a loss of confidence in the market" (L57).

In the opinion of a Melbourne lawyer "people worry about insider trading. Insider trading also harms the market as it is not fully informed" (L55). A Sydney lawyer, however, expressed the view that "no economic loss is caused by insider trading, but insider trading is just a question of fairness" (L56). Our lawyer interviewees sometimes also held more complex or ambiguous views. There is a certain degree to which a plea for fairness is something of a "motherhood" statement and so needs to be supplemented so as not to appear to be somewhat trite. Thus one Perth lawyer observed a little uncomfortably, "I believe in equal opportunity and oppose cheating. However, perhaps the system is bigger because of insider trading" (L15). Another Perth lawyer told us that the question of harm

"is always a difficult question as the person who bought the shares has made a conscious decision to invest. In a boom market, insider trading acts as a incentive and encourages people into the market. But insider trading does give some people an unfair advantage. It is more a question of fairness than the harm that insider trading causes" (L13).

The strongest critic of the view that insider trading might cause harm emphatically answered that "insider trading is not the major evil it is made out to be". However, even he went on to tell us that "one problem arises from an insider's ability to get out before the market knows what the real problems are. But most big investors and individuals don't invest in anything but blue chip companies

and the latter do not insider trade as insider trading is too risky" (L38). On balance, therefore, the predominant view was that insider trading was undesirable on the ground of fairness. This view was sometimes a little uncomfortably held and so was usually supplemented by some broader, and equally vague arguments, such as that insider trading was harmful to the market, although a few lawyers that we interviewed did not believe this to be so.

Turning to the responses received from the regulators, we found, perhaps predictably, that all but one felt that harm was caused by insider trading, although even this regulator acknowledged that "the sellers may suffer because they don't receive the proper advice" (R4). The issue of the perceived unfairness of insider trading once again kept surfacing. Thus we were told that "insider trading causes harm by denying equal access to information" (R2). Frequent references were made to the philosophy of the level playing field. This was put somewhat more colourfully by one regulator when he observed that "insider trading is unfair in the same way as a fixed horse race is unfair; it gives the Australian market a bad image" (R67). Another way of expressing this view was that "insider trading causes indirect harm by denying an equal bite of the cherry to all players" (R3). This position was explained somewhat more soberly by another regulator when he observed that

"an uninformed market is not a fair market, as it may not represent the true value of the securities. The end detriment is to the general public who are indirectly affected through their commitments to superannuation funds and the like" (R69).

The issue of unfairness was also seen to have a number of consequences. We were told that "if a market is seen as being 'unfair' then both the confidence of the players and the credibility of the Australian market are harmed" (R19). Frequent references were made to harm which was caused by insider trading to the small investor who did not have access to the inside information as well as to sellers generally. Also, the regulators commonly observed that the company itself was harmed by insider trading, such as by making it difficult for the company to raise sufficient capital (R1b). As another regulator saw it

"the company is harmed by the misuse of information which belongs to it. In some large corporations or groups this is not so simple because managers expect

to benefit from insider trading as a spin-off from the company's deals" (R1).

Thus the regulators were in no doubt that insider trading was harmful, for a range of quite different reasons, although the issue of fairness was once again the main reason for the perceived harm caused by insider trading.

Insider trading is clearly not the victimless crime that it is often made out to be. Harm is always caused whether it be to an individual or the corporation, or to the market. Individuals may not realize that they are a victim, yet they are nevertheless victimized by insider trading. Small investors and shareholders are widely seen as those who suffer most as a result of such conduct. Even where the protection of small investors did not evoke much sympathy, unfairness and the fraudulent nature of insider trading were seen as undesirable effects. There was also a strong feeling that the market itself is harmed by insider trading as it is desirable that there be perceived to be an honest and informed market. Insider trading could be seen therefore as corrupting or debasing the market. However, the perception of harm is obviously in the eye of the beholder. It is largely a question of standpoint. Yet, even defenders of insider trading qualified their views. No one was prepared to say that there were no harmful effects of insider trading.

3.2 Beneficial Effects of Insider Trading

In looking to see what beneficial effects insider trading might have, we of course asked respondents to exclude the direct benefit to the insider trader as a consequence of the trade. With this question (Q7) we also sought to explore the acceptability of Professor Henry Manne's argument in defence of insider trading, namely, that insider trading is appropriate as it acts as a price accelerator and helps to bring the price of securities to their proper level more quickly than would be the case without the insider trading taking place. This argument has recently been popularized by Graeme Samuel in Australia, although he seems lately to have begun to distance himself from it (BRW 15 July 1988 at p.62). Another argument in defence of insider trading which is identified with Manne is that insider trading is beneficial in that allowing management to insider trade in their company

stock provides an additional incentive to them to be more entrepreneurial in respect to the companies that they control.

Most answers from brokers were in the negative or qualified negative but an almost equal number of brokers were able to nominate some benefits (apart from the profit made by the insider trader). There was not a great deal of acceptance of either element of the Manne argument. The usual form of the negative answer was a flat "no". One expanded response was that "the only beneficiary is self interest" (B72) while another broker said that "insider trading goes away from a true market situation" (B27). The qualified responses included the observation that "whether there are benefits depends" (B58) and the same degree of equivocation was apparent in the answer of a Melbourne broker who said that "I haven't thought of any benefit" (B37). Another broker described it as "another form of redistribution" (B50). One of the other brokers found it "hard to see any benefits", but he then told us that "companies are restricted in talking to analysts if the law is too tough" (B48). According to a broker in Sydney, insider trading could "warn the market and thus stop premature selling [and it] could upset a takeover bid" (B54).

The most common answer of those who saw benefits was related to its effect in keeping the market moving. As one broker saw it, insider trading "encourages activity and is beneficial provided there is no fraud" (B31). His view found support from others who thought that

"insider trading is good for the market by providing increased activity" (B10)

and that "insider trading drives the market" (B8). A Melbourne broker saw some benefit in insider trading in that "money goes round, it provides a larger and more fluid market" (B30).

There were other broker views about the possible benefits of insider trading. A Sydney broker made the obvious point that "it is beneficial for the people getting out" (B52). A view that perhaps reflects poorly on the efficiency of the market was that "it forces information into the market" (B32). One dimension of insider trading which had not been spoken about widely was the impact of insider trading on takeovers. A Sydney broker offered the view that

"maybe it puts pressure on the bidders in takeovers to go higher. It is in the bidder's interest to reduce

insider trading; for the shareholders in targets perhaps it helps" (B51).

The indirect value of insider trading was explained in the statement that "if you follow the money you can profit" (B49).

When we tested the market accelerator argument the responses were almost all unfavourable. One broker identified a danger in that "insider trading is often based on false information and the price goes to the level they wanted" (B28). Some brokers challenged the premise on which the argument rests. As one put it, "it is not beneficial to the entire community" and he went on to say that "the price mechanism is not necessarily efficient" (B27). A stronger rejection of the argument came from a Sydney broker who said that

"[the market accelerator argument is] rubbish; it is for the benefit of a few. It is patently absurd. What is the proper price level? It should be determined in a free market" (B50).

Another broker asked "what is the proper level? Is knowledge exclusive property?" (B58). Other challenges to the argument came from a broker who told us that "stock does not necessarily go to its true price" (B32) and from another who said

"what is proper? It depends on a particular person's conception of value" (B51).

There were brokers who acknowledged that there was some appeal in the Manne view. As one said, "it sounds fine but if somebody benefits along the way that is not right. It is good for forcing information on to the market" (B48). One comment was that "more disclosure will show the price better" (B30) and his view was endorsed by a Sydney broker who said "that is fair enough but it is better to make the announcement before insider trading starts" (52). The Manne market accelerator argument was dismissed by others who described it as "justifying the black market" (B43), "a rationalisation" (B49) and as "nonsense" (B44).

The comments by those who did not disagree with the Manne argument were based on the informational efficiency of insider trading. As one broker said "I suppose I agree. It is a form of getting information to the market" (B37). The same view, expressed more definitely was that "insider trading helps restore the market to a truer level by providing information to the

market" (B31). Perhaps a less committed attitude to insider trading was that "it is a justification argument for smoothing prices. In stocks with a lower level of volatility it is acceptable" (B47).

While brokers were prepared to acknowledge some validity in the accelerator argument their views about the management reward argument were expressed more strongly and were almost universally condemnatory. One broker simply said that "this should never occur" (B28). There was a view that "they should be rewarded by a company profits incentive scheme" (B44) or, as another put it, "they should be rewarded in remuneration. They should get a reward for extra effort" (B49). Likewise, a Sydney broker described it as "a terrible idea" and he said that "they should be paid" (B47). Others felt strongly about the impact of the practice on shareholders. According to one broker "[the argument is] rubbish. Executives should be rewarded on performance by their employers not by participants in the market" (B50). A similar view was that

"it is wrong to bribe them. Their job is riskless, they do not put up any capital. They want to take it from the shareholders" (B37).

The argument was also criticised by another broker who said that "companies should keep shareholders fully informed" (B31).

Some brokers saw an ethical dimension in the argument and, in this context, a Sydney broker said of management that "they are not entitled to the information and should not trade" (B48). An even stronger reaction was that "I am violently opposed to it. It is a breach of confidentiality" (B54). Another Sydney broker thought that

"it is wrong. Executives are being paid from the profits of the company. They cannot trade." (B52).

A direct response from a Melbourne broker was that "it is not acceptable. It is not ethical" (B32). Other brokers told us that "directors have a responsibility to keep the market informed" (B8) and maintaining the distaste for entrepreneurs, one Melbourne broker said that "the market does not need entrepreneurs. It is not a legitimate argument" (B30). The only expression of support was "it is, okay. The market sets the price and therefore it is legitimate to allow this" (B58).

One view that did not directly address the question but which raised an important issue was that "if trading by insiders, in the absence of price sensitive information, were publicised, as it is under the US system, that would be a good thing. If an insider sells and people know, it gets a message to the public. Insiders who hold shares should do so for a year or longer. People jobbing in and out of their shares is a disgrace" (B47).

The reactions to these questions were very significant. They demonstrated quite clearly that the brokers have an aversion to insider trading, at least in principle, but, of even more significance is the commentary that these answers provide on the market. The brokers' responses suggest that insider trading does harm the market.

It seems a sorry state indeed if the market is forced to rely, even if only to a limited extent, for information from a practice that is, if not corrupt, at least highly questionable on ethical grounds. The fact that the market must obtain its information from insider trading is not a very satisfactory commentary on the efficiency of the existing process of informing the market and, as so many of the brokers told us, something must be done to improve that process. Such an improvement would at once contribute to a more informed market and go some way to eliminating a form of market abuse.

The majority view among financial advisers was that there are no benefits. As one respondent put it

"insider trading accelerates the market and this is okay from an efficiency viewpoint but it is not ethical or moral" (FA63).

Those who were not part of the majority said that insider trading brings news to the market more quickly. As to the Manne arguments, there was total rejection of both strands. Several commented that if bringing news to the market is a good thing it would be better if the disclosure was made by the company itself and some doubt was expressed as to whether it accelerates the price. The reward argument was described as "a twisted form of logic" (FA60) and another said that "it is a sad case if you have to rely on insider trading to provide an incentive" (FA11).

Without exception the view of the stock exchange officials was that insider trading has no beneficial effect. Two respondents

referred to the Manne theories. As to the accelerator element of the argument "it is better for the information to come from the company" (R66) and the other said that he did not agree with the Manne view "especially when prices are going down" (R18). The reward aspect of the Manne theory was described as "a pretty weak argument" (R66) and his colleague told us that "it forgets who owns the company. The incentive should be in other forms" (R18).

For the most part, the observers answered this question in the same way. Insider trading "is contrary to basic traditions of business" (O7), said one. Another told us that "it only benefits the winner. Insider trading should never be legalised" (O59). Insider trading "does no long term good" according to another (O34). One repeated a position that had been taken by several other of our respondents saying that "it allows information to hit the market earlier but it would be better to improve the disclosure of information" (O46). A very crisp answer was that

"regulation is about equity not about efficiency" (O53).

Those who could see benefits from insider trading argued that "insider trading allows the market to reassess the stock price. It is informationally efficient" (O5) and, perhaps in an effort to say something good about insider trading, one person told us that "the lenders of money used to buy shares benefit" (O75).

There was thus a resounding rejection of both aspects of the Manne theory. The accelerator argument attracted only faint support. As one observer said, "I agree to a point in respect of industrials but in speculative stock, insider trading can run the price up falsely" (O25). There was one person who, perhaps operating on a different plane, said that "I cannot understand why insider trading should affect the price" (O34). The mainstream opinion reflected a variety of criticisms of the accelerator argument "... it is true, but even if it advantages only a few it is crook" (O46). Another put forward the suggestion that "there are other ways of publicising information; there should be regular announcements, more than an annual report, especially for volatile stock" (O59). The reaction to the management reward aspect of the theory was much stronger. One described it as "outrageous". Another said that "it's trying to legitimise something that is wrong". Another reaction was that "it is a form of robbery of shareholders". One of the observers predicted that "managers would run the company for their own benefit". To another, insider trading is "an incentive for badly managed companies".

Whilst two of the lawyers respondents gave some degree of support to the price accelerator argument, it was generally also rejected by most lawyers. One Melbourne lawyer did however argue that "insider trading tends to cause the correct price to be reached more quickly. It is an incentive for small companies to go public". He also went on to tell us that "the incentives to management argument is okay" (L38). He was alone in being so confident in these views. Somewhat less confidently, a Sydney lawyer who agreed with the Manne thesis was a little less comfortable with it when he told us "the price accelerator argument is probably true, but it is inconsistent with the prevailing philosophy of equality of information. There is a need for better disclosure rules". However, he did not find any justification in the executive incentive argument for, as he put it, fairly characteristically, "it is better to give executives incentives through other means" (L57). Another Sydney lawyer took a similar approach when he argued that "insider trading has benefits to the extent that it assists the flow of information by tipping off the market. I agree that it brings the price to its proper price but I don't accept the entrepreneurial incentives argument. Insider trading laws actually make it difficult for management to deal in their own stock" (L56).

Most lawyers were however somewhat more vehement in their responses to the arguments regarding the supposed benefits of insider trading. This was expressed quite succinctly by one Perth lawyer who told us

"the Manne argument is bullshit. It is just a rationalization for dishonesty" (L15).

In a similar vein, a prominent Sydney lawyer observed at this point

"I'm not impressed with the ... view that insider trading greases the market. I emotionally oppose the price accelerator view. Section 128 should stay in the Code".

He did however concede that "the management incentives argument is true in a minor way. But management would be less free with information if this was allowed to occur" (L61). The market accelerator view tended to be rejected by other lawyers in less emotive terms. As one Perth lawyer put it

"the only benefit is for the participant in insider trading who enhances his profit or reduces his loss. The executive rewards argument is not acceptable as it is just ripping off the community. There is a moral question that is, that someone will lose out. The price accelerator argument is wrong" (L14).

A Melbourne lawyer took a similar view when he said "I can't think of any benefits from insider trading. As to the market accelerator view, the listing rules (s.3A(1)) cover this. The executive compensation argument is wrong as there are other legitimate means of remuneration available without disadvantaging others" (L35). A Sydney lawyer seemed to agree with this when he added

"there are no beneficial effects of insider trading. Instead of escalating the price to the proper price, inside information should be announced to the stock exchange instead. The executive incentives argument has no credence as executives should be rewarded in other ways" (L55).

The first of these arguments was also criticized by a Melbourne lawyer in the following terms "regarding the proper price argument, insider trading can also set an artificial price as the information can be misleading" (L39). He too was not persuaded by the management incentives argument. A Melbourne lawyer also observed that "as to accelerating the price, it should be noted that there is some insider trading based on inaccurate information" (L36).

The official position is much the same as that held by those in the private sector. Regulators saw little if any benefits arising from insider trading activity, apart from the obvious benefits to the insider trader. However, some saw benefits accruing to brokers through the additional turnover (R1a) or to the broader market "from the turnover of money in the economy" (R23). Another possible benefit that was mentioned was that "insider trading adds liquidity to the market, so that perhaps the State governments benefit from the additional stamp duty revenue" (R20). All of these reasons were seen as being less than strong benefits which would justify insider trading. There was very little support for the Manne arguments concerning the supposed benefits of insider trading. Thus, for example, we were told repeatedly that the Manne arguments were just immoral. As one regulator observed

"the Manne approach that insider trading encourages entrepreneurial activity is a short term view which ignores the longer term moral question" (R1).

In addition, another regulator added

"insider trading is immoral and far from providing incentive to managers may be seen as diverting them from their real purpose" (R20).

On the contrary it was felt that the possibility of insider trading "should act as an incentive for company officers to keep the market informed on a timely basis" (R69). The market accelerator argument was just as soundly rejected by the regulators so that the broader benefits of insider trading were far from being apparent to them.

Overall, there was little support for the supposed beneficial effects of insider trading, beyond the immediate benefits received by the insider trader. This was the consistent view of almost all the respondents. Apart from the profits to the insider trader, there are no identifiable beneficial effects of insider trading.

The respondents, especially those in the market place were critical of the arguments associated with Henry Manne. These arguments must therefore be seen as being academic and somewhat unsubtle and certainly not in accord with the perceptions of financial markets held by professionals closely involved in those markets in Australia. All attempts to justify insider trading were actually very strained and advanced without much confidence. Indeed, there was such a reaction against fashionable North American arguments in favour of insider trading that there is clearly a need for companies to improve their mechanisms for disclosing price sensitive information to the market as a whole. Insider trading is clearly not accepted as a means of ensuring that information is brought into the market efficiently and fairly. Furthermore, the complete dismissal of the executive incentives argument as a justification for insider trading suggests that the interests of shareholders need to receive far more attention than they do. These interests tend all too often to be given lesser priority than they ought.

3.3 Insider Trading and Market Confidence

Having looked at arguments regarding the possible harmful and beneficial effects of insider trading in general terms we then turned to more specific effects which might be caused by such conduct. One argument which is often heard is that insider trading might serve to undermine the confidence of investors and others in stock markets. We asked the respondents whether, and to what extent, this might be so (Q8).

A high proportion of brokers said that insider trading has not undermined confidence in the stock market. One common line of argument was that a certain level of insider trading was acceptable; another was that the incidence of insider trading was too low to have an effect. The former view was summed up by one broker who said that "people are prepared to live with a degree of insider trading and other market abuse" (B9). A Sydney broker described the market as being

"like the race track. Everyone tries to get a piece of the action. Are players concerned enough not to play? They still play. Turnover figures disprove any theory of lost confidence" (B47).

Similarly it was put that

"in speculative stocks people are basically gamblers. The low end of the market is like a casino with people trying to make a dollar. Does it matter there? Most people are philosophical about selling early. In a takeover you wait until a certain point; if the price goes further that is bad luck" (B52).

Another commentary on the community acceptance of insider trading was that "if people believed that you could win by insider trading that would attract more investment" (B51). In the same vein, a Perth broker believes that

"insider trading is not a big enough problem. The greed factor determines peoples' view of insider trading" (B10).

According to other brokers the low level of insider trading suggests that there has been no lowering of confidence because of it. As one said, "insider trading is not bad enough for the average

sensible investor to take too negative a view. People who have lost might attribute it to insider trading" (B47). While insider trading did affect confidence in the 1969-71 period "there is now so little that it does not" (B44). Perceived rather than actual insider trading has an effect "but it has not in recent years because of the lower level of insider trading and more serious forms of abuse like the Bond-SGIC-Bell deal" (B52). Another of the brokers remarked that "speculation about insider trading creates problems; publication gets it out of perspective" (B37). A variation of the low level argument was the view of a Sydney broker that

"there is not a high public awareness of it. They think it goes on to some extent. Two convictions would damage the market but would be a good thing in the long run" (B50).

Another said that "it is not a major issue in Australia. The market punishes brokers who do it. Clients never raise the issue" (B28). Of those brokers who said that confidence was damaged by insider trading, one view was that "the smaller person is disillusioned, they think that the stock exchange is a closed shop and that they won't win" (B27). Likewise, we were told that

"insider trading creates a degree of cynicism that only the big boys know what is happening and therefore tends to keep people away" (B29).

However, although "insider trading undermines confidence, the press exaggerates it and that does more damage" (B32).

Perhaps the attitude of investors to insider trading depends on their own experience. One broker felt that "in blatant cases victims would be sour" (B48). It maybe that the comment by a broker (B48) that "people hate insider trading if they do not have the information or did not make the profit" had more than just a grain of truth.

The most popular view among financial advisers was that there had not been any undermining of confidence. A few, however, said that there had been and several gave qualified answers. Of those who said that there had been no adverse effect on market confidence, one said that "on the contrary insider trading makes people get involved in the market" (FA11). Another explanation was that "people accept insider trading as part of the market background. In some markets such as Asia and New Zealand

where insider trading is rife there may be more damage" (FA60). One of the fund managers dismissed the proposition that market confidence had been adversely affected by insider trading as "bullshit" (FA6).

The opinions of those who differed from this were that "until recently there was no evidence that insider trading had damaged confidence. Until the crash in October 1987 insider trading was glossed over" (FA42). Insider trading was said to have an effect on small investors in that it "could be seen as frightening away the small investor" (FA45). Those who had a qualified opinion provided several views. A Perth merchant banker told us that

"it depends on whether the non-informed investor feels prejudiced - people don't mind so much if they have missed a profit but they hate to make a loss" (FA16).

Another said that "to some extent confidence has been damaged. People who have been hurt now put their money into trusts or real estate" (FA63). One of the accountants that we interviewed felt that "the community is cynical about the market and there may be some classes of investors who lose confidence" (FA17). Another view was that "the perception that insider trading is rife has undermined the confidence of small investors but not the big players - the professionals" (FA33). It was suggested that insider trading is not the only feature of the market to affect confidence "...events have a cumulative effect. At present the Holmes á Court sellout has damaged confidence" (FA40).

The ASX officials also did not think that insider trading has affected market confidence. One assessment was that "insider trading has not, but what has been said about it has done more damage. People trade because of their expectations" (R66). Another view was that "insider trading increases uneasiness. If people do it other market players exclude them" (R21). One official replied that it has had no significant effect as "people are not kept away by insider trading" (R18) and this was also the opinion of another who said that it had not affected confidence "to any significant degree" (R12).

There was a mixture of answers from the market observers that we spoke to. Of those who said that there had been an undermining of confidence, the most detailed opinion was that

"insider trading creates a casino image and investors have abandoned the market because of a lack of faith in it" (O7).

Another offered the opinion that

"people think that business is a bit dirty and think that success comes from corruption" (O5).

Some said that insider trading had not undermined confidence and one person in this category claimed that "people are aware of insider trading going on and have not been stopped from trading in shares" (O59). Another said that "the real damage to public confidence is done by people like [the entrepreneurs]" (O34). Another school of thought was somewhere in the middle - a qualified view - "it will be damaged if the media develops the perception of widespread insider trading" (O75). A more thoughtful view was that

"the low participation rate in Australia suggests that there is a lack of confidence in the market. Most people must be aware of the chance of a loss on the Stock Exchange. Confidence is undermined in the eyes of the naive. People will accept a level of corruption but it is much worse in horse racing than in the Stock Exchange (O64).

Although some lawyers felt that their own confidence in stock markets has been undermined by the existence of insider trading, there was a surprising degree of unanimity amongst them to the effect that, generally speaking, insider trading has not undermined confidence at all. A number of reasons were advanced for this being so. As one Perth lawyer told us, despite the knowledge that insider trading existed,

"people will still have a flutter. Insider trading is almost accepted as one of the risks of trading. In any event, confidence in the market is a cyclical thing" (L14).

Similarly, another Perth lawyer added

"insider trading hasn't undermined confidence as people think it is normal. It actually takes a lot to deter people from being greedy. Successful

enforcement of the law may disillusion people more" (L15).

One reason why insider trading may not have had much effect on stock markets was advanced by a Melbourne lawyer when he told us "I'm not sure that there has ever been a high level of confidence in stock markets. The people that I deal with professionally have always had a cynical view of the stock market, they are wary, but they still gamble" (L36). Likewise, a Sydney lawyer echoed this theme when he explained

"everyone knows that insider trading is going on, it is part of the gamble. Insider trading undermines confidence, but people are still prepared to take a punt" (L55).

Throughout our interviews with lawyers we were repeatedly struck by the widely held view that the stock market was perceived as being like a casino or like a horse race, where a degree of "fixing" of the race was accepted as a part of the risk and excitement of it all. Thus, a Melbourne lawyer told us that, whilst "there is a strong feeling that everyone should play by the same rules (i.e. section 128), insider trading has not deterred people from investing" (L35). Instead, we were told that "more confidence has been lost as a result of the crash" (L13) or due to the appearance of the Rae report in the mid-1970's (L56). Nevertheless, there seems to be an underlying "fear of market manipulation" (L56), although one lawyer told us that it is often said that "the last thing you want is an honest broker (i.e. to encourage rumours). But how do you draw the line between rumours and inside information?" (L13). One Melbourne lawyer was even prepared to say that "insider trading doesn't undermine confidence at all. It has the opposite effect. If directors are prepared to trade in their own company's stock, it will have the opposite effect" (L38). Perhaps the most thoughtful response was provided by one Sydney lawyer when he observed

"you have to look at market confidence in parts. There has been no material effect in respect to industrial stocks. In regard to the exploration market, people would believe the press that insider trading is rife. But most people regard the Australian mining market as a bit of a casino anyhow. There might even be some beneficial effects of insider trading at that end of the market" (L61).

Regulators also rarely thought that insider trading has significantly undermined confidence in the stock market. Those that did, limited it to small investors rather than institutional investors (R20). One regulator also felt that "the belief that insider trading is rife has affected the level of investment in the market. After the 1970's crash, the market was adversely affected by insider trading as people would not invest in a market where dirty tactics were used" (R24). Another regulator observed that more recently, "people who invested in the boom market and were hurt are still reluctant to re-enter the market" (R1). Put another way, we were told that "insider trading does undermine confidence when the market is bullish" (R3). On the whole, the following view seems to be characteristic of the regulators "...people will accept a certain level of wrongdoing" (R19), especially as "institutional investors expect that some insider trading will occur" (R20).

It is reassuring to know that insider trading has not impacted on confidence in the market place. It is less reassuring to hear that a significant reason for this is that investors tend to regard the stock market as something of a gamble. It was not within the scope of this study, but we had hoped to survey the level of public confidence in the stock market. We understand that the Australian Stock Exchanges Ltd has commissioned a study on that matter and the results might be a useful starting point in developing a higher stock market participation rate amongst the Australian public.

We further pursued the theme of market confidence by asking about the likely effect of the repeal of section 128 on market confidence (Q9). Given the recent international trend of introducing or strengthening laws against insider trading, we were interested to know what the possible effect would be on the Australian market of repealing apparently ineffective insider trading laws.

The majority view of brokers was that the repeal of section 128 would adversely affect confidence both in the domestic market and internationally. Those who considered that there would be such a reaction offered several reasons for this. One broker thought that "it must affect confidence. Small investors are aware of the laws" (B9). A Perth broker suggested that "the playing field would no longer be level. If the law was repealed it would lead to manipulation" (B10). A similar, but perhaps not so strongly held,

view was that "it would not be a plus. The market needs some regulatory arrangement to stop people exploiting their position. Internationally it would be detrimental. European investors need to have confidence in the market" (B48). The value of the law as a form of reassurance was reflected in the response from a Melbourne broker that "any impression of lesser control would be a concern" (B28). One broker thought that there would be some detriment but

"more importantly a loss of confidence from overseas investors. Australian capital raising would suffer. The effect could be greater at the international level" (B47).

A stronger opinion was that "it would be criminal. Any director could buy up before a major development. The Australian image overseas would suffer" (B50). A Melbourne broker thought that confidence would suffer if it was to be "open season and it would be internationally damaging; we would be treated as cowboys as in the 1969-71 period" (B44).

There were, however, other brokers who qualified their response to this question. One rather pessimistic view was that "some regulation is needed to focus peoples' attention. If it is removed they will think it is only for the rich. Perhaps there would be no change - most people are honest, those who are dishonest can always win" (B54). A Sydney broker put to us the view that "we do not want a market without rules. I would rather have laws even though it is difficult to get a criminal conviction" (B49). A simpler expression of the same view was that "we need something" (B37). One Sydney broker's approach to the issue was that

"legislation is a make work thing but spivs should not be allowed to run the country. On balance the authorities must be seen to be doing something. Every now and then it is necessary to make examples. The market is not over regulated" (B51).

Those brokers who did not believe that there would be a loss of confidence offered a similarly diverse range of reasons. One interesting feature of the responses was the number of references to other more damaging factors in the marketplace. A Melbourne broker said "confidence is suffering now because of the conduct of the big players. Investor confidence is so low it could not go any further" (B30). A similar point was made by a Sydney broker who told us that

"in mining companies there would be no effect. People treat these like horse races. In takeovers a different type of investor is involved. There are more things to tighten up before insider trading - the Bond/Bell deal really worries people. On the international scene we are regarded as cowboys but not as bad as New Zealand or Western Australia" (B52).

One of the other brokers thought that the repeal of the law would not of itself damage confidence "but share price gyrations could affect confidence and ultimately the market would be damaged" (B27). Perhaps a more realistic view was that there would be no effect on confidence because "investors are not aware of the laws" (B8). Another view was that it would have "no immediate effect - it would depend on what other forms of protection were in place" (B31). One of the Melbourne brokers offered an interesting insight into the impact of laws in saying that

"it would depend on how it was done. Probably there would be no change because the market could depend on the ethics of business. The laws on insider trading affect the law abiding. Internationally, Australia would lose credibility and it would reinforce the cowboy image. New Zealand does not have an insider trading law and they do things we would not contemplate" (B32).

A more robust assessment was that "it would be business as usual. Overseas investors are out to make money and would not worry too much about it. Overseas pressure and greed often drive prices up" (B48).

A totally different view, challenging the notion of external regulation, was that

"the regulatory process tends to seek a short term solution and penalises long term honesty and gives a false sense of protection. The regulatory process does not catch the crooks. They damage and impede the people who do the right thing. The common law covers it and is much safer but it has not been explored. The regulators have not done much better and will not catch the serious ones" (B43).

This view was not expressed elsewhere but it was perhaps the most profound commentary we heard about the state of the market.

The predominant view of the financial advisers seemed to be that the repeal of section 128 would be a bad thing. We were told that there would be "an outcry against any such repeal" (FA42) and that "if there was open slather the market would collapse" (FA17). A similar view was that "the market would suffer further" (FA16). One of the merchant bankers said "the public would lose confidence if they could not see something being done. If insider trading was not illegal many more people would be involved" (FA60). An equivocal answer was that

"there would be more obviously roguish behaviour and domestic investors would be wary. Internationally the Australian market would be discredited" (FA62).

Those who saw a different result said that "people already regard the law as a joke [but] there may be some fall in international confidence" (FA40). A merchant banker replied that "any blatant rort could be prosecuted under other criminal law. Internationally the Australian market is already regarded as a joke" (FA41).

According to an investment adviser "small investors provide the liquidity for the market although most investors are professionals. If the small investors were to withdraw this would affect the market" (FA72). Another investment adviser said that he did not know what would be the outcome "but that is not an argument for Rafferty's rules" (FA45).

The majority view from the stock exchange officials was that it would not be a good thing to repeal the law. One view was that "confidence would be impaired if laws were repealed" (R71). Another opinion was that "the immediate effect will be adverse" (R18). A more considered response was that

"it would be a bad thing - it would damage the stock exchange - people would suspect something was wrong with the market. Internationally it would not be as damaging. They are more interested in the currency aspects of trading" (R66).

A variation was that "the status quo would remain - we would rely on fiduciary obligations. It would be a retrograde step and would make regulation more difficult" (R21).

Two of the market observers felt that such a thing would never happen. We were also told that it "would not be a good idea and that it would "lead to a chaotic market with wealth being directed to friends" (O46). The danger was, according to one observer that

"Australia would end up like New Zealand" (O64).

There was, however, slightly more support for the view that there would be no difference - "nothing is happening now. Perhaps it might suffer at the margin" (O53) and others said that because of the ineffectiveness of the current laws and the fact that they are not enforced there would be no effect.

Surprisingly, while the existence of insider trading does not seem to affect the level of investor confidence, there was a strongly held view amongst lawyers that the repeal of our insider trading prohibition would adversely affect confidence in Australia stock markets, both internationally and at home. A Sydney lawyer summed up this sentiment when he said

"repeal would be a hopeless idea. It would affect confidence significantly. Internationally, repeal would deter those investors who are worried about a level playing field" (L55).

Another Sydney lawyer echoed this view when he observed that

"it would be damaging. There is a real confidence problem at the moment as the market is an investment medium beyond control. It would be damaging internationally to repeal our laws. New Zealand, for example, is seen as a market out of control. There is no real regulation of any significance" (L57).

Others provided more mixed views on the likely effects of repeal. For example, one Melbourne lawyer noted that "investor confidence in Australia would not suffer, but internationally, there would be a dampening effect" (L38). Similarly, a Sydney lawyer observed that

"the effect of repeal would be muted. If section 128 were repealed, the U.S. investor would see our market as like that of Hong Kong, i.e. less reliable as a market. The effect of section 128 is always in the background. People don't see a casino as long as section 128 is there" (L61).

The symbolic importance of section 128 was a recurrent theme. As a Perth lawyer put it "repeal would affect confidence, i.e. if people knew that there were no rules. The rules stop people from engaging in the worst excesses" (L15). Likewise, another Perth lawyer exclaimed that "if there was nothing there to replace section 128 then it would make a difference to investor confidence. The statutory prohibition does limit insider trading" (L14). Perhaps an even more apocalyptic view of repeal was adopted by a Melbourne lawyer when he argued

"If section 128 was repealed, you would lose some investors. There would be an enormous adverse reaction if it was a free for all. The system would break down" (L35).

On the other hand, there were lawyers who felt that these dire consequences would not flow from repeal. One Perth lawyer, for example, thought that "there is not much awareness of insider trading. It probably wouldn't make much difference to investors if the laws were repealed, but the principle should be there [i.e. that insider trading is wrong]" (L13). To the same effect, a Melbourne lawyer observed that "there would be no difference as insider trading laws don't have any impact upon people's behaviour as they are rarely prosecuted" (L36). One Sydney lawyer even went so far as to argue that "internationally there would not be any effect on market confidence, although there may be an outcry on the issue of fairness. However, people don't leave or enter the market due to its unfairness" (L56).

Two regulators did not believe that investor confidence would be harmed by the repeal of our insider trading laws. One of these felt this way because "Australia is a nation of gamblers" (R3). Another observed that "people still invest despite the knowledge that insider trading is common" (R23). However, it was felt by the remainder that were our insider trading laws to be repealed, there would be "more insider trading" (1a) or, put differently, that there would be "open slather" (R24) or a "free for all" (R22). It was felt that our current insider trading law "deters blatant insider trading" (R2). Many saw the present laws as having some

deterrent effects. As one regulator put it, "as long as people see the potential for prosecution they are reassured" (R22). A number of regulators also saw the repeal of our insider trading laws as adversely affecting Australia's international reputation. As one observed "the lack of any insider trading law would undermine Australia's international reputation. In New Zealand insider trading did enormous damage to the market" (R67). Similarly, another regulator noted that "the international perception of the Australian market would deteriorate if insider trading laws were repealed" (R20). Perhaps the most balanced assessment was offered by another regulator when he observed

"...the fact that insider trading is an offence under the Securities Industry Code and that share prices are monitored by the regulatory bodies must instil some confidence in the investors. The mere act of removing or radically changing the laws would only serve to convince investors that insider trading had become prolific" (R69).

On balance, it has to be said that although the issue of market confidence is a complex question, it seems that the existence of insider trading laws does at least have some effect upon the level of market confidence. This is so even though the market is generally perceived to be manipulated to a certain degree anyhow and despite the widely held view that the laws are ineffective. It is not possible to know how many of the investing public are aware that section 128 exists. Perhaps they know that something is there and it reinforces the view that the law currently serves a function as a form of symbolic reassurance. The overwhelming view was that the law should not be repealed and if it were to do so, Australia would be ignoring the international trend. This suggests that the prohibition of insider trading must remain a feature of the Australian marketplace and its regulation.

Having looked at the impact of insider trading on the market we then turned to the effect on individuals. We asked the interviewees to what extent a market participant would be damaged by being known as an insider trader (Q17).

From what we were told by the brokers it appears that if a person is known as, rather than convicted of, being an insider trader this reputation is not necessarily damaging. In words of one broker,

"it is probably not damaging, he could still deal. As long as he pays he is O.K." (B58). A more colorful reaction was that

"we are all thieves in this industry - there would be no damage. The industry is about money. Respectable outfits like banks and merchant bankers do immoral things" (B51).

The aura of success around insider traders appeared to be a factor in excusing insider trading behaviour, as a Sydney broker explained, "it would be no hindrance, people would continue to deal with him. A person who gets good information has a great advantage. Some people in the industry like the idea of being referred to as a Gordon Gekko" (B52). However if a person was convicted for insider trading "it would be the end of your career. But, if you are only known to engage in insider trading you would be still in business, a folk hero, a tremendous dealer - a most successful person" (B49). The extent of the damage according to a Sydney broker,

"depends on your assessment. Socially you would not have dinner with him. Professionally it would not be damaging across the broad spectrum. Somebody would deal with him because of the business he generates and the value of following a successful person" (B47).

For a similar reason, another broker told us that it is "no problem, you would still trade. There is strong competition within the industry and performance is a big factor" (B54). Another broker said that "nobody worries. If clients get to know, you can build up your client base" (B30).

One of those who considered that a reputation for insider trading would be damaging said that "your reputation would suffer and it would affect your ability to do business" (B44). Likewise, "the stigma of being associated with undesirable activity is powerful" (B8). It would be even more serious as one broker told us "you would have to close down. Your trust is blown" (B44). We learned that within the industry "nobody flaunts it. Colleagues would react negatively" (B9). A Melbourne broker told us that "in Melbourne insider trading is not condoned and it is probably the same elsewhere in Australia" (B29). A reputation for insider trading could have wider repercussions according to another broker who said that "the stock exchange would delist the company involved. Brokers' credibility is important and it would

suffer. A client's credit could be restricted and news would spread" (B28).

Other comments about the possible damage were not as direct, but they suggested that a reputation for insider trading would be negative. While "some people like to deal with insider traders, over the long term it is no good" said a Perth broker (B10). To be known for insider trading "would not be positive" (B48) and, in fact, according to another broker it

"would be damaging but the market has become amoral over the past ten to twenty years. Rumours of a firm being involved in insider trading would be very damaging" (B43).

A reflection on possible different values was that it "would be very damaging in Melbourne but maybe not in Perth. It could be rewarding in the sense of their advice being accurate but it is risky to deal with insider traders" (B27). Another broker told us that it "could be the finish but [a reputed insider trader] is still being accepted. Perhaps people forgive it on the basis of the type of stock involved. If it is an insignificant one that is okay but a leading industrial one would be regarded as serious" (B50). Another view of the matter was that it "would make it hard to hold a position of trust but it depends on the value a person places on his reputation" (B32).

In some interviews it was suggested that in some firms there are particular brokers who are so successful and so profitable for the firm as a result of insider trading that they are immune from any internal sanction. Brokers who were asked about this either agreed that it happens or did not dismiss the possibility. It was pointed out, however, that the brokers involved might not necessarily be engaged personally in insider trading but were trading on behalf of clients who were. It was also pointed out that pressure for this conduct comes from clients who "want very good information - the type that comes from insiders".

As far as the financial advisers who are close to the market are concerned, it appears that to be known as an insider trader might not be the end of the world although there were some who said it would be. The difference between being known and being caught for insider trading was also reflected in the answers to this question. The view of one of those who did not see it as a major handicap was that "gambling is an accepted part of Australian life" (FA6). Another observed that "most people within the industry do

not see insider trading as immoral" (FA11). As one merchant banker saw it, a person engaged in insider trading "would almost be regarded as a hero" (FA40). A senior merchant banker however told us that

"people who engage in insider trading are disreputable and they have no reputation to lose" (FA41).

Perhaps it was not altogether cynical of another of the merchant bankers to tell us that "money overcomes a lot of problems" (FA62). On the other hand, those who think that it would be damaging said that "it would destroy him" (FA17). We were told that "for a broker, dealer or merchant banker such an accusation would be extremely damaging" (FA33). On the subject of being caught, one of the fund managers said "publicity is effective, people will deal with you as long as you are not caught" (FA63). This view was echoed by a merchant banker in stronger terms when he said that

"there is an enormous amount of hypocrisy in the industry - many dealers and brokers build up their career by spreading information to favoured clients and companies encourage this in their roadshows. But when such a person is insider trading on his own account and is caught irreparable damage is done to his reputation" (FA60).

Most stock exchange officials thought that a reputation for insider trading would be damaging. It is, according to one, "a matter of utmost importance; it would tarnish the person's reputation for a long time" (R21). The same opinion was expressed by another who told us that "he would not be a hero in Victoria. A person known for insider trading should be dealt with by the regulators" (R18). An interesting observation was that "institutions would be extremely angry and the broker would suffer" (R12). Not as certain was the official who reported that it is "difficult to assess" (R71). A different view, but somewhat similar to that of some brokers, was that

"he would be king - the most popular man around. Others would just follow him - they would not stop dealing with him. If he was caught it would be different" (R66).

It was not possible to discern a single view from what the market observers told us in answer to this question. Some said that it

would be damaging. According to one observer "such a person would be poorly regarded by ethical traders" (O25). Another described the effect on a person's reputation as "very damaging both personally and professionally" (O75). Of those who said it would not be damaging, one said that "it can be but in Perth you just shrug it off. There is no social stigma" (O5). Another said that "people do not think of it as insider trading; it is more a case of keeping an ear to the ground" (O46). In a comment that touched on the state of enforcement an observer told us that

"at the moment it would not be very damaging. Insider trading is part of the culture and the existing law defines insider trading so narrowly" (O53).

Other respondents reflected sentiments expressed by other groups when they said that being known as an insider trader is not a problem but being convicted is the problem. As one said "people turn a blind eye but if one is caught and convicted that is the end" (O64).

The parallel of the anti-tax avoidance laws was often mentioned. One market observer made the interesting observation that "there is some similarity with tax avoidance - the public attitude has changed and it is now changing about corporate misconduct" (O5). Similarly another view was that to be known for insider trading has "the same impact as for a person who says that he does not pay tax. The market would stomp on a person who brags about insider trading" (O34).

One Perth lawyer illustrated the difference between the legal professions and other market participants most forcefully when he told us that

"insider trading is a badge of courage at the moment. It gives you a certain cachet which some people don't want. But, if your values are making plenty of money you won't care, except if you are convicted" (L15).

Similarly, a Melbourne lawyer told us that "in some commercial circles it would be very damaging to be known as an insider trader. But, some others who do it would not worry about the damage to their reputation, if they profited" (L35). Another Melbourne lawyer also took a similar view when he observed

"It doesn't matter too much at the moment if you are known as an insider trader, except if you are successfully prosecuted" (L36).

A Sydney lawyer confirmed the fact that merely being known as an insider trader would not be all too damaging when he explained "it would be pretty damaging if convicted, but if you were not convicted, a broker with such a reputation, for example, would not have trouble staying on" (L56). This was because, as another Sydney lawyer put it, "there would be some [clients] who would continue to go to a broker to get the good oil" (L61). Also, "people in the broking industry do develop a reputation for living on a fine line" (L56). Thus known insider traders are seen as being able to survive despite the stigma which is attached to insider trading by "fringe participants in the market", like lawyers (L38). As one Melbourne lawyer confirmed

"there will always be people who will make a market for anyone. If they are known as insider traders, people will be more wary in dealing with them" (L39).

Another Sydney lawyer saw it in similar terms when he said that whilst it would be damaging to be known as an insider trader "the insider trader would still have a clientele amongst the rogues" (L57). A Perth lawyer thought that although insider traders might suffer a little in their peer groups they would be unlikely to suffer any problems "with the world at large" (L14).

The intractability of insider trading as a phenomenon must to a large degree lie in this ability of insider traders to continue trading on the basis of inside information without any effective stigma being applied to them. In other words, the informal system of social control in the business community does not work well to drive out insider traders.

This was well illustrated by another Perth lawyer when he told us that "it all depends upon the market in question. People with poor reputations keep popping up and this doesn't stop other people from dealing with them. They mix with people of a similar ilk and so it doesn't affect their life styles" (L13). When this is added to the failure of the formal regulatory system to control insider trading it makes the problem an almost impossible one to effectively deal with.

Of the regulators we spoke to, there seem to be distinctive differences between attitudes in Perth, Melbourne and Sydney. Some regulators felt that it would not be very damaging for a person to be known as an insider trader in Perth, although one added that "if the participant was a new player then it would be damaging; but not if he were an old or established participant" (R4). Elsewhere, we were informed by regulators that "...any person known to be an insider trader would be ostracized" (R19). It was also reported that

"the general corporate culture would regard being known as an insider trader as a 'public badge of shame'. Most people seek to comply with the law in their day to day business" (R20).

Of course, it could be said that for regulators to say anything else would be an admission of their own irrelevance and of the contempt that is held for the law in this area. However a regulator in another State acknowledged that for a person to be known as an insider trader "...would probably cause him no damage, and may even enhance his position" (R69). A national regulatory official on the other hand confidently asserted that "moral standards are quite high; an insider trader is regarded as beyond the pale, the other traders would not deal with him" (R67). This may be so in regard to a convicted insider trader, but it is far from clear that this would apply to persons simply known to trade on inside information. As another senior regulator said

"it is generally accepted that being known as an insider trader does no real damage. If a big player was caught, the public expressions of shock and regret may not be very genuine" (R24).

Ultimately, it is probably true that "community perceptions [of insider traders] varies with circumstances; it must work both ways" (R22).

It seems that insider trading is so well entrenched a part of the Australian securities markets that it has relatively little impact upon market confidence. However, it also appears that insider trading laws serve as something of a smoke screen behind which the market operates, knowing full well that these laws are rarely if ever enforced. This conclusion also seems to follow from responses to our question regarding the damage, if any, which would follow from a person being known as an

insider trader in Australia. The general view seems to be that if you are a member of a highly respected profession, such as law or accounting, it would be damaging to be so known as it might lead directly to a loss of a person's practising certificate. This fear is evidently not as potent a consideration amongst other groups or elsewhere in the market. The answers to these questions illustrate once again how an ineffective program of enforcement can undermine the deterrent value of the law. It seems clear that if the law were to be properly enforced there would be less insider trading. The same result might follow if the illegality of insider trading were to be made more widely known to the public and if there were to be greater ethical pressure from within the broking industry in particular.

3.4 The Place of the Small Investor

It is often said that insider trading laws are important because they were intended to protect the small investor or small shareholder. We therefore inquired whether it was perceived to be important that the small investor remain in the market for securities (Q28). This question is also of interest because it has been advocated by some that the small investor should leave the market to the big players. None of our respondents adopted this view directly, although one suspects that many of them really did not have much to do with small investors as such. Whilst the stock response to this question was generally in the affirmative, this seemed to be for a number of quite different reasons and we detected amongst some responses a "motherhood" factor.

With only one exception, the brokers all responded to this question affirmatively. The exceptional view was that "it is not very important. Very little capital is raised from small investors" (B30). From the answers to this question there were two consistent themes, namely, the unsatisfactorily low stock market participation rate by Australian investors and the relatively expensive transaction costs for small investors. A sample of the brokers' comments in response to the question is set out below:

"It is very important -there are not enough in Australia; the participation level was improving up to the crash. Their value is in providing stability. Small investors helped in the post-crash period" (B58);

"There is a problem with the antiquated scrip system which is too expensive. Brokers have to ask if they

can afford the business. Small investors are important though. Many are ill-advised and misdirected. They seem to be gambling. Funds are a good way to go for small investors" (B51);

"They are vital. A better participation rate would help eliminate the 'them' versus 'us' mentality and might improve productivity" (B54);

"They are important for several reasons - they provide scope for retail brokers; they make capitalism work and they get a stake in the country; they help the free market operate by providing the capital; they subscribe to stocks that are currently ignored by institutions" (B52);

"Yes - to raise capital; it makes them better equipped for retirement. Over the long term people must be exposed to equities" (B47);

"Absolutely - they provide fluidity and get a better understanding of how the economy works" (B29);

"We would not have a market otherwise. Institutions used to be loyal" (B9);

"They have a logical place. It is impossible for brokers to give the same information to small and very large clients due to the cost of accumulating and disseminating it" (B44);

"They are the future. If Australia is to grow there needs to be up to 25% participation rate by small investors [it can be achieved] by union representation on boards and by encouraging employees to buy shares" (B28);

"They are very important as they make the market" (B72);

"Yes, so that people can participate in the market. An alternative like an equity trust is not a good deal because of the up front fees etc and their performance is poor. Small investors can be profitable for brokers" (B50);

"They have tremendous impact and are very important for the breadth of the market. They are coming in via the funds" (B32);

"Yes, but they should be encouraged to use collective vehicles. They can identify with the corporate identities of leading companies and provide checks and balances on companies" (B43);

"They are essential. Australia does not use the stock exchange to raise capital - it is a secondary market" (B10);

"The transaction cost is a problem and as a result some have gone to the funds. With a proper settlement system I would like to see more people dealing direct. Not as many small people lost in the 1987 crash" (B48);

"It is a difficult matter in view of the cost of the transaction. It is socially desirable but costly" (B37).

The financial advisers were overwhelmingly positive about the importance of small investors in the market. The reasons given for the encouragement of small investors to stay in the market were consistent with those of other groups. These reasons included the views that small investors are loyal; they provide liquidity, capital and depth and that there are good social and political reasons for them to be there. The enthusiasm for small investors was not, however, shared by one of the merchant bankers who told us that "small shareholders are a nuisance but they should not be discouraged" (FA16). Similarly, one of the accountants said that "it is hard to identify the place for the small investor but I am not saying that they should not be in the market" (FA40).

All stock exchange officials responded in the affirmative to this question. Those who expanded their answers said "... and in their own right rather than via funds. The loyalty of shareholders is different to ten or fifteen years ago" (R18); "absolutely - for the health of Australia" (R66); "... on philosophical grounds - people's capitalism. It is not very efficient but small investors are more stable" (R21); "... but not as chaff in the system. There are millions of reasons in favour" (R12).

The responses of the observer group were unanimously affirmative and there were no qualifications. The reasons given were the same as those given by other groups such as stability, depth, loyalty, socially desirable, the watchdog role of small investors, the mobilisation of savings, the development of Australian business, and several made the point that the participation rate was too low.

Some answers received from the lawyer interviewees were usually quite trite. Thus one Melbourne lawyer observed "it probably is important that small investors remain in the market. People should have free and easy access to investing" (L36). Another Melbourne lawyer responded that "the market should not be the province of any particular type of player" (L38). The participation of small investors was often seen as beneficial for a

number of reasons. One Perth lawyer answered this question in the affirmative, going on to tell us that

"although the amount which individuals put in is probably low, the presence of small investors is healthy for other economic reasons, even though they are never going to be a big factor" (L15).

As another Perth lawyer also put it, "small investors give the market depth. When there are a lot of small shareholders, the directors think about minority shareholders" (L14). Moreover, as many other respondents also told us

"small investors are needed for their cash as others invest with debt not cash" (L38).

Small investors are seen as still being "important as a source of funds for the market" (L55). Not all agreed with this. One Sydney lawyer, for example, thought that "their importance is psychological more than anything. Small investors are also there through superannuation funds, but they should be there more directly so that they can take a greater interest in government and economic policies" (L56). Similarly, another Sydney lawyer simply replied that "... the ownership of companies by individuals is important" (L57). However, a somewhat more sceptical view was expressed by another Sydney lawyer when he observed

"I don't know. I have heard all the arguments. But they probably should not be in the market directly. They should be involved through unit trusts, etc. Brokers don't want to deal with little people" (L61).

There are of course very good reasons why many brokers prefer not to deal with small investors, most of these seem to relate to economies of scale which come from handling large corporate orders.

Of the regulators that we interviewed, almost all also thought that it was important that small investors remained in the market for securities. The one person who disagreed with the other regulators felt that the involvement of small investors was not important as "... the small investor gets hurt most often and more than others" (R3). Others felt that "the small investor is less likely to be hurt if his or her funds are channeled through management trusts" (R19). However small investors were seen as making important contributions to the securities market. Thus some saw

them as providing "added stability to the market [so that] there is then less room for institutional manipulation of the market" (R2). Small investors were also seen as giving "depth to the market" (R20), as making "private savings available to the economy" (R24), and as partly countering the fact that the Australian market is so thin (R67). Others thought that it was important that individuals had stakes in companies (R1), although other regulators warned that "...the small investor does not take enough interest in the affairs of the company in which he invests" (R4). This view seems to reflect a broader legislative philosophy, for as another regulator urged "... the more people who invest the better it is for growth" (R19).

The weight of opinion in favour of preserving the role of the small investor is an eloquent response to those that have said that there is no place for the small investor. The references to an unsatisfactory participation rate suggest that more work needs to be done to establish why this is so. Perhaps it reflects a degree of disillusionment flowing from the perceived levels of insider trading and market manipulation.

3.5 The Fairness of the Market

Following from our question on the place of small investors we went on to ask whether the market was unfair to any particular groups of investors or traders (Q29).

None of the brokers said that there was unfairness but many pointed to disadvantages suffered by particular categories of investors, especially small investors. It appears from what we were told that larger investors are treated better by brokers. A Melbourne retail broker summed up the general perception of the broking community by saying that "I cannot see any unfairness - it is not persistent. The market is competing and has to be fair to win investors over. People need prompt disclosure" (B28). Another view was that the market is not unfair but

"investors could have suffered from insider trading.
Small investors are more likely to be treated unfairly"
(B8).

It was the view of another broker that "brokers are sometimes unkind to small investors" (B10) but he did not elaborate on this statement.

While rejecting the idea of unfairness, one broker said "... but it is harder for small investors to get information" (B54). On the other hand, another broker believed that "the market compensates. Small investors can get out faster" (B52). That was also the view of another who said

"the big guys cannot get out as easily as the small ones. The small investors do not get serviced as well" (B51).

The position of the large shareholder attracted this comment from an institutional broker in Melbourne "... but the shareholder with a controlling interest gets a raw deal" (B29). Another of the Melbourne institutional brokers acknowledged that small investors are not so well treated by brokers and went on to say "... but we cannot afford to service the small as well as the large shareholder" (B44). On this same point a Melbourne broker told us very frankly that

"clients should get benefits according to their size. Brokers do not run a social service; they must look after their best customers" (B37).

The relative positions of small and institutional investors attracted other comments. A Sydney broker told us that "small investors could be buffeted when there is a major institution investing in the company. While the market is not unfair, certain conduct by companies can be unfair" (B47). According to a Perth broker "the small investor is competing on brokerage. Money can move a market - the big players can run the market" (B9). We were told by a Sydney broker that

"small investors feel discriminated on cost. They hear information too late. People do not perceive the market as crooked. The market is unfair when there is insider trading; it is unfair to the others (B50).

Another broker reflected on the way in which small investors are treated saying that "the market itself is not unfair but the antiquated settlement system unreasonably loads costs against the small investor as transaction costs are high" (B43). Another reflection on marketplace realities was provided by a Sydney broker who explained that

"professional managers always have an edge as they get fed ideas and have access to a wider range of

views. That is not unfair. Small investors who rely on a broker get only one source of information; they should go to a managed fund" (B48).

Only a small proportion of the financial advisers felt that the market is unfair to any particular group. Most of them distinguished unfairness and advantages and as one pointed out

"the larger investor gets a better deal from brokers but this is just a fact of life - it is not unfair" (FA45).

We were told that "rewards are related to effort" (FA41) and that although it can be seen as unfair to the small trader "they go into it with their eyes open" (FA60). The market is unfair to "those without clout" according to a merchant banker (FA62). One of the accountants said that "the small investor plays a losing game, even though there are rules to protect him" (FA40).

Two exchange officials denied that the market was unfair. As one put it "everything is done to ensure fairness" (R12), while another answered elliptically (R71). One said that "in the past there was unfairness in the allocation of stock by brokers - they are likely to deal institution to institution; the small investors have suffered in new, good floats. The SEATS system will improve things - it applies a first in first served basis" (R18). Another explained that

"from the trading point of view - no. The small investor does well especially with SEATS - it is very fair. Administratively small business is costly; the small investor waits for certificates and pays up front. Big investors have a better deal" (R66).

A rather cryptic response was that "investors should be given the treatment equivalent to their size" (R21).

As with other groups there seemed to be some misunderstanding among the market observers about this question with observations being made about the disadvantages of being small and the lower level of service and the higher costs involved for small investors. Those who addressed the question expressed a range of views. One powerfully expressed statement was that

"it is unfair to individuals; regulation does not protect them, it is mainly symbolic; the big operators are not taken on; there are notable omissions in the existing package which allows the larger members to rip off

the small. The NCSC is not interested in small investors; the lack of class actions penalises the small investor; institutions override the interests of the small investors and some of their deals rip off the small investor" (O53).

Other views were that "there is a lack of corporate democracy" (O7) and that "small shareholders have no chance to participate in market action" (O5). One observer made the point that while there are disadvantages in being small "it is not always possible to protect small investors" (O25). One of this group saw no unfairness in this and reminded us that "it is up to investors to inform themselves" (O75).

Few of the lawyer respondents actually thought that the market was unfair in a discriminatory sense. As one Sydney lawyer answered "the market is fairer to those who can move more quickly than others. Smaller investors will also pay a higher brokerage, this is because their orders are uneconomic" (L56). Another Sydney lawyer explained that "it is much harder for the relatively uninformed individual. Most investors are fairly sophisticated" (L56). A similar position was adopted by a Perth lawyer when he told us

"the small investor is not privileged at the moment. People do go into it with their eyes open and so it is not unfair, although there is a bias to the better informed" (L14).

A Melbourne lawyer was however prepared to say that "no-one is disadvantaged more than anyone else" (L38). This was put a little more delicately by another Melbourne lawyer when he told us that, although the small investor was disadvantaged, "this is inherent in any system. You can only hold a person's hand to a certain degree" (L36). A similar explanation was offered by a Sydney lawyer when he observed that "small investors are disadvantaged, but the legislation makes it so difficult for a company to go through various procedures, such as a rights issue. It is easier just to do a placement to a friendly institution such as the AMP" (L55). One Perth lawyer was, however, quite vocal about the disadvantages suffered by small investors when he exclaimed

"... I feel that the market is enormously biased against small investors. Stock exchange releases and prospectuses are full of lies!" (L15).

Whilst brokers seem to have taken a renewed interest in the business of small investors since the events of October 1987, this seems to be in sharp contrast to the approach of many before that date. As one Perth lawyer explained "when things were very busy in 1987, some brokers didn't want new clients" (L13).

Regulators were generally of the view that the market was not necessarily unfair to any particular groups, although a number criticised the attitudes of brokers to small investors who suffered from a lack of information which was available from brokers to larger players. As one regulator also put it "large investors have an advantage as regards information, but the market is not necessarily unfair" (R22). Others pointed to the fact that the cost of entering the market tends to be higher for smaller investors (R24). Another regulator observed that "larger investors get more favourable brokerage rates and so can trade more profitably" (R69). However there were those who thought that the market could also be unfair to larger shareholders as there was "no special return for large investments" (R67).

Whilst very few of those persons interviewed felt that the market was unfair to any particular group, it was clear that definite advantages were enjoyed by larger investors and institutions, largely due to their market power. The small investor is unable to take advantage of the economies of scale which are available to larger investors. Generally, this was not seen to be an issue of fairness. However, there was some evidence that smaller investors are treated poorly by some brokers as their business is not valued. This was so at least up until the crash of 1987. This is unfortunate as it may have the effect of driving small investors away from the securities market, despite the recognition that they have much to contribute to it, as we saw earlier. Perhaps some improvement in the service provided to small investors would go some way to achieving the greater degree of stock market participation that is generally said to be important for Australia.

3.6 Conclusions

There is no doubt that insider trading is a practice that the market can do without. The overwhelming view of the participants in the study was that not only is insider trading harmful but that it brings no benefits.

Insider trading is said to be harmful to the market for a number of reasons. It is said to have the potential to erode confidence; to inhibit the capital raising process and to damage the efficiency of the market. According to a substantial proportion of the interviewees, it also directly harms investors who lose money to those who are engaged in insider trading. One view, which was mentioned by some, is that insider trading is a victimless crime. Whatever this term means, it ignores the fact that in an insider trading transaction there is a party who loses value from the securities involved or is forced to take a loss. Perhaps it might be more accurate to say that insider trading is a crime with an unknowing victim.

The discussion of the impact of insider trading on market confidence was rich in irony. On the one hand we were told that insider trading erodes confidence. On the other we were told that it has not affected confidence but yet it was asserted that if section 128 were to be repealed confidence would suffer. Another element of the confidence issue is that the impact of insider trading cannot be measured because confidence is already at a very low level and, in any event, investors expect that insider trading does occur. Whether the generally perceived low rate of participation in the market by individuals is attributable to the effect of insider trading or to a general lack of faith in the market does not emerge clearly from the study. The issue of market confidence is a complex one and requires further research and the recently announced survey on the matter to be undertaken by the Stock Exchange is a welcome development. More empirical research in this area is badly needed.

It was significant that there was no pressure from the interviewees for the removal of the prohibition on insider trading. It was also significant that the Manne arguments in favour of insider trading received very scant support. This reaction suggests that no matter how rigorous an academic theory might be its value can only be tested in the market place and that some of the legal and economic arguments should be reassessed in the light of market reality, particularly the realities of small markets such as that in Australia. The references to the usefulness of

insider trading in bringing news to the market reflect poorly on the efficiency of the market and it is clear that the performance of listed companies in disclosing price sensitive information needs to be improved. It might also be the case that the Stock Exchange needs to improve the enforcement of its listing rules in this regard. Finally, there is no doubt, from what we were told, that the small investor has an important part to play in the market. There seems to be no evidence that the market is unfair to small investors but there is a strong feeling that they are not treated as well as the large institutional investors.

4. Recommendations

On the basis of the findings in this part of the project there are a number of matters on which we recommend that action be taken. We should stress that some of these matters do not lend themselves to "quick fix" solutions. The responsibility for implementing these recommendations will lie with the stock broking community, the stock exchanges and government. In making these recommendations we should stress that they reflect the concerns and views of many participants in the market place. Many of those that we interviewed were emphatic that the market should be cleansed of corrupt practices of which insider trading is one. The following are our recommendations based upon the evidence presented in this report.

1. In the listing of company shares on stock exchanges greater control should be exercised in relation to those who are associated with companies, in relation to the allotment of shares in such companies and in monitoring the trading patterns of such shares. This greater degree of control appears to be especially necessary in respect of second board companies and those on the main board which might be described as speculative stock.
2. Greater awareness should be developed amongst the investing public, directors and companies of the illegality of insider trading. The development over recent years of a community sense of outrage towards tax avoidance offers a useful parallel. It is necessary in our view for insider trading (and other forms of market abuse) to be seen as a form of moral turpitude if the control of corporate crime is to be achieved. We believe that directors should be made aware of the risks that they run by trading and in this respect we believe that a body such as the Institute of Directors could usefully prepare material on directors' duties and responsibilities in relation to insider trading. Flowing from greater awareness amongst directors would be a higher degree of consciousness within companies of the need to protect the security of price sensitive information.
3. Much greater emphasis should be paid to training in ethics. We consider that the Securities Institute of Australia could make a signal contribution in this regard by incorporating a business ethics element into the courses it conducts. We believe that the same need for training in ethics exists in business courses in tertiary institutions throughout

Australia. We note that there is currently an international movement in this direction and also a growing concern about ethical standards in business.

4. In view of the economic significance of the stock market both in Australia and internationally, we recommend that there be further research into the issue of investor confidence in the market. We note that the Australian Stock Exchange Limited has recently commissioned a survey on this topic. We believe that this is an important feature of market operations and are concerned that market investment is all too often seen as a form of gambling.
5. Related to investor confidence is the issue of the participation rate in the stock market. There is no doubt that there is a place for small investors in the market for securities. Equally, there is no doubt that there is a perception that small investors are not as well treated as other investors. We believe that the broking industry could contribute to an improvement in this regard and that the encouragement of small investors could result in a healthier level of participation.
6. As a matter of priority, the disclosure practices of listed companies must be improved. The flow of information is critical to the efficiency of the market. Without accurate and timely information the market is prey to insider trading and to other forms of manipulation and abuse. The Stock Exchanges have an obligation to enforce actively their Listing Rules in relation to informing the market as a whole. It might also be necessary to consider some form of statutory regulation to ensure that there is timely disclosure and, in this respect, we draw attention to the terms of the Formal Agreement establishing the present co-operative scheme on companies and securities, which provides the philosophical base to the Australian system of company regulation.
7. As the securities market takes on a more international dimension, it becomes more important for Australia to participate to the fullest extent in the regulation of that market. There is evidence to suggest that off-shore based insider trading takes place and it appears that Australia should seek more vigorously and systematically to develop the necessary arrangements with foreign jurisdictions to control such activity. We note that the Cash Transactions



Reports Act will provide some means of control of international cash flows but we regard it as important that Australia should have arrangements with other countries, including the secrecy jurisdictions, in order to detect and to prosecute international securities offences.

8. As referred to in our paper *Insider Trading Regulation and Law Enforcement in Australia*, the enforcement effort in relation to insider trading leaves much to be desired. The effective immunity from prosecution and the impunity with which insider trading can be carried on reflects the poor level of performance of the enforcement agencies. It is necessary that, if insider trading is to be brought within acceptable limits, the agencies must be given the resources to enforce the law.
9. Enforcement agencies, including the Stock Exchanges, should pay more attention to other forms of market conduct. Our findings suggest that market manipulation and rigging, however they are described, are quite common. It also appears that warehousing is a frequent practice. There are grounds for believing that these practices also involve an element of insider trading. This suggests that a more wide-ranging strategy of dealing with securities market abuse is called for.
10. Finally, it is clear that there is an urgent need for more research and scrutiny in regard to securities market conduct in Australia. This needs to go hand in hand with improved mechanisms of market surveillance which need to be backed up by a greater governmental and private sector commitment to the introduction of appropriate computer technologies to facilitate research and oversight in the area of market abuse.

