WHY IS INSIDER TRADING A PROBLEM?

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Here in Slovakia, as well as in the Czech Republic and other transition economies, there was, especially in the initial phases of transformation, relatively large room for many unethical and illegal financial practices with clear or negative consequences for the capital market. In developed countries these activities are much better governed by legislation, in their own assessment and appropriate recourse. Neither can there be ignored the experience of the public, police and courts in these countries. Practice in Slovakia and the Czech Republic also confirms that the attitude of politicians, the government and public is staunchly against these practices. This is borne witness to also by recent cases of the misuse of information, or insider trading, or the coverage of those revealed in the general and professional press.

Recently we have heard rather frequently of such a term as "insider trading", as well as the closely-related terms "insiders" and "insider information". We designate as insider trading primarily those transactions and contracts in which information unavailable to other subjects has been used (or misused). These trades are almost exclusively connected with the purchase or sale of securities; only in exceptional cases do they occur in other financial and banking activities. A typical example of the use (misuse) of insider information is the purchase of securities at a low price, before the public knows of information that leads to a rise in the price of these securities, or conversely the sale of securities at a high price before the publication of information that leads to a fall in the price of these securities.

Is insider trading harmful?

Despite many legislative and other administrative and economic measures defending insider trading and despite the relatively high costs of realising these measures, insider trading continues to emerge in many countries. Therefore the question arises, why is insider trading sanctioned, whether it is really a problem, and whether it has a negative effect on the economy and its efficiency, whether the costs of the fight against insider trading are not excessively high, or even whether these costs are not a complete waste of money.

Those who rebuff the charge that insider trading is harmful base their argument primarily on the fact that the use of insider information is the fastest way to get the security prices to the level which they really belong. In their opinion outsiders do not even trade in securities; they do not buy or sell them not simply because they do not have information, but also because when they do have it, they do not manage to exploit it. In connection to this there arises a very serious problem of differentiating insider trading from informed trading.

The term informed trading means the better use of publicly available information than other investors would use it. In other words, this represents the ability to better analyse publicly available data or even the ability to use in a practical way publicly available information for trading.

An argument frequently used by defenders of insider trading is that used by the American professor H. G. Mann, one of the academic economists defending insider trading. In his view trading on the basis of information outside the public realm should not be sanctioned, as it is "a crime with no victim". Such opinions have recently surfaced also in the Czech Republic.

It is however not possible to agree with these (or other) arguments defending insider trading. First of all, it is possible to clearly identify not only those who have earned good money on insider trading, but also those harmed by it. The victims are numerous, including in particular uninformed shareholders. In no way is it possible to excuse the losses of almost all, while only a certain "privileged" group of "the informed" do not suffer the loss. Likewise it is not possible to excuse the fact that a certain privileged group comes to make certain profits (seemingly to the detriment of no one) on the basis of insider information. The profits of insiders are not an appropriate price to pay for the fact that the price of securities reaches the level it belongs a little sooner than it would without insiders and insider trading, or that a firm's shares collapse (or rise) regardless of whether someone trades in securities more frequently or not and how this person reacts or does not react to individual pieces of information. It cannot work like this in democratic societies.

Public trading and a public market can operate in as they should only if there is no discrimination against any subject, i.e. trading is made on the basis of public information.

Neither is it possible to agree with the argument that the internal information of a firm is the property of shareholders and not of the investing public. If this information remains in the firm and does not "confuse" the public, i.e. it does not represent information for the public on investment opportunities, then it supports this argument. But if this information is to inform potential or current investors of investment possibilities, economic results and any significant changes in the company, then in all democratic societies (this is their

cornerstone) all investors must have equal possibilities and the same information at the same time. It is here that the nub of the problem lies.

Several studies have pointed out the negative consequences of insider trading on capital markets, for example that the scope of insider trading negatively influences market liquidity, and the costs of its participants, and thereby also the efficiency of the capital market's functioning. Often these studies reach the conclusion that a greater scope of insider trading causes greater volatility on the capital markets. The argument put forward by the authors of one study reaching this conclusion is founded on claims supported by research in almost 50 countries. The authors' view is that an environment tolerant towards insider trading encourages insiders to be more active in the market, where this activity then induces greater volatility in the market.

There are relatively very few studies focusing on insider trading in Slovakia and other transitional economies, and on its consequences on the capital market. Those which do exist however showed that insider trading in these countries is relatively widespread, for example in the SPAD system of the Prague Stock Exchange up to 32% of share trades are influenced by insider trading, almost twice as many as in the case of less liquid shares on the NYSE.

The opening of coupon funds: insider trading or informed trading?

The problem of differentiating insider trading and informed trading may be seen for example in the mandatory opening of funds in the Czech Republic. This offered great room for insider trading, but also for informed trading. Even if the need to open up coupon funds was set by law and the public and potential investors were informed about this in sufficient advance, only a small share of them found courage to invest in the funds' undervalued mutual fund certificates. The discounts of some coupon funds reached from 30 to 60%, not simply due to an illiquid market and the fact that the funds were closed, but also due to the moot manner of pricing assets in certain funds. With this problem was closely connected the level of informedness of fund shareholders who did not have the possibility to acquire a corresponding share of assets in a fund when selling their shares or mutual fund certificates. In the world such high discounts are not common in the world, neither in the closed funds. This situation necessitated a change in legislation.

The amendment to the Act on Investment Companies and Investment Funds (1998) enabled funds to transform into open mutual funds, where it ordered mandatory opening by March 2000, should their discount exceed 30%, or mandatory opening by the end of 2002, should their discount exceed 20%. All coupon funds too had to transform into open mutual funds by the end of 2002. Closed funds may still be established but under much stricter conditions.

The preparation of legislation, adoption of the Act and in particular announcing funds' preparations for opening and the notification of the date of their opening were the steps reflected in a reduction in discount rates. It was also the possibility for shareholders and primarily for informed investors to make a profit in buying up undervalued mutual fund certificates that could then be sold after the fund's opening for a price approximately corresponding to the net assets pertaining to the mutual fund certificate.

The Securities Commission set very strict conditions for the mandatory opening of funds. The volume of the illiquid part of a fund's assets was not allowed to exceed the discount on the buy-back by more than ten percent of the value of its portfolio. The period for selling off the illiquid part of the asset was 120 days from meeting the conditions for the fund's mandatory transformation. Even where the portfolios of mandatorily opened funds were different, the majority of these subjects were not able to realise the necessary sales in time and ended up in liquidation. Some did not even attempt opening. Their problems lay especially in the fact that the funds had a large part of their assets in real estate or illiquid and devalued securities.

Identifying and proving insider trading

A key problem of insider trading remains the identifying of insider trades and in particular proving them. Generally it is true that identifying insider trades is relatively simple, where this is evidenced by a large number of cases. Proving them, though, is much more difficult, as confirmed by the highly-publicised case of Lord Archer. It is however not possible to agree with the opinion that it is not possible, or because the success of proving insider trading is low, or these activities are too expensive and essentially wasteful. This even despite the fact that in many cases also insider trades made clearly and explicitly have for various reasons not been and are not sanctioned.

Much uncertainty is connected with the definition itself of insiders and insider information. A wide range of persons may be included among those which may misuse insider information: this includes in particular the firm's management, but also members of its supervisory board, shareholders or the firm's internal audit staff. Confidential information on firms is also held by subjects outside the firm, for example, staff of state institutions and government ministries, accountants, lawyers, judges, notaries, auditors. Insiders may also be family members of these persons. The misuse of information may also concern securities traders. Therefore in all economically advanced countries there are relatively strict ethical laws on trading and trader codes of conduct. Experience however shows that rules and codes of conduct are frequently circumvented. Under the term "breaching of ethical trading rules", as this issue is usually presented to the public, lurk a number of specific problematic and controversial operations made by securities traders.

In the USA, for example, since the start of 1994 a wide-ranging discussion has been going on over the misuse of confidential information that is committed by the portfolio managers in the course of trading. This is since not only do portfolio managers make operations on the account of the funds entrusted to them, but often also operations on their own account. Incomes from private investments mostly exceed by several times the manager's salary. The principle of the basic operation, termed front-running, is very simple: a portfolio manager invests his own money in securities, where these are concurrently (or a little later) bought in a large quantity into the fund's portfolio. The fund's volume purchase has the consequence of increasing the price of the securities and the respective manager then sells his own securities – thus simply and very quickly accruing his own investment. Some portfolio managers even "mix" their account with that of the entrusted fund and credit profitable trades to their own account and the less so to the fund's shareholder accounts. A new wave of criticism of the unfair practices of funds is currently being covered in the Czech press where the spread of electronic forms of trading enables fund managers to exploit methods of market timing, i.e. brokers in their trading exploit timing differences between markets around the world, or do late trading.

Insider trading is closely connected with the issue of a conflict of interests. This issue was discussed in Slovakia and the Czech Republic at the end of the 90's in large auditing firms. Likewise they too have or can have very precise information on their clients – in the case of banks. Individual staff members or a bank's management can misuse this information for their own or bank's benefit. For example, it is very controversial whether this knowledge may or may not, should or should not be used in decision-making on investments in clients' securities, in decision-making on a bank's own investments in securities or in providing credit, etc. Preventing a conflict of interests is one of the reasons why investment and commercial banking remain relatively strictly separated in Japan and the USA.

In Slovakia, as in other transitional economies, there was and in many countries remains large room for insider trading and a conflict of interests, also in consequence of the cross-ownership of firms and financial institutions. Its main potential actors are investment and mutual funds. Holders of their shares, or mutual fund certificates, expect the highest possible appreciation on their money invested. Concurrently coupon privatisation instated collective investors as important owners on to the board of directors and the supervisory boards of many privatised firms. These therefore have the right to be informed of all decisive aspects of their firm's business. It is debatable to what extent confidential information, gained in the right of the owner, found its application in securities trades in the interest of appreciating the portfolios of investment and mutual funds. It has been quite clearly been confirmed that from the aspect of insider trading cross-ownership of firms and financial institutions is one of the most serious problems and in many countries is legislatively regulated and restricted. The misuse of information in this way is however in the case of cross-ownership, naturally, still possible.

With regard to the consequences of insider trading upon securities trading the centre of attention in this field is the acquisition of securities by insiders and securities trading by such insiders. This is since share ownership is considered a significant stimulus to the activities of business management and most top managers have a stock option as an integral part of their contracts – giving them the right to a certain number of the firm's shares in the case that the management achieves set economic results. An option system works in most countries around the world and in many of them the stock option forms more than a third of a manager's overall incomes. If stock trading for this group were to be excessively regulated, the possibilities of owners to influence the behaviour of the firm's managerial staff would be considerably lessened. A solution to this problem is sought in many countries' legislation in the greater transparency in the trading of these persons and in strict conditions under which they may acquire shares and trade in them. Therefore also many firms show, for example in their annual reports, in the list of shareholders, insiders as a separate group.

Conclusion

Examples from practice confirm that the sanctioning of insider trading does not represent the sanctioning of honourable traders, investment funds and their management or innovators by incompetent state bureaucrats. If insider trading is not unequivocally censured even by "independent" experts and observers, this bears witness to a misunderstanding of the essence of the problem.

Therefore it is in the interest not only of regulatory and supervisory bodies, and likewise the government and public, but in the end also securities traders, to minimise insider trading, or present the market as competitive, transparent and rid of illegal practices. If however they are not sufficiently controlled, appropriate legislation does not exist, and there is no threat of sanctions, or the public does not learn of such practices, then it is easy for insiders to forget the market's long-term interest.

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