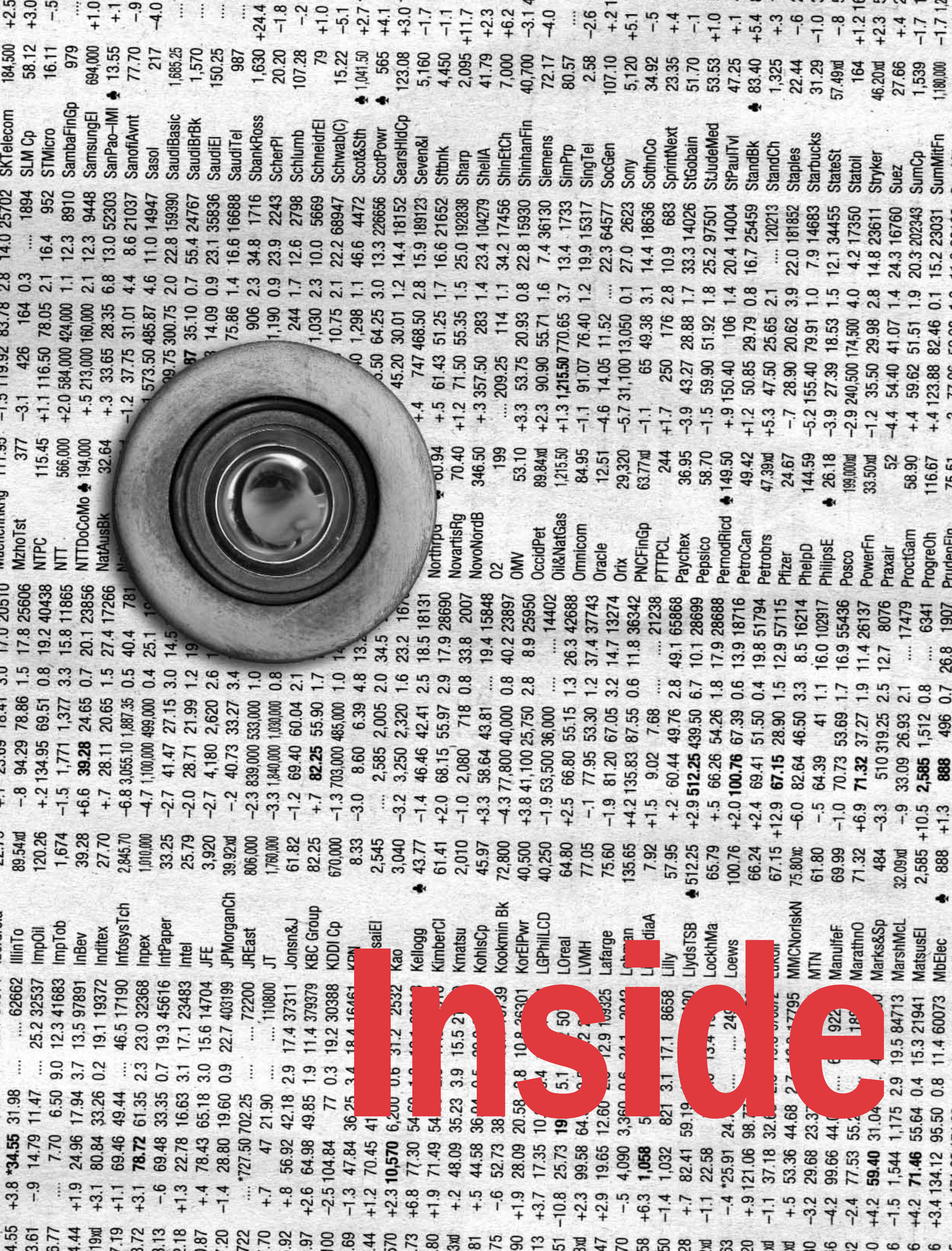

Inside

Is insider trading the high crime that we have been led to believe? **Andrew P. Kakabadse, Nada K. Kakabadse** and **Antje Kaspurz** interviewed more than four dozen members of three international exchanges. What their survey revealed, and what they concluded, may come as a surprise.

out

The past decade of scandals involving Enron, WorldCom, Parmalat and Martha Stewart – and the consequent shareholder mistrust of board members, traders and investment banks – has increased awareness of insider trading. There are many views on insider trading and what to do about it; but we conclude – after extensive research and interviews – that insider trading is an insignificant consideration when comparing the volume of shares traded and the level of insider knowledge utilised. The issue is not insider trading, but rather how traders can become better informed so as to enhance their trading capacity.

What is *insider trading*? Generally the term is understood as the buying and selling of securities on the basis of non-public, or privileged, information. Information is material that a reasonable investor is likely to consider as significant in making an investment decision, material that, in turn, may have a substantial impact on the market price of a company's securities. Non-public information refers to information that has not been disclosed to the marketplace and investors have not had the opportunity to consider. To become public, information must be disseminated so that it is reasonably available to a broad array of investors. The disclosure of information by a corporate insider to a select group (for example, analysts) is not sufficient to make that information public. We felt a deeper study was needed to explore the wider dimensions of insider trading.

The data for this study was collected at three different sites, the Vienna (VSE), London (LSE) and New York (NYSE) Stock Exchanges during late 2004 and early to mid-2005. The data was exclusively qualitative in nature using 54 semi-structured interviews, each lasting about one hour. Each of the study participants represented registered financial institutions.

Grey matters

Our research yielded four findings. The first was that people define *insider trading* differently. Parallel to the contrasting views on insider trading identified in the literature, the study participants also offered a range of interpretations of the subject. Differences of view of insider trading did not vary according to stock exchange location but by individual. In sum, each interviewee either viewed insider trading in a formal (legalistic) or in an informal way.

Thirty out of the 34 Austrian and British participants defined insider trading in a formal manner. Similarly, all 20 US participants initially defined insider trading in a formal way. A representative response comes from a VSE interviewee: "Insiders are people whose job gives them access to confidential market-sensitive information; and, if they trade on it, it is insider trading". For these interviewees, insider trading is as easy to perceive as whether a car is exceeding the speed limit.

Even so, the majority of participants viewed insider trading as the grey area of finance. For example, one VSE respondent said: "To be honest, it is such a grey area you can't draw a line and say this is insider trading and this is not. I don't think you can define insider trading. If someone wants to buy shares and does not buy them on account of insider information, such as bad news, in reality, although he did not do anything, he is still insider trading. He used inside information which was only accessible to a certain number of people, in a certain position, to not buy shares".

Others felt that attempting to define insider trading was a worthless exercise. As a legal requirement for debate in court, definitions may be necessary – but the circumstances of a court case would be impossible to replicate in everyday working life. As views varied according to source and type of information and circumstances surrounding such trades, a contextualist →

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→ interpretation of inside trading became our focus. In short, we tried to discover what *insider trading* means and why it occurs.

The information business

Our second finding was that insider trading is endemic to trading itself. According to key studies, insider information refers to information that is material but not public. However, the study respondents disputed such a distinction as they drew a difference between inside information and the grapevine, both of which could be an equally powerful stimulus for trade (or not). Although all of the study participants recognised it as illegal to trade on insider information, most held the view that it is impossible to draw a clear line between these two sources of information. Said one member of the LSE: "The Stock Exchange lives on gossip and information. It is impossible in most of the cases to get to the source of information, which would make it easier to classify this info. Hence it is impossible to decide if it was gossip or insider information".

Equally, the participants questioned whether obtaining material that was non-public could be classified as insider information. In their view, the only relevant, non-public material is that of a market sensitive nature. But no clear view emerged concerning what constituted market-sensitive information. A critical aspect of a professional market trader's job is research; if he or she uncovered information through their own research endeavour, no matter its source, such information cannot be seen in the legal sense as insider information. Consider this statement by a member of the VSE: "It is my job to investigate. I have to find out what is going on in the market to make the right decisions. If I find something out because of my investigation, no one else, apart from me knows. I don't believe that's insider information – that is my job".

Inside motivation

Our third finding was that those who engage in insider trading have diverse motivations. Even though no shared view emerged concerning the nature of such behaviour, the survey participants discussed the motivation for pursuing what could be *blatantly agreed* as insider trading. Three main motivators for insider trading emerged: power, money, and excitement of the deal.

Power was considered as a particularly pertinent motivator for insider trading by most, if not all. An LSE member phrased it this way: "These people are in positions where they have the highest power in a company. No one is above them. So they think who can ever get me? I am the boss".

The majority of respondents considered *money* as an equally powerful motivator for insider trading. For example, an LSE interviewee said, "I would say a motivator for an insider's trade is the most natural human quality, avarice. Especially people who work in this business, it is all about money, otherwise we would not do it".

Although power and money were identified by the majority of participants as motivators for insider trading, for certain of the participants the *excitement of the deal* emerged as an additional motivator. An LSE interviewee shared with us that "…insider information in the sense that I define it, may be rather exciting. People with insider knowledge, being human beings, quite often want to boast about how they have access to insider knowledge secrets".

Market forces

Our final finding is that the true impact of insider trading on market efficiency is great, small, or nil depending on whom you ask. The minority of interviewees believed that insider trading has a positive impact on market efficiency. Their view emphasised that insider trading maintains the real value of the market. One interviewee went further by stating that information asymmetry exists in markets with or without insider trading; he therefore questioned why insider trading is viewed as harmful. A VSE respondent typified responses in this regard: "I truly believe that insider trading has a positive impact on market efficiency simply because of the fact that information is quicker processed in market price. Furthermore I think that you always have people who know more than others."

Insider trading is an insignificant consideration when comparing the volume of shares traded and the level of insider knowledge utilised.

However, the majority of study participants considered that insider trading has a negative effect on market efficiency. While most agreed that market price is more realistically determined if insiders trade, the importance of trust in capital markets and its effect on efficiency were also emphasised. The point being made is that insider trading undermines investor trust that, in turn, harms market efficiency. Says a VSE member: "I think market efficiency suffers if insider trading is going on because trust of shareholders disappears. Let's take VSE as an

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example. It was always called the 'Insider Stock Exchange' and if you look at the performance of VSE at this time you can see that insider trading has a very negative impact on market efficiency".

Should you care?

It would be easy to look at our research results, as well as the past literature on insider trading, and state, simply, that the practice and punishment of trading on inside information is relative to time, place, and the people involved. To be sure, the contrast of views offered by our study participants parallels the literature concerning the insider trading effect on market efficiency, market confidence and insider trading regulation.

However, in contrast to the literature, the study participants raise doubt as to the meaning and definition of insider trading. Distinguishing insider trading from insider information, the study participants emphasise that gaining information through research and through their personal networks is a key aspect of their job. A clear distinction between research-gathered information and insider information does not emerge. The lack of equitable definition has led most of the study participants to conclude that the concept of insider trading exists for political reasons and does little to remove privileged insiders from trading in markets. The study participants consider that by creating an atmosphere of political correctness, western governments simply look good.

It's time to ask a fundamental question: Despite all the attention given, is insider trading really such a big deal?

Considering the volume and value of shares traded per day, the study participants and other commentators concur that the contribution of insider trading to market distortions is small. One insider or small groups of insiders are not considered as driving up share price to the point of generating dissonance in the market. Thus, market performance is viewed as being only marginally impacted.

Given the market abuse tactics adopted by large organisations to drive share price artificially in a certain direction, insider trading, by comparison, has little effect on the volumes traded. That some traders know more than others, and that this information affects their decision making and the trading behaviour of others should they become privy to this information, is concluded as factually true.

However, the significance of that statement is challenged, as markets are competitive by nature and, in order to be successful in a competitive market, one needs to be better informed than other parties. In order to minimise the mistrust and suspicion involved in being better informed, we offer the view that appropriate reward, while simultaneously making that information transparent, benefits all. Rather than looking to regulate or limit the individual who has access to privileged information, we conclude that attention should now focus on making more information available rather than increasing prosecutions. At the end of the day, which is the bigger problem: the insider trader – or the large, transnational corporations who have the capacity to sway markets that, in turn, potentially harm market efficiency in major ways? ■

It's time to ask a fundamental question: Despite all the attention given, is insider trading really such a big deal?

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