Juliette Overland – 'Insider Trading: Beneficial, Bad or Benign?'

Moderator: Welcome to the podcast series of *Raising the Bar Sydney.* Raising the Bar in 2016 saw 20 University of Sydney academics take their research out of the lecture theatre and into 20 bars across Sydney, all on one night.

In this podcast, you will hear Juliette Overland's talk: *Is Insider Trading Beneficial, Bad or Benign?* Enjoy the talk.

Juliette Overland: PhD student Sally. Thank you very much for coming, Sally. My very special research assistant, former student, Amelia, thank you for coming. And another former student of mine, John, thank you for being in the front row. Anyone's who's an academic at university knows the front row is always empty. Nobody ever wants to come and sit close to me. So thank you John and friends for making up the front row. I'm hoping it's not 'cause that was the only spot that was left for you.

I've had one glass of champagne tonight, which I think was the absolute perfect amount before I start to talk. Just enough to loosen me up ever so slightly. I mean I am a lawyer; I need a little bit of loosening up. But not so much that this is going to get sloppy. The rest of the drinking will be afterwards.

So I'm from the University of Sydney Business School and I'm absolutely delighted to be here to talk to you all tonight and I'm going to talk to you about insider trading. And one of the reasons why I'm so pleased to be able to take part in this Raising the Bar event is because I don't think people from universities get the opportunity enough to share with the broader public our research and to give people an understanding of how the research that we conduct relates to real live issues and has general importance and application that hopefully is relevant to a number of you. And you've chosen to come along tonight, so I'm very happy that you chose my talk about of the 20 that were available.

So I'm going to talk to you about insider trading and when I think about insider trading, I'm generally focussing on: Is the law doing what it is supposed to do? Do our laws really criminalise the offence appropriately or do they need amendment? That's something I spend a lot of my time thinking about. And when I think about, one of the things that I think is really important is having an understanding of what it is that we are trying to regulate, because laws mean nothing if they aren't sufficiently regulating a problem and if they're not easily understood. People need to know what their obligations are and we need to know why things are criminalised.

And I took inspiration from one of my colleagues last year, who participated in this event, in structuring my event around myths and misconceptions that relate to my topic. So I'm going to talk to you about insider trading in the context of five myths and misconceptions that I commonly encounter when I'm talking about my research with people. When I talk about insider trading with people inside … I'll just pause while we have the, the sound effects … myths and misconceptions that people have about insider trading, and hopefully I can give you a bit of understanding of that.

So my topic … the title that I have tonight is *Insider Trading: Bad, Beneficial or Benign?* And I want to talk about each of those myths and misconceptions in the context of whether they make people think that insider trading is bad, beneficial or benign.

And so the five myths I'd like to talk to you about are, first of all, the misconception that insider trading is a victimless crime. That's the first thing I'd like to talk about. The second misconception I want to talk about is the idea that insider trading's only relevant to people who are directly trading on a stock exchange. The third misconception is that insider trading is helpful because it creates price efficiencies. Fourth misconception is that insider trading is so prevalent that it can never be stopped, and the fifth is that insider trading cases just are not worth pursuing.

So I'm going to talk about each of those and hopefully share some insights that my research brings to those topics and I'll be very happy to talk to you, either as a group or individually, about some of those issue afterwards.

So the first thing I want to ask is: Is there anybody in the room who thinks they've been a victim of insider trading? Put your hand up if you think you've been a victim. Okay, Sally thinks she has. A couple of people over the back, maybe someone here, so a handful, okay. So I'd like those people to sit on that thought and we're going to … we might revisit that topic a little bit later.

Okay, so the first misconception I want to talk about is that insider trading is a victimless crime. So when we talk about insider trading, I'll give you my very brief definition of – well brief for me – my very brief definition of what I think it is, and some people might later like to share their thoughts if they have a different view. But insider trading is essentially buying or selling shares or other financial products while your possess price sensitive information that isn't generally available to other investors, so taking advantage of inside information to either make a profit or avoid a loss, while trading in shares, at the expense of other investors.

So there is a view that insider trading is a victimless crime, but I'd like to suggest that there are a number of victims. Now the first victim is the person who is on the other side of the trade with an insider. Now an issue with that is that trading on a stock exchange is generally anonymous. So if you're selling some shares or buying some shares, you don't know who you've sold them to or who you've bought them from.

So if you've bought from an insider who's quickly offloading their shares because they've heard some information that makes them think that that, that that company's going to turn into a dog, you don't know who you've bought from. Or if you're buying some shares vice versa. So if you don't know who you buy from, how can you know you've been a victim? Just because you're not aware that someone else has made a profit or avoided a loss at your expense, are you any less a victim?

Now people who want to counter their argument, will often say to me, "Well the person who sold those shares was perfectly happy to do it. They'd already made a decision to sell. It's their bad luck if somebody else knew something else." But if our market is supposed to represent the true price of shares, the idea behind trading on a stock exchange is that with all the information that's available, any investor can assess that information themself and make a decision on whether they're happy to buy or sell at a certain price. If some traders that have information that isn't available to everybody else, we don't have a fair and efficient market. So just because somebody might not realise that they've been a victim of insider trading, doesn't make it a victimless crime.

Now the other victim is the stock exchange and the market itself. And research shows that if we have a look at the countries that have well-developed securities exchanges, almost all of them prohibit insider trading.

But the enforcement differs from jurisdiction to jurisdiction. And in jurisdictions where there's either lax enforcement or there's a perception – and perception is very important – if there's a perception that insider trading laws are not enforced, investors are less likely to invest on a stock exchange, and that creates an increase in the cost of capital, which has a flow-on effect for all companies who might want to raise capital on the exchange, and effects every other investor. So it isn't a victimless crime.

If we move then to the next myth or misconception: Only people who trade on the exchange are affected by insider trading. Now how many people here would regularly buy or sell shares directly on the stock exchange themselves? We've got a few traders here, a few day traders, few people from investment banks? Just a few heavy drinkers? Just me? Okay. I'm going to back to those who said they thought they'd been a victim of insider trading. We had a couple of hands before. Anyone reconsidering their view? No? Because it's possible for all of us to be victims of insider trading.

Who here is not in employment? Anyone here not working? No? If you're in employment, chances are you're subject to the 9.5% superannuation contribution obligations, and out of your salary or wages, however small or large they may be, you've contributed to a superannuation fund, okay? All employed Australians, or almost all, are making superannuation contributions. And superannuation funds invest that money. And the most recent data is that on behalf of working Australians, there is about \$2.1T in superannuation. And about 22% of those funds are invested directly in stocks traded on the ASX. Now I did law because I don't like maths, but I believe that that is about \$4.5B.

So for all of us who have superannuation, we might not directly be trading on the stock exchange, but superannuation fund managers are making those trades on our behalf. And if insider traders are freely operating in the market, they're taking advantage of those investments. It affects the retirement savings, the retirement assets and the future standard of living for all employed Australians, if insider trading goes unchecked. It's not a victimless crime. You don't have to be directly trading on the stock exchange to be affected by insider trading.

Okay, so the third myth or misconception I, I want to address … and this is a topic that some of my colleagues in finance, I know, do disagree with me. In fact, when on my academic colleagues found out I was giving this talk, he said, "Well of course you're going to say that insider trading is beneficial because all sane economists and finance specialists say that it is." And of course my response is that that isn't true. But there is a belief that market efficiency requires insider trading to set prices. And those who subscribe to this belief consider that if people with inside information are allowed to trade, that will cause the share prices to change and reflect the value of that information.

But more recent research indicates that the share market has much more accurate prices when insider trading is prohibited and when we rely on continuous disclosure obligations, so when companies are obliged to inform the exchange of price sensitive information, that that is when prices are more accurate. So if companies are obliged to tell the exchange when they're aware of price sensitive information that might have an influence on their share price, and the exchange can make that information available to investors, that's when prices are truly efficient. And if insiders are allowed to trade on the basis of that information instead of that leading to more accurate pricing, they're actually much more likely to try to keep that information secret, until they have had the opportunity to trade. It actually hinders true price efficiencies.

Now another popular myth or misconception that I hear is that insider trading can never be wiped out. It's endemic to the securities industry. And when people say that, it's basically a recognition that insider trading is bad, but it's a bit of a shrug of the shoulders. So it's like, "Yeah, we know it's a problem, but what are you going to do?"

And my response to that is to compare insider trading to other crimes. Now insider trading's been a criminal offence since the early 70's and we've had obviously a number of cases, quite a few receiving heaving press in recent times. But the fact that it has been prohibited and is pursued doesn't mean that it doesn't happen. But if I was to say to you, "Well it's been prohibited since the, the early 70's but murder and serious physical assaults have been prohibited much longer than that, and yet every time we turn on the television, we hear about another ghastly murder, another ghastly assault," but our reaction to that is not to say, "Murder and assault is part of the human condition. It's a natural reaction, so let's just forget about policing it."

Our reaction to that sort of news is to say, "Let's get tough on law and order. You know, what do we need to do to educate people, you know, not to engage in physical assaults. How do we stamp out these violent crimes?" Yet people seem to take a different view to corporate crimes.

So when we consider whether insider trading actually is endemic to securities markets, empirical research does suggest that up to 10% of trades might be affected by insider trading. And if we look at the data, there are about a million trades … sorry, about … yeah, about a million … a billion trades – my numbers are getting confused; as I said, I don't like maths. There are many, many trades – let's use that language – on the ASX every day and they are … that's a very large of money. I'm, I'm not allowed to use notes. I've had to leave my data in my purse. But if 10% of trades are affected by insider trading, that's a huge number.

And it seems that, when we look at the cases, the type of information that's most likely to give rise to an insider trading case is information about merges and acquisitions, so proposed takeovers are very, very common types of information that will lead to insider trading. Now part of the reason for that seems to be that information about a proposed takeover is something that affects the share price. Whenever a takeover is imminent or is announced, both the target company – the one to be taken over – and the bidding company – the one that ones to do the taking over, their share prices seem to go up, especially the target company.

So that certainly is the type of information that does seem to give rise to these cases. But it seems that because that occurs, our regulators are quite well aware of that, and as detection … pardon me, as detection improves, it means that there's a general habit of our regulators going back over trades after a takeover is announced, and actually looking very carefully at volumes, at patterns, anything that's unusual there, to see if there's something that needs investigating further. So even though it might seem that we do have patterns, we do have this type of conduct that isn't stamped out just because it's illegal, doesn't mean that we shouldn't necessarily … that we should necessarily just accept that.

And the fifth misconception that I'd like to talk about is the idea that insider trading cases aren't, aren't worth pursuing. So a little bit of a tangent from "it's endemic," but there seems to be a view that people express to me, when I talk to them about insider trading, and they say, "Well, you know, insider trading cases, most of those defendants are well-heeled, well-resourced members of the business community.

They can fund expensive legal defences, they can drag a case out, and even when they get convicted, if they do, they don't get much of a sentence. And I think there's a few misconceptions contained in there, and I'd like to address each of those one-by-one.

So when there's a comment made that most insider traders are well-heeled and well-resourced members of the business community, few aspects of truth in there. Research indicates that most corporate criminals are white men in the mid-40's, very comfortably off and somehow under actual or perceived financial pressures. That's our most common profile of a corporate criminal.

Now if we look at insider trading cases particularly, out of the 65 cases or so that we've had in recent times, we've only had a couple of female offenders. So yes, most do seem to be men. We've had a few recent examples of men on the younger side in insider trading, and there've been a few on the older side, but the mid-40's does seem to be our pretty prevalent group for the majority of offenders as well.

And you know, sometimes will make the, the comment that people who are engaging in insider trading have a gambling problem, have addictive personalities, need to maintain a certain lifestyle, they're under certain actual or perceived pressures where they think they need to engage in this behaviour, or they just can't resist it.

But if we then look at the next step, they may be well-resourced or they may be well-heeled, but is that really a reason not to pursue them? And people make that comment about insider trading, but I never people make the comment that the ATO shouldn't go after people for tax evasion because who are engage in tax evasion are wealthy and need to, or are more motivated to try and get out of paying tax. I never hear those arguments. I just hear people suggest that you don't … you shouldn't bother to go after insider traders 'cause they're wealthy. No one makes that comment about tax evaders. So I think there's a very different perception there as to those different types of corporate criminal.

Now then people will say, "Well you know, they'll string out the trial, they've got these very well-paid lawyers, they'll, they'll have these very well-resourced defences, but you know, even if you get them to trial, even if they get there, you know, they won't be found guilty." But then if we look at the data, when insider trading was first prohibited, we had very few cases, but there have been an exponential increase over recent years. And overall, the success rates for those cases, has been about 65%. But over the last three to five years, there's actually been an 85% success rate.

So the suggestion that it isn't worth pursuing insider traders because they're too well-resourced and even if you do get them to trial they won't be found guilty, is not actually not borne out on the evidence. We've got a recently … that 85% success rate.

But then people will say to me, "Well okay, you've got them to trial, they've been found guilty, but they'll get off with a very light sentence." And the … my response to that is, "Well this year, we've actually had the longest sentence handed down for insider trading in Australia, of eight years and three months, and that was Steven Xiao from Hanlong. So that is not a, not an insignificant sentence. Now the sentences have ranged from a mere fine up to that, that eight years, three months, so there is a very wide range. But the data and research shows that average sentence is between two to three years.

But the important thing that the research in insider trading is showing as well is that it's the mere fact that someone goes to jail that's the important deterrent to other people who might be tempted. So if we want to stamp out insider trading in our securities markets, if we want to have a fair and efficient market where people are confident to invest in a stock exchange, we want to deter people who might be tempted to engage in it. And it isn't the length of the sentence of imprisonment that deters people, it's being detected and being sent to prison full stop that appears to be the greatest deterrent. So whether it's six months, whether it's one year or whether it's eight years, people think, "Well, if I'm going to be caught and I'm going to go jail, maybe I don't want to engage in that behaviour." It's not a crime where we need a lengthy sentence in order to deter prospective insider traders.

Now when I'm talking to people about these issues in my research, I hear a lot of comments made about our regulator, ASIC. And I've had a glass of champagne so I'm also happy to admit that I've certainly gone on the record in the past with some critical comments about ASIC, and I'm wondering, perhaps, if there may be any representatives of ASIC here, and maybe they can introduce themselves to me afterwards and we'll, we'll share a glass of wine or something like that. I won't ask you to out yourself right this minute.

But ASIC cops a lot of criticism on a number of these accounts and the first thing that I hear people say is, "Okay, you're suggesting now that we've got these better rates, we've had 65% success rate, moved up to 85% rate, but ASIC just goes after the easy cases." That's what people will say. They'll say, you know, "They're, they're just going after the small fish, the people who plead guilty. You know, that's not such a good success rate if you don't go after the big fish."

But on the occasions when they go after a more challenging case, where it might be someone who we'd call a bigger fish or a tall poppy, then they get the criticism of, you know, "That's a waste of public funds. What if they don't win that case? What if that trial and appeal goes for years?" So in some respects they're … our regulator's in a bit of a, a bit of a hard place between that's too easy; that's too hard. So it's a bit of a Goldilocks issue. If that's too easy and that's too hard, how can they find the position that feels just right?

So that's a bit of a challenge for them as well. And ASIC has, you know, devoted a lot of time and resources in recent years to bringing up its enforcement in insider trading. And when we think about those detection issues … and as I said before, the research shows the best deterrent for prospective insider traders is the thought that they'll be caught and the thought that they'll go to prison, regardless of the term of … the length of the sentence, additional surveillance, additional detection and an increased focus on whistle-blowers, who are willing to bringing information forward, or co-conspirators in insider trading informing on each other, certainly makes it easier to detect and become aware of these cases.

So what I'd like to leave you with, before I finish up … and I'm supposed to speak for an hour and I've absolutely no idea whether I've spoken for 20 minutes or 40, but what I'd like to leave you with is, is those five thoughts: If you believe that insider trading is a victimless crimes, you're basically saying it's benign, but I disagree; if you say that insider trading only matters to people who themselves trade directly on the stock exchange, I'd say, "You're admitting it's bad but you're saying you don't care." If you say you believe that insider trading accurately sets prices, you're actually saying it's a beneficial thing, but I disagree.

If you're saying insider trading is endemic but can't be stopped, you admit that it's bad but you shrug your shoulders. And if you say it's not worth pursuing, once again, that's an admission that it's a bad thing but it's not worth taking it any further.

So when I think about these things, I think, "Well hopefully that, that indicates, you know, why we want to prohibit insider trading," so in my work then I think about, you know, "Does the law do that properly? Do we have well-defined laws?" because if we're serious about insider trading, we need a couple of things. We need laws that can be understood and easily applied and we need to have market confidence so that people know that somebody who engages in insider trading will be detected, they'll be prosecuted and they'll be subject to an appropriate penalty as well.

So thank you very much for coming along tonight and thank you to (27:05) for introducing me and I, I hope you've enjoyed the presentation. Thank you very much.

Moderator: Thank you for listening to the podcast series of *Raising the Bar Sydney*. If you want to hear more Raising the Bar talks, head to raisingthebarsydney.com.au.

End of Recording.