

# DEPARTEMENT BEDRIJFSECONOMIE

## IN DEFENSE OF INSIDER TRADING

by

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# In Defense of Insider Trading.

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## *Abstract*

*This article looks into the problem of the prohibition of insider trading. Contrary to popular sentiment with respect to insider trading, the first part of the article shows that a prohibition of insider trading is difficult to support on the basis of economic grounds. Nevertheless, the Belgian legislator thought that a general prohibition was advisable. Using the law and economics framework, it appears that the current criminal sanctions are insufficient to restrict insider trading.*

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## In Defense of Insider Trading.

### 1. Introduction

Insider trading, i.e. trading based on nonpublic information about a certain firm-specific event that can influence the price of a security, has been prohibited in Belgium since 1989<sup>1</sup>. But it was not until 1995 that the first convictions were pronounced<sup>2</sup>. The debate on the prohibition of insider trading in Belgium has got a new impulse ever since. The aim of the article is double. First, we will examine if insider trading is an undesirable phenomenon. This problem is analyzed within the law and economics framework which was first introduced by Gary Becker(1968). According to this theory a certain phenomenon should only be prohibited if it damages the prosperity of others or of the society. If the answer is positive, we will have to examine in a second step what the most optimal enforcement policy is within the law and economics theory. The final goal is the creation of a theoretical framework that can serve as a policy basis for the legislator, administration and supervisory authorities in order to evaluate the regulation of insider trading. The preparatory works of the Belgian Parliament show that the Belgian legislator was lacking such a policy basis<sup>3</sup>.

### 2. The phenomenon of insider trading

Most of the literature on insider trading starts from the premise that insider trading is always

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<sup>1</sup> Incorporation of Article 509-4 into the Belgian Criminal Code by Article 27 of the Statute of March 9, 1989 modifying the Commercial Code and the Royal Decree nr.185 of July 9, 1935 on bank control and on the issuance of transferable securities, *Belgian Gazette*, June 9, 1989, erratum, *Belgian Gazette*, June 27, 1989. In consequence of a European Directive (89/592/EEC) of November 13, 1989 for the coordination of the regulations of insider trading, *O.J.*, L334/30 of November 18, 1989, the regulation of insider trading was rewritten in Part V (Art.181-193) of the Statute of December 4, 1990 on Financial Transactions and Financial Markets, *Belgian Gazette*, December 22, 1990, erratum, *Belgian Gazette*, February 1, 1991. At the same time Article 509-4 of the Criminal Code was abolished. The Statute which came into force on January 1, 1991 has recently been modified by the Statute of April 6, 1995 concerning the secondary markets, the regime of and the supervision on the investment companies, the financial intermediaries and the investment consultants.

<sup>2</sup> First Instance Criminal Court of Ghent, September 27, 1995, *Bank- en Financiewezen*, 9/1995, 535-538 and First Instance Criminal Court of Charleroi, September 27, 1995, *Bank- en Financiewezen*, 9/1995, 539

<sup>3</sup> *Parliamentary Report*, Belgian Senate, 1986-87, doc.nr.533/1 and *Parliamentary Report*, Belgian House of Representatives, 1989-90, doc.nr.1156/1

harmful, or offers only a very succinct argumentation against insider trading. Traditional arguments against insider trading are: insider trading causes a wrong price formation of securities, it harms the non-informed outsider and it undermines the confidence in the capital market. Nevertheless, the preceding question whether insider trading is harmful or not should be answered first. Within the law & economics framework, insider trading should only be prohibited if it harms the prosperity of other members of society (Becker, 1968, p.172-173). This section analyzes the possible harmful effect of insider trading.

## **2.1. Market efficiency, public confidence in capital markets and liquidity**

Capital markets are a major financing source for companies, for these markets allocate scarce financial resources to various securities. Given a specified degree of risk, investors will select (portfolios of) securities with the highest possible return. This return is determined by the future cash flows that investors expect, based on all currently available information. A security market is efficient if security prices instantaneously and fully reflect all relevant available information. Therefore security prices are a reliable criterion for the optimal allocation of scarce financial resources at a "fair" price.

Financial theory distinguishes three categories of market efficiency (Fama, 1970). The "weak-form" market efficiency says that all historical information is fully reflected in today's security prices. Therefore, an investor cannot earn excess returns on the basis of the analysis of historical data (for instance, on the basis of technical analysis or filter rules). The "semi-strong-form" market efficiency hypothesizes that security prices fully reflect all publicly available information, e.g. earnings reports or the announcement of a bonus dividend. A trading strategy based on this publicly available information will not generate an excess return. According to the "strong-form" market efficiency all information is reflected in security prices, irrespective of the public or nonpublic character of the information. If a security market is strongly efficient, no investor can earn an excess return based on nonpublic information. Empirical research mostly confirms the weak and the semi-strong-form market efficiency<sup>4</sup>; no empirical evidence is found on strong-form market efficiency. Based on nonpublic information, it is therefore possible to earn a better return than the market. Lorie & Niederhoffer (1968), Pratt & DeVere (1970), Jaffe (1974), Finnerty (1976), Baesel & Stein (1979), Keown & Pinkerton (1981), Penman (1982),

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<sup>4</sup> For a review of literature, see Copeland and Weston (1988, chapter 11), Brealey and Myers (1996, chapter 13), Haugen (1997, chapter 24) and Fama (1991).

Givoly & Palmon (1985), Seyhun (1986) en Heinkel & Kraus (1987) show clearly that insiders earn a higher return than the market.

But precisely due to the transactions of insiders security prices will better and faster reflect the intrinsic economic value. In this way insider trading adds to market efficiency. By reducing insider trading, security prices will deviate from their intrinsic economic value for a longer period. Therefore financial resources will be allocated less optimally on the capital market. Hence, by allowing insider trading, the allocation-efficiency of the security market will definitely improve. Analogously, Vermaelen (1986) concludes that "reduction of insider trading will reduce, rather than increase market efficiency because it will slow down the speed with which information will be reflected in security prices."

Another aspect of the efficiency-argument is the fact that insider trading creates an additional method for communicating information (Carlton & Fischel, 1983). Insider trading can therefore be an alternative way to communicate information to the financial markets, which could not be disclosed effectively through an official public announcement because investors perceive the information wrongly as unbelievable<sup>5</sup>.

As insider trading improves the efficiency of the security market, the confidence of a rational investor in the security market will not be damaged. It is irrelevant to him whether an insider can earn abnormal profits, because the investor can always buy or sell the security at a fair price, namely its intrinsic economic value. Nevertheless, the argument of confidence is frequently used to prohibit insider trading<sup>6</sup>. No empirical study has ever shown a decrease of the confidence of investors if insider trading were allowed. For instance, Young (1985) points out that the number of small individual investors on the American stock market sharply increased, despite the many cases of insider trading during the same period.

Kabir and Vermaelen (1996) examined the effect of the introduction of insider trading restrictions on the liquidity of the Amsterdam Stock Exchange. On January 1, 1987 a Model Code prohibited insiders<sup>7</sup> to trade in the company's stock and stock options during the two months preceding the announcement of annual earnings reports. This study clearly shows that liquidity (as measured by trading volume) decreases after the introduction of these restrictions on insider trading, while the amount of company-specific information did not change.

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<sup>5</sup> See Healy and Palepu (1995) for an excellent example of the difficulties with investor communication issues: see the case of CUC which had difficulty convincing investors of its profitable investments.

<sup>6</sup> *Parliamentary Report*, The Belgian House of Representatives, 1989-90, nr.1156/1, 107.

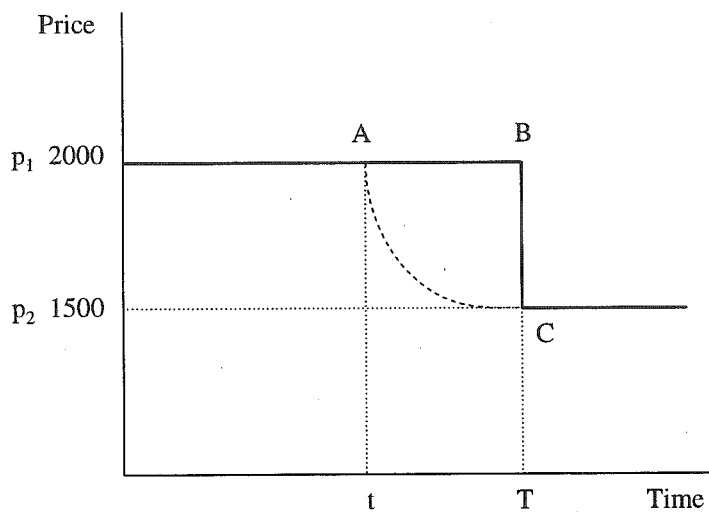
<sup>7</sup> I.e. top management and any other person connected with the company who can have access to private

Therefore, a ban on insider trading can cause a stock market to become less liquid.

## 2.2. The lesion of the outsiders

An argument that is often used to ban insider trading is the fact that it harms the outsider<sup>8</sup>. It will be demonstrated that outsiders are not harmed by insiders, but that on the contrary, they are better off than in a situation in which insiders do not use their inside information. In case of bad news with regard to the security price, insiders can realize a profit based on their inside information by selling the security before the news is announced (see figure 1). By this, the security price  $p_1$  will decrease between the price-sensitive event date  $t$  and the announcement date  $T$  (see line AC). If no insider trading occurs, the price will move along the line ABC and fall to price  $p_2$ .

Figure 1: Negative news with regard to the security price



Source: Haddock & Macey (1986, p.1469)

Suppose the original price at the moment  $t$  amounts to 2000. Because of the bad news insiders sell their securities so that the price falls as a result of the extra supply. Suppose an insider sells his security to an outsider for 1700. After that the price falls to 1500. By this, the outsider-buyer loses 200. But without insider trading the outsider-buyer would have bought the security for

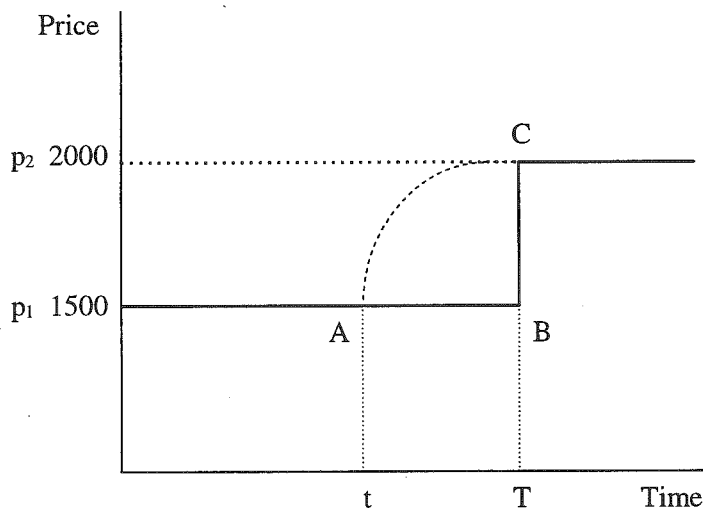
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information, like employees, stock exchange members, financial journalists with access to the exchange floor.  
<sup>8</sup> *Parliamentary Report*, Belgian Senate, 1986-87, nr.533/1, 49 and *Parliamentary Report*, The Belgian House of

2000 and he would have suffered a loss of 500! Precisely by the extra supply of the insiders, the buyers are better off, than when they also buy without the transactions of the insider.

Analogously the price of a security will rise in case of good news (see figure 2). Without insider trading the security price will move along the line ABC until it reaches the new equilibrium price  $p_2$ . In case of insider trading the security price will already change before the announcement date T along the line AC. Again it can be demonstrated that "if insider trading increases share prices before the announcement, all current share holders who were planning to sell before the announcement are better off, (while the other ones are not made worse off) than if no such insider trading occurred" (Vermaelen, 1986, p.439).

Figure 2: Positive news with regard to the security price



Source: Haddock & Macey (1986, p.1469)

### 2.3. Market-makers

The price formation of a security market can be organised in two ways: a market can be "quote-driven" or "order-driven". A security market is order-driven when there is a periodic or continuous matching of buy and sell orders. Demand and supply are confronted with each other until an equilibrium price is reached. On a quote-driven security market all trading of securities goes through "market-makers" who buy at a certain bid-price and sell at a certain ask-price. These market-makers quote bids and asks throughout the day. Market-makers make a part of

their profit on this bid-ask spread. Bagehot (1971), Benston & Hagerman (1974), Copeland & Galai (1983) and Seyhun (1986) show that market-makers quote a wider bid-ask spread if insider trading occurs than in a situation where no insider trading occurs. This will cause an increase of transaction costs for the other market participants which affects security returns in a direct way because transaction costs are not diversifiable in a portfolio. This negative effect of insider trading only occurs on security markets which are quote-driven and cannot be used as an argument against insider trading on security markets which are order driven as the Belgian Stock Exchange (Schmidt, 1991, p.26-28).

#### 2.4. Information processing channel

Most authors believe that a small individual shareholder does benefit from a prohibition of insider trading. They implicitly make the assumption that profits on the security market are equally and randomly distributed among all market participants if insider trading is banned (Haddock & Macey, 1987, p.338). The idea of equal access to information for all investors is a non realistic presumption<sup>9</sup>. In reality there exists a continuum of informed market participants ranging from very well informed to poorly informed (see figure 3). Market professionals are specialized in obtaining new information in order to differentiate themselves from other market participants and to obtain a higher profit. Because market professionals are in a position in which they can respond faster to new information than the average market participant, mainly those market professionals (and not the small investors) benefit from a prohibition of insider trading.

The Belgian Statute of December 4, 1990 on Financial Transactions and Financial Markets also has difficulties with differences in information availability. Article 181 paragraph 2 says that the information of which the holding companies<sup>10</sup> have the disposal because of their role in the control of the companies in which they participate, is not considered as inside information, provided that the information does not have to be publicly announced according to the Royal Decree of July 3, 1996<sup>11</sup>. Does this exception<sup>12</sup> for the holding companies has to be interpreted

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<sup>9</sup> The American Supreme Court also rejected the information-equality among various market participants as an argumentation against insider trading in the Chiarella and Dirks-cases. Or as J. Cox (1986, p. 631): "The utopian dream of information parity among investors was short lived, however. Two Supreme Court decisions (Chiarella and Dirks) have revolutionized the rules application."

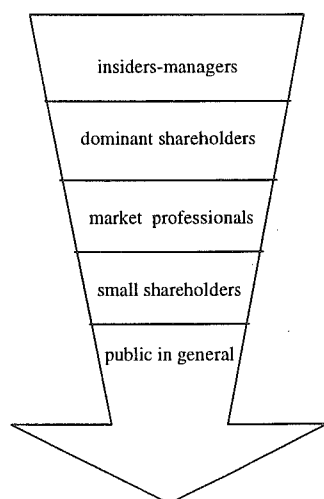
<sup>10</sup> This are companies in the sense of the Royal Decree nr.64 of November 10, 1967 on the regulation of the regime of portfolio companies.

<sup>11</sup> Royal Decree of July 3, 1996 on the obligations concerning occasionally information of companies whose



in the sense that they are the next-best information processors who benefit the most from a prohibition on insider trading?

*Figure 3: Information processing channel*



## 2.5. Insider trading as "improper" behaviour

Insider trading will only be restricted if it hurts the prosperity of others or of the society in general. From the above analysis it appears that on the basis of economic arguments insider trading will be rather beneficial; i.e. a more efficient and liquid security market and a better allocation of financial resources are to be expected. Moreover insider trading can serve as an additional communication method. Also, the argument that insiders harm outsiders does not seem to be valid. Nor is the fact of wider bid-ask spreads a valid argument on order-driven markets. Moreover, a prohibition of insider trading did not seem beneficial for the small investors. "It is surprising to find nowhere any argued justification for the prohibition of insider dealing beyond broad appeals to commercial morality"(White, 1974, p.494)<sup>13</sup>. Finally, these

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securities are quoted on the first market of the public stock exchange, *Belgian Gazette*, July 6, 1996.

<sup>12</sup> This is not an apparent exception. There exists a real application field on which those holding companies are exempted from the prohibition of insider trading. It is information that does not have to be publicly announced according to the Royal Decree of July 3, 1996, but which falls within the scope of the Statute of December 4, 1990 concerning privileged information. For instance, a proposal which the board of directors has not accepted yet. This proposal does not have to be publicly announced according to the Royal Decree of July 3, 1996, but if the proposal is sufficiently clear and price-sensitive it falls under the prohibition of insider trading. See P.Krekels (1992, nr.39).

<sup>13</sup> Also M. Kay (1973, p.185) states that most of the arguments are formulated "in notoriously questionbegging

value judgements appear to be the only justification for the restriction of insider trading<sup>14</sup>. But as Kay(1973) states: "However much one may sympathise with the moral argument for imposing such an embargo, it must be admitted that some of the economic consequences may not be desirable. A cost-benefit approach may well yield a different result from a purely moral one".

At first sight insider trading is unfair and immoral, namely insiders obtain high profits at the expense of others. Again, no argumentation is found *why* insider trading is unfair. Moreover, this fairness arguments seems not to be valid anymore at a closer look. This will be clear when insider trading is situated within a corporate governance-context. Because of the separation of ownership and control in stock exchange listed companies, an agency-problem between management and shareholders emerges. Managers will not automatically act in the best interest of shareholders i.e. maximalization of shareholders' value and will pursue their own objectives in adopting investment and financing policies. In order to align the objectives of management and shareholders, various disciplinary mechanisms exist: the product market, the managerial labour market, the capital market, the market for corporate control, the monitoring board and managerial compensation schemes (Moerland, 1995).

Managerial compensation schemes try to link managerial reward to the evolution of the stock price. This value-based management causes management objectives to deviate to a less extent from the objective of maximizing shareholders' wealth. Larcker (1983), Brickley, Bhagat & Lease (1985), Murphy (1985), Morck, Shleifer & Vishny (1988) and Mehran (1995) confirm this positive relationship between the stock price and the introduction of equity-linked compensation schemes. One way to obtain this kind of compensation is allowing insider trading. What is the difference between allowing insider trading and a stock option plan from an ethical point of view? As nobody would argue seriously that salaries, options, bonuses, and other compensation schemes allow insiders to profit at the expense of outsiders because these sums otherwise would have gone to shareholders (Carlton & Fischel, 1983, p.881), why should insider trading be treated differently? Some authors e.g. Scott (1980, p.808) and Easterbrook (1981, p.332) opposed to this view that insider trading is an inefficient compensation scheme. However, this is a false argument because no compensation scheme works perfectly. The relevant question should be whether the same benefits can be obtained at lower cost from other types of compensation. As Carlton & Fischel (1983) point out: unless this can be shown, it is

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terms as unfair advantage, improper use, etc."

<sup>14</sup> Schotland (1967, p.1439): "Even if we found that unfettered insider trading would bring an economic gain, we might still forgo that gain in order to secure a stock market and intracorporate relationships that satisfy such noneconomic goals as fairness, just rewards and integrity."

impossible to conclude that insider trading is an efficient compensation scheme. Moreover, allowing insider trading will stimulate management to innovate. Allowing insider trading seem to be a very efficient way to compensate for entrepreneurial services (Manne, 1966, p.166). If one would argue that besides such positive shocks to the firm's value, management could easily create a negative shock and exploit it by shortselling and thereby decreasing the value of the firm, this argument can be rebutted by the existence of two other disciplinary mechanisms. On the one hand the existence of a managerial labour market (Fama, 1980) prevents management to follow this value-decreasing strategy because their managerial reputation and therefore the value of their human capital is at stake. On the other hand the market for corporate control (Manne, 1965) is another inhibition on such a value-decreasing strategy.

Therefore, by allowing insider trading rather than banning it, shareholders will receive more benefits in the form of a higher stock price. This is the consequence of the higher innovative and entrepreneurial inputs of management on the one hand and of their objective of creating shareholders' value because of this equity-linked compensation form on the other hand. Thus, society seems to gain from allowing insider trading and the ethical argument seems therefore not to be valid.

## 2.6. Shareholders' choice

So far the discussion on insider trading has polarized between a general prohibition and a general tolerance of insider trading. Some authors point out that such a choice ignores the fact that the possible advantages and disadvantages may differ per company. In this view the choice between allowing insider trading or not is left to the company itself with the obligation to notify its choice publicly.

To the question whether shareholders will allow insiders to trade on the basis of nonpublic information, Haddock and Macey (1986, p.1467) answer: "it depends". Allowing insider trading or not depends especially on the "type of shareholder". Under reasonable assumptions<sup>15</sup> Haddock and Macey develop a model in which shareholders will permit insider trading depending on who, after the insiders-managers, are the next-best information processors (see figure 3). Small shareholders who are unable to monitor a company benefit more from a

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<sup>15</sup> 1. Insiders-managers are risk-averse and 2. the existence of a competitive labour market for insiders-managers (that will reduce the insider's salary if insider trading is allowed by the shareholders).

permission than from a prohibition of insider trading. This benefit consists of a lower salary cost of the insiders-managers and of an increased incentive for insiders-managers to innovate<sup>16</sup>. When insider trading is prohibited, small shareholders will not benefit from the nonpublic information, and yet they have to pay a higher salary to the insiders-managers. However, if dominant shareholders are the next-best information processors, they can take advantage of a prohibition on insider trading because they can monitor the company very well. In case of a ban on insider trading, those shareholders will rake in all benefits from the nonpublic information, unless market professionals (for instance portfolio managers, arbitrageurs and securities researchers) are the next-best information processors. It appears that especially dominant shareholders and market professionals benefit the most from a general prohibition on insider trading. Consequently, this model preserves a general prohibition of insider trading, but a company can opt out of this prohibition if they choose to do so.

### 3. A critical analysis of the Belgian enforcement policy of insider trading

Although there are little or no arguments for a prohibition of insider trading, the Belgian legislator felt that such a prohibition was advisable. The present criminal enforcement policy will now be tested for its optimality.

Within the law and economics framework the total number of offenses in a society can be represented by the relation (Becker, 1968, p.177-178):

$$(1) \quad O = O(p, f, u)$$

The explanatory variables  $p$  and  $f$  represent respectively the probability of conviction for the offense and the punishment for the offense. As  $p$  or  $f$  increases, i.e. the probability of conviction increases or the punishment augments, the total number of offenses in the society will be reduced<sup>17 18</sup>.

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<sup>16</sup> If these shareholders trade on a quote-driven security market, they have to balance these benefits against the possible higher transaction costs of the wider bid-ask spread. These transaction costs will be very small for individual investors who trade rather infrequently.

<sup>17</sup> Technically seen, this means that the first order conditions are smaller than zero:

$$\frac{\partial O}{\partial p} < 0 \text{ en } \frac{\partial O}{\partial f} < 0$$

A person will commit an offense if the expected profits exceed the expected costs. The expected profits are the gains  $Y$  that result from the offense. In case of insider trading this is the realized capital gain of a security. The expected costs are the product from the probability of conviction ( $p$ ) and the level of punishment ( $f$ ). The expected netto-gain is thus<sup>19</sup>:

$$(2) \quad \text{Expected netto - gain} = Y - p \cdot f$$

Although the European legislator did not necessarily require criminal sanctions in order to prohibit insider trading, the Belgian legislator chose criminal sanctions for the implementation of Directive 89/592<sup>20</sup>.

The explanatory variable  $f$  (sanction) has undoubtedly a very high value. The Belgian legislator has provided a very large arsenal of sanctions. Any infringement of the prohibition of insider trading is being punished with an imprisonment from three months to one year and a fine of 10,000 to two million Belgian francs<sup>21</sup>. Additionally, the judge can impose a civil fine which cannot exceed three times the direct or indirect profit derived or the loss avoided. Moreover, the conviction to imprisonment automatically imposes professional restrictions on management and board functions in companies<sup>22</sup>. With regard to the prior regulation the sanctions were seriously aggravated<sup>23</sup>. These sanctions are also being imposed in reality. In the Bekaert-case the criminal

<sup>18</sup> The variable  $u$  includes all other factors that have an influence on the number of offenses. These are for instance alternatives for a person to increase his prosperity. Because the enforcement policy has no impact on this variable, it will be left out of consideration.

<sup>19</sup> In general Gary Becker (1968, p.177) defines the expected utility of an offense for an individual  $j$  as:

$$EU_j = p_j U_j(Y_j - f_j) + (1 - p_j) U_j(Y_j)$$

with

$$\frac{\partial EU_j}{\partial p_j} = U_j(Y_j - f_j) - U_j(Y_j) < 0$$

$$\frac{\partial EU_j}{\partial f_j} = -p_j U'_j(Y_j - f_j) < 0$$

<sup>20</sup> Article 13 of this Directive only requires sanctions that are severe enough to guarantee the observance of the prohibition of insider trading. At the same time adequate supervision has to be organised by the assignment of a supervisory body, that must have the necessary authority to investigate and to control possible cases of insider trading. See Article 8 of the Directive 89/592.

<sup>21</sup> Article 189 of the Statute of December 4, 1990.

<sup>22</sup> See Article 192 of the Statute of December 4, 1990 and the Royal Decree nr.22 of October 24, 1934, *Belgian Gazette*, October 27, 1934, modified by the Statute of August 4, 1978, *Belgian Gazette*, August 17, 1978, the Statute of March 9, 1989, *Belgian Gazette*, June 9, 1989 and the Statute of December 4, 1990, *Belgian Gazette*, December 22, 1990.

<sup>23</sup> Article 509-4 of the Belgian Criminal Code imposed an imprisonment from one month to one year and a fine of 10,000 to 2 million Belgian francs, or one of these sanctions alone. The civil fine was limited to the profit derived or the loss avoided. Also, the professional restrictions were automatically imposed with a conviction of an imprisonment of three months. While the judge could still avoid these professional restrictions under the regulation of Art.509-4 of the Criminal Code, this is not possible anymore because the minimal duration of imprisonment is now

court imposed the following sanctions: an imprisonment of three months with delay, professional restrictions, a fine of 500,000 Belgian francs and a triple confiscation of 1.8 million Belgian francs<sup>24 25</sup>.

Within the expected costs component of an offense (see equation 2), it is evident that the variable  $f$  (sanctions) has a substantial influence. In order to restrict insider trading, variable  $p$  (probability of conviction) has to be sufficiently high as well. If the probability of conviction is close to nil, the severeness of the sanction will not have the desired effect. It will now be demonstrated that this probability of conviction is very small.

A first reason why the criminal regulation is not effective, results from a number of fundamental deficiencies in the Statute itself. Article 182 paragraph 1 prohibits buying or selling, or giving the order to buy or to sell on the basis of inside information. Simply doing nothing is not included within the scope of the Statute. Nevertheless, such a decision is, from the economic point of view, at least as important as a buy or sell decision. Take for instance, a portfolio manager who is planning to rebalance his portfolio by selling a security. Based on inside information he decides to keep the security in his portfolio because a sharp increase of the security price is expected. Although the portfolio manager deals on the basis of inside information, he is not affected by the prohibition of Article 182. Neither is a portfolio manager who renounces a planned purchase. Analogously, Article 183 does not include the simple dissuasion of a purchase or sale, without the communication of the inside information itself. A considerable number of transactions is thereby excluded from the criminal sanctions.

Only securities and other financial instruments that are traded on a regulated market in Belgium or in a EC-member state fall under the prohibition<sup>26</sup>. Orders that are executed in Belgium concerning securities that are traded on a regulated market outside the EC do not fall under this prohibition. Nevertheless, those markets are not unimportant, as they include e.g. Zurich, New York, Tokyo, Toronto and Hong Kong. Moreover, it is very difficult to determine univocally the "place of transaction" in the sense of Article 185 if orders are given via an electronic network that has countless connections and that is accessible from different countries. Also, the already mentioned exclusion of the holding companies is unfortunate.

The second reason why a criminal regulation cannot work effectively, is the fact that insider

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three months.

<sup>24</sup> First Instance Criminal Court of Ghent, september 27, 1995.

<sup>25</sup> In the Bemat-case the accountant was convicted to 50,000 Belgian francs.

<sup>26</sup> Article 185, paragraph 1 and 2 of the Statute of december 4, 1990.

trading is difficult to detect. Even if supervisory bodies try to detect abnormal price and volume-patterns with special software, a crafty insider will create such a construction that his transactions will not attract attention. He can obtain this by spreading his transactions over various orders or by using foreign intermediaries, preferably a financial institution in a financial centre where the identity of the principal is covered by the banking secrecy.

A third factor in the effectiveness of the criminal regulation is the judicial inquiry and prosecution. The Statute of December 4, 1990 assigned the first line supervision from January 1, 1991 on to the Banking and Finance Commission (the BFC), while the judicial inquiry and the actual prosecution are carried out by the judicial authorities (courts, investigating magistrate and public prosecutor)<sup>27</sup>. According to Article 28 the BFC could ask the Stock Exchange Commission and the financial intermediaries to give all information and documents necessary for its investigation of possible cases of insider trading. Yet the BFC does not have the authority to hear people. The authority of the BFC to investigate is rather limited, especially in comparison with, for instance, the Commission des Opérations de Bourses (COB) in France, which possesses a large authority to investigate. The COB can claim all documents, it can hear people, it can conduct a house search with the permission of the judiciary and it can carry out confiscations. In Belgium it is eventually the public prosecutor and the investigating magistrate who conduct the judicial inquiry. They could appeal to the BFC and the Stock Exchange Commission to ask for all information and documents that are useful for their inquiry. They could also gather non binding advice of the BFC<sup>28</sup>.

This construction shows a double possibility for dismissal: by the BFC on the one hand and by the public prosecutor on the other. Between January 1, 1991 and December 31, 1995 the BFC opened 108 investigations of insider trading; 74 cases have been dismissed, 19 have been passed on the public prosecutor and 15 are still under investigation<sup>29</sup>. Only two cases have been prosecuted (see figure 4). This means that less than 2% of the possible cases of insider trading have been prosecuted and that only 10% of the cases handed on by the BFC to the public prosecutor have been effectively prosecuted. Given the fact that the Public Prosecutor's Offices are already heavily overloaded and the fact that they probably do not possess the necessary specialized technical financial knowledge, in practice there will exist a strong tendency to dismiss.

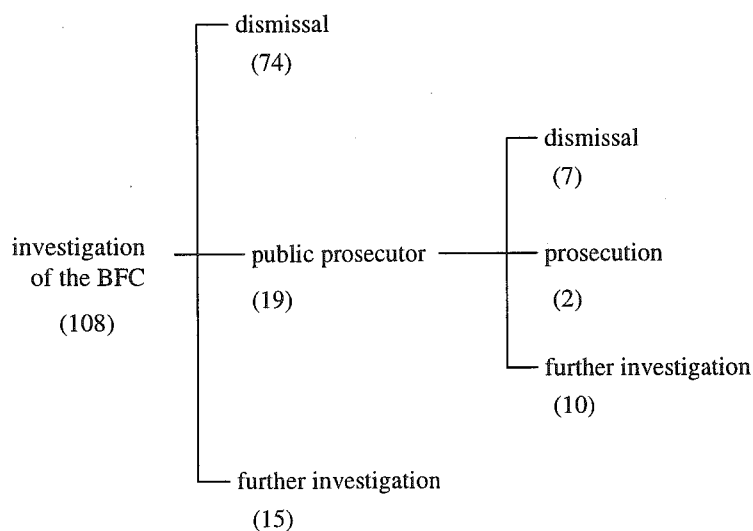
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<sup>27</sup> Article 186 of the statute of December 4, 1990.

<sup>28</sup> Article 187, paragraph 1 of the statute of December 4, 1990.

<sup>29</sup> Situation in May 1996.

Figure 4: Inquiry and prosecution of insider trading in Belgium between January 1, 1991 and December 31, 1995.



Source: *The Belgian Banking and Finance Commission*

Since January 1, 1996 the exclusive first line supervision of insider trading is assigned directly to the Board of Directors of the Stock Exchange itself<sup>30</sup>. The BFC will only perform the second line supervision in the future<sup>31</sup> (see figure 5). In 1996 the Board of Directors of the Stock Exchange examined 13 possible cases of insider trading: four have been handed on to the Public Prosecutor's Offices, two cases have been dismissed, while the other seven are still under investigation<sup>32</sup>.

<sup>30</sup> Article 19 paragraph 2, 2E, c of the Statute of April 6, 1995 and article 4 of the Statute of January 30, 1996 modifying the Statute of April 6, 1995 and the Statute of December 4, 1990, *Belgian Gazette*, February 20, 1996. See also *Parliamentary Report*, The Belgian House of Representatives, 1995-96, nr.287/3, 3.

<sup>31</sup> Article 4 paragraph 1 of the Statute of April 6, 1995. The CBF has to control if the supervisory authorities assigned for the first line supervision accomplish their task and if they apply the procedures effectively.

<sup>32</sup> "Beursdirectie wil nog meer bevoegdheden voor markttoezicht", *Financieel-Economische Tijd*, 15 maart 1997.



*Figure 5: Authority to inquiry into insider trading*

Period	Jan.1, 1991 - Dec.31, 1995	From Jan.1, 1996 <sup>33</sup>
	Art.186 of the Statute of December 4, 1990	Art.19 of the Statute of April 6, 1995
First line supervision	CBF	Board of Directors of the Stock Exchange
Second line supervision	non	BFC
Judicial inquiry	public prosecutor	public prosecutor

<sup>33</sup> Art.14 of the Statute of January 30, 1996 provided a transitional period in which the first line supervision was assigned to the BFC. This transitional period ended on March 31, 1996.

#### 4. Conclusion

Within the law and economics framework insider trading should only be prohibited if it harms the prosperity of others or of the society in general. The first part of the article sufficiently demonstrated that a prohibition of insider trading is difficult to support on the basis of economic grounds. After all, security markets work more efficiently so that the allocation of financial resources improves. It was also demonstrated that the insiders do not harm the outsiders. Furthermore, it appears that a wider bid-ask spread is not a valid argument against insider trading on a order-driven security market. Also, the decrease of the confidence of investors in case of insider trading has never been demonstrated empirically. Moreover, it appears that small individual investors do not benefit from a prohibition on insider trading. Also, insider trading can be efficient instrument in the current corporate governance debate to avoid some agency-problems and to stimulate innovation. Nevertheless, the Belgian legislator thought that a general prohibition was advisable.

In the second part of the article, a theoretical framework for the legislator, administration and supervisory authorities was presented. Within this law and economics framework, it appears that the current criminal sanctions are insufficient to restrict insider trading. The probability of conviction is very small, so that the value of the variable  $p$  will approximate zero. Despite the extensive potential criminal sanctions, the cost of the offense will therefore be very low. Only a substantial increase of the probability of conviction can improve the efficiency of the current enforcement policy. And there we arrive at the first problem again: what are the social gains of a prohibition of insider trading? Should insider trading be banned after all?

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