THE NEW INSIDER DEALING LEGISLATION -

A CONFUSING OUTCOME

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ABSTRACT

This paper assesses the impact of new insider dealing legislation on companies, brokers' analysts, professional fund managers and private investors. The revised legislation came into effect in March 1994. Our main conclusions are:

- The new legislation is open to many interpretations. In our view, the probability of successful conviction is negligible. There is already a need for a review of the implications of the legislation, to include an assessment of whether civil, rather than criminal, prosecution may present a more workable solution.
- The new legislation has succeeded in forcing companies to release new information into the marketplace through formal announcements. While this may have resulted in a fairer environment, it may also have damaged the efficiency of the stock market, in the sense that more knowable information is not reflected in share prices. There have been many instances of sharp falls in share prices in response to official announcements. Solutions will need to be found if stock market credibility is to be upheld.

1. INTRODUCTION

1.1 Two years have elapsed since the current insider dealing legislation (Criminal Justice Act 1993, Part V) came into force. The new law has not led to a rash of prosecutions, let alone convictions. Only three defendents have been found guilty in the last two years and the number of convictions in this area looks set to remain low.

1.2 The contention that has surrounded the new legislation results not only from its perceived failure in stamping out insider dealing but also from the damage it may be doing by impeding the flow of information into the marketplace. The environment in which investment professionals operate has changed markedly over the past two years. Investment analysts can no longer expect to be pointed in the right direction by obliging company officials; formal company announcements have become the order of the day. Equally, fund managers have been forced to become extremely wary of receiving information from companies which is not already in the public domain.

1.3 The new insider dealing legislation is not wholly responsible for the changes which have taken place. The Guidance on the Dissemination of Price Sensitive Information (The "Guidance"), published by the Stock Exchange in March 1994 for the benefit of companies in particular, and revised modestly in February 1995, has also played an important part. While the Guidance did little more than re-emphasise the practical requirements already in place, it did serve to focus the attention of stock market participants on the implications of the Act about to come into effect. The reality is that many market participants were failing to comply with existing requirements.

1.4 Section 2 of this paper looks at the crucial role that information plays in financial markets, and critically appraises the arguments for and against limiting the opportunities for exploitation of private information. Section 3 studies the new insider dealing legislation in detail and compares it to previous legislation. Section 4 assesses the effect of the Act, drawing on the results of a survey of City practitioners by one of the authors. Section 5 puts forward recommendations for policymakers.

2. INFORMATION AS A BASIS FOR REGULATION

2.1 Information is often much more valuable if its possession is exclusive. Knowledge of a piece of information for a period as short as a few minutes can have a very high private value but almost no social value (King and Roell, 1993). In this section, we appraise the arguments for and against limiting the opportunities that arise from the possession of private information.

2.2 Economists like Henry Manne argue that insider trading is beneficial since shares which are traded on information brought to the market are pushed towards their true value more quickly than shares which are traded on rumour or on whim (Manne, 1966). ‘Market efficiency’ is thus improved, revealing information through the price to ‘outside’ economic decision-makers, who benefit from stock prices that more closely represent the intrinsic worth of the company. More accurate prices mean less risk for investors, who will then require a smaller reward, or risk-premium, for buying the shares. Firms can then raise capital more cheaply, and invest more, thus boosting economic growth.

2.3 Decriminalisation of insider dealing, it is also argued, would not be unfair or exploitative since anyone could trade on their privileged knowledge and ‘outsiders’ are not harmed, perhaps even benefiting from the practice. Furthermore, the market itself would regulate the ‘excesses’ of insider trading by punishing rash speculators and by allowing the best-informed and those most able to gain information to deal. (Prindl and Prodhan, 1994).

2.4 Most practitioners are not convinced by the above arguments. While insider dealing tends to move prices in the right direction, it does so derivatively through price and trade decoding as the market deduces the information from the fact of the trading. This occurs only slowly and sporadically, and is dependent on such factors as the ability of other participants to separate the presence of insider dealing from the surrounding ‘noise’ of other trading in the market. Regulators also believe that public announcements are preferable as they push prices even closer to their true level despite being impounded in prices less frequently than information which is channelled through insiders.

2.5 There is another economic argument against insider dealing. The use of private information imposes costs on other investors because any profit accruing to an insider must, of necessity, mean a loss to all other market participants taken together. In practice, the direct victim is most likely to be the market maker with whom the insider deals. Market makers, realising that there is a chance that they will have traded with a better-informed trader, will set bid and offer prices so that, on average, profits on trades with ordinary investors offset losses on trades with better-informed investors. This wider spread, although allowing market makers to maintain an adequate rate of return, means all investors’ investments are ‘taxed’ at entry and exit (Mervyn and Ailsa, 1993).

2.6 Defenders of regulation argue that it should be possible to remove information advantages achieved unfairly through access to information which cannot be obtained by others. Opponents of regulation argue that this could only be achieved through the immediate disclosure of all information to ensure that all investors in the marketplace are informed and dealing on an equal basis. In practice, all this would do is create another category of insider, ‘near insiders’, made up of professionals, such as institutional investors and stock brokers, who are in a position to respond immediately to new information.

2.7 Defenders of regulation insist that, even if market egalitarianism is an unattainable goal, a more modest yet fundamental goal must be to ensure confidence in the market. The danger is that, if investors perceive themselves to be at a disadvantage, they may withdraw from the market so decreasing its liquidity and its effectiveness. The loss of confidence may also be felt by the company in whose securities the insider dealing occurred. The damage insider dealing can cause to a company's reputation and probity, and its standing in the capital market, may make capital raising more expensive. More importantly, the perception that the market is rigged in favour of insiders, together with conjecture that market makers widen spreads as a result, mean that the reputation of the market as a whole suffers.

2.8 Opponents of regulation maintain that it is the prohibition and not the practice of insider dealing which inhibits the flow of information to the marketplace. This is done in a number of ways. First, individuals may not deal because of doubts as to their position given the uncertain scope of the regulation. Second, prohibition deprives individuals of the incentive to acquire valuable information, for they are denied the opportunity to sell the acquired information to others or to profit directly by trading themselves. Third, prohibition forces speculators out of the market. Liquidity in a market relies on speculators buying and selling securities and their derivatives on short term considerations to reap a profit or avoid a loss when they think the general market opinion is wrong and that it will realise its mistake. This economically important role in stabilising prices is eradicated, thus increasing the volatility of the market by denying insiders the ability to ease prices gradually towards their 'correct' price (Alcock, 1994).

2.9 To conclude, it is clear that there are real costs as well as real benefits in having inside information revealed in prices via trading by those who possess the information. But it is not easy to judge whether the costs exceed the benefits. In the end, the ethical objection to the profit arising from trading on inside information may be the deciding factor in erring on the side of controls. What is less clear is how strict these controls should be.

3. PART V OF THE 1993 CRIMINAL JUSTICE ACT

3.1. The Legislative History of Insider Dealing

3.1.1 The recognition in Britain that it was "clearly improper for a director to act on his inside knowledge" was first made by the Cohen Committee of 1945. The Committee decided that it was unreasonable to prevent directors from trading in the shares of their companies but thought a device was nevertheless necessary to encourage a "high standard of conduct." The Jenkins Committee of 1962 deliberated longer over insider dealing but concluded that anything more than a requirement to disclose actual trades was unworkable. It recommended civil laws as a remedy for protecting shareholders from directors acting "on a particular piece of information" and also accepted the proposition that directors should not be allowed to deal in options in their own company securities.

3.1.2 It soon came to be widely accepted that insider trading was unethical and had to be regulated to maintain public confidence in the securities markets. But the most important form of regulation, prior to the enactment of specific provisions in the 1980 Companies Act, was by the various self-regulatory authorities, including the Stock Exchange, and the Panel on Take-overs and Mergers. The 1980 Act was consolidated in the 1985 Company Securities (Insider Dealing) Act ("the 1985 Act"). The Achilles heel of the 1985 Act was inadequate enforcement, despite the provision of wide investigatory powers for the Department of Trade and Industry. Recognition of the low level of successful convictions (see Table 1) was the primary reason for the changes that were introduced in Part V of the 1993 Criminal Justice Act ("the Act") on 1 March 1994.

TABLE 3.1

Insider Dealing Prosecutions - Statistics

YEAR	NO. OF TRIALS	VERDICT	
		Number of Defendents	
		Not Guilty	Guilty
1980	0	0	0
1981	1	0	1
1982	2	0	3
1983	0	0	0
1984	2	2	0
1985	1	1	0
1986	2	1	1
1987	2	0	2
1988	2	1	1
1989	7	7	3
1990	4	3	3
1991	4	5	3
1992	2	2	4
1993	4	7	0
1994	1	0	2
1995	1	0	1

Note: Not guilty verdicts include prosecutions where the case against the individual was withdrawn.

The 1993 figures include an individual acquitted on appeal in 1994.

Source: Department of Trade and Industry.

3.1.3 Apart from the hotchpotch of rules emanating from different sources which forms the Act, there are a number of ancillary regulations which also govern insider trading. These include the Stock Exchange Continuing Obligations under the Listing Rules, the 1994 Regulation of Disclosure of Directors' Interests, the City Code on Take-overs and Mergers, and the Stock Exchange Guidance on the Dissemination of Price Sensitive Information. We will concentrate on the Act itself, in conjunction with the Guidance.

3.2. <u>The "Insider"</u>

3.2.1 Under the 1985 Act, information was only "inside" if it was obtained by someone holding a position as a director or other officer of the company to which it related, or because of a business or professional relationship with that company. This "connection test" has been abolished, because the Act is now intended to protect markets and not just a company's confidential information. An insider is now an individual[1] who knowingly has "information from an inside source", that is if:

- that person has the information through being a director, employee or shareholder of an issuer (*not necessarily* being the issuer to which the information relates), or

- that person has it through having access to the information by virtue of employment, office or profession (*whether or not* such employment relates to the company to which the information relates), or

- the direct or indirect source of the information is a person falling within one of the above.

3.2.2 The removal of the "connection test" has obvious implications for analysts. Unless a conclusion is based *entirely* on public information (see Section 3.4.) an analyst may now be an insider if, through his own research, he arrives at a price sensitive conclusion about a particular company and acts on that conclusion, even though he has no connection with that company and has no inside information in the traditional sense. If he passes on his views before making them public the recipient of his advice may also be an insider (see Section 3.5.).

[1] As under the 1985 Act, the new offences will only be capable of being committed by an individual and not by a company.

3.2.3 An anomaly arises in connection with different buyers of shares in the same listed company who are dealing on the same inside information. For example, suppose that a company has won an important contract. If a person received this information from a rival listed company then this person will clearly be precluded from dealing, whereas information received from a rival *private* company may not constitute inside information and dealing would not constitute an offence (McGrigor Donald, 1994).

3.3. <u>**"Inside Information"**</u>

3.3.1 Section 56 of the Act describes inside information as information which:

- relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally;
- is specific or precise;
- has not been made public and
- if it were made public would be likely to have a significant effect on the price of any securities.

3.3.2 Note that the definition of 'inside information' is now much broader in scope. Information need not necessarily be 'precise', as laid down in Article 1 of the 1989 European Directive. Information which is 'specific or precise' could now constitute inside information. For example, an indication from a company director that 'business is down on last year' could be regarded as specific, albeit imprecise, information. As such it could be viewed as inside information.

3.3.3 Information can only be deemed to be inside information if it is likely to have a significant effect on the price of any securities were it made public. The problem here lies with the term 'significant'. What does it mean? Noticeable? More than 5%? More than 10%? Neither the Act nor the General Note to the Act offer any clarification. The Guidance issued by the Stock Exchange also offers no assistance, stating that:

> "It is not feasible to define any theoretical percentage movement in a share price which will make a piece of information price sensitive. Attempts at a precise definition of 'price sensitive' are not possible, since it is generally necessary to take into account a number of factors specific to the particular case, in addition to the information itself, which cannot be captured in a mechanistic formula."

3.3.4 In our opinion, the term 'significant' should have been omitted from the Act altogether. It is nonsensical to regard one action as lawful because the share price movement was insignificant yet another action as unlawful because the share price movement was significant, however that term is defined. Potential miscreants may be tempted to deal on inside information if the share price movement is not expected to be noticeably large. For an institutional fund, the money involved and the profit earned could still be considerable. On the other hand, a private investor unlawfully making a small profit out of a large price movement could be jailed.

3.3.5 It will be for the courts to set the legal precedents. But until that happens, uncertainty and inconsistency of interpretation will prevail.

3.4. <u>The Mechanics of "Public Disclosure"</u>

3.4.2 Perhaps the most contentious issue, and certainly one that is of great concern to analysts, is whether information has been made public or not. Unfortunately, the Act is, again, open to interpretation. The General Note to the Act states:

> "This is obviously an important aspect that goes to the heart of the mischief that the legislation seeks to prevent. However, defining the circumstances in which it can properly be said that the information is in the public domain, is not a straightforward exercise".

3.4.2 Section 58 of the Act does at least give examples of when information ***must*** be treated as made public:

- if it has been published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisers,

- if it is contained in records which by virtue of any enactment are open to inspection by the public.

- if it can be readily acquired by those likely to deal in any securities:
  (i) to which the information relates, or
  (ii) of an issuer to which the information relates,

- if it is derived from information which has itself been made public.

3.4.3 The confusion really arises because the Act is unclear about the status of information which falls outside these categories. Section 58 states that information ***may*** be treated as made public even though:

- it can be acquired only by persons exercising due diligence or expertise,
- it is only communicated to a section of the public and not to the public at large,
- it can be acquired only by observation,
- it is communicated only on payment of a fee,
- it is only published outside the United Kingdom.

As this type of information ***may*** be treated as made public, logic dictates that such information ***may not*** be treated as made public in certain circumstances.

3.4.4 It is hardly surprising that investment analysts find themselves in a quandary. Should price sensitive information discovered in an obscure foreign publication be regarded as inside information? How many members of the public constitute 'the public at large'? The main objective of skilful analysts is to unearth and bring to light facts which are not already 'in the price'. Most worrying is that clear answers may not be available for analysts until several have been dragged through the courts and legal precedents have been set.

3.5. The Components of the Offence of "Insider Dealing"

3.5.1 There are three distinct areas of activity that cannot be undertaken if inside price sensitive information is suspected:

- **Dealing** in price-affected securities. This covers both dealing or procuring someone else to deal, and covers all dealings whether conducted as a principal or agent.

- **Encouraging** another person to deal in securities which are price-affected while knowing, or having reasonable cause to believe, that dealing would take place. An encouragement not to deal (for example, a "Hold" recommendation) is not caught by this section.

- **Disclosing** inside information, unless in the proper functions of employment.

3.5.2 There is no longer any requirement for an insider to believe or have knowledge that the recipient of the information will deal. The onus of proof is thus reversed. Under the 1985 Act, the prosecution had to show that the person disclosing the inside information knew or had reasonable cause to believe that the recipient would use the information for dealing. It is now for the alleged insider to prove that he did not expect the recipient to deal or to encourage someone else to deal (See Section 3.7.). Proving a negative is always difficult.

3.6. <u>The Boundaries of the New Regime</u>

3.6.1 The 1985 Act was limited to dealings in securities issued by companies which could be dealt in on the Stock Exchange.[2] The definition of securities has been greatly extended to embrace shares, warrants, gilts, local authority stock, depository receipts, options, futures and contracts for differences.

3.6.2 The Insider Dealing (Securities and Regulated Markets) Order 1994 (No.187) which came into force at the same time as the existing legislation means that the UK regulated markets extend not only to the London Stock Exchange and all securities quoted on the Stock Exchange Automated Quotations System (SEAQ), but also to the London International Financial Futures and Options Exchange (LIFFE), the London Securities and Derivatives Exchange Limited (OMLX), and to the Alternative Investment Market (AIM). Also included are all primary exchanges of nineteen countries within the European Economic Area, as well as the National Association of Securities Dealers Automated Quotations (NASDAQ) in the United States. Furthermore, the acquisition or disposal of securities includes "off-market" transactions through a "professional intermediary".

3.7. <u>The Defences</u>

3.7.1 If analysts are forced to defend themselves against a charge of insider dealing, and the resulting punishment on indictment of an unlimited fine and/or imprisonment for up to seven years, they will find themselves in the position of being considered guilty until innocence can be proven.

[2] Dealing in most other securities was only caught in the 1985 Act if they constituted "advertised securities" and if the dealing in question was through or by someone making a market in those securities.

3.7.2 Briefly, there are a number of possible defences. Those which apply to the "dealing" and "encouraging" offences are: that at the time no profit was expected; that the information was believed to be sufficiently widely disclosed; and that the dealing would have been carried out with or without the information. Two defences which apply to the "dealing" offence are: that no-one was expected to deal as a result of the disclosure; and that the actual dealing was not expected to result in profit. There are also a number of special defences concerning marketmakers, market information and price stabilisation.

4. CONSEQUENCES OF THE NEW LEGISLATION

In arriving at the conclusions in this section, we have made use of The Rollo Survey of brokers' analysts and fund managers, carried out by one of the authors. The results of the survey are set out in the Appendix.

4.1. <u>The Effect of the Act on Analysts</u>

4.1.1 Formal company announcements are now more common and this has changed the way many analysts carry out their research. The traditional methods of relying on companies for information and gaining from acting on that information first, has to some extent been replaced by more independent fundamental research. There are now better opportunities for more skilful analysts and fund managers to shine by exercising their judgement and by taking advantage of mis-priced shares.

4.1.2 Offsetting these beneficial effects, however, is the reduced incentive for analysts to "chase" certain information because the ambiguity of the definitions of "made public" and "significant" prevents them from acting on it.

4.1.3 One of the questions in the Rollo Survey was "What do you understand by information being in the 'public domain'?". The most common responses to this open question were "published" or "freely available/accessible to all". But it is easy to agree with the General Note to the Act which does not find it "a straightforward exercise" to define the circumstances in which information is in the public domain.

4.1.4 The Rollo Survey does throw some light on how the term 'significant' is interpreted by investment professionals. Nearly one half of respondents indicated that a share price movement of 10% was, in their opinion, significant. Full details of the response are shown in the Appendix, (Part 3, Question 1).

4.1.5 Why should an analyst carry out in-depth research in any area which is not clearly "public" in case his conclusion *might* be price sensitive and therefore unusable? This uncertainty, the relatively low level of knowledge of the Act among analysts (see Appendix, Part I), and the fierce competition in equity research in the UK all tend to discriminate against the law-abiding analyst: first, by penalising innocent researchers who are only attempting to add value but who do not comprehend the Act fully; second, by allowing more ruthless rivals to gain a competitive advantage simply because they are more willing to take a risk and interpret the Act's definitions more liberally.

4.1.6 How are analysts expected to react in such an environment? Is it likely that the Stock Exchange will be increasingly bombarded with claims of "foul play" until such time as a level playing field has been established? Or are analysts finding themselves disadvantaged in this way expected simply to console themselves with the fact that they think they are complying with the letter and the spirit of the Act - even if many of them do not really know exactly what the Act constitutes or how it should be interpreted?

4.1.7 The case of the so-called "star analyst" has been particularly contentious. The very fact that an influential analyst's change in view can in itself move a price may, arguably, make such a recommendation inside information. However, the Treasury and the Stock Exchange insist that it should still be safe to deal with advance knowledge of such a recommendation provided the recommendation itself is not based on unpublished information.

4.1.8 The confusion caused by the vagueness and complexity of the Act is causing analysts to consult more than ever with Compliance. In the Rollo Survey, more than three-quarters of respondents felt it very or fairly important to consult with compliance officers or lawyers if they are not totally sure that information originates from the "public domain". This additional need to consult undoubtedly impedes the flow of information and analysis in the marketplace.

4.2. The Effect of the Act on Investor Relations

4.2.1 Uncertainty as to how the Act should be interpreted has had a noticeable effect on communications between corporate officials and the investment community. A survey by Focus Communications (1994) looked at the impact of the Act on financial communications from the companies' viewpoint; it found that the new rules had created confusion among public companies, with nearly 80 per cent of the sample admitting to finding the rules vague or unclear as to the implications for analysts' meetings. The problem of interpreting just what information can be considered to be in the public domain has caused corporate officials to adopt a cautious line. Information presented to small gatherings of investors or analysts now tends to be sterilised to avoid any accusation that privileged, price sensitive information is being imparted.

4.2.2 This sterilisation process is not one-sided. For example, one major institution requires company officials to sign a declaration after any meeting to the effect that no non-public information has been imparted. Should a company not be prepared to follow this procedure, the investment institution offers the alternative option of tape-recording the meeting. Although this reaction may be regarded as extreme, the evidence suggests that investment practitioners in general are now far more cautious in the handling of information and the conduct of meetings.

4.2.3 The Rollo Survey shows that City practitioners feel it is now more important to have clear evidence of what is said at meetings between analysts and company officials, particularly in the light of the case in which Thorold Mackie, then at Edinburgh stockbrokers Bell Laurie White, was acquitted on appeal. Interestingly, there is not perceived to be an overwhelming need for two or more analysts to be present at meetings, a finding which is at odds with the views of some law firms. For example, the law firm McGrigor Donald (1994) advises:

> "In any meetings between analysts and company officials an analyst should take at least one other person along with him to corroborate what was said at the meeting and should also keep detailed records of what was discussed and of any undertakings given."

4.1.4 Analysts unhappy with the present level of information are demanding more regularly disclosed information such as quarterly reporting or Operating and Financial Reviews (OFR). The Accounting Standards Board defines the OFR as:

> "A framework for the directors to discuss and analyse the business's performance and the factors underlying its results and financial position in order to assist users to assess for themselves the future potential of the business".

4.2.4 The OFR is more popular than quarterly reporting, probably because it fills the perceived information gap without a shift towards a more regulatory burden, and seems to be the obvious answer. Two-thirds of the respondents in the Rollo Survey strongly agreed, or tended to agree, that greater presentation of an OFR could improve communications between analysts and company officials. However, it is unclear whether the calls for an OFR is a consequence of the short-term distortions the Act has created or more of a longer-term demand for this type of disclosure.

4.3. <u>The Effect of the Act on Private Investors</u>

4.3.1 It is noticeable that companies are making more official announcements. Information which would previously have "leaked" into the marketplace is now more likely to be imparted through the Regulatory New Service (RNS). It could be argued that the environment is now a much fairer one and that private and professional investors are on an equal footing, although there are few private investors who have direct access to TOPIC and the RNS. Indeed the survey published by Focus Communications showed that only 1 per cent of companies thought that the Act would better "Sid's cause" by improved relations with private shareholders (Focus Communications, 1994).

4.3.2 It could also be argued that in the course of establishing a fairer environment, the efficiency of the market has been damaged, as we discuss below. Private investors holding undiversified portfolios who may suffer the worst effects of this. Unless solutions are found, the credibility of the stock market could suffer in the eyes of many private investors.

4.4. <u>The Effect of the Act on the Efficiency of the Market</u>

4.4.1 Is the dissemination of information now more, or less, efficient? And, do shares now trade closer to, or further away from, their 'true' intrinsic value?

4.4.2 The final question of the Rollo Survey produced conclusive evidence of the *ineffectiveness* of the new legislation in improving the flow of information into the stock market. Of the 110 respondents, just one thought it would be very effective, 38 per cent thought that it would be fairly effective, and a condemning 61 per cent thought it would not be at all effective.

4.4.3 We believe that there has been a substantial impact on market efficiency. It is true that greater use of official announcements means that at least professional participants receive price sensitive information at the same time. The sharp reaction in many share prices that often results demonstrates that the market responds quickly to that new information. On the other hand, until official announcements are made, more "knowable" information is being withheld from the market compared with the situation prevailing before the new legislation came into force. Furthermore, very few companies relay warnings that market expectations are too low. In other words, the efficiency of the market, in the sense that share prices should reflect 'true' intrinsic value, seems to have deteriorated.

4.5. <u>The Overall Success of the Act</u>

4.5.1 Despite the difficulties which have been created for investment practitioners by the new insider dealing legislation, it could be argued that a 'fairer' marketplace has been created. The release of price-sensitive information to individuals or to select groups of individuals has largely ceased and has been replaced by more frequent official announcements.

4.5.2 It could also be argued, however, that professional analysts and managers are being hindered in carrying out their duties to the highest possible standards. This is not to say that the professionals should have privileged access to inside information. But there is a need for the authorities and regulators to clarify exactly what is acceptable practice and precisely what constitutes insider dealing. Above all, there is a need to ensure that measures put in place to deter insider dealing do not result in falling professional standards to the detriment of the public at large.

4.5.3 The Act seeks to stamp out insider dealing with the threat of a stiff fine and up to seven years in prison. But a threat is empty without credibility. There is already a strong case for a thorough review of the implications of the new Act. Some commentators even think that a highly motivated, single market regulator and enforcement agency, along the lines of the US Securities and Exchange Commission, is now necessary.

4.5.4 The authorities have been largely successful in clamping down on the practice by companies of leading the market through contact with the professional investment community or through the Press. But the sharp share price reaction often witnessed in response to formal progress announcements suggests that in doing so, they may have unwittingly created a market which holds greater risk for unsuspecting participants.

5. RECOMMENDATIONS

5.1. <u>The Reduction of Uncertainty</u>

The broadening of the Act, and the wide definitions of insider dealing, has forced the government to incorporate the possibility of ever more complicated defences. The result is that the probability of a successful conviction for insider dealing is negligible. Ascertaining what is and what is not price sensitive information remains difficult. The Act needs to be narrowed in scope to heighten understanding of it and to enable it to be enforced. Abolishing the word "significant" would go a long way to reducing the existing uncertainty. A clearer benchmark, whereby *any* profit accruing from insider dealing is treated as an offence would be fairer.

5.2. <u>The Introduction of the Operating and Financial Review</u>

More company announcements should be encouraged. One way in which to encourage companies to supply more information is through the introduction of the OFR. The OFR is less of a regulatory burden than quarterly reporting, is likely to be a useful way to start any meeting, and can replace the more selective openness and self-regulation that existed before the Act. In addition, if introduction of the OFR encourages more company announcements, then short-term volatility should not increase.

5.3. <u>The Introduction of Civil Enforcement</u>

5.3.1 The poor record of success in insider dealing cases is largely due to the very high burden of proof needed to support criminal prosecutions. A criminal procedure requires the tough "beyond reasonable doubt" for conviction, while a civil action requires the more lenient "balance of probabilities". Of the seven people prosecuted in Britain in 1993 for insider dealing, none was convicted. The US Securities and Exchange Commission (SEC) fined 34 for the practice in the same year, and France's Commission des Operations de Bourse (COB) fined ten. While procedural and cost factors in Britain make it unlikely that the introduction of a centralised regulator along the lines of the SEC or COB would be an effective way of reducing insider dealing, stiff fines - ideally the "disgorgement" of profits plus a premium[3] - could be an attractive and effective way of handling insider dealing cases.

5.3.2 Introducing the right to bring civil or regulatory type actions would have the added advantage of enforcing these actions against the employer, thus encouraging the internal enforcement of the highest standards in City firms and quoted companies.

[3] The SEC can impose penalties of up to three times trading gains, and the COB up to ten times.

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APPENDIX - THE ROLLO SURVEY

During August 1994, a random sample of analysts, brokers and institutional fund managers from 29 financial institutions were sent a questionnaire asking them for their views on the new insider dealing legislation. Of the 325 questionnaires sent, 110 were returned completed, a relatively high response rate of about 34 per cent. This gives some indication of the intensity of feeling on the matter. The questionnaire and breakdown of responses follow.

PART 1

The new insider dealing provisions (Part V of the 1993 Criminal Justice Act) came into force on 1st March 1994. To assess how effectively the new rules have been communicated please circle one box in response to the following statements:

(The underlined answer is the correct one)

% % %

1. Insider dealing includes dealing in unlisted options and warrants:

<u>True</u> (59) ?(24) False (17)

2. The insider dealing Act is confined to transactions within UK recognised, regulated exchanges:

True (42) ?(17) <u>False</u> (41)

3. Both companies and individuals can be insiders: **True (62) ?(11) <u>False</u> (27)**

4. After much research, drawn exclusively from public sources, on a particular company, an analyst arrives at a conclusion that, if passed on, could significantly alter the company's share price. He is an insider:

True (7) ?(1) <u>False</u> (92)

5. Mr A, the chief executive of X plc, a leading food retailer, briefs analysts to the effect that a recently commissioned survey has found that the growth of the food retailing market has reached a ceiling and might badly affect his company's growth prospects - this is "inside information".

<u>True</u> (39) ?(7) False (54)

6. Dealing in the shares of other supermarket chains is "insider dealing"

<u>True</u> (31) ?(7) False (62)

PART 2

It would be interesting to see what, if any, effect this Act has had on you:

1. Will you do more fundamental research, and in greater depth, as a result of this Act?

Yes (15%) **Perhaps (33%)** **No (52%)**

2. To what extent is it important to consult with Compliance or your lawyers if you are not totally sure that your information originates from the 'public domain':

A great deal (43%) **A fair amount (33%)** **A little (19%)** **Not at all (5%)**

3. Company officials are advised by the London Stock Exchange to inform the entire market, rather than individuals, about information which might be price sensitive. To what extent have you noticed this change in the last four months?

A great deal (23%) **A fair amount (45%)** **A little (26%)** **Not at all (6%)**

4. Overall, to what extent has this Act changed (or might change) the way you do your research?

A great deal (4%) **A fair amount (23%)** **A little (44%)** **Not at all (29%)**

PART 3
Your Opinions:

1. In your opinion, what is a 'significant' share price movement?

2% (1%) 5% (30%) 10% (46%) 20% (11%) Other (2%) Impossible to say (10%)

2. What do you understand by information being 'in the public domain'?

3. To what extent is it increasingly important to check where your information comes from in the future, in case it is price-sensitive?

A great deal (22%) A fair amount (36%) A little (35%) Not at all (7%)

4. The recent Scottish case (in which Thorold Mackie was acquitted on appeal) involving disclosure to an investment analyst shows that it is now more important to have clear evidence of what is said at meetings between analysts and company officials:

Strongly agree(18%) Tend to agree(56%) Neutral(17%) Tend to disagree(7%) Strongly disagree(12%)

And to have at least two analysts present:

Strongly agree(8%) Tend to agree(20%) Neutral(27%) Tend to disagree(33%) Strongly disagree(12%)

5. The introduction of quarterly reports (like in the US) could improve communications between analysts and company officials:

Strongly agree(16%) Tend to agree(36%) Neutral(24%) Tend to disagree(15%) Strongly disagree(9%)

6. Greater presentation of an Operating and Financial Review could improve communications between analysts and company officials:

Strongly agree(20%) Tend to agree(45%) Neutral (20%) Tend to disagree(11%) Strongly disagree(4%)

7. An independent, centralised regulator for the securities industry, along the lines of the American Securities and Exchange Commission, would be an effective way of reducing insider dealing:

Strongly agree(8%) Tend to agree(31%) Neutral(28%) Tend to disagree(25%) Strongly disagree(9%)

8. How effective do you believe this new insider dealing legislation will be in improving the flow of information to the market?

Very effective (1%) Fairly effective (38%) Not at all effective (61%)