A review of *Stock Market Efficiency, Insider Dealing and Market Abuse* by Paul Barnes

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The global credit crisis of 2007–9 has raised important issues regarding the efficiency of financial markets and the role of regulation in reducing and controlling the social costs of financial risk-taking. In recent decades, the structure of financial markets has changed, shifting from a bank-based to a market-based financial system. Financial intermediation has moved from institutions onto markets, and financial crises are now manifest in markets and in those institutions dependent on their day-to-day functioning.

In early 2007, as substantial amounts of leverage were accumulating in the capital markets through securitised debt structures and the first signs of subprime mortgage problems were being felt in the US, investment banks such as Lehman Brothers and Merrill Lynch in their London and New York offices continued to issue massive amounts of collateralised debt obligations (CDOs), synthetic CDOs and credit default swaps referencing the CDOs to a large number of supposedly sophisticated investors (insurance companies, mutual funds, pension funds etc). Those parties eagerly invested in what they calculated to be low risk, high yielding instruments. The slicing and dicing of mortgage loan assets to the broader capital markets involved the originators of mortgage loans selling mortgage loan assets to special purpose vehicles (legally distinct third parties) which were created by investment banks (eg, Lehmans and Merrill) which in turn pooled the loan assets together before issuing debt instruments to investors in the lightly regulated capital markets for sophisticated investors. This so-called ‘shadow banking system’ created a great deal of liquidity which fuelled the property market boom in the UK, US and other countries, but, as with all financial bubbles and market manias, a sudden switch in investors’ perceptions popped the bubble and caused asset prices to plummet.

Compounding the problem was the ‘light touch’ regulatory approach taken by the UK Financial Services Authority and the complete absence of supervisory oversight of the US Securities and Exchange Commission to monitor leverage levels in securitised capital markets. Market failure and regulatory failure combined to seal the fate of the world economy to endure the worst global financial market crisis and recession since the Great Depression of the 1930s.

Against this backdrop, Professor Paul Barnes, Director of the International Fraud Prevention Centre at Nottingham Trent University Business School, has written *Stock Market Efficiency, Insider Dealing and Market Abuse*. It is a thought-provoking analysis and critique of modern capital market theories with a discussion of stock market practices in the UK and US. The book explores how market abuse and insider dealing legislation and regulation can enhance the efficiency and integrity of the stock market.
Chapter 1 observes the operation of the stock market and why efficiency is so important, and the important role that third party professionals—accountants and bankers—have in evaluating information that affects the value of shares which can contribute to market efficiency. In some circumstances, however, these third parties are influenced by corrupt motives or incompetence and thus are not able to contribute to an efficient price for shares. Chapter 2 discusses the basic operations of equity markets and how shares are valued and traded by investors and how investors can estimate the value of shares through various valuation methods including the present value of a discounted stream of future expected earnings. It also explores how price-earning ratios can provide investors with useful knowledge about firm value. It provides informative examples of how a return or yield on a company’s shares can be estimated and how investors can calculate a risk premium as well as how investors can measure the level of risk they are taking by purchasing a particular security.

Chapter 3 then examines a fundamental theory of corporate finance—the efficient capital markets hypothesis (ECMH). It provides a thoughtful discussion of the ECMH theory—from which Eugene Fama famously devised his hypothesis (which won him the Nobel prize) that ‘security prices fully reflect all available information’. Though it sounds simple, the ECMH theory has become the foundation theory of modern corporate finance and has served as gospel in the corporate finance literature and among market participants. Empirical evidence, however, shows that security prices often are not efficient and do not reflect a price which the market deems as reflecting all available information. Barnes examines the weaknesses in the ECMH theory and raises important questions about how the theory can be used as an accurate measure of risk in securities markets. Although he does not address the application of the ECMH theory to securitised debt markets in the run-up to the credit crisis, his incisive analysis and critique of the theory regarding its use to measure risk in securities markets raises important questions about how investors decide to invest in securities and whether their decisions are informed by valid measures of risk and return.

Professor Barnes then examines the development of UK insider dealing and market abuse laws and regulations over the last 30 years. He suggests that insider dealing and market manipulation, as well as weak accounting and auditing practices, are primarily responsible for the inefficient operation of listed equity markets in the UK and US. His analysis is based on the traditional principal-agent model in micro-economic theory which shows that agents (company directors and managers) have an incentive to expropriate the assets of the company’s owners (the shareholders). In doing so company insiders take advantage of privileged or confidential information to extract rents from those shareholder owners. This analysis is succinct and informative in reminding us that the insider dealing problem is another manifestation of the principal-agent problem in corporate governance.
UK company law had traditionally developed private law principles and rules including disclosure obligations and fiduciary duties to protect the company and shareholders against insider dealing on the grounds that trading on the basis of inside information was a form of theft from the company and indirectly extracted rents from shareholders. The traditional UK approach to policing the market was to use the criminal law, which often proved ineffective in curtailling the rampant abuse of insider information in UK securities markets. Indeed, the UK legal approach was built on earlier common law offences which criminalised attempts to interfere with the proper operation of the markets.

Since the 18th century, Parliament and the City of London adopted a number of measures aimed at promoting the integrity of investment banks, securities brokers and other financial intermediaries. Although the effectiveness of these measures has been questioned by academic economists (Henry Manne) and market participants, there has always been a recognition that manipulative and fraudulent conduct has especially serious implications for the efficient operation of capital markets because of the threat posed to individual investors. Indeed, maintaining the integrity and fairness of financial markets has generally been viewed as a prerequisite for their efficiency. Yet, the use of information obtained in privileged circumstances has not always been considered objectionable, let alone unfair. For example, economists have suggested that certain restrictions on insider dealing might actually undermine efficiency in financial markets and lead to a higher cost of capital for issuers.

Nevertheless, in today’s globalised financial markets, there is a general acceptance of the impropriety and economic inefficiency of insider dealing and market manipulation. Indeed, the International Organisation of Securities Commissions (IOSCO) expressly recognises market abuse and insider dealing to be a threat to the integrity and good governance of financial markets that can, in certain circumstances, undermine systemic stability in those markets. Accordingly, IOSCO has adopted international standards for the efficient regulation of securities markets that contain recommended prohibitions on market abuse and insider dealing.¹

In Chapter 7, entitled ‘Market Abuse’, Barnes discusses the adoption of insider dealing laws in the UK in 1980 and how they led to some significant enforcement actions (the Guinness case) which brought insider dealing and market manipulation into the realm of financial market regulation and reform. He argues that the bulk of the insider dealing cases in the UK over the last decade have concerned mergers and acquisitions. The community of bankers, lawyers, public relations advisors and others who receive advance knowledge of proposed takeovers, which invariably occur at a substantial premium over the existing market price of the acquired company’s shares, face a strong temptation to make a quick profit from inside information. Notwithstanding the fact that since 1980 in

¹ See IOSCO, ‘Objectives and Principles of Securities Regulation’ (IOSCO, 2001).
the UK abuse of this information has been a serious criminal offence, studies conducted by the FSA indicate that there is considerable evidence that such information is abused in a significant percentage of cases. This indicates that the control of insider dealing is a complex issue in regard to which the criminal justice system can only achieve so much.

The author concludes that ‘insider dealing probably occurs at least on a very minor level in virtually every merger bid and in respect of most other important announcements’. He also argues significantly that there are several factors that are likely to cause an increase in insider dealing and market abuse. The most important factor is technology that allows increased access to information and facilitates trading in modern markets, especially from remote locations. For instance, the spread of algorithmic trading has allowed traders to buy and sell shares more quickly while maintaining their anonymity. Another source of growing market abuse will be what he calls the growing ‘deskilling of jobs’ in financial intermediaries in which low level employees have increased access to privileged and confidential information and are in a position to exploit the information. On the other hand, he points out that electronic data systems have enhanced the ability of banks and other firms to store correspondence and record conversations and other communications that will help to protect against market abuse. On balance, technology will probably do as much to prevent and deter market abuse as it does to facilitate it.

Further, Barnes is sceptical of the FSA market cleanliness studies that attempt to quantify the amount of insider dealing and market abuse because of the poor statistical relationship one tends to find between the amount of insider dealing transactions and share price movements. He observes correctly that, even if an insider dealing transaction is so large as to affect the share price or the volume of trading and the market notices this, the subsequent increase in volume or share price resulting from increased trading will not legally constitute insider trading. In this situation, the data on share price movement and transactions can only be used to indicate that insider dealing probably occurred; it cannot show which particular transactions were insider deals. Significantly, he points out that most evidence submitted in enforcement actions shows that the price behaviour of a security subject to insider dealing was ‘largely unaffected’ by both the price and volume of trading. Finally, he observes that the main perpetrators of market abuse have been City insiders. He bases this on empirical evidence which shows that 75 per cent of the rise in a target’s share price at the time of a bid occurs before its announcement. He then suggests that this is attributable to the advising merchant banks and that there is no academic evidence to refute this.

This book is concerned mainly with stock market efficiency and how economic theories have been applied to interpret it as well as the role of market abuse and insider dealing law and regulation in protecting and improving the operations of the equity markets. In a few areas, such as Chapter 7, the definition of market abuse is confused with
the definition of market manipulation (misleading statement and misleading acts) under section 397 of the Financial Services and Markets Act 2000. Nevertheless, the book makes clear that the criminal offences of insider dealing and market manipulation are different criminal offences. It also rightly notes that the civil offence of market abuse is not the same type of offence as the criminal offences and therefore presents a different compliance challenge. He helpfully points out the regulatory dimension of market abuse compliance for issuers and how this affects internal risk management and strategy. Barnes insightfully calls into question the effectiveness of some of the disclosure requirements for issuers to produce substantial lists of thousands of potential insiders of the issuer.

Chapter 7 also contains a very useful chronology of recent FSA enforcement actions to show that the FSA has been exercising its enforcement authority more robustly than its critics would have us think to tackle the problem of market abuse and insider dealing. However, it might have been useful if the author had in an early chapter traced the definition of insider dealing and market abuse and showed how one—the criminal offence of insider dealing—was adopted with a somewhat limited purpose of protecting shareholders and the company from illicit expropriation of assets, while the other—the civil offence of market abuse—was intended not only to shelter shareholders and the company but also to promote the efficient functioning of securities markets in a systemic sense. Under the UK market abuse regime today, market abuse is very much about broader systemic concerns of efficiency and stability in financial markets.

Recent FSA enforcement actions demonstrate the systemic concern that the FSA has in enforcing the market abuse directive. The Jabre case, which is covered in the book, highlights the duty that market participants have to the market to maintain transparency and overall market confidence. An important aspect of the market abuse offence was that, unlike the criminal offence of insider dealing, it established a duty to the market for anyone whose conduct—whether on or off market—was defined as being market abuse. This meant that it was not necessary for prosecutors to prove that the defendant breached a duty to an investor or to the company or firm whose financial instruments were being traded. It was sufficient for the regulator to show that on a balance of probabilities the behaviour in question in respect of qualifying investments had impacted the market itself by undermining investor confidence and the integrity of the market as perceived by regular users of the market. In imposing liability, however, the FSA may still under certain circumstances need to show that the state of mind of the alleged abuser was relevant for committing the offence.

Although Chapter 7 provides a very good survey of the relevant UK law and regulation and the importance of EU law in driving recent reforms, more attention might possibly have been devoted to the economic impact of having a prescriptive harmonised definition of market abuse across EU states and how this might affect financial integration and the efficient development of EU capital markets. The EU Insider Dealing and Market
Manipulation Directive has defined insider dealing as a form of market abuse which can constitute both a civil and a criminal offence. The Directive expands the scope of personal liability for primary insiders under UK law by excluding any requirement that they have ‘full knowledge of the facts’ in order for criminal or civil liability to be imposed. The effective repeal of this ‘full knowledge’ requirement recognised the market reality that primary insiders may have access to insider information on a daily basis and are aware of the confidential nature of the information they receive. In addition, the Directive adopts an ‘information connection’ requirement to the definition of secondary insider. According to this definition, a secondary insider would be any person, other than a primary insider, ‘who with full knowledge of the facts possesses inside information’. They would be subject to the same prohibitions on trading, disclosing and procuring as primary insiders.

Professor Barnes’s book has made an important contribution to how we think about stock market efficiency by questioning the ECMH hypothesis and tracing the history of financial bubbles and manias, as well as by providing useful insights regarding how financial bubbles can be caused by market manipulation and other types of market abuse. He also significantly reminds us that insider dealing is not a victimless crime and that it is both a manifestation of inefficient markets and a considerable corporate governance problem for companies. This book will be read with much interest by economists, lawyers and market participants, and provides a framework for how we should think about building a more efficient and fair stock market.

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