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COURSE
11453B

Insider Trading and Reputational Consequences of Fraud

Insider trading remains one of the most closely scrutinized forms of financial misconduct, and its consequences extend well beyond legal penalties. This course examines how insider trading works, who it affects, and how regulators and markets respond. You'll also explore the relationship between financial fraud and reputational capital—how misconduct erodes trust and damages long-term value. For accounting and tax professionals, recognizing these dynamics is critical when advising clients on compliance, governance, and risk management.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the consequences of strict enforcement of laws aimed at preventing financial market abuse.
- Recall the definition of reputational capital.

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Chapter 1: INSIDER TRADING

Chapter Objective

After completing this chapter, you should be able to:

- Recall the consequences of strict enforcement of laws aimed at preventing financial market abuse.

5.1 INTRODUCTION

Insider trading refers to the use of private information to trade assets, whereas market manipulation involves attempting to cause the asset price to be above, or below, its expected equilibrium.[1] To achieve this end the price manipulator may engage in complex trading strategies or simply misrepresent information to other market participants. The intention from both practices is to make a financial gain from disruption of the proper functioning of markets. While these practices occur across many industries, media attention in recent years has focused on the activities of financial intermediaries, given the financial scale and scope of the reported activities.

There are several financial crimes of which insider trading and market manipulation are part. Others include fraud, electronic crime including cybercrime, money laundering, bribery, and corruption.[2,3] These crimes are universally condemned, and a rich suite of regulations and regulatory bodies are present at a national level to prevent, identify and prosecute these crimes.

Table 5.1 provides an example of the scope of regulation using the case of the United States of America (US), with the Securities and Exchange Commission (SEC) providing the centerpiece for regulatory enforcement. Note the layered regulatory structure that comprises specific statutes designed to capture certain practices, further statutes that clarify process, and those that establish agencies designed to monitor and affect the legislation. In the United Kingdom the Financial Conduct Authority (FCA) is the key authority with similar agencies operating in other countries.[4,5]

TABLE 5.1 THE NETWORK OF REGULATION AND AGENCIES INVOLVED IN THE DETECTION, PREVENTION AND INVESTIGATION OF FINANCIAL CRIME IN THE US.

US statutes and regulations
Section 32(a) of the *Securities Exchange Act* of 1934 (Exchange Act).
Section 24 of the *Securities Act* of 1933 (Securities Act).
Sarbanes–Oxley Act of 2002.

Mail and wire fraud statutes (18 U.S.C. §§ 1341, 1343).

Misapplication and embezzlement statute (18 U.S.C. § 656).

Criminal False Claims Act (18 U.S.C. § 287).

Internal Revenue Code (§§ 7201, 7206(1)).

Computer Fraud and Abuse Act (18 U.S.C. § 1030(a)(4)).

False Statements Statute (18 U.S.C. § 1001).

Major Fraud Act (18 U.S.C. § 1031).

Provisions that impose civil liability for fraud

Civil False Claims Act (31 U.S.C. §§ 3729-3733).

Sections 11, 12(a), and 17(a) of the Securities Act.

Sections 9, 10(b), 14, 16(b), and 18 of the Exchange Act.

Securities and Exchange Commission (SEC) Rules 10b-5 and 14a-9.

Commodity Futures Trading Commission (CFTC) Rule 180.1.

Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

US agencies involved in the detection, prevention and investigation of financial crime

Department of Justice (DOJ), including the US Attorney's Office in each federal district and the Federal Bureau of Investigation (FBI).

Securities and Exchange Commission (SEC).

Commodity Futures Trading Commission (CFTC).

Non-governmental self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA).

US Department of the Treasury, including the Internal Revenue Service (IRS).

Federal Trade Commission (FTC).

Source: Based on data from Zornow et al. (2017). Note also those regulations that exist within the European Union including Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, as well as specific national directives. Also, see the Council on Foreign Relations discussion on the US regulatory system: https://www.cfr.org/backgrounder/us-financial-regulatory-system and Cumming, Dai and Johan (2018) on the impact of markets of the implementation of the Dodd–Frank Act.

At an international level there is general guidance on *what* constitutes acceptable practice. The recent Principle 29, on effective banking supervision, by the Bank for International Settlements (BIS, 2016: 29) highlights the importance of monitoring the abuse of financial services and argues that

> "[the banking] supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities."

In addition, there is also guidance arising from key international institutions, such as the UN Global Compact, which asks for a "shared set of values and principles, which will give a human face to the global market" to help ensure that its basic activities—dealing with markets, commerce, technology, and finance—will move forward in ways that benefit economies and societies around the world (UN Global Compact, 2013 and 2015).

Better and more strict enforcement of law aimed at preventing financial market abuse has been shown to generate significant economic benefits as well as receiving widespread and popular support (Ernst and Young, 2018). For example, Bhattacharya and Daouk (2002) report reductions in the cost of *equity* capital due to the significant increase in worldwide restrictions on insider trading that began in the 1990s, while Aitken et al. (2015b) show that more detailed exchange trading rules and surveillance over time and across markets significantly reduces the number of suspected cases of insider trading. Overall, preventing market abuse encourages investment, both domestically and internationally, and thereby assists long-term economic growth and wealth creation.

What is novel now is the widespread use of technology, as well as the types of trading that expand the range of criminal possibilities. Recent attention has been directed to high frequency and algorithmic trading (see Coombs, 2016), which may provide benefits in the form of added liquidity and reduced-price dislocation (Aitken et al., 2015a), but also potential harms given that prices may be easily manipulated (Angel and McCabe 2013, Angel 2014, Angel et al., 2015 and Cooper at al. 2016). A recent example of the potential impact of high-frequency trading was the arrest and subsequent conviction of Navinder Sarao, a London-based day trader who used an automated trading program to manipulate the S&P 500 futures contracts on the Chicago Mercantile Exchange (CME) using techniques called spoofing and layering (see Stafford and Mackenzie, 2015). As noted by these authors, these trading techniques are difficult to distinguish from legitimate trading due to the role of algorithmic trading in many exchange- based markets, such as products trading on the CME.

It is worthy of mention that the pre-release of sensitive price information clearly has economic value and can be used by high-frequency traders and their trading systems to generate profits. Recently,Angel and McCabe (2018) considered the ethical issues associated with the recent practice by Thomson Reuters of selling the University of Michigan's Consumer Sentiment Index to

computerized trading firms two seconds before releasing its data to its other paying clients. This practice remains legal, although clearly it provides a select group of market participants with an information advantage.

The scale and scope of financial crime is enormous and has significant impacts on the global economy as well as the lives of those involved. In a presentation to The World Economic Forum, Craig (2018) argued that financial crime proceeds (i.e., the amount of money from criminal activities being laundered through the financial system) totaled at least $2.4 trillion annually, While this figure represents a broad perspective of financial crime, the impact of financial misconduct, including market manipulation and insider trading, are economically significant and have now transcended simple zero-sum games typically associated with fraud where a gain for one is simply a loss for another.

While criminal losses may be allocated very broadly, these crimes are not victimless, with significant damage to the social and regulatory fabric as well as to market reputation. The effective collapse of the international short-term lending market associated with the London Interbank Offer Rate (LIBOR) scandal is one such recent example, with the Wheatley Review estimating LIBOR price manipulation affected a financial market whose contracts range in value from US $202 to US $333 trillion.[6]

Detection of market manipulation and insider trading is possible in exchange-traded funds, such as stock markets, using sophisticated search algorithms that target anomalous trading as well as patterns of trading (Hawke, 2016; Ehret, 2017). This more detailed analysis has moved beyond earlier analyses of accounting data for detecting manipulation and assessing the reliability of accounting earnings (Beneish, 1999; Dechow et al., 2011) to *actual* trading data, termed high-frequency data. Identifying such distortions in over-the-counter (OTC) markets is more difficult, since price, trade, and volume information at such a high-frequency is not readily available given that it is not occurring on a single exchange. As noted by the International Compliance Society,

> "Due to the often complex nature of financial services, detecting and preventing fraud within the financial sector poses an almost insurmountable challenge. The threats are both domestic and international. They may come from within the organization or outside it. Increasingly, internal and external fraudsters combine to commit significant fraudulent acts."[7]

Thus, identification of key aspects of financial crime has shifted to incentivizing whistle-blowers (see Culiberg and Mihelič, 2016), which provides "enhanced protection and financial rewards."[8] For example, under the Dodd–Frank whistle-blower program there are bounty provisions, which provide monetary rewards of between 10 and 30% of any cash collected if the information provided leads to a successful enforcement action and monetary penalties exceeding $1 million. These incentives have had considerable success. For example, Lee (2017) notes that since financial incentives have been offered to whistle-blowers, the probability of accounting fraud was reduced by

7% between 2001 and 2010. Nonetheless, the rewards to whistle-blowers, often those involved in the original crime but who have received immunity from prosecution for their testimony, has attracted criticism (Rapp, 2007; Rapp, 2012). To put these payments in perspective, the US SEC awarded more than $111 million to 34 whistle- blowers in 2016. (SEC, 2017: 1).

The OECD (2018) has also recently highlighted the importance of the media and investigative journalism in combating financial crime. This owes much to the success of the Panama Papers investigation, by the International Consortium of Investigative *Journal*ists (ICIJ) into tax evasion and bribery.[9] Dealing with financial crime, broadly defined, is an important component of a corporation's risk management strategy and several authors have identified the importance of improving internal process. Key regulators, such as the SEC also highlight the importance of improving process *in firm*s.As noted by Hawke (2016),

> "The high percentage of cases that ultimately settle, and low recidivism rates, insider trading enforcement is also among the most visible of the (SEC) Division's programs. It should come as no surprise that the SEC seeks to optimize the technology that it uses to conduct investigations and to rethink and reinvent the methods, tactics, and strategies that it uses to identify and investigate suspicious trading activity. Given the reputational risk associated with even being investigated for insider trading, traders and compliance professionals should seek to better understand the SEC's "trader-based approach" to insider trading enforcement." The "trader-based" approach, refers to the examination of microstructure trading data to identify patterns between and among individual and institutional traders. Overall, while the identification and successful prosecution of these crimes remains important with considerable regulatory effort and expense directed to this purpose, much more needs to be undertaken to prevent these crimes from occurring. That is, it is not just a national, industry, or firm-based problem, but also one that must be effected at the individual level. Others, including Batten, Lončarski and Szilagyi (2017) in their discussion of the LIBOR scandal, argue that greater attention should be paid to the role of the individual and the importance of instilling and promoting individual ethical principles and standards as well as more effective compliance at the organization level. These themes are discussed in the final section on the management of risks.

5.2 REGULATORY FRAMEWORK ON INSIDER TRADING AND MARKET MANIPULATION

Goshen and Parchomovsky (2006) note that as custodians and intermediators of the nation's savings, financial market participants – both individuals and corporations – are subject to regulatory scrutiny, which falls into three broad categories: (i) disclosure duties, which reduce the costs of gathering information; (ii) restrictions on fraud and manipulation, which lower the costs of verifying information; and (iii) restrictions on insider trading that would undermine the investment made in gathering and verifying information. A taxonomy of market manipulation techniques is

provided in the surveys by Putniņš (2012) and by Pirrong (2017), while Cumming Johan and Peter (2018) review the recent literature on financial market institutions, governance, agency costs, and financial market misconduct.

In an economic sense, price manipulation artificially leads to an erroneous equilibrium that in turn may trigger adjustments to demand and supply.[10] However, insider trading pre-empts the price adjustment process that occurs in response to new information, thereby allowing an abnormal profit to be made by the insider. Profit taking by the insider relies upon the broader market eventually adjusting their prices to reflect the new information once it is known publicly. Nonetheless, in most jurisdictions it is not essential for successful prosecution for the insider to profit from these trades, since the initial act of trading signals intent to use the private information. With market manipulation, it is not *intend*ed to extract an economic rent from private information, but instead, to force the price to be above or below the correct market equilibrium. As will be discussed later on, given the scale and scope of some financial markets, successfully changing the price from its true equilibrium invariably involves collusion between some, but not necessarily all, market participants.

There may be subtle differences in the application of law associated with insider trading and market manipulation, although the types of acts considered are similar. For example, Table 5.2 lists a series of white-collar crimes investigated by the Federal Bureau of Investigation (FBI) in the US including the falsification of financial information, self-dealing by corporate insiders, kickbacks, and fraud. Some examples of these crimes are also provided. The FCA and European Commission regulation EU596/2014 on market abuse considers the following examples of insider trading and market manipulation and clarify by example aspects of the FBI list:

a. Insider trading occurs when prior to the official publication of certain price sensitive information, a trader learns from an insider the nature of the information and takes a position (possibly leveraged through futures or options) expecting to profit when the information is released. These positions may involve either buying or selling an asset.

b. Front running/pre-positioning involves taking an advantage of an expected price movement associated with a client order that the agent buys or sells beforehand. A detailed discussion of this activity in the Indian stock markets is provided by Chaturvedula et al. (2015).

c. In the context of a takeover, an offeror or potential offeror taking a bet on financial contract, such as an option that should increase or decrease in value once news of the takeover is made public.

d. Price squeezes occur regularly in markets due to demand and supply shocks. However, as the FCA notes, "Market tightness, is not of itself likely to be abusive . . . In addition, having a significant influence over the demand and supply of an asset is not in itself abusive."[11] What is important is intention and whether the parties act to mitigate the consequences of

their positions. One of the most famous market squeezes involved the Hunt brothers' cornering of the silver market, which involved stockpiling up to two thirds of the world's silver inventory. Nonetheless as Christopher (2016) points out, the case highlights the difficulty in distinguishing market manipulation from normal market trading.

TABLE 5.2 EXAMPLES OF WHITE-COLLAR CRIME INVESTIGATED BY THE U.S. FEDERAL BUREAU OF INVESTIGATION.

1. Falsification of financial information
    - False accounting entries and/or misrepresentations of financial condition

      The examples include:

        - Enron (2001), where executives misrepresented earnings and balance sheet items in order to boost performance.[12]
        - Worldcom (2002), where executives recorded expenses as investments and inflated profits (instead of showing the net loss).[13]
    - Fraudulent trades designed to inflate profits or hide losses

      The examples include:

        - Guinness (1986), where *"the* Guinness Four" manipulated the Guinness stock price on London Stock Exchange in order to facilitate the takeover of a larger drinks firm Distillers.[14]
        - Lehman Brothers (2008), where executives used the repurchase agreements with the non-independent party to misrepresent the company's net leverage position.[15]
    - Illicit transactions designed to evade regulatory oversight

      The examples include:

        - Deutsche Bank (2015), where employees were involved in the so-called mirror trading schemes in which the same entity sells and buys the same asset using companies at different locations, thus evading taxes by moving asset to offshore centers.[16]
        - UBS (2007 onward), where the bank systematically assisted nationals of many countries to evade taxes.[17]
2. Self-dealing by corporate insiders
    - Insider trading (trading based on material, non-public information) (continued)
        - Drexel Burnham Lambert (1986), a case that saw Dennis B. Levine, a banker at DBL, Ivan F. Boesky, a client of DBL, as well as Michael Milken, charged and convicted on several counts of insider trading and financial fraud.[18]