Insider Trading: Boom or bane for the capital market

Patrick D. Caoile
De La Salle University
Manila, Philippines
patrick.caoile@dlsu.edu.ph

ABSTRACT

Insider trading is simply defined as financially gaining from material information that is nonpublic. It can either be gaining financial rewards from material information that can increase the price of the publicly traded stock or cutting losses in case the news once disclosed could depress the market price. The main problem is insider trading can be considered either a boom or help the development of capital market or a hindrance to its development? There are two celebrated cases of insider trading in the Philippines and these include the case of former Minister of Trade Roberto Bobby Ongpin, involving the purchase of Philex shares of the Social Securities System financed by the Development Bank of the Philippines and approved within one day. Dante Tan and his Best World Resources that showed the stock price jumped from Php 0.80 centavos to Php 107. Methodology is the CFA Institute Code of Ethics and Standards of Professional Conduct, involving seven standards of professionalism, capital markets integrity, duties to clients and employees, investment analysis, recommendations and actions, conflicts of interest and responsibilities of a CFA Institute member and candidate. The case of Bobby Ongpin is ongoing and the Securities and Exchange Commission had fined him USD$3.6 million (Php174 million at Php 48/$) but he was able to secure a temporary restraining order from the Court of Appeals. Dante Tan secured government contracts due to his closeness to President Erap Estrada but the case against him did not prosper. The Western world and developed countries' financial capital market is more exacting as it jailed Michael Milken and reduced the influence of his company, Drexel Burnham and Lambert. It also fined and jailed Brex officials in Canada. Insider trading stimulates the capital market in the Philippine as well as other emerging markets in the short run but the long term survival of the capital market requires perfect information made available easily to the investing public with due regard to the CFA code of ethics. The availability of perfect information is the constraint in the development of the capital market.

Keywords: insider trading, nonpublic information, manipulation, capital markets

INTRODUCTION

Is insider trading a boom or a deterrent to the development of a vibrant and active capital market? Given two cases of insider trading, what models can be developed to analyze its effects? The main purpose of regulating the trading of securities in the capital market is to prevent fraudulent and manipulative practices in the sale of securities. The Securities and Exchange Commission (SEC) Code of Corporate Governance of 2009 expressly prohibits it. The SEC Code emphasizes transparency and rectitude in the conduct of the officers, key managers, and directors. The willful manipulation of material facts must be avoided that will cause harm to a person who reasonably relies on that misrepresentation. These includes false statements of a material fact, omitting a fact that makes a statement of material facts misleading, or engaging in any practice or scheme that would serve to defraud. Investors either buyers or sellers are particularly vulnerable to fraud because ultimately the value of the financial instruments depends almost entirely on the information that is oftentimes difficult to verify.

Insider trading is the illegal use of price sensitive, nonpublic information to buy and sells securities and other financial instruments and it has long been considered an endemic feature of the world's financial markets despite almost universal criminalization of insider trading (Ali & Gregoriou, 2009). The key here is the information is nonpublic and it can affect the price of the financial instrument whether it is a publicly trade stock, a derivative instrument, or even a bond. Theoretically if someone stumbles into a nonpublic information and does not use it then there is no insider trading.

Nonetheless the ideal for investment instruments is that the intrinsic value is equal to the real value, given adherence to perfect and symmetric information. The Corporation Code of the Philippines Batas Pambansa 68 mentions stiff penalties under Section 31 Liabilities of directors, trustees, and officers and Section 32 Dealings of Directors, trustees or officers within the Corporation. Most of the laws in the Philippines are inspired by American jurisprudence and the corporation code is no exception. The American Section 17 (a) of the 1933 Securities Act and Section 10 (b) of the 1934 Securities Act expressly disallows insider trading and both prohibit anyone from making false statements of material fact, omitting a fact that makes the statement of material fact misleading or engaging in any practice or scheme that defrauds the investing public.

The objective in the development of the capital market is to create a level playing field that requires everyone to play by the same rules and employing similar techniques for investing. The capital market to be an efficient and a viable source of funding for expansion and development must carry only market and unsystemic risks without the risks of fraud and manipulation. However, those who are more diligent and more astute in exploring the potentials of an investment destination can be able to earn more for themselves and their investing clients. Subsequently, not all will possess the same information and symmetric information is an unrealizable ideal and consequently, the capital market whether emerging or mature is characterized by disparities and great information asymmetries. The average investor can not hope to complete on equal footing with the savvy market investor, the so called market professionals but even these market professionals oftentimes possess different information or analyze information differently based on their risk appetite that leads them to make different investment decisions.

Much of the information is in the hands of the company and issuer that it discloses to the public as soon as possible. Another source of information is the issuing agent and in the Philippines, companies who are intending to go public as well as companies that already public but increasing their capital need an investment house to firmly underwrite their shares offering. There are two types of underwriting and these are firm underwrite and best efforts but in the Philippines, companies desiring to go public and increasing their capital secure the services of an investment house to firmly underwrite its shares offering. The investment house as an issuing agent is also a good source of information. Information that is not disclosed to the public but made part of the investment decision is insider trading.

Mc Gee (2009) identified 16 countries on the extent of compliance with OECD benchmark on insider trading and while the Philippines showed that the OECD benchmark is largely observed, it is still best to emulate the examples of South Africa and Hungary, as shown in Table 1.

Table 1. *OECD benchmark*

Country	Observed	Largely Observed	Partially Observed	Materially Not Observed	Not Observed
Bulgaria		X			
Chile			X		
Columbia				X	
Croatia		X			
Czech Rep.				X	
Egypt		X			
Georgia				X	
Hungary	X				
Korea			X		
Latvia		X			
Lithuania		X			
Mauritius			X		
Mexico		X			
Philippines		X			
Slovak Rep.			X		
South Africa	X				

Source: World Bank ROSC Reports from Mc Gee (2009)

METHODOLOGY AND FRAMEWORK

This research proposes two frameworks and these are the Chartered Financial Analyst (CFA) Code and its seven standards of professional conduit and the other is the theory of constraints. The CFA and its British counterpart, the Chartered Institute for Securities and Investment (CISI) are in the forefront of professionalizing and establishing ethical standards for the finance profession apart from the government regulatory that had demonstrated the susceptibility to rent seeking and lobbying activities of the investment community and the companies going public. The CFA Institute code of conduct admonishes its members and candidates to always act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, prospective clients, employers, employees, and colleagues in the investment profession, and other participants in the global capital markets. It is the holy grail of the vibrant and active capital market. Consequently, its ethical standards and paradigm can be used to evaluate violations such as insider trading. On the other hand, the Theory of Constraints (TOC) is a production tool that is applied to ethical concerns of insider trading to determine and ascertain the bottlenecks and constraints to a vibrant and active capital market.

CFA and CISI Members and candidates are expected to place integrity of the investment profession, and the interest of clients above their own personal interests, use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in professional activities. They are likewise expected to practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession; promote integrity and viability of the global capital markets to the ultimate benefit of society; and maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals. Naturally it is best to use their ethical codes and standards to establish the ethical concerns on insider trading and the general development of the capital market.

There are seven standards of professional conduct of the CFA Institute and these are:

1. Professionalism
2. Integrity of capital markets
3. Duties to clients
4. Duties to employers
5. Investment Analysis, recommendations, and actions
6. Conflicts of interest
7. Responsibilities as a CFA Institute Member or candidate

Briefly, professionalism contained four important aspects of knowledge of the law, independence and objectivity, misrepresentation, and misconduct while Integrity of the capital market had two on material nonpublic information and market manipulation. The duties to clients include the need for fair dealing, loyalty, prudence and care, suitability, performance presentation, and preservation and confidentiality. The duties to employers mentioned loyalty, additional compensation arrangements, and responsibilities of supervisors while investment analysis, recommendations, and actions focuses on diligence and reasonable basis, communication with clients and prospective clients and record retention. Conflicts of interest touches on disclosure of conflicts, priority of transactions and referral fees while the last standard is a reminder to the CFA member and candidate to be always forthright in their transactions so as not to compromise the Institute.

The theory of constraints (TOC) espouses the view that any process or system is determined by its weakest link. Every system has constraints that prevent it from fulfilling its ultimate goal under the principal agency theory of maximizing wealth for shareholders and owners. The theory proposes that by removing the largest constraint defined as the bottleneck, will result in increases in output. The output of the system is further improved by removing the new bottleneck, resulting from previous actions. The TOC searches for the bottleneck and seeks to remove it but making sure that another bottleneck will not be created. Goldratt and Cox (1984) explained the TOC, using the example of boy scouts marching in a line formation that cannot march faster than the slowest person and any attempt to by pass the slowest person will only extend the length of the line. Allowing the bottleneck to determine the pace holds the line together. The performance of the entire line is improved by making the slowest person walk faster.

The TOC is used to maximize the output of a production system with the ultimate goal to make money and maximize shareholders value. Goldratt and Cox (1984) focused on different financial and operational indicators that contribute to that goal and these include output and throughput defined as the difference between inbound and outbound cash flow; inventory defined as the financial means invested in the system for acquiring assets that should be sold; and operational costs defined as all costs made by the system for transforming inventory into output. Goldratt and Cox (1994) stated that to generate as much money as possible, the output of the system should be maximized. Operational focus is to improve output and throughput and operating time and not just on reducing operating costs. Instead of maximizing the output of new equipment in an assembly line of old and new equipment, it might be better to increase the output of an old and even fully depreciated machine.

There are five steps in the TOC:

1. Identify the constraints in the system.
2. Determine how exploiting the constraint can breach the constraint.
3. Subordinate other processes to the constraint.
4. Elevate and strengthen or breach the constraint.
5. Repeat the cycle and return to step 1 once the constraint is breached.

DISCUSSION AND ANALYSIS

The CFA Institute code of conduct and standards of professional conduct all prohibits the use and practice of insider trading, especially with respect to Standard II on the integrity of the capital market. Members and candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information. Moreover, members and candidates must not engage in practice that distort or artificially inflate the trading volume with the intent to mislead market participants. This is the essence of the insider trading case against Roberto Ongpin that involves around 550 million Philex shares for a total of 174 transactions that he sold to Manuel Pangilinan on December 2, 2009 at Php 21 per share when he was Chairman and Chief Executive Officer of Philex Mining Corporation. Ongpin was negotiating the sale of the company to Pangilinan so he knew the purchase price before hand but since the public does not know it yet at that time, this is considered insider information. Ongpin borrowed Php 510 million from a government bank, Development Bank of the Philippines that is story in itself because the loan was approved and released within one day.

The SEC fined Ongpin for Php 174 million and disqualified him from being a director of any corporation since he was adjudged to be in violation of Section 27 of the Republic Act 8799 of the Securities Regulation Code (Yamsuan, 2011 and Abadilla, 2016). The SEC Enforcement and Investor Protection Department (EIPD) initially fined Ongpin Php 17.4 million but the SEC Chairman Teresita Herbosa deemed it necessary to increase the fine to Php 174 million as a deterrent. Ongpin got a reprieve from the Court of Appeals when it issued on July 2016 a Temporary Restraining Order (Dela Paz, 2016). The case is still ongoing.

Another case of insider trading in the Philippines is the BW case that saw the stock move from Php 0.80 centavos to Php 107 per share within a few months and at its zenith had a market capitalization equivalent to Php 100 billion. BW is a good example of insider trading and stock manipulation where Dante Tan exploited his close relationships with President Estrada and his cabinet to obtain the nationwide bingo license from a Government Owned and Controlled Corporation (GOCC), the Philippine Gaming Corporation (PAGCOR) in 1998, using a penny ante stock without any asset nor track record for earnings except for the license.

Dante Tan acquired BW via a back door listing and employed now Senator JV Ejercito, the favorite son of President Estrada as one of its key officers then tied up with Stanley Ho of Macau gambling key figure. The stock manipulation lasted for about eight months and saw its price from 80 centavos to P107 per share but in its aftermath, collapsed the Philippine capital market. The Department of Justice dismissed the case in

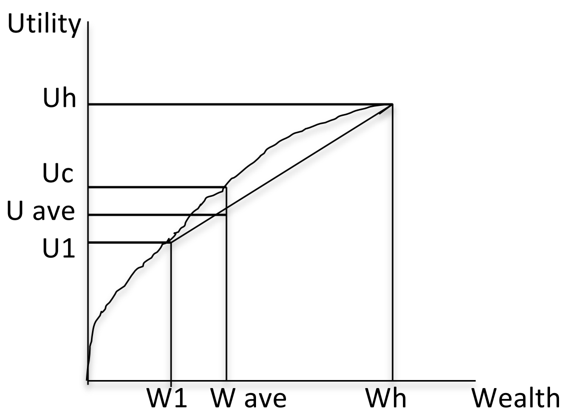
March 2013 against Dante Tan and seven other co-accused' that included President Estrada (Dela Pe, 2013). Only a handful of stockbrokers were indicted for stock manipulation and insider trading.

Boatright (2012) explained that manipulation generally involves the buying and selling of securities for purposes of creating a false or misleading impression about the direction of its price so as to induce other investors to buy or sell the securities and like fraud, manipulation is designed to deceived others but the effect is achieved by the creation of false or misleading appearances rather than false or misleading representations. Both are discussed in Standard II of the CFA code. While the government tries to prevent fraud and manipulation by mandatory disclosures and penalties for false or misleading statements, the more positive deterrent is to empower investors to have easy access to reliable information.

Diamond (1999) opined that the standard for stock price appreciation stills remains to be the Solow growth model. This is a long tern horizon model. The standard Solow model of economic growth does imply that slower long run economic growth with constant savings yield will also yield a lower marginal product of capital therefore lower stock returns. Diamond (1999) was investigating the trend in the light of the Federal old age survivors insurance and used the Solow growth model of 7% as the empirical growth rate manifestation in America over a long period of time of 50 years.

Mc Gee (2009) looked at insider trading as a victimless crime. He even cited the works of St. Thomas Aquinas who wrote way back in the thirteenth Century that there is no moral duty for a newly arrived grain merchant to tell the people that there are other grain merchants arriving after him so that there might be nothing inherently wrong about profiting from non public information.

Akerlof (1970) used the experience with second hand cars and the possibility of lemons among the second hand cars as analogous to the capital market when there is always the possibility of asymmetric information. Market participants safely assume that the price of a given security incorporates all known information. Grechenig (2009) dichotomized insider information into negative and positive information such that those who trade on negative insider information should not be penalized as it is akin to whistle blowing conditions while it should be made illegal for positive information.



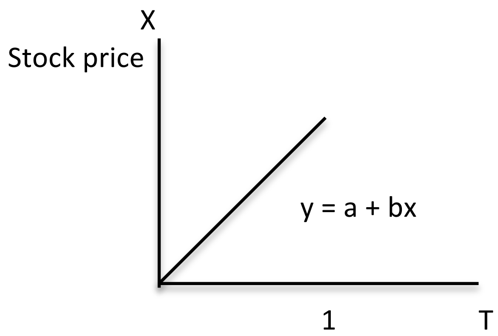
Jenner (1986) wrote at length about the Cumulative Abnormal Returns (CAR) from insider trading, using the modified Capital Asset Pricing Model (CAPM) into this equation, $R_{it} - R_{ft} = \alpha + \beta_i (R_{mt} - R_{ft}) + \varepsilon_u$ where R_{it} is the return on insider portfolio; R_{ft} is risk free trade; α

is Jenner's unconditional alpha; β is unconditional beta; R_{mt} is market return and ε is residual error. Jenner (1986) further refined this to include French and Fama improvement of the CAPM model where $R_{it}-R_{ft}= \alpha+\beta\ (R_{mt}-R_{ft})+\beta_{i2}SMB_i+\beta_{i3}HML+\beta_{i4}UMD+\varepsilon_{it}$ where SMB is a mimicking portfolio long in small capital stocks and short in big capital stocks, HML is mimicking portfolio long in stocks having high ratio of book value to market value, UMD is a mimicking portfolio long in stocks with having upward trend and short in stocks with downward trends. The graphical explanation for short-term gains is shown below:

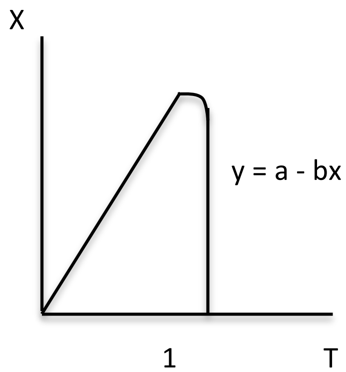
Consider two risk neutral traders who bought the stock at wealth 1 (w_1) and a corresponding utility1 (u_1). If one trader can benefit from insider trading at Php 1.0 million while the other will not benefit then this corresponds to Wealth H at utility H but if information is disclosed then both will receive Php 500, 000. The graph follows typical diminishing returns scenario such as more wealth is added utility declines. The utility of consumption, $U_{c,}$ comparatively shows a lower $U_{average}$ and the difference between utility c and U average is the social sacrifice due to insider trading.

There appears to be the best depiction of short term or short run model for stock capital appreciation to account for insider trading either mathematically using Jenner or the aforementioned graph. The model is reflective of short run phenomenon and to extent this model of short run stock market price appreciation is done with the insider trading activity as perhaps a white noise or an aberration. The stock price will certainly appreciate for the short run of at least one year (Y), that is, Y < 1 before it exhibits a permanent decline after one year, Y+ 1. BW took only eight months, perhaps precipitated by the onset of the Asian financial crisis. This is depicted in the graphs shown below:

Short Run Stock Price over Time



Long Run Stock Price over Time



This is by all means a theoretical model that will eventually require an empirical validation that the researcher intends to pursue upon securing the funds for such an endeavor or perhaps some other scholar or researcher can pursue the empirical validation in time for the summer session this year or the winter session next year.

CONCLUSION

Investors must play by the same rules and are equally equipped to compete to level the playing field. Insider trading is fostered by competition between investors with very unequal information. The possession of unequal information is indeed unfair only when the information is illegally obtained or when its use violates some obligation to others. The insider trader misappropriated the information that rightly belonged to the company. Consequently the wrongful acts of the insider trader include the violation of a moral obligation not to steal plus the fiduciary duty to serve others. Insider trading happens because others do not have equal access to information.

Investment analyses by professionals are not provided to the public but only to select clients. Now the regular investor will have to spend time and resources to put him in equal footing with the investment professionals. Assuming the government is fastidious with its regulatory functions then equal access to information appears to be the weakest link. This is a signal that the weakest link has shifted from that of inadequate regulations that allowed the BW scam. The regulations that were promulgated after the BW insider trading case plugged the hole created by information asymmetries. Thus it would appear that equal access to information is looming to be the weakest link.

Insider trading for sure has very negative effects on the capital market. It might spur the market across the board or target specific stocks, maybe in a short run like the example of Philex Mining recently and BW a few years back but the temporary gains is not matched by the backlash whether for ordinary investors and even trading professionals. BW collapsed the Philippine stock market in 1998 at the time of the Asian Financial crisis. The Philippines was relatively spared from the very negative effects of the Asian financial crisis that centered on Thailand and Indonesia. It should have made it easier and faster for the Philippines to recover if not for the BW scandal and its aftermath. The investors fleeing from Indonesia and Thailand and our other neighboring countries could have easily shifted their investments to the Philippines. There are models and literature that supports insider trading as a victimless crime (Mc Gee, 2009) or one that dichotomizes between negative and positive information (Grechenig, 2009). In the long run, the market appears resilient and has seen to weather even market meltdowns.

The insider trading of Philex Mining was centered only on one person, Ongpin, but the punitive actions just like in BW and Dante Tan had remained illusionary. Unlike in mature economies like America that saw the jailing of Michael Milken and Bernard Madoff, the Philippines capital market had not seen such jailing. Perhaps this is another weak link and constraint but unlike equal access to information, it does not encourage a long line and queuing.

There are two types of risks inherent in financial transactions and these are systemic and unsystemic. The unsystemic is found in individual companies and can be mitigated by several generations of financial models of risk mitigating strategies and tactics, starting with the Portfolio Theory of Harry Markowitz, the Capital Asset Pricing Model by William Sharpe and the Three and Four factors model by French and Fama while the systemic deals entirely with the collapse of the market.

We live in exciting times with a lot of uncertainties so there is a lot of temptation to take the easy way and perhaps a surefire approach of using and available of insider information for the needed edge. There is a caveat herein that by doing so runs counter against the common good. It casts aspersions on the integrity of the capital market that might lead to systemic conditions such that in the long run, unsystemic risks migrates to systemic risks because of insider trading. Is it more of a bane or boom? Whether on a personal level like that of the Bobby Ongpin case or system wide like that of Dante Tan and the BW, there were short term effects that can be considered as positive impact on the upward movement of capital market prices: however, in the long run the ethical concerns far outlay the initial gains.

NOTE

There were certain personalities, terms and phraseologies that are common and peculiar to the Philippines. Reversed take over is known more popularly in the Philippines as back door listing, the mental picture being that the Initial Public Offering (IPO) is listing through the front door. Roberto "Bobby" Ongpin or RVO is a common fixture in the Philippine finance environ. He is a Harvard educated management consultant of one of the first multinational of the Philippines, the SGV Corporation. He became a powerful person during the Martial Law years under President Marcos and with the departure of Marcos; he became a market mover and player in the capital market. He brought into the Philippines the Kuok brothers of Malaysia.

Dante Tan is a well-known Chinese Pilipino trader whose main business was importing cheap tires into the Philippine market until such time he leveraged his close relationship with President Erap Estrada to obtain gaming licenses for his listed company, BW Resources. The Philippine Gaming Corporation (PAGCOR) is a Philippine government owned and controlled corporation (GOCC) and is considered a paradigm on how the government can capture the lucrative gambling activities. The government hierarchical system borrows much from American influence. The Philippines Securities and Exchange Commission (SEC) is patterned after that of America and regulates the activities of Philippine Corporations. The Development Bank of the Philippines is one of three investment financial institutions in the Philippines that include the Land Bank of the Philippines and the National Development Company.

The Batasang Pambansa, literally means Legislative Body, was the Martial Law created Legislative Body envisioned by the President Marcos as a way to soften the stigma of the Martial law Regime. The Batasang Pambansa was a legislative assembly mainly composed of handpicked men and women by then President Marcos. The body had created and legislated a lot of laws that still exists to this day.

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