

Compliance Building

Doug Cornelius on compliance and business ethics

Do Prosecutions Stop Insider Trading?

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We generally assume that the prosecution of crime acts as a deterrence to others who may think about committing the crime. One of the key factors in fraud is opportunity. If the wrongdoer thinks they cannot get away with the violation, they are less likely to commit the violation.

At least that is the theory. Social scientists have been looking at this strategy for a long time, with sometimes mixed results. My guess is that the deterrent effect will vary from crime to crime and deterrence strategy to deterrence strategy.

What about insider trading?

The UK's Financial Services Authority has published a metric on insider trading. They look at the level of abnormal pre-announcement price movements (APPMs) in the share price of a company.

“The level of APPMs for the takeover data set has remained stable over the past few years including for 2009. The level of APPMs for the FTSE 350 data set remained at a low level in 2009.”

Table 2.1: The measure of market cleanliness for the takeovers analysis

Year	Announcements	APPMs	Percentage % (APPMs/Announcements)
2000	183	44	24.0
2002	147	37	25.1
2003	160	22	13.8
2004	102	33	32.4
2005	177	42	23.7
2006	199	57	28.6
2007	167	48	28.7
2008	181	53	29.3
2009	144	44	30.6

Table 2.2: The measure of market cleanliness for the FTSE 350 analysis

Year	Announcements	Significant Announcements	APPMs	Percentage % (APPMs/Announcements)
1998/1999/2000	487	51	10	19.6
2002/2003	734	54	6	11.1
2004/2005	927	49	1	2.0
2006/2007	1,085	78	6	7.7
2008	428	50	5*	10.0
2009	466	24	1	4.2

* In calculating the number of APPMs for the FTSE 350 analysis we cleansed the data by stripping-out two positive company announcements that were preceded by downward share price movements. This is because it is clear that both share price falls were attributable to wider market declines at that time and not to the announcements which were positive news stories.

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The data does not show any improvements. The data set is on the small side so it is hard to judge significance. The FSA program is also new. The program began during a period of great turmoil in the financial markets.

On the other hand, the FSA's new enforcement activity of criminal prosecutions and large fines did not affect the amount of abnormal pre-announcement price movements. If this robust enforcement activity is supposed to have a deterrent effect, it does not obviously appear in the data.

Perhaps robust enforcement activity catches more bad guys but does not reduce the bad activity.

Sources:

- [Do More Criminal Prosecutions and Bigger Fines Equal Deterrence?](#) by Thomas O. Gorman in SEC Actions
- [FSA Annual Report 2009/10](#)  page 35
- [FSA's Market Watch newsletter Issue No.26 \(April 2008\)](#) 
- [FSA's Market Watch newsletter Issue No.19 \(March 2007\)](#) 
- [Articles on Death Penalty Deterrence](#)