

At A Glance **Insider Dealing**

Overview

Regulators in multiple jurisdictions are increasingly emphasising enforcement against insider dealing. The UK Financial Conduct Authority (FCA), for example, has made use of both civil fines and criminal sanctions in this area. In the six-and-a-half years leading up to 31 March 2017, the FCA (and its predecessor, the Financial Services Authority) fined 13 individuals more than £5 million, in total, for insider dealing. Moreover, through 31 March 2017, the authority obtained criminal convictions against 33 individuals for insider dealing.

Key Areas of Expertise

NERA experts have over 20 years of experience in providing economic advice and testimony to parties involved in insider dealing investigations and have worked with both private litigants and regulators. In addition to allegations relating to trading in shares, NERA is well-versed in dealing with cases involving a range of securities and other instruments—for example, bonds, options, and credit default swap (CDS) contracts. Typically, one or more of the following issues arises in an analysis of insider dealing.

Price Sensitivity

The EU Market Abuse Regulation (MAR), which came into effect on 3 July 2016, defines “inside information” as information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments”. MAR widens the definition of “inside information” to capture inside information for spot commodity contracts, and also includes a new definition of inside information for emission allowances and auction products based on these.

Insider dealing cases, therefore, may involve a dispute as to whether the information at issue was in fact price-sensitive, which may bear on the legal question of whether investors considered information to be material. The behaviour of security prices when the information

is ultimately made public is a critical consideration in such a determination. NERA economists can employ statistical techniques to measure the effect of the release of information on a security’s price, controlling for market-wide, industry, and other developments that may also influence price. An examination of the statistical significance of a security’s price movement in response to the disclosure of information can allow for a determination of whether that price movement is meaningfully larger than would ordinarily be expected absent the company-specific news. In carrying out and interpreting such an analysis, it is important to focus on the question of price-sensitivity at the time the alleged insider trades occurred, as the value of information may be different at the time it is released to the market. Moreover, when multiple news items are announced simultaneously, various techniques may be applied to isolate the impact of the alleged inside information from that of other company-specific news.

Public Knowledge of the Information

The definition of inside information set out in MAR also stipulates that it has not been made public. A question that may call for an expert opinion is the extent to which the information at issue was in fact non-public at the time the dealing took place. NERA economists have extensive experience reviewing news stories, analyst reports, company financial statements, online message boards, and other information sources to assess whether and to what extent allegedly non-public information was already in the market.

Gains Made or Losses Avoided

An estimate of the gain made or loss avoided by alleged insider dealing is often required by regulators or in civil litigation. For example, the FCA's framework for market abuse penalties against individuals states that the regulator "will seek to deprive an individual of the financial benefit derived as a direct result of the market abuse (which may include the profit made or loss avoided)". In multiple jurisdictions, event studies have been used to estimate the price effect of inside information. As with an assessment of price sensitivity, an analysis of gain realized or loss avoided must isolate the value of inside information from price movements attributable to other factors.

Trading Patterns

A statistical comparison of alleged insider dealing with historical trading patterns by the same investor may support or undermine the theory that the investor transacted on the basis of inside information, rather than for other reasons. NERA economists are experienced in conducting detailed examinations of the trading records and strategies of investors alleged to have engaged in insider dealing. Such analyses may go beyond a simple assessment of the number of shares traded and incorporate factors such as the relationship of trading behaviour to price movements, other signals, or events other than the inside information.

Emerging Issues

As markets and the technology employed by investors evolve, allegations made in insider dealing cases have diversified from the classic paradigm of dealing in shares based on non-public information obtained by a company insider. In some cases, there is controversy surrounding whether the conduct in question should

indeed be described as insider dealing. NERA economists are thought leaders in this area and have applied their knowledge of diverse markets and instruments to the economic aspects of these emerging issues, including:

- Instances where, for an agreed price, data providers have released information to select market participants before the official release to the rest of the market. Such information is not official government data, nor does it relate to an issuer of publicly traded securities. Indeed, the information may be created or compiled by the entity releasing it. Nonetheless, the practice has attracted scrutiny from regulators concerned that it may give certain market participants an unfair advantage.
- High-frequency trading: In some jurisdictions, insider trading allegations have been made in connection with the ability of high-frequency traders to gain faster access than others to information relating to orders and trading. Here, the information at issue relates to other investors' behaviour rather than being, for example, fundamental information about the company issuing a security. Nonetheless, in the US, New York State Attorney General Eric Schneiderman has referred to high-speed trading as "insider trading 2.0", and the issue has attracted scrutiny from regulators elsewhere.
- Situations in which information known to an investor, but not to the general public, relates to the investor's own past or intended future actions. For example, an investor holding a substantial stake in a distressed company's debt, and sitting on that firm's creditors committee, may "over-insure" by buying CDS protection on a notional amount greater than the face value of the debt held. If so, it may be alleged that the investor has an economic incentive to trigger a credit event by not participating in a restructuring, in order to receive the CDS payout.

In such matters, NERA economists may combine experience gained in insider dealing matters with other experience in relevant markets and financial instruments. For example, we have analysed large, complex datasets of intraday prices and quotations, and evaluated the market microstructure issues relevant to high-frequency trading. NERA economists also have extensive experience analysing CDS and a range of other financial instruments. Moreover, many of our experts possess experience as market participants, which assists in evaluating allegations of non-traditional insider dealing.

Client Experience

NERA experts have provided advice, analysis, and expert testimony in a range of actions related to insider dealing. This has included:

- Estimation of losses avoided by alleged insider dealing in a civil action against a corporate insider and rebuttal of analysis by the regulator's experts.
- Advice to a national regulator on price-sensitivity of information in a case alleging the sharing of inside information with a hedge fund by an individual within a publicly traded company.
- Advice to a prosecutor relating to obstruction of justice and fraud allegations in connection with an insider dealing matter.
- Provided expert evidence at a criminal trial on materiality and profits gained by an alleged insider dealer using an event study methodology.
- Work with a major financial institution in implementing statistical tests to detect potential insider dealing by its employees.
- Analysis of alleged insider dealing in bonds by a hedge fund.
- Testimony on behalf of a regulator in a trial involving alleged insider dealing using CDS. The testimony covered the relationship between bond spreads and CDS spreads, and successfully supported the regulator's claim that CDS fell within its jurisdiction.

About NERA

NERA Economic Consulting (www.nera.com) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real-world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

Contact

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