Can Reputational Damage Restrict Illegal Insider Trading?

1. INTRODUCTION

Although it is a plausible hypothesis to assume that investors and companies care about the quality of the financial market in which they operate, the so-called law and finance literature, which was initiated by the seminal papers of La Porta a.o., only recently investigated the relationship between a country’s legal framework and its financial development. The law and finance literature offers strong empirical evidence on the importance of the legal environment (market integrity, investor protection) for the development of these markets and economic growth. La Porta a.o. clearly shows that a good legal environment expands the ability of companies to raise external finance through either debt or equity. The European Commission therefore stresses the importance of an adequate legal framework in order for companies to raise capital. Although the existence of legal rules is an important element for the development of financial markets, La Porta a.o. shows that the enforcement of these rules is of equal importance. The European Commission as well considers the enforcement of insider trading prohibition and market manipulation of crucial importance to ensure the integrity of European financial markets and to enhance investor confidence in those markets.

Although the prohibition of insider trading can be questioned on economic grounds,

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the question whether insider trading should be prohibited or not will not be adressed in this article. However, once the European legislator chooses to ban insider trading, the question of the optimal deterrence of insider trading regulation arises. While the enforcement of insider trading regulation is traditionally analyzed within an expected utility framework, this chapter elaborates this analysis by presenting an alternative measure for criminals’ risk attitudes that does not go through expected utility calculations. We will refer to this alternative framework as safety-first models.

The analysis is illustrated by the Belgian insider trading regulation. Insider trading has been prohibited in Belgium since 1989. Any infringement of the prohibition of insider trading in Belgium is punishable with imprisonment from three months to one year and a fine of EUR 250 to EUR 50,000. Additionally, the judge can impose a fine up to three times the direct or indirect profit derived or the loss avoided. Moreover, the criminal court can impose professional restrictions on management and board functions in companies.

The article is organized as follows. Section 2 gives an overview of the problems and shortcomings of the current enforcement strategy of insider trading regulation in Belgium. The next section analyzes how criminal behaviour can be modelled and offers an alternative framework compared to conventional expected utility framework. Using the safety first models, section 4 examines to what extent professional restrictions and reputational loss can restrict illegal insider trading in Belgium. Section 5 contains the conclusions and policy recommendations.

2. THE SHORTCOMINGS OF THE CURRENT ENFORCEMENT STRATEGY OF INSIDER TRADING REGULATIONS IN BELGIUM

Besides insider trading being difficult to detect, the criminal prosecution of illegal insider trading in Belgium is problematic. While the Market Authority of the Stock Exchange is responsible for the detection of possible insider trading cases, the judicial inquiry and the actual prosecution are carried out by the judicial authorities (courts,