The most valuable commodity on Wall Street: Information

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Wall Street – the movie

The 1987 movie Wall Street tells the story of Bud Fox (Charlie Sheen), a young and impatient stockbroker willing to do anything to get to the top. He gets involved with the corporate raider Gordon Gekko (Michael Douglas), who takes Fox under his wing, and teaches him about Wall Street and the stock market. One great memorable quote from the movie is when Gordon Gekko tells Fox that "the most valuable commodity I know of is information". Apparently, they are both willing to do anything to get to the top, including trading on illegal inside information. - So, what is the history of insider trading? This is set out below.

Ways to fraud the market….

There are many challenges with the stock market. One main issue is that investors are asked to part with their money, so that companies and brokers can manage the funds for them. This creates a principal – agent issue. The principle – agent problem arises when one party (the agent) agrees to work in favor/ on behalf of another party (principal) in return for some reward. However, if the interests between the agent and the principal are not fully aligned, or not sufficiently regulated, the principal risks that the agent may take advantage of the principal. And in some cases this may turn out to be fraud.

There are numerous ways the shareholders can be defrauded and get parted from their money. Trading on inside information undermines the confidence in the capital markets; what investors would like to put their hard-earned money in the stock markets if the chances of being cheated is a big risk? In addition, over the decades a number of other scams have come up to con the investors, like the following: *Boiler room operations* (a call center selling questionable shares to uninformed investors by telephone), *pump and dump* (which involves artificially inflating the price of an owned stock through false and misleading positive statements, in order to sell the cheaply purchased stock at a higher price); *Ponzi schemes* (where an individual or organization pays returns to its investors from new capital paid to the organization by new investors, rather than from profit earned through legitimate sources), *cooking the books* (the company falsifies its financial statements), *front running* (when a broker trading shares in his personal account based on advanced knowledge of pending orders from clients, allowing him to profit from the knowledge) and many more. Still, for many years trading on inside information was not illegal. Top management could make a gain by selling or buying with inside information, and this was considered as a "perk" for the management. In a landmark case in the US – Goodwin v. Agassiz – Supreme Judicial Court of Massachusetts in 1933 stated that while Mr. Agassiz "had certain knowledge, material to the value of the stock, which the plaintiff did not have," no wrongdoing was committed, the court found. Only in instances where an insider bought or sold shares in a private, face-to-face transaction might -- and the court stressed might -- he have to disclose material information. By buying Cliff Mining stock on the open market, Mr. Agassiz merely had exercised a perk of being an insider (Mr Agassiz had inside information that a mine which had been regarded as exhausted, still contained plenty of copper).

1933: Regulations of securities trading

Before the Wall Street Crash of 1929, there was little regulation of securities in the United States at the federal level. But scams like those described above flourished, and to maintain the confidence of the stock markets, regulations were brought to bear. One milestone was the US Securities Act passed by Congress in 1933, which required among other things that the company disclosed all relevant information to the market, prior to any share issue or listing. The following year, Congress passed the Securities Exchange Act 1934, to regulate the secondary market (general-public) trading of securities, i.e the stock exchanges and their listed companies. At this point insider trading was still not an issue, as the Goodwin v. Agassiz case above shows.

Interestingly enough, these US acts are still in place, but of course have been extensively amended over the years.

1961; the first insider trading case prosecuted in the US

Even though a large degree of regulation was in place for the listed companies after second world war, trading on inside information was not clamped down on before SEC prosecuted its first case in 1961. A company employee had tipped his broker that the firm would be cutting its dividend. Before the company had released this information, the broker sold the stock for his wife and clients. He was fined $3,000 by SEC and suspended for 20 days from the New York Stock Exchange. However, as the story goes, the case was good for business. Clients looking for a broker with an edge lined up to hire him for their trading.

Today trading on inside information is of course heavily fined in the US, and offenders may be locked up for years if they are caught.

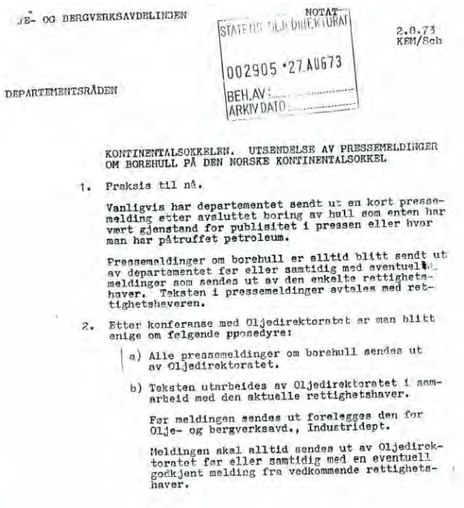
Securities regulation in Norway

Norway had no regulations against insider trading before the first real Norwegian Securities Trading Act was adopted in 1985. The background for this law was the deregulation the Norwegian capital markets in early 1980 ("jappetiden"). With growing capital markets opportunities for personal enrichment through economic crime rose dramatically. Finanstilsynet (previously named Kredittilsynet) began in the late 1980s to increase monitoring of securities trading in earnest, following several cases of possible insider trading. The Securities Trading Act has been replaced in later years, and the current Securities Trading Act of 2007 will probably be replaced with a new one next year.

The problem of prosecuting insider trading. And the CEO who did not read his mail

The first cases of insider trading that were prosecuted in Norway in the late 1980s and early 1990s did not succeed, often due to lack of evidence. It is very difficult to prove such cases, it is one person's word against another's. The following case from 1987 illustrates this point:

The CEO of Kvaerner Industrier was also a deputy board member of Saga Petroleum AS. He bought 6100 shares in the oil company in April 1987. Just a few days earlier he had received the agenda for an upcoming board meeting of Saga, where it emerged that the company would increase the quota of shares available for foreign investors. Which clearly was advantageous for the share price. A few months after the board meeting he sold the shares with a considerable profit. He later claimed that he had not read those board papers. Kredittilsynet made the case that he had bought shares in Saga on the basis of confidential company information, and investigation pursued. But the case was dismissed by the prosecutors because it could not be proved legally that he had read his mail.



OLJE- OG BERGVERKSAVDELINGEN

NOTAT

STATENS OLJEDIREKTORAT
002905 *27 AUG73
BEH.AV:
ARKIV DATO:

2.8.73
KEM/Sch

DEPARTEMENTSRÅDEN

KONTINENTALSOKKELEN. UTSENDELSE AV PRESSEMELDINGER OM BOREHULL PÅ DEN NORSKE KONTINENTALSOKKEL

1. Praksis til nå.

Vanligvis har departementet sendt ut en kort pressemelding etter avsluttet boring av hull som enten har vært gjenstand for publisitet i pressen eller hvor man har påtruffet petroleum.

Pressemeldinger om borehull er alltid blitt sendt ut av departementet før eller samtidig med eventuelle meldinger som sendes ut av den enkelte rettighetshaver. Teksten i pressemeldinger avtales med rettighetshaveren.

2. Etter konferanse med Oljedirektoratet er man blitt enige om følgende prosedyre:

a) Alle pressemeldinger om borehull sendes ut av Oljedirektoratet.

b) Teksten utarbeides av Oljedirektoratet i samarbeid med den aktuelle rettighetshaver.

For meldingen sendes ut forelegges den for Olje- og bergverksavd., Industridept.

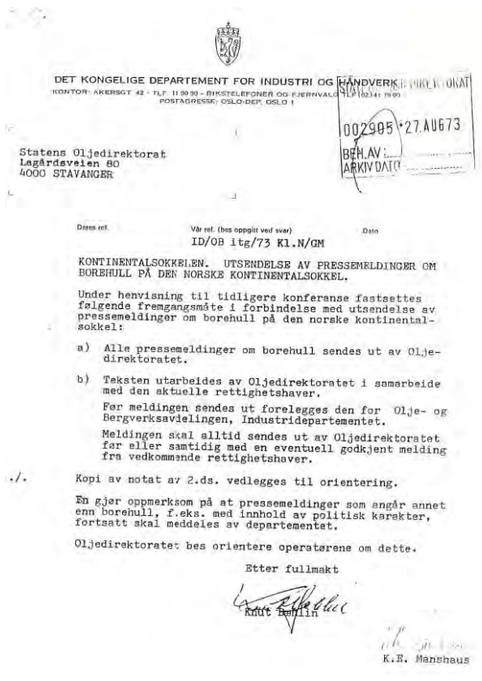
Meldingen skal alltid sendes ut av Oljedirektoratet før eller samtidig med en eventuell godkjent melding fra vedkommende rettighetshaver.

During the 1990s, only three inside cases were brought to court in Norway. The first verdict for insider trading came in 1995 and was for a long time the only one.

Oslo Børs, an exchange for insiders?

Oslo Stock Exchange was at this time criticized for being an insider's exchange, where insider trading threatened to undermine the confidence which is so crucial for the markets. Starting in 2000 Oslo Stock Exchange therefore introduced new monitoring systems of the trading. In addition Norwegian authorities struck down to a much greater degree on inside information. The reputation Oslo Stock Exchange had as a stock exchange for insiders therefore seems to be a thing of the past.

In this story about inside information also the Norwegian oil sector plays a part. Information about the results of exploration drilling is as we all know particularly sensitive information.



DET KONGELIGE DEPARTEMENT FOR INDUSTRI OG HÅNDVERK
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KONTINENTALSOKKELEN. UTSENDELSE AV PRESSEMELDINGER OM BOREHULL PÅ DEN NORSKE KONTINENTALSOKKEL.

Under henvisning til tidligere konferanse fastsettes følgende fremgangsmåte i forbindelse med utsendelse av pressemeldinger om borehull på den norske kontinentalsokkel:

a) Alle pressemeldinger om borehull sendes ut av Oljedirektoratet.

b) Teksten utarbeides av Oljedirektoratet i samarbeide med den aktuelle rettighetshaver.

Før meldingen sendes ut forelegges den for Olje- og Bergverksavdelingen, Industridepartementet.

Meldingen skal alltid sendes ut av Oljedirektoratet før eller samtidig med en eventuell godkjent melding fra vedkommende rettighetshaver.

Kopi av notat av 2.ds. vedlegges til orientering.

En gjør oppmerksom på at pressemeldinger som angår annet enn borehull, f.eks. med innhold av politisk karakter, fortsatt skal meddeles av departementet.

Oljedirektoratet bes orientere operatørene om dette.

Etter fullmakt

Knut Kjellin

K.E. Manshaus

Information handling of Norwegian exploration drilling – letter of 1973

After the rise of Norway as an oil producing country, for many decades Oljedirektoratet (NPD) was in charge of releasing results of exploration drilling.

The background for the policy was that a foreign oil company in 1973 had published a press release shortly after a significant discovery on the Norwegian sector, while the political leadership was not informed. The political authorities worried that such releases would set the terms for future developments and landing options if this was set out in the press release, and that way effectively overrule the political process. As we all know, regional development is a top priority for all Norwegian politicians. The political authorities wanted therefore to clear in advance all press releases oil companies were

making for exploration drilling.

2005; smaller oil companies get a license to drill

Fast forward to 2005; when also smaller oil companies were allowed to get exploration licenses on the Norwegian sector. This meant that a number of smaller E &P companies was listed on the Oslo Stock Exchange, in order to raise capital. When these companies got involved in exploration drilling, it became important to deal with this sensitive information in a timely way to investors and the Oslo Stock Exchange. The NPD practice from 1973 meant that up to several days could pass by before any inside information about drilling results was released to the market. This opened opportunities for employees of E&P or oil service companies to trade based on inside information (for instance the drilling crews could see what took place on the rigs).

In some cases, the share price of smaller oil companies conspicuously rose in the hours before a stock exchange release was made.

In 2009, Oslo Stock Exchange and NPD agreed to discontinue the practice of NPD controlling the releases from the E&P companies. (The oil company Revus played an important part of this work). Oil companies were then set on an equal footing with the other listed companies with regards to inside information, where the general rule has always been that inside information should be released as soon as possible.

Norsk Olje og Gass (NOROG) also followed up with recommended guidelines on how oil companies should handle inside information in connection with exploration drilling (no 139 - Anbefalte retningslinjer for håndtering av innsideinformasjon).

Impact on operators and oil service companies

An interesting point is also that several of the major oil companies in the NOROG panel that developed the 139 guidelines, initially believed that this guideline might not have any major consequences for them. Either because the result from one exploration well would have insignificant impact on an oil major/operator having a multitude of wells, or that the operator was not listed. While the result of an exploration well may be "make or break" for the much smaller E&P company. In working with the NOROG guidelines, however, the oil majors – listed or not – realized they could be held responsible if any of the company's/operators' employees leaked and/or traded based on inside information. This would also apply to any oil service company involved in exploration drilling.

Summed up

The listed companies' requirements that inside information as a main rule should be released immediately to the market, is crucial for the confidence of the investors. Releasing such information immediately, means that ideally there is no inside information available that Gordon Gekko and his likes could make use of. To the extent inside information is still present (due to certain specified exemptions from the main rule), it is of course illegal to act on this information and can lead to prosecution and fines.

Sources:

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Wikipedia

About the author:

Per is a State Authorized Public Accountant and joined PwC in May 2013. Prior to PwC Per worked as listing officer at Oslo Børs for several years, where he was in charge of a number of IPOs as well as the E & P companies' oil reserve reporting. He has also worked as Chief Accountant for Frontline and CFO for Northern Oil, an E&P company listed on Oslo Børs. He works as Director at PwC CMAAS and has over the years been involved in a variety of capital market transactions. He is responsible for several of PwC's internal and external publications as well as seminars covering the capital markets, including facilitating the SPE Oslo Section's full-day E & P seminar at PwC, together with Oslo Børs.