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Using rewards to catch white collar criminals

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This report outlines a new approach both to detecting and punishing the crimes of insider trading and collusion. The paper proposes that financial incentives be offered to individuals or firms participating in illegal activity in return for the provision of evidence against other participants. In order to ensure that attractive incentives can be offered, and large fines levied, it is also proposed that a revenue contingent payment mechanism be utilised to extract both incentive payments and fines from firms and individuals convicted of these offences. The use of a revenue contingent penalty payment increases the certainty of collecting penalties while reducing the incentive for recourse to bankruptcy.

Introduction

Collusion and insider trading, being white collar crimes, are often characterised as victimless crimes. However, contrary to what the name suggests, such victimless crimes impose large costs on individuals and the economy. They are only victimless to the extent that those harmed by crimes such as collusion and insider-trading are often unaware that they have been robbed. The absence of identifiable victims makes the detection of collusion and insider trading much more difficult. As the Australian Competition and Consumer Commission (ACCC) has stated:

> Collusion is extremely harmful to both businesses customers and consumers. The gains can be large and difficult to detect. The incentives for collusion are high in important areas of the modern economy (ACCC 2002, p.8).

Similarly, the US Securities and Exchange Commission (USSEC) has stated that:

> Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the Commission has treated the detection and prosecution of insider trading violations as one of its enforcement priorities (USSEC 2003).

The Dimensions of the Problem

Collusion and insider trading impose a wide range of costs on both society and the economy by delivering an inequitable distribution of gains and imposing a range of negative externalities such as reduced economic efficiency, reduced faith in the structure of markets and financial costs to governments.

For regulators a major problem associated with collusion and insider trading is the lack of information available to investigators. Without evidence from participants the tasks of detecting criminal activity and achieving successful prosecutions are made particularly difficult.

While it is difficult to determine accurately the extent of collusion and insider trading, some estimates are available. In recent years it has been argued that reductions in trade barriers and increased globalisation have resulted in increased collusive activity (ACCC 2002), with the OECD estimating that the value of commerce affected by collusive conduct in 16 large cartel cases that had been examined was greater than $55 billion (OECD 2002). Estimates of the impact of collusion on market prices range from ten per cent in the US (ACCC 2002, p. 23) to between 15 and 50 per cent (OECD 2002a, p. 9). The OECD has referred to collusive practices as the most 'egregious violations of competition law' (OECD 2002, p. 5).

While there have been relatively few prosecutions for insider trading in Australia some researchers have suggested that between five and ten per cent of all trades involve insider information (Richards 2000). Similarly, a study of Australian executives found that 52 per cent of respondents would be willing to buy shares before their own company made a favourable announcement (Richards 2000). It would therefore appear that the detection, and prosecution of insider trading lags well behind its prevalence.

What is Collusion?

Collusion is defined as an agreement 'between different firms to cooperate by raising prices, dividing markets, or otherwise restraining competition' (Samuelson and Nordhaus 1987, p. 900).

While examples of successful prosecutions for cartel activity can be found it is widely considered that most collusion is undetected. The OECD has stated that:

> The challenge in attacking hard-core cartels is to penetrate their cloak of secrecy. To encourage a member of a cartel to confess and implicate its co-conspirators with first hand, direct, 'insider' evidence about their clandestine meetings and communications, an enforcement agency may promise a smaller fine, shorter sentence, less restrictive order, or complete amnesty (OECD 2002b, p.7)

Detection of collusion is made more difficult because of the absence of an apparent victim. This is further complicated by the difficulty of proving, without access to insider information, that firms suspected of colluding are doing so. In 2001-02 the ACCC received 442 complaints of cartel and price fixing, of which 61 were investigated. On average, between three and five cases are taken to court each year (ACCC 2002, p. 24).

The Chairman of the ACCC, Graeme Samuels, has recently described cartels as the 'very worst form of violation of corporation law' and plans to use a leniency policy to encourage executives to 'squeal on their fellow offenders' (Dodd 2003). The potential for the provision of financial incentives to remove the 'cloak of secrecy' that surrounds collusive conduct is discussed in Section 7.

A Case Study in Collusion

In 1994 TNT Australia Pty. Ltd., Ansett Transport Industries (Operations) Proprietary Limited, and Mayne Nickless Ltd., as well as a number of individuals, admitted to contravening sections 45 and 45A[1] of the Trade Practices Act 1974. They were fined $4,100,000, $900,000 and $6,000,000 respectively.

In summarising the nature of the collusive conduct of the cartel, Justice Burchett described the components of the agreement as follows:

> 1. That the companies would not 'poach' each other's customers, by which the admissions of Mayne Nickless Limited specified, and I understand the other respondents to have meant, that if one was requested to quote by a customer of another, it would either fail to do so or would submit a quotation above the price charged by the other company, the existing supplier, a practice described as 'giving cover';
>
> 2. That if one received the custom of customers of another, compensation would be made by returning customers of the same value by the process of up-rating them or driving them away by the provision of poor service;
>
> 3. That there would be a balancing of accounts of customers lost and gained and payment of compensation;
>
> 4. That no quotes would be given to customers of another firm over the telephone; and
>
> 5. That uniform prices would be charged for what were referred to as 'air satchels' (Burchett J 1994).

While the then Chairman of the ACCC stated it was difficult to estimate the economic damage of the cartel (*The Age* 1995), the costs were estimated to be $100 million by a firm harmed by the cartel (*The Australian* 1996).

What is insider trading?

Insider trading is defined as 'profitable trading in securities by a person with material non-public information' (Freeman and Adams 1999, p. 2). Insider trading is illegal under section 1002G(2) of the Corporations Law.

As far back as 1974 the Rae Committee (Senate Select Committee on Securities and Exchange 1974) reported on large scale insider trading in Australia. Similarly, the Griffiths Committee confirmed the earlier concerns of the Rae Committee, concluding that '[a]s the overwhelming evidence indicates that insider trading does occur, attention should be focussed on how best to deal with the problem' (House of Representatives Standing Committee on Legal and Constitutional Affairs 1989, p. 16). A detailed discussion of these inquiries is provided in Tomasic (1991).

[1] Sections 45 and 45A of the trade Practices Act 1974 deal with proscribed agreements such as market sharing agreements which have the purpose or effect of substantially lessening competition and agreements that fix prices.

There is debate in the literature on the role of insider trading. On the one hand, it is seen as an abuse of information asymmetry which results in a theft from non-insiders (see for example Senate Select Committee on Securities and Exchange (1974) and House of Representatives Standing Committee on Legal and Constitutional Affairs (1989)). On the other hand, some authors argue that insider trading facilitates the flow of information within the market and therefore increases efficiency (see Manne (1996) and Jensen and Meckling (1976)).

In order both to increase the efficiency of the market and reduce insider trading listed companies are obliged to notify the stock exchange once they become aware of any information with the potential to have a material effect on the company's share price (Corporations Law section 1001A and ASX listing rule 3.1). These 'continuous disclosure' provisions require firms to make insider information public and serve to increase the efficiency of the market without individuals inside the firm profiting in the process.

The Australian regulator responsible for controlling insider trading is the Australian Securities and Investments Commission (ASIC). Despite the apparent widespread acceptance of the view that insider trading is common (see for example Brown 2003), and the recent publication of a discussion paper designed to increase awareness of the law in relation to insider trading (ASIC 1999), there have been few prosecutions for such behaviour. While the case of Rene Rivkin attracted substantial media attention (ASIC 2001a), only a small number of other cases have been pursued (see for example ASIC 2001b, 2002, ASIC 2003). Between 1990 and 2000 there were six prosecutions for insider trading (Richards 2000).

Insider trading is an information crime. It relates to the transfer and/or use of information in order to create a private profit for the individuals involved. As with collusion, there is often no identifiable victim. While regulatory authorities may attempt to identify unusual trading activity in order to prevent insider trading, such detection is both expensive and inaccurate. Statistical evidence of unusual behaviour may be sufficient to begin an investigation, but achieving convictions is difficult without testimony from a witness.

In order to successfully prosecute those engaged in insider trading and in turn deter potential criminal conduct, regulators need increased additional information. The following sections discuss mechanisms to encourage individuals with information about insider trading to come forward.

The Reform Proposal in Brief

The essential idea proposed in this report is to replace current corporate offence penalties with an improved fine mechanism involving the future capacity to pay of a company or individual. The instrument can be designed so as to increase the likelihood of offences being reported and verified. It would work as follows with respect to collusion.

Under the scheme a company found guilty of collusion will be fined as is currently the case, but with the penalty to be paid as a percentage of future profits, collected through the tax system. The arrangement might be known as the Repayment of Gains

Unlawfully Earned (ROGUE) scheme. The level of the fine would reflect the severity of the offence and the size of the reward.

The payment parameters would be designed to address a basic trade-off: the percentage of profits collected would be low enough to limit moral hazard associated with avoidance, but high enough to ensure that payment occurs promptly. Section 8 clarifies these issues through the presentation of a detailed example of collusion.

An insider trading variant of the arrangement would differ since, as explained above, this offence typically involves individuals rather than corporations. Accordingly, with ROGUE an insider trading offence would involve the imposition of fines to be repaid depending on individual incomes, again through the Australian Tax Office. A detailed example is offered in Section 9.

An important aspect of ROGUE involves a financial mechanism designed to encourage whistle blowing. That is, the government would set up a fund allowing financial rewards to be paid to informants for the supply of information leading to collusion or insider trading convictions. The reward, set at a minimum of $10,000 or ten per cent of the fine, whichever was greater, would be delivered to the informant at the time of sentencing. While the government would need to provide the initial financial resources, eventually the fund would be self-financing, paid for through the contributions of offenders.

There are several clear advantages of such a system compared to current arrangements. First, if fines are to be paid contingent on future economic circumstances, they can be set without concern for the possibility that penalties would lead to corporate or individual bankruptcy; thus fines can be levied to reflect the true social costs of these types of illegal activity. This aspect of the default-protection advantages of income related loans is explained fully in the following section.

Second, and closely related to the above, if fines are collected in a default-protected way, the probability that the courts will receive payments in full is increased compared to the current situation in which some offenders are able to avoid payments through bankruptcy or evasion. However, there is still a potential for a poorly designed ROGUE system to encourage avoidance of payment through other means, and this is considered further below.

Third, ROGUE actively encourages the supply of information, and in more positive ways than is feasible under current alternatives. While leniency policies rely on the principle of incentive, the incentive being offered is not very attractive, especially if conspirators are of the opinion that the probability of being caught is low. Furthermore, leniency policies do not provide an incentive for people who have knowledge of criminal conduct, but who are not directly involved, to come forward. The most important advantage of the system to the informant is that there would be a guarantee of financial reward independent of the circumstances of the offending individuals or corporations. This aspect of the policy provides those with the requisite information a much greater incentive to disclose hidden crime.

ROGUE would use insider information against insider traders and those engaged in collusive conduct. The provision of substantial rewards introduces an important new dynamic into the decision making process of those engaged in stable cartels and

insider trading networks. The provision of a reward to an individual who provides evidence against his/her conspirators serves to disconnect the relationship between the optimal decision for the group (maintain silence) and the optimal decision for an individual (be the first to provide evidence).

The Collection Mechanism: Income Related Loans

- The suggested reform scheme requires the collection through the tax system of income related debts. This is a recent public sector financial innovation now applied in two Australian policy arrangements, the payment of non-custodial child support and, with respect to university charges, the Higher Education Contribution Scheme (HECS).

To asses the viability of ROGUE it is important to understand schemes of this type, and their background and rationale are now considered.

Income related financial instruments are operated using the tax-welfare system. In certain circumstances an individual is able, or required, to incur a debt, such as with respect to the payment of a university charge. The debt is recorded with the taxation authorities and is repaid in the future, with the extent and structure of repayments depending on the level of the individual's income. Because interest rates are subsidised, debtors with low future income pay back less to discharge a given debt, in present value terms, than do those with high future incomes. In addition, the total amount to be repaid may be varied according to the individual's income.

The essential benefit of income-related financial schemes derives from the fact that, so long as they are designed properly, they offer a form of insurance against the risks associated with agents not being able to finance payment obligations. That is, implicit in an income-related payment system there is default-protection. With respect to ROGUE this aspect of the scheme increases the probability of full payment of a fine for collusion or insider trading.

The two applied Australian examples of income related instruments are HECS and the Child Support Scheme (CSS). In 1989 the Australian government introduced HECS as an alternative to proposals for the reintroduction of university fees, then under consideration as a response to the rising costs of financing higher education (Chapman 1997; Edwards 2001). The scheme requires all Australian undergraduates to pay a charge for each course undertaken.

A second instance of income-related payment obligations, more relevant in some ways to the prospects for income-related repayment of fines, is the child support scheme operated in Australia by the Child Support Agency of the Department of Family and Community Services. The scheme began in 1988 and facilitates the collection of child maintenance payments from non-custodial parents.

The CSS scheme differs from HECS in that there is no fixed obligation to be discharged. Rather the non-custodial parent's obligation is to make a contribution to the support of children aged under 18, this is determined on the basis of an assessment of both parents' means.

The HECS scheme costs very little to administer and collect. It was estimated in the early 1990s that the cost of HECS to the Australian Tax Office was around $20 million per year, or less than four per cent of annual receipts (Chapman, 1997).

The CSS collects a larger proportion of income from a more diverse range of payers, of whom there are currently around 700,000. The median taxable income of CSS payers was $28,038 in 2000-01, whereas the average starting salary for graduates was about $35,000. Moreover, graduates typically experience rising incomes over the period during which they repay their HECS liability, so that the difference between the two groups is greater than this comparison indicates.

The amount of child support collected for a single child is 18 per cent of adjusted income[2], up to a maximum of about $18,000 each year. Payments increase with the number of children, up to a maximum of 36 per cent of adjusted income, calculated to provide an implicit living allowance for the payer. Maintenance payments may be collected from pension and benefit payments at a maximum of $10 per fortnight. A similar maximum applies to payers with a taxable income below approximately $15,000.

Not surprisingly, these characteristics are reflected in higher collection costs and default rates for CSS. Estimates of default rates vary widely and are the subject of politically charged debate.

ROGUE could be applied in much the same way as is HECS and the CSS. These schemes all have in common the arguably distinct advantage of default-protection with respect to the payment of debt.

The Use of Detection Incentives

As discussed above, access to information is the primary barrier both to the detection and successful prosecution of white-collar crimes such as collusion and insider trading. The provision of financial incentives to those supplying evidence is likely to increase the number of people coming forward for several reasons:

- Given that financial gain is likely to be a major motivation of those engaging in collusion or insider trading, the provision of generous financial rewards (relative to the profits being made from illegal conduct) is likely to be an effective incentive to come forward.

- Individuals already engaged in illegal conduct are less likely to trust each other when the opportunity exists for one party to profit from reporting the actions of fellow conspirators. Despite individual conspirators possessing a preference to maintain the status quo, those involved in illegal conduct must estimate the probability that their co-conspirators will be the first to profit from revealing information to regulators.

- The existence of a financial incentive for reporting corporate crime significantly alters the profit maximising decision making process for an individual approached for the first time to participate in new illegal conduct. In addition to increasing the risk of detection, a financial

[2] Definition of adjusted income (Reference)

incentive to report illegal conduct provides an individual who has been approached to participate in a crime with a certain way to profit without risk of prosecution.

- The reward scheme can still operate in tandem with any leniency program offered by regulators, resulting in an improved likelihood that those who are motivated by the desire to avoid criminal sanction will come forward.

Existing incentive schemes

Incentives are already used in corporate regulation. The ROGUE scheme would extend and improve on existing practice. An important precondition for the success of an incentives based system is the perception of certainty of the reward payment by the informant. The ROGUE scheme, backed up with initial establishment funding provided by the Commonwealth Government, would increase such certainty.

The ACCC currently has in place a policy of leniency whereby firms that pass on information concerning collusive conduct may expect some leniency in terms of either prosecution or sentencing. ACCC states:

> The ACCC is of the view that a leniency policy that provides clear and certain incentives to potential applicants is a valuable tool in fighting illegal cartel conduct. When the extent of the leniency to be provided is certain, persons are more likely to take advantage of such policy and disclose potentially illegal and harmful conduct (ACCC 2002b, p. 2).

In describing the likely effectiveness of leniency programs, the Chairman of the ACCC recently stated that:

> Invariably in a hard-core cartel there will be a weak link. There will be someone that's nervous. There might be someone that isn't actually benefiting out of the cartel in the way they expected to. But more importantly, they'll be nervous about the implications of the cartel being found out… (Samuel cited in Dodd, 2003, p. 19)

In addition to the Australian scheme, leniency programs also operate in the US, UK, Canada and the EU and are discussed in OECD (2002b). The rationale behind such programs is that the potential to avoid sanction is, in itself, an incentive to provide information. However, while leniency programs have some capacity to act as incentive, it is possible to increase the benefits of providing information on corporate crime by offering rewards.

The existence of rewards is common both in Australia and internationally when law enforcement agencies are seeking information to assist inquiries into a specific crime. In the US rewards are paid to individuals who provide assistance in the detection and prosecution of white collar crime under the Qui Tam provisions of the False Claim Act (FCA) (see Bucy 2002), internal revenue laws (IRS 1983) and the Securities Exchange Act (USSSEC 2003).

Rewards are likely to be more effective than leniency for two reasons. Firstly, the incentive is larger, and second, the probability of a co-conspirator becoming an

informant is greater. As Pamela Bucy states 'Money, lots of it, is necessary to attract knowledgeable insiders with helpful information of complex wrongdoing' (Bucy 2002b, p261). The role of incentives in regulation is discussed in Grabosky (1995). He states that 'Incentives may be necessary to enlist the assistance of the general public when regulator powers and compliance capacities are inadequate to attain regulatory objectives' (Grabosky 1995, p. 263).

Given the difficulties faced in detecting and prosecuting white-collar crime discussed above, it would appear that incentives are well suited to aid in the achievement of regulatory objectives.

Grabosky (1995) also cites a range of potential problems associated with reliance on incentives including the capacity for material rewards to erode the effectiveness of moral rewards, the belief that citizens should not be rewarded for the normal responsibilities of citizenship, and the cost of providing rewards. While such concerns must be carefully considered in the development of any reward system, it is important to note that it is the existing failure of the business and finance community to live up to their responsibilities to report corporate crime that underpins the case for the provision of incentives.

An Example of Reform: Insider Trading

The suggested reform entails the imposition of fines on insider traders to be paid depending on the offender's future income. This raises the issue of what would constitute appropriate repayment parameters. As discussed above, the two obvious examples of current practice are HECS and the CSS.

The choice of repayment parameters entails a basic trade-off between two matters. On the one hand the repayment of a fine needs to be relatively quick since a short period of payment, for any given level of fine, constitutes a relatively high per period penalty, and this might be considered appropriate for a major white collar criminal offence.

On the other hand, a major benefit of an income related payment is that such arrangements diminish the burdens associated with debt remission as well as offering a form of default-protection insurance. However, the more severe the payment parameters, the lower the prospects of the delivery of these benefits.

It is possible to illustrate the timing and per period payment obligations of ROGUE with respect to both HECS and the CSS. The following assumptions are used.

(i) The offender earns a constant annual taxable income of $20,000, $40,000, $60,000 or $200,000.

(ii) If fine payment is made on the basis of HECS, the parameters used in 2001/02 are adopted (see DETYA, 2001).

(iii) If fine payment is made on the basis of CSS, the 2001 formula is used (see CSA (2001).

(iv) If fine payment is made on the basis of CSS, the annual obligation is equal to the obligation of a non-custodial parent of one child only, with the custodial parent receiving social security payments of a sole parent.

Tables 1 and 2 show respectively the annual payments and the time taken under these two regimes for a fine of $50,000. The rate of interest on the debt is assumed to be zero in real terms (that is, as with HECS, adjusted only for price inflation).

Table 1

$50,000 Fine Repayments Under HECS and the CSS: Annual Payments

Annual Income ($)	20,000	40,000	60,000	200,000
HECS	0	2,200	3,300	11,000
CSS	1,571	5,171	13,157	33,971

Table 2

$50,000 Fine Repayments Under HECS and the CSS: Years Taken

Annual Income ($)	20,000	40,000	60,000	200,000
HECS	Unpaid	22.7	15.2	4.5
CSS	31.8	9.7	3.8	1.5

The data from Tables 1 and 2 suggest the following. First, for very low incomes (under about $25,000), applying the HECS repayment parameters would mean that offenders would pay nothing and thus all of the debt would remain unpaid. Second, even at incomes close to the average of individuals working for pay, HECS parameters suggest very long periods of debt payment, for example about 23 and 15 years for incomes of $40,000 and $60,000 respectively. In other words, HECS seems to be far too generous a way in which to pay penalties for insider trading.

The CSS results seem much more appropriate. Even at the very low income of $20,000, some obligation ($1571 per year) is still required. Second, the CSS rules suggest relatively short, or at least manageable, periods of fine payment from less than ten years for incomes around $40,000 per annum, to just 1.5 years for those on very high incomes of $200,000 per annum.

It would seem then that applying the CSS repayment rules would come fairly close to satisfying the needs to have fines paid quickly without imposing undue duress on offenders. This is the same conclusion reached by Chapman *et al*. (2003) with respect to imposing income related fines on low level criminal behaviour. After all, the CSS arrangements are designed to enforce substantial payments while taking account of the financial needs of the payer. In summary, the payment of fines for criminal behaviour ought to constitute at least as arduous an experience as that associated with the financial support of a child.

Conclusion

In order to detect cartels and insider trading it is important to provide an incentive to individuals to supply information to the regulators. While most countries offer some form of leniency programs to individuals who volunteer information (see OECD 2002a), immunity from prosecution is far less attractive than immunity and large financial rewards.

Rewards are likely to increase the probability of detection as they would work on a number of different elements of the decision making process simultaneously. At present, if an individual is approached to enter a cartel or insider trading arrangement they are likely to compare the risk-weighted benefits of participation with the *status quo*. Given the potential for illegality to increase profits and income, combined with the low risk of detection, it is likely that the profit maximising strategy is to participate.

However, if financial rewards are available to those who provide information to regulators then not only does the financial benefit of non-participation in the cartel increase, the assessed risk of detection is also likely to increase. Put simply, if the incentives offered are large relative to the potential profit from collusion, the profit maximising strategy would shift from entering a cartel to reporting its existence.

By relying on income contingent payment mechanisms, the potential for large penalties to bankrupt firms, and therefore further disrupt the distribution of resources, is minimised. Similarly, individuals would not be able to escape their sanctions by declaring bankruptcy, a situation serving both to increase equity and the certainty of incentive payments being paid.

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