

THE INSIDER INFORMATION AND SECURITY OF THE STOCK MARKET: THE EUROPEAN EXPERIENCE

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Abstract

One of the main principles of the financial market is its information transparency, that is a maximum awareness of market participants about the occurring processes. Insider deals perform the information function on the stock market and are essential elements of the investment decisions mechanism. They contain specifics of circumstances unknown to the broad range of investors, thus enabling them to take decisions which, adequate to the current market situation. The comparative analysis of Anglo-Saxon and continental (European) model of financial markets proved the existence of a high degree of insider trading, exactly in continental model. The high role of banks, as shareholders of industrial companies, and direct or indirect impact on them are determined. At the same time German economy as a classic representative of the insider model demonstrated the greatest resistance to the crisis. The analysis proves that insider information usage in the European market model does not justify the actions of insiders as speculators or for profit. The strong interest of banks, as shareholders, led to timely decisions on debt restructuring, risky investments return and a considerable stabilization of the financial system.

Key words: financial model, insider information, security, stock market.

Introduction

Information always played a leading role in taking investment decisions and was a dominant factor in the asset prices formation in the securities markets. Traditionally, one of the main principles of the financial market is its information transparency and maximum awareness of market participants about the occurring processes. These conditions are required for taking rational and balanced decisions concerning investments and financial conditions that are equal for both investors and issuers. Since the foundation

of the first financial market, its participants used the so-called insider information for obtaining additional profit or avoiding losses. Some scientists even believe that the mass insider trading was one of the main causes of the Great Depression in the United States in 1929. Majority of the researchers perceive insider trading as a very negative thing that destabilizes securities markets. It was determined that the country financial market model selection has a significant impact on the level of availability and use of insider information.

So it would be logical to assume the presence of a higher level of risk in the European countries financial market, because of massive use of insider information. It is believed that price manipulation by using insider information as well as false information in the short period lead to market distortions and inadequate formation of market prices on assets.

At the same time one can observe the situation when Germany appeared to be one of those countries that survived during the global financial crisis attack in 2007 with the minimum losses. Germany is a bright representative of insider continental (European) model, i.e. a significant portion of corporations capital belongs to stakeholders associated with them, that is often subject to harsh criticism. It is necessary to analyze the relationship of the capital market insider model, the degree of its impact on the financial security level in the country and the ability to withstand financial crises.

1. Definition and functioning principles of financial market insider model

Continental European model emerged only in the nineteenth century, government regulation has played an active role, but a banking system had a simpler structure and participated actively in the financing industry. It was a centralized, well-organized and structured model of the market and its emergence was usually associated with France and Germany. Its formation was influenced by the Commercial Code in 1807 («Code de Commerce»), that granted a monopoly on securities transactions to stockbrokers. It was suggested that in the era of Napoleon's conquests this model of centralized market was rapidly spread throughout continental Europe (Spieser, Belze, 2005: 315-317, 478-488).

Historically one of the main factors of the formation of the financial market model is a traditional, extremely cautious attitude, and sometimes even prejudice against joint stock companies – there were demands even to prohibit by law the existence of joint-stock banks (Yasnopolsky, 1914: 146). Monopolies mobility at the end of the 19th century, constant struggle for prospective cartels members have been the main reasons why the German

entrepreneurs are extremely cautious about issuing shares. Tax policy in the studied model made the most profitable investments not in securities but directly into production. This led to the fact that the state involvement in the share capital and the reproduction process is very high, but does not transform the state into a major owner.

Continental model of financial market is characterized by banks domination in the economy, as financing system is based mainly on the banks, insider system corporate management and more conservative corporate strategy. The basic principles of such model functioning include:

- low equity share;
- high share of financing through the bonds issuance;
- the lowest share of investment funds;
- a tradition of direct lending to cover the deficit, along with the issue of government securities;
- high share of direct bank loan in the national economy financing;
- high share of banks' participation in the industrial enterprises statutory funds, various forms of banks and enterprises associations;
- universal banks play the major role on the financial market.

The lack of regular information on the situation in corporations complicates decision-making on the transaction on the continental Europe stock markets which contribute to business. Large investors, who control all big corporations, are dominating these markets. Typically, such investors are banks. Additional relationships with similar industrial companies are established as well as financial-industrial groups are also formed through the banks. Thus, banks in the continental Europe are free to hold shares of non-financial corporations (banks in this region are not divided into commercial and investment), that allows them to collect information about their customers in a much more full volume than ordinary shareholders (Matrosov, 2002: 256).

According to the insider model of corporate governance, ownership structure has a high degree of concentration, it means that shareholders are a limited number of owners. These shareholders are called insiders. Insiders are:

- Holders of equity that do not work in the company, but hold the company shares in an amount that gives them the right to convene unilaterally a special meeting of shareholders;
- Employees, that are the company shareholders, regardless of their share in the authorized capital.

In addition to these groups, we may, but in a lesser extent, include to insiders: labor unions, the state, municipalities. But, considering the relationship of insider financial market model and the classical use of insider information it is necessary to define a number of non-typical for the Anglo-Saxon model features.

2. Insider information and stock market safety: theoretical approaches

Information symmetry (equal volumes of information flows) is a significant factor in pricing. The impact of information flows on pricing occurs both during decision making on securities purchasing, and in carrying out the decision. Developed financial markets are characterized by a high level of information symmetry, as for the emerging and developing markets, their level of information symmetry is not just low – there is the information asymmetry. The prices are not fully adequate, it creates the tensions on the market, instability and crisis (Moshenskiy, 2010: 239).

The value of any information used on the stock market, mainly due to its individual perception by decision maker, is not objective. Insider information structure provides several benefits to market participants, that include: reuse of information; temporary advantage; effect of confusion. With the information technology development there is a number of problems related to information security. Most publications tend to believe that today the worst threat to information security is namely insiders (Zhyvko, Voytovych, 2013).

In accordance to Methodological Recommendations of the economic security level, assessing among financial security components of the state, an important place belongs to the stock market security that provides optimization of its capitalization as well as allows to provide a stable financial position of issuers, owners, buyers, trade organizers, traders, collective investment institutions, intermediaries, consultants, registrars, depositories, custodians and others. Unstable financial condition of any entity of the stock market or the group is an indicator of poor security level of the stock market and, consequently, the financial security as a whole. It is believed that insiders violate principles of fairness by their actions, that should be a base of free market economy.

According to some authors, the factors affecting the economic security of the Joint Stock Company at issue and placement of shares should be defined not as a potential danger, i.e. risk, as well as potential damage possibility to the issuers, i.e. threat, because a joint stock company that has decided to issue shares through public offering is influenced by a variety of threats immediately (Mihus, 2013). In connection with this under the term “threats to the Joint Stock Company economic security” at issue and placement of shares, we must understand potential possibility of harm to the issuer economic activities in the process of issue, distribution and turnover of shares.

Manipulation with insider information usage can occur in a variety of ways: insiders taking actions that influence stock prices; false information release; accounting and earnings manipulation; speculations; stock bubbles;

driving up and down securities prices etc. As an independent economic phenomenon, the stock market integrates all sectors of society as members of stock transactions. Due to attracted investments it stimulates socio-economic development, promotes economic independence of investment entities, provides free competition as well as affects the social structure and condition of the society. However, there is a great uncertainty not only in the evaluation of the actual dimensions of fictitious capital and the closed type of many stock transactions, but also in high speed virtualization of capital market instruments.

When we speak about continental model of a stock market we imply primarily the presence of ability to use insider information of issuers for making decisions faster than other market participants do. Investors, who possess insider information, are able to avoid losses or affect the issuer's decision at least.

Insider deals perform the information function on the stock market and are essential elements in the investment decisions mechanism. They contain specifics of circumstances unknown to the broad range of investors, thus enable them to make decisions, adequate to current market situation. Traditionally it is considered that banks have the ability to use inside information and to receive a distinct advantage in the stocks manipulation, that is reflected in the imperfection and lower liquidity of the European stock market compared with the U.S. Thus, there should be a security threat of the stock market, its imbalance and preconditions for instability.

However, in theory, the use of insider information on the real condition of the issuer should equalize information asymmetries and lead to the formation of a fair price for the shares as a result. Most models also show that the price of a firm's stock will be more responsive to random changes in order flow on stock exchanges if insider trading is permitted because people will infer that such changes are most likely due to insiders' activity based on their superior information (Hu, Noe, 1997).

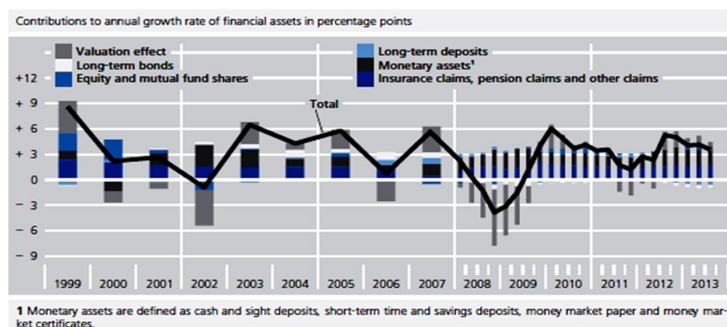
3. Practical aspects of the financial market continental model construction and the effects of the insider information usage

Germany has the so called insider model of corporate control, characterized by, on the one hand, the strict control of the owners over company managers, including the fact that the owners often hold key positions in the organization, and, on the other hand, the priority of the interests of major shareholders. Insider model allows a more efficient implementation of the company's long-term policy irrespectively to the interests of minority

shareholders and “spraying” funds for dividends. Under the risk of negative developments for any company, the owners with a small stake have no incentive to save it. It is easier and more profitable for such owners to sell stake in troubled companies and to acquire shares of perspective ones, because, they can’t influence the situation in the troubled company due to the small number of votes at the meeting. In Germany, where the concentration of share capital is much higher, the owners do not have incentives to sell their shares at the deteriorating situation, because they have enough votes to make strategic decisions in the company and it is more profitable for them to make these decisions, rather than avoid them. Extremely big banks’ role for controls on effectiveness and the restructuring of companies is motivated by efficiency and competitiveness.

In general, 67% of shares that are in domestic financial institutions, are accounted by banks. Non-bank financial institutions are not focused on the investment function (number of shares in their assets is around 5%). The principle of shares ownership in German banks – the formation of a concentrated portfolio (usually in blocks of 25% of the company’s capital plus one share, because under German law this percentage gives the right to veto the vote). Banks are the main trade participants. Registration of securities on the stock exchange is permitted only after the joint request of the company and the current Exchange Bank. Individuals may enter into an agreement only with the involvement of bank intermediation. In Germany there is also a system of cross-shareholdings, that increases the impact of banks on the industry because it gives them the opportunity to hold large blocks of shares in a small group of key companies.

Figure 1. Financial assets and portfolio behavior of households in Germany in 1999-2013



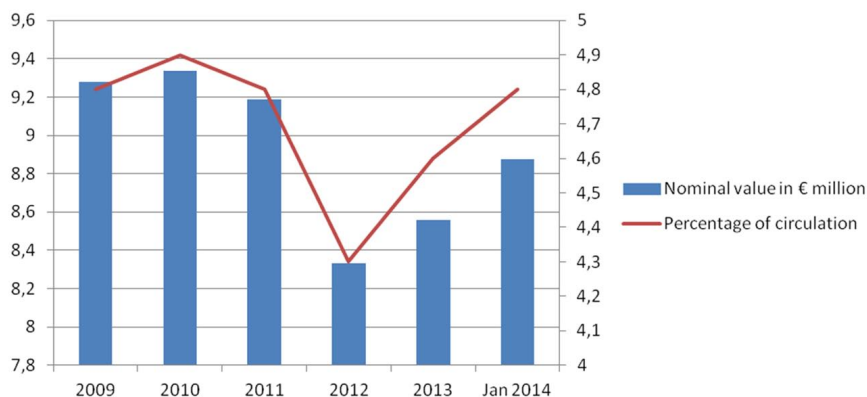
Source: Deutsche Bundesbank.

mation. German banks also act as depositary and play a significant role in proxy voting. Actually banks have the right to vote all the shares deposited in the bank. Previously, such right was used automatically without any restrictions, and now the bank must update the authorization every 15 months and receive voting instructions.

In Germany in the early 1990s, bank managers had an average of 61% of the vote (most of them – by proxy) in 24 largest companies, and in 11 companies their part exceeded 75%. At the general shareholders meetings of three largest German banks the transferred by proxy (mostly to bank managers) were over 80%. Deutsche Bank had the right to vote at 47% of its own shares, Drezdner Bank – 59% (Levine, 2005). Despite low percentage in the structure of direct investors in the national shares (10%), bank management in Germany receives from shareholders the right to control not only the banks, but also the majority of German companies. The anonymous management explains the appearance of a very significant category of shares – Unclassifiable residual deposit holdings, that includes securities in personal custody and paper held abroad. It is logical to assume that this category is mainly under the control of the major German banks.

Based on the Deutsche Bundesbank data, confidence of households to invest in stocks is slowly returning, but traditionally they do not participate in management of corporate property.

Figure 2. Bank-owned shares holdings structure in 2009-Jan 2014



Source: Deutsche Bundesbank.

According to statistics, the non-financial companies are the largest group of owners, and their share has been steadily decreasing: since 2

Figure 3. Share ownership, by group of shareholders in 1984-Jan 2014

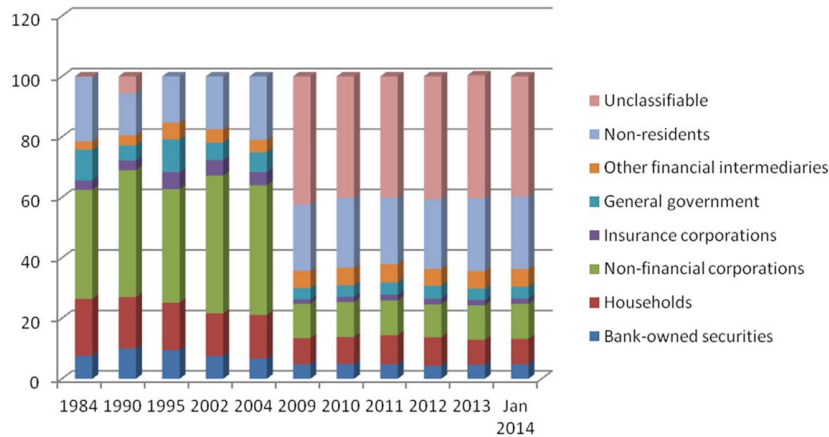
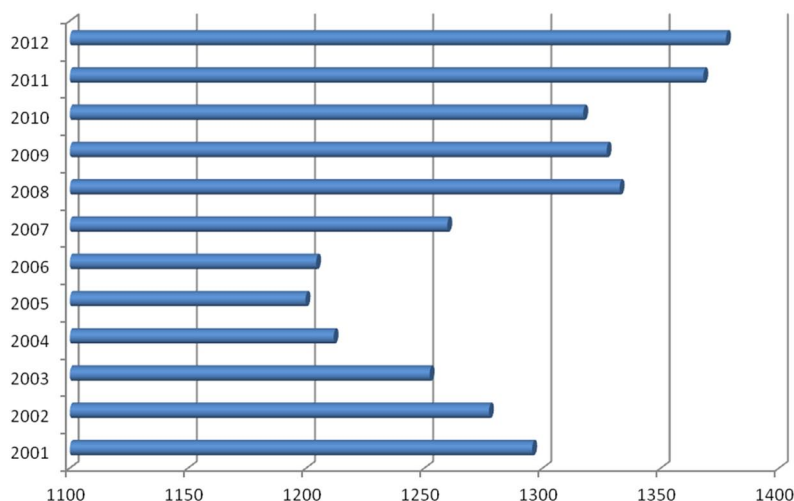


Figure 4. Bank loans to enterprises and self-employed in 2001- 2012, billions €

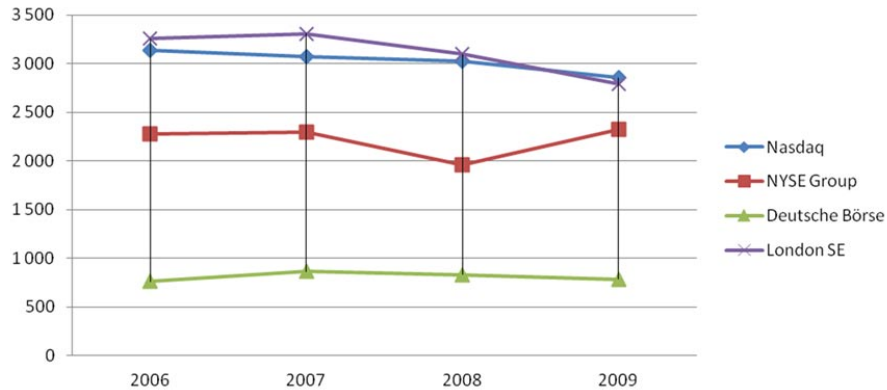


Source: Bundesverband deutscher Banken e. V.

Widespread practice of banks right to participate in corporate governance is one of the explanations of this situation. As a result, there is a merging of banking and industrial capital and formation of an oligarchic structure. As a result, shareholders are dominated by large banks that in addition to the interests of the owners have other interests in the corporations. For example, on the one hand, the bank as a creditor in the implementation of credit operations must cover operating costs and interests on attracted deposits. Thus, they will seek to get as much interest on loans provided, including corporations owned by them.

At the same time, interest rates on loans reduce the size of the net profit remaining at the disposal of shareholders and, as a consequence, the goal of the bank does not meet the interests of the owners of the corporation. On the other hand, acting as a major shareholder of the company, the bank is interested in getting a large company profits and respecting interests of the owner. We can see conflict of bank interests as a shareholder and as a creditor. This often leads to the issuance of bad loans, that, in turn, does not meet the requirements of banks shareholders. However, this practice in crisis conditions helps to stabilize the enterprises activity and help them to regain pre-crisis levels.

Figure 5. Number of listed companies in 2006- 2009



Source: World Federation of Stock Exchanges.

And finally we will try to compare stock markets stability of Germany, UK and the U.S., because resistance determines safety. Such basic indicators like market capitalization, trading volume, number of deals are typically used for comparison. But in our case, all these figures are not enough to be comparable because the main difference between the two models is precisely the role of the stock market and the extent of its influence. Therefore, for comparison we'll use such indicator as a number of securities listed at the stock exchanges in 2007-2009, that characterizes the presence of stable and high-quality issuers at the stock market. Because in 2006

It is proved theoretically that unless other informed agents are crowded out of the speculative financial market, insider trading renders prices more informative, potentially increasing the efficiency of investment and capital budgeting decisions. Wide possibilities of insider information usage and mutual intertwining of banking and industrial capital lead to a more sustainable model of the stock market. Such market participants are more focused not on immediate benefits, but on the strategic, long-term objectives. The characterized by the Anglo-Saxon model of financial market global financial crisis that began in 2007 in the United States, got spread to the majority countries with the developed and emerging economies.

The German economy, as a classic representative of the continental model, showed the greatest resistance to the crisis. Due to the significant participation of the government (as a regulator and shareholder), the banking system (as a financial institution and a shareholder) and access to restricted information, the volume of lending to manufacturing companies was not reduced, but increased. The strong interest of banks, as companies shareholders, led to timely decisions on debt restructuring, the risky investments return and a considerable stabilization of the financial system. The indicator of writing off bad debt remained at a satisfactory level. Thus, it can be argued that the use of corporate insider information in the stock market continental model, from strategic investor position, strengthens the economic security and increases efficiency of corporate governance.

The result of comparative analysis of the stock market dynamics for the period 2007-2013 years in the countries with Anglo-Saxon and continental model showed the relatively more stable financial market conditions in countries with banking model. Banks usage of insider information about the state of manufacturing companies significantly reduced the proportion of risky decision-making. The analysis shows that the insider information use in the European market model does not justify the actions of insiders as speculators or for profit. However, the greater stability and endurance of the European market insider models are indicated the evidences of the global financial crisis of the 21st century.

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