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Is it ‘essential’ to imprison insider dealers to enforce insider dealing laws?

by Jacob Öbergⁱ

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A Introduction

Pre-crisis financial regulation in the European Union has arguably failed, leading to calls for reform and for an expansion of the criminal law dimension. Because of the reforms of the Lisbon Treaty which provided the Union with an explicit competence to define criminal offences and impose criminal sanctions, the Commission has engaged in a new centralized process of financial regulatory enforcement and sanctioning by adding the criminal law dimension.¹ Financial regulatory enforcement based on effective, proportionate and dissuasive sanctions is regarded as one of the main principles behind the reform.²

As part of the Commission's regulatory enforcement reform package, it has decided to adopt a market abuse crimes proposal³ setting forth criminal sanctions.⁴ The intention of the Market Abuse Crimes proposal is to ensure market integrity and enhance public confidence in securities and derivatives markets⁵, thereby boosting trust and increase economic activity.⁶ The Market Abuse Crimes proposal defines two offences, insider dealing and market manipulation which should be regarded by Member States as criminal offences if committed intentionally.⁷ The proposal also requires Member States to criminalise inciting, aiding and abetting insider dealing and market manipulation, as well as attempts at these forms of market abuse. The Directive requires Member States to ensure that the criminal offences defined in the Directive are punishable by criminal sanctions which are effective, proportionate and dissuasive.⁸

¹ See Consolidated Version of the Treaty of the Functioning of the European Union [2012] OJ C 326 (TFEU), Art 83(2). See also Ester Herlin-Karnell, 'White-collar crime and European financial crises: getting tough on EU market abuse' (2012) 37 EL Rev 481,485.

² See Shaun Elder, 'Financial Regulation Enforcement and the Criminal Dimension: Irish Perspective, EU Context', (2011) 11 Papers from the British Criminology Conference 54, 63-64. <http://www.britisoccrim.org/volume11/pbcc_2011_wholevolume.pdf> Accessed 4 September 2013; Case 68/88 *Commission v Greece* [1989] ECR 2965 (Greek maize case), para 24.

³ Commission, 'Proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation, COM (2011) 654 final, (the 'Proposal' or 'Market Abuse Crimes Proposal').

⁴ Which has been approved by a decision of the Council: See the press release :< http://europa.eu/rapid/press-release_MEMO-12-963_en.htm?locale=en>. Accessed 4 September 2013.

⁵ See Herlin-Karnell, n 1, 484-485.

⁶ See Proposal, (n 3) Recital 1.

⁷ Ibid, Arts 3 and 4.

⁸ Ibid, Arts 5 and 6.

While the question whether the adoption of the Market Abuse Crimes proposal falls within the scope of the Union's competence to define criminal laws is an important question from a legal perspective, this article is interested in enquiring more generally about the effectiveness of criminal sanctions in the enforcement of insider dealing laws. Taking the Commission's Market Abuse Crimes proposal as a starting point of the debate, the effectiveness of criminal laws and alternative sanctions in the enforcement of market abuse regulations is examined comprehensively. Drawing on general criminological research and literature on enforcement, the article assesses the effectiveness of criminal sanctions and compares their effectiveness with other types of sanctions. The evidence-based and comparative approach is consistent with current trends in EU criminal policy and criminal law literature where the emphasis is placed on the need for reliable and adequate evidence to justify Union action in the field of criminal law.⁹ Although the focus of the analysis is on insider dealing laws, the findings are generally applicable to the design of a sanctioning regime for the enforcement of corporate crimes.

The article's main assumption is that imprisonment sanctions should not be employed to sanction violations of insider dealing laws unless two conditions are fulfilled. First, it must be established that imprisonment sanctions are 'effective' for the implementation of insider dealing laws. This implies determining whether criminal laws and imprisonment sanctions have some effect on inducing compliance with insider dealing regulations. Secondly, it must be demonstrated that other alternative sanctions are not equally effective as custodial sanctions in the enforcement of insider dealing laws. This examination aims to determine whether imprisonment sanctions have a larger positive effect than alternative sanctions in achieving compliance with insider dealing laws.

The article's working hypothesis is supported by policy reasons as well as by the legal framework established by the Lisbon Treaty. The new legal basis of Article 83(2) TFEU, which is particularly concerned with the Union's power to impose criminal laws and criminal sanctions, states that criminal sanctions can only be employed if it is 'essential' to 'ensure the effective implementation of a Union policy'. This means that imprisonment sanctions can be adopted only if it is demonstrated that other available or potential alternative sanctions cannot to an equal extent ensure effective implementation of the Union policy at stake.¹⁰

The policy reasons for also considering the effectiveness of alternative sanctions before adopting imprisonment sanctions are also convincing. According to the *ultima ratio* principle, a general principle of criminal law, it should, because criminal investigations and sanctions may have a

⁹ See European Council, 'The Stockholm Programme – An open and secure Europe serving and protecting citizens', [2010] OJ C 115, point 4.3.3; Victor Tadros, 'Criminalization and Regulation' in R A Duff and others (eds), *The Boundaries of the Criminal Law* (OUP 2010), 163-164; Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions- Towards an EU Criminal Policy: Ensuring the effective implementation of EU policies through criminal law', COM 2011/573 final, 7-8 ('COM 2011/573').

¹⁰ See Petter Asp, *The Substantive Criminal Law Competence of the EU – Towards an Area of Freedom, Security & Justice - Part I*, (Jure 2013), 130-132; Peter Whelan, 'Contemplating the Future: Personal Criminal Sanctions for Infringements of EC Competition Law' (2008), 19 King's Law Journal 364, 371.

significant impact on citizens' rights and include a stigmatizing effect, be investigated whether criminalization is necessary given the alternatives available to us. It is necessary to analyse whether measures other than criminal law measures, e.g. sanction regimes of administrative or civil nature, could not sufficiently ensure the policy implementation and whether criminal law could address the problems more effectively. Although some conduct is harmful and publicly wrongful, and in principle deserves punishment, it should not be criminalized if it is a disproportionate response to the conduct at issue. It is disproportionate if some less severe alternative is available. Therefore, criminal law should always remain a measure of last resort of social control.¹¹

On the basis of this assumption, the first part of the article examines the question whether imprisonment sanctions are 'effective' for the implementation of insider dealing laws. This part deals comprehensively with the main arguments underlying the claim that criminal laws are effective in the enforcement of insider dealing laws. This section further articulate and evaluate the main criticisms against the introduction of imprisonment sanctions for the enforcement of insider dealing laws. The second part of the article scrutinizes whether there are other less severe sanctions than imprisonment sanctions that are equally effective in the enforcement of insider dealing laws. In this respect, a particular focus is placed on examining the effectiveness of civil liability regimes, individual fines and disqualification orders. The final part of the article concludes by asking whether imprisonment sanctions are 'essential' for the implementation of insider dealing laws.

B Do criminal sanctions contribute to the effective implementation of insider dealing laws?

1. Why are criminal laws effective measures for the enforcement of insider dealing regulations?

The deterrence argument

The strongest argument for why we should introduce criminal sanctions to enforce insider dealing laws from an effectiveness perspective is based on the deterrence philosophy. The argument is that

¹¹ See Tadros, (n 9) 163-164; See COM 2011/573 (n 9) 7; See Maria Kaiafa-Gbandi, 'The Importance of Core Principles of Substantive Criminal Law for a European Criminal Policy Respecting Fundamental Rights and the Rule of Law' (2011) 1 European Criminal Law Review 7, 17-21; Martin Böse, 'The Principle of Proportionality and the Protection of Legal Interests (Verhältnismäßigkeit und Rechtsgüterschutz)' (2011) 1 European Criminal Law Review 35, 39-42; Sakari Melander, 'Ultima Ratio in European Criminal Law', (2013) 3 European Criminal Law Review 45, 63-64; see also 'A Manifesto on European Criminal Policy' (2009) Zeitschrift für Internationale Strafrechtsdogmatik, 707. <http://www.zis-online.com/dat/artikel/2009_12_383.pdf> Accessed 4 September 2013

criminal sanctions, in contrast to other sanctions, are apt to promote compliance and prevent would-be offenders from violating insider dealing laws. This effect is achieved through the educative function of criminal law, through the assumption that an official denunciation of offenders acts as a strong disincentive for other would-be offenders to commit similar infringements and through the social stigma attached to criminal sanctions.

The deterrence argument is prominently endorsed by official regulators and Union institutions. The European Commission explains that there are three reasons why criminal sanctions are indeed dissuasive sanctions. Firstly, by characterising the most serious market abuse offences as criminal offences clear boundaries in law are expressed that certain behaviours are regarded as unacceptable. Secondly, by criminalising certain behaviour and by prosecuting individuals for such offences a message is sent to the public via the potential extensive media coverage of the prosecutions that these offences are taken very seriously by society. This could be expected to lead to changes in behaviour and help deter potential offenders. Thirdly, the Commission argues that the stigma relating to criminal sanctions enhances their deterrent function.¹²

The director of the Financial Services Authority (FSA) in the UK, Margaret Cole, has strongly emphasized the importance of having deterrent sanctions available and using them. She submits that the threat of civil fines has not worked well and that the FSA is convinced that the threat of an individual custodial sentence is a much more significant and credible deterrent than civil fines. She also claims that the imposition of criminal sanctions is something that the whole regulatory community supports. By adopting the approach that the 'end justifies the means' she argues that the objective of cleaning up the market and changing behaviours to achieve greater compliance will be pursued by all possible means, criminal, civil and administrative, that are available to the FSA.¹³ Other financial regulators, such as the Danish, Finnish, German, Hungarian and Irish financial authorities, has followed FSA's lead and adopted the same punitive language. Financial regulators over the Union emphasize the economic rationale of the new criminal law conceptualization for deterrence and the reinforced use of criminal laws is a 'hallmark' of the risk-based regulatory approach adopted by the G20 and the EU.¹⁴

¹² See Commission, 'Commission Staff Working Paper, Impact Assessment, Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation and the Proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation, SEC (2011) 1217 final, 164.

¹³ See Margaret Cole, 'How Enforcement makes a difference'. FSA Enforcement Law Conference of 18 June 2008. <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0618_mc.shtml> Accessed 4 September 2013.

¹⁴ See Elder, (n 2) 64; Robert Baldwin, 'The New Punitive Regulation' (2004) 67 MLR 351, 352-360; Hungarian Financial Supervisory Authority 'Annual Report 2011', 65. <http://www.pszaf.hu/data/cms2371932/annual2011_jav3.pdf>. Accessed 4 September 2013; Finanstilsynet, 'Strategy 2015 18 new initiatives' (2012), 22-24. <<http://www.finanstilsynet.dk/en/Om-os/Strategi-2015/~media/Om-os/2013/Strategy2015.ashx>> Accessed 4 September 2013; Finnish Financial Supervisory Authority, 'Annual Report 2012', 3, 22-23, 37, 47, 50, 57. <http://www.fin-fsa.fi/en/Publications/Annual_reports/Documents/FIN-FSA_Annual_Report_2012.pdf> Accessed 4 September 2013; Federal German Financial Supervisory Authority, 'Annual Report 2011', 201-208. <http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2011.pdf?__blob=publicationFile>. Accessed 4 September 2013.

Let us assess these claims by first examining the foundation for the criminalisation of insider dealing. While the Commission and the above-mentioned national financial authorities may not be explicit about the rationales for proposing criminalisation, their arguments are deeply rooted on economic arguments and the rational choice theory. The next section therefore accounts for the rational choice theory and how this can be used to explain why criminal laws are needed to enforce insider dealing laws.

How deterrence is effectively achieved through the criminalisation of insider dealing- the rational choice calculus

The general deterrence argument submits that the most important positive effect that the criminal law might have is the tendency to deter people from committing criminal offences. This effect is simply achieved by issuing strong disincentives to people which the law enforces through punishment.¹⁵ Criminal sanctions are, as argued by Jeremy Bentham, imposed on individuals in order not only for them (individual deterrence) but to deter others, from engaging in wrong-doing (general deterrence).¹⁶ By imposing penalties on individuals the state is ‘stipulating examples’ which assumedly is serious enough to ‘deter’ similar wrongdoing acts by other would-be offenders.¹⁷ The general deterrence argument is founded on the assumption that individuals are to a certain extent rational actors and thus able to assess benefits and disadvantages of certain behaviours and also able adjust their behaviours in relation to risks.¹⁸ While deterrence theories were developed as early as in the 18th century by Bentham and Beccaria, they have been prominently refined and elaborated by the law and economics literature.¹⁹

The law and economics literature provide for the rational calculus which determines the optimal penalty for infringements of rules. It states, according to the formula by Gary Becker, in a simplified version, that the optimal penalty is decided by the probability (pd) that an offence is detected, (pc) and the offender convicted, the (f) size/severity of the expected punishment for those convicted, and the expected gain from the offence (EG).²⁰ The optimal penalty, in this simplified version, thus results from the size of the expected gain divided by the probability of being detected and convicted. If the expected gain divided by the probability of being detected and convicted exceeds the prescribed penalty, a rational actor would decide to commit the offence. Let us assume that the expected gain is

¹⁵ See Tadros, (n 9) 170-171.

¹⁶ See Jeremy Bentham, *The Rationale of Punishment* (Robert Heward, London, 1830), 19-20.

¹⁷ See Tadros, (n 9) 174-175.

¹⁸ See Bentham, (n 16) 19; Raymond Paternoster, ‘How much do we really know about criminal deterrence?’ (2010) 100 *Journal of Criminal Law and Criminology* 765, 782-783.

¹⁹ See Paternoster, (n 18) 767-780.

²⁰ See Gary Becker, ‘Crime and Punishment: An Economic Approach’ (1968) 76 *Journal of Political Economy* 169, 207- 208.

100 000 euro and the probability of being detected is 50% and the probability of being convicted is 20 %. In this case, the optimal penalty must be at least 1 000 000 euro= $F = EG/PC/PD$, to be deterrent.²¹

The rational choice theory suggest that a person violates the insider trading laws in order to make a profit and makes a rational calculation by weighing the expected benefits against the expected penalties when considering committing insider dealing offences. On the cost side of the rational calculation an insider will calculate the expected penalty by taking into account the probability of detection, the celerity of the sanction, the probability of successful prosecution, and the severity of the potential sanction.²² Crime rates can go down by either increasing severity of sanction, increasing probability of detection or by increasing celerity of the sanction.²³

This theory is arguably relevant in the context of insider trading since insider trading falls within the broad area of 'white collar crime'²⁴ and white collar crime is a distinct category of crimes due to the social and financial status of the offenders.²⁵ White collar-crime typically requires advance planning which provides an opportunity for reflection and an assessment of the risk of detection and punishment. The education and training of a white-collar offender enables them to engage in rational calculations.²⁶

What though, is the empirical evidence supporting the above-mentioned characterization of insider dealers as rational actors? Based on the findings made by Geis and Szockyj, it appears that the rational actor model has an explanatory value for clarifying the motivations and reasons behind insider dealing offences. These authors have carried out one of the first systematic criminological studies aimed at characterizing insider dealers, the offence and the penalties imposed for the offences. Their findings are therefore important for the discussion here on the characterization of insider dealers as rational actors.²⁷

Geis and Szockyj have firstly found that insider dealing is a profit-driven crime, i.e. a crime related to the accrual of financial gain or the avoidance of financial losses, and that the motivation for such offences is a purely financial one.²⁸ The gains to be made from these offences appear to be substantial. For criminal defendants the median amount of profit in the survey was US \$50,000 with a range of

²¹ See G Becker, (n 20) 192-193; John C Coffee Jr, 'No Soul To Damn - No Body To Kick - An Unscandalized Inquiry Into the Problem of Corporate Punishment' (1981) 79 Michigan Law Review 386, 389. Added to this rational choice formula is the 'celerity' of the sanction. A legal punishment is more costly when it is swifter and the punishment arrives sooner rather than later after the offense (Paternoster, (n 18) 783).

²² See e.g. Marleen A O Connor, 'Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)' (1989) 58 Fordham Law Review 309, 314; Rokiah Kadir and Suriyani Muhamad, 'Insider Trading In Malaysia: Sanctions And Enforcement' (2012) 6 Advances in Natural and Applied Sciences 904, 906; Geraldine S Moohr, 'An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime' (2003) 55 Florida Law Review 937, 957; See David M Becker, 'What More Can Be Done to Deter Violations of the Federal Securities Laws?' (2012) 90 Texas Law Review 1849, 1850.

²³ See Paternoster, (n 18) 783-784.

²⁴ 'White collar crime' is typically defined as one committed by a person of respectability and high social status in the course of his occupation. Hence what distinguishes white collar crime from other crimes is the sociological difference of the criminals: see Edwin H Sutherland, *White Collar Crime. The Uncut Version* (1983, New Haven CT: Yale University Press). First published in 1949.

²⁵ See Kadir and Muhamad, (n 22) 906.

²⁶ See Michael P Dooley, 'Enforcement of Insider Trading Restrictions' (1980) 66 Virginia Law Review (1980) 1, 5.

²⁷ See Kadir and Muhamad, (n 22) 906.

²⁸ See Elizabeth Szockyj and Gilbert Geis, 'Insider trading: Patterns and analysis' (2002) 30 Journal of Criminal Justice 273, 273.

US\$0– 50 million.²⁹ The motivation is also mainly driven by self-interest. Insider trading differs from other white-collar crimes, such as antitrust crimes, which more directly advance the fortunes of the business entity rather than the perpetrator, suggesting that insider dealing primarily advances the fortunes of the perpetrator though in some cases.³⁰ The highly fluctuating and detached environment in the trading platform does also influence traders to think self-interestingly in short- term perspectives and focus on immediate gains.³¹

Secondly, Geis and Szockyj's survey suggest that insider traders are risk-averse. They strive to minimize losses, they trade on stable securities, and they seek to transform uncertainty into more manageable and profitable risks while they also take steps to reduce detection. Insider traders only take illegal advantage of situations when they perceive the risk to be minimal.³² It can thus be assumed that a risk-averse manager would be deterred by high penalties even where there is a low chance for such penalties being imposed.³³

These findings seem to both confirm the relevance of the rational choice theory for explaining the commission of insider dealing offences and confirm the assumption that imprisonment sanction can be an effective deterrent. The consequence of accepting the rational choice theory is that potential offenders respond to changes in probability of detection and respond to changes in the severity of the sanction.³⁴ The argument can thus be plausibly made that the imprisonment sanction, is, assuming that the probability of detection and sanctioning is not insignificant, likely to have a deterrent effect on the individuals involved in insider dealing offences.³⁵

The assumption that the rational actor model applies and that imprisonment is a serious deterrent in the field of enforcing insider dealing laws is supported by several commentators in their discussions of sanctions within the field of insider dealing.³⁶ It is suggested that mandatory imprisonment for insider dealing offences is a deterrent sanction because the threat of imprisonment is likely to be deterring regardless of the amount of profit to be earned from insider trading.³⁷

It is also confirmed by the general literature on corporate crime that imprisonment is effective in deterring rational actors.³⁸ It is proposed that imprisonment is the most credible threat to potential

²⁹ Ibid, 280.

³⁰ Ibid, 281.

³¹ See Michael Levi, 'Suite justice or sweet charity? Some explorations of shaming and incapacitating business fraudsters' (2001) 4 Punishment and Society 147, 149.

³² See Geis and Szockyj, (n 28) 283.

³³ See Coffee, 'No Soul To Damn' (n 21) 394; Levi, (n 31) 149.

³⁴ See Emiliios Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, (OUP 2005), 464-65; Mirela V Hristova, 'The Case for Insider-Trading Criminalization and Sentencing Reform,' (2012) 13 Tennessee Journal of Business Law 267, 302.

³⁵ See eg Dooley, (n 26) 5; Moohr, (n 22) 957; Kadir and Muhamad, (n 22) 906; See Carole B Silver, 'Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984' (1985) Duke Law Journal 960, 963.

³⁶ See eg Kadir and Muhamad, (n 22) 905-906; D Becker, n 22 1850, 1867; Dooley, (n 26) 5; O Connor, (n 22) 314; Moohr, (n 22) 957; Levi, (n 31) 149.

³⁷ See Kadir and Muhamad, (n 22) 905-906.

³⁸ See eg Martin F McDermott, 'Occupational Disqualification of Corporate Executives: An Innovative Condition of Probation' (1982) 73 Journal of Criminal Law and Criminology 604, 614-615; James Gobert, and Maurice Punch, *Rethinking Corporate Crime* (London:

offenders in cases of deliberate crimes prompted by greed or the pursuit of power. The imposition a prison sentence on a convicted corporate director or executive serves as a deterrent to other directors and executives who become aware that white-collar crimes are taken seriously by the society. The underlying assumption for the argument is that directors have much to lose in terms of status and reputation if convicted of a criminal offence.³⁹

Even though his argument is not restricted to insider dealing, it is noteworthy that Braithwaite very recently affirmed the proposition that criminal laws must be imposed to deter white collar crime. Despite first suggesting a regulatory pyramid with criminal sanctions only to be used as a last resort⁴⁰, the financial crisis seems to have prompted him to adopt a more pessimistic view of the voluntary compliance approach or negotiation/persuasion approach as a proper regulatory strategy. He argues that white-collar crime is under-deterred in comparison to other crimes than for other forms of crime has suffered more under-investment in prevention.⁴¹

Social stigma, shaming and communication as arguments for using criminal laws to combat insider dealing

Another argument in favour of imprisonment's deterrent effect is the shaming argument. The shaming argument proposes that punishment can deter white-collar crime effectively by conveying public censure.

While 'shaming' is a mechanism which relies for its effectiveness upon people being 'pinpointed' and deeply entrenched in a network of social relations, it is contended that the stigma of arrest and conviction are effective in deterring potential offenders from committing insider trading due to insider dealing's character of being a 'while-collar crime'. Because of the social standing occupied by insider dealer offenders, imprisonment has greater deterrent effect for these offenders because humiliation brought about by prison punishment is felt more by middle and upper-class offenders. Respectable persons whose social lives are rooted in the society and who are sufficiently detached from their business situation to appreciate the impact that a criminal conviction might have upon their social standing, are thus likely to respond to the stigma and threat of criminal sanctions. The deterrent function of criminal sanctions works through the perception of individuals that they risk not

Butterworths, 2003), 216; John Braithwaite, 'Diagnostics of white-collar crime prevention' (2010) 9 *Criminology and Public Policy* 621, 623-625.

³⁹ See Gobert and Punch, (n 38) 216; McDermott, (n 38) 614-615.

⁴⁰ See Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (OUP 1992), 35-44.

⁴¹ See Braithwaite, 'Diagnostics of white-collar crime prevention' (n 38) 623-624.

conforming to the social standards of their community.⁴² Being publicly shamed and humiliated are powerful considerations that logical and career-motivated managers take very seriously since the devaluation as a white-collar criminal can impair or destroy an offender's career, community status, and future economic potential.⁴³ The criminal process thus conveys public censure far more effectively than the civil-law process in terms of white collar offending since the threat of stigmatization is the primary deterrent for such offenders.⁴⁴

The shaming argument is related to the expressive and communicative dimension of criminal law and the fact that criminal punishment speaks a language.⁴⁵ The language of criminal law does communicate social stigma and moral condemnation.⁴⁶ The 'expressive' dimension of punishment reinforces deterrence through the formation of adverse public sentiments against criminal behaviours. Citizens form aversions to the kinds of behaviour that the criminal law tells them are unworthy of being valued. This formation of negative public sentiment takes place because the community perceives the criminal law as expressing society's moral condemnation of such conduct. The message of moral condemnation is particularly clear when society deprives an offender of his liberty due to the high value attached to liberty by our society. Depriving someone of their liberty is therefore the strongest means and symbol of expressing public condemnation.⁴⁷

The communicative dimension of criminal law relies on 'censure' as a critical moral communication to potential perpetrators. Criminal penalties convey to potential offenders both an authoritative prudential and moral reason for desisting from violating the law. The normative message that is communicated to potential offenders through the act of criminalization and by the imposition of criminal sanctions is that certain behaviours are morally reprehensible and this message imposes strong public censure on those who violate the law. By representing a societal condemnation of a regulatory offence criminal sanctions act as a deterrent and send a wide message to the regulated sector.⁴⁸

It is contended in the literature that imprisonment sanctions do send a strong deterrent normative message. The message to other directors and corporate executives, as well as to the public, is that white collar offences are taken seriously by the courts and will be subject to the same type of

⁴² See Levi, (n 31) 155, 158; See Kadir and Muhamad, (n 22) 904, 906; Rokiah Kadir, 'Cheating Offences and Punishment; A Malaysian Perspective' (2012) 3 OIDA International Journal of Sustainable Development 11, 18- 19; John Braithwaite, *Crime, Shame and Reintegration*, (CUP 1989), 125-127, 143, 179.

⁴³ See John M. Ivancevich, Robert Konopaske, Jacqueline A. Gilbert, 'Formally shaming white-collar criminals' (2008) 51 Business Horizons 401, 404.

⁴⁴ See Coffee, 'No Soul To Damn' (n 21) 424-425; Hristova, (n 34) 305.

⁴⁵ See Joel Feinberg, 'The Expressive Function of Punishment', reprinted in Joel Feinberg, *Doing and Deserving: Essays in the Theory of Responsibility* (Princeton University Press, 1970).

⁴⁶ See Tadros, (n 9) 174-175.

⁴⁷ See Dan M Kahan 'What do alternative sanctions mean?' (1996) 63 University of Chicago Law Review 593, 599, 603, 617, 639; Linda S Eads, 'From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof' (1991) 79 California Law Review 1421, 1483.

⁴⁸ See A P Simister and Andreas Von Hirsch, *Crimes, Harms and Wrongs- On the Principles of Criminalisation*, (Hart 2011), 11- 14; Antony Duff, *Punishment, Communication, and Community* (OUP 2001), 19; Mark R Reiff and Rowan Cruft, 'Antony Duff and the Philosophy of Punishment' in Rowan Cruft and others (eds), *Crime, Punishment, and Responsibility: The Jurisprudence of Antony Duff* (OUP 2011), 7; Baldwin, (n 14) 371; Hristova, (n 34) 303; Richard Macrory, 'Regulatory justice- Making Sanctions Effective', Final Report, November 2006, 10, 15. < <http://www.bis.gov.uk/files/file44593.pdf>.> Accessed 4 September 2013.

punishment which the criminal justice system reserves for serious offenders. The processing through the criminal justice system may prove highly disconcerting for a convicted corporate executive which would have to go through the degrading rigors involved in being treated as an ordinary prisoner, while animated fellow prisoners and guards, who may be jealous of the offender's social standing, will often reinforce the executive's state of severe discomfort. Media coverage adds to the denunciatory effect of the sentence and presumably to the embarrassment, shame and guilt experienced by the convicted executive.⁴⁹

But how can we be sure that insider dealers generally can be characterised as white-collar offenders?

Geis and Szockyj's survey support that insider dealers generally are of a high social standing in society. Insider offenders are not ordinary employees but often in a higher position within a firm assuming a position of corporate officer, director or security personnel. Insider dealer offenders have thus assumedly a considerable investment in their public reputation and much to lose if prosecuted.⁵⁰ The public shaming function of criminal sanctions is therefore highly applicable to insider-trading cases. Whereas shame is a context-, individual-, and culture-dependent phenomenon⁵¹, reputation is of particular importance to inside traders, who are unlikely to take challenges to their public images lightly.⁵² To this we can add the denunciatory and communicative function related to media attention for criminal prosecution of insider fraudsters. Since many insider traders are enthusiastic readers of the professional trade press they can be expected to be aware of any criminal sanctions imposed on their peers.⁵³

The general moral denunciation of insider dealing offences is reinforced by the nature of the offence. Because insider dealers' gains are much greater than the typical profits of street criminals and because of the fact that the breach of trust associated with such offences is notably serious, it is generally considered by the community as a condemnable offence. Given this general moral censure of insider dealing offences, the society's imposition of criminal sanctions appears to express strong public censure thus reinforcing the deterrent function of criminal laws.⁵⁴

2. *Questioning the assumption that criminal law is an effective measure for the enforcement of insider dealing laws*

No relationship between criminal laws and decreased insider dealing and higher compliance with insider trading rules

⁴⁹ See Gobert and Punch, (n 38) 275; Kahan, (n 47) 652; Austin Sarat, Kenneth Mann and Stanton Wheeler 'Sentencing the White-Collar Offender' (1980) 17 American Criminal Law Review 479, 486-87.

⁵⁰ See Geis and Szockyj, (n 28) 282; Hristova, (n 34), 303, 306.

⁵¹ See Braithwaite, *Crime, Shame and Reintegration* (n 42), 71-75.

⁵² See Hristova, (n 34) 306.

⁵³ See Levi, (n 31) 149.

⁵⁴ See Geis and Szockyj, (n 28) 284; Hristova, (n 34) 304.

The claim that the introduction of criminal sanctions has resulted in a greater level of deterrence in the enforcement of insider trade laws is contested by several commentators. The first challenge to the deterrence model comes from the law and economics scholarship that mainly question the empirical support for the rational actor model.

Seyhun claims that increased regulation and increased sanctions seemed to have little effect in deterring insider trading.⁵⁵ By looking at trading regulation in the US in the 1980's and the adoption of the Insider Trading Sanctions Act in 1984 (ITSA), he notes that while the legislation increased the maximum criminal fines to 1 million USD and prison sentences to ten years and accompanied this with significant increases in levels of enforcement, corporate insiders earned more abnormal profits after 1980 comparing to before and even higher abnormal profits after the enactment of ITSA in 1984. Following the introduction of tighter regulations there was, instead of a decrease in insider trade, larger volume of insider trading activity followed by greater favourable abnormal price movements, and an increased frequency of large volume insider trading.⁵⁶ Frijns *et alia* suggest in a similar vein that criminal sanctions have not assisted in deterring insider dealing offences. Their research, conducted on the stock exchange in New Zealand, suggests that the introduction of criminal sanctions in New Zealand for insider trading offences has, instead of reducing the impact of insider trading, increased the cost of trading and the cost of information asymmetry.⁵⁷

Weaknesses to the rational actor model- lack of information, irrational calculations, incorrect assessments of risks and adverse psychological predispositions

Another weakness to the criminal law response is that the assumption of individuals being rational actors is not necessarily an accurate and complete account of white collar offenders' behaviours. The rational actor models assume that individuals must know what type of behaviour is prohibited in order for criminal laws to have an effect and that they must have the capacity to evaluate the risks associated to that behaviour. Unless individuals have this knowledge and capacity, the formal threat of criminal sanctions will not have any deterrent effect.⁵⁸

Moohr takes the Enron case as an example of why the rational actor model cannot generally explain the existence of corporate crime. This case shows that even if the US legislator had longstanding federal criminal laws, and had increased the penalties and the certainty of punishment, these actions did not deter serious business misconduct occurring in an impressive number of corporations. Wrongdoers were not deterred by the possible contact with the criminal justice system's enforcement

⁵⁵ See H Nejat Seyhun, 'The effectiveness of the Insider-Trading Sanctions' (1992) 35 Journal of Law and Economics 149,169.

⁵⁶ See Seyhun, (n 55) 176; Avgouleas, (n 34) 453-54.

⁵⁷ See Bart Frijns, Aaron B Gilbert and Alireza Tourani-Rad, 'Do Criminal Sanctions Deter Insider Trading?' 24. <<http://ssrn.com/abstract=1785873>>. Accessed 4 September 2013. See also Moohr, (n 22), 957.

⁵⁸ See Bentham, (n 16) 19, 24.

agents, courtrooms, fingerprinting and bail hearings nor were they deterred by the stigma and societal condemnation that is attached to a conviction.⁵⁹ What is the explanation for why individuals are not deterred to the extent they should be according to the rational choice theory?

Psychological research suggests that the rational choice theory cannot fully explain white-collar crime. The failure of the rational choice theory lies in the fact that it cannot account for individuals' different perceptions of risks, different psychological perceptions of risks and reduced rational thinking.⁶⁰ Firstly, not all individuals have the capacity to properly identify illegal behaviour, assess risks or make a rational calculation. Some individuals are so optimistic and confident that their ability to assess reality becomes impaired, amounting to a judgment bias. Secondly, rational calculation may also be impaired by timing and events undermining the individual's assessment of the risks of detection, conviction and the imposition of penalties.⁶¹ The commission of offences may arise in situations where the manager or executive fear that discovery of the truth will cost them their jobs, reputations, and privileges, and that they therefore have a strong incentive to delay their acts being uncovered so that they can stay in control for longer and hope that events turn around to good fortune. Thirdly, company incentive may give perverse results for individual behaviour. This might be the case if compliance with the legal standard subjects the manager to a risk of dismissal for failure to meet a sales quota which is higher than the risk for being convicted for an offence. In such a case, it may be rational for the individual to commit the offence.⁶²

Ineffective enforcement of insider trading laws and low probabilities of detection challenges the rational choice theory

It is generally recognized that the deterrent effect of criminal sanctions may depend less on its length and more on the celerity with which it is imposed and on the perceived likelihood of it being imposed. The threat of prison will not have a deterrent effect if the imposition of such sentences is seen as remote and improbable outcomes of the offence. If there is no risk of detection and sanctioning, criminals would rationally infringe the law. Having a battery of tough sanctions on paper is not very useful in influencing behaviour on financial markets, if such sanctions are not followed up by stringent

⁵⁹ See Moohr, (n 22), 956, 958.

⁶⁰ What matters for deterrence is potential offender's subjective perceptions of the risk and threat of punishment. While legislators may modify the objective properties of punishment with the expectation that the subjective perceptions will be affected there is no necessary correlation between objective properties of punishment and subjective perceptions (Paternoster, (n 18) 785-787).

⁶¹ See eg Moohr, (n 22) 956, 958, 968; D Becker, (n 22), 1851; Robert A Kagan and John T Scholz, 'The Criminology of the Corporation and Regulatory Enforcement Strategies' in Keith Hawkins and John M Thomas (eds), *Enforcing Regulation* (Kluwer-Nijhoff, 1984), 71-72; Donald C Langenvoort, 'On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability', (2007) 42 Wake Forest Law Review 627, 635.

⁶² See eg Langenvoort, (n 61) 635; Coffee, 'No Soul To Damn' (n 21) 400.

and intense enforcement. Deterrence and successful prosecution is thus dependent upon the combined resources that public and private enforcers commit to detect and convict offenders.⁶³

There is evidence that difficulties of enforcement of criminal laws for insider dealing offences do impede the deterrent effect of such laws.⁶⁴ Prosecution is often difficult in insider dealing cases, because of the difficulty in obtaining direct evidence and testimonies, because of the cost and difficulties in detection and because of the high burden of proof in criminal trials which does exacerbate the intrinsic problem of proving that the requirements for the insider dealing offence are fulfilled.⁶⁵ Proving the defendant's fraudulent state of mind beyond 'reasonable doubt' is a daunting task that is often very hard for the prosecution to achieve. For instance, it is very difficult to ascertain a trader's intent in the context of a 'suspicious' market transaction. Insider trading and market manipulation is effected against a backdrop of vast amounts of data and studies that try to forecast the profitability or other utility of the trade. The direction of investors' trades may also be motivated by other considerations such as a struggle between rival traders for market dominance, divergent valuations and so forth, which might have a price effect without any intention to manipulate the market price or deceive other traders. Since the level of proof is fixed at this very high level, criminal law sanctions does not arguably deter insider dealing sufficiently.⁶⁶

The US scholarship also asserts that weak enforcement from the US Securities and Exchange Commission (SEC) undermines the effectiveness of criminal laws against insider dealing. Potential infringers of insider trading rules often assume that there is a significant likelihood that their wrongdoing will not be detected and punished because of the SEC's weak record in uncovering securities frauds.⁶⁷ Geis and Szockyj's empirical research supports these assertions by noting that the problem of proving violations of insider laws, the prospect of financial recovery of losses, and the very considerable skills of the defence bar involved in handling white-collar crimes regularly push prosecutors to file civil actions.⁶⁸

The inherent problem of detection and prosecution of insider dealers affects the rational calculation made by individuals, who may accurately assess the chances of prosecution as insignificant thereby

⁶³ See Dooley, (n 26) 5; John C Coffee Jr, 'Law and the Market: The Impact of Enforcement' (2007) Columbia Law and Economics Working Paper No. 304, 4-5, 79. <<http://ssrn.com/abstract=967482>>. Accessed 4 September 2013. See Kadir and Muhamad, (n 22), 906-907; See Gobert and Punch, (n 35) 276. The Commission recognise the importance of enforcement: Commission Staff Working Paper, Impact Assessment, Accompanying document to the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'Reinforcing sanctioning regimes in the financial services sector', SEC(2010) 1496 final, 14.

⁶⁴ See Nasser Arshadi 'Insider Trading Liability and Enforcement Strategy' (1998) 27 Financial Management 70, 76.

⁶⁵ See Kadir and Muhamad, (n 22) 906.

⁶⁶ See Avgouleas, (n 34) 453-54.

⁶⁷ See D Becker, (n 22) 1868-69; See Larry Elder, 'Legalize Insider Trading', CAPITALISM MAGAZINE, 24 September 2004 (interviewing Henry Manne), <http://capitalismmagazine.com/2004/09/legalize-insider-trading/>. Accessed 4 September 2013.

⁶⁸ See Geis and Szockyj, (n 28) 284.

undermining the deterrent effect of criminal laws.⁶⁹ The low probability of conviction makes encouraging reading for potential offenders who engage in a rational cost-benefit analysis.⁷⁰

Criminal laws do not necessarily form an internalized moral obligation to comply with insider dealing rules

The argument that criminal law has an educative function and that the imposition of punishment communicates societal standards and moral condemnation is also challenged in the literature.

Moohr argues that criminal law generally fails to create internalized social norms necessary to foster compliance. While criminal law may help to influence and internalize the norms of social groups, criminal laws may ultimately have a greater impact on reinforcing the behaviour of the good citizen than changing the behaviour of the 'bad man'. Sanctioning individuals that are embedded in influential and deviant sub-cultures, without endeavouring to tackle the powerful culture that influences individuals to deviance, will not deter other individuals from being similarly influenced by such cultures.⁷¹ This point is affirmed by Scholz and Pinney's empirical research on compliance with tax law which suggests that penalties and enforcement activity have little influence on improving compliance. Their findings suggest that taxpayers comply with tax rules not because of a threat of sanctions but instead because of a sense of duty. Individuals then adhere to the law for normative reasons, because people perceive that they have a moral obligation to comply. The state's ability to obtain compliance will therefore depend on how well state policies meet the expectations and preferences of the citizenry.⁷²

3. Evaluation on the effectiveness of imprisonment sanctions

Even if it is correct that criminal laws does not always have a significant deterrent effect, even though people may not always respond as rational actors and even if individuals may comply with rules because of a sense of duty and not because of the threat of criminal sanctions, it seems unquestionable that criminal laws is an effective sanctions for enforcing insider dealing laws. There are three reasons for this.

Firstly, it appears that the risk of criminal sanctions being imposed is likely to be taken seriously by potential infringers of insider dealing rules. This is because such offenders, either if they are security

⁶⁹ See Moohr, (n 22) 960-961; Cally Jordan, 'Lessons from the Bennett Affair', (1993) 38 McGill Law Journal 1071, 1086-1087.

⁷⁰ See Avgouleas, (n 34) 456; Paternoster, (n 18) 810.

⁷¹ See Moohr, (n 22) 963, 966, 968, 973; Eads, (n 47), 1484; John M Conley, William M O'Barr, 'Crime and Custom in Corporate Society: A Cultural Perspective on Corporate Misconduct' (1997) 60 Law and Contemporary Problems 5, 20-21.

⁷² See John T Scholz and Neil Pinney, 'Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior' (1995) 39 American Journal of Political Science 490, 508-509; Dan M Kahan, 'Social influence, Social Meaning and Deterrence' (1997) 83 Virginia Law Review 349, 358, 379; Ayres and Braithwaite, (n 40), 22-23.

professionals, managers or executives, do regularly engages in rational calculations of whether to engage in insider dealing. The fact that insider dealing is profit driven, because the offenders are often situated in a high and established positions within the society and because insider dealers are risk averse, it is likely, as suggested by the predominant part of the literature, that the rational choice theory has some explanatory value.⁷³ Even Paternoster, who is sceptical about the rational choice theory, suggests that while offenders and potential offenders may not be perfectly rational, they certainly are rational in the sense that they respond to incentives and disincentives.⁷⁴

Secondly, because many managers and dealers are regular readers of the financial press, they are likely to be informed of criminal prosecutions and sanctions imposed on their colleagues and peers in the insider trading field. The communicative function of criminal law is therefore likely to enhance deterrence. Finally, and most importantly, criminal sanctions, in particular, imprisonment express a strong moral condemnation by the community. This condemnatory effect is very likely to enhance deterrence.

Furthermore, although the deterrent effect of criminal laws is partly dependent upon credible enforcement and the probability of sanctions being imposed on offenders and even if in a specific jurisdiction the probabilities of detection and conviction are quite modest, this does not disqualify the claimed effectiveness of criminal laws. As long as criminal sanctions do provide some sort of deterrent effect and do have some effect on individuals' rational decisions as to whether or not to comply with the law, we should principally have criminal sanctions as a matter of effectiveness. Criminal sanctions should not be abandoned because criminal sanctions both serve to reinforce our notion of morality and because the evidence suggests that criminal law has some deterrent effect.⁷⁵

Thus, it can be concluded that criminal laws are effective in enforcing insider dealing laws. The next issue to discuss is whether other alternative sanctions are equally effective in the enforcement of insider dealing regulations.

C Are there alternative sanctions which are equally as effective as imprisonment sanctions in the enforcement of insider dealing laws?

There are obviously, apart from imprisonment sanctions, several different types of sanctions that can be used to enforce insider trading laws. The examination here is, however, necessarily selective and the emphasis of the analysis is put on those individual sanctions that can be considered as the most appropriate alternatives to imprisonment sanctions.

⁷³ See Geis and Szockyj, (n 28) 283-284.

⁷⁴ See Paternoster, (n 18) 819.

⁷⁵ Ibid, 820.

It is appropriate to commence the discussion on alternative sanctions by restating the Commission's view on the issue. The Commission does make quite a controversial empirical claim in the Market Abuse Crimes proposal and argues that the adoption of administrative sanctions is generally insufficient for enforcing compliance with the rules on market abuse. The Commission's assumption is that criminal laws are a more effective deterrent than other sanctions.⁷⁶ In order to examine this claim, the most serious alternatives to criminal sanctions must be considered and examined in depth from an effectiveness perspective.

1. *Are civil liability regimes equally effective as imprisonment sanctions in deterring insider dealing activity?*

One of the most important sanctions to deter insider dealing is the use of civil penalties.

Several commentators suggest that civil litigation can be an appropriate alternative to criminal sanctions because of its powerful deterrent effect, because of its procedural advantages and because of the low enforcement costs associated with civil sanctions.⁷⁷ It is submitted by those commentators that the existence of civil remedies in the US against insider trading has proved an effective means of enforcement and an effective deterrent. This is because civil remedies provide economic incentives which encourage both companies and individuals to bring suits and may thus be used to enhance regulatory compliance. Civil litigation also has a deterrent effect because the threat of such litigation increases the risks of engaging in unlawful conduct.⁷⁸ It is contended in the literature that the civil suit imposing a penalty amounting to three times the gains made by the trader as well as an extremely high financial burden does certainly have a deterrent effect on prospective insider dealing offenders of insider trading. There is no benefit to be gained from the commission of insider dealing offences if the offender envisaged that he/she is likely to pay triple damages to the victims if detected and prosecuted.⁷⁹

It is further suggested by scholars that the use of civil penalties have advantages over criminal sanctions since civil procedural rules permit the enforcer to prosecute many more cases successfully than criminal safeguards would allow. This is the case because the cost of prosecuting criminal cases is higher than that of civil actions and because the lower burden of proof applicable in civil cases allows a greater number of successful prosecutions than the high standards of proof in criminal cases.⁸⁰

⁷⁶ See the Proposal, (n 3) 2; Margaret Cole Speech, (n 13).

⁷⁷ See Macrory, (n 48) 18-19.

⁷⁸ See eg Moohr, (n 22), 969; Eads, (n 47) 1483.

⁷⁹ See e.g. Mark A Spitz, 'Recent Developments in Insider Trading Laws and Problems of Enforcement in Great Britain' (1989) 12 Boston College International and Comparative Law Review 265, 290, 297; Silver, (n 35) 963; Moohr, (n 20) 969; Kadir and Muhamad, (n 22) 905; Eads, (n 47) 1483; Avgouleas, (n 34) 450.

⁸⁰ See eg Silver, (n35) 963; Macrory, (n 48), 18.

There is also some, although inconclusive, evidence that private civil litigation is a more effective regulatory mechanism for financial markets than public law enforcement. La Porta and others suggests that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter for the development of stock markets.⁸¹ Brown even submits that public enforcement may be less effective than private enforcement because of severe limitations on enforcement budgets entailing limited enforcement. Private enforcers have the potential to be very effective supplements or substitutes for public enforcement because they may have better resources or more substantial information about offenders' wrongdoing.⁸²

There are, however, three serious problems with a civil liability regime. Firstly, there is the problem of imposing civil liability claims against individuals because of their lack of resources or because of litigant's preference to sue firms, the deterrent effect of civil penalties may be diluted. Secondly, excessive litigation may impede the deterrence of civil liability regimes. Thirdly, civil penalties provide weak social stigma and this may dilute its deterrent effect.⁸³

Firstly, there is the problem of imposing civil liability claim against individuals. Private plaintiffs are significantly less likely to pursue actions against other individual whose limited wealth and insurance cover does yield a much smaller recovery. Since individuals committing insider dealing offences often are neither insured or sheltered from civil liability, or because investors prefer to sue the individual's employer which will have much 'deeper pockets' than the individual, a proliferation of civil remedies may not have a serious deterrent effect.⁸⁴

Secondly, the abuse of a system of civil liability for market abuse by fictitious claimants and their lawyers also seriously impede the effectiveness of civil liability regime. The threat of excessive litigation may impede beneficial corporate practices, distort business decisions, deter disclosure of important information, and deter valuable risk-taking or make qualified individuals unwilling to serve as directors. Furthermore, excessive litigation imposes substantial costs on the issuers of new securities in the form of excessive investment in 'due diligence'. This prejudices the improvement of the supply of securities in the market and leads firms to supply other, less efficient, forms of financing. The problem of excessive litigation is caused by the practice of placing enforcement discretion in the

⁸¹ See Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1, 19-20, 27-28.

⁸² See Darryl K Brown, 'The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement' (2004) 1 *Ohio State Journal of Criminal Law* 521, (2004), 538-39, 541. There is, however, conflicting evidence in the literature to the one presented by Brown and La Porta et alia, suggesting that the information collection and enforcement costs, necessary in preventing insider dealing offences, are so high and the ability of a regulatory body to obtain synergies over such functions so superior to that of private litigant that public enforcement presents distinct advantages over a purely private system of enforcement (See Jordan, (n 69), 1086, 1088; Avgouleas, (n 34), 458-459). Limited resources seriously reduce the ability of private plaintiffs to gather evidence against dishonest managers without the firms' cooperation. As a result, civil liability has a limited reach in deterring insider dealing frauds (See Urska Velikonja, 'Leverage, Sanctions, and Deterrence of Accounting Fraud' (2011) 44 *University of California Davis Law Review* 1281, 1313-15).

⁸³ See Wouter PJ Wils, 'Is Criminalization of EU Competition Law the Answer?' in Katalin J Cseres and others(eds), *Remedies and Sanctions in Competition Policy: Economic and Legal Implications of the Tendency to Criminalize Antitrust Enforcement in the EU Member States* (Edward Elgar 2005), 84, 87; Avgouleas, (n 34) 454; See Impact Assessment SEC(2010)1496, (n 63) 18- 19.

⁸⁴ See Avgouleas, (n 34) 469; Adam C Pritchard, 'Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers' (1999) 85 *Virginia Law Review* 925, 959.

hands of revenue-maximizing plaintiffs' attorneys. Plaintiffs' attorneys' willingness to sacrifice deterrence for revenue is reflected in customary settlement practices through which liability is shifted from the wrongdoing manager to the corporation. Private enforcement may achieve limited deterrence because its costs fall on innocent shareholders, not the culpable corporate officers actually responsible for financial misstatements and other misdeeds. In all, these risks seriously damage the effectiveness of civil remedies.⁸⁵

Thirdly, while civil actions can substitute for criminal enforcement when goals are utilitarian ones of deterrence they are much less effective at fulfilling criminal law's retributive role of imposing just deserts or expressive roles of public condemnation.⁸⁶ The criminal law can be more directly effective than civil liability sanctions in increasing compliance with its commands. Since the criminal law earns a reputation as a reliable statement of what the community perceives as condemnable and not condemnable, people are more likely to defer to its commands as morally authoritative. Civil damages fail to express moral condemnation relative to criminal liability. Civil liability seems to connote that society is 'pricing' corporate crime.⁸⁷

In sum, because of individual offenders' lack of resources and plaintiff's perverse incentives to engage in excessive litigation and because of civil liability's lacking condemnatory nature it appears that civil liability regimes cannot be an equally effective sanction as criminal sanctions in the enforcement of insider dealing regulations. The article continues to examine the effectiveness of administrative fines.

2. *Are individual fines equally effective as imprisonment sanctions in the enforcement of insider dealing laws?*

Fines are generally the most commonly advocated sanction to be used as an alternative to imprisonment.⁸⁸ The general advantages of fines are manifold. One advantage of a fine is that it is a relatively cost-free sanction to administer.⁸⁹ The rational choice theory does also support the use of monetary sanctions. Where corporate crimes are driven by financial gain, a potential offenders can directly compare the profit which they expect to make from violating the law with the loss which they can expect to incur if their offence is discovered and they are prosecuted, convicted and fined. Thus, to the extent that an individual is a rational actor he/she should be responsive to financial

⁸⁵ See Avgouleas, (n 34), at p. 473; Coffee, 'Law and the Market' (n 63) 74.

⁸⁶ See Brown, (n 82) 541.

⁸⁷ See Paul H Robinson, 'The Criminal-Civil Distinction and the Utility of Desert' (1996) 76 Boston University Law Review 201, 212-13; Dan M Kahan, 'Social Meaning and the Economic Analysis of Crime' (1998) 27 Journal of Legal Studies 609, 619; Hristova, (n 34) 302.

⁸⁸ See e.g. Kahan, 'What do alternative sanctions mean?' (n 47), 650; Ivancevich and others, (n 43) 406.

⁸⁹ See Gobert and Punch, (n 35) 221.

penalties.⁹⁰ Thus, on the condition that “optimal sanctions” are imposed, fines should work as a deterrent.⁹¹

Posner argues that fines should be preferred over imprisonment since, in a cost-benefit analysis of the choice between fining and imprisoning the white-collar criminal, the cost side of the analysis always favours fining because the cost of collecting a fine from one who can pay is lower than the cost of imprisonment. On the benefit side, there is no difference in principle between the sanctions. The fine for a white-collar crime can be set at whatever level and since it arguably imposes the same disincentive as imprisonment on the defendant it achieve the same level of deterrence as the potential imprisonment sentence. Thus, whereas fines are comparably a more cost-effective sanction than imprisonment and no less deterring than imprisonment, society should thus impose fines rather than imprisonment whenever feasible.⁹²

Hinton and Patton note, consistent with Posner’s view, that there is a coherent economic justification for imposing ‘optimal fines’ which are proportionate to the social costs of the misconduct.⁹³ They cautiously suggest that the imposition of increased fines by the FSA may have had a small deterrent effect on the basis of reduced abnormal pre-announcement price movements. This is because the level of such potentially suspicious trading activity prior to initial public offerings declined in 2010/11 subsequent to the increase of penalties by the FSA.⁹⁴

There are however several arguments against the use of fines as a sanction for violations of insider dealing regulations. Firstly, regulators do not generally have the formal powers to impose optimal penalties nor do they impose optimal penalties when they have such powers. Secondly, fines may not have an appreciable deterrent effect for directors and managers that are able to hide or transfer their wealth. Thirdly, criminal laws have a greater deterrent effect than fines because of their stigmatic and expressive nature.⁹⁵ Fourthly, the optimal deterrence argument, used to defend optimal fines, may lead to markedly unfair consequences in terms of social stigma.

Firstly, monetary fines are unlikely to be a serious deterrent since the maximum available fines are rarely imposed. The power to impose a fine equivalent to double or triple the profits from the offence is according to Geis’ and Szockyj’s survey not exercised frequently.⁹⁶ The imposed fines are

⁹⁰ Ibid, 223.

⁹¹ See eg Langenvoort, (n 61) 653; See Impact Assessment SEC 2011/1217, (n 12) 123; See Ivancevich and others, (n 43) 406.

⁹² See eg Richard Posner, ‘Optimal Sentences for White-Collar Criminals’ (1980) 17 American Criminal Law Review 409, 410; Kahan, ‘What do alternative sanctions mean?’ (n 47), 619, 650.

⁹³ See Paul Hinton and Robert Patton, ‘Trends in Regulatory Enforcement in UK Financial Markets’, Fiscal Year 2011/12, Nera Consulting, at p. 30. <http://www.securitieslitigationtrends.com/PUB_FSA_Trends_A4_0612.pdf>. Accessed 4 September 2013

⁹⁴ See Paul Hinton and Robert Patton, ‘Trends in Regulatory Enforcement in UK Financial Markets’, Fiscal Year 2010/2011, Nera Consulting Paper, at p. 26. <http://www.securitieslitigationtrends.com/PUB_FSA_Trends_A4_0711.pdf>. Accessed 4 September 2013.

⁹⁵ See Roman Tomasic and Brendan Pentony, *Casino capitalism? Insider trading in Australia*, Chapter 9, (Canberra: Australian Institute of Criminology, 1991). <<http://www.aic.gov.au/publications/previous%20series/lcj/1-20/casino/chapter%209.html>>. Accessed 4 September 2013.

⁹⁶ Only 9.9 per cent of the examined convictions were imposed a fine amounting to such a magnitude (Geis and Szockyj, (n 28) 282).

sometimes even less than the profit. Because of the fact that optimal fines are seldom imposed, fines do not have the capacity to work as serious deterrents.⁹⁷

Secondly, white-collar offenders may have an advantage since they often know how to hide assets, divert income, overstate expenses, or otherwise reduce the amount of the fine. Spagnolo contends, discussing sanctions for cheating bankers, that dishonest bankers are often specialists in transferring and hiding money and will likely react to large individual fines by transferring or hiding their wealth.⁹⁸

Thirdly, it is unclear whether the imposition of fines expresses sufficient social censure to be deterrent. Kahan notes that the optimal deterrence argument for fines has not worked in practice because fines do not unequivocally express sufficient moral condemnation. When used as an alternative to imprisonment, fines often convey the normative message that society is willing to accept the offender's behaviour.⁹⁹ To be effective sanctions fines have to channel public reproach as effectively and forcibly as incarceration. What makes fines unacceptable, when viewed as just a cost of doing business, is that they fail to impose the censure that the offender deserves. By viewing fines as mere prices for committing an offence, the seriousness of the offence is belittled and it defiles the victims of the crime. Fines have a social meaning that is sufficiently concrete, sufficiently widespread, and sufficiently at odds with serious moral denunciation, to rule them out as a serious alternative to imprisonment.¹⁰⁰

Fourthly, the optimal deterrence argument is utterly unfair. Proponents of the optimal deterrence argument has contended that fines should be reserved mainly for white-collar offences, since those are the offences most likely to be committed by wealthy individuals and that non-affluent offenders should be imprisoned. However, it appears perverse and contrary to principles of equality and justice to impose prison terms only on the basis of limited affluence. In addition, even if the white-collar offender who is fined suffers as much as the common offender who is imprisoned, which is unlikely, the white-collar offender is clearly not being reproached to the same extent as the common offender.¹⁰¹ This is once again because only imprisonment does express sufficient condemnation against the background of social norms.¹⁰²

In sum, it appears that the arguments supporting the assumption that 'imprisonment' is more effective and appropriate than fines weighs more than the argument supporting the contrasting hypothesis. Fines are ineffective because offenders cannot always be fined at a level sufficient to achieve deterrence, due to the offenders' lack of wealth, because white-collar offenders regularly can transfer or hide their

⁹⁷ For 1/5 of the defendants in the survey, the fine was less than the profit that had been realized (Geis and Szockyj, (n 28) 282); See also Wheeler and others, (n 49) 496-98; See McDermott, (n 38) 614-615.

⁹⁸ See Kadir and Muhamad, (n 22) 904; See Giancarlo Spagnolo, 'Saving the banks, but not reckless bankers', VOX, 13 August 2012. <http://www.voxeu.org/article/criminal-sanctions-how-save-banks-without-rewarding-bankers>. Accessed 4 September 2013. See also Elizabeth Szockyj, 'Imprisoning White-Collar Criminals' (1999) 23 Southern Illinois University Law Journal 485, 499.

⁹⁹ See Kahan, 'What do alternative sanctions mean?' (n 47) 593, 650.

¹⁰⁰ See eg Tadros, (n 9) 165; Kahan, 'What do alternative sanctions mean?' (n 47) 620; See Hristova, (n 34) 302.

¹⁰¹ See Wheeler and others, (n 49) 499-500; Szockyj, (n 98) 499.

¹⁰² See Kahan, 'What do alternative sanctions mean?' (n 47) 621-622.

wealth and because imprisonment, is capable of expressing greater social disapproval than fines. Additionally the optimal deterrence theory, which argued that fines can be used instead of imprisonment in cases where the offender is not affluent, led to perverse results thus making it more appropriate, as a matter of policy and philosophy, to employ imprisonment indiscriminately for serious offences.¹⁰³

3. *Are disqualification orders equally effective as imprisonment sanctions in the enforcement of insider dealing regulations?*

Another severe alternative to imprisonment is the disqualification order. A disqualification order prohibits a person from serving as a company director or otherwise taking part in the management of companies. Disqualification orders normally serve both a preventative purpose and a punitive purpose. While the purpose of disqualification of directors in the UK and Canada is not so much to punish directors for past conduct but intends to protect the public from the activities of ‘unfit’ directors and maintain the integrity of the business environment, the US disqualification order has a primarily punitive purpose.¹⁰⁴ In all these jurisdictions, the ‘disqualification’ order is assumed, however, also to have a deterrent function. The imposition of disqualification orders is designed to deter undesirable conduct by acting as a general deterrent to potential offenders within the business community.¹⁰⁵ How then, do disqualification orders achieve deterrence?

Firstly, disqualification orders have the potential to be seriously burdensome given that they significantly interfere with the livelihood of a director.¹⁰⁶ Because it impairs the defendant’s future employment opportunities, it also serves as a monetary penalty for those defendants who have no ability to pay a substantial fine.¹⁰⁷ Secondly, disqualification orders also arguably express social stigma and may lead to a tarnished reputation. If it becomes known that a director has seriously breached the law or committed a criminal offence, it is likely that they will suffer a loss of reputation which ultimately may lead to a consequent inability to obtain jobs as director in the future.¹⁰⁸ Disqualification

¹⁰³ See Kadir and Muhamad, (n 22) 906.

¹⁰⁴ See e.g. Caroline Bradley, ‘Enterprise and Entrepreneurship: the Impact of Director Disqualification’ (2001) 1 Journal of Corporate Law Studies 53, 65, 67; Jassmine Girgis, ‘Corporate Directors’ Disqualification: The New Canadian Regime?’ (2009) 46 Alberta Law Review 677, 684-85, 704; Richard Williams, ‘Disqualifying Directors: A remedy Worse than the Disease?’ (2007) 7 Journal of Corporate Law Studies 213, 219-220; John C Coffee Jr, ‘Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions’ (1980) 17 American Criminal Law Review 419, 446.

¹⁰⁵ See National Audit Office, ‘Insolvency Service Executive Agency, Company Director Disqualification A Follow-up Report’ (House of Commons Papers, Session 1998- 1999, 424), 37-40; Bradley, (n 104) 66.

¹⁰⁶ See Girgis, (n 104) 685-86, 694, 712; Jayne W Barnard, ‘When is a Corporate Executive “Substantially Unfit to Serve”?’ (1992) 70 North Carolina Law Review 1489, 1494-95, 1522; Gobert and Punch, (n 38) 222-223, 273; See Jaap W Winter, Jan Schans Christensen, José M Garrido Garcia, Klaus J Hopt, Jonathan Rickford, Guido Rossi and Joelle Simon ‘Report of the High Level Group of Company law Experts on a Modern Regulatory Framework for Company Law in Europe’ Brussels, 4 November 2002, 70.

<http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf>. Accessed 4 September 2013. The Commission has suggested in their new Market Abuse Regulation that there should be temporary disqualification orders natural persons, who are held responsible for exercising functions in investment firms, in the event that they infringe the EU insider dealing rules. See Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM (2011) 651 final, Art 26 (h).

¹⁰⁷ See Szczokaj, (n 98) 500; McDermott, (n 38) 615-616.

¹⁰⁸ See Gobert and Punch, (n 38) 278; McDermott, (n 38) 620-21; Baldwin, (n14) 362, 367.

orders may serve, as the UK disqualification order does, deterrence by providing public shaming system and public registers of disqualified directors.¹⁰⁹

There are however concerns with disqualification orders relating to its effectiveness. Firstly, it is unclear whether they have any deterrent effect.¹¹⁰ Disqualification order does simply not catch all insider dealers. The denomination of the sanction, ‘director disqualification’ plainly suggests that they cannot be used against non-directors involved in criminal activity.¹¹¹ The UK disqualification order has a very narrow scope since it only captures directors of companies that enter into formal insolvency proceedings.¹¹² Disqualification orders in the US do not capture all insider dealers since a large number of insider trading offenders are traders in the securities business who do not have a directorial or management position. Geis and Szockyj found that defendants from the securities field, where confidential information was potentially available to a wider range of individuals, were more likely to have a lower status position. More than 84 % of the criminal defendants did not enjoy a managerial position and could therefore not have been subject to disqualification sanctions.¹¹³

Secondly, although disqualification orders should in theory prevent ex-directors from becoming a *de facto* or shadow director, practice seem to suggest that this is not always the case. The effectiveness of disqualification orders is further weakened by the fact that the order does not preclude a convicted director from serving as a paid consultant, joining a partnership or working as an ordinary employee or having a spouse replacing the convicted director in the board. Convicted director and officers may in comparison, to doctors or lawyers that are disqualified from their profession, put their experience in profitable use.¹¹⁴

Nevertheless, although there may be some drawbacks with this sanction, the disqualification order cannot be rejected on principal grounds as an ineffective sanction. Firstly, it is quite obvious that the disqualification order does resemble the imprisonment sanction if it is properly designed. In the US, it appears that the disqualification sanction has a punitive purpose and that directors are seriously threatened by the sanction. It also seems that disqualification orders provide a stain on the executive’s reputation and communicate to the public that the director in question has done something morally reprehensible.¹¹⁵ Insider traders are enthusiastic readers of the professional trade and broadsheet press

¹⁰⁹ See, Girgis, (n 104) 685, 693-94; Williams, (n 104) 219-220.

¹¹⁰ It must be recognised that this seems to be a particular problem with the UK disqualification order thus making it difficult to draw any generalized conclusions on the effectiveness of disqualification orders. The argument in the UK context goes as follows. The claim is that directors do consider that the probability of being subject to a disqualification orders is a remote possibility in their day-to-day activities of directors, given the low rate of detection and conviction for disqualification orders. Given the low probability of detection and conviction, a rational calculation would support the choice of non-compliance. Even if there is a high level of infringement of disqualification orders there is still perceived to be a low risk of offenders being apprehended. This suggests that the achievement of ever-higher numbers of disqualifications is unable the claimed policy goal of removing rogue directors. The deterrent effect of UK disqualification orders is thus limited since it does not deter ‘unfit’ conduct (See Williams, (n 104) 235-236.)

¹¹¹ See Peter Whelan, ‘A Principled Argument for Personal Criminal Sanctions as Punishment Under EC Cartel Law’ (2007) 4 Competition Law Review 7, 37.

¹¹² See Williams, (n 104) 234.

¹¹³ See Geis and Szockyj, (n 28) 280, Table 2.

¹¹⁴ See Gobert and Punch, (n 38) 279.

¹¹⁵ See footnote 108 for references.

so they can be expected to be aware of any formal sanctions imposed on their peers.¹¹⁶ Those who investigate insider dealing offences can also use the weapon of media publicity to put an end to their profit.¹¹⁷

If designed to catch both middle managers and corporate executives, if applicable more generally to violations of company rules, financial regulation, competition law infringements and the commission of other regulatory offences such as environmental law and health and safety offences and if it is imposed more stringently to enhance its deterrence, it is likely to constitute an effective sanction. However, there is a cogent argument that probably defeats the disqualification order in its comparison with imprisonment. Even if Kahan does not particularly discuss the ‘expressive’ function of disqualification orders, it can be plausibly argued that disqualification orders do not carry the same social stigma as imprisonment sanctions.¹¹⁸ Because of the value attached to liberty in contemporary society, imprisonment does arguably convey stronger denunciation of wrongdoers than disqualification orders. Consequently, the deterrent effect of the moral consequences of criminal behaviours will therefore in the case of disqualification orders not be as strong as it would have been in the case of imprisonment.¹¹⁹

If however a disqualification order were to be used as an alternative to imprisonment and be combined with a small term of imprisonment it would convey a different meaning and conceivably achieve a deterrent effect equivalent to that of imprisonment.¹²⁰ This is the argument made by McDermott. Disqualification, used in conjunction with a short prison term in egregious cases, or as part of a suspended sentence with probation, provides an alternative to lengthy imprisonment.¹²¹ Nevertheless, given that the core question of the article is about making a choice between ‘disqualification’ and ‘imprisonment’, it seems probable that ‘disqualification’ would not provide an equally effective deterrent as ‘imprisonment’. It is not plausible that the community or general public in any jurisdiction would consider ‘disqualification’ as condemnatory in nature as they consider imprisonment sanctions.¹²² Unless disqualification orders are linked to the commission of a criminal offence or unless they are combined with probation or conditional prison sentences they fail to express serious moral condemnation. Furthermore, suggesting that disqualification orders must be combined with conditional sentences or imprisonment logically entails the proposition that ‘disqualification orders’ *per se* does not communicate sufficient social censure. It is more likely that the threat of a prison term

¹¹⁶ See Levi, (n 31) 149.

¹¹⁷ See Michael Levi, ‘White-collar, organised and cyber crimes in the media: some contrasts and similarities’ (2008) 49 *Crime, Law and Social Change* 365, 367-372.

¹¹⁸ See Kahan’s argument, (n 47) 599, 603, 617, 621.

¹¹⁹ See e.g. Whelan, (n 111) 37; Wils, (n 83) 86-87.

¹²⁰ See McDermott, (n 38) 615-617, 620-621.

¹²¹ *Ibid*, 641.

¹²² See Gobert and Punch, (n 38) 273, 275, 279.

carrying a strong social stigma and depriving the corporate official of his or her liberty is a stronger deterrent than disqualification.¹²³

In sum, given that disqualification orders do not catch all security employees engaged in insider dealing, given that disqualification orders has a limited effect on the director's livelihood and given that the expressive dimension of criminal law makes it a slightly more deterrent sanction than disqualification orders, we can conclude that criminal sanctions are more effective than disqualification orders.

D Conclusions

The purpose of this article was to consider whether it is 'essential' to employ imprisonment sanctions to ensure the effective implementation of insider dealing laws. The first part of the article considered whether criminal laws and imprisonment sanctions are effective for the effective enforcement of insider dealing laws. It was found that imprisonment sanctions are effective for three reasons. Firstly, it appears that the assumption of the rational actor model seems to be accurate in the context of insider dealing offences. The fact that insider dealing is profit driven, because the offenders often are in a high and established positions in society and because insider dealers are risk averse, it is likely that the rational choice theory has some explanatory value. It is argued that insider dealing offenders do generally engage in a rational calculation of whether to engage in insider dealing. This is because insider dealers face serious risks in terms of tarnished reputation, lost job opportunities and humiliation by being subjected to criminal punishment. It thus appears, because of the social status of the offenders, that the risk of criminal sanctions being imposed is likely to be taken seriously by potential perpetrators of insider dealing rules. Although the deterrent effect is partly dependent on credible enforcement and the probability of sanctions being imposed on offenders, the overwhelming evidence in the literature points to the conclusion that criminal laws have a certain effect in deterring insider dealing. Secondly, the communicative function of criminal laws contributes to its effectiveness. Since insider dealing offences are regularly reported by the media and managers and dealers are regular readers of the financial press, they are likely to be informed about criminal prosecutions and sanctions imposed on their peers in the field of insider dealing. Thirdly, criminal sanctions, in particular, imprisonment, express a strong moral condemnation by the community, which enhance its effectiveness.

The second part of the article considered alternative sanctions. In terms of alternative sanctions, the paper considered three serious alternatives to criminal sanctions: civil liability, fines and disqualification orders. The general argument in the article for the superiority of imprisonment

¹²³ See e.g. Wouter PJ Wils, *The Optimal Enforcement of EC Antitrust law*, (Kluwer Law International 2002), 222; Gobert and Punch, (n 38) 279.

sanctions was based on the expressive dimension of imprisonment sanctions and their inherent social meaning. The failure of alternative sanctions such as civil liability, fines and disqualification orders to replace imprisonment stems from the fact that these sanctions do not express sufficiently strong moral condemnation. Independently of whether fines, disqualification orders and civil liability sanctions can inflict suffering, their effectiveness as punishments is questionable based on their ambivalent expressive effects. In terms of specific problems with different sanctions, there are additional reasons why alternative sanctions would not be as effective as criminal sanctions. Although most of the alternative sanctions would be more efficient in terms of reduced enforcement costs and in terms of higher rates of conviction because of reduced evidentiary rules and procedural standards, those benefits does not exceed the ‘effectiveness’ disadvantages. In addition to lack of censure, civil liability was considered less effective than imprisonment sanctions in the enforcement of insider dealing regulations because of individual offenders’ lack of resources and because of plaintiff’s perverse incentives to engage in excessive litigation. The examination went on to assess the effectiveness of individual administrative fines. Imprisonment, in addition to expressing greater social disapproval, is superior to fines. In addition to expressing less social disapproval as imprisonment sanctions, fines are less effective than prison sanctions, because offenders cannot always be fined at a level sufficient to achieve deterrence, due to the offenders’ lack of wealth and because white-collar offenders regularly can transfer or hide their wealth and because the optimal deterrence theory, which argues that fines can be used instead of imprisonment in cases where the offender is not affluent, leads to perverse results thus making it more appropriate, to employ imprisonment for insider dealing offences. In terms of disqualification orders the problem of diluted denunciation is not as strong as in the case of other sanctions. However, the effectiveness of the disqualification order is not as appreciable as the effectiveness of criminal sanctions because of the generally weaker deterrent effect of disqualification orders and because disqualification orders do not catch all security employees engaged in insider dealing. In light of these reasons, it was concluded that imprisonment sanctions are more effective than disqualification orders.

ⁱ PhD Researcher at the European University Institute, Florence. E-mail: Jacob.Oberg@EUI.eu. Postal address: Villa Schifanoia, Via Boccaccio 121, I-501 33 Firenze/Italy. Special thanks to Professor Giorgio Monti, EUI, for his support and constructive comments. I would also like to specifically thank the anonymous reviewer for his/her fruitful comments on the manuscript. I would also like to thank Professor Elis Ferran, University of Cambridge, for her nice support in the drafting process.