Chapter 7

Foreign Regulations on Insider Trading

7.1 Introduction

In order to understand the problem of insider trading in general and with reference to India in particular, we have studied the core definitions of different related terminologies and concerned theories of insider trading in Chapter -2. In order to understand the ways and means of insider trading in India not only we have done case studies in Chapter-3, but also have made of identical problems in the advanced capital markets like the USA, the UK and Australia in chapter-4. Transparency, depth, resilience, efficiency and liquidity of those securities markets are remarkable in terms of turnover, global participation and their impact on economic development. These securities markets are regulated by their respective securities law, exchange law and state law. Although our primary objective was to study insider trading regulations in India, we have now taken a venture in this chapter to cross examine insider trading regulatory practices of those foreign countries.

The objective of this chapter is to study insider trading regulations of the USA, the UK and Australia. The USA is chosen as the first country to be studied because the securities market in this country is considered to be among the best regulated and fairest securities markets in the world. The US market model has been emulated in a large number of developed and developing countries like India, China, Pakistan and others. The main goal of the US securities market regulators has always been to fair, orderly and open stock market. The second country to study in the process is the UK. Like those in the USA, the stock market regulators in the UK have also a very long experience in regulating stock markets. Although the insider trading regulatory practices in the UK have features, which are similar
in many respects to those in the USA, there exist certain areas like market confidence, public awareness, protection of consumers and reduction of financial crime where the UK stock market regulators have some unique experiences, which are worthy of special attention. The study of UK insider trading regulatory practices is particularly relevant in India in view of the fact that the prevailing Indian financial market regulatory system owes much of its origin in English legislations. Australian insider trading regulations is studied for a very different reason. Australia has good network of stock exchanges, strong surveillance mechanism and stringent regulations.

In view of the above, this chapter has been arranged in 6 sections. Section - 7.2 offers enactment of insider trading regulations -a global perspective. Section-7.3 discusses insider trading regulations of the United States of America (USA). Insider trading regulation of United Kingdom (UK) is discussed in Section 7.4. Insider trading regulation of Australia is dealt in Section 7.5. A comparative study of insider trading regulation of USA, UK and Australia are dealt in Section 7.6. Section- 7.7 concludes the chapter.

7.2 Enactment of insider trading regulations —a global perspective

The regulation of insider trading in India is relatively of recent origin. However, it was established much earlier in foreign countries. The United States (US) was the first major country not only to enact insider trading regulation but also to put restrictions on it. The roots of the US insider trading laws have been developed from the securities legislation that was enacted in 1934 to prohibit other kinds of stock manipulation¹. France was the second country to enact an insider trading law, but France did not place prohibitions on insider trading until 1967. The UK, Australia Japan and Korea have adopted insider trading laws along the US model. As of 1990, only 34 countries had laws restricting or prohibiting
insider trading and only 9 of them had prosecuted any one for insider trading. By 2000, 87 countries had passed insider trading laws and 38 had prosecuted, at least one insider trading cases\(^2\). On November 13, 1989, the Council of the European Communities (EC) adopted the Directive that coordinates regulations of insider trading\(^3\). Prior to the adoption of the Directive, member states were free to regulate insider trading. Some countries treated insider trading as a criminal offence while others had voluntary codes of conduct or no specific regulations at all.

The Global Competitiveness Survey of 50 countries \(^4\) suggested that the United States has arguably the most stringent regulations relating to insider trading. The survey team also observed that insider trading tends to be illegal and it is difficult to measure it directly. One must use perception to estimate the degree of insider trading. Their study clearly shows a positive association between the degree of insider trading and the degree of market volatility.

Exhibit 7.1 shows the year in which insider trading regulations where first adopted by the stock exchanges of selected countries and the year in which violations of insider trading rules were first prosecuted.

**Exhibit 7.1: Enactment of Insider Trading Restrictions in Selected Countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Year of Establishment of the First Stock Exchange</th>
<th>Year of Insider Trading law enacted</th>
<th>Year of First Enforcement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>1859</td>
<td>1991</td>
<td>1996</td>
</tr>
<tr>
<td>China</td>
<td>1990</td>
<td>1993</td>
<td>No</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1891</td>
<td>1991</td>
<td>1994</td>
</tr>
<tr>
<td>India</td>
<td>1875</td>
<td>1992</td>
<td>1998</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1912</td>
<td>1991</td>
<td>1996</td>
</tr>
<tr>
<td>Iran</td>
<td>1966</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
From the above exhibit it has found that the first insider trading regulations enacted by the USA in the year 1934 and prosecution enforced in 1961. Whereas in UK, first stock exchange was established in 1773 but insider trading regulations was first introduced in 1980. Insider trading regulations had been introduced in most of the other securities markets during the last decade. In most of the cases prosecutions have also been enforced for those violating the rules.

Bhattacharyya and Daouk (2002) also found that out of 103 countries that have securities market, 87 countries have introduced insider trading regulations. The median year of enforcement of all 103 countries insider trading regulation is 176.
1991. For developed countries, the median year is 1989 and for emerging markets it is 1992. Today 100% of developed countries and 80% of emerging countries have insider trading regulations. Percentage of prosecution in insider trading cases among developed countries is 82% whereas the same is 25% in case of emerging markets.

Beny (2005, 2006) has studied insider trading regulations of 33 countries. Her study was based on five fundamental considerations viz., (i) violation of the insider trading is a criminal offence; (ii) individuals who receive information from insiders are prohibited from trading on material non-public information; (iii) insiders are prohibited from tipping outsiders about material non-public information and or/ encouraging them to trade on such information for personal gain; (iv) monetary penalties are proportional to profit arising out of insiders' trading and (v) investors have a private right of action. Compliance of one parameter indicates one point. Exhibit 7.2 shows the ranking of the countries between one to five scales.

Exhibit 7.2: Classification of 33 countries on the basis of variations in Stringency of insider trading laws

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Country</th>
<th>Score</th>
<th>Sl. No.</th>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Mexico</td>
<td>1</td>
<td>18</td>
<td>Luxemburg</td>
<td>3</td>
</tr>
<tr>
<td>2</td>
<td>Norway</td>
<td>1</td>
<td>19</td>
<td>Malaysia</td>
<td>3</td>
</tr>
<tr>
<td>3</td>
<td>Russia</td>
<td>1</td>
<td>20</td>
<td>Netherlands</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Austria</td>
<td>2</td>
<td>21</td>
<td>South Africa</td>
<td>3</td>
</tr>
<tr>
<td>5</td>
<td>China</td>
<td>2</td>
<td>22</td>
<td>Sweden</td>
<td>3</td>
</tr>
<tr>
<td>6</td>
<td>Greece</td>
<td>2</td>
<td>23</td>
<td>Switzerland</td>
<td>3</td>
</tr>
<tr>
<td>7</td>
<td>India</td>
<td>2</td>
<td>24</td>
<td>Thailand</td>
<td>3</td>
</tr>
<tr>
<td>8</td>
<td>Indonesia</td>
<td>2</td>
<td>25</td>
<td>UK</td>
<td>3</td>
</tr>
<tr>
<td>9</td>
<td>Japan</td>
<td>2</td>
<td>26</td>
<td>Australia</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Country</td>
<td>Score</td>
<td>Rank</td>
<td>Country</td>
<td>Score</td>
</tr>
<tr>
<td>---</td>
<td>--------------</td>
<td>-------</td>
<td>------</td>
<td>-------------</td>
<td>-------</td>
</tr>
<tr>
<td>10</td>
<td>Philippines</td>
<td>2</td>
<td>27</td>
<td>Portugal</td>
<td>4</td>
</tr>
<tr>
<td>11</td>
<td>Belgium</td>
<td>3</td>
<td>28</td>
<td>Singapore</td>
<td>4</td>
</tr>
<tr>
<td>12</td>
<td>Brazil</td>
<td>3</td>
<td>29</td>
<td>Taiwan</td>
<td>4</td>
</tr>
<tr>
<td>13</td>
<td>Denmark</td>
<td>3</td>
<td>30</td>
<td>Canada</td>
<td>5</td>
</tr>
<tr>
<td>14</td>
<td>Finland</td>
<td>3</td>
<td>31</td>
<td>Ireland</td>
<td>5</td>
</tr>
<tr>
<td>15</td>
<td>Germany</td>
<td>3</td>
<td>32</td>
<td>South Korea</td>
<td>5</td>
</tr>
<tr>
<td>16</td>
<td>Hong Kong</td>
<td>3</td>
<td>33</td>
<td>USA</td>
<td>5</td>
</tr>
<tr>
<td>17</td>
<td>Italy</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It has been found from the above exhibit that Mexico, Norway, Russia have relatively lax insider trading laws scoring 1, whereas India and China fall under the same category scoring 2 and Canada, Ireland, and South Korea, the United States have strict regulations scoring 5.

The issue of insider trading regulation continues to attract a considerable amount of attention for economists, legal academics, the media, the stock
exchanges and government agencies around the world. Insider trading regulations have also been introduced by most of the securities markets during the last decade. The regulations have also been enforced with the prosecution of those violating rules.

7.3 Insider trading regulation in the USA

The US securities markets ranks first not only in the context of financial innovation but also in having tough most stock market regulations in the world. Before 1933 the securities markets of the USA were mostly regulated by their self regulations and by state criminal and civil laws. The statutes of New York and the verdicts of several court cases of that state related to the securities market were particularly important because the leading stock exchanges in US are located there. Control of such markets was not considered within the jurisdictions of the US government.

The Senate Committee on Banking and Currency was appointed to investigate the collapse of the US securities markets during the debacle of 1929 and found considerable evidence that corporate insiders and members of the securities industry were engaged in 'sure-thing speculation' or insider trading. The Committee had two purposes: (i) to uncover real or alleged flaws and irregularities in economic system and (ii) to build up a strong political support by extensive publicity for the forthcoming legislation that was to follow the investigation. The Committee met many of the most powerful figures in Wall Street such as bank presidents, exchange officials and prominent brokers, investment bankers and utility executives. Many irregularities, unethical practices and often cases of outright fraud were uncovered by the inquiry, which was highly publicised by the press. It was found in a survey published in the New York Times that 90 percent insiders thought that short-swing speculation in their issuers’ securities was legitimate.
Afterwards four federal laws were developed from the investigation in USA, the Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935. Thereafter, a new and powerful federal agency, the Securities and Exchange Commission (SEC) was established to enforce the Act.

In order to understand the depth of the US securities markets, a regulatory structure of the principal securities markets in USA is shown in Exhibit 7.3\(^{15}\).

**Exhibit 7.3: Structure of regulation of the principal securities markets**

<table>
<thead>
<tr>
<th>Market</th>
<th>Self Regulation</th>
<th>Government Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>US and agency securities</td>
<td>None</td>
<td>Treasury, the Federal Reserve Bank, Securities Exchange Commission</td>
</tr>
<tr>
<td>Money market</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Mortgage-backed securities</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Corporate stocks and bonds</td>
<td>NYSE and other stock exchanges, NASD</td>
<td>SEC, the Fed (margin requirements)</td>
</tr>
<tr>
<td>Municipal securities</td>
<td>Municipal securities Rule-Making Board</td>
<td>None</td>
</tr>
<tr>
<td>Financial Futures</td>
<td>National Futures Association</td>
<td>Commodity Futures Trading Commission(CFTC)</td>
</tr>
<tr>
<td>Financial Options</td>
<td>Options Clearing Corporation</td>
<td>SEC (futures options Regulated by CFTC)</td>
</tr>
</tbody>
</table>

From exhibit 7.3 it becomes clear that the US stock market is mainly regulated by the SEC, while the market for stock index futures is regulated by the CFTC. The division of jurisdiction between the SEC and the CFTC were agreed in
1981. The SEC regulates options on futures. After the crash of 1987, there were calls to unify the regulation of these markets, but nothing has happened yet. Wholesale markets with few small investors, like the money market and the market-based securities, largely escape regulation. The market for municipal securities is not regulated by the federal government because of federal issues. The United States has been considered as the leading country in prohibiting the illegal insider trading.

7.3.1 Securities Exchange Act and prohibition of insider trading

There is no statutory definition of insider trading in the US securities laws\textsuperscript{16}. However, the prohibition of insider trading has been developed through the implementation of statutes and regulatory rules as well as common law interpretation\textsuperscript{17}. Before 1933 there was no insider trading regulations in the USA. After the enactment of the Securities Exchange Act, 1934, some provisions have been addressed to protect fraudulent trade practices and insider trading. Important provisions of insider trading regulations in the USA have been shown in Exhibit 7.4.

\textbf{Exhibit 7.4 Summary of the securities laws and regulations regarding insider trading in the USA}

<table>
<thead>
<tr>
<th>Section/ Rule/Act</th>
<th>Detailed Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 10 (b) and Rule 10b-5</td>
<td>Prohibits fraud, misstatements or omissions of material facts in connection with the purchase or sale of any security.</td>
</tr>
<tr>
<td>Section 13(d)</td>
<td>Provides early warning to target firms of acquisitions of their stock by potential acquirers: 5% threshold, 10-day filing period. Applies to all large stock acquisitions</td>
</tr>
<tr>
<td>Section 14(d)(1)</td>
<td>Requirements of Section 13(d) were extended to all public tender offers. It provides for full disclosure to SEC by any</td>
</tr>
</tbody>
</table>
From exhibit 7.4 it has been observed that section 10(b) and 16(b) of the Securities Exchange Act, 1934 (SEA) addressed fraudulent trade practice including insider trading issues either directly or indirectly. Section 10(b) of the SEA, 1934 makes it unlawful for any person to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered. So, any manipulative or deceptive device in
contravention of such rules and regulations that the SEC may prescribe as necessary or appropriate in the public interest or for the protection of the investors.

Section 16(b) of the SEA prohibits short-swing profits\textsuperscript{18} by corporate insiders in their own company's shares, except in very limited circumstances. It applies only to directors or officers of the company and those holding greater than 10\% of the share and is designed to prevent insider trading by those who are likely to be privy to important corporate information. Section 16(b) provides that the company or any of its shareholders may file a suit against the offending corporate insider to return the profits to the company because insider trading has been done within six month period.

These two broad anti-fraud prohibitions make it unlawful to engage in fraud or misrepresentation in connection with the purchase or sale of security. These sections do not mention insider trading explicitly. The act prohibits the purchase /sale of a security of any issuer on the basis of material unpublished information.

In 1942, the SEC promulgated Rule-10b-5 under section 10(b). This rule makes unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange. If any person (i) to employ any device, scheme, or artifice to defraud; (ii) to make any untrue statement of a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading or (iii) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security may be penalised of violating this rule.

Basic elements which have been identified from section 10(b) and rule 10b-5 in connection with insider trading are:

- possession of material non-public information;
- trading while in possession of that non-public information and
• Violation of relations of trust and confidence.

A number of elements for a cause of action have been set forth in connection with Rule 10b-5 as follows:

a) There must be fraud, misrepresentation, material omission or deception in connection with the purchase or sale of securities.

b) The misrepresentation or omission must be a fact as opposed to an opinion. However, inaccurate predictions of earnings may be held to be misrepresentations and failure to disclose prospective developments may be challenged.

c) The misrepresentation or omission must be material to an investor's decision in the sense that there was a substantial likelihood that reasonable investors would consider the fact of significance in their decision.

d) There must be a showing that the plaintiff believed the misrepresentation and relied upon it and it was a substantial factor in the decision to enter the transaction.

e) The plaintiff must be an actual purchaser or an actual seller to have standing.

f) Defendant's deception or fraud must have sufficiently close nexus to the transaction so that a court could find that the defendant's fraud was 'in connection' with the purchase or sale by plaintiff.

g) Plaintiff must prove that the defendant had scienter.19

The SEC amended the Rule 10b-5 of SEA by adopting new Rules 10b5-1 and 10b5-2. The new insider trading rules took effect on October 23, 2000. The amendments clarify and enhance existing prohibitions against insider trading. Insider trading liability can arise in two situations where previously the law was in dispute. Rule 10b5-1 provides that a person will be deemed to have traded on the basis of material non-public information if the person effects the transaction while being aware of the information. Thus, a person will not be able to claim that
material non-public information did not affect his or her decision to trade. Rule 10b-5-2 defines the relationships in which a duty of trust or confidence may arise. If the recipient of material non-public information regarding a company owes a duty of trust or confidence to the person who communicated the information, then it constitutes insider trading for the recipient of the information to trade the company’s securities. Under this rule, the SEC addresses the circumstances under which family, personal and other non-business relationships may give rise to a duty of trust or confidence for purposes of the misappropriation theory of insider trading. This rule provides that a duty of trust or confidence exists where a person:

- obtains material non-public information from his or her spouse, parent and child;
- has a history, pattern of practice of sharing confidences with the recipient of the material non-public information, such that the recipient knows or reasonably should know that person communicating the information to the recipient expects that the recipient will maintain the information in confidence and
- agrees to maintain information in confidence.

The SEC has three broad categories under which insider trading, fraud or illegal profits can be ruled. Rule 10b-5 is a general prohibition against fraud or deceit in security transactions. Rule 14e-3 prohibits trading in non-public information in connection with tender offers.

The Insider Trading Sanctions Act of 1984 applies to insider trading more generally. It states that those who trade on information which are not available to the general public can be made to give back their illegal profits and pay a penalty up to three times of the amount that their illegal activities had produced.
7.3.2 Self-regulation and insider trading

The regulatory framework for securities markets is principle based. Regulatory structure is bifurcated into statutory regulation and self-regulation. Under the statutory regulation the state directly influences the market by prescribing rules for the market to follow and conferring upon a supervisor i.e. a government authority. Self-developed standards can serve as a guideline for statutory regulation. Self-regulation, in which market players independently monitor compliance with rules which they have agreed among themselves and undertaken to follow\(^{20}\). Self-regulations make use of market players’ expertise in financial market issues. US exchanges are SROs with rules designed to prevent fraudulent acts and practices to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities\(^{21}\).

The surveillance departments at the SROs, such as the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the Options Regulatory Surveillance Authority, use cutting-edge software programmes to isolate unusual trading activity that may indicate insider trading. These surveillance programmes employ complex algorithms\(^ {22}\) that alert analysts to anomalous trading activity. The SROs can rapidly identify the executing broker-dealer and the account for which a particular transaction was performed and investigate the basis for the trading. These programmes are constantly being re-evaluated and updated as new trading mechanisms and strategies are introduced in the markets. SROs provide the SEC with reports of suspicious trading, detailed reports of their investigations including backup materials.
7.3.3 Disclosure by the insiders

When corporate insiders trade in their own securities, they need to report their trades to the SEC. Insider is one who holds more than 10% of a class of equity securities registered under section 12 of Securities Exchange Act of 1934 (SEAct). He must file with the SEC a statement of ownership regarding such security. When a person becomes a director, an officer or beneficial owner of a company, he must be filing the necessary information in Form No. 3 with the SEC within 10 days. Any change of ownership of securities should be reported on Form No. 4 to SEC within 10 days from the end of the month in which the change took place.

The Wall Street Journal has a weekly column on Wednesdays entitled 'Insider Trading Spotlight' which reports large insider transactions over the past week. The Sarbanes-Oxley Act of 2002 (SOX) amended Section 16(a) of the Securities Exchange Act, 1934 by requiring that insiders disclose any changes in ownership within 2 business days of the transaction, sharply decreasing the time between the insider transaction and disclosure. In addition, the Act requires that changes in ownership must be filed electronically, rather than on paper as was done earlier and SEC must upload the filing on the internet within 1 business day after the filing is made.

7.3.4 Penal measures

Two types of penalties may prosecute against violations viz. civil and criminal penalty. The SEC cannot bring a criminal action for violation of insider trading regulations. It can only recommend criminal prosecution to the Justice Department according to section 21(d) (1) of the Securities Exchange Act, 1934. SEC can bring civil action against an insider and obtain an injunction preventing future securities trading or an order requiring disgorgement of profits gained.
through insider trading and a fine as high as one million dollars or three times of the profit gained or loss avoided. The Justice Department may bring such a prosecution in its own initiative. The SEC may pursue a variety of civil penalties in insider trading cases. As per section 21(d) of the SE Act, the SEC may seek a permanent or temporary injunction whenever it appears to the commission that a person is engaged or is about to engage in any acts or practices constituting a violation of the act or any rules promulgated thereunder.

Prior to the 1980's the Securities Exchange Act of 1934 (SEA) was the only national-level statute that used to regulate insider trading. The SEA focused on the use of manipulative or deceptive devices rather than insider trading in a clear sense. An insider who wilfully violates securities laws i.e. Rule 10b-5 or 14e-3 is punished US$1 million fine for individuals and US$2.5 million for companies and up to 10 years of imprisonment. Since the mid-1980s insider trading scandals followed by criminal prosecutions have become fairly common in this area.

This act did not provide adequate deterrence to illegal insider transactions due to its ambiguous definition on insider trading and consequent weak court implementation. In 1984, a more stringent legislation was passed to deter illegal insider trading which is Insider Trading Sanctions Act (ITSA) 1984. The ITSA broadened SEC's authority. Followed by ITSA Insider trading and Securities Fraud Enforcement Act (ITSTFEA) was passed in 1988. It has been found that after the enactment of the ITSTFEA, insiders appeared to adjust the timing of their transactions so that the trades could occur after the release of the relevant information.

The ITSA greatly increased the penalties for illegal insider trading and helped resolving the conflicting stands of previous legal cases. It authorised the SEC to seek a court order requiring the offenders to pay a sum up to three times the illegal insider trading profit. It also increased the maximum fine of violation from $10,000 to $1,00,000. These two acts provide more penalties for illegal
insider trading. These acts have expanded the SEC’s ability to provide assistance to foreign regulators by allowing it to use its compulsory powers to compel testimony and production of documents at the request of a foreign securities authority. The substantive law of insider trading is judge-made case law which on several occasions has reached up to US Supreme Court.

The very purpose of professionalism in the financial activities is to base its trades on knowledgeable information. The basic issue is to determine the border line of permissible trades which makes it illegal for someone with special knowledge about an issuer of securities, to trade in the securities of that issuer without telling the person with whom the trade is made. Public and its legislators have generally opposed to insider trading. Public policy has sought to prevent it. Along with rules and regulations three theories have firmly been developed on insider trading in the USA.

7.4 Insider trading regulation in the United Kingdom

The stock market in the United Kingdom (UK) is dominated mainly by the London Stock Exchange (LSE). Until 1960, it had been the largest stock exchange in the world. The LSE was established much earlier than the New York Stock Exchange (NYSE). The LSE has its self regulation and Financial Services Authority (FSA) is the main external regulator in the UK. The Financial Services and Market Act (FSMA) was passed in 2000.

United Kingdom (UK) is one of the first countries to enact laws against insider trading. Insider trading regulation in the UK is primarily based on the British Common Laws and various companies’ legislations are now in force in England and Wales. The general principles of corporate securities law apply throughout the UK and there is a little divergence in the various statutory provisions. With regard to the regulation of insider trading, there was no
difference at all either in law or practice. The company laws of Northern Ireland and Eire, although are similar to those of England & Wales. The UK’s early attempt to construct a regime against insider dealing was permeated with a theory of liability, broadly based on the US classical theory. In the United Kingdom (UK), insider trading is known as insider dealing and it is defined as a process where individuals use, or encourage others to use, information regarding a company which is not generally available to deal within order to extract their own financial advantage. With the help of inside information they make profit or avoid losses.

Prior to 1980, there were no specific provisions relevant to insider trading except those relating to the disclosure of director’s shareholding. Insider trading was first made illegal in the Companies Act of 1980. Insider trading was made as a criminal offence by Part V of Sections 68-73 of the act. Those provisions were re-enacted in the Companies Securities (Insider Dealing) Act, 1985. The provisions concentrated on punishing misuse of unpublished information acquired in confidence from a company, which would affect the price of that company’s securities if made public. In 1989, a Directive was adopted to coordinate regulations on insider dealing throughout the European Union. This has been implemented in UK law by Part V of Section 52-64 of the Criminal Justice Act 1993. These provisions were brought into force on March 1, 1994. This new law is more focused on the control of securities markets than the abuse of confidential information.

There are three ways of committing the offence of insider trading: (i) dealing in securities; (ii) encouraging another person to deal; and (iii) disclosing information. An individual who possesses information, as an insider is guilty of insider trading if he deals in securities that are price-affected securities in relation to the information. A person has information as an insider if he obtains
that information from an inside source. A person has information from an inside source if he has obtained by dint of his position being a director, employee or shareholder of an issuer of securities or having access to the information by virtue of his employment, office or profession. An individual who has information as an insider is also guilty of insider dealing if he encourages other to deal in securities that are price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place. An individual who has inside information, as an insider is guilty of insider dealing if he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession to another person.

7.4.1 Criminal Justice Act and prohibition of insider trading

The Financial Services Authority (FSA) regulates the financial services industry. It is an independent non-governmental body, given statutory powers by the FSMA 2000. It is financed by the financial services industry. The Majesty’s Treasury appoints the Board, consisting of a Chairman, a Chief Executive Officer, three Managing Directors, and 11 non-executive directors (including a lead non-executive member, the Deputy Chairman). This Board sets the overall policy of FSA. Its four objectives are: (a) Market confidence: maintaining confidence in the financial system; (b) Public awareness: promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealings and the provisions of appropriate information and advice; (c) The protection of consumers: securing the appropriate degree of protection for consumers; and (d) Reduction of financial crime: reducing the extent to which it is possible for a business, carried on by a regulated person to be used in connection with financial crime. These are supported by a set of principles of good regulation which are: efficiency and economy, role of management, proportionality, innovation,
international character of financial services and markets and the desirability of maintaining the competitive position of the UK and competitive advantage.

The FSMA hold the legal definition of market abuse and require the FSA to produce a code – the Code of Market Conduct. The Code sets out in more detail the standards that should be observed by everyone who uses the UK’s markets. The Code of Market Conduct, through the Misuse of Information Act, regulates the Insider trading legislation. Through its descriptions of what is and is not acceptable, the Code brings new levels of transparency to all market users. It helps to ensure that they know where they stand and what standards are expected of them. The main objective to tackle abuse of the UK’s financial markets is in order to maintain the UK’s hard-earned reputation for efficient, clean and fair markets. It not only covers the insider dealing scenarios through misuse of information regulation but also extends to other type of market abuse, viz., creating a false or misleading repression and distorting market. The Code has been welcomed by retail investors because it would make it more difficult for others to take unfair advantage of any information what they have and which has not yet been made available to all investors. It reduces the risk of investors having the price of their investments (whether held in their pensions or elsewhere) manipulated to their disadvantage.

By virtue of Section 57(2) (a) of the Criminal Justice Act, 1993, insiders have been defined in two categories. The first are those who obtain inside information, through being a director, employees or shareholder of an issuer of securities. In other words, there must be casual link between the employment and the acquisition of the information, but not in the sense that the information must be acquired in the course of the employee’s employment. The second category of insider has been identified by Section 57(2) (b) as ‘secondary insiders’. These
persons would receive information from first category of insiders which has been called tipping of information.

Inside information is defined in section 56 (1) of the Criminal Justice Act. It includes information which relates to particular securities or to particular issuers of securities. Securities whose price would likely to be significantly affected if an item of inside information were made public are known as ‘price affected securities’ in relation to that information, and the information is called ‘price-sensitive information’ in relation to them [Section 56(3)]. Information must be treated as relating to a company not only where the same is about the company but also where it may affect the company’s business prospects.

7.4.2 Self-Regulation and insider trading

In addition to statutory regulation, there is a body of self-regulatory provisions applying to insider trading. The Stock Exchange’s listing requirements include a model code for directors’ dealing activities. The City Code of London is often used as a model of self-regulation. Regulation of brokers as far back as the thirteenth century took the form of licensing by the Lord Mayor and aldermen of the City Code of London. Licensed brokers were required to swear an oath of good behaviour and in particular to deliberately avoid deceit. They were required to disclose the identity of their principal and under pain of disqualification for life not to deal on their own account.

The reordering of the international financial market, especially its globalisation, imposed pressures on the financial services sector in London which led to a series of reviews of the system of regulation. The review process finally resulted in the Financial Services Act, 1986 which established a new style of regulation for the securities market. The power of regulation has been delegated to the Securities and Investments Board (SIB) as recognised self-regulating organisation. The Bank of England also has a role in the supervision of the SIB.
SIB provides a mechanism for investigation of complaints and to oversee the operations of the SROs.

Self-regulatory organisations made provisions to combat insider dealing. The Stock Exchanges listing requirements include model code for directors dealing activities. The City Code on Takeovers prevent false securities transactions in relation to mergers which also ensures equal access to all relevant information for all shareholders prior to the announcement of a bid. The penalties available are private reprimands, public censure and referral of cases to the DTI, reference to professional disciplinary bodies, suspension or delisting of securities. The rulebooks of the new self-regulatory organisations also prohibit insider trading. Companies prohibit dealers from short swing trading or dealing through outside firms on their own account.36

The UK Listing Authority requires a listed company to adopt rules to govern dealings by its directors in its securities. A director of a listed company must not deal in any securities of the company on considerations of a short-term nature. He must take reasonable steps to prevent any person with whom he or she is connected for dealing in its securities on considerations of a short-term nature. Before dealing in the company's securities, a director of listed company must notify the chairman (or some other director designated for the purpose) in advance and receive clearance. A written record must be kept by the company of notifications and clearances. A director of a listed company must not buy the company's securities during a close period which is usually two months before the preliminary announcement of its half-yearly and annual results or the month before the announcement of its quarterly results.37
7.4.3 Disclosure by the insiders

During 1977, the Stock Exchange Council appointed a special committee to draw a model code for securities transactions by directors of listed companies. In addition to the Model Code, the stock exchanges lay down five basic principles. First, directors should not deal in their companies securities on a short time basis. Second, directors must adopt that they possess more information about the company than what is available publicly. Therefore, they are not free to deal in their companies securities throughout the year. Third, subject to these general constraints directors in principle should be regarded as free to deal in their companies securities at a specific time slot during the year. Fourth, the directors-dealings should not normally take place for a minimum period, prior to the announcement of regularly recurring information, particularly about profits, dividends or other distributions. It is immaterial that the announcement in question is liable to affect the market price. Fifth, the dealings should not normally take place prior to the announcement of matter of an exceptional nature, which are liable to affect the market price.

According to the Company Securities (Insider Dealing) Act, 1985, every company is required to keep a register of director’s share and debenture interests available for inspection by members and public. Directors must inform the company within five working days of any transactions carried out for their personal account and the company must make the entry within three working days. The act gives a very broad definition of the word ‘interest’. It includes entering into a contract to purchase shares, entitlement to exercise shareholders rights even when he is not a registered holder. Interests of spouses and children are included though shares held as a trustee have not been considered. The disclosed information includes the price paid (including any non-monetary consideration) and the number of shares in question. Any listed company in UK must disclose the
stock exchange of this information strictly by the next day. The Stock Exchange is empowered to publish any such information at its discretion and further imposes even more disclosure requirements.\textsuperscript{39} The Financial Times provides a weekly coverage of insider trading activity in the UK. The ‘Yellow Book’ (Admission of Securities to Listing) requires immediate notification by the company. The unlisted securities market imposes a similar obligation.

The provisions of insider trading under the Company Securities (Insider Dealing) Act 1985 were repealed by the Criminal Justice Act, 1993 in Part- V. Under this act insider trading has been considered as an offence for an individual. Individuals who deal in securities with unpublished price sensitive information about shares or debt securities and if the dealing is affected on a regulated stock exchanges or market. If the directors of the company carry out a transaction in securities on the company’s behalf which involves them in insider dealing, the directors individually and not the company are liable as principals for the offences they commit.

LSE has imposed upon companies the requirements to state in their annual reports whether they have complied with the Cadbury Code of Best Practice. Companies are required to fulfill a number of regulatory requirements in order to obtain and continue listing with the stock exchange. If a company wishes to enjoy listing facilities, it has to submit a variety of data, including audited financial statements. These should consist of the balance sheet, the profit and loss account, and the cash flow statement. After being listed, a company must publish audited financial statements within six months of its year-end and un-audited interim financial statements semi-annually. It is also obligatory for a listed company to release important ancillary information such as details of major transactions entered into by the company, preliminary announcements, particularly of
borrowings and departures from accounting standards and the reasons thereof, on a timely basis.

7.4.4 Penal measures

Persons who violate the confidentiality of information may be rendered liable. From the standpoint of insider trading regulation, there was no general principle of liability. Before insider trading became a criminal offence in 1980, instances were dealt with by the Stock Exchange Council as breaches of ‘club rules’. Between 1975 and 1979, eight public statements were issued concerning individuals but no fines were imposed. Between 1980 and June 1985, 251 cases were examined in detail by the Stock Exchange investigators of which over 100 were referred to the Department of Trade & Industry (DTI), the prosecuting body. Six cases involving nine individuals resulted in prosecutions and these led to convictions in four cases.\(^{40}\)

In UK section 47 of the Financial Services Act 1986 makes insider trading a criminal offence to make false or misleading statements in order to induce someone to deal in investments or to do any act or engage in any course of conduct which creates a false impression as to the value of an investment. An offence under Part V of the Criminal Justice Act 1993 is trialable either way. Once the offence is proved, penalty can be imprisonment for a period up to seven years and/or unlimited fine (section 61(1)). The offenders can also be forced to repay all profits made or losses avoided arising out of insider dealing. There are restrictions on the commencement of prosecutions. In England and Wales the FSA may institute proceedings as per section 402 of the Financial Services and Markets Act 2000 (FSMA), but otherwise prosecution can be initiated only by or with the consent of the Secretary of State or the Director of Public Prosecutions. Either the FSA or the Secretary of State may appoint investigators under section 168(3) of FSM Act, 2000 if a breach of the Criminal Justice Act 1993, Part V is suspected.
7.5. Insider trading regulation in Australia

Many personalities believe that insider trading could also be a problem faced by the Australian securities market and enforcement of the insider trading laws like in the USA and to a lesser extent in the UK would reduce this problem. Adam M. (2008) has found that between 5 to 10 percent of securities trading in Australia would be classified as insider trading as per the existing laws and definitions.\(^{41}\)

The Rae Committee for reviewing securities markets in Australia collected much useful data on the extent of insider trading in Australia during the nickel boom of the late 1960s and the early 1970s. A small number of cases arising from the legislation have resulted in a lack of judicial clarification of the law and an attempt has been made to reform the law. Thereafter, the National Companies and Securities Commission (NCSC) constituted a committee in 1983 under the chairmanship of Philip Anisman, a Canadian expert on insider trading. The committee published its report in 1986 and made arguments for regulation of insider trading in Australia. It stated that insider trading is essentially a problem of non-disclosure. A person whose position provides him with access to information that indicates a disparity between the value of a company’s securities and the price at which it may be acquired or disposed of. It can occur in the shares of both closely held private companies and widely held public companies and with respect to the latter either directly in a face-to-face transaction or otherwise or impersonally through the facilities of a stock exchange. Not surprisingly, the context of an impersonal market necessitates a broader focus than direct transactions and presents a number of conceptual and practical difficulties for the development of legislation.\(^{42}\)
7.5.1 Corporations Act and prohibition of insider trading

The Companies Act 1961 of Australia had two legislative provisions which could apply to insider trading. Section 126 was related to holding and disclosure of shares by directors. Section 124 was introduced to consider insider trading as improper. Insider trading has been an offence under various Securities Industry Acts since 1970. Section 75A of the Securities Industry Act of 1970 provided that a person has knowledge of specific information relating to the company or body and that information is not generally known. It might reasonably be expected to affect materially the market price of those securities. Once proved, he is guilty of an offence against this act.

After the stock market crash in 1987, in February 1989, the Federal Attorney General requested the House of Representatives of the Standing Committee on Legal and Constitutional Affairs (the Griffiths Committee) to conduct an inquiry into insider trading and other forms of market manipulation. The report of that Committee was placed in October 1989. The Griffiths committee confirmed the wide spread nature of insider trading and called for legislative reform. In October 1990, the Australian government largely endorsed the recommendations of the committee. In December 1990 the Federal Attorney General released an exposure draft of proposed new insider trading legislation. This draft proposed that section 1002 of the Corporations Act, the successor to section 128 of the Securities Industry Act be repealed and replaced by twelve new sections. A number of other consequential changes taken place to the civil remedy provisions in section 1005 and section 1013. Thereafter, the Corporations Act was amended in 2001.

Under the Division 3 of Part 7.10 of the Corporations Act 2001, anyone who possesses ‘inside information’ is prohibited from trading or procuring trading, or communicating that information where trading is likely to take place, in
relation to relevant financial products, subject to various exceptions and defenses. Insider trading is specially prohibited under section 1043A (1) of the Corporations Act 1989. This section sets out the principal elements of insider trading offence which are: (i) a person possesses certain information; (ii) the information is not generally available; (iii) a reasonable person would expect the information to be material (i.e. to have a material effect on the price or value of certain securities); (iv) the person knows (or should know) that the information is not generally available; (v) the person knows (or should know) that a reasonable person would expect the information to be material and (vi) whilst in possession of the information, the person trades in those securities (i.e. buys and sells those securities) or procures another person to trade in those securities.

With the passages of time more number of securities was brought under the purview of insider trading. Until March 2002, the insider trading prohibition was confined to transactions in securities (whether of public or private entities), investment schemes and futures contracts that relate to securities of a body corporate or the price of those securities. Since then, the prohibition has been extended. The financial products now covered by the prohibition are: (i) securities, including options on unissued shares (ii) derivatives (iii) interests in a managed investment scheme (iv) debentures, stocks or bonds issued or proposed to be issued by a government (v) superannuation products (other than prescribed products), or (vi) any other financial products that are able to be traded on a financial market.

7.5.2 Self-Regulation and insider trading

Self-Regulatory Organisations (SROs) like Australian Stock Exchanges are also taking initiative to investigate insider trading cases. Australian Securities Exchange (ASX) is the primary stock exchange in Australia. The ASX began as separate state-based exchanges established as early as 1861. Today trading is all-
electronic and the exchange is a public company, listed on the exchange itself. ASX as it is now known resulted from the merger of the Australian Stock Exchange and the Sydney Futures Exchange in December 2006.

7.5.3 Disclosure by the insiders

The Australian Corporations law prohibits a listed company or other entity from intentionally, recklessly or negligently contravening the listing rules of its stock exchange by failing to notify the exchange of information that is not generally available and that a reasonable person would expect to have a material effect on the price of the shares or other securities. Any contravention that is intentional or reckless is an offence. The ASX Listing Rules require a listed company or other entity to immediately inform the ASX once it becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price of its shares or other securities. However this rule does not apply if a reasonable person would not expect the information to be disclosed and the information is confidential and –

- it would be a breach of the law to disclose the information; or
- the information concerns an incomplete proposal or negotiation; or
- the information comprises matters of supposition or is insufficiently definite to warrant disclosure; or
- the information is generated for the internal management purposes of the entity; or
- the information is a trade secret.

The Australian Corporations law requires a director of a listed company to notify the stock exchange of the shares or other securities of the company or a related body corporate that the director holds or has a relevant interest in. The
director must notify the exchange within 14 days of any change in the director's holdings.

7.5.4 Penal measures

Breach of the insider trading provisions is a serious criminal offence. Criminal liability may be imposed against those who have been found guilty for violating insider trading regulations in Australia. An individual who has been committing this white-collar crime would be fined with a maximum fine of A$ 200,000 and maximum imprisonment for 5 years. The company has to pay maximum cash penalty of A$ 1 million45.

Civil action may be initiated against the insiders in three ways. First, any person who traded with the inside information may recover the amount of the difference between the transaction price of the securities and the price at which the securities were likely to have been transacted if the relevant confidential information had been made available46. Secondly the company whose securities were traded may claim against the offender a similarly calculated amount. In this case insiders need not to pay compensation to both the other traders and the company compensation in respect of the same transaction. The payment works on a ‘first-to-claim’ basis. The ‘first-to-claim’ rule gives equal weightage to the rights of both these parties. Finally if it considers that it is in the public interest to do so, the ASIC may bring a claim in the name of and for the benefit of the body corporate47. Insider transactions are not void but voidable at the instance of the innocent party. In addition, the Court, upon finding a contravention of insider trading legislation has wide discretionary powers to make ancillary orders, including an order cancelling an agreement for the acquisition or disposal of the securities48.
7.6 Comparative Study of Insider Trading Regulations of the USA, UK and Australia

Through our study we make a comparative study of different aspects of insider trading regulations among the three countries. Exhibit-7.5 offers a comparative issue wise profile of three leading countries under study.

**Exhibit 7.5: Comparative study of insider trading regulations of the USA, UK and Australia**

<table>
<thead>
<tr>
<th>Point of Comparison</th>
<th>U.S.A</th>
<th>U.K</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Insider</td>
<td>No such restrictions on Ceiling of Share holding</td>
<td>No such restrictions on Ceiling of Share holding</td>
<td>5% Share holder who hold not less 5% of share in a Company</td>
</tr>
<tr>
<td>3. Offence Civil/ Criminal</td>
<td>Civil Three types of offences a)Dealing b) Encouraging another person to deal c) Disclosing</td>
<td>Criminal. Criminal prosecution may be recommended by the Department of Justice.</td>
<td>Civil and criminal both</td>
</tr>
<tr>
<td>4. Inside Information</td>
<td>Insider trading could be legal also.</td>
<td>Information may (and not must) be treated as made public even though it is public outside U.K</td>
<td>Any single mortgage sell or write-off of a major asset used in the business of the Company that exceeds 30% of the said assets.</td>
</tr>
<tr>
<td>5. Penal</td>
<td>Maximum fine USD</td>
<td>Summary Conviction; by a</td>
<td>Insiders like</td>
</tr>
</tbody>
</table>

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Measures | 1 million or three times the profit gains or loss avoided for individuals and $2.5 million for corporations. | Magistrate Court. A fine not exceeding two thousand pounds sterling or by imprisonment for not more than six months or by both. **On indictment** Unlimited amount at the discretion of the Court or by imprisonment for a period not more than 7 years or by both. | individuals be imposed a maximum fine of A$ 2 million and 5 years imprisonment and for corporations cash penalty is A$ 1 million |
---|---|---|---|

### 7.7 Conclusions:

Even in the US, the SEC has been hardly successful in providing the charge of insider trading. Instead the serious offender Ivan F Boesky went virtually scoot free since the Court rejected the circumstantial evidence. In another famous case of Milken, SEC found it impossible to prove the charge and had to rope him in some other offence to put him behind bars since the public outrage against Milken was phenomenal;

- In Australia the Regulator has been able to succeed only in respect of six cases since 1992;
- In Japan the Regulator has not detected any instance of insider trading till date;
- Of the 87 countries which have introduced law relating to insider trading only 38 countries have been able to proceed under the insider trading.

The result of this inter country comparison are further strengthened when we compare insider trading in a country before the first enactment of insider trading regulations with private information trading in the same country after the
first enforcement of insider trading restrictions. The primary objective of insider trading restrictions is to encourage the uninformed public to participate in the market. Stock exchanges in the USA, UK and Australia have installed sophisticated computer surveillance software systems to track insider trading. The exchanges and the regulators of these countries use software that continually flags unusual price and volume swings in the 10 days before and after major news events such as takeovers based on the historical patterns of the individual stocks. Information generated by the programme dubbed SWAT (Stock Watch Automated Tracking) system then used to build a chronology of events and cases. Most of investigations undertaken by the SEC are computerised. The SEC's success in tracking cases of fraud including insider trading has been greatly complemented by the Electronic Data Gathering Analysis and Retrieval (EDGAR) system that performs automated collection, validation, indexing, acceptance and forwarding of the various submissions which the companies listed in the US are required to file with the SEC. The London Stock Exchange uses similar on-line surveillance systems which are renowned for their effectiveness. With these on-line tracking systems in place it becomes extremely difficult for any large-scale collusion between brokers and company managements to manipulate price movements. Australian securities market regulators are also using good surveillance mechanism to track down insider trading offences.
Notes and References


3 89/592/EEC

4 This survey report has been prepared by Julan Du, Professor of the University of Hong Kong and Shang-Jin Wei, an advisor in the International Monetary Fund (IMF)'s Research Department.


6 Ibid

7 Ibid


9 Bhattacharyya and Daouk (2002), op. cit, p-23


17 Ibid

18 Profits realised in any period less than six months

19 Scienter literally means ‘knowingly or wilfully’. It also means that the defendants had a degree of knowledge that makes the individual legally responsible for the consequences of their act and that they had an actual intent to deceive or defraud. Negligence is not sufficient


include the NYSE, AMEX, NASD, the Regional Stock Exchanges and the Chicago Board Options Exchange (CBOE).

22 Set of rules or procedures that must be followed in solving problems

23 Similar actions have been taken in India. In the Economic Times similar information is available


25 Profits gained or loss avoided is defined as the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the non-public information.


28 Public Law 100-704 [H.R.5133] November 19, 1988


32 It is based on Section 195 of the British Companies Act of 1948


34 EU Directive No. 89/592/EEC)

35 Section 16 of the Criminal Justice Act, 1993

36 In September 1987, two employees of the Financial Times group were dismissed for trading on advance knowledge of share tips published in the 'Investors Chronicle'. Two men worked as clerks and had access to copies of the magazine on the day before publication. Although the amount of money involved were small (10,000 pound), but their activities were detected by the alert editor because the securities concerned were so called thinly traded shares whose price had fallen to very low levels with a scarce potential for recovery. Because the two had no connection with the companies, their actions did not constitute insider trading in the legal sense, and they were not prosecuted. They were dismissed for breaching their employer's code of practice.

37 Para 3 of the UK Listing Rules

38 Mathew, M.R and Peter, M H B (1999), "Accounting Theory and Development" 3(e), Nelson p- 275


210
40 Ibid


42 Anisman Committee Report 1986, p-2


45 Section 1312 of the Corporations Act

46 Ibid Section 1013(3)(4)

47 Ibid section 1013(6)

48 Singh vs. Crafter (1992) 10 ACLC 1,365