THE LAW OF INSIDER TRADING IN PAKISTAN

by

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ABSTRACT

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The corporate world became fully aware of phenomenon called insider trading towards the middle of the last century. This occurred when separation between ownership and control of large corporations was almost complete, at least in United States, and professionals rather than the owners were managing such corporations. Since then most of the developments took place in the United States, and then the law was passed on to the rest of the world.

The insider uses material information not yet disclosed to other shareholders or the outside world to make profits by trading in the firms stock. He comes into possession of vital nonpublic information about a corporation by virtue of his position. Insider trading, therefore, occurs when someone makes an investment decision based on information that is not available to the general public. In some cases, the information allows them to profit, in others, avoid a loss. Insider trading not only causes a loss to small investor, it shakes the confidence of investor in the market for he believes that the market is no longer honest.

Today, out of more than 103 countries that have stock markets, 87 (including Pakistan and India) have introduced insider trading rules. In Pakistan, the law was first introduced in 1995 through an amendment in the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of

1969). The law came into the limelight due to the stock market crash of the year 2000. The reform process continued into the year 2001. To impose transparency in trade, curb the practice of insider trading, and bring Stock Exchange operations to international standards, SECP ordered some amendments to the Articles of Association of the Karachi Stock Exchange and issued Listed Companies (Prohibition of Insider Trading) Guidelines. Later crashes confirmed the existence of uncontrolled insider trading in Pakistan. The recent report of the Task Force constituted by the SECP has confirmed this fact and made some recommendations. The purpose of this study was to understand the laws applied in different jurisdictions and to come up with the best definitions so that the law can be implemented and enforced in Pakistan in the best possible manner to safeguard the interests of the investors and the companies concerned.

Insider trading is a very complex issue, and from a legal perspective existing laws are quite ambiguous and confusing. It is also highly controversial from an ethical perspective. In other words, not everyone agrees that insider trading should be prohibited. There is a heated debate about the merits of such prohibition; a debate that still continues. The first chapter of this study records the underlying issues of this debate, in particular the following:

- Does insider trading disturb the prices of securities and affect the efficiency of the market?
- Does insider trading harm company operations or does it promote the interest of the company by compensating the managers?
- Is insider trading regulation intended to benefit some powerful groups?
- Does insider trading harm the individual investor and undermine investor confidence?
- Does insider-trading amount to theft of corporate property?

The conclusion drawn in this study was that insider trading should be prohibited to prevent market abuse and manipulation, if for no other reason.

The second chapter dealt with the law of insider trading developed in the United States. A study of the theories developed by the US Courts gave us a deep insight into how the different kinds of liabilities arise in this offence and what compelled the Courts and the SEC to extend the liability to those who were not strictly insiders.

The third chapter took up the implementation of the law in the rest of the world on being exported from the US. The main focus was on the law of the United Kingdom, Hong Kong and India. These laws were studied as they are relevant for our law and the way we implement it. The law in India has been updated and can be very helpful in framing and improving our own law. In most laws, it was observed that insider trading is treated as a category of the offence of market manipulation and abuse. The law of Pakistan does not do so.

The next chapter analysed the law of insider trading as implemented in Pakistan. Some of the complications and deficiencies in the way the law has been drafted were pointed out. It was felt that the law must be changed to conform to the laws as they are implemented in the rest of the world. Issues of investigation and detection were not taken up as these were beyond the scope of this study and deserve a more comprehensive treatment that may be taken up in a future study.

The final chapter lists the conclusions and makes recommendations for improvement of the law of insider trading as applied in Pakistan.

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ABBREVIATIONS

CFR Code of Federal Regulations (USA)

EEC European Economic Community

EU European Union

FEA Federal Exchange Act, 1934 (USA)

FSA Federal Securities Act, 1933 (USA)

FSMA Financial Services and Markets Act, 2000 (UK)

IDD Insider Dealing Directives (EEC)

ISDA International Swaps and Derivatives Association

KSC Karachi Stock Exchange

MAD Market Abuse Directives (EEC)

SEC Securities and Exchange Commission (USA)

SECP Securities and Exchange Commission of Pakistan

SEO Securities and Exchange Ordinance, 1969

SEBI Securities and Exchange Board of India

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This study is dedicated to my parents to whom I owe everything.

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I would like, first, to acknowledge all that my parents have done for me. It is their support and care that has enabled me to undertake my studies with diligence and determination. I would like to acknowledge next the support of my supervisor, Professor Imran Ahsan Khan Nyazee, who has not only discussed each idea with me, but has also edited my text and helped me improve my writing. Finally I would like to acknowledge the support of the International Islamic University during my LL.M programme for granting me a full merit scholarship throughout the course.

PREFACE

The importance of the topic of insider trading, within the wider context of securities regulation and corporate governance, cannot be denied in the modern world. Insider trading lies at the bottom of the stock market crashes that have taken place in Pakistan in the recent past. It provides the fundamental motive for market abuse and market manipulation.

Unfortunately, in our law courses very little time is given to the subject of company law. Even the topics falling under the Companies Ordinance, 1984 are not fully covered in the time allocated. Nevertheless, subjects like insider trading, mergers and takeovers, and corporate governance are very important in the modern times and should be given more space in the LL.M Corporate Law courses offered by International Islamic University, Islamabad, as well as other universities.

A more severe problem is the lack of resources in the libraries. This is true not only of our own library but many of the larger libraries like those of the Ministry of Law. It is simply impossible to find the latest books on a given topic. The usual excuse is the lack of the funds. Research, however, is impossible without the latest books and periodicals. It is generally believed that most of the material is available on the Internet. This is not wholly true. Material that is essential for research is available on the Internet only for money. The Universities must pay attention to the acute shortage of books and periodicals.

During my study of the topic I came to realise that unknown topics like insider trading, which may appear insignificant to some are very important, and sometimes fatally affect the economic life of the country. Uncontrolled insider trading can shatter the confidence of the small investor and demolish the efficiency of the market. The topic, along with other related topics, should be given space in corporate law courses.

I sincerely hope that my study will contribute in a small way to highlighting the topic so that an efficient and comprehensive law is made to deal with the larger problem of market abuse and the narrow yet vital issue of insider trading.

CHAPTER I

Introduction: The Emergence of Insider Trading Law

> Our era aptly has been styled, and well may be remembered as, the "age of information." Francis Bacon recognised nearly 400 years ago that "knowledge is power," but only in the last generation has it risen to the equivalent of the coin of the realm. Nowhere is this commodity more valuable or volatile than in the world of high finance, where facts worth fortunes while secret may be rendered worthless once revealed.[1]

The law of insider trading in company shares deals with valuable undisclosed (non-public) information pertaining to a company and seeks to prevent its unlawful use for profit. The law emerged in the United states as early as 1934, if not earlier,[2] and started spreading to the rest of the world in 1980. Today, out of more than 103 countries that have stock markets, 87 (including Pakistan and India) have introduced insider trading rules.[3] Insider trading is a very complex issue, and from a legal perspective existing laws are quite ambiguous and confusing. It is also highly controversial from an ethical perspective.[4]

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[1] Irving R. Kaufman, Circuit Judge (United States Court of Appeals, Second Circuit), in Securities and Exchange Commission v. Anthony Materia, 745 F.2d 197 at 198.

[2] According to some writers the first insider trading case allegedly arose when the Rothschilds benefited from insider trading. They learnt of Wellington's victory in Waterloo earlier than the rest of London. At about the same time in Laidlaw v. Oregon, (15 U.S. 178, 2 Wheat.178, 4 L.Ed. 214 (1817)), the U.S. Supreme Court dealt with a case that arose when the buyer of tobacco received knowledge that the peace of Ghent had been signed by British and American commissioners. This news increased the value of tobacco from 30 to 50 cents. The court found that the buyer was not bound to communicate knowledge of extrinsic circumstances, which influenced the price of a commodity. However, the court came to this conclusion because "the means of intelligence [were] equally accessible to both parties." This information has been reproduced from Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga. J. Intl. L.* (1997-98), available at http://www.gonzagajil.org/ (last visited July 3, 2006).

[3] Utpal Bhattacharya and Hazem Daouk, "The World Price of Insider Trading," *Journal of Finance* 57, 75-108 (2002); Art A. Durnev and Amrita S. Nain, "The Unanticipated Effects of Insider Trading Regulation," *American Law & Economics Association Annual Meetings*, Paper 23, 2004.

[4] "Insider trading is one of the most controversial aspects of securities regulation, even among the law and

Richard Posner defines insider-trading as, "the practice by which a manager or other insider uses material information not yet disclosed to other shareholders or the outside world to make profits by trading in the firm's stock."[5] Insider trading, therefore, occurs when someone makes an investment decision based on information that is not available to the general public. In some cases, the information allows them to profit, in others, avoid a loss.[6]

Insider trading was not considered illegal at the beginning of the twentieth century, and insider information was for a long time treated as a "perk"[7] for the insiders who owned and managed the corporations. As separation between ownership and control increased,[8] and the most wealthy moved into the financial services industry, the "perk" of insider information was denied to the professionals or the bureaucracy who now managed the corporations.[9] In other words, laws were made to control the profes-

economics community. One set of scholars favours deregulation of insider trading, allowing corporations to set their own insider trading policies by contract. Another set of law and economics scholars, in contrast, contends that the property right to inside information should be assigned to the corporation and not subject to contractual reassignment. Deregulatory arguments are typically premised on the claims that insider trading promotes market efficiency or that assigning the property right to inside information to managers is an efficient compensation scheme." Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, Eds. Boudewijn Bouckaert and Gerrit De Geest (Ghent: Edward Elgar and the University of Ghent, 1996–2000).

[5]Richard A. Posner, *Economic Analysis of Law* (Boston: Little Brown, 1977), 308. "Insider trading, the unlawful stock trading by persons possessing material, non-public information, is one of the best-known concepts in securities law. Brought to life in the 1987 movie Wall Street, insider trading often conjures up images of furtive reviews of confidential documents, hushed conversations, and cryptic messages. The concept has grabbed headlines recently with well-known corporations and individuals under investigation for alleged insider trading." Thomas E. Geyer, *Insider trading: Evolution, Prevailing Theories and Recent Developments.*

[6]Joshua Kennon, "Understanding Insider Trading," *Your Guide to Investing for Beginners.* Free Newsletter available at http://beginnersinvest.about.com/mbiopage.htm (last visited May 31, 2006).

[7]This word was used by an early US Supreme Court case.

[8]"The separation of ownership and control refers to the phenomenon associated with publicly held business corporations in which the shareholders (the residual claimants) possess little or no direct control over management decisions." Stephen G. Marks, "The Separation of Ownership and Control," *Encyclopedia of Law and Economics*, Eds. Boudewijn Bouckaert and Gerrit De Geest (Ghent: Edward Elgar and the University of Ghent , 1996–2000).

[9]The debate about separation and control as the central problem of corporate governance was recorded in the classical study by Berle and Means. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace & World, [1932] 1968). "Berle and Means focused on the separation of ownership and control in large corporations where multiple layers of salaried managers coordinated production and distribution. What is perhaps less well recognised about their work is that the large public corporation had only recently become the dominant way of organising production in the United States. The book was therefore prescient in that it recognised this way of organising the enterprise would be lasting, and hence it was important to study how they would be governed." Raghuram G. Rajan & Luigi Zingales, "The Governance of the New Enterprise," *NBER Working Papers*, No. 7958 (National Bureau of Economic Research,

sional managers who managed the companies, but did not own them.[10] Added to this were the excesses of the 1920s,[11] the subsequent decade of depression, and the resulting shift in public opinion. Insider trading was banned, with serious penalties being imposed on those who engaged in the practice.

Accordingly, the thesis developed by some of the earlier writers was that prohibition of insider trading, after denying the "perks" to managers, benefits the people in the financial services industry. They benefit from the information as they are next in line after the insiders to receive the information. One famous writer who advocated this was Henry G. Manne.[12] After giving detailed arguments, he maintained that "[i]t is not too hard to find some suggestive evidence to support the hypothesis that investment bankers and their related functionaries are trying to get valuable information that would otherwise go to corporate insiders."[13] He elaborated that when information passes from corporate officials to the financial service people, who are the next in line to gain access to information before the public does, it is no longer "illicit" inside information, but is treated as "data" that financial analysts use to make their evaluation of stocks.[14]

Inc., 1998).

[10]"The fundamental issue in corporate governance was how the surplus that accumulated at the top of the organisational pyramid could be prized out from the sticky fingers of top management and given to the rightful owners, the dispersed shareholder. We say "rightful" because, after all, top management came into the surplus largely because shareholders delegated to them rights over the firm's unique assets, which were the primary source of the surplus." Raghuram G. Rajan & Luigi Zingales, "The Governance of the New Enterprise," *NBER Working Papers*, No. 7958 (National Bureau of Economic Research, Inc., 1998).

[11]That led to stock market volatility.

[12]Henry G. Manne, "Insider Trading and Property Rights in New Information," *Cato Journal*, vol. 4, No. 3 (Cato Institute, Winter 1985). "It seems fairly clear then that the economic, moral and legal arguments are very strong against the SECs stand on insider trading. There remains then only one area of investigation, and that is a political one. Ever since George Stigler elaborated the modern "interest theory" of regulation, scholars have been well-advised in seeking the explanation for a particular regulatory position to ask who would be benefited most by the rule. Ethical and economic welfare arguments aside, who stands to benefit most if in fact the arguments for enforcement against corporate insiders carry the day? If we know the answer to that question, we will have an important insight into what is really going on here.

[13]Ibid.

[14]"But no amount of semantics can change the fact that if insiders cannot use the information, these functionaries will get it and use it to their advantage more quickly than anyone else." Ibid.

While this reasoning has been very influential, not many agreed. It was generally maintained that disclosure provisions and prohibition of insider trading as part of the securities laws are completely justified.[15] The literature on insider trading is considerable both in the legal and in the economic field, and we will have occasion to say more about this debate. Nevertheless, the law that grew in the United States has become quite complex and has influenced the rest of the world.

After prolonged incubation within the US legal system, the law of insider trading started spreading to the rest of the world. It spread to the European Union, to the Far East and to India and Pakistan as well. It is maintained by some that the law has been adopted by the rest of the world under pressure from the United States and its Securities and Exchange commission.[16] In Pakistan, the law was first introduced in 1995 through an amendment in the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of 1969).[17] The law came into the limelight due to the stock market crash of the year 2000. The reform process continued into the year 2001. To impose transparency in trade, curb the practice of insider trading, and bring Stock Exchange operations to international standards, SECP ordered some amendments to the Articles of Association of the Karachi Stock Exchange and issued Listed Companies (Prohibition of Insider Trading) Guidelines.[18] Nevertheless, a report of the Asian Devel-

[15]See, e.g., Nicholas L. Georgakopoulos "Why Should Disclosure Rules Subsidise Informed Traders?" *International Review of Law and Economics* 16:417-451 (New York: ELsvier Science Inc., 1996). See also Alexandre Padilla, *Insider Trading, Agency Problems, and Corporate Governance*, University of Law, Economics and Science of Aix-Marseille (France).

[16]See Enrico Colombatto and Jonathan R. Macey in "A Public Choice Model of International Economic Cooperation and the Decline of the Nation State," an article that is forthcoming in the *cardozo Law Review*. It is available at http://web.econ.unito.it/colombatto/cardoso.pdf.

[17]See Chapter III-A on Insider Trading in the Ordinance.

[18]See Stock Exchange Members (Inspection of Books and Records) Rules 2001; Brokers and Agents Registration Rules 2001; and Listed Companies (Prohibition of Insiders Trading) Guidelines. Issued at Islamabad on 27th March, 2000. See also Asian Development Bank, *Country Economic Review: Islamic Republic of Pakistan*

opment Bank maintains that "Front running is [still] common, and insider trading is widespread. As a result, there is little genuine investor interest; the market is heavily discounted; and companies with solid fundamentals, yielding a 20 percent dividend and two times price earnings ratios, are left without buyers."[19] A report (2004) of the International Monetary Fund maintains that "SECP should review the rules about insider trading to ensure that they can be enforced effectively in particular cases."[20] The report further maintains that "The SECP has started the review of legal provisions pertaining to insider trading and security disclosure."[21] This study is in particular directed at such a review of the law, so that useful suggestions be made where possible. Further, despite so much debate in the rest of the world, there are very few people in Pakistan who understand the law on insider trading, and it is sometimes felt that insider trading is being confused with market manipulation. The law in Pakistan, therefore, needs to be explained in the light of developments in the rest of the world, so that what are deemed good practices at the international level may be implemented in Pakistan too.

The purpose of this study is to first understand the nature of this law and see how it has been developed in the United States and passed thereafter to other countries including our neighbour India. Once the law has been analysed and its intricacies resolved, to see how it has been applied

(Manila: November 2001), 9. "To implement the Prohibition of Insider Trading Regulation, new rules were also issued that allow SECP to investigate and inspect the accounts and records of individuals deemed to be insiders and associated members of stock exchanges." Ibid.

[19]Asian Development Bank, *TAR: PAK 35055, Technical Assistance to the Islamic Republic of Pakistan for Capacity Building for Capital Market Development and Corporate Governance* (August 2001), 1.

[20]International Monetary Fund, *IMF Country Report No. 04/215 Pakistan: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation* (July 2004), 42. "In addition, the assessors have queried whether insider trading law is adequate to deal with those who benefit from insider trading but are not insiders as defined, in particular, tippees of insiders." Ibid, 39.

[21]Ibid, 45.

in Pakistan. The main purpose is to make proposals for the efficient implementation of the law in Pakistan. Before the goals of the study can be clearly understood, it is necessary to understand the meaning of "insider trading" and to examine the various theories that are used by the courts and administrative agencies to justify this law. This introduction will, therefore, deal with the meaning and theories of insider trading and then clearly identify the goals that will be pursued in the rest of the study.

1.1 The Meaning of Insider Trading

The United States, Securities and Exchange Commission (SEC) directive on the meaning of insider trading states that "all insider trading is not illegal even though the term 'insider trading' is usually associated with illegal conduct. The term includes both legal and illegal conduct."[22] Legal insider trading occurs when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies.[23] Legal insider trading, by corporate insiders trading in the securities of their companies, is required to be reported on prescribed forms prior to the transaction.[24] According to the same directive, illegal insider trading occurs when buying or selling in a security is undertaken, in breach of a fiduciary duty or other relationship of trust and confidence, while the person trading is in possession of material, nonpublic information about the security.[25] Insider trading violations can also include "tipping" such information, securities trading by the person "tipped," and securities trading by those

[22] U.S. Securities and Exchange Commission, *Insider Trading*. Directive available at http://www.sec.-gov/answers/insider.htm. It was modified last on 04/19/2001.
[23] Ibid.
[24] Ibid.
[25] Ibid.

who misappropriate such information.[26]

To understand the nature of the offence of insider trading, the essential distinction between acts that are *malum in se* and acts that are *malum prohibitum* has to be kept in mind. An act that is *malum in se* is "wrong in itself." It is in its very nature illegal, because it violates the natural, moral or public principles of a civilised society.[27] In contrast, an act that is *malum prohibitum* is not obviously wrong or injurious, In other words, it is not clearly one that should be illegal, but it is prohibited.[28] The only reason a *malum prohibitum* act is wrong is that the government has declared it to be wrong. The leading example given today of an act that is *malum prohibitum* is insider trading.[29]

In the United States, insider trading liability may arise in the context of criminal, civil or administrative proceedings. "The U.S. Department of Justice has jurisdiction to pursue criminal actions. The Securities and Exchange Commission (SEC), self-regulatory agencies, and state securities enforcement agencies may initiate civil and administrative proceedings based on insider trading allegations. Private parties may also bring civil claims based on insider trading allegations."[30] Accordingly, insider trading cases have been brought by the SEC, in the United States, against corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments.[31] Cases have also been brought against friends, business

[26]Ibid.

[27]Examples are murder, rape, and theft.

[28]*Black's Law Dictionary* 7th Ed., Bryan A. Garner & Henry Campbell Black Eds., *s.v.* "malum prohibitum."

[29]Donald J. Boudreaux, "Insider-Trading Prohibitions Should Go out of Style," *Commentaries* (Virginia: The Future of Freedom Foundation, 2003).

[30]Terry Fleming, "Telling the Truth Slant—Defending Insider Trading Claims Against Legal and Financial Professionals," *William Mitchell Law Review*, vol. 28:4, 1422.

[31]U.S. Securities and Exchange Commission, *Insider Trading*. Directive available at http://www.sec.-

associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information.[32] Then there have been cases against employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded, and even government employees who learnt of such information because of their employment by the government.[33] Some of these persons were those who misappropriated, and took advantage of, confidential information from their employers.[34] Famous names associated with insider trading in the US include Ivan Boesky, Michael Miliken, Charles F. Fogarty, Martha Stewart (ImClone) and more recently Enron Corporation. The following table is reproduced to show some of the convictions in the United States up to 1990.

Table 1: Insider Trading Charges and Convictions in the United States of America up to 1990

Trader	Occupation	Fines and Repayment	Jail sentence
Michael R. Milken	Banker, Drexel Burnham Lambert	$600 million	Pending
Ivan F. Boesky	Arbitrage	$100 million	3 years
Dennis Levine	Banker, Drexel, other firms	$11.6 million	2 years
Martin Siegel	Banker, Kidder Peabody, Drexel	$9 million	2 months
James T. Sherwin	Vice Chairman, GAF Corp	$2 million	6 months
Charles Zarzecki	Partner, Princeton/Newport LP	$1.6 million	3 months
Paul Bilzerian	Investor, chairman, Singer Co.	$1.5 million	4 years
Salem Lewis	Arbitrage	$400,000	Probation
James Sutton Regan	Partner, Princeton/Newport	$275,000	6 months
Boyd Jefferies	CEO, Jefferies & Co	$250,000	Probation
Paul Berkman	Partner, Princeton/Newport	$100,000	3 months
Jack Rabinowitz	Partner, Princeton/Newport	$50,000	3 months
Steven Smotrich	Comptroller, Princeton/Newport	None	3 months
John A. Mulheren	Partner, Jamie Securities	Pending	Pending

Sources: Off. of US Attorney, S. Distt, NY. Reproduced from The Sun, Baltimore, 15 July 1990.

gov/answers/insider.htm. It was modified last on 04/19/2001.
[32]Ibid.
[33]Ibid.
[34]Ibid.

1.2 Insider Trading and Market Manipulation

Consultation Paper No. 6 of the Jersey Financial Services provides a good definition of "market manipulation." The definition is as follows:

> Market manipulation involves transactions or orders to trade which
> - give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments;
> - alter, by one or more persons acting in collaboration, the price of one or several financial instruments to an abnormal or artificial level; or
> - employ fictitious devices or any other form of deception or contrivance.
>
> Market manipulation includes the dissemination of information through the media, including the Internet, or by any other means, which give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments, including the dissemination of rumours and false or misleading news.[35]

Insider trading is sometimes linked to market manipulation as well, however, the two concepts are quite distinct.[36] The link between them is that in both cases, that is, "As a result of insider dealing or market manipulation, innocent investors may well buy or sell investments at a false price. Moreover, market abuse of this kind undermines confidence in markets."[37] According to a well known writer on insider trading, Bainbridge, "Manipulation of stock prices, as a form of fraud, harms both society and individuals by decreasing the accuracy of pricing by the market."[38] Those who favour regulation of insider trading sometimes argue that it is the insiders who have the maximum incentive to indulge in market manipulation, because they have a "strong interest in keeping the stock pricing stable or in moving it in the correct direction while they are trading."[39] Even the opponent of insider trading regulation, Manne, acknowledged that manipulation is harmful and that manipulation of stock

[35]Consultation Paper No. 6, Paper 2003-06, *Market Manipulation and Insider Dealing* (Jersey Financial Services Commission, 2006), 6.

[36]Ibid., 9.

[37]Ibid., 6.

[38]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 790.

[39]Ibid. quoting Schotland, "Unsafe at Any Price: A Reply to Manne, 'Insider Trading and the Stock Market'" *Virginia Law Review* vol. 53 (1967), 1425, at 1449-1450.

prices would cease if insider trading could be effectively eliminated because nobody would then benefit from it.[40]

In this study, however, we will attempt to keep the two concepts distinct so that the meaning of insider trading is not confused with "market manipulation" and a clear definition of insider trading stands out for purposes of future legislation and implementation of the law.

1.3 The Justification for Insider Trading Law

Insider trading when prohibited is *malum prohibitum* and not *malum in se*, as stated above, that is, it is prohibited just because the government has declared it to be prohibited. Insider trading has now been declared unlawful in many countries. What is the justification for such prohibition and what policy considerations push governments to prohibit this activity? Are these policy considerations the same for countries with highly developed markets, like those of the United States and the European Community, and those with small or emerging markets, like Pakistan? If these considerations are different, then, will the prohibition of insider trading stifle the growth of these growing markets? The answer to these questions will help us understand the justification for imposing insider trading laws and will also determine the direction and severity of the laws required for a country like Pakistan.

A protracted debate has taken place over the basis of the prohibitions contained in insider trading laws. The main discussion is around the point that "information is power" and people use information to make

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[40]Henry G. Manne, "Insider Trading and the Law Professors," *Vanderbilt Law Review*, vol. 23, 547-590 (1970), at 575, as quoted in Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 790.

investment decisions. This is true for commodities, for real estate and for each and every business opportunity. A dealer in grains who has inside information, not available to the public, about the supply of grain is in a better position to exploit this information, and he actually does so. So does an investor in real estate. Making use of inside information in such businesses is not prohibited, why then should it be prohibited for trading in company shares? The various theories about insider trading attempt to answer these and other questions. Without an explanation of these theories, it is difficult to understand insider trading law.

1.3.1 Types of Theories for Justifying Insider Trading Law

A survey of the various theories shows that there are three broad categories of theories. The first category is that of economic theories that provide an economic justification for the prohibition of insider trading.[41] The second category is that of legal theories that show how the ambit of the prohibitions widened and on what legal considerations.[42] The third category of theories deals with the spread of insider laws from the United States to the rest of the world.[43] Almost all theories are US specific and even the third category of theories deals with the export of the law from the United states to the rest of the world.

[41] For a comprehensive explanation of these theories see Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, Eds. Boudewijn Bouckaert and Gerrit De Geest (Ghent: Edward Elgar and the University of Ghent, 1996–2000). See also Laura N. Beny, "A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading," *Discussion Paper No. 264, 9/99* (Cambridge: Harvard Law School, 1999) and Alexandre Padilla, "Can Agency Theory Justify the Regulation of Insider Trading?" *The Quarterly Journal of Austrian Economics*, vol. 5, No. 1 (Spring 2002), 3–38.

[42] These theories have been developed in US case law, but have been elaborated systematically by writers. See, e.g., Thomas E. Geyer, "Insider Trading: Evolution, Prevailing Theories and Recent Developments," *Report Prepared for Bailey Cavalieri LLC* (Columbus, Ohio: February 14, 2003) and Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics* as well as others.

[43] The main contribution in this area is that of Enrico Colombatto and Jonathan R. Macey in "A Public Choice Model of International Economic Cooperation and the Decline of the Nation State," forthcoming article in the *cardozo Law Review*. Laura N. Beny, in the article mentioned above has taken a different position and we shall have occasion to refer to that article too.

We shall deal with the first and third categories of theories in this introduction. The second category of theories or legal theories will be taken up in the next chapter that deals with the development of the law in the United States.

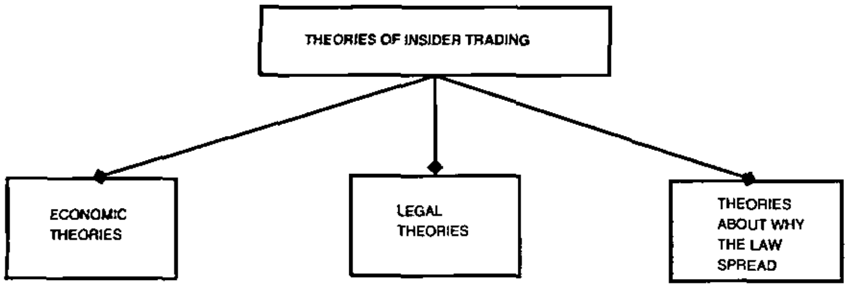

Figure 1.1: Theories of Insider Trading

Some writers classify economic theories into agency and market theories.[44] We shall follow a more straightforward approach and focus on the main theories including agency and market theories, as well as those about the spread of the law outside the U.S., in the form of issues.

1.3.2 Issues Addressed by Theories Justifying Insider Trading Law

A large number of countries that have stock markets have introduced insider trading laws. Nevertheless, in the theoretical discussions, the debate whether insider trading should be regulated is still alive and there is no consensus about the necessity of such a law. The discussion began when, more than thirty years ago, Henry Manne questioned the basic assumptions of those who wished to regulate insider trading.[45] His writing generated scepticism and controversy about regulation for he reached the opposite conclusion that insider trading is beneficial to the firm, the mar-

[44] Laura N. Beny, "A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading," *Discussion Paper No. 264, 9/99* (Cambridge: Harvard Law School, 1999).
[45] This he did in Henry G. Manne, *Insider Trading and the Stock Market* (1966).

ket and society, and, therefore requires no regulation. Today, a number of arguments are advanced for and against regulation. The arguments presented are complex and detailed, and we cannot go into all the details in this study. These arguments and theories can, in the view of this writer, be understood more easily in response to the following questions:

- Does insider trading disturb the prices of securities and affect the efficiency of the market?
- Does insider trading harm company operations or does it promote the interests of the company by compensating the managers?
- Is insider trading regulation intended to benefit some powerful groups?
- Does insider trading harm the individual investor and undermine investor confidence?
- Does insider trading amount to theft of corporate property?

Most of points raised in the debate can be captured within the discussion of these questions. We shall include the views of those who favour regulation and those who oppose it under these questions. In the final section, we shall summarise the arguments for regulation and deregulation.

1.3.3 Issue No. 1: Does Insider Trading Disturb the Prices of Securities and Affect the Efficiency of the Market?

Most scholars agree that both firms and society benefit from accurate pricing of securities.[46] Such a price is possible when "all information relating to the security has been publicly disclosed."[47] The effect of accurate

[46]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 777.
[47]Ibid.

pricing is that the allocation of capital investment improves and this helps the economy.[48] Further, it decreases the volatility of security prices, and the stabilising effect removes the likelihood of individual windfall gains thus increasing the attractiveness of investing in securities.[49] The corporation, whose securities are priced accurately, also benefits through reduced investor uncertainty and improved monitoring of management-effectiveness.[50]

It is well known that securities laws encourage accurate pricing by requiring disclosure of corporate information, but these laws do not require the disclosure of all material information. Disclosure laws normally do not interfere with legitimate business transactions, and disclosure by the corporation is not required unless the firm is dealing in its own securities at the time.[51] In other words, some non-public information that is likely to affect the price of the security is not released as this is not required by the disclosure laws. "When a firm lawfully withholds material information, its securities are no longer accurately priced by the market. If the undisclosed information is particularly significant, the error in price can be substantial."[52]

Henry G. Manne, the first person to oppose insider trading laws, argued that insider trading provides an incentive to release non-public information and this helps in maintaining accurate securities prices. He maintained, with the help of illustrations, that if insider trading is prohibited,

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[48]Ibid.
[49]Ibid.
[50]Ibid. See also Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga J. Intl. L.* (1997-98), available at http://www.gonzagajil.org/ (last visited July 3, 2006).
[51]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 777. Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga J. Intl. L.* (1997-98), available at http://www.gonzagajil.org/ (last visited July 3, 2006).
[52]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 777.

the non-public information when released suddenly will cause rapid fall or rise in prices and this is not good for the market.[53] "Thus, insider trading acts as a replacement for public disclosure of the information, preserving market gains of correct pricing while permitting the corporation to retain the benefits of nondisclosure."[54]

These arguments led to various studies about the actual effect of insider trading on the prices of securities. Some of these studies maintained that insider trading had an insignificant effect on actual prices.[55] In other studies, the opposite conclusion was reached.[56] There are many other studies that reach complex conclusions, however, the position is not devoid of confusion and no clear view can be expressed about the benefits of permitting insider trading on the grounds that it will lead to accuracy of prices in a gradual and non-volatile manner.[57]

We may safely conclude that while the reasoning of those who argue against insider trading laws, because insider trading leads to an efficient market, may not be very convincing or verified, there is also little justification for prohibiting insider trading on the basis of arguments that this form of trading adversely affects the efficiency of the market. Nevertheless, those who wish to regulate insider trading are dominating the field at present.

[53]Henry G. Manne, "In Defence of Insider Trading," 44 *Harvard Business Review*, (1966) 89.
[54]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 777.
[55]Roy A. Schotland, "Unsafe at Any Price: A Reply to Manne, 'Insider Trading and the Stock Market'," 53 *Virginia Law Review* (1967) 1425-1478.
[56]Joseph E. Finnerty, "Insiders and Market Efficiency," 31 *Journal of Finance* (1976) 1141-1148.
[57]For a detailed discussion of such studies and their divergent conclusions, see Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics* and Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga. J. Intl. L.* (1997-98) mentioned above.

1.3.4 Issue No. 2: Does Insider Trading Harm Company Operations and Interests or Does it Promote the Interests of the Company by Compensating Managers and Controlling Shareholders?

The second argument in favour of insider trading, that is, for not prohibiting it, was also advanced by Henry G. Manne. His deregulatory argument was based mainly on the claim that "allowing insider trading was an effective means of compensating entrepreneurs in large corporations."[58] By corporate entrepreneurs he meant those who produce new valuable information within the corporation. He asserted that such persons need an incentive for generating valuable information and bringing it to the market and insider trading is an effective way to compensate corporate agents for such innovations. In other words, the corporate entrepreneur is entitled to the gain he makes for trading in the shares of his corporation. Manne's arguments were developed further by others. Thus, Carlton and Fischel maintained that an advantage of insider trading is that an agent revises his compensation package without renegotiating his contract thereby self-tailoring his compensation to account for the information he produces.[59] "As insider trading provides the agent with more certainty of reward than other compensation schemes, it also provides more incentives."[60]

Writers like Harold Demsetz have argued that insider trading functions as a compensation scheme for the controlling shareholders as well.[61] As they hold a large number of shares to control the corporation, and this means holding stocks of one particular corporation without diversification

[58]Henry G. Manne, "In Defence of Insider Trading," 44 *Harvard Business Review*, 116.
[59]Dennis W. Carlton and Daniel R. Fischel, "The Regulation of Insider Trading," 35 *Stanford Law Review* (1983) 857-895 as quoted in Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 781.
[60]Ibid.
[61]Harold Demsetz, "Corporate Control, Insider Trading, and Rate of Return," 76 Am. Econ. Rev. 313 (1986).

of their portfolios, they assume high risks. It is, therefore, just to provide some incentive to them for undertaking such high risks.[62] The incentive comes from the profits of insider trading.[63]

Those who wish to regulate insider trading argue that there is no evidence that insider trading acts as the most efficient and most accurate form of compensation.[64] They maintain that the financial ability of the corporate entrepreneur to purchase stock limits their compensation, thus, compensation depends not primarily on the value of the information or on the value of the contribution to the information, but rather on wealth owned by and available with the entrepreneur.[65] Consequently, a managers' ability to tailor his own compensation package is limited.[66]

There are many arguments and counter arguments, with some becoming, too technical. We have listed the broad idea here. The conclusion provided by Bainbridge is: "As with the market efficiency argument, little empirical evidence supports or counters the compensation argument." Regulators, however, strongly believe that a compensation scheme based on stock options avoids the disadvantages of insider trading, because they allow managers to participate in the firm's success.[67] Many writers treat deregulators' arguments regarding compensation to be unconvincing.[68] Nevertheless, the debate continues.

[62] Ibid. at 316.

[63] Ibid.; see also Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga. J. Intl. L.* (1997-98).

[64] Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 782.

[65] Roy A. Schotland, "Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market," 53 *Va. L.Rev.* 1425, 1455 (1967).

[66] Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 782.

[67] Louis Loss & Joel Seligman, *Securities Regulation* (3d ed. 1991 and 1996 supplement), 1461.

[68] See, e.g., Joerg Hartmann, "Insider Trading: An Economic and Legal Problem," 1 *Gonzaga. J. Intl. L.* (1997-98).

1.3.5 Issue No. 3: Is Insider Trading Regulation Intended to Benefit Some Powerful Groups?

We referred to this in the first section of this chapter. The idea is that insider information is denied to the insiders and passed on to those next in line for whom it is very useful. Thus, the critics of the insider trading prohibition "contend that the prohibition can be explained by a public choice-based model of regulation in which rules are sold by regulators and bought by the beneficiaries of the regulation."[69] This thesis was first developed by Dooley[70] and later on by Haddock and Macey.[71] Their research focused on why the SEC (US) wants to sell insider trading regulation and to whom.[72]

The argument advanced by Dooley was that the SEC, like all other government agencies, wished to enhance for its power and prestige and consequentially to acquire larger budgetary grants and hence salaries.[73] Further, the SEC wanted to federalise corporate law in order to acquire a lead role in corporate law that was superior to state laws. "The SECs prominent role in attacking insider trading thus placed it in the vanguard of the movement to federalise corporate law and ensured that the SEC would have a leading role in any system of federal corporations law."[74]

Haddock and Macey, on the other hand, argued that the insider trading prohibition serves the interests of market professionals, "a cohesive and politically powerful interest group, which the current legal regime

[69]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 782.
[70]Michael P. Dooley, "Enforcement of Insider Trading Restrictions," 66 *Virginia Law Review*, 1-89 (1980).
[71]David D. Haddock and Jonathan R. Macey, "Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation," 30 *Journal of Law and Economics*, 311-352 (1987).
[72]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 782.
[73]Ibid., 783.
[74]Ibid.

effectively insulates from insider trading liability."[75] The information ultimately becomes "data" and is used safely by market professionals and bankers.

Colombatto and Macey take the argument one step further and state that the law of insider trading was forced upon countries in Europe and other jurisdictions. The main thesis of their research in their words is as follows:

> The starting point for the analysis is that nations do not decide to cooperate or forge international agreements: rather the regulators, bureaucrats and politicians within nations do. And regulators will not agree to enter into international agreements unless it is in their (private) interest to do so. Furthermore, regulators are political support maximising actors. They respond to political pressure and to self-interest. All else equal, regulators would prefer not to cede—or to share—regulatory authority with regulators from other countries. For this reason, regulators in a particular country generally do not want to coordinate their activities with regulators in other countries because such coordination forces the regulators to sacrifice autonomy. The thesis of this article, however, is that technological change, market processes and other exogenous variables can deprive the regulators in a particular country of the power to act unilaterally. Such change can cause regulators acting alone to become irrelevant. When this happens, the regulators in a particular country will have strong incentives to engage in activities such as international coordination in order to survive.[76]

They proceed to show that the SEC did just that in the case of insider trading as there was a dire need to control insiders who were using international financial arrangements to evade the restrictions imposed by the SEC. Laura N. Beny has tried to counter this thesis to some extent.[77]

1.3.6 Issue No. 4: Does Insider Trading Harm the Individual Investor and Undermine Investor confidence?

Bainbridge identifies two ways in which Insider trading is said to harm the investor.[78] The first argument is that "investors trades are made at the

[75] Ibid. See also Enrico Colombatto and Jonathan R. Macey in "A Public Choice Model of International Economic Cooperation and the Decline of the Nation State," an article that is forthcoming in the *cardozo Law Review* (http://web.econ.unito.it/colombatto/cardoso.pdf).
[76] Enrico Colombatto and Jonathan R. Macey in "A Public Choice Model of International Economic Cooperation and the Decline of the Nation State," an article that is forthcoming in the *cardozo Law Review* (http://web.econ.unito.it/colombatto/cardoso.pdf).
[77] Laura N. Beny, "A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading," *Discussion Paper No. 264, 9/99* (Cambridge: Harvard Law School, 1999.
[78] Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 785.

'wrong price.'"[79] An investor trading at the same time as the insider will claim that he has suffered an injury insofar as he sold at the wrong price. The reason is that he sold at a price that does not reflect the undisclosed information.[80] Bainbridge maintains that this is not a very convincing argument. The claim of the investor can only be true if immediate disclosure of material information is to be required by the law. The law, however, does not require corporations to disclose all information. In such a situation, "there will always be winners and losers. . . irrespective of whether insiders are permitted to inside trade or not, the investor will not have the same access to information as the insider."[81]

The second argument, which is more sophisticated, is represented by the theory that the investor is induced to make a bad purchase or sale due to the distortions caused by insider trading.[82] Even this argument is not very convincing. In fact, it is considered a flawed argument as many investors would have traded irrespective of the presence of insiders in the market. In reality, the transactions took place "at a price closer to the correct price" due to insider trading.

When the arguments of injury to the investor fail, "it is difficult to see why insider trading should undermine investor confidence in the integrity of the securities markets."[83] The performance of the markets, after scandals, refutes this claim. Bainbridge says that:

> The enormous publicity given those scandals put all investors on notice that insider trading is a common securities violation. At the same time, however, the years since the scandals have been one of the stock markets most robust periods. One can but conclude that insider trading does not seriously threaten the confidence of investors in

[79]Ibid.
[80]Ibid.
[81]Ibid.
[82]Ibid.
[83]Ibid., 786.

the securities markets.[84]

Macey maintains that the experience of countries, other than the U.S.A., confirms this conclusion.[85] For example, Japan and Hong Kong only recently began regulating insider trading, but both have vigorous and highly liquid stock markets.[86]

1.3.7 Issue No. 5: Does Insider Trading Harm the Issuer and Amount to Theft of Corporate Property?

The injury to the issuer argument has four parts, and we will describe these briefly below:

1. **Insider trading may delay the transmission of information or the taking of corporate action.** A manager may delay information beneficial or detrimental to the firm to assure himself sufficient time to trade on the basis of that information before the corporation acts upon it. This may cause some harm, but it is maintained that its importance is exaggerated,[87] and in this electronic age and the rapidity with which markets function, it is not possible to delay information for very long.[88] further, delay is easily detectable by the employer.[89]

2. **Insider trading may impede corporate plans.** This argument pertains to acquisitions, mergers and takeovers by corporations. "The risk of premature disclosure poses a more serious threat to corporate plans. The issuer often has just as much interest in when informa-

[84]Ibid.
[85]Ibid. quoting Jonathan R. Macey, "From Judicial Solutions to Political Solutions: The New Direction of the Rules Against Insider Trading," 39 *Alabama Law Review*, 355-380 (1991).
[86]Ibid.
[87]Ibid., 787.
[88]Michael P. Dooley, "Enforcement of Insider Trading Restrictions," 66 Virginia Law Review, 1-89 (1980), 36-37.
[89]Ibid.

tion becomes public as it does in whether the information becomes public."[90]

3. **Insider trading gives managers an incentive to manipulate stock prices.** There is general agreement that manipulation of stock prices, as a form of fraud, harms both society and individuals by decreasing the accuracy of pricing by the market.[91] Those who favour regulation maintain that "if managers are permitted to trade on inside information they have a strong interest in . . . [and] a strong incentive to use manipulative practices."[92] Insider trading as a cause of market manipulation was acknowledged even by Manne, who was otherwise against regulation of insider trading.[93]

4. **Insider trading may injure the firms reputation.** A number of arguments are advanced to show that insider trading by corporate managers may "cast a cloud on the corporations name, injure stockholder relations and undermine public regard for the corporations securities."[94] The general conclusion is that even though "insider trading is not actually unfair, the reputational injury story may remain viable if most investors believe it to be unfair. This perception of unfairness most likely proceeds from resentment of the insiders informational advantage, which suggests that it may be based on envy as much as on fairness norms."[95]

[90]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 788.
[91]Ibid.
[92]*Ibid. quoting* Roy A. Schotland, "Unsafe at Any Price: A Reply to Manne, 'Insider Trading and the Stock Market'," 53 *Virginia Law Review* 1425-1478 (1967), 1449-1450.
[93]Henry G. Manne, "Insider Trading and the Law Professors," 23 *Vanderbilt Law Review* 547-590 (1970), 575.
[94]Diamond v. Oreamuno, 248 NE 2d 910, 912 (NY 1969).
[95]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 788.

Finally, the argument is advanced that insider trading is theft of corporate property. There is a general consensus that the insider trading prohibition is most easily justified as a means of protecting property rights in information.[96] This approach, it is said, has great explanatory as well as "justificatory" power.[97] The property right arises by prohibiting others from using such information, but it can only be enforced through government regulation, like insider trading prohibition and enforcement. "The rationale for prohibiting insider trading is precisely the same as that for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce socially valuable information."[98] The theory is detailed, but for our purposes this is sufficient.[99]

1.4 Summarising the Arguments for Regulation and Deregulation

We have now seen that the debate about regulating and deregulating insider trading is drawn out and complex. Further, there are no convincing answers from either side. The debate that has been going on for the last three decades in the U.S., and now in other countries, is still continuing. One thing is clear though that those who wish to regulate insider trading are at present dominating the field. This has led to the introduction of insider trading laws in many countries of the world, including Pakistan. Now that the law has been applied, it must be improved and applied efficiently. It will be useful to state the arguments of regulators and deregulators, considered above, in a summarised form.

[96]Ibid.; U.S. v. Chestman, 903 F.2d 75; Michael P. Dooley, *The Fundamentals of Corporation Law* (Mineola, NY, Foundation Press, 1995), 820–23.
[97]See, e.g., Stephen M. Bainbridge, "Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition," 52 *Washington and Lee Law Review* (1995) 1189.
[98]Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 792.
[99]For the details of this theory, see ibid.

1.4.1 Arguments for Regulation

The main arguments for regulating insider trading fall into three main categories, and these categories have further subdivisions:

1. **Insider trading harms investors and thus undermines investor confidence in the securities markets.** This argument is based on the reasoning that investors trades are made at the "wrong price" due to the actions of the insiders or due to the distortions caused in the market for stocks. We saw that this argument is not very convincing.

2. **Insider trading harms the issuer of the affected securities.** The acts of insiders may disturb company plans for acquisitions, mergers and takeovers and impede other corporate plans.

3. **Insider trading is usually the cause of market manipulation.** This argument is actually part of the previous argument, however, we have singled it out to show that perhaps this is the strongest argument for regulating insider trading. Further, manipulation is often witnessed in markets like those of Pakistan and is linked to insider trading.

4. **Insider trading amounts to theft of property belonging to the corporation and therefore should be prohibited even in the absence of harm to investors or to the firm.** This is also considered a strong argument and there is general consensus that using insider information amounts to corporate theft.

1.4.2 Arguments Against Regulation

The main arguments of those who oppose the regulations of insider trading are as under:

1. ***Insider trading* is an efficient compensation scheme for those who generate such information.** This argument is the oldest and the most interesting. It has been discussed at length above. The benefits of insider trading are a "perk" to which insiders are entitled.
2. **Insider trading leads to efficient markets and the accurate pricing of securities and should not be prohibited.** Insider trading helps release information that is not covered by the disclosure provisions and brings such information to the market leading to accurate pricing in the shortest possible time.
3. **The regulation of insider trading does not affect the market, but benefits some powerful groups within the system, therefore, such regulation is bad.** These powerful groups are the bankers and other significant players in the market for whom the information becomes "data" and not undisclosed information, and they benefit from it. Another aspect of this argument is the enhancing of the power of the regulatory agencies. Thus, it is in the interest of the SEC, for example, to enforce the law of insider trading to enhance its prestige and budgetary grants.

We may mention in the end that the United States Securities and Exchange Commission provides the following reason as the basis for prohibiting insider trading: "Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the SEC has treated the detection and prosecution of insider trading violations as one of its enforcement priorities."[100]

1.5 The Scheme of the Study

We have now had the opportunity of seeing why insider trading should be prohibited and why it should not be prohibited. This gives us an understanding of the issues underlying the phenomenon of insider trading. Whatever the outcome of the debate, it is clear that those who wish to regulate insider trading are dominating at present. Consequently, laws prohibiting insider trading have been introduced in many countries. In Pakistan too the law has been implemented, however, it is in the process of being improved and made more effective. In Pakistan, the reason for prohibiting insider trading may be the same as that given by the SEC, and stated in the previous section. Nevertheless, the malaise of market manipulation combined with insider trading is rampant in the stock markets of Pakistan. The interests of the small investor need to be protected. This study is intended to help in refining and improving the law of insider trading.

The goal of the study, therefore, is to understand the laws applied in different jurisdictions and come up with the best definition and scope of insider trading. Once this has been done, a proposal will be made for the improvement of the law so that it can be implemented and enforced in the best possible manner. As stated earlier, we will first examine the

[100] U.S. securities and Exchange Commission, *Insider Trading*. Directive available at http://www.sec.-gov/answers/insider.htm (last visited July 1, 2006).

development of the law in the United States and see what form it has acquired today. This will be followed by the study of some important jurisdictions like Europe and the Far-East. The law of our neighbour, India, will also be discussed with the law applied in the rest of the world. After examining all these laws, we will be able to assess our findings and decide what form the law should take in Pakistan. A draft law will also be prepared as a proposal.

CHAPTER II

Insider Trading Law in the United States

2.1 The Meaning of Insider Trading in the United States

Insider trading is a term that is usually associate with illegal conduct, but the term actually includes both legal and illegal conduct.[1] Legal insider occurs when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies.[2] When legal insider trading takes place, the corporate insiders dealing in their company's own securities are required by the United States Securities and Exchange Commission (hereinafter referred to as the "SEC") requires them to simply report such trading.[3] Here we are concerned with the illegal form of insider trading. Today, after development of the law for almost a century in the United States, illegal insider trading is described by the SEC as follows:

> Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.[4]

To explain the meaning further, the SEC provides examples of transactions that have actually constituted insider trading in cases brought by

[1] U.S. securities and Exchange Commission, *Insider Trading*. Directive available at http://www.sec.gov/answers/insider.htm (last visited July 1, 2006).
[2] Ibid.
[3] For the details see ibid, and *Forms* 3, 4, 5 at the SEC website.
[4] Ibid.

the SEC:

- Corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments;
- Friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information;
- Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded;
- Government employees who learned of such information because of their employment by the government; and
- Other persons who misappropriated, and took advantage of, confidential information from their employers.[5]

Insider trading liability may arise in the context of criminal, civil or administrative proceedings. The U.S. Department of Justice has jurisdiction to pursue criminal actions. The Securities and Exchange Commission (SEC), self-regulatory agencies, and state securities enforcement agencies may initiate civil and administrative proceedings based on insider trading allegations. Private parties may also bring civil claims based on insider trading allegations.[6]

Enforcement is governed by section 10(b) and section 21(A) of the Securities and Exchange Act of 1934.[7]

Section 21A(e) of the Act authorizes the SEC to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, or from a person who directly or indirectly controlled an insider trader.[8] Rule 14e-3 prohibits insider trading during a tender offer

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[5]Ibid.

[6]Terry Fleming, "Telling the Truth Slant—Defending Insider Trading Claims Against Legal and Financial Professionals," *William Mitchell Law Review*, vol. 28:4, 1422.

[7]15 U.S.C. 78u-l(e).

[8]http://www.sec.gov/ Division of Enforcement Insider Trading.htm (last visited July 1, 2006). Section 21A(e) of the Exchange Act states: "[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payment, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review."

and thus supplements Rule 10b-5. It prohibits anyone, except the bidder, who possesses material, nonpublic information of a tender offer, from trading the targets securities. The Rule also prohibits anyone with any form or connection to a tender offer from tipping material, nonpublic information.

In July 2002, the SEC has adopted new rules, where courts have disagreed, to address three issues:

- the selective disclosure by issuers of material nonpublic information;
- when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information; and
- when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading.[9]

The rules, it is maintained, are designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading.[10] The meaning of insider trading and the impact of these rules cannot be fully understood, unless we trace the development of insider trading law in the United States with the help of SEC action and the theories developed by the courts.

2.2 The Development of Insider Trading Law in the United States

In order to understand contemporary insider trading jurisprudence, it is essential to discuss three prevailing theories of insider trading liability:

[9]U.S. securities and Exchange Commission, *Selective Disclosure and Insider Trading*, Directive available at http://www.sec.gov/rules/final/33-7881.htm (last visited July 3, 2006).

[10]U.S. securities and Exchange Commission, *Insider Trading*. Directive available at http://www.sec.gov/answers/insider.htm (last visited July 1, 2006).

the Classical Theory, the Tipping Theory, and the Misappropriation Theory. This section attempts to do just that with the help of court decisions and the growing SEC law on the subject.

2.2.1 The Law Prior to 1933

The story of insider trading in the United States may be said to start in the year 1903 when neither state corporate law nor state common law[11] imposed a duty on corporate insiders[12] to abstain from using material, non-public information for their own benefit.[13] At that time, "the conventional wisdom" of the day held that the benefits of inside information were a normal emolument of being a corporate insider.[14] It has already been indicated that it was called a "perk" by one court.

At this time, in 1903, the Supreme Court of the state of Georgia departed from conventional wisdom, in *Oliver v. Oliver*,[15] and took the position that "where a corporate director obtained material, non-public information by virtue of his position as a director, the director held such information in trust for shareholders."[16] This position was supported by the well-accepted corporate law principle that a director owes fiduciary duties to the corporation.[17] As a result, the director had a duty either to

[11]Compare, however, the following statement with reference to liability under the common law: "Since the depths of the Great Depression, the Securities and Exchange Commission (SEC) has tried to prevent insider trading in U.S. securities markets. Insiders—a firm's principal owners, directors, and management, as well as its lawyers, accountants, and similar fiduciaries—routinely possess information that is unavailable to the general public. Because some of that information will affect the prices of the firm's securities when it becomes public, insiders can profit by buying or selling in advance. Even before the thirties, insiders were liable under the common law if they fraudulently misled uninformed traders into accepting inappropriate prices. But the Securities Exchange Act of 1934 went further by forbidding insiders from even profiting passively from superior information." David D. Haddock, "Insider Trading," *The Concise Encyclopedia of Economics* (The Library of Economics and Liberty), http://www.econlib.org/ (last visited July 3, 2006).
[12]That is, directors, executive officers and controlling shareholders.
[13]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments* (Columbus, Ohio: Bailey Cavalieri LLC, 2003), 2. (Available at http://www.baileycavalieri.com, last visited June 29, 2006)
[14]Ibid.
[15]45 S.E. 232 (Ga. 1903).
[16]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 2.
[17]Ibid.

abstain from using the information for personal gain, or to disclose the information to shareholders before trading with them.[18]

After this, the United States Supreme Court held in *Strong v. Reptide,*[19] in 1909, that "although corporate directors generally owed no duty to disclose material, non-public facts when trading with shareholders, a duty could arise under 'special circumstances.'"[20] This is what came to be known as the "special facts doctrine." The court identified two circumstances that would trigger the applicability of the special facts doctrine: (i) concealment of identity; and (ii) facts having a dramatic impact on the stock price.[21]

Following these decisions, that is, prior to enactment of the first federal securities law in 1933, there were three lines of court decisions regarding insider trading:[22]

1. that there was no duty to disclose or abstain from using material, non-public information for personal gain (the majority view that treated insider trading as a "perk");
2. that there was a duty to abstain or disclose when dealing with shareholders, following *Oliver* (a minority view); and
3. courts following the "special facts doctrine" (a minority view developed in *Strong v. Reptide.*[23]

[18]Ibid.
[19]213 U.S. 419 (1909).
[20]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 2.
[21]Ibid.
[22]Ibid.
[23]213 U.S. 419 (1909).

2.2.2 The Federal Securities Act of 1933 and the Federal Exchange Act of 1934

The concept of federal regulation of securities was firmly established by the federal Securities Act of 1933 (1933 Act) and the federal Securities Exchange Act of 1934 (1934 Act).[24] The major focus of the 1933 Act was on initial offering of securities. The 1934 Act dealt primarily with securities professionals, securities markets, and regular reporting by publicly-held companies.

The two Acts codified the anti-fraud standard, and it is under the anti-fraud standards of the 1934 Act, specifically §10b of the Act[25] and Rule 10(b)3 (promulgated under the authority of section 10(b) Securities Exchange Act of 1934)[26] and Rule 10b-5[27] promulgated thereunder, that the theories of liability for insider trading took root and grew. Rule10b-5, however, does not even use the term insider trading.

[24]The text of the 1933 Act is available at http://www.law.uc.edu/CCL/33Act/index.html (last visited July 14, 2006) as well as http://www.sec.gov/divisions/corpfin/33act/index1933.shtml (last visited July 14, 2006) and that of the 1934 Act at http://www.law.uc.edu/CCL/34Act/ (last visited July 14, 2006) as well as http://www.sec.gov/divisions/corpfin/34act/index1934.shtml (last visited July 14, 2006).

[25]**Section 10(b) of the Act states:** "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, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[26]**Rule 10b-3—Employment of Manipulative and Deceptive Devices by Brokers or Dealers:**
a. It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term "manipulative, deceptive, or other fraudulent device or contrivance", as such term is used in section 15(c) of the Act.
b. It shall be unlawful for any municipal securities dealer directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any municipal security, any act, practice, or course of business defined by the Commission to be included within the term "manipulative, deceptive, or other fraudulent device or contrivance," as such term is used in section 15(c)(1) of the Act.
See http://www.law.uc.edu/CCL/34ActRls/rule10b-3.html (last visited July 14, 2006).

[27]**Rule 10b-5—Employment of Manipulative and Deceptive Devices.** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
a.To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state 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
c. 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.

2.2.3 The Application of the Anti-Fraud Provisions In the Matter of Cady, Roberts & Co—The Cady, Roberts Rule

It was after several decades, in 1961, that a significant development took place in the evolution of insider trading law. In an administrative proceeding before the Securities and Exchange Commission (SEC), *In the Matter of Cady, Roberts & Co.*[28] The SEC determined that rule 10b-5 mandated that corporate insiders have a duty to either abstain from trading on material inside information or disclose the inside information prior to trading.[29] In these proceedings the SEC examined the actions of a director of the Curtiss-Wright Corporation, who telephoned a fellow stockbroker with news that Curtiss-Wright intended to cut its dividend before such news was released to the public. The SEC held that "the anti-fraud provisions of the federal securities law imposed upon corporate insiders in possession of material, non-public information an affirmative duty to abstain from trading or to disclose such information before trading."[30] The SEC commented that the anti-fraud provisions of the 1934 Act were "broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit."[31] The SEC concluded that company insiders owed a duty not only to company shareholders, but also to members of the public.[32] The administrative proceeding created the "Cady, Roberts Rule," which was another way of saying that "in light of a corporate insider's duty to both the corporation shareholders and the

[28]SEC Release No. 34-6668 (Nov. 8, 1961).
[29]Emily A. Malone, "Insider Trading: Why to Commit the Crime From a Legal and Psychological Perspective," *Journal of Law and Policy* 327-68 (2004), 351.
[30]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 3.
[31]Ibid. quoting SEC Release No. 34-6668 (Nov. 8, 1961), at 3.
[32]Ibid.

investing public, a corporate insider in possession of material, non-public information was required either to disclose the information before trading, or to abstain from trading."

The Cady, Roberts Rule was judicially embraced in 1968 and expanded by the Second Circuit Court of Appeals in *SEC v. Texas Gulf Sulphur.*[33] The Second Circuit stated that the anti-fraud standards of the 1934 Act were based on "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to information."[34] The court focused on "equal access to information," rather than on a duty owed either to the shareholders or the investing public. The *Texas Gulf Sulphur* court concluded that: "anyone in possession of material inside information must either disclose it to the investing public. . . or abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[35] This became known as the "Parity of Information" rule. The *Texas Gulf Sulphur* holding[36] became "the high water mark of insider trading liability."[37]

The United States Supreme Court, beginning 1981, decided a series of cases that "returned the focus to the question of whether or not there is a duty (as opposed to just possession of material, nonpublic information) that gives rise to an obligation to abstain or disclose."[38] It is these cases that establish the three prevailing theories of insider trading liability. The

[33]SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2nd Cir. 1968). In that case, mining company insiders traded in the companys stock and options between the time the company discovered a "mother lode" of commercially minable ore and the time the discovery was fully disclosed to the public.

[34]Ibid. at 848.

[35]Ibid.

[36]That anyone in possession of material, non-public information was required to abstain or disclose

[37]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 3.

[38]Ibid.

theories are discussed in the following section.

2.3 Prevailing Legal Theories of Insider Trading Liability

2.3.1 The Classical Theory

The outlines of the Classical Theory were laid down by the United States Supreme Court in *Chiarella v. United States*[39] in the year 1980. Vincent Chiarella worked for a printing company that printed documents pertaining to corporate takeovers. Despite the existence of procedures to maintain the confidentiality of the companies to the transactions, Chiarella was able to deduce the true identities of the companies and profit by purchasing stock in the companies before the public announcement of the takeovers.

In examining Chiarella's failure to disclose before trading, "the Court started with the proposition that silence could create liability for fraud only where there was a duty to disclose."[40] This led the Court to reject the *Texas Gulf Sulphur*" "Parity of Information" rule that the mere possession of material, nonpublic information required a person to abstain or disclose. Instead, "the Court held that there must be a relationship of special trust and confidence (such as a fiduciary relationship) between the possessor of material, non-public information and the shareholders in order for the possessor to have a duty to abstain or disclose."[41] The Court acknowledged that corporate officers and directors have such a fiduciary relationship, but Chiarella was not a corporate officer or director. Accord-

[39]Chiarella v. United States, 445 U.S. 222 (1980).

[40]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 3.

[41]Ibid., 4. The Court said: "We hold that a duty to disclose under Sec.10(b) does not arise from the mere possession of nonpublic market information." 445 U.S. 234. In other words, there can be no Sec.10(b) violation absent a duty to disclose. In so holding, the Court rejected the argument that a person violates Sec.10(b) simply because he has trades in a security with respect to which he has an informational advantage.

ingly, he was not otherwise in a relationship of special trust and confidence. The Court stated that Vincent Chiarella was not required to abstain or disclose before trading.[42] Subsequent to the Chiarella decision the SEC adopted Rule 14e-3,[43] which generally prohibits transactions in securities on the basis of material, non-public information in the context of corporate takeovers.

Under the Classical Theory of insider trading liability, then, a person in possession of material, non-public information has a duty to abstain from trading, or disclose the information before trading, if the person has a fiduciary relationship with the shareholders. As a result, the Classical Theory normally is available only with respect to directors, executive officers and controlling shareholders of a corporation.[44]

2.3.2 The Tipping Theory

The Classical Theory is limited primarily to corporate insiders. What about non-insiders who acquire, and take advantage of, material, non-public information? The Tipping Theory imposes liability on non-insiders who receive "tips" of material, non-public information under certain circumstances.[45] The case that refines this theory is *Dirks v. Securities and Exchange Commission.*[46]

> Raymond Dirks was a securities analyst who specialized in analyzing insurance company stocks for large "institutional" investors. He received a tip from Ronald Secrist, a

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[42]The case abstract records the holding as follows: "A duty to disclose information arises if there is a relationship of trust and confidence between parties to the transaction. Chiarella had no such duty. He was not a corporate insider in the acquiring corporation and he did not receive confidential information from the target company. He also had no fiduciary relationship with the shareholders of the target company: he was not their agent; they placed no trust or confidence in him; indeed, they had no prior dealings with him. A duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information." *Chiarella v. United States*, 445 U.S. 222 (1980), Docket Number: 78-1202, Abstract (available at http://www.oyez.org/oyez/resource/case/877/ (visited July 14, 2006)).

[43]17 C.F.R. 240.14e-3

[44]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 5.

[45]Ibid.

[46]Dirks v. SEC, 463 U.S. 646 (1983).

former officer of Equity Funding of America (EFA), that EFA, a diversified company primarily engaged in selling life insurance and mutual funds, had committed fraudulent corporate practices resulting in the overstatement of its assets. Dirks began to investigate, and obtained some corroboration of the allegations. Although neither Dirks nor his firm owned or traded any EFA shares, he openly discussed his investigation with a number of clients and investors, and several sold their EFA holdings. EFAs share price declined as word of the alleged corporate improprieties spread. Dirks was vindicated when the California insurance authorities seized EFAs records and discovered the fraud. The SEC then filed charges against EFA, and EFA went into receivership Despite uncovering the fraud, Dirks was censured by the SEC for insider trading. The SEC contended that where tippees, regardless of their motivation or occupation, come into possession of material corporate information that they know is confidential and know or should know came from a corporate insider, they must abstain or disclose.[47]

The contention of the SEC, stated above, was rejected by the Supreme Court. The Court, in line with its earlier decision in *Chiarella*, spelled out the Tipping Theory. The Court maintained that

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been breach.[48]

The Court went on to note that whether an insider's disclosure of confidential information to a third party is a breach of duty depends on the purpose of the disclosure, which involves an inquiry into whether the insider would personally benefit, directly or indirectly, from the disclosure. In the Dirks case, Secrist did not benefit from the disclosure, and therefore did not breach his duty. As a result, Dirks did not inherit a fiduciary duty and was not liable for insider trading.[49]

Consequently, the Tipping Theory requires that where a tipper passes along material, non-public information, the duty of the tipper must first be examined and the question should be raised whether or not the tipper has breached his or her duty to shareholders.[50] The test is "whether the

[47]As summarized in Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 5. For the details of the case see U.S. Supreme Court, Dirks v. SEC, 463 U.S. 646 (1983) at http://caselaw.lp.findlaw.com/scripts/printer_friendly.pl?page=us/463/646.html (last visited July 15, 2006).
[48]Dirks v. SEC, 463 U.S. 646 (1983), at 660.
[49]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 5–6.
[50]Ibid., 6.

tipper will benefit, directly or indirectly, from the tip."[51] The benefit can be of a pecuniary or reputational nature, represent a *quid pro quo*, or be in the nature of a gift. If the tipper is in breach of his or her fiduciary duty, the duty is passed to the tippee and the tippee must abstain from trading or disclose before trading.[52]

2.3.3 The Misappropriation Theory

As has been seen above, the Classical and Tipping Theories require the existence of fiduciary duty towards shareholders, thus, they do not touch non-fiduciaries. Such non-fiduciaries are those who discover material non-public information through skill, industry or luck. In addition to this, these two theories also fail to reach non-fiduciaries who acquire material, non-public information through inappropriate means. The Misappropriation Theory deals with the latter type of non-fiduciaries.

The governing case under the Misappropriation Theory is *United States v. O'Hagan*[53] decided by the United States Supreme Court.

> James O'Hagan was a partner in a Minneapolis law firm that was retained by Grand Metropolitan regarding a potential takeover of the Pillsbury Company. Although Grand Met and the law firm took precautions to protect the confidentiality of the takeover plans, O'Hagan learned of the plans. O'Hagan then purchased both Pillsbury shares and "call options," which entitled him to purchase shares at a later date. When the takeover was announced, O'Hagan sold his shares and options, making a profit of over $4.3 million.[54]

The Classical Theory did not apply to this case as O'Hagan was not an "insider" of Pillsbury, nor did the Tipping Theory apply as there was no "tipper." Consequently, O'Hagan was charged with illegal insider trading under the Misappropriation Theory. This theory holds that "a person

[51] Ibid.
[52] Ibid.
[53] United States v. O'Hagan, 521 U.S. 642 (1997).
[54] Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 6.

commits fraud in connection with a securities transaction, and therefore violates the federal anti-fraud standards, when he or she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information."[55] The Supreme Court approved the Misappropriation Theory in the O'Hagan case. The Court noted that the theory premises liability on a "fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[56]

In reality, the Classical and Misappropriation Theories are complementary. This was recognized by the Court. The reason is that the classical Theory targets a "corporate insider's" breach of duty to shareholders with whom the insider transacts, while the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.[57]

As a result of the O'Hagan decision, the Misappropriation Theory stands as the third theory of liability under contemporary insider trading jurisprudence. The theory examines the relationship between the trader and the source of the information. If a person misappropriates material, nonpublic information for securities trading purposes in breach of a duty owed to the source of the information, the Misappropriation Theory applies.

[55]Ibid.
[56]United States v. O'Hagan, 521 U.S. 642, at 652.
[57]United States v. O'Hagan, 521 U.S. 642, at 652-53.

2.3.4 The Misappropriation Theory Extended

The Misappropriation Theory's clearly applies to cases involving misappropriation of confidential information in breach of an established business relationship, such as lawyer-client or employer-employee relationship.

After the *O'Hagan* decision, the SEC promulgated an administrative rule that clarifies what types of family and other non-business relationships can give rise to liability under the misappropriation theory.[58] Rule 10(b)5-2 extends the liability to family members and others having a non-business relationship with a provider of inside information. Here it is maintained that such people generally owe a duty of trust and confidence, and thus will be liable under the Misappropriation Theory. The liability will arise when:

- the person agreed to keep the information confidential;
- the person involved in the communication had a reasonable expectation of privacy;
- or the person who provided the information was a spouse, parent, child or sibling of the person who received the information, unless it is shown that there was no reasonable expectation of privacy,

In July 2001, in *U.S. v. Falcone*,[59] the Second Circuit Court of Appeals extended the Misappropriation Theory to the "tippee of a misappropriator."

In that case, Joseph Falcone paid cash to obtain certain information appearing in Business Week before the magazine was available to the public. The information came from a distributor of the magazine, who obtained the information in breach of a contractual obligation to keep the information confidential until a specified release time. The

[58] 17 C.F.R. 240.10b5-2

[59] U.S. v. Falcone, 257 F. 3d 226 (2nd Cir. 2001).

> Falcone court noted that the Misappropriation Theory was applicable in the tipping context where: (i) the tipper breached a duty owed to the owner of the material, non-public information; and (ii) the tippee knew that the tipper had breached the duty.[60]

In July 2002, the SEC adopted rule 10(b)5-2 to further elaborate the concept of "duty" under the Misappropriation Theory.[61]

2.4 The Impact of the Law on the Meaning of Insider Trading

In more recent times, all three theories have come into play in very interesting ways, especially in the *The ImClone Matter* involving Dr. Waksal, his family members and also Martha Stewart. The insider trading aspects of the Enron matter are still pending.

For our purposes, it is sufficient to say that the Classical Theory imposes liability primarily on corporate insiders who trade on material, non-public information in breach of their fiduciary duty to shareholders. Under the Tipping Theory, the recipient of material, non-public information must abstain or disclose if the provider of the information breached his or her fiduciary duty to shareholders by benefiting from the tip. The Misappropriation Theory imposes liability where a person misappropriates material, non-public information for securities trading purposes in breach of

[60]U.S. v. Falcone, 257 F. 3d 226, at 232. See also Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 6.

[61]**Rule 10b5-2—Duties of Trust or Confidence in Misappropriation Insider Trading Cases.**

a. *Scope of Rule.* This section shall apply to any violation of Section 10(b) of the Act and Rule 10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

b. *Enumerated "duties of trust or confidence."* For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:

1. Whenever a person agrees to maintain information in confidence;
2. Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
3. Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

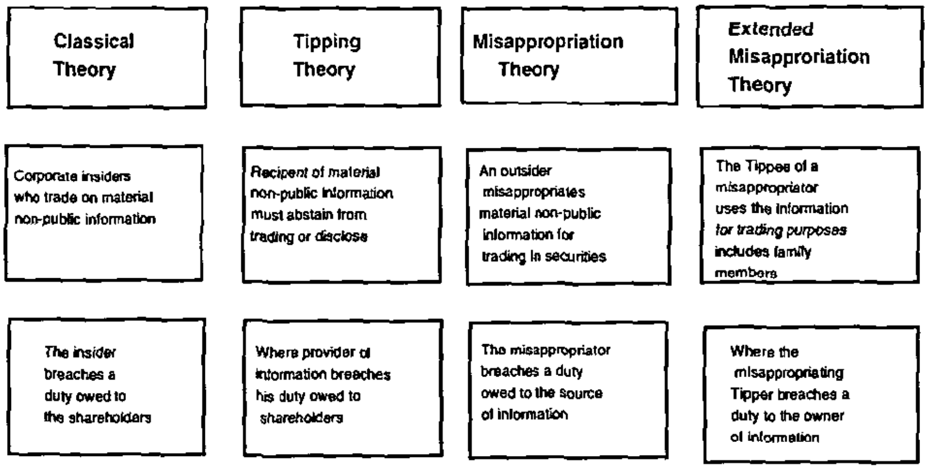

Figure 2.1: The Three Prevailing Theories in the US

a duty owed to the source of the information. And the Misappropriation Theory may be extended to tippees where the tipper breaches a duty owed to the owner of the material, non-public information and the tippee knows that the tipper has breached the duty.

CHAPTER III

Adoption of Insider Trading Laws by the Rest of the World

In this chapter, our purpose is to examine in a general way the adoption of insider trading law by different countries of the world, with or without the influence of United States, so that the way insider trading has been conceived, defined and regulated by them can be understood. As stated in the introduction, out of more than 103 countries that have stock markets today, 87 have introduced insider trading rules.[1] Our focus will be on the the insider trading law of those countries that can be highly relevant and useful for improving the law in Pakistan. We consider two such countries to be Hong Kong and India. Accordingly, their laws on the subject will be described in a little more detail. In addition to this, the law of insider trading as implemented in Europe will also be examined, with a focus on the UK.

[1]Utpal Bhattacharya and Hazem Daouk, "The World Price of Insider Trading," *Journal of Finance* 57, 75-108 (2002); Art A. Durnev and Amrita S. Nain, "The Unanticipated Effects of Insider Trading Regulation," *American Law & Economics Association Annual Meetings*, Paper 23, 2004.

3.1 The Implementation of Insider Trading Laws in Different Countries

It is generally acknowledged that the law of insider trading developed first in the United States and then moved to the rest of the world. This fact does not imply that the approach adopted in other countries is the same as that followed in the United States. Michael Ashe and Lynne Counsell explain that while only a few countries have adopted the US approach to the law in this field, the fact that the US has a law on insider trading and has adopted, since the early 1960s, a fairly aggressive stance in enforcing it has influenced most other countries to enact laws on insider trading.[2] Enrico Colombatto and Jonathan R. Macey have developed a theory that the law has been forced upon the rest of the world by the bureaucracy inside the SEC so as to perpetuate and spread their authority over corporate law in the United States.[3] They state their thesis as follows:

> The article builds on a model of international behaviour where regulators would prefer to remain wholly autonomous, but are unable to because the firms that the regulators want to regulate are increasingly able to avoid domestic regulation. Bureaucrats who want a particular policy outcome, yet lack the political clout to obtain that outcome domestically can collude with regulators in other countries to achieve the policy outcome they prefer. Where the bureaucrats' desired policy outcome is enshrined in an international accord, then the bureaucrats' claim that the policy should be adopted has much more force.[4]

Whatever the underlying reason for the spread of the law, the fact is that it has spread and is the subject of vigorous debates all over the world. As the way the law is implemented in these countries may be different from the peculiar way it has been applied in the United States, it gives us a wider perspective on the law for defining the law in our own country.

[2]Michael Ashe and Lynne Counsell, *Insider Trading*, 2nd ed. (London: Butterworths Tolley, 1993) 27.
[3]See Enrico Colombatto and Jonathan R. Macey in "A Public Choice Model of International Economic Cooperation and the Decline of the Nation State," an article that is forthcoming in the *cardozo Law Review*.
[4]Ibid., "Abstract."

3.2 Insider Trading Law in Europe, Especially the UK

The law of insider trading in Europe has been addressed by Articles 1-4 of the *Insider Dealing Directive (Directive 89/592/EEC) (called the "IDD")*[5] and Articles 1-4 of the *Market Abuse Directive (Directive 2003/6/EC)2 (called "MAD")*.[6] Our main reliance, however, will be on a research report by the The British Institute of International and Comparative Law on the implementation of the EU directives on insider trading and market abuse.[7] The report deals with the law of five EU Member States—the UK, Germany, France, Spain and the Netherlands. This will be sufficient for our purposes.

In Europe, the basic premise for the directives is that for the regulatory framework on insider trading to function effectively in an even-handed fashion, "it is necessary for EU directives to be implemented in a compatible way in each Member State."[8] If the directives are not followed, "the companies will find themselves having to contend with varying requirements in different European countries—something which is not only contrary to the objectives of the single market, but is also likely to produce competitive disadvantages for firms operating across borders."[9]

The report states that before the adoption of the IDD, there were wide variations in the approach taken by the relevant Member States to the prohibition of insider dealing. France first introduced legislation in 1967,

[5]Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, *OJ 1989* L334, p.30. The deadline for implementation was 1 June 1992.

[6]Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market abuse, OJ 2003 L96, p.16. The deadline for implementation was October 12, 2004.

[7]Jane Welch, Matthias Pannier, Eduardo Barrachino, Jan Bernd, and Philip Ledeboer, *Comparative Implementation of EU Directives (I)—Insider Dealing and Market Abuse* (London: The British Institute of International and Comparative Law, 2005) [hereinafter referred to as the *EU Directives Report*.

[8]*EU Directives Report*, "Foreword by Michael Snyder," 4.

[9]Ibid.

not been in possession of inside information."[15]

After considerable efforts, the text of the national laws in Europe may now be very similar, if not identical, "but there is no guarantee that the provisions will be interpreted, monitored and enforced in the same way in all the Member States." The *EU Directives Report* examines these problems at length.[16] It is not possible to look at all the laws of these countries, but we may note a few details about the law as implemented in the UK.

Before the implementation of the EU Directives, the law of insider trading was laid down in the Criminal Justice Act, 1993.[17] In this Act, the definitions of "insider" and "insider information" were quite comprehensive, but did not conform fully to the EU Directives. Further , it proved extremely difficult to prosecute cases of insider dealing successfully under the criminal law.[18] The Financial Services and Markets Act 2000 (FSMA), therefore, reformed the regulatory structure and transfered enhanced regulatory powers to the Financial Services Authority (FSA) along with the power to overhaul the substantive law.[19] The FSMA gave the FSA the power to impose civil sanctions, including fines, on persons engaging in market abuse.[20] The concept of market abuse included insider dealing, though the type of behaviour targeted differed somewhat from that caught by the criminal law, which continued in force.[21] The FSMA required the FSA to draw up a "Code of Market Conduct," indicating which types of conduct would amount to market abuse and the defences or "safe

[15]Ibid.
[16]The *EU Directives Report* does so in great detail and may be examined for this purpose.
[17]See ibid., pages 15 to 19, for a detailed comparison of the provisions of this Act with the EU Directive.
[18]Ibid., 20.
[19]Ibid., 20.
[20]Ibid.
[21]Ibid.

harbours" available. The Market Abuse Directive (MAD) was finally implemented in the UK through the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005[22] and through changes to FSA rules.

Section 118(C) deals with "inside information" and defines it as information which "is not generally available" as opposed to the EU definition of "information which has not been made public."[23] The FSA in its "Code of Market Conduct" lists several factors which are to be taken into account in determining whether or not information is generally available (and therefore not inside information),[24] however, research and estimates developed from publicly available data are not regarded as inside information.[25] The terms "precise" and "likely to have a significant effect on the prices of financial instruments" are also the same in the two provisions. A further provision[26] includes all regulated markets, and the impact of this is to include commodity derivatives within the meaning of "all financial instruments." For curbing market abuse[27] in general, section 118C (4), follows the EU Directive completely, and outlaws front-running, which means dealing ahead of client orders.[28]

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[22]*Financial Services and Markets Act 2000(Market Abuse) Regulations 2005*, SI 2005/381. All the necessary amendments came into force on July 1, 2005, (apart from some provisions which came into force on 17 March 2005) some nine months after the deadline set in MAD for implementation.

[23]*EU Directive Report*, 21.

[24]Ibid.

[25]Ibid.

[26]Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001, as amended by Regulation 10 of the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005.

[27]**Section 118, FSMA.** (1) .... market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert) which:
a) occurs in relation to—
i) qualifying investments admitted to trading on a prescribed market,
ii) qualifying investments in respect of which a request for admission to trading on such a market has been made, or
iii) in the case of subsection (2) or (3) behaviour, investments which are related investments in relation to such qualifying investments, and
b) falls within any one of the types of behaviour set out in subsections (2) to(8)
(2) The first type of behaviour is where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information relating to the investment in question.

[28]*Ibid*.

Insider trading takes place when dealing is carried out "on the basis of" insider information.[29] This is in line with the MAD requirement that the insider dealer must "use" the information when dealing. In other words, dealing when in possession of inside information is not sufficient to constitute the offence.[30] Insider dealing covers both "on and off-market transactions in traded instruments."[31]

Section 118B defines an "insider" as follows:

> ...An insider is any person who has inside information—
>
> - as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments,
> - as a result of his holding in the capital of an issuer of qualifying investments,
> - as a result of having access to the information through the exercise of his employment, profession or duties,
> - as a result of his criminal activities, or
> - which he has obtained by other means and which knows or could reasonably be expected to know, is inside information.[32]

In addition to this, Section 118B, FSMA, includes "secondary insiders" to mean a person who has inside information "which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information." This shows that the meaning of insider, inside information and market abuse is quite comprehensive. To this we may add that in the UK both criminal and civil penalties are available.

The law in other countries of Europe is now quite similar. Even Turkey is in the process of implementing and improving its laws.[33]

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[29]Ibid.

[30]"Thus dealing will not be on the basis of inside information if the decision to deal was made before the person was in possession of the relevant information, or if the person is dealing to satisfy a legal or regulatory obligation which came into being before he possessed the relevant inside information." *Ibid.*

[31]Ibid.

[32]See ibid., 25.

[33]For a detailed proposal about Turkey, see Senem Demirkan, *Insider Trading Regulations in U.S. and a Proposal for Turkey*, available at http://fic.wharton.upenn.edu/fic/cmbt/Senem%20Demirkan.ppt (last visted July 14, 2006).

3.3 Insider Trading and Hong Kong

The primary source of the law relating to insider dealing is contained in Parts XIII and XIV of the Securities and Futures Ordinance (the "Ordinance").[34] The Ordinance operates in conjunction with the other laws designed for the protection of investors, in particular minority shareholders.[35] Some of these laws and regulations are contained in "The Model Code for Securities Transactions by Directors of Listed Companies (the "Model Code")," "The Hong Kong Code on Take-overs and Mergers," "The Hong Kong Stock Exchange's Listing Rules," and the disclosure of interests provisions of the Ordinance.[36] An Insider Dealing Tribunal has been established by the Government of Hong Kong.[37] The Tribunal has published reports pertaining to cases tried and these are available on its website.

The Ordinance consists of two parts. Part I deals with the following:

- Definition of insider dealing
- Relevant information and person connected with a corporation
- Exemptions
- Procedures and powers for the Insider Dealing Tribunal
- Penalties
- Illustration of actual life examples

Part II of the Ordinance deals with:

- Licensing requirement
- Market Misconduct Tribunal
- Disciplinary sanctions
- Supervision and investigative powers
- Disclosure of interests in listed companies
- Investor compensation
- Securities and Futures Appeals Tribunal

[34]The full text of the Ordinance is available at http://www.sfc.hk/sfc/ html/EN/legislation/securities/ securities/securities.html.

[35]William Mackesy, "Insider Dealing in Hong Kong," *Deacons*. Article available at http://www.deaconslaw.com/eng/knowledge/knowledge_25.htm (last visited July 22, 2006.

[36]The Ordinance imposes obligations, backed by criminal penalties, on substantial (5% or more) shareholders and directors and chief executives of listed companies to disclose their interests (and certain changes in interests) in listed companies. Ibid.

[37]See its website at http://www.idt.gov.hk/english/welcome.html.

- Process review panel[38]

The Ordinance contains a dual civil and criminal regime for insider dealing. Thus a case may either be brought against the alleged insider dealer before the "Market Misconduct Tribunal (civil proceedings)" or he can be prosecuted in court (criminal proceedings).

In order to understand the nature of insider dealing in Hong Kong law, one has to first understand the meaning of "a person connected with a corporation." Such a person may be a director, a substantial shareholder (holding 5% shares), the occupant of a position with access to relevant information, a person having access due to a connection with another corporation, or a person who is connected due to his position as a public officer. The explanations of these persons are detailed. A corporation may also be connected to another corporation. The idea of being connected does not depend on actual knowledge of relevant information. Take-over bidders are also added to this meaning.[39]

The connected person must be in possession of "relevant information" for insider dealing to take place. This is information that is (a) not generally known and (b) is likely to materially affect the price of a listed security.[40]

A corporation may also be an insider. In such a case, officers of the corporation (meaning the directors, the company secretary, managers and any other person involved in the management of the corporation) may be identified as insider dealers if the corporation of which they are an officer

[38]See the text of the Ordinance at the Securities and Futures Commission website at http://www.sfc.hk/sfc/html/EN/ legislation/securities/securities.html (last visited July 14, 2006).
[39]William Mackesy, "Insider Dealing in Hong Kong," *Deacons.* Article available at http://www.deaconslaw.com/ eng/knowledge/knowledge_25.htm (last visited July 22, 2006).
[40]Ibid.

is an insider dealer and that the corporation carried out insider dealing with their consent or connivance.[41]

Insider dealing takes place:

- When connected persons and take-over bidders deal in listed securities or their derivatives on the basis of insider information, knowing that such information is relevant.[42]
- When connected persons and take-over bidders pass on, that is, disclose this information to another person knowing that such person will use this information for dealing in the relevant securities.[43]
- When a person who has obtained relevant information with the knowledge that it is relevant information and then uses this information to deal in the securities.[44]
- When a person has information in the three cases above, but then procures or counsels someone "outside Hong Kong" to deal outside Hong Kong in such securites.[45]

The law, however, provides a number of exceptions so as to provide defences to persons who are innocent of insider dealing. The main concepts to be noticed here for our purposes are those of the "connected person," "relevant information" and "cases that amount to insider dealing."

3.4 Insider Trading Law in India

The law on insider trading in India was improved in 2002. The governing Act is the the Securities and Exchange Board of India Act, 1992 (No.15

[41]Ibid.
[42]See Division 4, § 1 of the Securities and Futures Ordinance.
[43]*Ibid*.
[44]Ibid.
[45]*Ibid*.

of 1992).[46] It was amended in the year 2002. Regulations were made under this Act for preventing insider trading. These Regulations have also been amended and updated in 2002. These are called the Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 1992.[47]

A report of the Expert Group constituted under the Chairmanship of Mr Justice M. H.Kania (Former Chief Justice of India), has the following to say:

> The Securities and Exchange Board of India Act, 1992 (the SEBI Act) was amended in the years 1995, 1999 and 2002 to meet the requirements of changing needs of the securities market and responding to the development in the securities market. Based on the Report of Joint Parliamentary Committee (JPC) dated December 02, 2002 , the SEBI Act was amended to address certain shortcomings in its provisions. The mission of SEBI is to make India as one of the best securities market of the world and SEBI as one of the most respected regulator in the world. SEBI also endeavours to achieve the standards of IOSCO/FSAP.[48]

3.4.1 The SEBI Act, 1992

Indeed the law on insider trading, after the 2002 amendments, is considerably improved and simplified. It does away with the earlier complications and simplifies things to a great extent. A new chapter, very wisely, links insider trading with market abuse or market manipulation, and deems insider trading a category of such abuse. This, as we have seen in the previous chapters, is what is found in the law in the United States and very clearly in the law of Europe. The law of Hong Kong, also follows the same approach. It will be helpful to reproduce the entire chapter here:

CHAPTER VA[49]

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[46] The complete text of the Act is available at http://www.sebi.gov.in/acts/act15ac.html.

[47] The Gazette of India Extra-ordinary Part II—Section 3—Sub-section (ii) Published by Authority Securities and Exchange Board of India Notification, Mumbai,the 20th day of February 2002. The full text is available at http://www.sebi.gov.in/acts/insider.html.

[48] See foreword to Report, Expert Group Headed by Mr. Justice M. H. Kania (Former Chief Justice of India) for Suggesting Amendments to Securities and Exchange Board of India Act, 1992. Available at www.sebi.gov.in/commreport/rep032005.pdf.

[49] The entire chapter was inserted by the Securities and Exchange Board of India (Amendment) Act, 2002.

PROHIBITION OF MANIPULATIVE AND DECEPTIVE DEVICES, INSIDER TRADING AND SUBSTANTIAL ACQUISITION OF SECURITIES OR CONTROL

Prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities and control 12A. No person shall directly or indirectly—

a. use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made thereunder;
b. employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;
c. engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made thereunder;
d. engage in insider trading;
e. deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules or the regulations made thereunder;
f. acquire control of any company or securities more than the percentage of equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange in contravention of the regulations made under this Act.[50]

Section 15G deals with the penalties for insider trading. The Act has enhanced these penalties recognising the significance of the offence. Section 15G provides as under:

Penalty for insider trading 15G. If any insider who,—

(i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or
(ii) communicates any unpublished price sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or
(iii) counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price sensitive information, shall be liable to a penalty (twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher.[51]

3.4.2 Regulations on Insider Trading

The Regulations deal with three key concepts: "connected person," "person deemed to be connected" and "insider."

[50]See http://www.sebi.gov.in/acts/act15ac.html 7/25/2006 for the text.

[51]See Chapter VIA. PENALTIES AND ADJUDICATION. Substituted for the words "not exceeding five lakh rupees" by the Securities and Exchange Board of India (Amendment) Act, 2002 vide Gazette Notification dated 18th December 2002. Available at http://www.sebi.gov.in/acts/act15ac.html 7/25/2006.

clause (e) of the definitions defines "insider" as any person who:

- is or was connected with the company or
- is deemed to have been connected with the company, AND:
  - who is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company, or
  - who has received or has had access to such unpublished price sensitive information.[52]

Clause 2(c) defines "connected person" to mean any person who—

(i) is a director of a company, or

(ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company whether temporary or permanent and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;[53]

The explanation to clause (c) extends the meaning of "connected persons" to include persons who were connected six months prior to of an act of insider trading.

Clause (h) says that a "person is deemed to be a connected person" if such person—

(i) is a company under the same management or group or any subsidiary company of the connected company;

[52]clause 2(e) of Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 1992. Available at http://www.sebi.gov.in/acts/insider.html.
[53]Clause 2(c), ibid.

(ii) is an intermediary, investment company, trustee company, asset management company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation;

(iii) is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, investment Advisor, subbroker, investment company or an employee thereof, or, is a member of the board of trustees of a mutual fund or a member of the board of directors of the asset management company of a mutual fund or is an employee thereof who have a fiduciary relationship with the company;

(iv) is a member of the board of directors, or an employee, of a public financial institution;

(v) is an official or an employee of a self regulatory organisation recognised or authorised by the board of a regulatory body;

(vi) is a relative of any of the aforementioned persons;

(vii) is a banker of the company;

(viii) relatives of the connected person;

(ix) a concern, firm, trust, Hindu undivided family, company, association of persons wherein the relatives of persons mentioned in sub-clauses (vi),(vii) and (viii) has more than 10% of the holding or interest.[54]

Clause (ha) defines "price sensitive information" to mean any information which relates directly or indirectly to a company and which if pub-

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[54]Clause 2(h) ibid.

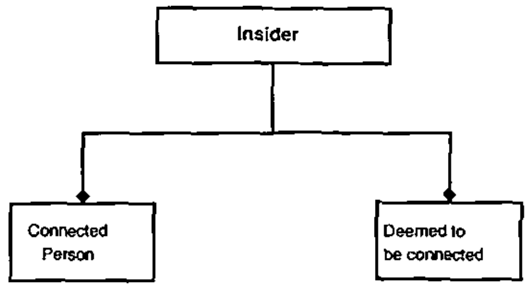

Figure 3.1: Meaning of Insider—India

lished is likely to materially affect the price of securities of company.[55] Whereas "unpublished" means information which is not published by the company or its agents and is not specific in nature. Further, speculative reports in print or electronic media are not to be considered as published information

3.4.3 Mandatory Codes of Conduct

Schedule I, issued under regulation 12(1), Part A provides a "Model Code of Conduct for Prevention of Insider Trading for Listed Companies," while Part B provides a "Model Code of Conduct for Prevention of Insider Trading for Other Entities." Many companies in India have started adopting the code and information can be found on their websites.

Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2003 have added a third schedule that provides a number of forms for disclosure.[56]

[55]Clause 2(ha), ibid. The explanation to the clause says that the following shall be deemed to be price sensitive information:
(i) periodical financial results of the company;
(ii) intended declaration of dividends (both interim and final);
(iii) issue of securities or buy-back of securities;
(iv) any major expansion plans or execution of new projects;
(v) amalgamation, mergers or takeovers;
(vi) disposal of the whole or substantially part of the undertaking;
(vii) any significant changes in policies, plans or operations of the company.

[56]The Gazette of India extraordinary. Part II, section 3, sub section (ii) published by authority Securities and Exchange Board of India notification, Mumbai, the 11th july, 2003, Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2003.

3.5 Comparing the Definitions of Insider Trading in Different Jurisdictions

A number of studies are found where the law on insider trading has been compared with that of other countries, in particular the United States. Thus, there is a study on China,[57] one on Turkey,[58] and another one on New Zealand.[59] Our purpose in this section is to identify those vital factors that are important in defining the terms "insider," "insider trading," "price sensitive information" and so on.

3.5.1 Person Connection Approach or the Information Connection Approach

It is generally acknowledged that there are two approaches to the defining of "insider." These are the "person connection" approach and the "information connection" approach. The "person connection approach" defines an insider as someone who has a relationship (direct or indirect) with the issuer of the securities. Insider trading, under this approach, is considered inconsistent with a fiduciary or similar duty owed to the entity whose securities are traded or which is the owner of the inside information.[60] The person connection approach can be divided into three categories:

- the direct connection,
- employment, and

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[57]Wenyan Ma, "The Misappropriation Theory Under the Chinese Securities Law: A Comparative Study With its U.S. Counterpart," *Richmond Journal of Global Law and Business* (2000) Vol. 1:1, 35–44.

[58]Senem Demirkan, *Insider Trading Regulations in U.S. and a Proposal for Turkey*, available at http://fic.wharton. upenn.edu/ fic/cmbt/Senem%20Demirkan.ppt.

[59]Z. Su and M. A. Berkahn, "The Definition of 'Insider' in Section 3 of the Securities Markets Act 1988: A Review and Comparison with other Jurisdictions," *Discussion Paper Series* (New Zealand: Massey University, 2003).

[60]The approaches are discussed in Ministry of Economic Development (New Zealand), *Insider Trading: Discussion Document* (September, 2000), sections 7.1–7.17. Available at http://www.med.govt.nz/ templates/MultipageDocumentTOC_7574.aspx (Last visited July 13, 2006).

- fiduciary duty approaches.[61]

The "information connection approach" considers any one who has "material price-sensitive information" that is not generally available to be an insider, regardless of his relationship to the source of the information.[62] It is considered that trading with knowledge while in possession of information, rather than a persons connection, is what can detrimentally affect the market.[63]

In theory, under the person connection approach it is easier to identify a person who falls within one of the categories provided by the law. In practice, however, difficulties may arise in the use of the person connection criteria.[64] Countries that employ this approach have to list as many potential insiders as they possibly can. The resulting definitions have become long and complex, such as that used in Japan.[65] Even with a comprehensive list, the person connection criteria may still leave gaps in coverage. A good example is the old insider trading laws in Singapore, where not all people who traded on inside information could be covered by the definition of insider, even though that definition was very comprehensive.[66] Nevertheless, it does provide certainty as to who can be an insider.

In short, we may say that today some countries adopt one approach, while others follow the second approach. Thus, Australia, the UK and Singapore adopt the information connection approach. The law in Japan,

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[61] Ibid.
[62] Ibid.
[63] Ibid.
[64] Z. Su and M. A. Berkahn, "The Definition of 'Insider' in Section 3 of the Securities Markets Act 1988," 15.
[65] Ibid.
[66] See Yang Ing Loong, Andy Yeo and Sharon Lee, *Insider Trading: New Wine in Old Wineskins?* Available at http://www.lawgazette.com.sg/2001-9/Sep01-focus3.htm.

Hong Kong, New Zealand and China still adopt the person connection approach.[67] To this we may add that Pakistan and India also follow the "person connection" approach. Which approach is better to define the term "insider"? This is a difficult question to answer as both approaches have their advantages and disadvantages.

3.5.2 Is a Wide Definition Better?

As the law on the prohibition of insider trading progresses, the definitions of insider have become long and complex.[68] In addition to this, in the U.K. for example, the definition has been extended to cover markets other than the securities markets like the commodity exchanges. Some organisations feel that such extension of the definition is not useful.[69] There are others who feel that a wide definition in cases of misappropriation may be better, but having a very wide definition is not always better.[70]

3.5.3 Penalties and Defences

Following the United States, most regimes have provided both criminal and civil penalties. The law in Pakistan, as we shall see, does the same. Nevertheless, writers feel that the defences for those who are in possession of insider information and do not intend to misuse it should be clearly

[67] Z. Su and M. A. Berkahn, "The *Definition of 'Insider'* in Section 3 of the Securities Markets Act 1988," 15.
[68] Ibid., 23.
[69] International Swaps and Derivatives Association, Inc., "ISDA comments on the proposal for a *Directive on Insider* Dealing and Market Manipulation (Market Abuse)," 2. The text of the observation about the EU directive is as follows: **Insider dealing concepts should not be extended beyond the securities markets.** As currently drafted, the bulk of the Directive applies both insider dealing and market manipulation provisions equally to securities instruments as well as to commodity, interest rate, foreign exchange and other non-securities related derivatives. While we appreciate that appropriate market manipulation provisions may need to apply beyond securities instruments, we strongly believe that it is inappropriate to apply insider dealing concepts to commodity, interest rate, foreign exchange and other non-securities related derivatives.
[70] See section V. "Caveat: Wider is Always Better" in Wenyan Ma, "The *Misappropriation* Theory Under the Chinese Securities Law: A Comparative Study With its U.S. *Counterpart*," *Richmond Journal of Global Law and Business* (2000) Vol. 1:1, 35–44.

CHAPTER IV

The Law of Insider Trading in Pakistan

The study of the law of insider trading so far has armed us with sufficient knowledge and criteria for undertaking an analysis of this law as it is applied in Pakistan. In the first introductory chapter, we tried to understand the justification for the prohibition of insider trading. A number of theories, by those who favour regulation and those who are against it, were examined. One significant point we noted was that insider trading has an intrinsic link with market manipulation or market abuse. This has special significance for Pakistan in the light of the two major crises in 2005 and 2006. In the chapter on American law, we saw how the law grew and the meaning of insider trading was expanded gradually. The theories developed by the Courts to identify duties owed to the source of information and misappropriation of information were analysed. It was also noted that in the United States there are civil remedies as well as criminal penalties, and in addition individuals can file suits too. In the law applied in the rest of the world, the main point to be seen was that insider trading was considered prohibited conduct within the larger problem of market manipulation and abuse. In the U.S. too, the law has grown from the use of deceptive devices to manipulate the market. In most countries of the world, the general approach, while defining the terms "insider" and "insider dealing" has been the "person connection" approach. A few countries have, however followed the "information connection" approach. Keeping in view all these issues and other facts, we may now examine the law of Pakistan.

4.1 The Sources of Insider Trading Law in Pakistan

The main source of the law on insider trading is the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of 1969).[1] The prohibition of insider trading was inserted as Chapter III-A through an amendment introduced by the Finance Act, 1995.[2] Chapter III-A deals with the following:

1. It prohibits insider trading on the "Stock exchanges."
2. It defines inside information as information about a company that:
   (a) is not generally available;
   (b) would, if it were so available, be likely to materially affect the price of those securities; or
   (c) relates to any transaction (actual or contemplated) involving such company.
3. It defines the meaning of "associated person."
4. Provides for liability for contravention of section 15A of Chapter III-A. This includes compensation to the extent of actual loss and also

[1]The latest version of the Ordinance can be found on the SECP website: http://www.secp.gov.pk.
[2]See Chapter III-A on Insider Trading in the Ordinance.

imprisonment for a term that may extent to three years.

5. Provides the grounds on which notice to an alleged insider can be withdrawn.

The law came into the limelight due to the stock market crash of the year 2000. The reform process continued into the year 2001. To impose transparency in trade, curb the practice of insider trading, and bring Stock Exchange operations to international standards, SECP ordered some amendments to the Articles of Association of the Karachi Stock Exchange and issued Listed Companies (Prohibition of Insider Trading) Guidelines.[3] Nevertheless, a report of the Asian Development Bank maintains that "Front running is [still] common, and insider trading is widespread. As a result, there is little genuine investor interest; the market is heavily discounted; and companies with solid fundamentals, yielding a 20 percent dividend and two times price earnings ratios, are left without buyers."[4] A report (2004) of the International Monetary Fund maintains that "SECP should review the rules about insider trading to ensure that they can be enforced effectively in particular cases."[5] The report further maintains that "The SECP has started the review of legal provisions pertaining to insider trading and security disclosure."[6] This study

[3]See Stock Exchange Members (Inspection of Books and Records) Rules 2001; Brokers and Agents Registration Rules 2001; and Listed Companies (Prohibition of Insiders Trading) Guidelines, Issued at Islamabad on 27th March, 2000. See also Asian Development Bank, *Country Economic Review: Islamic Republic of Pakistan* (Manila: November 2001), 9. "To implement the Prohibition of Insider Trading Regulation, new rules were also issued that allow SECP to investigate and inspect the accounts and records of individuals deemed to be insiders and associated members of stock exchanges." Ibid.

[4]Asian Development Bank, *TAR: PAK 35055, Technical Assistance to the Islamic Republic of Pakistan for Capacity Building for Capital Market Development and Corporate Governance* (August 2001), 1.

[5]International Monetary Fund, *IMF Country Report No. 04/215 Pakistan: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation* (July 2004), 42. "In addition, the assessors have queried whether insider trading law is adequate to deal with those who benefit from insider trading but are not *insiders as defined, in particular, tippees of insiders.*" Ibid. 39.

[6]Ibid. 45.

is in particular directed at such a review of the law, so that useful suggestions be made where possible. Further, despite so much debate in the rest of the world, there are very few people in Pakistan who understand the law on insider trading, and it is sometimes felt that insider trading is being confused with market manipulation. The law in Pakistan, therefore, needs to be explained in the light of developments in the rest of the world, so that what are deemed good practices at the international level may be implemented in Pakistan too.

4.2 The Link Between Market Abuse and Insider Trading—Stock Market Crises

A definition of market manipulation was provided in the introduction. This was taken from Consultation Paper No. 6 of the Jersey[7] Financial Services. The definition is as follows:

> Market manipulation involves transactions or orders to trade which
>
> - give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments;
> - alter, by one or more persons acting in collaboration, the price of one or several financial instruments to an abnormal or artificial level; or
> - employ fictitious devices or any other form of deception or contrivance.
>
> Market manipulation includes the dissemination of information through the media, including the Internet, or by any other means, which give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments, including the dissemination of rumours and false or misleading news.[8]

As noted earlier, the law of insider trading in Europe has been addressed by Articles 1-4 of the *Insider Dealing Directive (Directive 89/592/EEC) (called the "IDD")*[9] and Articles 1-4 of the *Market Abuse Directive (Directive 2003/6/EC)2 (called "MAD").*[10] Section 118 of the British Financial Ser-

[7]Jersey is an island in the English Channel.

[8]Consultation Paper No. 6, Paper 2003-06, *Market Manipulation and Insider Dealing* (Jersey Financial Services Commission, 2006), 6.

[9]Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ 1989 L334, p.30. The deadline for implementation was 1 June 1992.

[10]Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market abuse, OJ 2003 L96, p.16.

tion of stock prices, as a form of fraud, harms both society and individuals by decreasing the accuracy of pricing by the market."[15] It is generally felt by the advocates of regulation of insider trading that it is the insiders who have the maximum incentive to indulge in market manipulation, because they have a "strong interest in keeping the stock pricing stable or in moving it in the correct direction while they are trading."[16] This was acknowledged even by the major opponent of insider trading regulation, Manne. He maintained that manipulation is harmful and manipulation of stock prices would cease if insider trading could be effectively eliminated because nobody would then benefit from it.[17]

In Pakistan, section 17 of the Securities and Exchange Ordinance, 1969[18] does talk about fraudulent acts in the context of manipulation and the use of deceptive devices. The section is reproduced below:

> **17. Prohibition of fraudulent acts, etc.**—No person shall, for the purpose of inducing, dissuading, effecting, preventing or in any manner influencing or turning to his advantage, the sale or purchase of any security, directly or indirectly,—
>
> (a) employ any device, scheme or artifice, or engage in any act, practice or course of business, which operates or is intended or calculated to operate as a fraud or deceit upon any person; or
>
> (b) make any suggestion or statement as a fact of that which he does not believe to be true; or
>
> (c) omit to state or actively conceal a material fact having knowledge or belief of such fact; or
>
> (d) induce any person by deceiving him to do or omit to do any thing which he would not do or omit if he were not so deceived; or
>
> (e) do any act or practice or engage in a course of business, or omit to do any act which operates or would operate as a fraud, deceit or manipulation upon any person, in particular—
>
> (i) make any fictitious quotation;
>
> (ii) create a false and misleading appearance of active trading in any security;
>
> (iii) effect any transaction in such security which involves no change in its beneficial ownership;

[15]Stephen M. Bainbridge, *Encyclopedia of Law and Economics*, 790.
[16]*Ibid.* quoting Schotland, "Unsafe at Any Price: A Reply to Manne, 'Insider Trading and the Stock Market'" 53 *Virginai Law Review* 1425 (1967), at 1449-1450.
[17]Henry G. Manne, "Insider Trading and the Law Professors," 23 *Vanderbilt Law Review*, 547-590 (1970), at 575, as quoted in Stephen M. Bainbridge, "Insider Trading," *Encyclopedia of Law and Economics*, 790.
[18]Hereinafter referred to as SEO.

(iv) enter into an order or orders for the purchase and sale of security which will ultimately cancel out each other and will not result in any change in the beneficial ownership of such security;
(v) directly or indirectly effect a series of transactions in any security creating the appearance of active trading therein or of raising of price for the purpose of inducing its purchase by others or depressing its price for the purpose of inducing its sale by others;
(vi) being a director or an officer of the issuer of a listed equity security or a beneficial owner of not less than ten per cent of such security who is in possession of material facts omit to disclose any such facts while buying or selling such security.

This section appears to be quite comprehensive, and it may be possible to read into it the offence of insider trading as well. Nevertheless, we feel that the two concepts must be integrated for better understanding and simplicity. The consequence will be better implementation of the law and its observance by players in the stock market. For this purpose, the new laws of India, Hong Kong and the United Kingdom may be consulted and followed.

4.2.1 Report of the Task Force on the Stock Market Situation in 2005

Item (iii) of the terms of reference of the Report of the *Taskforce: Review of the Stock Market situation March 2005*[19] was to: "Investigate allegations of market manipulation, insider trading and other market abuses and suggest regulatory and operational reforms for enhancing investor protection."[20] Among the conclusions drawn by the task report was that investigations of the KSE are handicapped by a number of structural flaws, which hide the identity of persons undertaking transactions.[21] This has been facilitated by brokers dealing through other brokers with the clear intention of covering their tracks as symbolised by the existence of "dhobi"

[19]Securities and Exchange commission of Pakistan, *Report of the Taskforce: Review of the Stock Market situation March 2005* (June 2005), iii.
[20]Ibid.
[21]Ibid., 8.

brokers.[22] Further, brokers do not declare whether their trade represents a transaction on their own account or on behalf of a client.[23] The Report added that "The other factors that have plagued this investigation were potential insider trading and the liberal existence of Benami and Group accounts. These factors make the KSE an opaque market and, consequently, a haven for manipulators."[24] The Report also identified that some "Research Analysts" were also involved in insider information problems.[25]

The Report makes the following recommendations under the heading **"Monitoring and Surveillance of Members for market Abuse and Insider Trading:"**

1. It is essential that the regulators have proper surveillance and monitoring systems in place, supported by a strong compliance culture, backed by appropriate rules and penalties as well as having exchange staff fully up to date with market practices and vulnerabilities.
2. Therefore, there needs to be a concerted and determined effort within the KSE to staff both a properly functioning surveillance department with a modern array of data analysis software as well as a properly resourced and capable enforcement/prosecution function with the ability to levy meaningful and very substantial penalties (like hefty fines, suspension of trading rights for a week, etc.) with appropriate reference to

[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] Ibid., 29. "The Taskforce noted that some research seemed to be geared to "painting" a very rosy outlook for companies and it was told that front running by brokers' staff and their favoured clients was described as common. An example of research was referred to the Taskforce that amounted to the distribution, clearly against rules, of 'insider information.'" Ibid.

the SECP for criminal prosecution of market abuse and insider trading.

3. The rules and framework in this area need considerable bolstering and if the Exchanges are not willing to undertake the necessary changes, both policy and procedurally the SECP should become more front-line in this area of regulation (supported by legislative changes wherever necessary) and levy members to cover the costs of undertaking such work.
4. Furthermore, it is essential not only to have adequate rules but to ensure there is a proper compliance culture in place for the rules to be effective. In addition the rules have to be supported by a determination within the exchange to police the rules and subject abuse to heavy sanctions including large fines and suspension or expulsion of members.[26]

These are excellent proposals and we fully agree with them. The rest of the chapter will, therefore, focus on "bolstering the rules." We may now turn to the provisions of the SEO Ordinance, 1969[27] and the Listed Companies (Prohibition of Insiders Trading) Guidelines[28]

4.3 Analysis of the Provisions of the Ordinance and the Guidelines

The SEO Ordinance and the Guidelines on insider trading combine to give a complex law that is difficult to understand and is very confusing. It is difficult to see how such a law can be implemented with ease. The

[26]Ibid., 33-34.
[27]Securities and Exchange Ordinance, 1969 (*Ordinance No. XVII of 1969*).
[28]Listed Companies (*Prohibition of Insiders Trading*) Guidelines, Published by Authority, Islamabad the, 27 March, 2000.

reason may be that it has been conceived and drafted in parts. This has been the case with the law of other countries too, especially that of India. Just as India has simplified its law on insider trading, Pakistan should do so too. The following analysis will confirm this.

4.3.1 The Ordinance Speaks in Terms of the "Associated Person" and not the "Person Connected"

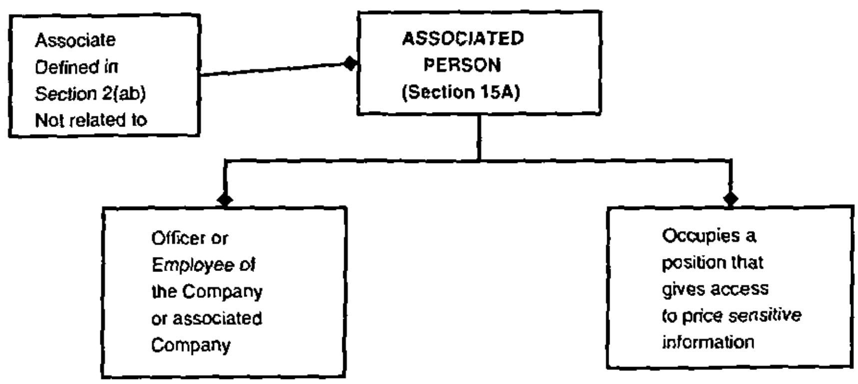

Figure 4.1: Person Associated With Company

Section 2(ab) gives us the definition of the term "associate," however, this is not the same term as "person associated with" as defined in section 15A, even though the persons identified may be the same. Section 15A[29] of the SEO Ordinance states the following:

> *15-A. Prohibition on stock exchange deals by insiders.*—No person who is, or has been, at any time during the preceding six months, *associated with a company*[30] shall, directly or indirectly, deal on a stock exchange in any listed securities of that or any other company or cause any other person to deal in securities of such company, if he has information which

[29] This is section 15A of the new Chapter III-A, which was inserted in 1995.
[30] Emphasis added.

and is not generally known or published by such company for general information, but which if published or known, is likely to materially affect the price, of securities of that company in the market:—

a. financial results (both half-yearly and annual) of the company;
b. intended declaration of dividends (both interim and final);
c. issue of shares by way of rights, bonus, etc.;
d. any major expansion plans or execution of new projects;
e. amalgamation, mergers and takeovers;
f. disposal of the whole or substantially the whole of the undertaking;
g. such other information as may affect the earnings of the company; and
h. any changes in policies, plans or operations of the company.

In short, it is the "associated person" who is prevented from insider trading. This law was made in 1995 and at that time the SEO Ordinance did not speak of the "connected person" or the "person deemed to be connected." We have indicated earlier that there are two approaches to the defining of the term "insider." These are the "person connection" approach and the "information connection" approach. The "person connection approach" defines an insider as someone who has a relationship (direct or indirect) with the issuer of the securities. Insider trading, under this approach, is considered inconsistent with a fiduciary or similar duty owed to the entity whose securities are traded or which is the owner of the inside information.[32] The SEO Ordinance introduced the concept of "associated person," a term not used by any other law. Does the law intend the meaning of"connected person;" apparently not.

4.3.2 The Guidelines Speak in Terms of the "Connected Person" and "Person Deemed to be Connected"

The Guidelines suddenly come up with the definitions of "connected person" and "person deemed to be connected." They do not attempt to redefine the term "associated person." Instead, the Guidelines repeat the definition of the term "associate" as given in article 2(ab) of the Ordinance, but this is not the same as "person associated with the company" as that is defined separately in section 15A of the Ordinance, as described above.

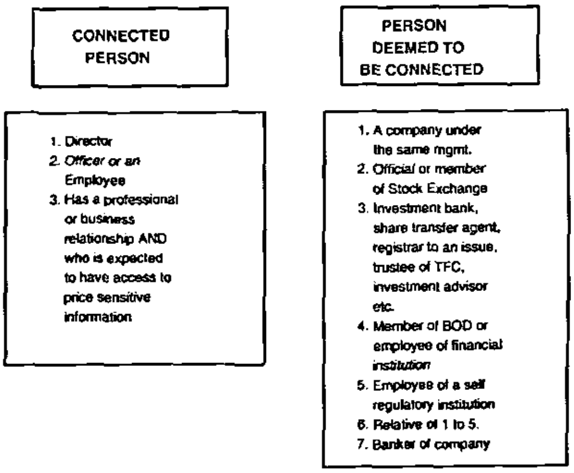

Figure 4.3: Person Connected With the Company

Clause 2(v) states that the "connected person" means any person who

a) is a director, as defined in clause (13) of sub-section (1) of section 2 of the Companies Ordinance, 1984; or

[32]The approaches are discussed in Ministry of Economic Development (New Zealand), *Insider Trading: Discussion Document* (September 2000), sections 7.1–7.17. Available at http://www.med.govt.nz/templates/MultipageDocumentTOC_7574.aspx.

b) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;

clause 2(xi) defines a person who is deemed to be connected to a company. It says:

"person is deemed to be a connected person" if such person

a) is a company under the same management or group or any subsidiary company;

b) is an official or a member of a stock exchange or of a clearing house of that stock exchange, or any employee of a member of a stock exchange;

c) is an investment bank, share transfer agent, registrar to an issue, Trustee of Term Finance Certificates, Investment Advisor, Investment Company (closed end mutual fund) or an employee thereof, or, is a member of the Board of Directors of an investment company or a member of the Board of Directors of the Asset Management of an Investment Scheme (open-end mutual fund) or is an employee having fiduciary relationship with the company;

d) is an official or an employee of a self-regulatory organisation recognised by the Commission;

e) is a relative of any of the aforementioned persons; or

b) a person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company who has received or has had access to such unpublished price sensitive information;

Here too it is obvious that sub-clause (a) is talking about the "associated person" yet this term is not employed in the Guideline definitions.

4.3.4 Strangely, Chapter II of the Guidelines Prohibits Insider Trading for the "Associated Person," but not for the "Insider"

Then comes the strangest thing of all. It is the "associated person" for whom insider trading is prohibited. *Insider trading is not prohibited for the "insider."* This is the height of the rigmarole. Let us reproduce section 15A of the Ordinance again:

> *15-A. Prohibition on stock exchange deals by insiders.*—No person who is, or has been, at any time during the preceding six months, *associated with a company*[33] shall, directly or indirectly, deal on a stock exchange in any listed securities of that or any other company or cause any other person to deal in securities of such company, if he has information which
>
> a) is not generally available;
>
> b) would, if it were so available, be likely to materially affect the price of those securities; or

[33]Emphasis added.

c) relates to any transaction (actual or contemplated) involving such company.

We fail to understand the logic of the Ordinance and the Guidelines in this case. The question arises as to why was the definition of "associated person" so important that it had to be retained in the Ordinance as well as the Guidelines. The argument that the meaning of "associated person" is included in the meaning of the "connected person" and *vice versa* is not tenable as it makes the law cumbersome, overlapping and difficult to comprehend. Further, the argument that some people had to be separated for the assigning of criminal liability is also not valid. This could have been done through a uniform definition.

4.3.5 For the "Connected Person" the Guidelines Provide Civil Liability for Compensation Through Court, but there is no Criminal Liability

Section 5, in CHAPTER III of the Guidelines,[34] delineates civil liability for the "connected person," the "insider," the "associate" and a number of other persons. To simplify things, this may be depicted through the following figure:

Under the title "Liability, Action by Commission on behalf of Issuer," section 5 dealing with "Liability" fixes the following liabilities:

i. *Every connected person* who purchases, sells or otherwise deals in and with securities of an issuer with the knowledge of unpublished price sensitive information with respect to the issuer that has not been generally disclosed is liable to compensate the seller or purchaser of

[34] *Listed Companies (Prohibition of Insiders Trading) Guidelines*, Islamabad the, 27 March, 2000.

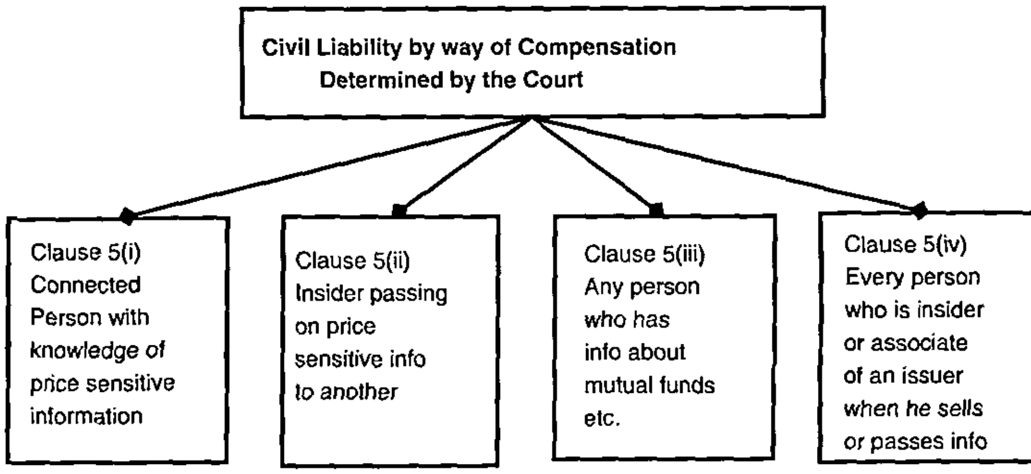

Figure 4.5: Civil Liability for Insiders and Others

the securities, as the case may be, for damages as a result of the trade unless,

a. the connected person proves that the person reasonably believed that the unpublished price sensitive information had been generally disclosed; or

b. the unpublished price sensitive information was known or ought reasonably to have been known to the seller or purchaser, as the case may be;

ii. *Every insider* who informs another person of unpublished price sensitive information with respect to the issuer that has not been generally disclosed, shall be liable to compensate for damages any person that thereafter sells securities of the issuer to or purchases securities of the issuer from the person that received the Information unless;—

a. the person who informed the other person proves that the informing person reasonably believed the unpublished price sensitive information had been generally disclosed;

b. the unpublished price sensitive information was known or ought reasonably to have been known to the seller or purchaser, as the case may be; or

c. in the case of an action against an issuer or a person in special relationship with the issuer, the information was given in the necessary course of business;

iii. *Any person who has access to information* concerning the investment program of a mutual fund in Pakistan or in the investment portfolio managed for a client by an investment adviser and uses that information for his, her or its direct benefit or advantage to purchase, sell or otherwise deal in and with securities of an issuer for his, her or its account where the portfolio securities of the mutual fund or the investment portfolio managed for the client by the investment adviser includes securities of that issuer is accountable to the mutual fund or the client of the investment adviser, as the case may be, for any benefit or advantage received or receivable as a result of such purchase or sale;

iv. *Every person who is an insider or associate of an issuer* that,—

a. sells or purchases the securities of the issuer with the knowledge of an unpublished price sensitive information with respect to the issuer that has not been generally disclosed; or

b. communicates to another person, other than in the necessary course of business, knowledge of unpublished price sensitive information with respect to the issuer that has not been generally disclosed.

In this case, section 6 provides action by the Commission and awarding of costs if deemed necessary.

4.3.6 The Ordinance or the Guidelines do not Link Insider Trading with Market Manipulation and Abuse

We have stated at length above that most laws link market abuse or manipulation with insider trading. In fact, insider trading is considered a category of market manipulation. The SEO Ordinance deals with the two concepts separately.

Section 17 of the SEO Ordinance deals with fraudulent acts in the context of manipulation and the use of deceptive devices under the heading of **Prohibition of fraudulent acts, etc.** The section states the following:

> No person shall, for the purpose of inducing, dissuading, effecting, preventing or in any manner influencing or turning to his advantage, the sale or purchase of any security, directly or indirectly,—
>
> (a) employ any device, scheme or artifice, or engage in any act, practice or course of business, which operates or is intended or calculated to operate as a fraud or deceit upon any person; or
>
> (b) make any suggestion or statement as a fact of that which he does not believe to be true; or
>
> (c) omit to state or actively conceal a material34 fact having knowledge or belief of such fact; or
>
> (d) induce any person by deceiving him to do or omit to do any thing which he would not do or omit if he were not so deceived; or
>
> (e) do any act or practice or engage in a course of business, or omit to do any act which operates or would operate as a fraud, deceit or manipulation upon any person, in particular—
>
> (i) make any fictitious quotation;
>
> (ii) create a false and misleading appearance of active trading in any security;
>
> (iii) effect any transaction in such security which involves no change in its beneficial ownership;
>
> (iv) enter into an order or orders for the purchase and sale of security which will ultimately cancel out each other and will not result in any change in the beneficial ownership of such security;
>
> (v) directly or indirectly effect a series of transactions in any security creating the appearance of active trading therein or of raising of price for the purpose of inducing its purchase by others or depressing its price for the purpose of inducing its sale by others;
>
> (vi) being a director or an officer of the issuer of a listed equity security or a beneficial owner of not less than ten per cent of such security who is in possession of material facts omit to disclose any such facts while buying or selling such security.[35]

[35] Section 17, *Securities and Exchange Commission Ordinance*, 1969.

The law of insider trading and the various liabilities are treated separately, as described in detail above. We feel that, like the laws of the rest of the world, and even India, the two concepts should be dealt with comprehensively to facilitate easy understanding and implementation. The Report of the Task Force on the Stock Market Situation of 2005 deals with the two concepts together.[36]

4.4 Penalties and Liability for Insider Trading

Section 15 B. of the Securities and Exchange Ordinance, 1969 fixes the liability for contravention of section 15A of the Ordinance. Section 15A speaks in terms of the "associated person" and the liability here is of such person. The "associated person" as already stated may be an officer or employee of the company whose securities are traded or of an associated company or he may be a person who occupies a position which gives him access to inside information "by reason of any professional or business relationship between him or his employer or a company or associated company of which he is a director."[37] Now such a person is a true insider, but he is not called as such by the Ordinance. Section 15B is as follows:

> (1) Where a person contravenes the provisions of section 15A, the Authority may, by a notice in writing, ask such person to show cause for compensating any person who has suffered loss for such contravention and initiating prosecution against him.
>
> (2) Where a person to whom a notice has been issued under sub-section (1) satisfy the Authority that—
>
> (a) any dealing on stock exchange or communication of any information was not made with the intent of making any profit or causing a loss to any person or company; or
>
> (b) the dealing on stock exchange or any information was communicated in good faith in discharge of his legal responsibilities. the Authority may withdraw such notice.

[36] Securities and Exchange commission of Pakistan, *Report of the Taskforce: Review of the Stock Market situation March 2005* (June 2005), 33-34.

[37] Section 15A of Securities and Exchange Ordinance, 1969 (Ordinance No. *XVII OF 1969) (28th June, 1969,* as amended up to 7th September, 2000).

(3) Where the Authority is not satisfied with the explanation of the person given in response to the show cause notice served upon him under sub-section (1), it may direct him to pay any other person who has suffered loss for any contravention of section 15A, compensation which shall not be less than the amount of loss sustained by any other person as a result of such dealing or communication of information:

Provided that where the person who has suffered any loss for any contravention of section 15A is not determined, the amount of compensation equivalent to the gain accrued or the loss avoided by such contravention, shall be payable to the Commission.

(4) In addition to compensation payable under sub-section (3), a person contravening the provisions of section 15A shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to three times the amount of gain accrued or loss avoided by such contravention, or with both.

(5) Any compensation payable under this section shall be recoverable as arrear of land revenue.[38]

Thus, this section imposes both civil and criminal penalties. Section 15B(2)(a) and (b) provide defences against such liability.

For the insider as defined in the Guidelines,[39] however, there is only civil liability as discussed in detail above. This is an anomaly, and civil as well as criminal penalties should be provided for all persons connected with insider trading irrespective of whether they are true insiders, their tippees, misappropriators or their tippees.

[38]Ibid., Section 15B.

[39]See section 5 of *Listed Companies (Prohibition of Insiders Trading) Guidelines*, Islamabad the, 27 March, 2000.

CHAPTER V

Conclusion and Proposals for Improvement

5.1 Conclusions

During our study, we came to the following major conclusions:

5.1.1 Insider trading should be prohibited on account of market abuse if for no other reason

In Chapter 1, we traced the growth of insider trading law and analysed the fundamental reasons for prohibition of insider trading. After examining the extensive debate about this law, and after considering the associated economic theories, we concluded that there is no end to the debate about the justification of insider trading, and the debate still continues. Nevertheless, if a single reason were to be advanced it would be the brutal market abuse that has been witnessed in Pakistan. As insider trading is directly linked to market manipulation and abuse, and it is insiders who usually need to manipulate the market, this underhand activity must be prohibited and punished in the interests of the investors and in order to ensure the fairness of the markets. Further, like the laws all over the world, insider trading must be conceived by our law as part of overall market abuse and punished as such.

5.1.2 The law began with the "special facts doctrine" followed by the codification of the anti-fraud standards

In Chapter 2, we examined the growth of insider trading law in the United States, the birth-place of this law. We saw that the seeds of this law were sown in the early 1900s. The law grew initially, and even later, through theories developed by Courts. One of the early theory was contained in what was called the "special facts doctrine" developed by the United States Supreme Court in *Strong v. Reptide.*[1] This was followed by the federal Securities Act of 1933 (1933 Act) and the federal Securities Exchange Act of 1934 (1934 Act). These Acts firmly established the anti-fraud standard, and it is under the anti-fraud standards of the 1934 Act, specifically §10b of the Act and Rule 10(b)3 (promulgated under the authority of section 10(b) Securities Exchange Act of 1934) and Rule 10b-5 promulgated thereunder, that the theories of liability for insider trading took root and grew.

5.1.3 The Cady, Roberts Rule was adopted by the Courts and expanded to widen the impact of the law through the "parity of information rule"

In 1961, a significant development took place in the evolution of insider trading law. In an administrative proceeding before the Securities and Exchange Commission (SEC), *In the Matter of Cady, Roberts & Co,* the SEC determined that rule 10b-5 mandated that corporate insiders have a duty to either abstain from trading on material inside information or disclose the inside information prior to trading. The SEC concluded

[1] 213 U.S. 419 (1909). The Court held in 1909, that "although corporate directors generally owed no duty to disclose material, non-public facts when trading with shareholders, a duty could arise under 'special circumstances.'" This is what came to be known as the "special facts doctrine." The court identified two circumstances that would trigger the applicability of the special facts doctrine: (i) concealment of identity; and (ii) facts having a dramatic impact on the stock price.

session of material, nonpublic information required a person to abstain or disclose. Instead, "the Court held that there must be a relationship of special trust and confidence (such as a fiduciary relationship) between the possessor of material, non-public information and the shareholders in order for the possessor to have a duty to abstain or disclose."[6] The Court acknowledged that corporate officers and directors have such a fiduciary relationship, but the defendant had no such duty. The Court maintained that: "A duty to disclose information arises if there is a relationship of trust and confidence between parties to the transaction. Chiarella had no such duty. He was not a corporate insider in the acquiring corporation and he did not receive confidential information from the target company. He also had no fiduciary relationship with the shareholders of the target company: he was not their agent; they placed no trust or confidence in him; indeed, they had no prior dealings with him. A duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."[7] Under the Classical Theory of insider trading liability, then, a person in possession of material, non-public information has a duty to abstain from trading, or disclose the information before trading, if the person has a fiduciary relationship with the shareholders. As a result, the Classical Theory normally is available only with respect to directors, executive officers and controlling shareholders of a corporation.[8]

[6]Ibid., 4.

[7]Chiarella v. United States, 445 U.S. 222 (1980), Docket Number: 78-1202, Abstract (available at http://www.oyez.org/oyez/resource/case/877/ (visited July 14, 2006)).

[8]Thomas E. Geyer *Insider Trading: Evolution, Prevailing Theories and Recent Developments*, 5.

5.1.5 The Tipping Theory extended liability for insider trading to the "tippees" of those who had duty based on the special relationship of trust

The Classical Theory is limited primarily to corporate insiders. What about non-insiders who acquire, and take advantage of, material, non-public information? The Tipping Theory imposes liability on non-insiders who receive "tips" of material, non-public information under certain circumstances. In *Dirks v Securities and Exchange Commission,*[9] the Court developed the Tipping Theory, which requires that where a tipper passes along material, non-public information, the duty of the tipper must first be examined and the question should be raised whether or not the tipper has breached his or her duty to shareholders. The test is "whether the tipper will benefit, directly or indirectly, from the tip." The benefit can be of a pecuniary or reputational nature, represent a *quid pro quo,* or be in the nature of a gift. If the tipper is in breach of his or her fiduciary duty, the duty is passed to the tippee and the tippee must abstain from trading or disclose before trading.

5.1.6 The Misappropriation Theory made even the non-fiduciaries ("outsiders") liable when they acquired information through inappropriate means

The Classical and Tipping Theories required the existence of fiduciary duty towards shareholders, thus, they did not touch non-fiduciaries. Such non-fiduciaries are those who discover material non-public information through skill, industry or luck. In addition to this, these two theories also failed to reach non-fiduciaries who acquire material, non-public information through inappropriate means. The Misappropriation Theory deals

[9] Dirks v. SEC, 463 U.S. 646 (1983).

with the latter type of non-fiduciaries. In *United States v. O'Hagan*,[10] The Court held that "a person commits fraud in connection with a securities transaction, and therefore violates the federal anti-fraud standards, when he or she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information." Thus, if a person misappropriates material, nonpublic information for securities trading purposes in breach of a duty owed to the source of the information, the Misappropriation Theory applies.

5.1.7 The Misappropriation Theory was extended to apply to the "tippee" of a misappropriator

In July 2001, in *U.S. v. Falcone*,[11] the Second Circuit Court of Appeals extended the Misappropriation Theory to the "tippee of a misappropriator." This form of liability was incorporated in July 2002, by the SEC, in rule 10(b)5-2. the rule further elaborates the concept of "duty" under the Misappropriation Theory.

5.1.8 Stated simply there are four types of liabilities in the law of insider trading in the United States

We may conclude that there are four types of liability in the law of the United States on insider trading. These are:

1. The insider proper.
2. The tippee of the insider.
3. The "outsider" misappropriator.
4. The tippee of the misappropriator.

[10]United States v. O'Hagan, 521 U.S. 642 (1997).
[11]U.S. v. Falcone, 257 F. 3d 226 (2nd Cir. 2001).

5.2 Proposals for Pakistan

5.2.1 The new law of Pakistan should link insider trading with market manipulation and abuse

We have seen all along that the laws implemented in the rest of the world, insider trading and market manipulation and abuse have been dealt with together. In the United States, where this law developed, insider trading grew out of market manipulation and the use of deceptive devices. More recently, India deals with the issue in the same way. Accordingly, we feel that the new law in Pakistan should be drafted in such a way that integrates the two concepts and deals with market abuse comprehensively with insider trading as a part of the larger concept.

5.2.2 The concept of "associated person" should be replaced by that of "connected person" in line with the law in the rest of the world

The term "associated person" is additional and unnecessary. In fact, it is the same thing as the "connected person." We would suggest that the term "connected person" be used instead. This will bring the law in line with the definitions adopted all over the world, especially where the "connected person" approach has been given importance.

5.2.3 The term insider should be made comprehensive and distinguished from other market players

The term insider, especially when related to "associated person," is not clear. The term should be defined very clearly as to who is an insider and what is his liability. Further, the term should be defined in such a way that the true insider is distinguished from the "tippee," the "misappropriator" of information and also his tippee. The present law is not clear about these distinctions.

5.2.4 A special tribunal should be established for dealing with cases of market abuse and insider dealing

It is suggested that an independent tribunal should be established to deal with cases of market abuse and insider trading on the lines of or similar to the Insider Dealing Tribunal established by the Government of Hong Kong. The following introduction is provided on the Tribunal's website:[12]

> Insider dealing is defined in section 9 of Hong Kong's Securities (Insider Dealing) Ordinance. It may occur in a number of ways, but generally the legislation is directed at prohibiting the misuse of particular information about a listed company's affairs by persons connected with that company who are in possession of that information using it (or encouraging others to use it) for the purpose of trading in the company's stock to make a profit or avoid a loss.
>
> The Insider Dealing Tribunal was established in 1991 under the provisions contained in the Ordinance. If the Financial Secretary is of the view that insider dealing in relation to the securities of a listed corporation has (or may have) taken place, he may require the Insider Dealing Tribunal to inquire into the matter and determine:
>
> - whether insider dealing in relation to the named listed corporation's securities has taken place;
> - the identity of every insider dealer; and
> - the amount of any profit gained or loss avoided as a result of the insider dealing.
>
> The Insider Dealing Tribunal is an inquisitorial tribunal. It may consider all relevant and logically probative evidence. It is empowered to conduct further inquiries to supplement the evidence presented by the parties in order to assist it in determining whether or not the allegation of insider dealing it is concerned with has been proved.
>
> The Insider Dealing Tribunal may order that a person found to be an insider dealer pay to the Government of the Hong Kong Special Administration Region an amount not exceeding the amount of any profit gained, or loss avoided, by him as a result of his insider dealing. The Tribunal may also make an order imposing on the insider dealer a penalty of an amount not exceeding three times the amount of any profit gained, or loss avoided, by any person as a result of the insider dealing.
>
> The Insider Dealing Tribunal currently sits in two divisions. The Chairman of each (who must be a High Court Judge or a Deputy High Court Judge) is appointed by the Chief Executive on the recommendation of the Chief Justice. The Chairman sits with two members who are prominent members of Hong Kong's business and professional community. They are appointed by the Financial Secretary, who acts on the recommendation of the Chairman. Every sitting of the Tribunal must be held in public unless the Tribunal considers, in the interests of justice, that a sitting (or any part of it) should be held in private.

Establishing a tribunal will ensure that market abuse and insider trading are monitored and watched constantly. It will eliminate the need for

[12] See http://www.idt.gov.hk/english/intro.html (last visited 11 July, 2006).

appointing commissions and task forces for each violation.

5.2.5 Financial penalties should be enhanced to crores of rupees as has been done in India

Section 15G (iii) of the SEBI Act dealing with penalties for insider trading provides that: ".... counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price sensitive information, shall be liable to a penalty *twenty-five crore rupees*[13] or three times the amount of profits made out of insider trading, whichever is higher."[14] In other words, the minimum financial penalty is 25 crore rupees. It is suggested that the new law of Pakistan on insider trading should also include heavy financial penalties.

5.2.6 All insiders, misappropriators of information and their tippees should also be made criminally liable

Almost all the laws of the world provide both financial and criminal penalties for insiders, misapproriators and their tippees. The current law of Pakistan, provides financial liability for all, but criminal liability is limited to the "associated person" alone.[15] It is suggested that criminal liability, along with civil liability, be fixed for all those unlawfully dealing with inside information.

5.2.7 All Listed Companies and Corporate Bodies Should Adopt Codes for the Prevention of Insider Trading

Chapter IV of the new regulations in India provides for a "Policy on disclosures and internal procedure for prevention of insider trading." This chapter requires listed companies and organisations to adopt Codes of

[13]Emphasis added.
[14]The Securities and Exchange Board of India Act, 1992 (No.15 of 1992).
[15]See section 15B of the Securities and Exchange Ordinance, 1969.

Corporate Disclosure Practices. Section 12 of the new Regulations provides that:

(1) All listed companies and organisations associated with securities markets including:

(a) the intermediaries as mentioned in section 12 of the Act, asset management company and trustees of mutual funds;

(b) the self regulatory organisations recognised or authorised by the Board;

(c) the recognised stock exchanges and clearing house or corporations;

(d) the public financial institutions as defined in Section 4A of the Companies Act, 1956; and

(e) the professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies, shall frame a code of internal procedures and conduct as near there to the Model Code specified in Schedule I of these Regulations.

(2) The entities mentioned in sub-regulation (1), shall abide by the Code of Corporate Disclosure Practices as specified in Schedule II of these Regulations.

(3) All entities mentioned in sub-regulation (1), shall adopt appropriate mechanisms and procedures to enforce the codes specified under sub-regulations (1) and (2).

(4) Action taken by the entities mentioned in sub-regulation (1) against any person for violation of the code under sub-regulation (3) shall not

preclude the Board from initiating proceedings for violation of these Regulations.[16]

It is suggested that such codes be made mandatory for listed companies and organisations in Pakistan as well.

[16]The Gazette of India extraordinary. Part II, section 3, sub section (ii) published by authority Securities and Exchange Board of India notification, Mumbai, the 11th July, 2003, Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2003.

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