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Insider Trading In Malaysia; Sanctions And Enforcement

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ABSTRACT

Insider trading can erode investor and market confidence. Due to this, many countries have enacted legislation prohibiting insider trading. Despite such laws, cases of violation of confidential information by insiders still occur around the world and the loss to the victims is often massive. This paper aspires to discuss issues with regard to the efficiency of legal mechanism in addressing the problem of misuse of corporate information by insiders. It considers the causes why people engage in insider trading and analyzes problematic aspects under the existing law in combating insider trading along with the issues of enforcement.

Key words: insider trading, prosecution of insider trading, insider trading law, enforcement of insider trading.

Introduction

Insider trading refers to dealing in shares by persons who have access to corporate non-public information affecting the value of the shares. An example of insider trading is a director of a company who after knowing some favorable news such as a research breakthrough or an award of a huge project to the company, buys a large amount of shares in that company in order to make a profit. Similarly a finance director who sells all his shares shortly before the announcement of a financial loss is another example of insider trading.

One of the main reasons behind the prohibition of insider trading is the upholding of the principle of fairness. It is unfair to allow an executive to use corporate information for personal gain. Such a practice would give rise to unfairness to the investors who are not insiders or have no access to the information. Thus if left unaddressed, insider trading can diminish confidence in the country’s capital market.

Why people commit insider trading:

Understanding the reasons which lead potential offender to commit insider trading would help policy makers in determining the appropriate punishment for the offence in question. The causes and reasons can provide insights pertaining to whether criminal sentencing should include mandatory imprisonment or whether the law should be contented to impose a fine only to convicted offenders. The theory of criminology explains that criminals act rationally, calculating the prospective gains of the crime and considering the probable risks in the event they are caught and convicted (Becker and Mulligan, 1997). Under this utility theory, potential criminals base their decision to commit a crime on an analysis of the costs and benefit of the act. The theory explains that individuals are expected to respond to changes in the probability of apprehension and harshness of punishment. Monetary penalties, convictions and the severity of punishment can influence the level of commission of the crime.

The utility theory is even more relevant in the context of insider trading. Insider trading falls in the broad area of white collar crime and white collar crime is a distinct category of crimes due to the social and financial status of the offenders. White collar or commercial crime is typically defined as one “committed by a person of respectability and high social status in the course of his occupation” (Sutherland, 1940). Hence what distinguishes white collar crime from other crimes is the sociological difference of the criminals. The background enables offenders to calculate the risk and the illicit gain by studying the existing punishment and evaluating the risks. A criminal sanction without mandatory imprisonment may be less effective as that could induce a criminal to set off the fine from the gain. Research has confirmed that with the social position occupied by commercial criminals, imprisonment had more deterrent value to these offenders because humiliation brought about by prison punishment is more felt by the middle and upper-class offenders (Braithwaite, 1984).
Another researcher reported testimony from businessman shows that even short term imprisonment is most feared by corporate executives (Clinard and Quinney, 1973 and Kadir, 2012).

The general strain theory also explains why people engage in criminal behavior. The theory explains that there is uniform pressure on everybody in the society to gain more wealth (Kornhauser, 1978). The theory is a psychological reaction to any perceived negative aspects’ of social environment (Agnew, 1992). Criminals are often driven by the fear of falling, or the stress of losing their wealth (Weisburd et al, 2009, Kadir, 2012).

The pressure to commit crime under the strain theory may be affected by the deterioration of moral standard of society. Thus greed, corruption and the lack of ethics may further promote the propensity to commit crime. The theory also finds support in Nykodym (2005) who concluded that a criminal is mainly guided by mercantile motive for personal gain. The research which was conducted to probe criminal behavior amongst insider cyber crime found that the sole motive of the cyber thief was to steal valuable information from an organization and utilise it afterwards for money, and his or her crime is not driven by hate or revenge but rather by greed and hunger for money. The commission of insider trading offences driven by such factor could be reduced by deterrent punishment for the offences.

The utility and general strain theories raise a question whether the punishment provided for insider trading under the existing laws is adequate. It may be thought that the mandatory imprisonment imposed under section 188(4) of the Capital Market and Services Act 2007 is highly appropriate. Potential criminals are likely to be deterred by the threat of imprisonment regardless of the amount of profit to be earned from the insider trading. The mandatory imprisonment is a laudable sanction as the imposition of the punishment is compulsory and not subject to the exercise of discretion. The civil suit allowing for an amount three times the gains made by the trader as well as the maximum RM1 million penalties would also have the deterrent effect on prospective offenders of insider trading. There is virtually no benefit gained from the commission of the crime when the offender knows that he or she will have to pay triple damages to the victims.

Insider trading and investor’s confidence:

Marcial regarded insider trading as the second-oldest profession in the world after prostitution. Those who have access to corporate information and utilize it for their advantage are regarded as financial prostitutes. Insider trading promotes informational disadvantage for those who have no access to the confidential information. The public confidence in the security market will be gone as there is no more a level playing field in the capital markets (Marcial, 2002). In the same context Newkirk (1998) affirms that investor’s confidence is necessary for maintaining healthy markets, and investor’s confidence in turn is mainly determined by his or her belief in fairness in terms of information disclosure and protection in case insider trading occurred.

The role of insider trading law in promoting investors confidence is also explained by Hartmann (1997). According to him, investors’ perception of justice is important for maintaining confidence in capital market. Investors who feel that they have been unfairly victimized in share dealing might move their capital from the market. This rationale explains the effort by many countries to prohibit insider trading.

Studies on the impact of insider trading regulation show that the regulation produces good outcome on securities market. Insider trading laws are found to have a correlation with a decrease in the cost of capital and an increase in the number of analysts analyzing local companies. The insider trading regulation can also encourage wide distribution of share ownership, more accurate share prices, and improved liquidity (Gilbert 2007, Kadir and Muhamad, 2012). The findings discovered in Beny (2005) show that the restrictive laws correlates with a more widespread share ownership, more accurate share prices and improved liquidity.

The need to protect investor’s confidence and integrity of securities market has warranted the move by the Malaysian authorities to enact laws against insider trading. This raises a question whether the laws have really worked in discouraging insider trading.

Shortcomings of the regulation:

Strengthening insider trading law is very crucial if securities market wishes to attract foreign investment in the future. In his presentation titled “Regaining Investor’s Confidence in Malaysia: Recent Capital Market Awards”, the chairman of Securities Commission announced that improving market transparency and corporate governance would be an important recovery objective for capital market. To achieve this objective, the enhancement of insider trading law and enforcement capabilities would be high on the agenda. Malaysia has paid attention to this issue of insider trading over the past decades as reflected in the legislations enacted to regulate and control insider trading. This is done through a number of statutes such as Companies Act 1965, Securities Industry Act 1983, Futures Industry Act 1993, and Capital Market and Services Act 2007. The Securities Industry Act 1983 has been repealed by the Capital Market and Services Act 2007, where the 2007 Act is intended to consolidate the Securities Industry Act 1983 and Futures Industry Act 1993. Nevertheless the
law on insider trading as provided under the Securities Industry Act 1983 has been retained under the Capital Market and Services Act 2007. The Acts employ criminal prosecution and sentencing to discourage prospective offenders from committing the crime. The criminal prosecution under section 188 of the Capital Market and Services Act 2007 represents one of the toughest legal measures against the offence. Subsection (4) provides that contravention of the provision containing the prohibited activities is liable on conviction to a fine of not less than RM1 million and to imprisonment for a term not exceeding 10 years. The severe sentencing of a huge amount of monetary penalty and the mandatory imprisonment implies a serious fight against insider trading. The imposition of mandatory imprisonment is a laudable effort in deterring criminal conduct, however its actual effectiveness hinges much on its implementation. As the following discussion shows, criminal sanction of mandatory imprisonment cannot be enforced without great obstacles. Prosecution is not always a viable route especially if there is difficulty in obtaining evidence, which more often than not is a challenge in the case of insider trading.

An alternative device to the criminal prosecution is the civil suit under section 200(2) of the Capital Market and Services Act 2007. The provision allows the following claims against the offender: (a) an amount equal to three times the amount being the difference between the price at which the securities were acquired, or agreed to be acquired, by the insider or the other person, and the price at which they would have been likely to have been acquired at the time of the acquisition or agreement, as the case may be, if the information had been generally available; and (b) civil penalty in such amount as the Court considers appropriate having regard to the seriousness of the contravention, being an amount not more than RM1 million. It is obvious that section 200(2) gives power to the Security Commission to take a civil action against the alleged insider if it considers that it is in the public interest to do so to recover the above-stated amount. The Malaysian Security Commission has resorted to this provision in their aggressive measures to control insider trading. The annual report of 2010 by the Security Commission shows that more than 40% of active investigation files relate to insider trading cases. The recent news that “Security Commission goes hard on insider trading is an example of serious effort to combat insider trading and invoke confidence in the capital market. The move to publicize the alleged breach in media as well as the publication of Security Commission annual reports on the web including the names of the offenders/investigated parties is a creditable measure for its deterrent effect. The Security Commission in this case collected from the alleged insiders an amount over RM770,000 as part of regulatory settlements under section 90A of Securities Industry Act 1983 (section 199 of the Capital Market and Services Act 2007). The individuals agreed to settle claims without admission or denial of liability and on the basis of section 90A, the amount required from each individual was three times the gains the traders made from the trades in the shares.

Section 90A(1) of the Securities Industry Act 1983 (section 199(1) of the Capital Market and Services Act 2007) allows the recovery of the triple amount as well as the claim of civil penalty regardless of whether the offender has been charged with an offence or whether a contravention has been proved in a prosecution. Section 90A(1) of the Securities Industry Act 1983 is highly commendable. With the difficulty to bring a criminal conviction to insider trading offenders, it is good to see that section 90A(1) of the Securities Industry Act 1983 is devoted to victims’ interest. The provision does not require criminal charges being pressed against the offender or a conviction being obtained before a civil action can be commenced.

Nevertheless the civil liability regime is not fully satisfactory. Under section 90A(7) of the Securities Industry Act 1983 (section 200(3) of the Capital Market and Services Act 2007), the amount recovered from the traders will be used first to reimburse the Security Commission for the costs of investigations and proceedings. The remainder will be paid as compensation to people who suffered financial losses due to insider trading. With the lengthy and complicated process of investigation, one cannot ensure that the victims will receive any residue as a substantial portion of the amount may be swallowed up by the Security Commission’s cost. As a result the victims may not be paid the amount they should have received had the information been available to them when the shares were sold, defeating the very idea of the prohibition of insider trading. It may be thought that the provision does not embody a creditable policy of a fair compensation to the victims. Guaranteeing that the victims are refunded the money which they should have received without the insider trading can achieve a better protection for them. The cost borne by the Security Commission should be imposed on the traders over and above the gains returned to the claimants. Such an undesirable position is also reflected in section 90A(8) of the Securities Industry Act 1983 which provides that the Security Commission ‘may decide not to distribute to the victims if it considers that it is not practicable to do so, on the basis of the likely administration costs, the amount of any potential distribution to each person and the difficulty of ascertaining or notifying the victims’’. The reason of administration cost has been removed under section 200(4) of the Capital Market and Services Act 2007.

The enforcement problems:

Despite the vigorous effort by the Security Commission, fighting insider trading is not always an easy task. Using criminal law as a tool to bring the offenders to justice may have its drawbacks, including the high burden
of proof and the deliberate procedural matters to be complied with. The difficulty is evidenced from the low rate of prosecution. CLJ database in March 2012 shows that there are only 10 cases of insider trading throughout 35 years compared to 379 criminal breach of trust, and more than 500 cases of fraud. Along with the above given reasons, poor enforcement is also caused by problems in detection. Malaysia is not alone in facing the problem; the low rate of prosecution is also encountered in Australia. A study by Tomasic (1991) reveals that the phenomenon could be attributed to many factors, the chief of which is the difficulty of proof. Traders could easily explain their share transaction as a result of a thorough research, or by following the trading pattern of a market leader. Problems in detection and the cost and difficulties of pursuing enquiries also contribute to the low level of prosecution. Research shows that brokers who are aware of the illegal transaction often hesitate to act as witnesses for fear of losing clients. The problem is compounded by the difficulty to obtain the necessary evidence required to prove this particular offence; in particular, the requirement to demonstrate in a positive way that the information was in fact price sensitive and that the defendant was motivated to trade as a direct result of having that particular information. The fact that the victims are unaware that they have suffered loss in the transactions also contributes to the scenario (Tomasic, 1991).

In a trading by a company’s director who bought shares shortly before the announcement of good news about a company insider, or has sold shares in the company before the announcement of the bad news, the public prosecutor can argue that the transaction was not a coincidence and thus provides evidence of insider trading. The evidence is further corroborated if there are other friends or relatives who traded the same securities. However this is not a conclusive proof of insider trading, friends and relative can be shown to have traded based on the observation of the trading pattern in the market or the conduct of the insider. This constitutes no wrong under the law as the transaction was not prompted by inside information. The transaction may also be defended on the basis that the investment was the result of a research.

The conversation between the tipper and the tippee before the transaction can be used to support that there is insider trading. The evidence may show that the tipper and the tippee knew each other, that they had communication with each other, and that they traded just before the announcement of the favorable or bad news. However, the conversation is not conclusive proof of insider trading. People have a right to talk to each other, and their conversations must be placed in the context of all other evidence in the case. Similarly, the size of the investment is not a conclusive proof of insider trading if it can be shown that the insider can afford the risk and that he or she had traded involving an equally a large sum in the past.

The prosecution might not be able to substantiate his or her case if it can be shown that the information is in the public domain, for example the information is available in the company’s annual reports. It may also be argued that the trading is based on an analysis of past performance which indicates a consistent pattern of growth (Tomasic, 1991).

The stigma of arrest and conviction are most effective in deterring potential offenders from committing insider trading. However difficulties with the enforcement may defeat insider trading laws; the stringent sanction of the criminal law and the triple damages from the disgorgement of profit under the civil action would not serve its purpose if the law is not applied. Being white collar criminals, insider trading offenders are better able to calculate the risk of their offences under the utility theory of criminology. Thus problems with the enforcement can constitute an incentive for these criminals to commit the crime. 10 cases brought to court within three decades may be viewed as few, and the deterrent effects sought by the law would be seriously undermined.

**Concluding remarks:**

Insider trading can be detrimental to national economic performance of Malaysia in terms of the loss or reduced number of potential investors. It is very important that the matter be given due attention if the government is to promote investors’ confidence to the security market. Understanding the reasons which lead people to commit insider trading, identifying problematic aspects under the existing law in combating it, and ascertaining problems of enforcement can provide a more structured and comprehensive way of addressing the problem of insider trading. The laws are found to be generally satisfactory and have the deterrent value needed to scare prospective criminals from committing the crime in the future. However the rate of prosecution is not very impressive and the problems are largely contributed by difficulty to implement and enforce criminal law in prosecuting the alleged criminals. Realizing the predicament, the Security Commission of Malaysia has made use of the civil suit provisions against the alleged insiders. This measure confers benefit to the victims and will hopefully revive investor’s confidence in the market. With some improvements made particularly in relation to section 90A(7) of the Securities Industry Act 1983 (section 200(3) of the Capital Market and Services Act 2007), it may be thought that the civil suit provides a good option for the regulators to combat insider trading.

References