

What is Insider Trading?

"Insider Trading" is a term that most investors have heard and usually associate with illegal conduct. But the term actually includes both legal and illegal conduct. Insider Trading clearly is not a recent phenomenon in the business world, legal as well as economic discussions about it still continue.

Insider Trading is the trading of a company's (A Listed Company in this case) stock or other securities by individuals with potential access to non-public information about the company. Simply put, Insider Trading means buying or selling stocks, bonds or other securities based on significant information that's not available to the general public. Besides creating an uneven playing field that disadvantages regular investors, Insider Trading by corporate officials also violates their responsibility to operate in the best interests of shareholders.

Insider Trading can be illegal or legal depending on when the insider makes the trade. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take advantage of non-public information. There is more to Insider Trading than internal parties trading in a company's securities. The president, Chairman and other principal officers of a company aren't prohibited from trading in their company's stock offerings; quite the contrary, it would be unfair to prevent a company's major decision makers from investing in it. Insider Trading policies seek to define for all company employees the wide range of activities considered illegal Insider Trading. In most cases, buying or selling stock in a company based on information not generally available to the public is the target of Insider Trading policies.

The term Insider Trading is frequently used to refer to a practice in which an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation, or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company. Illegal Insider Trading therefore includes tipping others when you have any sort of nonpublic information. Directors are not the only ones who have the potential to be convicted of Insider Trading. People such as brokers and even family members can be guilty.

Insider Trading is legal once the material information has been made public, at which time the insider has no direct advantage over other investors. Insider Trading is quite different from market manipulation, disclosure of false or misleading information to the market, or direct expropriation of the corporation's wealth by insiders.

Section 32 of the Securities and Exchange Commission of Sri Lanka Act No 36 of 1987 (as amended by Act No 26 of 1991, Act No 18 of 2003 and Act No 47 of 2009) covers Insider Dealings as "Trading in the shares of a Listed Company whilst in the possession of unpublished, price sensitive information in respect of the securities of the said Company, with a view to the making of a profit, or the avoidance of a loss".

Some universal examples of Insider Trading cases are against:

- 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.

The case against insider trading

The four main ethical arguments against insider trading are that of:

- (1) Asymmetry of information;
- (2) Unequal in-principle access to information;
- (3) Contravention of property rights in information; and
- (4) Being counter to fiduciary duty

The notion of Insider Trading being unfair includes a number of arguments. One is that Insider Trading is unfair because the two parties to a transaction in the stock market do not have equal information. According to this view, both parties to a transaction should have the same material information concerning the conditions underlying a transaction. Asymmetry of information is thus proposed to be unethical because the two parties do not come to the transaction as equals.

Insiders with advance knowledge can avoid losses or profit from future market moves, leaving typical investors at a great disadvantage. The loss of investor confidence in capital markets can lead to severe consequences. Insider Trading regulation has been adopted on a global scale to help avoid these problems. It exists in most jurisdictions around the world.

When a person discloses material nonpublic information to someone who can trade on the basis of that information, regulations dictate that the individual must make disclosure of the information public. Another form of Insider Trading, known as tipping, can be done in person, on the phone, or by mail. Insider tipping is against the law because it gives the recipient an unfair advantage over other investors. Regulatory authorities have liberally interpreted Insider Trading regulation to encompass all forms of tipping confidential information.

A second argument against Insider Trading is that the information is not accessible to the ordinary shareholder to ascertain the appropriateness of buying and selling securities in the marketplace. This argument is not against the asymmetrical distribution of information *per se*, but more concerned that, in principle, this information should be public in the sense that hard work on the part of potential or actual dealers in the market will be able to unearth it. This aspect of fairness concentrates on the information being "in principle" open to everybody given sufficient hard work and research into the market and the economy in general

A third argument against Insider Trading is that it contravenes property rights in information. In a similar way that inventions and trade secrets are treated as property, proponents of this view argue that inside information is a type of property, and that dealing in this information is a violation of property rights.

A related, fourth argument against Insider Trading is that of fiduciary duty, which argues it is not the entrepreneur who has the right to the information, but the entrepreneurs, managers and workers who owe a fiduciary duty to shareholders. This theory posits the notion that insiders have a long-standing ethical duty to enhance the interests of shareholders.

Why are stock transactions involving specific inside knowledge bad? The theory is that not only are the ignorant buyers and sellers taken advantage of, but - worse, perhaps - confidence in the securities markets themselves is sabotaged because potential participants, fearing they will be taken advantage of, will stay out of the market, depriving it of capital. Whereas for the market to be able to play its role effectively, every measure should be taken to ensure that market operates smoothly. The smooth operation of the market depends to a large extent on the confidence it inspires in investors. The factors on which such confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information; whereas, by benefiting certain investors as compared with others, insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the market. Investors' confidence is fundamental for the proper functioning of securities markets. A well functioning securities market is a precondition of the common wealth. Therefore, legislatures all over the world must maintain and restore this confidence. As long as outside investors experience unequal treatment, potential risks for the capital market will remain.

Insider Trading requires regulation and should not be left to the market. Unregulated Insider Trading may have detrimental effects for the securities market. Insider Trading regulation is considered essential for the functioning of modern securities markets. Regulation is important to gain investor's confidence in the integrity of the securities market. Legislatures have been aware of the detrimental effects of Insider Trading and the significance of investors' confidence when regulating Insider Trading.

Various countries have adopted Insider Trading regulations. The rules and regulations vary slightly from country to country, but the essential elements are the same. Unlawful disclosure of proprietary information is the basis for all international insider trading policies. Insider Trading has been regulated in an effort to protect investors and to preserve market integrity.

Sources:

Insider Trading in financial markets: legality, ethics, efficiency - Phillip Anthony O'Hara

<http://www.sec.gov/>