“Insider Trading – Good, Bad or Ugly”

Seminar organized by ICCS in association with the SEC and Daily FT

Monday, 26th March 2012

at the JAIC Hilton Residencies

from 4.00 p.m. to 6.30 p.m.

SEC Chairman Mr Thilak Karunaratne’s Opening Remarks

Let me start by citing an Anonymous quotation on insider trading, quote, ‘“... but if Insider Trading was prohibited, there would not be any trading in the market”, unquote.

Though some may gain short term benefits from insider trading, the long terms repercussions would likely to be of a different nature. If insider trading continues unabated, this will result in the loss of investor confidence and market integrity.

This is why; we believe that Insider Trading should be dealt with rigorous regulatory and enforcement actions. Regulation is essential to retain investor's confidence and to maintain the integrity of the Securities market.

First let me give you a brief overview of the laws governing insider trading in Sri Lanka.

The prohibition on insider trading in Sri Lanka is articulated in Part IV of the Securities and Exchange Commission of Sri Lanka Act No 36 of 1987. This Chapter contains comprehensive provisions in respect of prohibited conduct with regard
to insider trading. It is noteworthy, that the Sri Lankan law is based on the traditional approach where a connection has to be always shown to an insider in a listed company.

In Sri Lanka insider trading is defined in the statute books. This means that the SEC has to ensure that, in an insider trading case the accused falls strictly within the prescribed definition given in the law. Whilst in some other countries the offence is not tightly defined and leaves room for interpretation by a regulator or a court of law. There are many provisions in the SEC Act dealing with insider trading. To cite one such definition in our law;

Section 32(1) of the SEC Act states, an individual connected with a company shall not trade in listed securities of that company if he has information which,

a. He holds by virtue of being connected with the Company;
b. It is reasonable to expect such a connected person by virtue of his position, not to disclose except for the proper execution of his official duties; and
c. He can reasonably be expected to know is unpublished price sensitive information in respect of those securities.

All three of the above criteria have to be satisfied before an individual could be found to be guilty of insider trading under this provision.
Whilst corporate insiders are generally thought to be primary candidates for insider trading violations in Sri Lanka, the reality in other countries is that others outside the corporate environment can also be charged with insider trading.

It is a significant fact that in the United States only a very few cases involved a corporate officer or a director. In contrast, many lawyers, law firms, employees, investment bankers, arbitrageurs, stockbrokers, financial printers, police officers, reporters of ‘Wall Street Journal’ and even a dentist have been charged with insider trading.

It is pertinent to mention here that on last Thursday i.e. 22nd March the US senate approved by an overwhelming majority of 96-3 legislation to strengthen ethics rules of Insider Trading by forbidding lawmakers from buying stocks based on information they gather while performing duties. The bill also forbids all congressional and White House staff from buying stock products if they have inside information. Elected officials would also have to report any purchases they make on the stock exchange of more than $ 1000 within 60 days. This will be signed into law by President Obama shortly.

With the local legal framework in mind, let’s turn our attention now to an international perspective on laws and principles applicable to us.

Sri Lanka is an ordinary member of the International Organization of Securities Commissions (IOSCO) which is the standard setting organization for all securities regulators.
IOSCO identifies

1. Investor protection,
2. Ensuring that markets are fair, efficient and transparent, and

as key objectives of securities markets regulators.

The discussion of these "Core Principles" state that "investor protection" in this context means "Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets." More than 85% of the world's securities and commodities market regulators are members of IOSCO and have signed on to these Core Principles.

It is in line with local laws and international principles that Insider Trading has become an enforcement priority of the Securities and Exchange Commissions all over the world and Sri Lanka is no exception.

Regulators all over the world are discovering, governments cannot afford to turn a blind eye to insider trading if they hope to promote a lively securities market and attract international investment.

In Sri Lanka, there is renewed interest in business ethics and insider trading. Commentators are beginning to question the ethics, integrity and the goals of those working in the financial markets;
We wish to have a market where all pertinent information is fully available to all participants and where prices respond immediately and correctly to available information. This would help in creating and maintaining a market in which securities can be issued and traded in an orderly and fair manner.

More Sri Lankans are investing in the stock market than ever before. Sri Lankans now invest several times of the amounts than they have invested in the pre-war era. We believe that these investors will remain in the market only if the trust and confidence is preserved.

The SEC and the public have raised concerns from time to time that penalties for violating securities laws are too lenient, that imposition of fines are too lenient and that very few cases have been prosecuted to the end.

It is also interesting to note that the law does not provide for the restitution of those investors who have suffered losses due to the insider trading activities of some. SEC Sri Lanka too will be looking towards addressing this concern.

It is a point of interest that the Insider Trading and Securities Fraud Enforcement Act of USA enacted in 1988 increased the maximum fine from $ 100,000 to $ 1,000,000 per criminal count for individuals committing insider dealing. The monetary penalty for criminal violation of insider trading by a body corporate was increased from $ 500,000 to $ 2,000,000 per criminal count. The maximum jail term was raised to 10 years. This law authorized the US, SEC to pay bounties up to
10% of the penalties the government raises from the insider traders, to persons who provide information concerning insider trading violations.

This law also requires every broker, dealer and investment advisor to establish, maintain and enforce written policies and procedures that were designed to prevent employees from committing insider trading.

The Sri Lankan law contains no affirmative obligation on a broking company or an investment banker to adopt such procedures to prevent insider trading.

In spite of the internationally recognized principles to combat insider dealing, certain economic and legal scholars have expressed skepticism about the enforcement of insider trading laws.

They claim that insider trading based on material nonpublic information benefits investors, in general, by quickly introducing new information into the market.

Further they say that, insider trading is a legitimate form of compensation for corporate employees, permitting lower salaries that, in turn, benefit shareholders. It provides an incentive to innovation, by promising huge rewards for developing a plan or product that will lead to a steep rise in the stock.

This argument, however, fails to address the real and significant hazard of creating an incentive for corporate insiders to enter into risky or ill-advised ventures for short term personal gain, as well as to put off the public release of
important corporate information so that they can enjoy the economic benefits at the expense of retail shareholders.

There are those who argue that insider trading is a victimless offense and that enforcing insider trading prohibitions is simply not cost effective; the amount of money recovered does not justify the money and human capital spent on investigating and prosecuting insider traders.

This is a one sided argument which lack the merits of a balanced market analysis. We strongly believe that a market cannot be efficient in the long-term, when some investors take a big advantage over the majority of other investors.

Those who are at a great disadvantage due to Insider Trading will eventually leave the market because they will lose their money to the unjustly enriched minority. A decreased volume of trading due to fewer investors in the bourse will make the market less efficient because buyers sometimes won't be able to find sellers, and sellers sometimes won't be able to find buyers. Market efficiency is an important goal to which we should always aspire to, but not at the expense of fair play.

To sum up what I have been talking about at length, I would like to reiterate the merits or rather, the demerits of Insider Trading from a market perspective.

1. Insider trading distorts the economic incentives for corporate decision makers and market participants;
2. It allows corporate managers to profit at the expense of the companies and thus tempts managers to undertake non-optimal ventures;
3. It also discourages swift public disclosure of corporate information and promotes manipulative collateral activities in the market;
4. Insider trading is unfair to non-insiders who suffer an insurmountable trading disadvantage.

In order to ensure that the Sri Lankan securities market functions efficiently and integrity, time is ripe to borrow from other jurisdictions new ways of dealing with insider trading. I am happy to state that we at the SEC has embarked on a project to modernize the current securities laws in Sri Lanka and to ensure that we are equipped to face the future challenges.

We plan to introduce new methods of dealing with offenders of Insider Trading. With the amended Act, Insider Trading will not be a compoundable offence and it will enable the imposition of civil sanctions in addition to the criminal sanctions available under the present Act.

But the most challenging task before the public, the market and the SEC today is to be able to distinguish illegal trading from that of permitted trading. So today’s seminar will hopefully contribute significantly towards clearing this fog in the minds of many as to what would actually constitute insider trading.

I would like to conclude this short address with a quote from the country’s first Executive President. In opening up the economy in 1977, he said, and I quote, “. . . . Let the robber barons come”, unquote.
The question now is whether we are now going to emulate him and turn a blind eye to robbers invading the bourse and taking the innocent investors for a ride? The SEC is determined not to do so, and work towards the protection of market integrity.

Thank you.