

*Full Length Research Paper*

# Disclosure and corporate governance of insider trading: The Malaysian perspectives

Edward Sek Khin Wong \*, Choong Kwai Fatt and Priscillia Yap Poi Yok

Faculty of Business and Accountancy, University of Malaya, Kuala Lumpur, Malaysia.

Accepted 14 June, 2010

**This study examined the issues of disclosure of and corporate governance of insider trading in Malaysia. Insider trading has evolved itself in various jurisdictions from the agency theory to the misappropriation theory. In Malaysia, the mere fact of the receipt of information itself resulted in a triggering of a breach of insider laws regardless of unrealized gain or loss. In this paper, documents from several articles, section 183 - 188, Capital Market and Services Act 2007 (CMSA), including the inclusion of “Chinese walls” were used as a defence for a corporation with regard to conduct of its officers under section 194 of the CMSA. Moreover, the Malaysian disclosure best practises guidelines of 2004 were scrutinized in studying and establishing an evolution of insider provisions leaning towards the philosophy of disclosure theory. The findings indicated that should the insider misappropriated the “property information” of a Company by non-disclosure, by not disclosing it in a timely manner, by being inaccurate, by being ambiguous, or by disclosing to another person who have proprietary information before it officially reached the market warrant the prospect of violating insider-trading rules? As a result, the removal of intentional misappropriation and the inclusion of the recipient of such information being liable depict the emphasis of disclosure. This study can assist law enforcement bodies to provide legitimacy to the transparency rules and insider trading provisions to reduce the gap between the legal norms and the social norms of the day.**

**Key words:** Inside trading, corporate governance, homo-economicus, homo-sociologicus.

## INTRODUCTION

Insider trading has evolved itself in various jurisdictions from the agency theory to the misappropriation theory. In Malaysia, the mere fact of the receipt of information itself results in a triggering of a breach of insider laws regardless of unrealized gain or loss. Under Malaysia Securities Law, section 183 - 188, Capital Market and Services Act (2007) (CMSA), including the inclusion of “Chinese walls” used as a defence for a corporation with regard to conduct of its officers under Sec 194 of the CMSA, and the release of Disclosure Best Practises in 2004, created an evolution of insider provisions leaning towards the philosophy of disclosure theory. In other jurisdictions, failure of disclosure, by itself, warrants prosecution merely from the market stability view of the particular stock in question. Particularly desirable due to the

complexities involved, the securities markets should not be left to the realism effect of Homo-Sociologicus.

Under the homo-economicus theory of Adam Smith, behaviour is supposed to be guided by instrument rationality, while the behaviour of homo-sociologicus (Emilie Durkheim) is dictated by social norms. The homo-economicus (market theory) is “pulled” by the prospect of future rewards, whereas homo-sociologicus is “pushed” from behind by quasi-inertial forces (Gambetta, 1987). The former adapts to changing circumstances, always on the lookout for improvements while the latter is insensitive to circumstances, sticking to the prescribed behaviour even if new and apparently better options become available.

The homo-economicus is easily cari-catured as a self contained a social atom, and the homo-sociologicus as the mindless plaything of social forces<sup>1</sup>. Here the authors

\*Corresponding author. E-mail: [edwardwong@graduate.uwa.edu.au](mailto:edwardwong@graduate.uwa.edu.au).

<sup>1</sup> Elster, J (1989). Social Norms and Economic Theory, J. Econ. Perspectives, 3(4): 99-117.

will address the general understanding of the laws on insider trading in Malaysia and the development of the securities market in Malaysia.

An understanding of the laws on insider trading in Malaysia requires an understanding of the evolution and development of the securities market in Malaysia, and the rationale of the regulation using the underlying philosophy of such regulation. Against the backdrop of the changes in the securities laws, also analysed are the gaps in market behaviour.

A discussion on securities regulation cannot divorce itself from the disclosure provisions, corporate governance, and the use of best practices, to avoid breaches of these regulations or to enforce these insider trading provisions (Choong et al., 2010). Simplistically speaking, a Damocleanic Sword should not hover above the head of the separate legal entity of a corporation by mere fact of the conduct, or breach of fiduciary duties, or poor corporate governance practices of the Board, or senior management with regard to disclosure, transparency, and accountability.

If viewed into the perspective from disclosure of and corporate governance, insider trading laws in Malaysia serve not only as a sword, due to its civil and criminal sanctions, but also as a regulator of market behaviour sourced from the defence, or exception provisos. However, could it also serve as a handmaiden towards a disclosure-based regime or as a tool towards corporate governance? If a legal provision becomes a legal norm that translates itself into a social norm, the inculcation of these concepts of fiduciary relationship and respect of investors leads to market integrity, while at the same time, respecting and supporting the law, customs, and fiscal responsibilities of all.

However, before a law becomes a legal norm, all must accept it as such. However, some traders may lack confidence in these new laws and may believe that the new rules are not legitimate and compelling; these attitudes arise as the consideration and acceptance of these new rules lack personal credibility and seriousness. In addition, some consider that it makes no sense to manipulate society solely for benefit of the financial markets<sup>2</sup>. Here, therefore, lies the rationale for enforcement and the importance of enforcement towards the legitimacy of rules and the translation of such rules into a legal norm, and then into a social norm that does consider the new rules seriously.

The rationale of corporate governance includes the concepts of disclosure or transparency. The rationale of corporate governance as a premise has a basis on long term shareholder value, and a realistic check of corporate sustainability, within the landscape of sustainable development of the existing environment. This includes the interplay of forces that facilitate and enable the

sustainability of the corporation, and includes requisite behaviour expected from the market. This underlies the alignment of corporate governance with the concept of Market Theory's requisite parity of information, which equates to equal level playing fields for market participants.

Is the issue of market liquidity having its sources from poor enforcement of disclosure rules and lack of consideration and investigation of insider trading, a major problem? Is the issue of liquidity due to time gaps in the availability and consumption of vital market information?

In the environment of Disclosure Based Regulatory (DBR), there has been constant debate on the various proposed legislative acts that are yet topics of serious business and legal dialogue. The reason of existence of such gaps is commented along the application of the "Homo-economicus" and "Homo-sociologicus" theory.

Further, the initial confusion caused by the introduction of the present wide ranging insider trading provisions have subsided, and in its place there should be an appreciation of the duties of traders arising from insider trading prohibition and the impact of insider trading regulation generally upon the conduct of a company's business.

Arising from the present insider trading laws, now consolidated into the Capital Market and Services Act (2007), the communication of information via long and established channels, e.g., information being passed by directors to a pool of family shareholders prior to the information being made available to the company's board or its shareholders in a general meeting, were suddenly challenged as being unlawful. Some Board members have refused to receive insider information in the exercise of their duties, and have required lawyers or other professionals to separate insider information from other information forwarded to the Board, particularly in merger and acquisitions negotiations<sup>3</sup>.

This study seeks to answer the following research questions: Do the directions of market approach of securities regulation and disclosure based regime affect the philosophies of the insider-trading provisions, Are there any influences of the factors from the gap in effectiveness of insider trading provisions homo economicus and homo sociologicus.

This study will first address the understanding of the securities regulation framework. It will then argue that the

<sup>2</sup> Özsoy I (2007) Human Transformation in the Transition Economies: The Case of Georgia. *J. East-West Bus.*, Volume 12, Issue 4 March 2007, pages 71 - 103

<sup>3</sup> (Note: Malaysia insider proviso is similar to the Australia "Proprietary Approach" where they do not place emphasis on the evidence of a relationship between insider and the corporation whose securities are traded. The provisions prohibit any person) regardless of their relationship or dealings with corporation) from dealing in securities, when they are in possession of price-sensitive information concerning the corporation that is not generally available by prescribing that all such persons as insiders. It must be noted that the absence of a "relationship" requirement focuses attention on the corporation proprietary rights to the information instead of the fiduciary relationship or relationship of confidence that the insider may have with the corporation. Thus, although family shareholders have no nexus in the management of the corporation, the mere fact of receipt of information suffice. This includes information of and on Target Company.)

same direction of change to the market approach of securities regulation and direction of disclosure based regime are closely related to both philosophies of the insider-trading provisions, economic and legal. The research then begins with six legal case studies analyses of insider trading cases to explore into the concept of the gap in effectiveness of insider trading provisions particularly on Homo economicus and homo sociologicus.

## LITERATURE REVIEW

### Securities regulation framework

The principal Act of the present Securities Industry Amendment Act, 1998, is the Securities Industry Act 1983 (the "Act") which was officially gazetted on March 10, 1983 and came into force as from July 7, 1983. The Act replaced the old Act, the securities industry Act (1973)<sup>4</sup> by virtue of section 129 of the Securities Industry Act (1983), but all regulations, instructions, orders, and decisions made under or in accordance with the repealed act remain valid and binding and shall be made deemed to have been made under the provisions of the present act.

As insider trading is substantially under securities regulation, the policy and philosophy of both regulation of securities in Malaysia and insider trading shall be compared and discussed here.

### Market approach of securities regulation

Malaysia has evolved from a government with a centric regulation of the securities industry towards a consultative basis with industry groups since the formation National Economic Action Council (NEAC)<sup>5</sup> in 7 January, 1998. The overabundance of legislation and regulation that had been lamented by the market since the launching of the capital market master plan is not only a remedial approach towards the then economic crisis, but we view it as a double prong approach not only for damage control but also to leapfrog towards a globally competitive capital market. Concurrently, it is noted that the merit-based regulation has moved towards a disclosure based regulatory regime<sup>5</sup> in the capital market by a series of progressive phases (Note: The NEAC is a

consultative body to deal with the immediate issues to tackle the Asian financial crisis in 1997). The full implementation of DBR of planned to be from the year 2003 onwards, though plans now expect completion in 2006 - 2007. Full implementation of DBR demands not only high standards of disclosure, due diligence, and corporate governance, but also the exercise of self-regulation and displays of responsible financial conduct.

The present insider-trading provisions in the Malaysian capital market and service act, 2007 (CMSA) is a consolidated provision of the earlier provisions under the securities industry amendment act 1983 (SIA), which commenced and came into effect and included the earlier insider trading provisions<sup>6</sup>, on 1 April, 1998. These former insider trading provisions under the SIA, namely the origin of the insider trading regulatory framework in Malaysia, is modelled along the reforms introduced into Australia's Corporations Law in 1991. The substance of the SIA has not changed in the CMSA except for clarity in its wording. Hence, the recent insider trading cases in Australia shall be discussed in this article. The authors opined that insider trading provisions serves as a sword towards poor corporate governance and a shield for poor market confidence. It could be also a handmaiden towards market liquidity by virtue of market confidence.

From the analysis of the above development of the DBR in Malaysia (towards a market based approach for its capital market) with the securities regulation framework of insider trading provisions, the nexus of requisite transparency in corporate governance with legislative reforms in dealing with insider trading is evident.

The best practices in corporate disclosure, although not sanctionable, needs to be a social norm base on the 'Homo-Sociologicus' theory among Malaysia corporate citizens, otherwise the scenario would be legal enforcement to impose the "Homo-economicus" intent of the regulators quoting from the Act '...and such cases be reported although it may be at the lower courts.' A market approach should not be divorced from the corporate governance aspect. Quality corporate law protects buyer and seller, and it includes not only statute law but also the quality of the regulators and judges, that is, the efficiency, accuracy, and the honesty of the regulators and the judiciary, plus the capacity of the stock exchanges to manage the most egregious diversions. If these protections are of high quality, buyers and sellers will consider the managerial agency problem under control, and share trading will continue. It is also agreed by LLS and V<sup>7</sup> and Mark Roe as main driver of corporate governance systems and the degree to which we have

<sup>4</sup> ct 112 of 1973, gazette on June 21, 1973. Based upon recommendations of the Ferris Report. The old Act was finally enforced on December 27, 1976 ( Government Gazette No.26 P.U.(B) 658, December 9,1976)

<sup>5</sup> The merit-based regulatory approach inherited from the Capital Issues Committee ("CIC") administration prior to formation of Securities Commission had been adopted during the early stages of capital market development, when there existed a high degree of relatively unsophisticated retail investor participation. The booming market for corporate activity in the early -to-mid 1990s then illustrated the increasing importance of the capital market as a medium for raising funds by the Malaysia private sector. Due to this, it was then already clear a thorough review of the continued effectiveness

of the traditional regulatory approach to the new issuance of securities was needed.

<sup>6</sup> The earlier provision prohibit insider trading and directed the prohibitions at persons in possession of information by virtue of a connection with the Corporation. That is the "relationship" approach rather than the "proprietary right" approach of the corporation towards such information.

<sup>7</sup> Rafael L P, Silanes L, Florencio, Shleifer, A and Robert W., (1998) Law and Finance. Journal of Political Economy, Vol. 106, No. 6, December 1998.

Berle Means firm.

Roe (2002) further reiterated that corporate law, when effective, impedes insider machinations: it stops, or reduces, controlling shareholders from diverting value to them, and bars managers from putting the firm into their own pockets.

“When, for example, controllers obtain very high private benefits from control, because they divert firm value into their own pockets, then distant shareholders mistrust the insiders, and are unwilling to buy<sup>8</sup>.”

From this, the authors opine that insider trading is a clear corporate governance issue which has its roots from conflicts of interest, concepts of agency cost and requires the seed of transparency and disclosure to be effective.

## POLICY AND PHILOSOPHY

### Disclosure based regime

Under the old Merit based regulatory (“MBR”) approach, the regulators would make an assessment of a company’s viability, the quality and capability of the company’s management, its suitability for listing (where applicable), and the public interest, before approving any issuance proposal. This approach posed the problem of moral hazard. As long as a securities regulator approves the merits of a particular company, there is a danger that investors will perceive the corporation to be a good investment as the regulator had given “a seal of approval,” and leading to the false impression that the investor did not need to individually evaluate the merits or risks of investing. In addition, this also indirectly absolved the promoters of securities from the fiduciary responsibility owed to their potential investors. From this market philosophy, this “over-protection” of the investing public had compelled issuers to raise funds at a substantial discount from the actual value of their securities or add to the perception of initial investors that they would be “guaranteed” a premium when the corporate body is launched onto the marketplace.

The paradigm shift in the philosophy of the securities market of Malaysia towards the premises of the DBR rests upon the aspiration to promote a market-based regulatory framework to avoid over regulation of the primary market for securities. The review of the MBR was viewed to place greater responsibility on both the promoters and investing public in any new securities issue<sup>9</sup> or offering, thereby reducing the need for intervention by the SC.

The DBR environment in the Malaysia securities market

could not tap its greatest potential if there is no strong accounting and reporting framework to support the market. There is a need for high investor awareness, strong enforcement, a strong financial press, and an adequate pool of skilled and expert market practitioners to ensure effective adherence to disclosure standards. If investor awareness is founded upon a lack of market integrity, poor regulatory enforcement, poor corporate governance, or poor disclosure in a DBR environment, all the law and standards will not result in a capital market worthy of the name. From the initial benchmarks of corresponding practices and regimes in other jurisdictions, e.g. Australia, Hong Kong, and the United States, the sum of these relevant parts yields a better whole. However, if the parts are deliverable within the necessary legal norms required, but the original goals are not present, the introduction of new and necessary ways will take longer and the market lacks the necessary dynamism, all due to the lack of confidence in the “system.”

### Insider trading

The insider-trading provisions are an aspect of corporate governance that enables systemic stability and integrity in the necessary and relevant financial and other disclosures. Whatever theories are propounded upon the policy and philosophy of insider-trading provisions, with regard to its breadth and depth, and the reach of its sanctions, both in civil and criminal, if there is no enforcement of these provisions, regardless of the success or likelihood of the success of a case, legal norms could be not be a reality, and additionally, greater problems arise if the social norms and rules are not taken seriously as well. For norms to be social, others must share them and partly sustain these norms by their approval and disapproval of actions both inside and outside these norms. Social norms are sustained not only by the feelings of embarrassment, but also by the anxiety, guilt, and shame that a person suffers at the prospect of violating them. Legal norms have the intent to regulate society towards social norms, and should rules not be taken seriously, and where there are gaps between and among such norms, how is transparent corporate governance to be considered effective?

### Economic philosophy of insider trading provisions

One of the important goals of company law is to provide rules and guidance that will assist the parties involved in the corporation’s business to reduce “agency costs.” Conflicts of interests create agency problems, and coping with them imposes agency costs (monitoring, bonding, and residual loss)<sup>10</sup>. The main agency costs in the firm’s

<sup>8</sup> Roe, Mark J. (2002) Corporate Law’s Limits, 31 Journal of Legal Studies 233 (2002).

<sup>9</sup> New securities offering does not confine itself to Initial Public Offer ,but any further raising of capital by the listed entity.

<sup>10</sup> Jensen M C. and Meckling W.J. (1976) Theory of the Firm: Managerial Behaviour Agency Costs and Ownership Structure (1976) J. Finan. Econ., 3: 305

business stem from three “agency problems,” each of them resulting from conflicts of interest. First is the agency problem between managers and shareholders, resulting from the separation of ownership and control (the management problem). Second, the agency problem between controlling shareholders and minority shareholders, resulting from the combination of partial ownership and control (the control problem), and thirdly, the agency problem between creditors and shareholders, sourced mainly from the limited liability of shareholders (the creditor’s problem).

In different business structures, as between dispersed ownership and concentrated ownership, agency problems may be different in nature and it is impossible to determine in the abstract which business structure leads to lower agency costs. However, other factors will influence the agency costs. Among these are the quality of the judicial system in handling the company law issues, the quality of the capital market, the quality of the market for corporate control, and the quality of institutional investors<sup>11</sup>.

Accepting the realities where capital markets are inefficient, the market for corporate control is ineffective, and the judicial system is not proficient, none of these prevents a policy maker from trying to change and improve the vitality of the financial markets. It is here, where the impact of insider trading provisions can be noticed, and it is reiterated that restrictions on insider trading is a crucial step necessary for the formation of an efficient and liquid capital market.

Efficient markets incorporate relevant and current information about the value of firms into up to date stock prices, from this, timely disclosure is important, and the enforcement of the rules considering these processes. Calculating value, comparing it with market prices, and trading to capture the profits gained from the deviations between the price and value leads to incorporation of all information into prices. This process involves two different tasks, firstly, the production of information, as searching for information affects prices, and secondly, putting a price on this information for the analysis of this data and then trading on the discrepancies between price and value.<sup>12</sup>

For financial markets to be liquid there must exist sufficient trading to enable buyers and sellers to consummate transactions expeditiously. This liquidity is achieved for three principal reasons; these are portfolio adjustments, consumption/investment adjustments, and divergence of opinions<sup>13</sup>. The two roles of providing efficient pricing and liquidity can be performed either by “insiders,” those who have access to inside information and to provide a price for this information, or by “analysts”

(that is a wide range of professional and institutional investors) who produce financial analytical opinions upon which they base their investment decisions.

As earlier stated, insider-trading provisions could provide a shield against poor confidence within a market, further, should there be insider trading prior to an analyst entering into that market, there is a likelihood of an over-reaction to the expected trade and its intrinsic value<sup>14</sup>. The reason being is that “insider trading” and “analyst trading” cannot coexist, as the inability of the analyst to receive normal return on their investments using currently available information when insiders are trading using information unavailable to the market. Investing using informed trading is a costly activity, and an analyst undertaking such activity expects to achieve some extra return from their investment and trading to compensate for the additional costs of producing and analysing information. However, should there be insider trading or where insider trading is permitted; analysts are unable to capture deviations between price and value. Since insiders enjoy a fundamental and informational advantage, due to their proximity to the information, they will consistently beat the analyst. Unable to gain normal return on their investment in information,<sup>15</sup> analysts will exit the market. Thus, permitting insider trading entrusts the role of creating an efficient and liquid market into the hands of insiders instead of market forces.

On the other hand, restricting and effectively enforcing insider trading penalties, will enable analysts to gain normal returns on their investment evaluating the data and information available to all, and thus will lead to the development of analyst industry. Analysts working in a competitive information market are better traders than insiders (who enjoy exclusivity over information) in providing an efficient and liquid capital market.

### Legal philosophy of insider trading provisions

A corporation has the moral obligation to disclose appropriate information to those with whom it enters into transactions and to those whom its actions affect. This premise relies upon two principles as follows:

- (i) Each person has the right to the information he needs to enter into a transaction fairly; and
- (ii) Each person has the right to know which actions of others will seriously and adversely affect him.

A transaction is fair if those who are a party to it have the appropriate information and freely enter into a transaction based upon freely available information. They cannot fairly participate in a transaction if denied pertinent

<sup>11</sup> Black B, R.Kraakman, (1996). A Self Enforcing Model of Corporate Law’ (1996) 109 Harv. Law Review.1911

<sup>12</sup> Zohar G, Parchomovsky G (2001). On Insider Trading, Markets, and Negative Property Rights in Information. Virginia Law Rev., 87; 1229–1277.

<sup>13</sup> Stoll HR (1989). Inferring the Components of the Bid-Ask Spread: Theory and Empirical Tests. J. Finan., 44: 115-134.

<sup>14</sup> This may be the lamentations of foreign funds analyst also as part of the stock market crash due to overvalue shares or securities of privatized entities ; when there are mass exit of the investors other than the fact that it has been argued it’s a out flow of fund.

<sup>15</sup> Supra 10

information. On the other hand, it is not necessary for each party to make sure that the other party is properly informed. What is necessary is that each party has access to the appropriate information. A transaction is fair even if one of the parties does not take advantage of information that is available even though they could profitably use it to their advantage.

A person is responsible to those whom his actions affect, and he is morally bound not to harm others unless there is some overriding reason for doing so. Respect for persons, a contract formed behind a veil of ignorance, and a utilitarian calculation all lead to the conclusion that, if we are going to engage in some action that endangers others, then we are morally bound either to warn them or not to perform the action. Though we are not morally permitted to harm others, we are permitted to do some things that might cause others harm, providing we take the precautions necessary to prevent harm to them, including warning them. This underlies the philosophy of basic rights, such rights are by virtue where one can rationally take other actions and to exercise other rights, is the right to be informed ("Disclosure theory").

Information is a proprietary right of a corporation. Those whom enter into transactions with the securities of a corporation and to those whom its actions affect are:

- a) The shareholders and potential shareholders of the corporation
- b) The board of directors,
- c) The staff,
- d) The government, and
- e) The general public, whether or not they are consumers of the product.

Hence, from the above, where there is no corporate disclosure, and where the realities of absence of legal norms or social norms towards corporate disclosure, there is a likelihood of insider trading, unless it falls under trade secrets or rules which result in market disorder by premature disclosure as set out in the Bursa Listing Requirements.

### Legal analysis of insider trading cases

#### ***Case one: Australian securities and investments commission v Petsas (2005 FCA 88)***

In this Australian federal court decision, another author was in opining that insider trading is a serious offence, observed that the legislative intent behind insider trading provisions was to ensure that the securities market operates freely and fairly, so that one party to a transaction does not, due to possession of information, secure an advantage over the other.

The publically traded Call options over BRL Hardy Ltd ('BRL') used the Australian derivatives trading facility.

One of America's largest producers of alcoholic beverages opened merger discussions with BRL. BRL went on to retain its banker, ANZ, to study and advice on certain aspects of the proposed merger. An associate director from the particular ANZ department specifically handling the assignment shared some information with some associates about a 'confidential deal' he was working on, without giving details.

One of those who heard this, from a wholly different department in ANZ, managed to assume, and later had secured confirmation in respect of his hunch - that the 'confidential deal' was indeed a merger involving BRL. Armed with this initial lead, he then secured further information in respect of this proposed transaction by accessing the ANZ bank's database.

Using the information obtained, his friend, a 3<sup>rd</sup> party individual from outside the ANZ bank, placed orders for the purchase of call options over BRL shares. When news of the merger broke, the call options were then sold thereby making profits.

The federal court found that the information regarding the existence of confidential merger discussions involving BRL was information that was not generally available at the material time, and that nature of this information was that if it were generally available, a reasonable person would expect such information to have a material effect on the price of BRL shares.

Communication of this information to the outside 3<sup>rd</sup> party but not the market, knowing that he would go on to trade in BRL shares was a contravention of the legislative provisions against insider trading.

The 3<sup>rd</sup> party, in using the information which possessed these qualities to acquire BRL shares, had also contravened the legislative provisions against insider trading.

#### ***Case two: Australian securities and investments commission v Citigroup global markets Australia Pty Ltd (ACN 113 114 832) (No 4) 2007 FCA 705***

Citigroup was a global financial services organization. It provided, inter alia, investment banking and equities trading services. Citigroup employees who were engaged in the investment banking section were invariably exposed to confidential market sensitive information and were called 'private side employees,' while those who were not exposed to such information were called 'public side employees.' "Chinese walls" were put in place to prevent free flow of information from private to public employees.

T Ltd had retained Citigroup advice on its takeover bid for P Ltd. It so happened that an employee from the public side purchased substantial shares in P Ltd just one day before T Ltd announced its takeover bid for P Ltd. The employee who worked in the Equities Division of Citigroup made the purchase in the normal course of business.

In the proceedings commenced by ASIC, there was no allegation that the trader possessed insider information. The allegations were: As an advisor to T Ltd, Citigroup was in a fiduciary relationship to T Ltd. By purchasing shares in P Ltd (the target company), Citigroup had placed itself in a position where its duty of loyalty to T Ltd conflicted with its own profit interest in the trade of P Ltd shares. Because it was in a fiduciary position, the duties under the Australian Corporations Act 2001 came into play, and Citigroup was accordingly in breach of those provisions.

The Federal Court held that the appointment letter between Citigroup and T Ltd clearly excluded a fiduciary relationship. It provided that Citigroup was acting 'as an independent contractor and not in any other capacity, including as a fiduciary'.

Since the fiduciary relationship was non-existent, conflict did not arise. Consequently, the relevant provisions of the Corporations Act 2001 did not apply because the operation of those specific provisions was dependant on there being a fiduciary relationship.

Two further claims involving insider-trading contraventions were also pleaded against Citigroup. The first failed because the trader who purchased the shares for Citigroup was not an 'officer' within the definition of the Corporations Act. While for the second charge pertaining to insider trading, the "Chinese walls" defence prevailed.

It must be borne in mind that in this factual matrix, it was common grounds that the trader, when affecting the purchase, was not in possession of insider information.

***Case three: Australian securities and investments commission v Southcorp Ltd (No 2) 2003 FCA 1369***

Although insider trading was not of direct relevance in this case, and it concerns the continuous disclosure provisions of the Corporations Act 2001 (these provisions intend to prevent selective disclosure of market sensitive information). Enforced publicity is the intended effect of continuous disclosure provisions. This minimizes opportunities for insider trading, and it keeps the market informed as a whole.

Subject to limited exceptions, it is a contravention of the Act to fail to notify the securities exchange of information that is generally not available, and which if were generally available, a reasonable person would expect the same to have a material impact on the price or value of the securities of the entity.

With particular regard to analyst briefings, all awareness and guidance material issued prior to the enforcement of these provisions had urged companies to put in place procedures that would ensure their shareholders are not denied access to information that was otherwise given to analysts.

During the course of email discussions in respect of its financial performance, Southcorp sent an email to 11 analysts containing sensitive information that had not been

released to the market via notification to the market operator (the Australian Stock Exchange). It was common ground that there was no fraud, dishonesty, or other 'unworthy motive' involved on the part of the sender. In fact, the incident was termed an 'honest blunder' by the Corporate Affairs department of Southcorp.

Nevertheless, Southcorp admitted that the communicating such information to the analysts without first disclosing it to the entire market by notifying the ASX was a contravention of the relevant section. Southcorp had to pay a fine of AUD\$100,000.

***Case four: Re Chemeq Ltd (CAN 009 135 264) Australian securities and investments commission v Chemeq Ltd 2006 FCA 936***

Yes again, the Australian Federal Court pointed out that an effective continuous disclosure system can function as an effective inhibition on questionable corporate conduct. Knowledge that such conduct is quickly exposed to the glare of publicity as well as criticism by shareholders and the financial press would make it less likely to occur in the first place.

Chemeq shares were publically traded on the ASX, and Chemeq owed intellectual property of certain antimicrobial substances, for which it had applied for patents in the USA. In order to fund the construction of a production facility intended to produce this substance, it raised capital through share subscription offers.

Chemeq was bound to conform to its continuous disclosure obligations. It was required to notify the market operator (ASX) of information that was generally unavailable, if this information was in a form that a reasonable person would expect, if made generally available, to have a material effect on the price or value of the shares of Chemeq.

Chemeq had in April 2002, informed the ASX that it had begun construction of the production facility budgeted to cost AUD\$25 million. Over the next 2 years Chemeq knew that due to cost overruns, the estimated cost had moved from AUD\$25 million to AUD\$35 million, then AUD\$45 million and then eventually to more than AUD\$50 million. However, Chemeq failed to notify the market operator of the cost increases.

In October 2004, it had informed the ASX that it was granted an additional US patent. But it failed to notify the market operator that the patent was nevertheless immaterial to its overall commercial position because in the context of that particular patent, it had minimal commercial significance. Both failings were contraventions of its continuing disclosure obligations, which Chemeq eventually admitted. However, it was common ground that there was no dishonesty involved on the part of Chemeq, neither was there deliberate intent. What happened was merely symptomatic of Chemeq's overall lack of appreciation of its disclosure obligations. Chemeq

got off with pecuniary penalties in this instance.

**Case five: United States, petitioner v James Herman O'Hagan No 96 – 842 supreme court of the United States**

A law firm was retained to represent the offeror in a potential tender offer for a publically traded company. A partner in the firm, who was not assigned to the retainer, purchased call options and shares which he converted to substantial profits once the tender offer was announced and stock prices spiked. He eventually used the profits to cover up a previous embezzlement of client trust funds.

A Federal District Court convicted him on charges of inter alia, securities fraud, notably being in violation of his duty to either disclose material non-public information he had concerning an impending tender offer, or to abstain from trading in stocks 'implicated by the offer'.

The US Court of Appeal reversed all convictions on grounds; inter alia, that in order for the offence to apply, there ought to be an underlying fiduciary duty between the perpetrator and the source of the information. The US Supreme Court later overturned the decision of the US Court of Appeal.

The Supreme Court opined that the relevant Rule 14e-3(a) proscribed any person from trading on the basis of material non public information that concerns a tender offer, and where that person knows or ought to know that the information had been acquired from an insider, or someone working on their behalf. In such an instance there is a duty imposed - a duty to either disclose or abstain from trading, quite independent from whether the trader owes a fiduciary duty in respect of the information or otherwise.

Another plank of the decision was the Securities and Exchange Commission Rules which prohibits the employment of any device to defraud or deceive any person in connection with the purchase or sale of securities. The misappropriation of non-public information fell within the definition of "device."

Not surprisingly, the Court made use of misappropriation theory as the basis of the legislative provisions against insider trading; meaning that a person commits fraud in connection with a securities transaction when he misappropriates confidential information for trading purposes, in breach of a duty owed to the source of the information. However, the court emphasize that the average investor's informational disadvantage vis-à-vis a misappropriator with material, hence non public information stems from contrivance, not luck, a disadvantage that cannot be overcome with research or skill.

Although the misappropriation theory which drives most legislative provisions ensures honest security markets, thereby promoting investor confidence; the fact is that the "Chinese Wall" is a good defence (Citigroup Global Market), as the onset of breach for a successful

prosecution is the informational disadvantage to the market or acknowledgement by courts that non public information stems from contrivance (James Herman O'Hagan). Note however the following points: Absence of dishonest and deliberate intent is not material (Re Chemeq Ltd); privity of information for internal arrangement between parties in open market does not entirely result to insider trading (Ming Holdings (M) Sdn.Bhd) but it does reemphasize the support of misappropriation theory and this would not come to fore if the disclosure duty to disclose, accompanied by the fiduciary duty to disclose, is not embedded into this theory. Hence, it could be surmised that disclosure theory is the underlying basis of misappropriation theory, as the root of the theory is disclosure theory accompanied by a fiduciary duty to openly disclose to the market. Disclosure theory enables insider-trading concepts to include prevention and discouragement of such actions through to sequestration of all profits from such trading and even if no actual profits arise from the trading processes.

Finally, those who act on inside information of the corporation by misappropriating the proprietary rights of the information belonging to the company (misappropriation theory) and if they are also insider traders, they are also in breach of their fiduciary duty (fiduciary theory) as well. As the insider provisions in Malaysia do not limit the prohibition to cases of intentional misappropriation, and in that the liability also falls on recipients of information who come by that information in "innocent" circumstances, however, the disclosure theory would be more appropriate to explain the circumstances should trading derive from information that is price sensitive. Such information being information that would, or would tend to, on becoming generally available, influence a reasonable person who invests in securities in deciding whether or not to acquire or dispose of those securities.

## DISCUSSION

### **The gap in effectiveness of insider trading provisions homo economicus and homo sociologicus**

In light that Malaysia insider trading provisions follow along Australia's provisions, it is interesting to evaluate what would be the direction of effectiveness on enforcement by Malaysia concerning insider-trading provisions.

As stated earlier, Malaysia insider-trading provisions are a legal instrument towards a market approach using regulation of the securities in a disclosure based regime. Under the homo economicus theory of Adam Smith, behaviour is supposed to be guided by instrumental rationality, while the behaviour of homo sociologicus (Emilie Durkheim) is dictated by social norms. Homo economicus (market theory) is "pulled" by the prospect of future rewards, whereas Homo Sociologicus is "pushed"

from behind by quasi-inertial forces (Gambetta, 1987). The former adapts to changing circumstances, and is always on the lookout for improvements. The latter is insensitive to circumstances, sticking to the prescribed behaviour even if new and apparently better options become available. The caricature of the homo economicus is as a self contained a social atom, and the caricature of the homo sociologicus is as the mindless plaything of social forces<sup>16</sup>.

Should there be a gap in effectiveness of the transparency provisions, the application of Best Practices in Disclosure (BSD), and the effectiveness of insider trading provisions should fill the gaps between the market theory approach of the law, and the social norms of the market<sup>17</sup>. So, and one must ask why are the gaps are allowed to exist? If anxiety, guilt, and shame are present would there be a social norm on the lack of concern towards disclosure? Could enforcement provide legitimacy to the transparency rules and insider-trading provisions to reduce the gap between the legal norm and the social norm?

### Issues in enforcement of insider trading

#### *“Unlock” a treasure box analogy*

Let us assume an owner of a treasure box has a key that could be used to unlock a lock on the treasure box that is beginning to rust. However, the owner of the treasure box concludes that a rusty treasure box looks better so long it still serves its purpose of protecting the treasure safely held within. Eventually the rust will look unbecoming and not befitting its purpose and no longer perceived as an appropriate “adornment” of a treasure box.

The owner of the rusty treasure box may be trying to find the answer himself because the fact that he has the key but does not utilize it due to his preferred paradigm of what a treasure box ought to be.

It has become an embarrassment to others who wish to view it and perhaps put to use the treasures inside the treasure box, and a rusty treasure box may affect the treasures inside resulting in permanently encased rusty treasures. At some time, it will be too late, and the key would not be of use even though it could open the box because the forward value or the intrinsic economic value of the held treasures has deteriorated to become nearly worthless.

Analogically the treasure is the stocks value of the Exchange, the treasure box being the movement of the market, and the owner being the regulators.

Likewise, a legal key that is effective in form and substance but not used or fully utilized, eventually may

support the legitimacy of the social norm of poor disclosure and insider-trading. Such norms may eventually result in market illiquidity due to poor corporate governance with regard to market information transparency and misinformation resulting in investors leaving the market.

### Political realities in market realities

Enforcement of insider-trading regulations should not be viewed only from the legal evidential aspect as insider-trading provisions have an economic philosophy. Interestingly, in *Tuan Syed Azahari bin Noh Shahabudin v Ming Holdings (M) Sdn Bhd* (2007) 4 MLJ 333, the court in Malaysia has in the course of these proceedings ruled that there is a legally recognized agreement contrary to the insider-trading public policy. This is in regards to the sale of Bumiputra special rights issue shares to the plaintiff but being held on trust by the defendant Bumiputra. From the law report, it was reported that the Court of Appeal is its awareness of the notes of proceedings where the High Court brought in the probable issue of criminal sanction under insider trading arisen from a “Pool Account”<sup>18</sup>. The High Court then stopped short when the defendant witness tried to answer the question, and as reported it proceeded to seek to delete the defendant witness statement on the question. As to a future event that could unfold from the unravelling of such a piece of information on insider-trading in the proceedings and how it shall be dealt with by the relevant regulatory authorities, e.g. a Securities Commission, would be interesting to observe as it involved the interesting Palmco Bhd shares. The court of appeal on issues of the contention therein which does not concern insider trading has allowed the appeal to the Federal Court.

Would an inevitable back-to-back arrangement with the knowledge of a banking institution who force sells those shares, put the bank who is in receipt of information that could be price sensitive, that is, include changes in substantial shareholder and Bumiputra shareholdings (thus probable control of the corporation) into the web of the tentacles of a sanction? In addition, how does one reconcile with public policy and market integrity concerning Bumiputra issues? The fact that public policy and stakeholder concept may be in contention is note - worthy enough to have further research and discussion on Malaysian corporate governance.

Perhaps future Bumiputra concerns are confined to Bumiputra public institutional investors rather than individuals or private Bumiputra entities. This is not the purpose of this article, and to discuss and look into these

<sup>16</sup> Elster Jon (1989). Social Norms and Economic Theory, *J. Econ. Perspectives*, 3(4): 99-117.

<sup>17</sup> Supra 11. The history and lessons in the controversial UEM Renong saga should not repeat itself or allowed to be repeated ; perhaps could have resulted to the gap which regulatory authorities should be always be mindful of.

<sup>18</sup>The Court of Appeal concurred with the learned judge in High court in that he had quite rightly identified the issue to be decided i.e. whether there was a pool agreement made between the plaintiff and the defendants that 500,000 of the 3,158,959 Bumiputra special rights issue were to be considered sold to the plaintiff but to be held on trust by the defendants on the plaintiff's behalf.

probable issues in depth and breadth would require another article and research, and is beyond the subject of this article on insider trading provisions.

### Disclosure best practices

The Corporate Disclosure Best Practices (CDBP) launched in 2004 by Bursa Malaysia Securities Berhad after working with the industry emphasized the importance of corporate disclosure and corporate accountability. Although compliance with these Best Practices is purely voluntary, the compliance itself is noteworthy enough to be recognized and be read with the Insider trading provisions in the Capital Market and Services Act 2007.

CDBP has emphasized the establishment of a Company Disclosure Policies and Practices (CDPP)<sup>19</sup> that encompass the Corporate Disclosure Policy and other requirements relating to corporate disclosure as set out in the Bursa Securities Listing Requirements (Bursa Securities Disclosure Requirements). CDPP is meant to deal specifically with procedures for maintaining confidentiality, preventing abuse of undisclosed material information, and monitoring and responding to market rumours, leaks, and inadvertent disclosures. It has also advocates that a senior person to be designated as Chief Information Officer (CIO) or Corporate Disclosure Manager (CDM).

Although it set out procedures to deal with issues like responding to market rumours, leaks, and inadvertent disclosures, such issues should not be a cover-up concerning insider breaches especially concerning inadvertent disclosures. To do so would result to a social norm of shutting oneself off from the reality of the spirit of the insider provisions under the Act. Nonetheless due merit must however be given to the CDBP for putting into the market's consciousness, measures that could reduce the risk of breaching the continuous disclosure requirements and to minimize the risk of contravening the insider-trading law. The effectiveness and the extent and degree of the application of the CDBP would assist to identify the gaps in effectiveness and quality of insider trading provisions in Malaysia to befit falling under the category

<sup>19</sup> The Board is to be ultimately responsible for ensuring that policies and procedures are in place for the disclosure of material information. CDPP advocates not only disclosure of material information but material information that is accurate, clear, timely and complete. The first author opined that the quality of disclosure of material information is the essence of price sensitive information, and not material information in itself. There may be no misappropriation theory that sets in but a thin line that allows insider trading – quality of information is peg to the market price of the securities. CDPP should provide interalia procedures that include limiting the number of people with access to the confidential information, ensuring security of confidential documents, and such confidential documents cannot be accessed through technology such as shared servers; creating awareness not only amongst directors but also staff and implementing a code of ethics in respect of the same; and procuring confidentiality agreements or undertakings from the company's advisers, auditors and lawyers (including if necessary, potential advisers, auditors and lawyers)

of quality corporate law as agreed by LLS and V and Mark Roe. Perhaps the quality of corporate law should allow certain variable that is social norms or extent and degree of voluntary application of best practices (Karaibrahimoğlu, 2010). This at least could be the adaptive mechanism of corporate governance that lies outside the law.

### CONCLUSION

There has been clear desire on the part that the insider misappropriates the "property information" of a Company by non-disclosure, by not disclosing it in a timely manner, by being inaccurate, by being ambiguous, or by disclosing to another person who will have proprietary information before it officially reaches the market (Sufian and Habibullah, 2009). There may be no misappropriation if such information is misleading and causes unwarranted price movement, and there are neither feelings of embarrassment nor anxiety, guilt or shame felt by the person who suffers from the prospect of violating insider-trading rules. The removal of intentional misappropriation and the inclusion of the recipient of such information being liable depict the emphasis of disclosure (Chan et al., 2009).

Finally, if however, there is anxiety, there is also social guilt and shame, and would there not be a violation of social norms on lackadaisical attitude towards disclosure? Could enforcement provide legitimacy to the transparency rules and insider trading provisions to reduce the gap between the legal norms and the social norms of the day? If the reality is that legal enforcement of insider trading breaches have the least likelihood of success, should insider trading law remain as is with its evidentiary issues in enforcement or could an adaptive mechanism under 'Best Practices' be mutually 'enforced' towards a social norm of addressing the stakeholder theory under Corporate Governance on price sensitive information. We thus have to ask ourselves - "does price sensitive information belong to the market or to the Company?"

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