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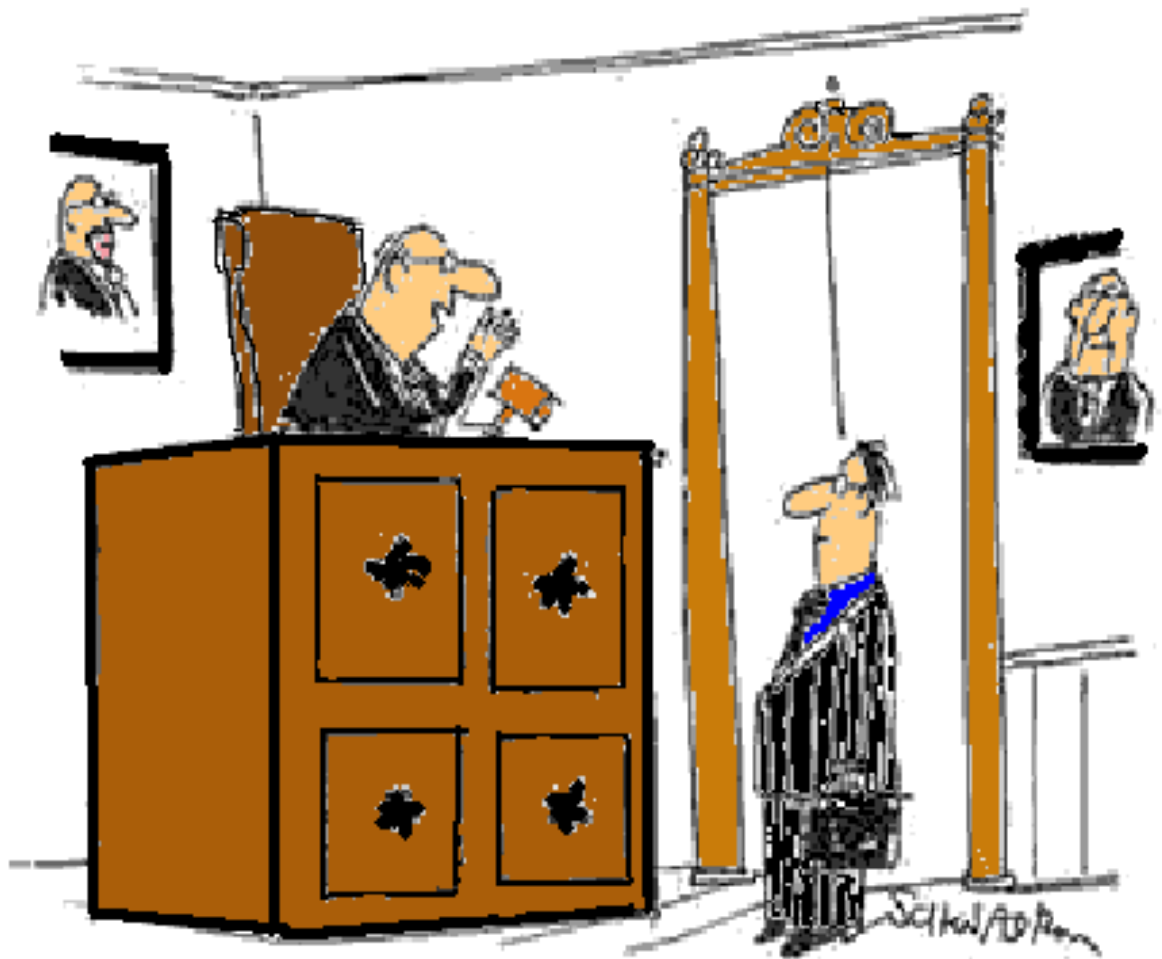
Implications of Insider Trading on Share Market in Karachi

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IMPLICATIONS OF INSIDER TRADING ON SHARE MARKET IN KARACHI



"Psst! If you have any stock tips to pass on, I can probably lighten your sentence for insider trading."

<u>TABLE OF CONTENTS</u>

<u>Chapter # 1: Background & Statement of the Problem</u>
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1. Introduction

2. History

3. Statement of the Problem

4. Significance of the study

5. Basic Assumptions

6. Definitions

7. Delimitations

<u>Chapter # 2: Research Methodology & Procedure</u>

8. Research Design and Method

9. Respondents of the study

10. Research Instruments

11. Treatment of data

<u>Chapter # 3: Review of related Literature & studies</u>

12. Local Literature

13. Foreign Literature

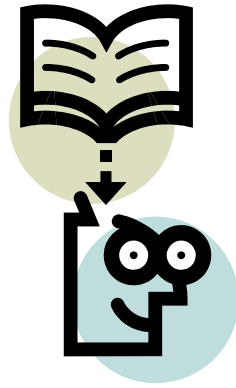
14. Summary

15. Relevance

--

<u>Chapter # 4: Presentation Analysis</u>
16. Introduction to Insider Trading
17. Prevention Procedure
18. Cases of Insider trading under investigation of SECP
19. Penalties
20. Statutory Notification (S.R.O)
21. Rules and regulation for brokers and agents

<u>Chapter # 5: Summary of findings, Conclusion and Recommendations</u>
22. Questionnaire
23. Harmful effects of Insider Trading
24. Beneficial Effects of Insider Trading
25. Insider Trading and Market Confidence
26. The fairness of the market
27. Finding Graphs
28. Conclusion.



“CHAPTER # 1”

Problem

&

Its Background

INTRODUCTION:-

What Is Insider Trading?

Insider trading occurs when someone makes an investment decision based on information that is not available to the general public. In some cases, the information allows them to profit, in others, avoid a loss. There are two types of insider trading: legal and illegal. First, let's discuss about the illegal variety. Illegal insider trading is the buying or selling of a security by insiders who possess material that is still non-public. The act puts insiders in breach of their fiduciary duty. As you can imagine, this is a definite *faux pas* for anyone closely involved with a company. A common misconception is that only directors and upper management can be convicted of insider trading. Anybody who has material and non-public information can commit such an act. This means that nearly anybody--including brokers, family, friends, and employees--can be considered an insider.

OR

Illegal inside trading occurs when the insider violates a fiduciary duty or other relationship of trust and confidence by virtue of the insider trading.

he following are examples of illegal insider trading:

- The CEO of a company sells a stock after discovering that the company will be losing a big government contract next month.
- The CEO's son sells the company stock after hearing from his dad that the company will be losing the big government contract.

- A government official realizes that the company will lose a big government contract, so the official sells the stock.
- As an assistant to the Chief Executive Officer learn that your company is going to be taken over before it is announced to the Knowing that such a move is liable to cause the price to rise, you buy shares in the company and subsequently profit from the transaction.

The Securities and Exchange Commission (SEC) is extremely strict with those who trade unfairly and thereby undermine investor confidence and the integrity of the financial markets. There are rules against such insider trading in most jurisdictions around the world, though the details and the efforts to enforce them vary considerably. In the United States, for example, there is no general federal law directly prohibiting insider trading. Authority to prosecute cases of insider trading came from the Supreme Court's interpretation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, prohibiting fraud in connection with the purchase or sale of securities.

Not only are those who place the trades the only guilty ones. If someone is caught "tipping" an outsider with material nonpublic information, that tipster can also be found liable. The SEC uses the "Dirks Test" to determine if an insider gave a tip illegally. The test states that if a tipster breaches his or her trust with the company and understands that this was a breach, he or she is liable for insider trading.

Within a company, there are many people who might have access to information that might be construed as privileged to their position in the company. Nevertheless, they may wish to trade in the shares of their company (*e.g.*, selling share options). To ensure

that their employees can easily comply with the regulations, these companies will often publish dates when managers and senior staff members can trade in shares of the company without breaking the law.

In practice, for insider trading tend to be rare and difficult to win for a variety of reasons. It can be difficult to prove what the accused actually knew at the time the trades were made -- and people may not even be told directly but merely advised to buy or sell with a nudge and wink. Proving that a particular individual was responsible for a trade can also be difficult, because a clever trader can hide behind a variety of nominees, companies, and some of which may be located offshore in jurisdictions that don't cooperate with the local authorities. Insider trading is usually performed by the already wealthy, who can afford the best lawyers available and have the resources to drag a case out and cost the prosecutors millions along the way. Finally, the details of insider trading can be highly confusing to non-experts, and convincing a randomly-selected jury, many with no experience of share trading, that a crime was committed can be difficult.

Insider Trading Isn't Always Illegal

There is an important thing to emphasize here: insiders don't always have their hands tied. Insiders legally buy and sell stock in their own company all of the time; their trading is restricted and illegal only at certain times and under certain conditions. The SEC considers insiders to be company directors, officials, or any individual with a stake of 10% or more in the company. Insiders are required to report their insider transactions within two business days of the date the transaction occurred (before the 2002 Sarbanes-Oxley Act it used to be the tenth day of the following month). **For example**, if an insider sold 10,000 shares on Monday

June 12th, he or she would have to report this change by Wednesday June 14th. Changes in insider holdings are sent to the SEC electronically (although not required to be sent electronically) as a "Form 4," which details a company's insider trades or loans.

OR

Insider stock market trading also includes tipping others when you are in possession of nonpublic information. Directors are not the only ones at risk. People such as brokers and even family members can be guilty. Well it may be a definite no-no, but many are guilty of it!

It's a tricky question. On the face of it, Stock Market Insider Trading is a straight out-and-out fraud. An insider has internal information that will - in the insider's opinion - cause the stock price to move. So, she buys or sells ahead of the move, and takes the profits.

This is a straight fraud because it takes money from the shareholder base. The shareholders are poorer because they did not enjoy the benefits of the change in price. Of course, this assumes that an insider cannot also be a shareholder, and therein lays the conflict of interest: an insider has a fiduciary duty to shareholders, which may be breached if acting on the basis of own, shareholdings.

However, the real issue that is at the heart of this insider stock market trading fraud is that, economically, it's pretty high on impossible to detect and prosecute. In practical terms, the information is a) in the heads of the stock market insiders, b) subject to misinformation constraints as much as any market noise, and c) hard to determine as being "inside" or "outside" some magic circle.

Thus in purely transaction cost terms, making **Insider Stock Market Trading** illegal is a very difficult sell. It's a bit like the Music intellectual property debate: songs became property when records were invented, because it was now possible to control their sales by following the shellac and the Panola rolls and sheet music.

The Effects of Stock Market Insider Trading

It is virtually unquestioned today that stock market insider trading in the securities markets is an immoral act. We must make a distinction here between trading by insiders and trading by insiders on the basis of nonpublic information. Insiders are legally allowed to buy and sell stocks. The Securities and Exchange Commission (SEC) requires insiders to disclose their trades, and the financial newspapers report such trading. Investors find this information a source of valuable clues about companies. (It is possible that even without the SEC requirement; shareholders would require their executives and directors to declare their trades.)

Put that way, maybe it doesn't seem so immoral after all. The idea that knowledge can ever be evenly distributed is one of those utopian pipe dreams the realization of which would require nothing less than secret police and gulags. Knowledge, like everything else about people, is most definitely unevenly "distributed." It is not distributed at all. It is acquired - by effort or luck. It's not as though there is a central knowledge-giver who spitefully short changes some of us. This leads to the first observation: if the law prohibits people from exploiting knowledge advantages, they have less incentive to ferret out valuable knowledge and bring it to market. Would that be good?

Those who seek to stamp out stock market insider trading concede this point, so they object only when the knowledge is unavailable to the public. But the line between prohibited inside knowledge and permissible inside knowledge is far from clear. **“As law professor Daniel Fischel writes in Payback, although inside knowledge of specifics - an earnings report, a pending merger - is an illegal basis for stock market insider trading, more general inside knowledge is not:”**

Maybe the insider believes that a planned reorganization of a company's sales force is going better than expected or knows that a key executive is distracted by health or marital problems. Corporate insiders are permitted, even encouraged, to trade on this kind of informed hunch.

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

What is it? What are the penalties?

Insider Trading has been all over the news lately. First it was Enron and WorldCom. Then even the apparently squeaky clean Martha Stewart got pulled in. So just what is Insider Trading? How can you avoid problems with it, even if you are not classified as an insider?

Insider trading:-

The illegal kind of Insider Trading is the trading in a security (buying or selling a stock) based on material information that is not

available to the general public. It is prohibited by the Pakistan Securities and Exchange Commission (SECP) because it is unfair and would destroy the securities markets by destroying investor confidence.

An Insider

A company insider is someone who has access to the important information about a company that affects its stock price or might influence investor's decisions.

The company executives obviously have material information. The Vice President of Sales, for example, knows how much the company has sold and whether it will meet the estimates it has provided to investors. Others within the company also have material information. The accountant who prepares the sales forecast spreadsheet and the administrative assistant who types up the press release also are insiders.

A public company, if it is smart, limits the number of people who have access to material information and, therefore, are considered insiders. This is done for a couple of reasons. First, they want to limit the likelihood that anyone will "leak" the information. Second, being an insider means being subject to severe limits on when you can trade in the company stock, usually only the middle month of each quarter.

The company's senior management are insiders. So are some of the financial analysts. The top sales people usually also are insiders, although a regional sales manager who only sees his or her own region's results may not be one. The individuals in Investor Relations and/or Public Relations who prepare the public announcements also are insiders.

If the company is developing a new product that could be a big seller, the key people in the Research & Development team would

also be considered insiders, provided the information they have is material, as defined above.

Other individuals who are not employees, but with whom the company needs to share material information, are also insiders. This list could include brokers, bankers, lawyers, etc.

Not an Insider

So does that mean you are not an insider unless you are on the company's management team, financial or development teams, or someone hired to handle the material information? In a word, "No".

The SEC includes in its definition of insiders those who have "temporary" or "constructive" access to the material information. If the President of a company tells you that the company's best hope for a breakthrough product isn't going to get regulatory approval, you are now every bit as much an insider as he is, with respect to that information. It is illegal for him to trade based on that knowledge before it becomes public knowledge. It is equally illegal for you to do so because you are now a "temporary insider". This remains true regardless of how many times the information is passed. If the president tells his barber, who tells her baby sitter, who tells her doctor, who tells you, the barber, doctor and you are all "temporary insiders".

Anyone who has material information is prohibited from trading, based on that knowledge, until the information is available to the general public.

Significant Penalties

Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 give the SEC the authority to seek a court order requiring violators to give back their trading profits. The SEC can also ask the court to impose a penalty of up to three times the profit the violators realized from their insider trading.

In addition to the financial penalties, there are criminal penalties. Many now feel those penalties are not strong enough and are working to increase them substantially. A bill in the US Senate, for instance, seeks to make defrauding shareholders a felony punishable by up to 10 years in prison.

HISTORY:-

With stock market insider trading, stock market transactions are made with knowledge of nonpublic information about corporate activity. In the United States, it has been illegal since 1934. The Securities and Exchange Commission regards it as unfair to investors who are not privy to such information. Several stock market insider trading scandals shook Wall Street in the mid-1980s.

The US Supreme Court ruled recently, that this even applies to someone with no ties to the company. Possession of material information makes you an insider, even if you stole the information.

STATEMENT OF PROBLEM:-

BASIC PROBLEMS:-

Following are the main problems that will be investigated.

1 Harmful effects of insider trading

- Effects on Market Mechanism

- Regulator
 - Institutional Investors
 - Small Investors
 - Share Market
- 2 Beneficial effects of insider trading.
 - 3 Insider trading and market confidence.
 - 4 The fairness of the market.
 - 5 Legal issues related to Insider Trading.
 - 6 Motives of Companies engaged in Insider Trading.

SIGNIFICANCE OF STUDY:-

- Significance for Author

This thesis will help me in

1. In understanding the market Mechanism.
2. Understanding environment of Stock Exchange and build up my career in Stock Exchange.
3. Taking investment decision in future.
4. Understanding the recent boom and recession in the Karachi Stock market.

- Significance for Institutional Investors
- Significance for Small Investors
- Significance for Board of Directors
- Significance for KSE Management
- Significance for Auditors
- Significance for Company regulators

- Significance for Companies trading in stock exchange.

RANGE/SCOPE:-

The Time period of this study will start from 2000 and continuous up till now.

- The research study of this thesis will be limited to Karachi Stock Exchange only.

DEFINITIONS OF TERMS:-

- 1 Faux Pas:** - A Blunder done by any Insider in a company.
- 2 Insider:** - A company insider is someone who has access to the important information about a company that affects its stock price or might influence investor's decisions.
- 3 Dirks Test:** - The test states that if a tipster breaches his or her trust with the company and understands that this was a breach, he or she is liable for insider trading.
- 4 Caveat Emptor:** - Let the buyer beware. It means that a customer should be cautious and alert to the possibility of being cheated.
- 5 Superannuation Funds:** - Funds deposited in a superannuation account will typically grow without any tax implications until retirement or withdrawal. These plans are also referred to as company pension plans, and are usually either defined benefit or defined contribution plans.

DELIMITATIONS:-

This research has certain delimitations. It is expected that after globalization there might be more significant and strict policy for the fiduciary acts of Insider Trading. Inaccurate and incomplete provision of information by the respondents, non disclosure of the company's and organizational information and biasness in information provided by the respondents.



“CHAPTER # 2”

Research Method

&

Procedures

RESEARCH DESIGN:-

The research is a descriptive study with data collected from the primary and secondary sources. The internet being a source of massive material, news, articles, sites, online books and other sources are utilized to gather the pertinent and supporting material. Books and publications have also provided immense support which has accounted for secondary sources whereas questionnaires and structured and unstructured interviews have been accounted for assembling primary data. The study would focus on the qualitative evaluation of findings.

PURPOSE OF STUDY:-

“A descriptive study will be undertaken”

The type of this study is based on descriptive and hypothetical model which has been undertaken to effectively describe the effects the insider trading creates on the share market. The strategies that could be adopted so that it could eliminate its illegal perspective and what are the basic motives behind a company engaging in such activities.

TYPE OF STUDY:-

“Analytical study”

I have analyzed a research problem and found a few reasons and variables that can have a major influence on the share market and the companies related to the Insider Trading cases.

EXTENT OF RESEARCHERS INTERFERENCE:-

“Minimal extend of interference”

As I have not interfered in the normal flow of events in the organizations from which I have collected my information. I have just collected and analyzed the data, therefore the extend of my interference in to a very minimal extend.

STUDY SETTINGS:-

“Field study in a non-contrived setting”

It is a co relational study and is conducted in a non-contrived setting. As I can not manipulate the variables, so I have relied on a field study.

UNIT OF ANALYSIS:-

“Share market is the unit of analysis”

As my research is based on the effects of the share market and its actions therefore the unit of analysis of my study is also the share market and the share of Karachi specifically.

TIME HORIZON:-

“Cross- sectional”

It is a cross- sectional study, as the data has been collected only once, with the help of questionnaires, interviews, mailed questionnaires, telephonic conversations with the concerned authorities and people.

RESPONDENTS OF THE STUDY:-

The respondents of the questionnaires and the interviews for gathering primary data will be as follows:-

- 1 Institutional Investors.
- 2 Directors of brokerage houses.
- 3 Company lawyers.
- 4 Share holders.
- 5 Small Investors.
- 6 Company Regulators.

INSTRUMENTS:-

The instruments include the primary and secondary sources of data collection for the research. Primary sources of data collection:-

- Observations techniques.
- Structural interviews
- A questionnaire has been designed to investigate the related matters of research which includes all the related questions about the share market and its mechanism.

While the secondary sources include the:-

1. Magazines
 - Business recorder.
 - Accountant.
 - The economist.

2. Newspapers
 - 1 The Dawn.
 - 2 The News.
3. World Wide Web.

TREATMENT OF DATA/ INFORMATION/ ANALYSIS:-

Verbal Analysis will be done to explain research problems. The treatment of data includes the techniques which will be used for processing and analyzing the data are:-

- 1 Quantification and description of data.
- 2 Sorting and tabulating of data.
- 3 Tables and figures.

The tools which will be used in processing the data include:-

- 1 MS excel



“CHAPTER # 3”

Review of related

literature

&

Studies

LOCAL LITERATURE:-

Business News

MARKET TO RESPOND POSITIVELY

Mustafa Kamal Pasha

Market closed on Thursday, April 21, 2005 last day of the trading week under review at 7101.38, while it had closed at 7512.91, on Friday, April 15 2005.the last day of the previous trading week .Row between members and SECP on various issues has constantly been affecting the market behavior. Investors have lost their confidence in the market. Stocks on Thursday finished with an extended gain but well below the session's best levels on late selling triggered by Friday's closure on account of Eid-e-Milad-un-Nabi. After early rising by about 200 points to touch the sessions high of 7, 261, it fell to 7,030.83, but closed recovered with a fresh gain of 70.55 points at 7,101.38 as compared to previous 7,030.83 points.

The recovery was again initiated by the index heavy weights, notably OGDC, PTCL and PSO, which are still considered a goodbye at the current rates. Some of the second-liners also played an active supporting role to keep the market in a good shape. Although some of the Carry Over Trade (COT) related issues including KSE's request to the SECP to withdraw the proposal aiming at freezing COT positions on April 29 remained unresolved (but it has been resolved for the time being). Prime Minister Shaukat Aziz has asked a Minister to sort out the issues and iron out differences between the KSE and the

SECP for the smooth sailing on the market .It seems that things have started moving in the positive direction Investors were, therefore, back in the market and resumed normal trading on the hopes that the phasing out the COT until Aug 3 is now a reality and they could take long position until then .How ever, it is still doubtful whether or not the massively battered general investors are willing to take financial risks or stay on the sidelines until they are sure that the worst is over. Stock market on Monday April 18, 2005 the first of the week under review fell across a board front on panic selling ignited by the on going confusion over the extension of Carry Over Trade (COT) issue but due to lack of any official word from the KSE about its meeting with SECP chairman on its proposal worsen the market situation. The panic selling ruled the entire market but the decline was led by the energy and cement sectors, which remained under pressure. The market sentiment was also affected by the reports of fiscal measures in the new federal budget that will have a provision to tax the speculators who have made massive capital gains in the shares and property business.

The KSE 100-share index lost a reasonable part of the previous gains and was marked down by 278.70 points at 7234.21 as compared 7512.91 points at the last weekend session. Market capitalization also eroded Rs.32.564 bn at Rs.2044.977 bn. The confusion on the COT issue affected badly and the gains made in terms of index and capital appreciation during last three sessions of the previous week were eroded. The KSE delegation met SECP chairman on Saturday 16 April, 2005 to sought his approval to extend badla financing to pull the market out of the on going state of uncertainty but due to lack of any official

word from the SECP no improvement in the situation was there during the week under review. But the things appear to be sorted out in the greater interest of market and hence market would respond positively during the on going week. While investors are still recovering from the shock of the last month's stock market crash, there are rumors of an investigation by the Securities and Exchange Commission of Pakistan (SECP) against some heavyweight stock brokers accused of insider trading or playing the market on the basis of information about a company which was not revealed to the stock market officially. The, as some others are believed to have been instrumental in taking the KSE-100 index up to 10,000 points last month.

The market saw a correction at 5,500 points but none after that even though people were expecting it. But the rally was mishandled by certain quarters. That had created panic. The market is not in bad shape. After a 2000-points decline, it has not suffered any problem in setting claims and dues. If the privatization process continues at the current pace the KSE-100 index should be again bullish when Pakistan State Oil and Pakistan Telecommunication Company Limited (PTCL) are sold. The idea of a free float index, introduced recently, may be taken seriously in the market in the coming years. Right now a capitalization-based index is there and a free float base index may be formed on a parallel basis, said a market pundit. Pakistan Telecommunication Company Limited (PTCL) results were only partially released to KSE, says Shazeb Khan of SAT Securities "In April 2004, the PTCL results were announced in the Islamabad Stock Exchange 10 minutes before they were announced at the KSE. On the September 29, 2004, the results

were announced 20 minutes late.” The KSE management later said that they had not received the full report from the company and could thus not make the result public. But during these few precious minutes, many fortunes were made, he said. Apparently, insider trading in the cement sector also continued as reports from the companies about investment in new plants or export prospects of cement to Afghanistan or Iraq kept pouring into market even though official announcements from the companies were seldom made. The same was the case with privatization.” There were reports in mid-November 2004 that PTCL will be privatized,” says Jamal Abdul Nasir an advocate and a small investor from Lahore. Also, reports of Oil and Gas Development Company (OGDC) making a discovery in Sindh created hype late last year.

Rumors of privatization continued to inflate OGDC’s price from January onwards. Some small traders at the LSE trading hall believed that rumors were circulating in the market about the number of expressions of interest (EOIS) being received for PTCL’s privatization. Rumors were also rife that EOIS for the privatization of Pakistan State Oil (PSO) were going to be recalled. While few culprits were netted, SECP fined Pak-Kuwait Investment Company (PKIC) 0.536 million rupees for insider trading in the shares of Fauji Fertilizer Company Limited. The PKIC is rumored to have made 10 million rupees in the trading.

In March 2001, the SECP had imposed the listed Companies (Prohibition of Insider Trading) Regulation under which were drawn the Stock Exchange Members (Inspection of Books and record) Rules, 2001. These rules empower the SECP to order inspections of books and records of any member of the

country's Stock exchanges. Following the KSE crash in March, the SECP has announced that it would probe the books of the members to determine who made how much money in the crisis. Small investors believe however, that this is just a hoax as anyone can see who the culprits are. Besides, since the privatization process is underway and will gear up in the coming months. It will be very difficult for the regulators to stop market movement on tips .If PTCL or PSO privatization precedes accordingly then any positive news means buy.

DAILY TIMES

Saturday, December 03, 2005

SECP to check insider trading behind stock rise

Staff Report

ISLAMABAD: The Securities and Exchange Commission of Pakistan (SECP) decided to investigate the current rising trend in the stock market and to check speculative trade in the market. The regulator to this effect will soon carry out inspections of brokers to find out whether the current trend in the market is based on the fundamentals or the grand rises are sequel of insider trading.

The Chairman SECP, Dr. Tariq Hassan addressing a press conference at his office on Friday said that a team comprising SECP official had been sent to Karachi for gathering facts and information from the Karachi Stock Exchange (KSE). In this regard, the inspection of brokers is likely to begin after a week. The main purpose of the exercise is to track the movement of

stocks and see who are the investors. The team will check any abnormality like insider trading, market abuse by speculation and manipulation during this exercise.

He said that if the SECP team detects any market abuse like manipulation or insider trading, it would take action as admissible. “After investigation, if it is found that there is non-compliance of rules and regulations, the SECP will go for enforcement action”, Chairman SECP maintained.

Dr. Tariq Hassan, while replying a question, said that even under normal circumstances, SECP has the right and duty to ensure that there should be level playing field for all the investors in the market and there is no abuse-taking place in the market. It is part of normal activity to conduct such inspection and there is no abnormality about it, he added.

He told that market capitalization during year and a half has grown to \$40 billion from US\$ 19 billion and if the privatisation program of the country remains on the track the capitalization would increase in further.

Dr. Tariq Hassan said that SECP has directed the stock exchanges to implement various risk management measures within a stipulated time frame.

The introduction of these reforms is a part of SECP’s second-generation capital market reform program in the field of risk management. “The implementation of these measures is crucial to the preservation of market integrity and investor’s confidence”, he mentioned.

The Chairman SECP said that the stock exchanges are required to submit a time bound plan of action to the Commission by April 15, 2005, after reviewing the current system of risk management. The directive in this regard was issued about a week ago.

The SECP over the previous years had issued groundbreaking reforms in the field of risk management, governance, and transparency and investor protection. The risk management measures will further the objectives of these reforms in a significant way.

FOREIGN LITERATURE

The Concise Encyclopedia of Economics

Insider Trading

by David D. Haddock

Since the depths of the Great Depression, the Securities and Exchange Commission (SEC) has tried to prevent insider trading in U.S. securities markets. Insiders - a firm's principal owners, directors, and management, as well as its lawyers, accountants, and similar fiduciaries - routinely possess information that is unavailable to the general public. Because some of that information will affect the prices of the firm's securities when it becomes public, insiders can profit by buying or selling in advance. Even before the thirties, insiders were liable under the common law if they fraudulently misled uninformed traders into accepting inappropriate prices. But the Securities Exchange Act of 1934 went further by forbidding

insiders from even profiting passively from superior information.

One of the most famous instances of insider trading was Charles F. Fogarty's purchase of Texas Gulf Sulphur shares during 1963 and 1964. Fogarty, an executive vice president of Texas Gulf, knew that the company had discovered a rich mineral lode in Ontario that it could not publicize before concluding leases for mineral rights. In the meantime Fogarty purchased 3,100 Texas Gulf shares and earned \$125,000 to \$150,000 (in 1991 dollars).

The basic argument against insider trading is that insiders should not be permitted to earn such sums at the expense of uninformed traders. Yet in almost all other markets where information is important, insider trading is well established and widely accepted. For example, mineral leases are routinely bought by those better able than the sellers to evaluate a site's potential, as Texas Gulf Sulphur's behavior exemplified. Cattle buyers rely on superior estimates of what packers will pay when negotiating with ranchers. And so it goes, in markets for art, for real estate, for professional athletes - indeed in practically every market with substantial variations in prices. In all those markets a few buyers routinely profit from knowledge that most sellers do not possess, and a few sellers profit from knowledge that most buyers do not possess. Commentators rarely cast aspersions on such traders' ethics or contend that their transactions should be regulated because of the asymmetry in information. Why should securities markets be treated differently?

One reason frequently cited by policymakers and commentators is that insider trading undermines public confidence in the securities markets. If people fear that insiders will regularly

profit at their expense, they will not be nearly as willing to invest. A similar argument is that companies prefer that their securities trade in "thick" markets - that is, markets with many traders, substantial capital available, and frequent opportunities to trade at readily observable prices. Efficient securities markets, it is argued, require a "level informational playing field" to avoid frightening away speculators, who contribute to securities market liquidity, and investors, who could invest their savings in markets with less risk of insider predation. Working on such a premise, over the last quarter-century the SEC has brought new and ever more stringent enforcement initiatives against insider trading.

Related to this argument is the harm that insider trading causes for "specialists." A specialist is someone whom the stock exchange appoints to ensure that a buyer of a particular security listed by the exchange can readily find a seller, and vice versa. These specialists must buy from or sell to any trader whose order cannot be offset against other orders arriving simultaneously. If, for example, a buyer wants a hundred shares of IBM, but no one wants to sell at that moment, the IBM specialist sells from his inventory of IBM stock. The specialist charges a "bid-ask spread" to cover the cost. A bid-ask spread implies that a slightly higher price is asked from someone who wishes to purchase a security than will be contemporaneously offered to someone who wishes to sell.

An inside trader, however, will sell securities to the specialist when only he knows that the securities will soon be worth less. After the price has fallen, the insider is free to repurchase the securities from the specialist for the lower price. If that occurs,

the specialist loses money. If insider trading recurs, the security's specialist cannot continue indefinitely without recouping the funds being lost to informed traders. Therefore, specialists will insist on larger bid-ask spreads if insider trading is permitted and occurs often.

To investors, the bid-ask spread is a trading cost. If insider trading increased the spread but did nothing else, it would decrease a security's attractiveness relative to certificates of deposit, government bonds, and other assets. Raising new capital would, thus, be more costly for a firm whose securities were subjected to repeated insider trading. Hence, all else being equal, insider trading makes it harder for a firm to raise money when opportunities to undertake new projects arise.

But insider trading might also have offsetting benefits. Insider trading can be profitable only if securities prices move. Therefore, insiders hoping to trade on inside information may try to get the price to move by cutting the company's costs, seeking new products, and so on. While such actions benefit the insider, they also benefit the firm's security holders as a group.

Of course, insiders can also profit by borrowing and then selling securities when the price is apt to fall. Some argue that insider trading is more likely to harm companies because damage is easier to inflict. That argument, in turn, has been countered; major actions by a company require teams, not individuals. Efforts to damage a firm would likely be brought to the attention of higher management or shareholders by some ambitious team member looking to capitalize on the resulting gratitude.

Unfortunately, no evidence has been presented to help resolve this debate.

A number of financial economists and law professors take the position that insider trading ought to be legal. They base their case on the proposition that insider trading makes the stock market more efficient. Presumably, the inside information will come out at some point. Otherwise, the insider would have no incentive to trade on the information. If insider trading was legal, this group argues, insiders would bid the prices of stocks up or down in advance of the information being released. The result is that the price would more fully reflect all information both public and confidential about a company at any given time.

Even if insider trading sometimes creates more harm than good, rules against it could be contractual (e.g., "employees of our company who trade on material, nonpublic information forfeit their pension rights") rather than mandated by government. Because the circumstances facing companies differ, insider trading might be advantageous for some companies and not for others. And if so, would it not be sensible to permit firms to "opt out" of insider trading enforcement? Interestingly, Texas Gulf insider Charles Fogarty was subsequently elevated to chief executive officer of his company. Moreover, following Fogarty's death, another insider, who was also known to have traded on the same information, was elevated to replace him. Clearly, Texas Gulf's board of directors and shareholders must not have found the trading completely reprehensible. Yet the law makes no provision for opting out, implicitly assuming that insider trading injures all companies. Policymakers never seriously ask

who is harmed, who is helped (other than the insiders), and by how much.

Of course, insider trading can injure a firm if the trading elevates prices that the firm itself has to pay. For example, if Fogarty had purchased Ontario mineral rights before Texas Gulf Sulphur agents could acquire them, Texas Gulf would have been injured. Similarly, if Alpha, Inc., quietly tries to acquire control of Gamma Corp., unauthorized purchases of Gamma securities by Alpha's president could drive up Gamma's share price, thus making the acquisition more costly. But most litigated cases reflect trading in competition with ordinary participants in the securities markets, not with the insider's own firm.

Considered narrowly, most investors are on average neither hurt nor helped by insider trading because most investors are "time-function traders." That is, they buy securities (and other assets) when their income exceeds their expenditures, and sell securities when an emergency, the period of their life, or a propitious moment to initiate some project necessitates expenditures that exceed income. Hence, time-function traders do not try to "beat the market." Since statistical examinations show that insider trading affects securities prices even before nonpublic information is released, time-function traders can be harmed or helped by insiders. Suppose that an insider's trading has elevated a security price. Those time-function traders who, by chance, want to buy that security must pay a higher price for it, one closer to the price it will reach when the insider's information becomes public. But those time-function traders who chance to sell unwittingly realize a higher price as a result of the insider's action. Consequently, some time-function traders have lost, but

others have gained. Over a time-function trader's lifetime, the reasonable expectation would be to break even.

Besides specialists the one group systematically injured by insider trading are "price-function traders" - those who trade securities because they believe the present price is inappropriate. If an insider secretly buys securities, the result is an increase in price. Because some price-function traders believe that the security is now overpriced, they sell, but soon regret their action. Few people, however, have the expertise to realize trading profits repeatedly. Those who "play the market" without such expertise soon loses their capital. Thus, few active investors - even the professionals who manage pension funds - are properly considered price-function traders.

Sometimes, through luck or effort, individuals with no formal relationship with a firm discover important nonpublic information about it. Like true insiders they can profit by trading prior to public awareness of the information. A peculiar feature of insider trading law is that informed trading is treated more leniently if the trader is such a "quasi insider" (often a market professional who holds a seat on an organized securities exchange) than if the trader is a true insider.

For example, in 1975 and 1976 Vincent Chiarella netted more than \$60,000 (1991 dollars) by trading on important nonpublic information about firms other than his employer, a financial printing firm. Even though clients tried to mask sensitive information in documents that Chiarella's employer was hired to print, Chiarella was often able to "crack the code." By buying

from uninformed individuals, Chiarella became a successful trader. Yet the Supreme Court ruled that Chiarella did not violate the insider trading regulations because he did not work for and thus was not an insider of any firm whose inside information he had discovered.

This decision is puzzling. Whether the benefits to companies from true insider trading outweigh the costs, at least there are potential benefits. Quasi-insider trading, in contrast, imposes many of the same costs on firms with no obvious benefits. Although there has been pressure to strengthen the rules against quasi insiders, the legal constraints on them are still not as stringent as those on true insiders.

One matter is clear. Because insider trading has little effect on time-function traders, they do not participate in the debate. Most proponents of stronger insider-trading laws are price-function traders - arbitrageurs, floor traders, investment bankers, and others who earn a living from the securities exchanges. Insiders are such traders' most potent competitors for trading profits from new information. Price-function traders benefit from laws curtailing insider trading whether or not firms, and hence common investors, do also.

Far from the clearly settled moral issue that naïve media pieces, movies, and novels would have it be, both the theory and the evidence of insider trading remain primitive and equivocal. Present rhetoric and law have far outrun present understanding.

Reference: www.financial-spread-betting.com/stock-market-insider.trading.html

The Effects of Stock Market Insider Trading

It is virtually unquestioned in America today that stock market insider trading in the securities markets is a dastardly act. We must make a distinction here between trading by insiders and trading by insiders on the basis of nonpublic information. Insiders are legally allowed to buy and sell stocks. The Securities and Exchange Commission (SEC) requires insiders to disclose their trades, and the financial newspapers report such trading. Investors find this information a source of valuable clues about companies. (It is possible that even without the SEC requirement; shareholders would require their executives and directors to declare their trades.)

But what could be more immoral than someone's selling or buying stock on the basis of information he knows the other party lacks?

Put that way, maybe it doesn't seem so immoral after all. The idea that knowledge can ever be evenly distributed is one of those utopian pipe dreams the realization of which would require nothing less than secret police and gulags. Knowledge, like everything else about people, is most definitely unevenly "distributed." It is not distributed at all. It is acquired — by effort or luck. It's not as though there is a central knowledge-giver who spitefully shortchanges some of us. This leads to the first observation: if the law prohibits people from exploiting knowledge advantages, they have less incentive to ferret out valuable knowledge and bring it to market. Would that be good?

Those who seek to stamp out stock market insider trading concede this point, so they object only when the knowledge is unavailable to the public. But the line between prohibited inside knowledge and permissible inside knowledge is far from clear. As law professor Daniel Fischel writes in *Payback*, although inside knowledge of specifics — an earnings report, a pending merger — is an illegal basis for stock market insider trading, more general inside knowledge is not:

Maybe the insider believes that a planned reorganization of a company's sales force is going better than expected or knows that a key executive is distracted by health or marital problems. Corporate insiders are permitted, even encouraged, to trade on this kind of informed hunch.

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Table 1: Recent Insider Trading Charges and Convictions in the United States of America

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

Sources: Office of the US Attorney, Southern District of New York
 Reproduced from *The Sun*, Baltimore, and 15 July 1990.

This Is A Serious Charge. What's The Truth?

Markets and prices

A good place to start when inquiring whether an act is a crime is to ask: who's the victim? Current law has two in mind: the specific buyers or sellers of stock shares who did not possess the inside information and "the market."

Let's dispose of the second one first. "The market" cannot be a victim. It's an abstraction, not a living, breathing being. You can only victimize — that is, violate the rights of — individuals. But what about the claim that insider trading erodes confidence in the market? Even if that were true, it would not turn the act into a crime.

But the assumption that stock market insider trading erodes confidence in markets is false. On the contrary, confidence is increased by the realization that prices reflect up-to-date information. To explain this we must digress briefly to discuss the role of prices.

The price system does more than tell us what we must pay for goods and services. It produces information — in a highly concentrated and economic form — about supply and demand. We all use that information to guide our activities. For example, when a bad hurricane devastates a town and destroys homes, the new demand for plywood by suffering homeowners will bid up the price for the existing supply and attract new supply from other areas. (Unless socialistic laws prohibit "profiteering.") Whether or not I know about the new acute need for plywood, the higher prices will probably prompt me to postpone my plans to build a doghouse for Rover.

Note the social niceties of free pricing and the free movement of goods in response to price changes. Without making impossible interpersonal comparisons of subjective utility, most people would think that it's good that my doghouse will probably wait until after people rebuild their homes. The market's price system accomplishes this without a dictator issuing decrees or secret police shooting the uncooperative. Strangely, the market never gets credit from the intellectuals and "human rights" activists for this not inconsiderable achievement.

Of course, the contrast among most everyday alternatives is not so dramatic, but the principle is the same. The price system enables people to make decisions about scarce resources that take into account individual needs and knowledge spread throughout society, but without burdening them with an unmanageable amount of data.

Stock prices too are generated by supply and demand. But supply and demand for stocks are not disembodied concepts. They are generated; obviously enough, by suppliers and demanders — people with preferences, objectives, expectations, knowledge, and, therefore, plans. Part of what goes into an intention to buy or sell shares in a company is expectations about its future based on knowledge about its management, organization, and so on. These expectations are incorporated into the share price, and changes in expectations bring about changes in price. The more knowledgeable the participants, the more fully do price perform their communications work. Nothing would undermine confidence in markets more than the belief that prices are out of date.



“CHAPTER # 4”

Presentation Analysis

Definition of Insider Trading:

Insider trading occurs if you know material confidential information about a public company (whether it is your company or another company) and you trade on that information or tip others about it before the information is released publicly. Material information is news that can affect a company's stock price, such as knowledge of a takeover or accounting problems, a dividend change, a new product, or earnings that are better or worse than expected.

Insider Trading Is Illegal For More than Executives or "Insiders"

This anti-fraud rule does not apply only to company insiders, employees, or executives. The prohibition applies to you, your business associates, your family members, and your friends—anyone who possesses material non-public information at the time of the trade or tip.

Civil Penalties: any profit made or loss avoided and penalty of up to three times this amount. Bar for serving as D&O of public company.

Individuals face up to 25 years in prison for securities fraud and fines of up to \$1 million. Mail and wire fraud, tax evasion and obstruction of justice. Corporations face penalties.

Material information: news that can affect a company's stock price, for better or worse

This includes knowledge of:

- takeover
- accounting problems
- dividend change
- blockbuster product
- earnings better or worse than expected

Myths:

Only a company's insiders or employees can commit insider trading. Need to trade and be caught in the act.

Truths:

- The law applies to anyone who knows material nonpublic information at the time of the trade or tip
- Applies to trades of stock in customers, suppliers, clients
- Tipping, even without the tipper trading, is illegal
- Most cases based on circumstantial evidence
- These rules are separate from the Section 16 rules for senior executives and directors

Insider Trading Harms the Goals of Employee Ownership:

Employee ownership culture encourages information-sharing and boasting about company. Even well-intentioned actions can be illegal. Destroys the financial link between employees and shareholders. Damages reputation of equity compensation. Investors interpret insider trading investigation as sign that company has undisclosed financial or accounting troubles.

Prevention Procedures:

- Blackout Periods vs. Quarterly Trading Windows
- Pre-clearance for Senior Executives and Directors. Ongoing Education: Seminars, Videos (e.g., “Think Twice”), Reminders, Press Clippings
- Substantive prevention efforts, internal investigations and cooperation with SECP and reduce corporate liability.

What Information should be disclosed?

- Existence of program (selling or buying)
- Names of insiders
- Number of shares
- Percentage of holdings (vested and unvested)
- Duration, other terms
- Whether insiders will trade outside plan

Four cases of insider trading under investigation:

SECP:

KARACHI: Securities and Exchange Commission of Pakistan (SECP) is investigating four cases of insider trading or market abuse, the commission chief Wednesday said.

SECP had settled two cases of insider trading last year while rules for market analysts were also being drawn to check malpractices at the stock markets, Dr. Tariq Hassan, told newsmen at ringside of a seminar organized by Insurance Association of Pakistan

SECP, he said, was preparing rules for equities analysts to regulate this sensitive area of capital market as well, while the regulatory framework is already in place to govern the market and prevent its abuse and take the abusers to the task. In past few years with the spate of capital market reforms the market abuse has become difficult, he claimed.

Dr. Hassan also said the code of governance for equities analysts was also under way and it would come into force soon. He said the SECP had observed the requirement of the regulatory framework in this area and it had already started working to develop rules for this area.

According to the sources in SECP, the issue regarding the regulatory framework for equities analysts came under spotlight in Pakistan and other regional capital markets after Stock research analysts in the U.S. came under fire for trapping investors with arbitrary stock recommendations.

He said so far, analysts in Pakistan were out of any regulatory ambit despite in presence of potential conflict of interests by many stakeholders at the stock market. But the unclear line between their company's research division and investment department often implied that analysts' work was not produced impartially and independently.

On the other hand US case does not apply much in Pakistan because it is rare that equity analysts are proportionally involved in investment. And those who have collaboration with any foreign brokerage house follow the rules set by their regulatory authorities.

Equities analysts in Pakistan are required to be Chartered Financial Analysts, a

degree, which experts say lays great emphasis on issues of ethics. But as the US case has proven that ethics don't hold sway over the decision-making process at even the world's biggest, most successful brokerages.

And that's why when an investigation by the New York attorney general led to Merrill Lynch coughing up a \$100 million fine and promises of reform, other big houses moved swiftly to pre-empt regulatory action. Just after the incident in United States, US Securities & Exchange Commission introduced new laws regarding the issue, prohibiting investment banking personnel from discussing research reports with analysts prior to distribution, unless staff from the firm's legal and compliance department monitor communications. The new rules also bar securities firms from tying an analyst's compensation to specific investment banking transactions.

And the rules clamp down on analysts and members of their households from investing in a company's securities prior to its initial public offering if the company is in the business sector that the analyst covers. Analysts and securities firms are also now required to disclose financial interests that can alert investors to potential biases in their recommendations. —

Staff Report

Severe Penalties

Anyone found liable in a civil case for trading on inside information may need to pay the government an amount equal to any profit made or any loss avoided and may also face a penalty of up to three times this amount. Persons found liable for tipping inside information, even if they did not trade themselves, may face a penalty of up to three times the amount of any profit gained or any loss avoided by everyone in the chain of tippees. Individuals can be barred from serving again as an executive or a director of a

public company and can also face private lawsuits. These penalties are not the only consequence of an insider trading violation and investigation. Publicity and embarrassment also surround the investigation, even if it does not result in any formal charges, and damage is done to the company's business and image.

STATUTORY NOTIFICATION (S.R.O)

Government of Pakistan

SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN (SECP)

PUBLISHED BY AUTHORITY

Islamabad the, 27 March, 2000

1. Short title and commencement.-

- i. These guidelines may be called the Listed Companies (Prohibition of Insiders Trading) Guidelines.
- ii. These shall come into force at once.

2. Definitions. - In these guidelines, unless the context otherwise requires:-

- i. "Act" means the Securities and Exchange Commission of Pakistan Act, 1997;
- ii. "associate" means an associate as defined in clause (ab) of sub-section (1) of section 2 of the Ordinance;

- iii. "Company" means a company as defined in clause (7) of sub-section (1) of section 2 of the Companies Ordinance, 1984.
- iv. "Commission" means the Securities and Exchange Commission of Pakistan.
- v. "connected person" means any person who-
 - a. is a director, as defined in clause (13) of sub-section (1) of section 2 of the Companies Ordinance, 1984; or
 - b. occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;
- vi. "dealing in securities" means an act of buying, selling or agreeing to buy, sell or deal in any securities by any person either as principal or agent;
- vii. "insider" means-
 - a) a person who is a director, chief executive, managing agent, chief accountant, secretary or auditor of a listed company or the beneficial owner holding directly or indirectly not less than 10% of the shares of a listed company; or
 - b) a person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company who has received or has had access to such unpublished price sensitive information.
- viii. "Listed" in relation to securities, means securities which have been allowed to be traded on a stock exchange.
- ix. "Officer" means a person as defined in clause (24) of sub-

section (1) of section 2 of the Companies Ordinance, 1984 and includes an auditor of the company.

x. Ordinance" means the Securities and Exchange Ordinance, 1969;

xi. "Person is deemed to be a connected person" if such person-

a. is a company under the same management or group or any subsidiary company

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

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

d. is an official or an employee of a self-regulatory organization recognized by the Commission;

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

f. Is a banker of the company.

xii. "Stock exchange" means a stock exchange which is registered with the Commission under section 5 of the Ordinance, 1969.

xiii. "unpublished price sensitive information" in relation to a listed security means any information which relates to the following matters or is of concern, directly or indirectly, to a company, and is not generally known or published by such company for general information, but which if published or known, is likely to

materially affect the price, of securities of that company in the market:-

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

Chapter II

Prohibition on Dealing, Communicating or Counseling

3. Prohibition on dealing, communicating or counseling by insiders.- No person who is or has been, at any time during the preceding six months associated with a company shall:

- i. either on his own behalf or on behalf of any other person, deal in securities of a company listed on a stock exchange on the basis of any unpublished price sensitive information; or
- ii. communicate any unpublished price sensitive information to any person, with or without his request for such information, except as required in the ordinary course of business or under any law; or

iii. Counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.

4. Violation of provisions relating to insider trading.- A person who deals in securities or communicates any information or counsels any person dealing in securities in contravention of the provisions of paragraph 3 shall be guilty of insider trading and shall be liable to penal action under section 15B of the Ordinance.

CHAPTER III

Liability, Action by Commission On Behalf Of Issuer

- i. Every connected person who purchases, sells or otherwise deals in and with securities of an issuer with the knowledge of unpublished price sensitive information with respect to the issuer that has not been generally disclosed is liable to compensate the seller or purchaser of the securities, as the case may be, for damages as a result of the trade unless,
- a. the connected person proves that the person reasonably believed that the unpublished price sensitive information had been generally disclosed; or
 - b. The unpublished price sensitive information was known or ought reasonably to have been known to the seller or purchaser, as the case may be.
- ii. Every insider who informs another person of unpublished price sensitive information with respect to the issuer that has not been generally disclosed, shall be liable to compensate for damages any person that thereafter sells securities of the issuer to or purchases securities of the issuer from the person that received the Information unless;-

- a. the person who informed the other person proves that the informing person reasonably believed the unpublished price sensitive information had been generally disclosed;
 - b. the unpublished price sensitive information was known or ought reasonably to have been known to the seller or purchaser, as the case may be; or
 - c. in the case of an action against an issuer or a person in special relationship with the issuer, the information was given in the necessary course of business;
- iii. Any person who has access to information concerning the investment program of a mutual fund in Pakistan or in the investment portfolio managed for a client by an investment adviser and uses that information for his, her or its direct benefit or advantage to purchase, sell or otherwise deal in and with securities of an issuer for his, her or its account where the portfolio securities of the mutual fund or the investment portfolio managed for the client by the investment adviser includes securities of that issuer is accountable to the mutual fund or the client of the investment adviser, as the case may be, for any benefit or advantage received or receivable as a result of such purchase or sale.
- iv. Every person who is an insider or associate of an issuer that,-
- a. sells or purchases the securities of the issuer with knowledge of a unpublished price sensitive information with respect to the issuer that has not been generally disclosed; or
 - b. Communicates to another person, other than in the necessary course of business, knowledge of unpublished price sensitive information with respect to the issuer that has not been generally disclosed.
- v. Where more than one person in a special relationship with an issuer is liable under sub-paragraph (1) or (2) of this paragraph

as to the same transaction or series of transactions, their liability is joint and several.

- vi. In assessing damages under sub-paragraph (1) or (2) of this paragraph, the Court may consider,
 - a. if the plaintiff is a purchaser, the price paid by the plaintiff for the security less the average market price of the security in the twenty trading days following general disclosure of the unpublished price sensitive information; or
 - b. if the plaintiff is a vendor, the average market price of the security in the twenty trading days following general disclosure of the unpublished price sensitive information less the price received by the plaintiff for the security,
 - c. In addition to the above, the Court may consider such other measures of damages as may be relevant in the circumstances.

6. Action by Commission on behalf of issuer

- i. Upon application by the Commission or by any person who was at the time of a transaction referred to in sub-paragraph (1) or (2) of paragraph 5 or is at the time of the application a security holder of the issuer, the Court may, if satisfied that,
 - a. the Commission or the person has reasonable grounds for believing that the issuer has a cause of action under sub- paragraph (4) of paragraph 5; and
 - b. the issuer has failed to obtain prosecution of an action commenced by it under paragraph 5,make an order, upon such terms as to security for costs and otherwise as to the Court seems fit, requiring the Commission or authorizing such person or the Commission to commence or continue an action in the name of and on behalf of the issuer to enforce the liability created by sub- paragraph (4) of paragraph 5.
- ii. Where an action under sub-regulations (3) or (4) of regulation 5 is,

- a. commenced;
- b. commenced and prosecuted; or
- c. continued,

by a board of directors of an issuer or the Court may order that the costs properly incurred by the Board in commencing, commencing and prosecuting or continuing the action, as the case may be, shall be paid by the issuer, if the Court is satisfied that there were apparent grounds for believing the action was in the best interest of the issuer and the security holders thereof.

- iii. Where an action under sub-paragraph (3) or (4) of paragraph 5 is,

- a. commenced;
- b. commenced and prosecuted; or
- c. continued,

by a person who is a security holder of the issuer or the Court may order that the costs properly incurred by such person in commencing, commencing and prosecuting or continuing the action, as the case may be, shall be paid by the issuer, if the Court is satisfied that,

- i. the issuer failed to commence the action or had commenced it but had failed to prosecute it diligently; and
- ii. There are apparent grounds for believing that the continuance of the action is in the best interest of the issuer and the security holders thereof.

- iv. In determining whether there are apparent grounds for believing that an action or its continuance is in the best interest of an issuer and the security holders thereof, the Court shall consider the relationship between the potential benefit to be derived from the action by the issuer and the security holders thereof and the cost involved in the prosecution of the action.

- v. Notice of every application under sub-paragraph (1) or (2) of paragraph 5 shall be given to the Commission, the issuer or the

mutual fund as the case may be, and each of them may appear and be heard thereon.

- vi. Every order made under sub-paragraph (1) or (2) of this paragraph, requiring or authorizing the Commission to commence and prosecute or continue an action, shall provide that the issuer or mutual fund, as the case may be, shall co-operate fully with the Commission in the commencement and prosecution or continuation of the action, and shall make available to the Commission all books, records, documents and other material or information known to the issuer or mutual fund or reasonably ascertainable by the issuer or mutual fund relevant to such action.

CHAPTER IV

Investigation

7. Investigation by the Commission.-

- i. Where the Commission, on the basis of the information available with it, is of the opinion that it is necessary to investigate and inspect the books of account, other records and documents of an insider and that of the member of a stock exchange for such a purpose, it may appoint an enquiry officer for the said purpose.
- ii. The purpose referred to in sub-paragraph (1) may include:-
 - a. to investigate into the complaint received from an investor, market intermediary or any other person on any matter having a bearing on the allegations of insider trading; and
 - b. to investigate suo-moto on the basis of its own knowledge or information in its possession to protect the interest of investors and the securities market.

8. Procedure for investigation.-

- i. Before undertaking any investigation under paragraph 7, the Commission shall provide an opportunity of being heard with a reasonable notice to the insider for that purpose.
- ii. Notwithstanding anything contained in sub-paragraph (1), where the Commission is satisfied that in the interest of investors or in public interest no such notice should be given, it may by an order in writing direct that the investigation be taken up without such notice.
- iii. On being empowered by the Commission, the enquiry officer shall undertake the investigation and inspection of books of accounts, records and documents of the insider. Such a person shall be bound to discharge his obligations as provided in paragraph 9.

9. Obligations of insider on investigation by the Commission.-

- i. It shall be the duty of every insider, who is being investigated, to produce to the enquiry officer such books of account and other documents in his custody or control and furnish the statements and information relating to the transactions in securities market within such time as the enquiry officer may require.
- ii. The insider shall allow the enquiry officer to have reasonable access to the premises occupied by such insider and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock broker or any other person and also provide copies of documents or other materials which, in the opinion of the enquiry officer are relevant.
- iii. The enquiry officer, in the course of enquiry, shall be entitled to examine or record statements of any member, director, partner, proprietor and employee of the insider.
- iv. It shall be the duty of every director, proprietor, partner, officer and employee of the insider to give the enquiry officer all

assistance in connection with the investigation, which the insider may be reasonably expected to give.

10. Submission of Report to the Commission.- The enquiry officer shall furnish enquiry report to the Commission within such time as may be specified by the Commission.

11. Communication of findings, etc.-

- i. The Commission shall after consideration of the enquiry report communicate the findings to the insider and he shall be given an opportunity of being heard before any action is taken by the Commission on the findings of the enquiry report.
- ii. On receipt of the explanation, if any, from the insider, the Commission may call upon the insider to take such measures as the Commission may deem fit to protect the interest of investors and in the interest of the securities market and for due compliance with the provisions of the Act, the Ordinance and the guidelines.

12. Appointment of Auditor.- Notwithstanding anything contained in paragraph 6, the Commission may appoint an auditor who shall be a practicing Chartered Accountant to investigate into the books of account or the affairs of the insider: Provided that, the auditor so appointed shall have the same powers of the enquiry officer as stated in paragraph 6 and the insider shall have the obligations specified in paragraph 9.

13. Directions by the Commission.- On receipt of the explanation, if any, from the insider under sub-paragraph (2) of paragraph 11, the Commission may without prejudice to its right to initiate criminal prosecution under section 15B of the Ordinance, give such directions to protect the interest of investors and in the

interest of the securities market and for due compliance with the provisions of the Act, the Ordinance and the guidelines, as it deems fit for all or any of the following purposes, namely:-

- i. directing the insider not to deal in securities in any particular manner;
- ii. prohibiting the insider from disposing of any of the securities acquired in violation of these regulations;
- iii. restraining the insider to communicate or counsel any person to deal in securities.

SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

Islamabad May 10, 2001.

NOTIFICATION

RULES AND REGULATION FOR BROKERS AND AGENTS

Cancellation of registration

Where the Commission is of the opinion that the cause of suspension of registration under-rule 8 continues during the period of such suspension, or a broker whose registration has been suspended:

- (i) is engaged in insider trading;
- (ii) has been found guilty of fraud, or convicted of criminal offence;
- (iii) has his membership cancelled by a stock exchange; or
- (iv) has not complied with a directive of the Commission.

The Commission may, if it considers it necessary for the protection of investors so to do, by order in writing, cancel the registration of the broker:

Provided that no such order shall be made except after giving the broker an opportunity of being heard.

	FY97	FY98	FY99	FY00
Total No. of Listed Companies as on 30th June	782	779	769	762
Total Listed Capital as on 30th June (Rs billion)	206.7	211.2	215.0	229.0
KSE-100 Index as on 30th June	1,565.7	879.6	1,054.7	1,520.7
KSE All Share Index as on 30th June	1,057.0	586.8	675.4	942.7
Initial Public Offering (Number)	7	2	0	3
New Debt Instrument Listed (Number)	1	3	2	3
Trade Volume (million shares)	8,095.1	14,992.4	25,524.8	48,097.0
Value of Shares Traded (Rs billion)	233.2	509.6	605.3	1,877.8
Average Daily Turnover (Million Shares)	34.0	63.9	103.0	194.3
Trading Days	239	235	247	249
Foreign Investment (Rs billion)				
Inflow	8.4	31.1	8.9	7.4
Outflow	8.6	27.8	10.0	8.6
Net flow	-0.2	3.3	-1.1	-1.1



“CHAPTER # 5”

Summary of Findings,

Conclusion



Recommendation

IMPLICATIONS OF INSIDER TRADING ON SHARE MARKET IN KARACHI

QUESTIONNAIRE:

Name: -----

Qualification: -----

Organization: -----

Designation: -----

1. Are familiar with the term Insider Trading*?
 - Yes
 - No

(If your answer is no please don't proceed further. Thank you for cooperation)

2. In your view sophisticated Insider Trading done on large scale, erodes market confidence?
 - Yes
 - No
3. Does the perception of unfairness created by Insider Trading builds up an environment of disinvestment by the Investors?
 - Yes
 - No
4. Do you think that an uninformed market is not a fair market as it may not represent the true value of the shares?
 - Yes
 - No
5. Do you think that the company is harmed from the misuse of Information because it is difficult for a company to raise capital it self?
 - Yes

- No
6. Do you think that Insider Trading tends to cause the correct prices to be reached more quickly and acts like a price accelerator?
 - Yes
 - No
 7. Do you think that the regulatory authorities are reluctant to bring Insider Trading charges unless they have an extremely good chance of success in courts?
 - Yes
 - No

 8. Do you think that the penalties that have been imposed by the government in breach of Insider Trading are significant?
 - Yes
 - No
 9. What should be the significant penalties for the breach of such fiduciary duty?
 - Profit from trading
 - Double of the profit made from trading
 - Significant imprisonment plus monetary charges.
 10. Do you think that Insider Trading is legal when we see the fact that it passes loads of Information to the market and stimulates the turnover of money in the economy?
 - Yes
 - No

*Insider Trading: Insider trading occurs when someone makes an investment decision based on information that is not available to the general public. In some cases, the information allows them to profit, in others, avoid a loss.

**THANK YOU FOR YOUR PRECIOUS TIME AND YOUR
COOPERATION.**

“FINDINGS”

HARMFUL EFFECTS OF INSIDER TRADING

Brokers View:-

Almost all of the brokers said that insider trading is harmful and the most commonly expressed view was that the harm was done to the market. Some said that small shareholders suffered. Some of those who expressed contrary views said that there were no losers because there were willing sellers. Amongst those who agreed that there was harm to the market there were various qualifications of that view. According to one broker, "in its rawest form insider trading dislocates the market. It upsets overseas investors". Similarly, a broker asserted that "sophisticated insider trading done on a big scale erodes market confidence. Share markets image was damaged by insider trading in the mining boom. "Innocent" insider trading has negligible effect". A more specific statement was that "the harm is to confidence in the marketplace. It is necessary to protect smaller people-insider trading hurts small people". A similar opinion was that "it is a form of stealing. It damages the system, especially small people. The entrepreneurs steal from the weak".

A more general explanation was that "the vast majority of shareholders suffer. They miss out on value; they should be able to share profits". A somewhat different assessment of the damage was that quote; there is more money lost by people acting on what they think is inside information than by those who sold".

Some brokers were more specific about where the harm is felt. A broker said "smaller shareholders are disadvantaged. The institutions are not. They are in a privileged position, in a favored position and are getting all the information that is around-but are not necessarily insider trading". One of the very senior brokers described insider trading as "a victimless crime. In the equities market you cannot totally protect everybody. It has an unfortunate effect on the market". It is a caveat emptor in the market place.

Financial Advisors View:-

Most of the financial advisers felt that insider trading is harmful and for the most part they identified the victim as the market. In more specific terms they said that investor confidence is eroded; the raising of capital is made more difficult; the efficiency of the market is destroyed; the perception of unfairness leads to disinvestment and that the international reputation of the market suffers. One view was that the market does not suffer from insider trading because it is always in need of information investors, small traders, and those who do not have the information and trade in that state of ignorance.

Stock Exchange Officials View:-

The stock exchange officials believed that there was some harm associated with insider trading. They said that the market suffers, the seller is the victim and mathematically, persons who conduct transactions without being properly informed are banned. The one dissenting view was that there is no harm, "particularly as the

market is so thin. The seller is not forced to sell. He sells at a price he thinks is fair".

In the market observer group the view was that insider trading is harmful and the words "unfair", "wrong", and "defrauds" were used in describing its effect. The views as to the victim of the harm fell into the two usual categories - the market, and those who were on the other side of the transaction. An answer that perhaps summed up the views of the group was that "it distorts the market; it is unfair to small shareholders; it creates an unfair advantage and it destroys the level playing field".

The concept of a group of uninformed shareholders being taken advantage of was summarized as "people on the outer ring of the market are disadvantaged". A more robust view was that "the real harm is that the game is not straight. We need an informed, honest market" but less concerned with the effect on investors was the observer who said that "in some situations insider trading could undo a deal".

Lawyer's View:-

Most lawyers agreed that there was harm caused by insider trading but they also said that it was a question of perspective. As one lawyer put it, "it all depends upon where you stand.. There must however be a minimum level of regulation. It seems wrong when you hear of cases of insider trading. The law has a role to inhibit it but not to stop insider trading entirely". In a similar vein, a lawyer observed that "the degree of harm depends upon the circumstances of a particular stock. Insider trading can both advantage and disadvantage an individual". The most common view was that insider trading was harmful because of its unfairness to the person who does not have the inside information.

A strong view was taken by a practitioner, who said that "insider trading distorts securities markets. Insider trading is a fraud. People should be fully informed or have the capacity to be so if they seek advice". A lawyer expressed the view that "no economic loss is caused by insider trading, but insider trading is a question of fairness". Lawyer interviewees sometimes also held more complex or ambiguous views. The strongest critic of the view that insider trading causes harm emphatically answered that "insider trading is not the major evil it is made out to be". He acknowledged however that "a problem arises from an insider's ability to get out before the market knows what the real problems are. But most big investors and individuals don't invest in anything but blue chip companies and the latter do not insider trade as insider trading is too risky". The predominant view of the lawyers was that insider trading was undesirable on the ground of fairness.

Regulators View:-

Amongst the regulators, the issue of perceived unfairness was common. Frequent references were made to the level playing field. One regulator observed that an uninformed market is not a fair market, as it may not represent the true value of the securities. The end detriment is to the general public who are indirectly affected through their commitments to superannuation funds and the like" It was also said that "if a market is seen as being 'unfair' then both the confidence of the players and the credibility of the market are harmed". The regulators commonly observed that the company itself was harmed by insider trading, because it became difficult for the company to raise capital. One regulator said that "the company is harmed by the misuse of information which belongs to it. In some large corporations or groups this is not so simple

because managers expect to benefit from insider trading as a spin-off from the company's deals.

The regulators were in no doubt that insider trading was harmful for a range of reasons, but again ranked fairness as the main reason for the perceived harm caused by insider trading. They think that that damage to shareholders is not the most important damage which arises from insider trading activity. One broker said that:

“I would like to argue that insider trading is not the malfunction that does the most harm. I believe, and the all of us believe, that misleading accounts, secret deals, the reversible put and call options that have recently become quite popular, the misuse of controlling shareholders' positions, market manipulation and warehousing, all cause more damage to shareholders, and more identifiable damage, than insider trading. However, I do not think that damage is the most important argument. Confidence is the most important argument. People recognize or believe that a certain amount of insider trading is going on and they stay away from the market as a result... I believe that we should be very concerned about that because in Pakistan only a few percent of our population holds shares”.

The PICIC corporate officer said that “My view is that while insider trading exists, we do not see it as being the major corporate crime that seems to be running around the country at present. It is certainly one of a number but we see it as no more rampant and difficult than some of the other things happening such as directors within companies moving money around and manipulating things. Perhaps, at the end of the day, those sons of crimes are even worse than insider trading”.

It is difficult to accept that insider trading is the victimless crime that it is said to be. Perhaps those who hold to this view mean to say that insider trading is a crime without an obvious victim. Harm is caused whether it is to an individual or the corporation, or to the market. Individuals might not realize that they are victims, but they nevertheless suffer at the hands of an insider trader. They either sell shares for less than their true value or purchase shares that are about to lose value. In either case, they are at least taken advantage of or deceived. There was also a strong feeling that the market is banned by insider trading because it detracts from an honest and informed market. Insider trading has the effect of corrupting or debasing the market.

BENEFICAL EFFECTS OF INSIDER TRADING:-

Many people argued in defense of insider trading that it acts as a price accelerator and brings the price of securities to their proper level more quickly than would otherwise be the case. Another argument identified is that insider trading is beneficial because it provides an additional incentive to management to be more entrepreneurial in running the companies that they control.

The brokers were equally divided about whether or not insider trading had any beneficial effect (apart from the profit made by the insider trader). The usual form of the negative answer was a flat "no". One expanded response was that "the only beneficiary is self-interest". According to one broker, insider trading could 'warn the market and thus stop premature selling [and it] could upset a takeover bid".

The most common answer of those who saw benefits was that "insider trading is good for the market by providing increased activity" and that "insider trading drives the market". Other views about the possible benefits of insider trading included the obvious

point that "it is beneficial for the people getting out". A more serious commentary was that "it forces information into the market". One dimension of insider trading spoken about widely was that: "maybe it puts pressure on the bidders in takeovers to go higher. It is in the bidder's interest to reduce insider trading; for the shareholders in targets perhaps it helps".

The responses to the market accelerator argument were almost all unfavorable. Some brokers challenged the premise on which the argument rests. One said that "the price mechanism is not necessarily efficient". A stronger rejection of the argument came from a broker who said: "the market accelerator argument is rubbish; it is for the benefit of a few. It is clearly absurd. What is the proper price level? It should be determined in a free market".

One of the brokers who acknowledged that there was some appeal in the price accelerator argument said, "it sounds fine, but if somebody benefits along the way that is not right. It is good for forcing information on to the market". A reaction to that was "that is fair enough but it is better to make the announcement before insider trading starts so that everybody benefits from the flow of additional information in the market".

The majority view amongst financial advisers was that there are no benefits. As one respondent put it "insider trading accelerates the market and this is okay from an efficiency viewpoint but it is not ethical or moral". Those who were not part of the majority said that insider trading brings news to the market more quickly. Several financial advisers commented that if bringing news to the market is a good thing it would be better if the disclosure were made by the company itself and some doubt was expressed as to whether it accelerates the price. Another advisor said that "it is a sad case if

you have to rely on insider trading to provide an incentive and information and accelerate the market".

The observers shared the same attitude to the view of insider trading. It "is contrary to basic traditions of business" said one, "it only benefits the winner. Insider trading should never be legalized". The benefits from insider trading were that "it allows the market to reassess the stock price.

The price accelerator argument was generally rejected by most lawyers. One lawyer argued that "insider trading tends to cause the correct price to be reached more quickly. It is an incentive for small companies to go public".

But according to my research there is a need for better disclosure rules. There are no beneficial effects of insider trading. Instead of escalating the price to the proper price, inside information should be announced to the stock exchange and the exchange should through proper channel announce it to the public.

Regulators saw few, if any, benefits arising from insider trading activity, apart from the obvious benefits to the insider trader. Some saw benefits arising "from the turnover of money in the economy". A less plausible benefit referred to was that "insider trading adds liquidity to the market, so perhaps the State governments benefit from the additional stamp duty revenue". None of these factors were enough to justify insider trading but the fact is repeatedly it has been described by every person that has been interviewed that "insider trading encourages entrepreneurial activity is a short term view which ignores the longer term moral question".

Attempts to justify insider trading were strained and advanced without much confidence. There is a need for companies to improve their mechanisms for disclosing price sensitive

information to the market as a whole rather than to the privileged few. Insider trading is clearly not accepted as a means of ensuring that information is brought into the market efficiently and quickly.

The defense of insider trading on the grounds of its "informational efficiency" paints a sorry picture indeed. If the market is forced to rely for information, even to a limited extent, on a practice that is, if not corrupt, at least highly questionable on ethical grounds, it is not an impressive commentary on the process of informing the market.

INSIDER TRADING AND MARKET CONFIDENCE:-

It is often argued that insider trading undermines investors' confidence. Respondents were asked to comment on this argument. The brokers said that insider trading has not undermined confidence in the stock market. A common line of argument was that a certain level of inside- trading was acceptable; another was that the incidence of insider trading was too low to have an effect. The former view was summed up by one broker who said that "people are prepared to live with a degree of insider trading and other market abuse". A broker described the market as being "like the race track". Everyone tries to get a piece of the action. Are players concerned enough not to play? They still play. Turnover figures disprove any theory of lost confidence". The market is like a casino with people trying to make money". According to other brokers, insider trading is not bad enough for the average sensible investor to take too negative a view".

The contrary view was that "the smaller person is disillusioned; they think that the stock exchange is a closed shop and that they won't win". It is this investor distrust that keeps people away. Perhaps the attitude of investors to insider trading depends on their own experience and whether they know that they are victims. One broker felt that "in blatant cases victims would be sour". But a more accurate assessment might be that "people hate insider trading if they do not have the information or did not make the profit". Clients never raise the issue". Of course the person who was upset by insider trading would not be a client.

Another said that "to some extent confidence has been damaged. People who have been hurt now put their money into trusts or real estate". One of the accountants interviewed felt that "the

community is pessimistic about the market and there may be some classes of investors who lose confidence".

There was a high degree of unanimity amongst lawyers to the effect that insider trading has not undermined confidence at all. A number of reasons were advanced such as, "people will still have a flutter. Insider trading is almost accepted as one of the risks of trading. In any event, confidence in the market is a recurring thing". A more mocking view was that, "insider trading hasn't undermined confidence as people think it is normal. It actually takes a lot to deter people from being greedy. Successful enforcement of the law may disillusion people more". The lawyers clearly saw the stock market as being like a casino or horse race, where a degree of "fixing" was accepted as a part of the risk and excitement.

On balance, it seems that the existence of insider trading laws has at least some effect on the level of market confidence. This is not the perception that the market is manipulated and that the laws are ineffective. It is not possible to know how many of the investing public is aware that the law exists, but it would be reasonable to say that an overpowering majority are not aware of the law. Those who would be so aware, however, would be most unlikely to understand it. Perhaps they know that something is there and it reinforces the view that the law currently serves a function as a form of symbolic reassurance.

THE FAIRNESS OF THE MARKET:-

Interviewees were asked whether or not the market was unfair to any particular group. The overwhelming view was that it was not unfair but that there were disadvantages suffered by specific groups. It appears that larger investors are treated better by brokers. Cost is a factor in this regard. One broker pointed out that

"clients should get benefits according to their size. Brokers do not run a social service; they must look after their best customers". An example of a disadvantage was that "... it is harder for small investors to get information". But on the other hand, another broker believed that "the market compensates. Small investors can get out faster". That was also the view of another who said "the big guys cannot get out as easily as the small ones. The small investors do not get serviced as well".

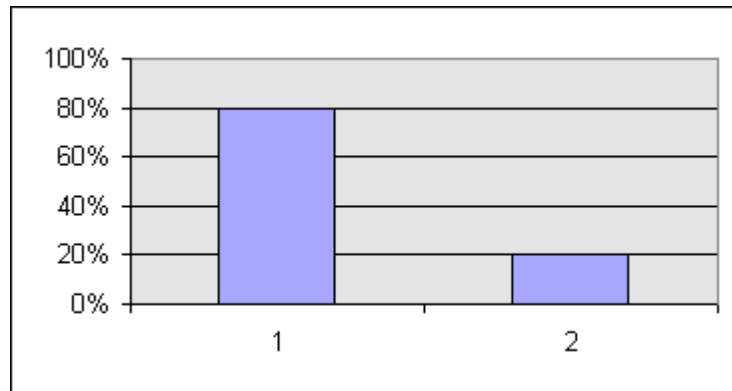
Only a small proportion of the financial advisers felt that the market is unfair to any particular group. Most of them distinguished unfairness and advantages and as one pointed out "the larger investor gets a better deal from brokers but this is just a fact of life-it is not unfair". The exchange officials, not surprisingly, denied that the market was unfair.

It was clear that distinct advantages are enjoyed by larger investors and institutions, largely due to their market power. Small investors lack the economies of scale available to larger investors. There was some evidence that small investors have been treated poorly by some brokers.

Question #1

Awareness to the term

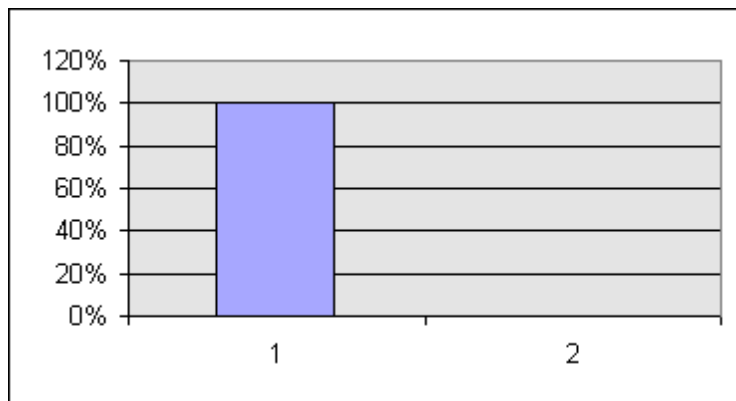
Yes	80%
No	20%



Question #2

Market Confidence

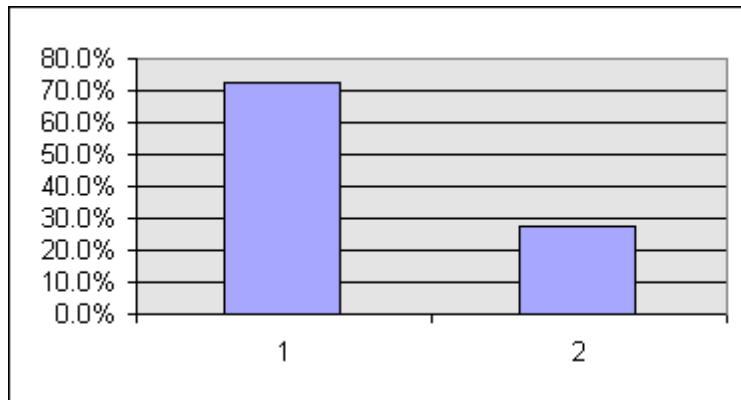
Yes	100%
No	0%



Question #3

Perception of Disinvestment

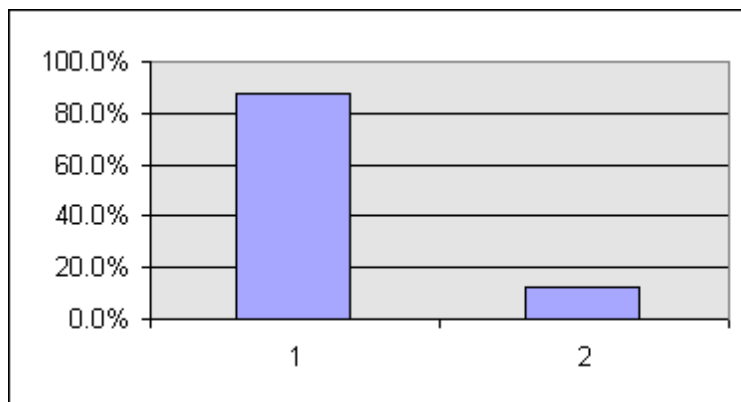
Yes	72.5%
No	27.5%



Question #4

Uninformed Market

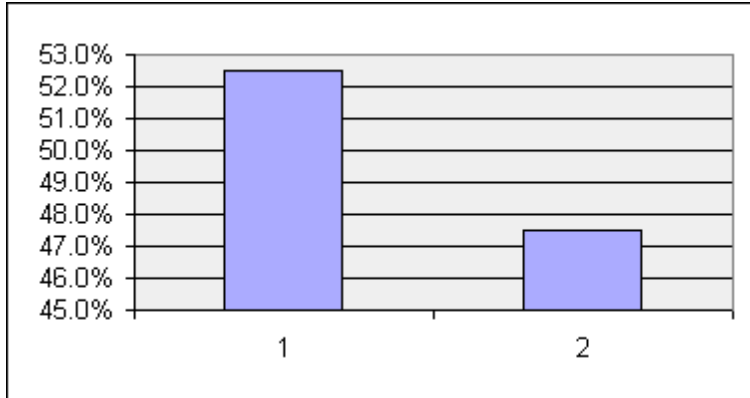
Yes	87.5%
No	12.5%



Question #5

Misuse of Information

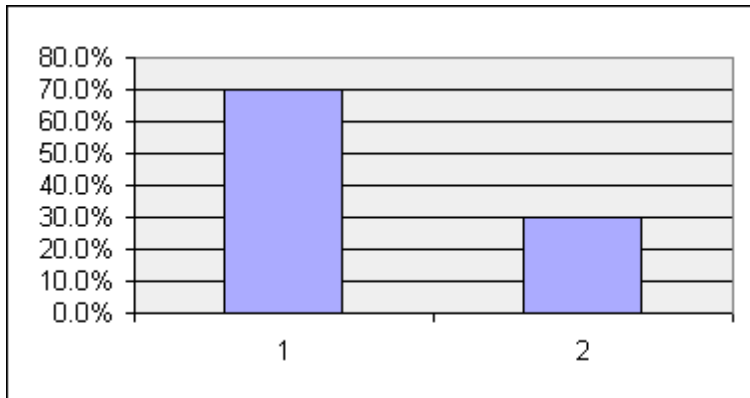
Yes	52.5%
No	47.5%



Question #6

Price Accelerator

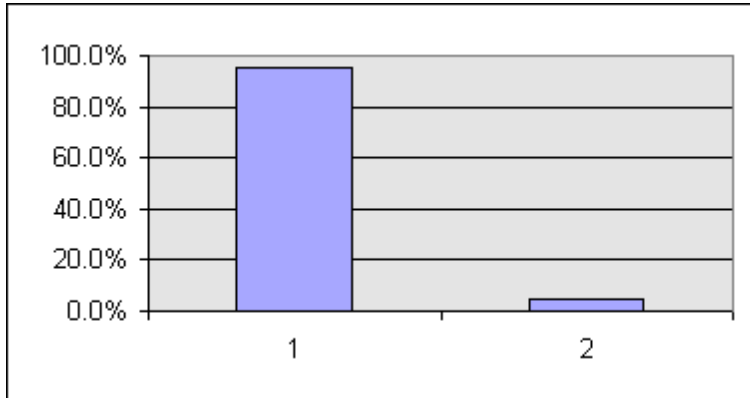
Yes	70.0%
No	30.0%



Question #7

Regulatory Authorities

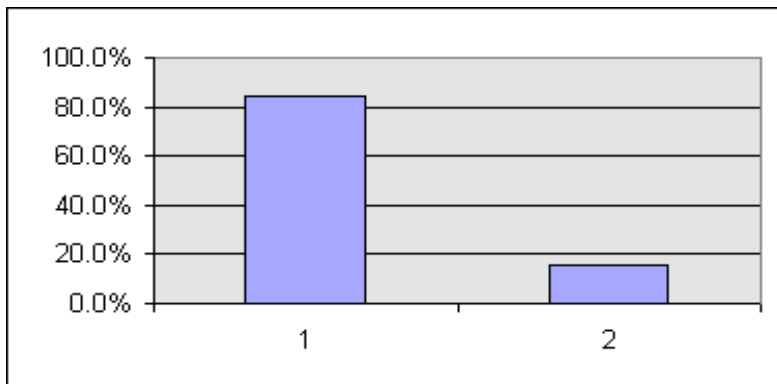
Yes	95.0%
No	5.0%



Question #8

Significant Penalties

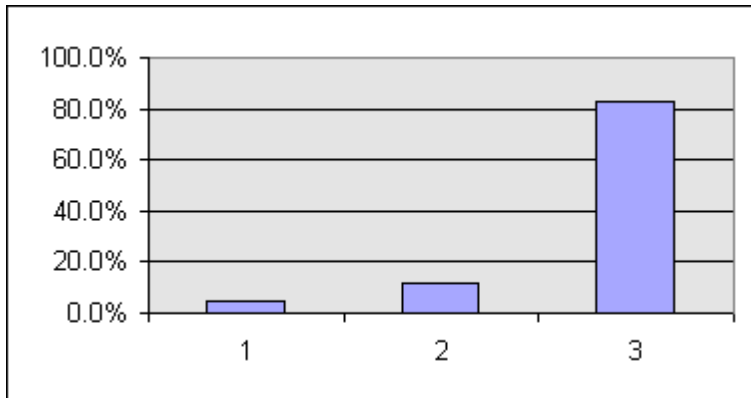
Yes	84.5%
No	15.5%



Question #9

Imposed Significant Penalties

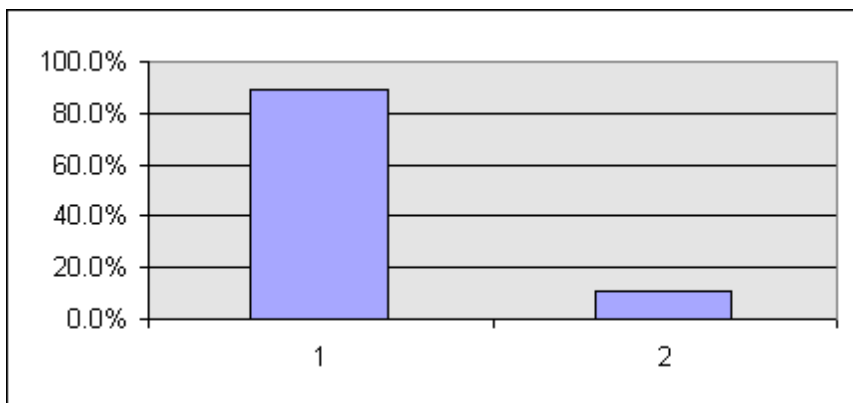
Profit from Trading	5.0%
Double of the Profit	12.0%
Imprisonment plus Monetary charges	83%



Question #10

Information & Stimulation

Yes	89.0%
No	11.0%



CONCLUSION:-

Insider trading is a practice that the market can do without. The overwhelming view of the participants in the study was that insider trading is not only harmful, but that it brings no benefits. Insider trading harms the market in a number of ways. It is said to erode confidence; to inhibit the capital raising process and to damage the efficiency of the market. It also of course directly harms investors who lose money to those who are engaged in insider trading. The view of insider trading as a victimless crime ignores the fact that in an insider trading transaction there is a party who loses value from the securities involved or is forced to take a loss. Perhaps it might be more accurate to say that insider trading is a crime with an unknowing victim and most of the participants in the study think that significant penalties imposed by the Government are not significant enough. The discussion of the impact of insider trading on market confidence was rich in irony. On the one hand, it was said that insider trading erodes confidence yet on the other hand, it was stated that it has not affected confidence, but if the law were to be repealed, confidence would suffer. One element of the confidence issue is that the impact of insider trading cannot be measured because confidence is already at a very low level and, in any event, investors expect that insider trading will occur. The interviews leave no doubt that small investors are considered to be important players in the market. Although there was no evidence that the market is unfair to small investors the strength of the feeling that they are not well treated suggests that there is considerable scope for improving the lot of small investors.