CHAPTER 1 INTRODUCTION

1.1. Background

Insider trading has been of interest to social scientists as well as to legal researchers. The business and finance literature include empirical studies on the impact of insider trading, the empirical measurement of the occurrence of insider trading, the size of abnormal returns, if any, and on the price discovery benefit of information content of insider trading. The legal literatures on insider trading are mainly concerned with the definition and judgement of insider trading cases.

The extent of researches carried out and literature available on insider trading is a testament in itself on the seriousness and importance placed on insider trading activities by academics and non-academics. It has been perceived that those who run the day to day business of a company such as top management or persons who make the ultimate business decisions such as directors and substantial shareholders possess information that is not available in the public domain.

The limited group of people holding important position of trusts in public-listed companies and have access to the private information are perceived to be able to make a gain for themselves by trading on the securities which they possess information on. Such actions may erode investors' confidence and result in misallocation of resources i.e. investors would channel their investments elsewhere and stifle companies which genuinely need to raise equity capitals. In order to avoid such consequences, laws against insider trading have been developed to prevent those who owe a fiduciary duty to the shareholders not to profit personally from information obtained in the course of their professional duties.
In Malaysia there are strict laws which make insider trading an offence. The severity of insider actions can be reflected in the punishment for such unlawful activity which ranges from an imprisonment term of up to ten years of a fine of not less than one million Ringgit. Furthermore, civil remedies can also be instituted against a person whether proven guilty of such criminal acts or not. Under the Securities Industry Act 1983, such civil proceedings can be instituted by a person who has suffered loss or by the Securities Commission on behalf of the affected person.

With such monetary and prison penalties associated with insider trading, does insider activities exist in Malaysia? There are many studies carried out overseas to prove that there is evidence of insider trading in spite of laws prohibiting insider trading. However, there has not been any published empirical study carried out to determine the existence of insider trading in Malaysia based on an analysis of the daily share price movements. Although statutes have defined who an insider is and require disclosure of insider trades, it is still very difficult to identify true insiders in the practical sense. As such this study sets to find out directly activities of registered insiders to see whether daily stock movement is in any way affected by the published purchases or disposals of their interest.

1.2. Laws on Insider Trading

Insider trading tend to distort the efficient allocation of resources. In order to avoid such distortion, most countries that have internationally recognised stock exchanges enacted laws that define and penalise insider trading. However, the definition of insider, insider information and what constitutes illegal insider trading varies from one country to the other. Therefore, the legal environment that governs insider trading greatly influences the research methodology on insider trading studies. It is therefore important that we gain an understanding of the laws, legislations and practices surrounding insider trading.
1.2.1 Laws and Regulatory Agencies

Under the common law, insider trading can be regarded as a violation of fiduciary duty. Insider trading erodes fiduciary duty that lies at the heart of business organisations. Fiduciaries are bound to act in the interests of those who depend on them even if these interests goes against the interests of the fiduciaries. However, arguments for permitting insider trading states that such activity will increase the likelihood of fiduciaries to act in the interest of everybody including the company. Jennifer Moore in her article "What is Really Unethical about Insider Trading" argued that such activity will encourage new inventions, creative deals and efficient new management practices which will ultimately increase profitability, strength and overall competitiveness of the company. It is with such difficulty to argue against insider trading and establish liability under the common law that we refer to Acts of Parliaments on insider trading.

There are two Acts of Parliament that govern insider trading in Malaysia:
1. Companies Act 1965; and
2. Securities Industry Act 1983 (SIA)

Furthermore, companies listed on the Kuala Lumpur Stock Exchange (KLSE) are governed by Rules and Listing Requirements issued by the KLSE.

The SIA provides the regulatory framework of the securities industry in Malaysia. The SIA has provisions against false trading, market rigging and insider dealing. In 1993 with the advent of the Securities Commission Act 1993, the Securities Commission (SC), which is the body that regulates the securities industry as a whole, was established to administer the SIA. The SC has wide enforcement and investigation powers ensuring the smooth running of a fair and orderly market.

The laws governing insider trading in Singapore are quite similar in many aspects and form to the Malaysian laws. The two main legislations which govern insider trading are the Companies (Amendment) Act 1984 and the Securities Industry Act
(SIA) 1986. Companies listed on the Singapore Stock Exchange must also adhere to the Listing Manual issued by the Singapore Stock Exchange. Chapter 12 of the Listing Manual Corporate Disclosure Policy lists out Policy on insider trading. Under the Singaporean SIA, the Monetary Authority of Singapore is the ultimate authority that regulates the securities industry as a whole.

In the USA, the most important piece of legislation which regulates insider trading is the Securities Exchange Act (1934) (SEA). The Act is enforced by the Justice Department and the Securities Exchange Commission (SEC). The SEC can conduct formal investigations and administrative proceedings against local stock exchanges, brokers, associations and individuals. The SEC also issues rules to govern the running of the securities industry and these rules are enforceable in courts of law.

1.2.2 Who is An Insider?

Section 89E of the Malaysian SIA define an insider as a person who:

a) Possesses information that is not generally available which on becoming generally available a reasonable person would expect it to have a material effect on the price or the value of securities; and

b) Knows or ought reasonably to know that the information is not generally available.

This definition is encompassing and wide. It compliments the definition of an "officer" under Section 132A of the Companies Act which includes a person who at any time within the preceding twelve months was an officer of the corporation. Insider therefore includes not only directors, secretary, employee of a company, agent (e.g. banker, advocate & solicitor, auditor, accountant or stock broker), receiver and manager or liquidators but also substantial shareholders, tippees or
even any persons having business relationship with or connected to the company. It also covers a person who has resigned from a company but had connection with the company within the past one year. Therefore, an officer can be liable under the Malaysian laws for any insider trading acts committed even after an officer had resigned from the company within the past one year.

The Singaporean definition is more restrictive. Under Section 103 of the SIA (1986) an insider is person who is connected with a body corporate or a person who receive price-sensitive information from a person who is connected with a body corporate. Examples of insider includes officer of the body corporate, substantial shareholder in that body or a related body or person occupying a position that may reasonably be expected to give him access to price-sensitive information by virtue of a professional or business relationship.

In the US, the SEA defined insiders to include officers with decision-making authority over the operations of the company, all members of the board of directors, and beneficial owners of more than ten percent of the company's stock. American Courts have interpreted Rule 10b-5 of the SEA to define insider as someone who has access directly or indirectly to information which is intended only for corporate purpose. Therefore, a tippee is also considered an insider in the US.

1.2.3 What is Insider Information?

The Malaysian SIA defines information to include matters that are not known to the public, matters relating to the future, information relating to the financial performance of a corporation and such information when generally available would tend to have a material effect on the price or value of securities. The definition implies that the information is not publicly available and is price-sensitive.
The Malaysian definition is quite similar to the Singaporean definition where the information "need not be specific, special or confidential but must not be generally available. If available, it would be likely to materially affect the price of securities." (Ter and Tay (1986)).

In the USA, insider information is taken to mean the material facts not generally known to the public and the information if known can affect the value of the stock. (Boland 1985). It can be loosely defined as private information that a reasonable investor would consider important in the decision to buy or sell a corporation's security (Jeng, Metrick and Zeckhauster (1999)).

1.2.4 Restrictions on Insiders
The similarity of the Malaysian, Singaporean and US is that all these three countries have both direct and indirect regulations to discourage and to prohibit insider trading.

The Malaysian SIA prohibits an insider from dealing, whether directly or through a third person, with securities which the insider possesses inside information. The Act also prohibits an insider from causing inside information to be communicated to another person whom the insider reasonably knows the other person will deal with such securities. Section 132A of the Companies Act prohibits an officer, agent or employee of a corporation and even an officer of the Stock Exchange from dealing with securities which the insider possess price sensitive information.

Chapter Nine of the KLSE listing rules also specifically prohibits insider trading based on material information which is not known to the investing public. The listing rules also prohibit insiders from trading on publicly available material information until the public has had an opportunity to evaluate such information thoroughly.
In short, the prohibition of insider trading which deals with the misuse of corporate information under the Malaysian statutes and regulations is a general offense not specifically directed at directors or officers. There are three elements of the offense:

1. An insider must be in possession of information that is not generally available;
2. The information must be the sort of information that, if it were generally available, a reasonable person would expect it to have effect on the price or value of securities of a corporation;
3. An insider must have traded in those securities or procured another person to do so. If the securities are listed securities, the insider must have passed on the information to someone else knowing (or ought to have known) that that person would deal in the securities or in turn procure some third person to do so.

The SIA also requires notice to be given to the SC if a person or bare trustee becomes a substantial shareholder of a company or if there is any change in interest of a substantial shareholder. Section 7 of the Securities Industry (Reporting of Substantial Shareholding) Regulations 1998 define substantial shareholder to mean a shareholder holding not less than 2 per centum of the aggregate of the nominal amount of all voting shares in the company. Such notice must be given within seven days after the date of the occurrence of the change. Section 69I of the Companies Act 1965 requires a copy of the notice to be served on the KLSE the day the notice is given.

Directors of listed companies have a general duty to make disclosures under the Companies Act 1965. A director must give notice to the company within fourteen days from any change in interest in the company and serve a copy of the notice on the KLSE. Under Section 69L and Section 134 of the Companies Act, companies must also maintain a register of substantial shareholders and a register of directors' interest.
In Singapore, Section 42 of the Singaporean SIA makes it mandatory for dealers, investment advisors and financial journalist to maintain a register of the securities in which he/she has an interest. Companies are also required to maintain a register of substantial shareholders and a register of directors' interests. The Singaporean SIA 1986 prohibits any insider from dealing while in possession of price-sensitive information or communicate to another person on price sensitive information.

The SEA makes it unlawful to use private nonpublic information to make personal gain from trades in securities. The SEA also prohibits short swing profits by registered insiders.\(^1\) Imposing numerous reporting requirements, Section 16 of the SEA, requires insiders to file an initial report to the SEC identifying themselves as insiders and report changes in their shareholding interest in companies. Trades by insiders must be reported to the SEC within the first 10 days of the end of month following the trade. Furthermore, an individual who acquires 5 percent of a company's stock must also disclose this position within 10 days. The disclosure documents are made publicly by the SEC immediately upon filing on the SEC Form 4.

1.3. The Objective Of This Study

In Malaysia, there are no published studies carried out to provide direct evidence on the strong-from efficiency of the Efficient Market Hypothesis (EMH). An inference on the strong-form can only be implied from conclusion of empirical testings carried out to test semi strong-from efficiency via event studies in the local context.

\(^1\) A short-swing transaction involves a matching purchase and sale, or sale and purchase, within a six-month period.
The objective of this study is to determine whether there is statistical evidence to suggest the existence of insider trading in the Kuala Lumpur Stock Exchange based on an analysis of daily share price movement on a short horizon.

If there is evidence that the KLSE is not efficient in the strong-form sense, then we will answer the following questions:

1. Whether abnormal returns due to insider trading is more significant on the KLSE Main Board or KLSE Second Board companies.

2. Whether insider-trading signals provide valuable investment information. Such signals will allow us to determine whether outsiders can profit from knowing insider trading activity i.e. if outsiders can use the public filings of insiders to construct successful trading strategies.

With the above two objectives in mind, this study will conduct an in-depth analysis on the daily price movement of shares traded by registered insiders on the KLSE.

This study is carried out purely for academic purposes in finding out whether insider trading exists in the Malaysian stock exchange. The results of this study do not in any way imply the laxity or inefficiency of any regulatory bodies. On the same note, the companies and their respective substantial shareholders, directors or officers sampled in this study do not in any way imply any illegal activities or wrong doings other than sampling conducted solely for academic research. Nevertheless, the outcome of this study may be helpful to the regulatory authorities especially the Securities Commission to gauge the effectiveness of existing legislation on insider trading and for further positive development of the legal environment on insider trading.
1.4. Limitation of the Study

This study relies heavily on secondary data. The major disadvantage of secondary data is that they are not designed specifically to meet the present project needs. However, due to the sensitive and secretive nature of insider trades and the difficulty in obtaining real insider trades and positively confirming such specific illegal insider trade, secondary data will have to be used to infer on such activities.

While insiders are required to register their transactions under the SIA and Companies Act, they might not accurately register their activity. This further exemplifies the problem of identifying true insiders. The insiders may intentionally use others to complete trades based on inside information. Other people may come to possess and utilise inside information. The filings made with the KLSE may not provide information on such transactions or returns. Empirical studies using filings made to the KLSE may not correctly identify the presence of true insider trading or accurately analyse signals of such activities.

It is very difficult to ascertain actual abnormal returns that insiders make from their purchases and sales. It is extremely difficult to determine the actual holding period for insider purchases. As for sales, there is no way to know when the stocks were actually purchased. In view of such difficulties, this study employ a 150-day holding period for the stocks of insider buy and insider sale and calculate hypothetical insider profits from purchases and sales on this basis. Nevertheless, some insiders may carry out their trade longer than the study window covered in this study.

This study is sampled based on convenience sampling for one week's filing of change in interest of registered insiders made to the KLSE. Only one-weeks' filing is used here due to the high volume of data churned out consequentially from the one week's filing. Filings made at other dates may possibly reveal different trends and results. This study is also based on analysis of daily price
movement and did not take into account the volume of shares traded in each
day. To incorporate volume of shares traded for analysis may stretch this study
beyond the limitations imposed for submission of this paper. Nevertheless the
one-week filing has yielded more than 10,000 data which is sufficient for
purposes of this study.

Another limitation of this study is that the transactions sampled for this study
have not been controlled for other events or noises such as year end corporate
earnings announcements, takeover announcements, etc. With nearly 300
transactions sampled and all having occurred at different dates, it would be
extremely difficult to track and control for events or noises that coincide with the
transaction dates.

1.5. Organisation of the Report

The report will consist of five chapters.

- **Chapter 1** provides a background to insider trading and an understanding
  of the legal environment surrounding insider trading in United States,
  Singapore and Malaysia. Relevant regulations and statutes governing
  insider trading will be looked at. This is followed by the objective of the
  research and limitation of the research.

- **Chapter 2** will consist of the review of other findings and studies in the
  related area of EMH. The reviews will predominantly focus on researches
carried out in the US where there are many literature in this area. Studies
carried out in Singapore will also be reviewed due to the similar legal
background in the laws governing insider trading in Malaysia and
Singapore and coupled with the proximity of the Singaporean Stock
Exchange (SES) and KLSE. Malaysian literatures on EMH will then be
reviewed.
- **Chapter 3** will cover the research methodology of this study which includes the theoretical framework, establishing the hypothesis to be tested, detailing out the types and sources of data, justification for sample design and market proxy and a description of data analysis technique.

- **Chapter 4** will provide the result of the findings on the hypotheses established under chapter 3.

- **Chapter 5** will be the conclusion, recommendations for future research and policy implications from findings of this study.