INSIDER TRADING: ILLEGAL TRADING IN STOCK MARKET WITH MATERIAL NON-PUBLIC INFORMATION IN BRAZIL

The illegal conduct of trading in stock market, based on material non-public information, commonly known as insider trading, has had little attention from inquiries in national (Brazilian) scope. Nevertheless, this crime brings forward many relevant issues. In this article, I will introduce three of them, which I consider most important: i) what is the importance of information in stock price formation; ii) who may be defined as insider; and iii) which is the incriminating norm's legally protected interest (1).

In Brazil, insider trading was criminalized by the Law n. 10.303, of 31 October 2001, which introduced the Article 27-D in the Securities Market Act (Law n. 6.385/1976) (2), read as follows:

Art. 27-D. Using relevant non-public information, previously known and about what secrecy must be held, capable of offering, oneself or to someone else, undue advantage, by trading securities, on its own or on a third party's behalf.

Penalty – imprisonment, from 1 (one) to 5 (five) years, and fine of up to 3 (three) times the sum of the illicit advantage gained as a result of the crime.

Although it's been more than ten years since the criminalization of this conduct, there are no more than five issued indictments up to now, in Brazil. Maybe, this can be explained by the existing gaps in both the control of relevant information in stock market – and of all its reflections – and the understanding of the penal law.

With the intention to shed light on each of the three issues presented above, I must demonstrate, foremost, how the information flow reverberates in stock prices formation, i.e., how information influences the constitution of the stock price in securities markets.

At first, one must know that, in stock market, the traffic of information reaches probably its utmost dynamics, not just for its velocity, but mainly for the possibility of directing and redirecting large amounts of resources within moments. «A trade performed with wrong information or without it can cause a disadvantage not only to the involved parties, but also to collectivity, if one considers the extent of the stock market in society» (3).

There's no doubt stakeholders act in a market naturally characterized by a high risk level. The information disclosure does not intend to reduce or prevent that risk, but to make it known and acceptable, as a measure of avoiding possible responsibility levels' surpass. Consequently, even if investors were provided with all necessary information, they would still incur in risks intrinsic to the socioeconomic relation, once there's no way of carrying out any kind of control over them. The information just provides them

(1) The Brazilian Criminal-Law scholars have been highly influenced by the German Rechtsgut, what has been commonly translated as hem juridico, i.e., literally, legal good. For this essay, author and translator have agreed to use the phrase legally protected interest, excluded from this definition purely economic interests.


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visibility. In other words, it’s not about averting the pure and simple risks assumption, but preventing that those risks derive from lack or inaccuracy of information. Within this context, the legal system has the role of ensuring the publicizing of the necessary information to enable stakeholders to make their own decisions, without the intent of avoiding that they eventually make wrong investment decisions. Therefore, information must be available to the investor, however its interpretation and employment ought to be an individual task to which government should remain distant (4).

Taking our lead from the «efficient-market hypothesis» developed during the 1960s by the Chicago School, regarding the relation between stock prices information and formation, the stock market is efficient when all information is instantly available, so that investors, based on that information, become capable of pricing correctly the assets (5). The most often accepted concept of efficient market, within studies on speculative markets behavior, defines that prices reflect completely and instantly all available info, so that any new significant information shall not be used for extraordinary gains. Thereby, in theory, the market reproduces all available info. A significant issue concerns this information relevance, what enables the rating of profits and risks involved in a stock (6).

Thus, one can affirm that, if the stocks of an oil company X are being traded in Brazilian stock market by US$ 20.00 each, this price translates the combination of «all» information related, directly or indirectly, to the company and to the commercial sector in which she operates, and that already has been publicized to the market, as, for instance: a) the oil price upward/downward trend; b) the oil barrels/day production capacity; c) the increase/decrease production forecast; d) the expectation of international consumption growth/reduction; e) the annual profit increase/decrease prognosis; etc. I.e., the current quotation portrays the «fair» price that the market is willing to pay for this corporation stocks, taking into account all available info.

All gathered disclosed material about the company is used to project its economic value and this is reflected in the price its stocks are being traded in stock market; in this manner, any info suppression or alteration will directly reverberate in this rating and, consequently, in the stock prices. If any of this information were omitted, the quotation shall oscillate, either positively or negatively. Therefore, if the market became aware of the discovery of a new oil field, accountable for the barrels’ 10% daily production raise, that info, already publicized, will constitute the oil corporation’s economic value and, as a consequence, the stocks’ quotations.

Information is essential, thus, in orienting investors’ and market agents’ decisions. By its nature, content and source, though, it might be reserved to a restricted circle of persons for a given time, being disclosed to the market only when administrators feel it’s opportune. In this sense, the disclosure moment, as the info quality, will also be able to influence the market agents’ decisions, with significative reflections in stocks’ prices.

So that the investors are properly qualified to make a clear decision, by their own, it’s important that they have access, to the full extent, to all necessary info. To this effect, information becomes one of the main investors’ protected interests in stock market (7). Therefore, the investor must know, as far as possible, all about financial security, financ-

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cial market and the issuing companies’ business info considered relevant to the price quotation, for, in all these fields, the advanced info may result in high economic influence (\(^4\)).

Making use of material non-public information creates illegitimate advantage to some investors over the other stock market participants (\(^5\)). Information and, therefore, transparency in stock market are primary elements for the proper stock pricing. More information available, the more faithfully the market will reflect the reality of corporations, providing, then, tranquil investment choices. Otherwise, any false or manipulated info will lead to fictional pricing and to an artificial stock market (\(^6\)).

Equal conditions in accessing information is fundamental to investors, once it’s from the combination of «all» available info that the market, with its supra-individual nature, will have suitable conditions to reach a good economic evaluation of companies and, so, to check if the trading shares depict a «fair» price.

When someone, having a privileged info, trades securities in the stock market, this person holds an undue advantage because he knows something that, after its disclosure, will repercuss in share prices. The insider is able to do, beforehand, a company’s economic evaluation that is not possible to the other market’s participants. Due to this privilege, he knows that given company already has a superior or an inferior economic value to the one rated by the market and, consequently, that the stocks are not translating its «real» price, what will only happen after the information announcement to the market. I.e., if an insider knew that an oil company had discovered a new oil field, he recognizes that its value is superior to the actual market pricing. The company stocks, therefore, are not reflecting the company’s real economic value. For instance, if this company shares were being traded at a price X, this price translates the company’s economic value according to the facts yet disclosed and known by the market. So, the discovery of the new oil field has not been embodied to it. The insider, in turn, already knows that the company has a higher economic value and, thereby, that her stocks are not transcribing her real value and should be traded by X (actual economic value) plus Y (value ascribed to the new discovery). The discovery of the oil field is real, a fact; not yet disclosed to public, though. In this case, if the insider bought the company’s shares, he will benefit from this privileged info to purchase something for which solely he knows to be paying an inferior price, disconnected, then, to the company’s reality.

Based on these explanations, insider would be the person who, due to his situation or function, has access to relevant information of a certain company and, by handling it, trades the company’s shares in stock market. It means that, to be depicted as insider, one doesn’t necessarily must have direct bond with the company of which stocks are being traded. To illustrate it – what will be helpful in delineating this figure -, I’ll make use of a Supreme Court of the United States’ Judgment on this issue. In this country, the regulation and the control of insider trading started in 1934 and, since then, control procedures have improved over theses conducts.

One of the first Judgments in which the Securities Exchange Act’s (1942) Rule 10b-5 was implemented was the case Cady, Roberts & Co. versus Securities and Exchange Commission, wherein third parties who had no functional bond with the company, but who

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\(^5\) Proença, 2005, p. 213.

had direct and indirect access to privileged info due to relations kept with its administrators, were acknowledged as insiders (11).

On October 23, 1959, Roy T. Hurley, president of Curtiss-Wright Corporation's Administration Board, invited nearly 2,000 people, among journalists, military, economists and financial market agents, for the announcement of a new kind of engine that was being developed by the company. On November 24, the national press published the news. On this day, the company stocks had a remarkable increase of US$ 3.25, more than 10%, closing the day at US$ 35.25. Between November 6 and 23, Robert M. Gintel, partner at the broker-dealer Cady, Roberts & Co., bought approximately 11,000 stocks of Curtiss-Wright to several portfolios he administered. At the November 24 high, he started to sell them, reaching, by the end of the day, an amount of 2,200 stocks sold. In the next day, the company's stocks came up to US$ 40.75, and Gintel, by 11:00am, had sold 4,300 more stocks.

On the morning of the 25th, the Curtiss-Wright directors, including J. Cheever Codwin, assembled and agreed to reduce the quarterly dividends. The company had been paying US$ 0.625 per share on the three first trimesters of the year and she would reduce it, yet on the fourth trimester, to US$ 0.375 per share. By 11:00am, the Board authorized the transmission of the information to the New York Stock Exchange, and the secretary immediately left the room to do so. Due to data transmission problems, the telegram, sent at 11:12am, had not yet arrived to the Bourse up to 12:29pm. Besides that, it was customary to inform the Dow Jones News Ticker about any change in paying the dividends. Nevertheless, apparently by mistake, the Wall Street Journal had not published the news by 11:45am and the release did not come out at Dow Jones Ticker until 11:48am.

It turns out that, during a break in Curtiss-Wright's Board meeting, Codwin phoned to Gintel's office and left a message, forewarning that the company's dividends had been cut. Right after receiving this information, Gintel ordered two sales of Curtiss-Wright's shares. The first, of 2,000 stocks; the second, of 5,000 stocks, among which were Codwin's shares.

When the dividend reduction release was announced in the Dow Jones News Ticker screen, at 11:48am, the Bourse had to put on hold the trading of Curtiss-Wright's stocks, because of the large number of sale orders. By the end of the day, the stocks closed quoted at US$ 34.90.

The Securities and Exchange Commission brought an action in order to find out if Cady, Roberts & Co. and Gintel, the broker-dealer's partner, had violated the Section 10(b) of the Securities Exchange Act of 1934, and the Rule 10b-5 along with the Section 17(a) of the Securities Act of 1933.

The consequences were a 20-day suspension for Gintel from the Stock Market and a US$ 3,000.00 fine. The broker-dealer was not accounted for violating the Section 16(b), once it did not have 10% of the company shares. Besides, Codwin, Curtiss-Wright's director, didn't suffer any punishment, since it was established he didn't use, directly, the information to trade, only transmitting it to the broker, which, made use of that.

The case became notable by the influence it had for the Rule 10b-5 application, which turned out to be one of the broader mechanisms to repress the improper use of material information. The decision set that the insiders were not limited to administrators, supervisors and employees, so that third parties, not functionally bounded to the

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company and who had had privileged access to certain info, could be acknowledged as such. Therefore, the Rule 10b-5 is grounded on the existence of any relationship that enables direct or indirect access to confidential information, and on the disloyalty of who deals with the not yet disclosed information, knowing that it is not available to the public (12).

This understanding on who are the ones that might be recognized as insiders is perfectly suitable to the Brazilian legislation on the regulation of the conduct of people that have direct and/or indirect access to privileged information and trade companies’ stocks at the Brazilian stock market (13).

The last issue that demands our attention regards the crime’s specific legal objectivity, its material object and protection outlines.

There’s no common understanding on the legally protected interest of the crime of trading in stock market, based on material non-public information. Scholars diverge; and by doing so, they can be distinguished in two major groups. The first one holds that the prohibition of this conduct seeks to protect the securities market’s perfect operation, thereby, ensuring the equality of opportunities among investors and developing a transparent environment, trustworthy to investors and savers. In other words, the legally protect interest would be, then, the trust in investors’ actions and the maintenance of an honest structure, clear and without breaches, that enables the equitable access to all the distinct operations performed at the stock market (14), (15).

The second group, which gathers a greater number of scholars, in its turn, advocates that the protected object is the investors’ trust in the orderly operation of the market. Barja de Quiroga asserts that the legally protect interest is circumscribed to the stock market’s scope, protecting the security of transactions and the reliance of investors (16). Sticking to the same line, Foffani argues that the protection is addressed to the preservation of the trust of all market traders and, mainly, of potential investors in the

(14) «Sin embargo otras opiniones consideran que la utilización abusiva de información privilegiada en el mercado de valores implica una lesión o puesta en peligro de los bienes jurídicos en conflicto, aunque en la determinación del bien jurídico es donde surgen las discrepancias. Además de las teorías que abogan por la sancionabilidad del abuso de información privilegiada, puesto que con ello se lesiona un interés patrimonial de carácter individual o también de naturaleza societaria, la doctrina dominante considera que con el abuso de información privilegiada referente al mercado de valores lo que se lesiona es el correcto funcionamiento del mercado de valores como bien jurídico colectivo orientado a satisfacer las necesidades en el ámbito económico. Lo que se produce con estos comportamientos es un daño a la confianza en el tráfico bursátil, una deformación en el equilibrio de mercado de valores y una de su competencia sobre bases igualitarias». JERICÓ OJEI, Utilización de la información privilegiada en el ámbito del Mercado de Valores. In: CORCUY BIDASOLO, Derecho Penal de la Empresa. Pamplona: Universidad Pública de Navarra, 2002, p. 187-190.
(15) Likewise, Gonzáles Rus asserts that: «El bien jurídico protegido es el correcto funcionamiento del mercado de valores, en el que la formación de los precios debe ser consecuencia de la normal evolución de las contrataciones. Ello constituye la garantía básica de los inversores, que deven concurrir al mismo en condiciones de igualdad de riesgo, y cuja confianza en la transparencia del mercado es indispensable para su mantenimiento y para el propio sistema económico y financiero». GONZÁLES RUS, Delitos Contra el Patrimonio y Contra el Orden Socioeconómico (VIII). Delitos relativos a la Propiedad Intelectual y Industrial, al Mercado y a los Consumidores. In: CORO SAR ROJAL (Org.), Curso de Derecho Penal Español. Madrid: Marcial Pons, 1996. Parte especial 1, p. 817.
integrity and in the loyal behavior, i.e., in the right functioning of financial markets. So, the prohibition of using material non-public information to trade in stock market would be directed to strengthen the investor’s confidence in the equilibrarian management of all market operators in accessing relevant info and, thus, to enhance the market’s proper performance. The illegitimate employment of informative disequilibrium, that would have relevancy in stock quotation, not only violates the economic ethics but also the efficiency of the market, for the reliance on an orderly market is associated with the seriousness of prices constitution (17), (18).

It seems obvious that, at some point, the criminalization of using privileged information to trade reflects on the raise of investors’ trust on capital market. That is so because, as Gómes Iniesta points out: «The economy of a country depends fundamentally on an essential and key piece for its development, its starter, the stock market, as component of the financial system [...]» (19). This, for its turn, carries out the important role of permanent bankrolling of companies in a market economy, channeling resources for the productive sector, thus, being vital that the markets become efficient and transparent. Therefore, in countries where there’s a concern of the State in correctly regulating the capital market, ensuring the transparency and the equitable info disclosure to the maximum, the markets will, most likely, become more reliable and appealing to investors.

However, I don’t agree with either group above, specially the second one, which argues that the crime of using privileged info protects, solely, the investors’ trust in the orderly operation of the market. I understand there’s a prior value, more solid and concrete, that the norm intends to safeguard (20).


(18) Íñigo Corroza also shares this point of view: «En este delito creo que se protege la confianza de los inversores en el sistema. Por eso dar la razón a los que han mantenido que éste es el bien jurídico. Con la conducta del art. 285 lo que se provoca es la quebra de la confianza en el sistema. Lo que se ha lesionado no la infracción de este deber institucional (y extremadamente configurado) es la confianza de los operadores en el mercado de valores. La lección se manifiesta aquí como un deterioro de la confianza en el mercado de valores, donde ya dijimos que la información era un bien escaso y fundamental». ÍNIGO CORROZA, La Relevancia del Fraude en los Delitos de Competencia. In: SILVA SÁNCHEZ (Dir.), Libertad Económica o Fraudes Punitibles?: riesgos penalmente relevantes y irrelevantes en la actividad económico-empresarial, 2003, p. 299-300.


(20) Regarding the protection of the investors’ trust in the securities market’s orderly operation, it seems that this interpretation is much more suitable to the conduct described at Art. 27-C, of the (Brazilian) Securities Market Act: «To perform simulated operations or to execute other fraudulent maneuvers, with the purpose of artificially altering the securities market’s orderly operation in securities, commodities and futures exchange, in over-the-counter trading or in organized OTC market, aiming to obtain undue advantage or profit, to oneself or to someone else, or to cause harm to third parties». Brazil, 2001. Law n. 10.303, of 31 October 2001. Likewise, the Directive 6/2003/EC cites that the criminalization of this conduct intends to ensure the market’s integrity and to promote the investor’s trust. Simulated operations – i.e., purchase and sale between investors, providing an actual papers exchange?, with the goal of, for instance, artificially raising the stocks’ price up to a certain level for, then, selling them to a specific investment fund or, indistinctly, to the market – jeopardize the investor’s trust in the securities market. This kind of operation, which artificially coins the stocks’ price, directly violates the good faith of investors, who purchase the paper with an artificially inflated price, believing they are paying a fair price, according to the supply and demand rules in a regular market. In this case, one may affirm that the legally protected interest is the system’s credibility and the investors’ trust; nevertheless, such an assertion would need a deeper investigation on the crime of market manipulation, which, for obvious reasons, won’t be analyzed

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For the shares quotation is nothing but the reflection of a company's economic value, at a certain moment, considering all information known by the market. If securities are investment contracts, it's extremely important that the investors know all relevant info about a company and, thus, have the same possibilities of doing the economic evaluation of the companies in which they are investing.

Based on what was previously presented, in my opinion, the incriminating norm on using material non-public information to trade in stock market is intended to secure a complex legally protect interest, of supra-individual nature, whilst, by seeking to preserve the conditions equality in accessing relevant information (21), it also focus on performing a patrimonial protection, consubstantiated in the prevention of obtaining improper patrimonial advantage. It is not possible to unite this two faces of this legally protect interest. The equality of circumstances in accessing information by investors must be protected, exactly because all shall have the same possibilities of economic evaluating the companies and in them investing resources. Information is considered relevant precisely for its patrimonial prominence. The economic character, therefore, is linked to the relevance of this information.

In this sense, it's important to look at the capital market as a unit, in which all participants must have equal conditions regarding the access of all required information to decide about investments, provided that, evidently, its disclosure won't jeopardize the ongoing business of companies. This equality, thus, has a supra-individual nature, i.e., it has an expectation of protecting the market and the investors, in a global sense. An information, when publicized, is accessible not only to one or other investor, but to all investors, both current and potential ones. In capital market, there's no face-to-face individualized negotiation; trading is impersonal. The protection, then, in the crime of using material non-public information to trade in stock market, comprehends the securities trades, on equal terms regarding the access to patrimonial prominence information to investors and capital market agents, in a supra-individual perspective. Despite the preservation of the investor before financial intermediaries or other market participants, it's necessary to set the difference between the protection of a particular investor, singly thought (individual protection), and the protection of investors as a whole, with a supra-individual nature (22). I'm not speaking of the direct relation between the purchaser and the seller of traded stocks in a specific operation, but of the equality of market at large, expecting all investor acquire all required info to evaluate and decide about the destination of their investments.

For this reason, the equality of terms regarding access to information, more than protecting individuals or groups, intends, mainly, to preserve the market as a whole. The automatic balance that could be achieved through the market operation is, de facto, substantially perturbed by the existence of information asymmetries, what could result in the imperfect wealth allocation (23).

Once the criminalization of using material non-public information to trade in stock market aims to protect a complex legally protect interest, it's important to examine, un-

(21) It’s important to make it clear: the equality of which I’m talking about is not the one between the investors. This equality, per se, will hardly be seen in the securities market’s scope, once there will always be persons more or less informed and more or less diligent in searching for information. Therefore, this inequality is natural in the market and it’s even salutary for its operation. The equality, as I refer, concerns the possibility of accessing the info that may influence stocks' price.

(22) Ferreira, 2001, p. 138-139.

(23) Ibidem, p. 143-145.
under the offensiveness principle, if we are facing a harmful crime or an endangerment crime.

As D’Avila teaches, the paradigm of crime as an offense to legally protect interest is an expression of one of the most important legacies of the liberal thought. The modern Criminal Law asserted the idea of «[...] a criminal law of (subsidiary) safeguarding of legally protect interest as paradigm of a secular, democratic and pluralist legal order, committed with the recognition and the assistance of individual rights and liberties» (25), being required, then, the examination of effective lesion (harmful crimes) or potential lesion (endangerment crimes) to the legally protected interest, so the result may be considered penally relevant.

Therefore, in our case, it’s important to analyze individually each facet of this complex legally protected interest. So, first, regarding the equality of terms in accessing patrimonial prominence information, when an insider, with privileged non-public info, uses it for his own or for other’s benefit, purchasing or selling stocks in the capital market, he breaks the equality among investors as a whole. About this conduct, I believe there’s no doubt that, if the organization disruption had happened, we would be staring at a lesion to this first face of the protected interest.

In relation to the second face of the legally protected interest, i.e., the patrimonial protection consubstantiated in the possibility of obtaining an undue patrimonial advantage, I believe we are facing a potential hazard to patrimony, once there’s the possibility of achieving an unjustified patrimonial benefit through trading with securities. Precisely, according to D’Avila, we could classify this kind of jeopardy as a crime of aptitude, to the extent that the criminal type phrasing demands the «capable of offering undue advantage», i.e.: «(Abstract) aptitude whose need of inquiry has its raison d’être in the criminal norm itself» (25). The use of a privileged information must present, in such terms, aptitude, in other words, concrete potentiality to influence stock prices, producing undue advantage, as expressed on the criminal type, what leads me, logically, to classify this wrongdoing, among the endangerment crimes, as a crime of aptitude.

ZUSAMMENFASSUNG

Der Beitrag zielt darauf ab, kurz die wichtigsten Aspekte des Tatbestandes des strafbaren Insiderhandels im brasilianischen Rechtssystem zu erläutern, der mit Gesetz Nr. 10.303 vom 31. Oktober 2001 («Uso indevido de informação privilegiada no mercado de capitais») eingeführt worden ist, aber

(25) Aware of the limits of this essay, I’m unable to deepen the analysis of the different classifications of endangerment crimes; therefore, I turn to Fabio Roberto D’Avila’s own lesson, quoting a brief passage of his Ofensividade e Crimes Omissivos Próprios: «Diferentemente dos crimes de perigo de concreto pôr- em-perigo no que é necessário verificar a ocorrência de um concreto perigo para o bem jurídico, bem como dos crimes de perigo abstrato no que essa verificação é desnecessária, encontrar-se-iam os crimes de perigo abstrato-concreto que caracterizam-se por um acertamento a ser procedido pelo juiz-gador, em termos de idoneidade do fato em atingir o bem protegido pela norma. Essa idoneidade, entretanto, consiste em uma idoneidade abstrata, não determinada pela situação concreta, mas sim, por critérios gerais. Idoneidade (abstrata) cuja necessidade de apurar encontra a sua razão de ser na própria norma penal». D’AVILA, 2005, p. 104-105, nota 53.

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