Fine Line: Insider Trading and Director Dealings

OALP Finance and Capital Markets Newsletter

INTRODUCTION

As banks make efforts to comply with the Central Bank of Nigeria (**CBN**) recapitalisation circular,[1] which mandates an upward revision of minimum capital requirements for commercial, merchant, and non-interest banks in Nigeria, the equities capital market has become increasingly active. This surge in activity creates an environment ripe for potential insider trading. In such a dynamic market, where significant financial stakes are at play, the distinction between legitimate transactions and illegal activities becomes ever more critical.

Market integrity is foundational to the proper functioning of capital markets, ensuring that all participants operate on a level playing field, free from unfair advantages that could distort market prices or undermine investor confidence. However, market abuse, such as insider dealing and market manipulation, directly threatens this integrity. Insider dealing occurs when individuals with access to non-public information exploit it for personal gain, while market manipulation involves artificially influencing the price or volume of securities. Both practices disrupt market efficiency, distort the true value of securities, and erode trust in the financial system. Investors typically rely on publicly available information about a company's operations, financial performance, or upcoming developments to make informed decisions. However, those with access to confidential information, such as upcoming mergers or strong earnings reports, may be tempted to capitalize on these insights before they are publicly disclosed, positioning themselves to profit or avoid losses. This information asymmetry not only raises ethical concerns but also undermines the integrity of financial markets. This Newsletter delves into the murky world of insider trading and director dealings, exploring the fine line between legitimate transactions of directors and the illegal activities of insider trading.

WHAT IS INSIDER TRADING?

The Investments and Securities Act (ISA)[2], defines ""insider dealing" as when a person or group of persons who being in possession of some confidential and price-sensitive information not generally available to the public, utilizes such information to buy or sell securities for the benefit of himself, itself or any person. Similarly, the Rulebook of the Nigerian Exchange Limited (**NGX**) of 2015 (as amended) (the **NGX Rulebook**)[3] provides that Insider Dealing occurs when a person or group of persons who being in possession of some confidential and price-sensitive information not generally available to the public, utilizes such information to buy or sell securities for the benefit of himself, itself, or any person. Based on these definitions, an insider dealing constitutes the following elements: (i) the information is unpublished and not accessible to the general public, (ii) the information is price-sensitive and of a material effect, and (iii) the information is exploited in the securities market to generate profit or mitigate losses.

1. *Circular No. FPR/DIR/PUB/CIR002/009 to All Commercial, Merchant and Non-interest Banks; and Promoters of Proposed Banks dated 28 March 2024 titled Review of Minimum Capital Requirements for Commercial. Merchant and Non-Interest Banks in Nigeria.*
2. *Section 315 of the Investment and Securities Act, Cap 29, Laws of the Federation of Nigeria (2004) ("ISA 2007").*
3. *Rule 1.24 of the NGX Rule Book.*

WHO IS AN INSIDER?

For further context, under the Rules and Regulations of the Securities and Exchange Commission (SEC) 2013 ((as amended) (the **SEC Rules**)[4], anyone with access to unpublished, price-sensitive information is considered an "insider." This includes individuals with professional access to such information (e.g., auditors, lawyers, directors, executives, and other management officials, as well as family members and close associates of insiders. The NGX rule book expands insiders to include a shareholder who owns five per-cent or more of any class of securities or any member of the audit committee, who, by virtue of their connection with the company, have access to unpublished price-sensitive information related to the company's securities.[5] Thus, an insider is someone who, by virtue of their connection with the company, has gained access to unpublished price sensitive information regarding the company's securities.

PRICE SENSITIVE INFORMATION

Going by the NGX Rulebook, price sensitive information would include changes in the company's leadership, such as alterations in the Directorate or the appointment, resignation, or dismissal of principal officers. Also, proposed capital raisings, restructuring exercises, or changes in capital structure are deemed price sensitive information. Other notable events include notices of intention for takeovers, mergers, acquisitions, or divestments, as well as proposed alterations to the company's business model, major developments, changes in voting control, unusual or non-recurrent event, and any other information crucial for shareholders to accurately assess the company's position and avoid market manipulation.

WHAT ARE DIRECTORS' DEALINGS?

Investors constantly seek clues about a company's future performance. One source of valuable information for them are directors' dealings. Directors' dealings refer to transactions involving a company's securities undertaken by its directors or other insiders that are not based on non-public, price-sensitive information. Directors' dealings are legal provided they are not predicated on confidential, price-sensitive information not available to the public.

When carried out with full transparency and without leveraging non-public information for personal gain, such transactions are not only legal but also provide a valuable signal of insider confidence in the company's outlook.

Rule 400 1(e) of the SEC Rules places stringent limitations on the trading activities of insiders. It categorically prohibits any insider from trading directly or indirectly in the securities of a company if they are privy to material, non-public information, regardless of whether the transactions occur on a recognized securities exchange or through off-market dealings. However, this rule does not completely preclude directors from engaging in securities transactions. Directors are permitted to trade in the company's securities, provided that they do so without exploiting privileged information for personal benefit.[6] This balanced approach aims to preserve market integrity while allowing directors, who are often deeply invested in their companies, to align their financial interests with those of shareholders, as long as they adhere strictly to the principles of fairness and transparency.

Directors' dealings are made public, allowing investors to track their activities. This transparency not only helps prevent insider trading but also allows investors to interpret director purchases as a vote of confidence in the company's prospects, potentially influencing market sentiment positively. Directors' dealings encompasses a broad spectrum of activities beyond simple purchase and sales which include acquisitions and disposals, where directly buy or sell company shares as well as stock options and awards granted as part of their compensation package.

4. *Rule 400 of the SEC Rules.*
5. *Definition provision of the NGX Rule Book.*
6. *See Rule 400(2) of SEC Rules.*

COMMON, PROFITABLE AND HARD TO PROVE

Despite significant legal and reputational risks, insider trading remains a tempting prospect for some because of its potential for high profits and the perception of being difficult to detect. Studies have consistently highlighted how confidential and price-sensitive information available to directors, , by virtue of their positions, incentivizes them to exploit such knowledge for personal gain.[7] Insiders, especially those higher in the corporate hierarchy, are privy to more material and confidential information than outside investors.[8] This privileged access enables them to make well-informed trades based on upcoming events or undisclosed facts, allowing them to secure profits or avoid losses before the market reacts. The challenge in proving insider trading further contributes to its persistence. Even when insiders base trades on publicly available information, their deeper insights and ability to interpret market trends can give them a distinct advantage over outsiders. This blurs the line between trades driven by superior analysis and those rooted in non-public information. Additionally, with global companies, the complexity of the information flow adds another layer of difficulty to detection.

The infamous case of Martha Stewart in 2001 exemplifies both the allure and dangers of illegal insider trading. Stewart, a well-known entrepreneur and television personality, faced charges of obstruction of justice and securities fraud related to the ImClone case.[9] At the center of this scheme was Peter Bacanovic, Stewart's broker, who received insider information from Samuel Waksal, the CEO of ImClone. Stewart being aware of impending negative news from the FDA regarding ImClone's cancer drug, Erbitux, sold nearly 4,000 shares of ImClone stock. This move allegedly saved her from a substantial loss when the FDA announcement caused the stock price to plummet by 16% in a single day. The clandestine nature of insider trading often involves a complex web of communications and transactions, making it arduous for regulatory authorities to gather concrete evidence. Insider trading investigations typically require extensive evidence linking trades to material nonpublic information and demonstrating the trader's knowledge of its confidentiality. In Stewart's case, the prosecution struggled to definitively prove that she acted solely on the tip of Waksal, rather than the non-public reason for the sale, the impending FDA rejection. While Stewart faced charges, she was ultimately convicted of fewer offenses related to obstruction of justice and making false statements.

FINE LINE BETWEEN INSIDER TRADING AND DIRECTOR DEALINGS

The distinction between insider trading and director dealing can be thin and blurry, given that both involve insiders trading a company's securities and potentially possessing non-public information. Directors' dealings refer to transactions involving a company's securities by its directors or other insiders, conducted transparently and in full compliance with regulatory requirements. These dealings are tightly regulated to prevent any misuse of material, non-public information, and directors are only permitted to trade during pre-approved windows designed to ensure that no material, non-public information is in their possession. The sanctity of these transactions rests on two pillars: **timing and disclosure**. The timing safeguards the integrity of the market, while the requirement for timely disclosure ensures that the market remains fully informed. In this way, the broader principles of fairness and transparency are preserved, demarcating legitimate dealings from the unlawful practice of insider trading, which seeks to exploit confidential information for personal gain.

Conversely, insider trading represents a clear breach of both legal and ethical boundaries. It occurs when an individual, armed with confidential information that is not available to the public—such as knowledge of an upcoming merger, a significant earnings announcement, or any other material development—trades on this information to gain an undue advantage. This conduct not only violates securities laws but also undermines the very foundation of a fair and transparent market. It erodes trust and skews the level playing field that investors rely on, where all participants are presumed to operate with equal access to information.

The key to distinguishing between these two lies in understanding the circumstances surrounding the transaction. Directors' dealings are considered legal and ethically sound when they are devoid of any hint of information asymmetry.

7. *J. Fidrmuc, M. Goergen, and L. Renneboog, 'Insider Trading, News Releases and Ownership Concentration,' The Journal of Finance, 2006, 6(1): 2931–2973; Betzer, André; Theissen, Erik 2007. Insider trading and corporate Governance: The Case of Germany, CFR Working Paper, No. 07-07.*
8. *D. Aboody, and B. Lev, 'Information Asymmetry, R&D, and Insider Gains', The Journal of Finance, 2000, 55(6): 2747-2766; B. Ke, S. Huddart, and K. Petroni, 'What Insiders know about Future Earnings and How They Use It: Evidence from Insider Trades'. Journal of Accounting and Economics 2003, 35: 315–346*
9. *SEC v. Martha Stewart and Peter Bacanovi, 03 Civ. 4070 (RJH) (S.D.N.Y.) https://www.sec.gov/enforcement-litigation/litigation-releases/lr-19794*

For instance, a director might choose to increase their shareholding in the company following a period of publicly disclosed positive financial performance, signaling confidence in the company's future.

This act, when executed within legal trading windows and with requisite disclosures, can be seen as a vote of confidence and a legitimate expression of the director's alignment with shareholder interests. However, such act of purchase becomes insider trading when a Director's dealing in the company's securities are influenced by material non-public information. For example, if a director is aware of an imminent acquisition that is likely to boost the company's stock price and decides to buy shares before this information is made public, they have crossed the line into insider trading. Here, the timing is crucial: it is not the act of trading itself that is problematic, but the unfair advantage gained from information not yet available to the market.

Yet, even when directors' dealings comply with legal frameworks, ethical concerns remain. The timing of a trade, even if based on public information, can invite scrutiny. A director selling a substantial number of shares just before the announcement of negative news could raise questions about whether they had prior knowledge of undisclosed events, leading to suspicions of insider trading. Such scenarios underscore the delicate nature of directors' dealings, where the perception of fairness is often as critical as the reality. Additionally, directors may engage in selective disclosure, sharing confidential information with certain analysts or investors, thereby creating an uneven playing field. This selective dissemination distorts market dynamics and undermines investor trust. Even when directors act without ill intent, the mere possession of non-public information may unconsciously influence their decisions, further blurring the line between ethical behavior and misconduct.

In precis, the distinction, though delicate, is profoundly significant. Directors' dealings, when conducted within the boundaries of the law, are an acceptable and transparent form of engagement with the company's securities. In contrast, insider trading is a violation of legal and ethical standards, representing the misuse of insider knowledge to the detriment of market integrity.

RESTRICTIVE MEASURES ON INSIDER TRADING

To uphold market fairness and prevent the misuse of confidential information, regulatory frameworks impose stringent measures on insider trading. One such key control is the implementation of a "closed period," a designated window during which insiders are barred from trading in the company's securities, ensuring that no undue advantage is gained through access to non-public, price-sensitive information.

The NGX Rulebook provides for a "closed period", which is a period triggered by specific price sensitive events during which insiders of a company are restricted from trading in the company's securities. This period is designed to prevent insider trading and safeguard market integrity by ensuring that insiders do not exploit material, non-public information for personal gain.[10] Under the NGX Rulebook[11], a closed period is triggered by certain events, including the declaration of financial results; declaration of dividends (interim and final); Issue of securities by way of public offer or rights or bonus, and significant corporate actions such as mergers, takeovers, or buy-backs. It also covers major developments like expansion plans, project bids, or any material changes in the company's policies, operations, or plans that could significantly affect the company's stock price. Additionally, events such as operational disruptions due to natural disasters, litigation with substantial impact, or any other information that, in the opinion of the disclosing party, could materially influence the company's stock price, also trigger a closed period.

The closed period commences either fifteen (15) days before a scheduled Board of Directors meeting to discuss any of these matters or from the date the agenda papers are circulated, whichever comes first. It continues until twenty-four (24) hours after the price-sensitive information has been submitted to the NGX. The company is also required to notify the Exchange in advance of each closed period. Once this period ends, the trading window reopens, allowing insiders to resume trading. Any director's dealings within a closed period would constitute insider trading, as they would be based on material, non-public information.

10. *See Rule 17.17 of the NGX Rulebook.*
11. *See Rule 17.17 of the NGX Rulebook.*

Director's dealings are also subject to strict disclosure requirements to enhance transparency and discourage potential insider trading. Under the SEC Rules, Directors and other insiders of public companies are mandated to notify the SEC of the sale of their shares in the company or any purchase of shares within 48 hours of such sale or purchase.[12] Furthermore, the NGX Rulebook mandates the directors, persons discharging managerial responsibility and other insiders of any issuer to notify the issuer in writing through the Company Secretary of all transactions conducted on their own account in the issuer's shares on the day on which the transaction occurred and the Issuer must maintain a record of the transaction to be provided to the NGX within two business days of receiving a request from the NGX.[13]

Any person found guilty of insider trading is liable to a fine of not less than five hundred thousand naira or an amount equivalent to double the profit derived by him, or 7 years imprisonment in the case of a person not being a body corporate and a fine not less than one million naira or double the profit derived by it, if it is a body corporate under the ISA[14] while the NGX imposes a fine of an equivalent to three times the amount of profit or gain derived by the Dealing member involved in insider trading to be paid no later than 10 business days after the fine is imposed. . Although these rules specifically apply to members of the exchange, they serve as a valuable benchmark for determining when a director's dealing crosses into the realm of insider trading.

A VOYAGER'S LESSONS FROM OTHER JURISDICTIONS

The United States

In the United States (the U.S.), the evolution of insider trading law has largely stemmed from court decisions, with landmark cases shaping the legal framework. One of such case is **SEC v. Texas Gulf Sulphur Co.**[16], where the United States Securities and Exchange Commission (**U.S. SEC**) sued Texas Gulf Sulphur Co. and 12 of its employees for insider trading. Texas Gulf insiders purchased shares while withholding positive information on mining activities. Despite arguing that the information was not material, the court ruled that insiders had a duty to disclose or refrain from trading based on the withheld information. This case established a precedent in which material non-public information could create liability for insider trading, emphasizing the obligation to abstain or disclose.

The enactment of the Securities Exchange Act of 1934 marked a significant step toward the disclosure of company stock transactions, particularly by insiders. Individuals designated as insiders, including directors and executives, are subject to the stringent reporting requirements enforced by the SEC. These requirements, including filing SEC forms, such as Form 3 for initial ownership disclosure and Form 4 for transaction reporting, aim to ensure transparency and accountability. The U.S. has tightened the noose on insider dealing in the form of a stiffer penalty in extant statutes, such as the Insider Trading Sanctions Act 1984, the Insider Trading and Securities Fraud Enforcement Act 1988, the Securities Enforcement Remedies Act 1990, and The Financial Disclosure Regulation Act 2000. The aforementioned statutes also provide an avenue to institute civil and criminal lawsuits for practices tantamount to insider trading.

The U.S insider trading law places a duty on individuals in possession of material nonpublic information to disclose it before trading. Failure to do so, or trading while in possession of such information, can lead to legal repercussions. Unlike some European countries, the U.S. SEC maintains that trading with insider knowledge alone is sufficient for liability.

12. *Rule 401 of the SEC Rules 2013.*
13. *Rule 17.15, Part A of the NGX Rulebook.*
14. *Section 115 of the ISA.*
15. *Rule 17.15(e) of the NGX Rulebook.*
16. *401 F.2d 833 (2d Cir. 1968)*

For instance, in SEC v. Baker[17], proceedings were initiated against a defendant who traded on material non-public information, even though the defendant claimed the decision to trade preceded the information. This strict stance highlights the SEC's commitment to combatting insider trading and underscores the importance of transparency and disclosure in the US financial markets.

Overall, the U.S. regulatory framework on insider trading underscores the importance of fairness, transparency, and accountability in financial markets. By imposing obligations on insiders to disclose material information and refraining from trading on nonpublic knowledge, the law seeks to maintain market integrity and investor confidence. Through rigorous enforcement and adherence to reporting requirements, the SEC endeavors to uphold the principles of fairness and equal access to information in the US financial system.

The United Kingdom

In the United Kingdom (the U.K.), the anti-insider dealing regime is primarily governed by the Criminal Justice Act 1993 (**CJA**), which outlines three distinct offenses related to insider dealing. These offenses encompass dealing while in possession of inside information, encouraging others to deal with similar circumstances, and improperly disclosing information. [18] However, it is worth noting that CJA does not extend to private off-market transactions that lack professional intermediary involvement.[19] To secure successful prosecution under the CJA, specific elements must be established, including the knowledge of internal information, awareness of its insider source, and recognition of its potential significant impact on securities prices. Prosecution must demonstrate the accused's subjective awareness of the status of the information as inside information.[20]

The concept of 'price-sensitive information' is pivotal in the U.K. law, determining whether information, if made public, would likely affect securities prices significantly. The CJA criminalizes insider dealing when individuals trade securities based on such information, especially if they rely on professional intermediaries or engage in transactions in regulated markets. The definition of "dealing in securities" under the CJA is expansive, covering various actions, such as acquisition, disposal, or agreement to acquire or dispose, whether directly or indirectly. Interestingly, mere agreement to acquire or dispose of securities, even without execution, can constitute insider dealing under UK law.[21]

While insider dealing has been illegal in the UK since 1980, the broader concept of market abuse, encompassing insider dealing, was introduced in 2000. This allowed the Financial Services Authority (**FSA**) to pursue these offenses as civil matters.

CONCLUSION

Regulatory frameworks play a crucial role in combating insider trading, however, their effectiveness hinges heavily on a company's internal culture. Strong corporate governance, characterized by transparency and accountability, is the first line of defence. A culture that emphasizes upholding of directors' fiduciary duties, including acting in the company's best interests and refraining from secret profits, discourages insider dealing.[22] Research, such as the empirical study conducted by Dai et al[23], underscores the influence of corporate governance codes on mitigating insider dealing practices. This reveals that well-governed companies are more inclined to adopt voluntary policies that restrict insider dealing and are more effective in enforcing such policies. Moreover, they demonstrate a greater propensity for disciplined directors who are likely not to engage in insider dealing.

17. *Securities and Exchange Commission v. Peter Baker, et al., No. 1:19-cv-02565 (N.D. Ga. filed June 4, 2019).*
18. *See section 52(2) of the CJA.*
19. *A "professional intermediary" according to the Act refers to someone involved in the buying and selling of securities (stocks, bonds, etc.) who meets two criteria: (a) They offer services related to securities as their primary business activity, this could include acting as a stockbroker, investment advisor, or other financial professional involved in securities transactions; (b) they work for someone who offers these services.*
20. *See section 52(3) of the CJA.*
21. *See section 55 of the CJA.*

This trend is exemplified by anti-insider trading policies embraced by certain companies. For instance, the Dangote Cement Plc's Insider Trading Policy[24] imposes restrictions on directors and other insiders to trade only during trading windows approved by the company. This policy also requires that directors and senior management staff must disclose any trades in company securities within 10 calendar days of being an insider and any trade committed during their time as insiders must be approved in writing by the Chief Financial Oficer with such approval expiring after 48 hours. This is similar to the policies implemented in companies such as Microsoft, JPMorgan Chase, and Bank of America. Similar to the closed period rules under the NGX Rulebook, LeadFX's Blackout Period Policy[25] imposes restrictions on director trading during specific periods, such as before earnings announcements, to minimize suspicions of insider dealing. This policy, which extends to all employees, mandates a two-week blackout period preceding the quarterly and annual financial statements. Notably, this approach mirrors the practices adopted by industry giants, such as Tesla, Apple, and Meta.

By fostering a culture of compliance and implementing transparent practices, companies can significantly reduce the risk of insider trading and build investors' trust. This two-pronged approach, which combines strong regulations with robust internal controls, is essential for a healthy and fair investment environment.

22. *Shoroye, B., 2022. Insider dealing and corporate governance: Understanding the legal position of directors. Nnamdi Azikiwe University Journal of International Law and Jurisprudence, 13(1), pp.90-102.*
23. *L Dai, J Fu, J Kang, I Lee, 'Corporate Governance and the Profitability of Insider Trading', Journal of Corporate Finance, 2016, vol. 40: 235-253.*
24. *Dangote Cement Plc's Insider Trading Policy Insider Trading Policy - Dangote Cement Plc*
25. *Leadfx Inc. Insider Trading, Reporting & Blackout Policy. https://www.leadfxinc.com/files/doc_downloads/governance/LeadFX-Trading-and-Blackout-Policy.pdf*

FOR MORE INFORMATION, PLEASE CONTACT :

Folake Alabi
Partner
falabi@olaniwunajayi.net

Ogechi Onuoha
Senior Associate
oonuoha@olaniwunajayi.net

Abdulganiy Abdulganiy
Associate
aabdulganiy@olaniwunajayi.net