The (in)effectiveness of punishments for insider trading in Brazil.

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ABSTRACT: Insider trading occurs when individuals use privileged information or significant facts to gain profits in the financial market, undermining its fairness and trust. Although insider trading emerged as a significant issue in 1929, in Brazil, it was only criminalized in 2001 through an amendment made by Law No. 10,303 to the Corporations Law. Employing a deductive methodology, this article aimed to comprehend the potential penalties presently applicable to insider trading, tracing its evolution in Brazilian legislation, and assessing its effectiveness.

Keywords: insider trading. financial market. corporation law. criminal penalty.

1. Introduction

With the crash of the New York Stock Exchange in 1929 came the Great Depression. In an attempt to revive the economy, then-President Franklin Delano Roosevelt implemented the New Deal, an economic program aimed at controlling and regulating the market. Among the measures was, in a way, insider trading.

Insider trading, also known as the misuse of privileged information, is considered one of the most detrimental crimes in the financial market. This behavior has been subject to close scrutiny by regulatory authorities worldwide due to its negative impact on investor confidence and market integrity.

By trading based on undisclosed information not available to the public, market participants seek unfair advantages for themselves or third parties. In a market that relies on equitable and complete dissemination of information, insider trading represents one of the greatest threats to be faced.

Consisting of anticipating market moves with data not yet available to the general public, this practice was finally criminalized in Brazil in 2001, following a lengthy process of legislative changes. Thus, this article aimed to understand the possible current punishments for insider trading and analyze their effectiveness, assessing whether the legislation is - or is not - achieving the desired effect.

2. What is insider trading?

Insider trading became significant after the 1929 Great Depression, when the New York Stock Exchange crash triggered an economic crisis in the United States. The destabilization and lack of credibility in the financial market led the USA to adopt various measures aimed at controlling the market to make it more attractive to investors. Thus, the New Deal was created, a program designed to stabilize and regulate this market. As part of this effort, measures were implemented to regulate insider trading and control the financial market, including the establishment of the Security and Exchange Commission (SEC) in 1933 to oversee financial transactions and corporate reporting.

Today, insider trading is understood as the use of privileged information or material facts - typically before their disclosure to the media for financial gain. This concept, now criminalized as we will see further, is based on anticipating market movements with data not yet available to the public. It is clear that possessing confidential information is extremely common for companies, hence the illegality lies in using it for financial gain [1].

Thus, it is in this sense that the need for confidentiality duty is understood, especially for such privileged information, to prevent trading securities based on information available only to those connected to the company..

However, it is necessary to examine the requirements to configure this practice: (a) the presence of undisclosed privileged information to the market; (b) access to this privileged information;

and (c) the intention to trade taking advantage of this privileged information.

The existence of insider trading is only possible when there is privileged information in the specific case. When the agent is aware of this type of information, he has two options: disclose it (if possible) or refrain from trading based on it. These alternatives can be summarized in the expression "disclosure or refrain from trading" [2].

The prohibition of using privileged information in transactions is based on ethical and economic reasons. From an ethical point of view, it is deeply condemnable for someone to benefit from information to which others do not have access, constituting an act of disloyalty with even legal implications. In this perspective, combating insider trading represents a true "moralization" of the capital market .

From an economic standpoint, information asymmetry among market agents can result in operations where the security price does not reflect reality, ultimately undermining the necessary trust in commercial relationships. The detrimental effects can endanger the entire securities market.

For insider trading to be considered, it is not sufficient for there to be privileged information deserving of special protection. It is necessary for there to be an individual with access to this information, capable of using it in trading securities - this is the insider. Therefore, to determine the configuration of the insider trading offense, it is crucial to identify who can be considered an insider.

Furthermore, the commission of the insider trading offense is not complete without the actual execution of the transaction, with the insider's intention to gain advantage using the privileged information to which they had access. This is the subjective element of the crime, the animus driving the agent to carry out the operation.

It is important to note that, although it is relevant to investigate the intention to gain advantage, it is not necessary for the advantage to be actually obtained. In Brazil, legislation does not require the realization of harm to characterize the administrative offense. The existence of harm is essential to determine the obligation to compensate the harmed party, but it is not necessary to entail consequences in other aspects. Therefore, the mere execution of the transaction with the intention of causing harm (expressed in the intention to gain undue advantage) is considered a serious enough fact to apply the appropriate administrative disciplinary sanctions [2].

3. The risk of insider trading

As observed by some authors, over the years, investor confidence has been a crucial element in the formation and consolidation of the Brazilian securities market. Obtaining, encouraging, and maintaining this confidence has been essential tasks for the development of this market. In this context, the prohibition of insider trading plays a significant role.

Indeed, to attract investors, including foreigners, to trade securities in the Brazilian market, it was essential to ensure that the conduct of participants in this market followed ethical standards. Ultimately, the law aims not only to protect investors from practices such as the unfair use of privileged information but, above all, seeks to protect the capital market itself, its confidence, and its existence as a legal asset, especially in the face of globalization, massification, and anonymity of economic relations in the capital market. In this environment, trust in ethics, fairness, and free competition is fundamental to the existence and maintenance of the legal order of this market [2].

The protection aimed at investors' confidence in the securities market is justified by the crucial role that the market itself plays in the country's economic development. This importance is so significant that the preservation of information, the securities market, and investors' confidence become the main objectives of the regulations that regulate and combat insider trading.

It is crucial to emphasize that insider trading not only harms the parties involved in the economic transaction in question but, more broadly and significantly, affects the community within the securities market itself, and as mentioned earlier, the market itself. In other words, the practice directly harms the so-called diffuse interests - indivisible interests that go beyond the individual and whose holders are indeterminate persons but united by shared circumstances, such as investors in general.

In this sense, as noted by doctrine, beyond the potential for damage that this conduct may cause, it is important to remember that the abuse of information occurs in an anonymous and massified market, making it very difficult, if not impossible, to individually identify those harmed.

The economy greatly depends on a structured capital market, given its enormous contribution to a country's economic development. Therefore, the need for regulation of this market was verified, mainly regarding the protection of investors, responsible for capital injection.

With this in mind, as a rule, the legal assets to be protected in crimes against the capital market are divided into: investors' patrimonial interests, equality among investors, proper functioning of the capital market, interests of the issuer of securities, and investors' confidence [3]. Thus, what is aimed to be protected, in addition to the individual investor's assets, is their equity with others and the security they have to invest.

Obviously, in the financial market, strict equality

among participants is unfeasible since it is built by different investors with distinct characteristics, such as economic power and qualification. However, the equality in question refers to equal access to information among investors, even if there are personal differences among them.

Therefore, possessing investors' confidence makes the market attractive and efficient; hence, the repression of insider trading is justified, mainly due to market efficiency. In a situation where this behavior is not criminalized, publicly traded companies would have a conflict of interest with their own members, as they could access relevant information and use it freely for their own benefit.

This profitability through information is only possible due to the Efficient Markets Hypothesis, which understands that stock prices quickly reflect all available data. As there is competition among investors for higher gains, each one investigates information that could justify their transactions. Therefore, past information cannot generate high gains since it is already reflected in the current price. In other words, having undisclosed information means having a share whose price only those who own it know, allowing them to predict which operation to perform to obtain the highest possible profit. Thus, the market becomes completely unfair and unequal.

4. Insider trading in Brazilian legislation

Although, as mentioned, insider trading having its early signs during the New York Stock Exchange crash in 1929, its legal prediction in Brazilian law is very recent. In the year 1965, with Law N°. 4,728 [4], the National Monetary Council was attributed the regulation of the financial and capital markets, and the Central Bank was given the respective supervision and utilization of undisclosed information for one's own benefit or that of third parties, by shareholders or individuals who, by virtue of the positions they hold, have access to them, according to article 3, X.

Furthermore, article 4, §6, made reference to Chapter V of Law No. 4,595 [5], enacted in 1964, which addressed police sanctions for generic behaviors. However, the law did not specify the parameters for the exercise of police power, nor did it determine which acts could characterize the privileged use of information [6].

However, with Law No. 6,404 [7] of 1976 (the Corporations Law), repression of insider trading was addressed in a pioneering manner, better disciplining this issue in its articles 155 and 157. In it, a more detailed approach is observed, providing elements that not only better delineate insider trading but also allow for the reparation of damages suffered.

The first paragraph establishes a duty of confidentiality for the administrator, which covers any information not yet disclosed in the market. However, this undisclosed information must be capable of significantly influencing the quotation of securities, and the administrator must be aware of it by virtue of the function he/she performs. In addition to maintaining confidentiality about this information, the administrator cannot use it to gain advantages for himself or for third parties.

The second paragraph assigns an additional duty to the administrator: to prevent the information from being used by his subordinates or trusted third parties. This clearly constitutes a case of liability for omission, where it is the administrator's responsibility to prevent the leakage of confidential information.

Finally, the third paragraph addresses civil liability for the damages caused. In general terms, this liability requires verification of the prerequisites of civil liability: unlawful conduct, existence of damage or loss, and the causal link that connects them. However, if the injured person already had knowledge of the information when contracting, there is no room, logically, to claim compensation for losses and damages.

As for the sanctions, it is important to remember that insider trading was criminalized in the year 2001, by Law N°. 10,303 [8], but this time through its amendment in Law N°. 6,385/76 [9]. At the time, by its article 27-D, it was established that using such relevant undisclosed information to obtain undue advantage was subject to imprisonment, from one to five years, and a fine of up to three times the amount of profit obtained from the crime.

5. Repression of insider trading in Brazil

As presented, insider trading is a crime that can undermine the credibility of the financial market, resulting in losses for investors and the economy as a whole. In Brazil, this practice is prohibited, and the Securities and Exchange Commission (CVM) is responsible for monitoring and punishing cases of insider trading. However, there are still questions about the effectiveness of existing monitoring and punishment methods.

Although the CVM has the power to impose penalties for infractions, some voices in the market argue that the punishments are not sufficiently rigorous to deter the practice. The CVM's inability to prosecute criminals in the criminal sphere, limiting itself to applying administrative sanctions such as fines, is one of the main criticisms.

Additionally, some people question the effectiveness of the monitoring carried out by the CVM. The commission has a limited structure and restricted financial resources, which can make it difficult to identify cases of insider trading. Moreover, investigations can be lengthy, which may reduce the

effectiveness of punishments.

The forms of monitoring and punishment play a crucial role in repressing insider trading in Brazil. These measures aim to ensure the integrity of the financial market and prevent the use of privileged information for personal gain. However, there is an ongoing debate about the effectiveness of current monitoring and punishment strategies in the country.

In terms of monitoring, the Securities and Exchange Commission (CVM) plays a central role in regulating and overseeing the securities market in Brazil. The CVM has a specialized team dedicated to investigating reports of insider trading and other illicit practices. Additionally, the commission has access to a vast array of financial information and has the power to request information from companies and individuals involved in securities transactions. This information can be crucial for identifying cases of insider trading.

Nevertheless, despite these measures, some criticisms have been raised regarding the effectiveness of the CVM's monitoring. Some reports of insider trading have been investigated for long periods without conclusion. Additionally, the fines imposed by the CVM are often seen as insignificant compared to the profits obtained from insider trading. This can create a sense of impunity and encourage illicit practices.

Criticism also extends to the forms of punishment for insider trading in Brazil. Although it is considered a crime, the penalties are generally seen as relatively lenient. Law No. 10,303/2001 [8] establishes penalties of imprisonment ranging from 1 to 5 years, in addition to a fine of up to three times the value of the illicit advantage obtained. However, in many cases, the prison sentence is converted to community service or payment of food baskets.

An analysis of the judgments made by the Securities and Exchange Commission (CVM) between 2002 and 2016 revealed a total of 262 individuals indicted for the use of privileged information, either for their own benefit or for the company to which they are affiliated. These defendants were categorized as primary insiders, secondary insiders, and market agents. Primary and secondary insiders were previously defined, while market agents are individuals not directly linked to companies holding undisclosed information but who somehow gain access to this information to conduct business. Examples of these agents include individual investors, investment funds, and brokerage firms.

It is important to note that more than 67% of the defendants fall into the category of market agents, and many of them are repeat offenders in the accusations. These data show that the pedagogical effect of the regulations is not achieving the desired effect, suggesting legislative inefficiency in combating insider trading.

Regarding the penalties imposed by the agency on the defendants, it is observed that out of the 262 individuals indicted for the use of non-public information, 184 were acquitted and 78 were punished. Of the punishments imposed, the most frequent is the fine, with 70 occurrences, followed by a warning, with 5, and disqualifications, with 3 [10].

Furthermore, these data raise questions about the effectiveness of the legislation regarding insider trading. The open wording of the law regarding proof requirements and the interpretation and application of facts by the Securities and Exchange Commission may lead to the conclusion that the legislation is not being fully enforced. Based on the findings, only 3 out of 10 defendants are punished, despite strong indications of criminal activity, and recidivism is not treated as an aggravating factor. These factors suggest the need for a review of laws and enforcement processes to more effectively combat insider trading [10].

6. Conclusion

The criminalization of insider trading arises from the need for market regulation and assurance, providing security for investors, as the illegality of self-use and disclosure prevents abusive profit within the financial market. TAs a result, the United States has criminalized the practice since the 1929 crisis, making it a pioneer in this regard. Gradually, the need for regulation arose in other countries.. Therefore, in Brazil, the 1976 Law of Corporations introduced the criminalization of insider trading in an introductory manner. Subsequently, in 2001, reforms to the Law of Corporations introduced an important addition to insider trading: the criminalization of using information for personal gain.

Although the criminalization of insider trading and other regulatory measures have been implemented, criticisms have arisen regarding the effectiveness of CVM's supervision, as certain insider trading allegations remain under investigation for prolonged periods without resolution. Additionally, fines imposed by the CVM are often considered insignificant compared to the profits obtained from insider trading, which can foster a sense of impunity and encourage illicit behavior. Therefore, it is evident that the measures implemented by the Brazilian government to combat insider trading are insufficient for effectively repressing and preventing new illegal activities.

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