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Insider trading, broker scandals in Hungary and the Questor case¹

Introduction

Insider trading is considered to be an illicit activity in many countries from New Zealand to the United States. In order to constrain and control it they spend serious amount of money to maintain the liable agencies and market monitoring systems. The foreign economists generally write long analysis about the negative effects of this crime on economy and about the importance of market integrity, protection of investors and equality. There are several cases abroad when the court called to account for insider trading and employed serious sanctions. In Hungary, there are also some companies, who had suspicious activity, hence had criminal proceedings against them. The most notable and recent one is the Questor case. Both in Hungary and abroad, it is regarded as a frequently committed conduct. Since 1990, when the insider trading related provisions has become the part of the Hungarian Criminal Code, there were merely a few investigation after this crime and three cases entered the court phase, but only two ended with condemnation. Virtually, there are no calling to account practice in relation to insider trading in the last quarter century in Hungary.²

The undermentioned case shows a good example for this.³

The Chief Prosecutor's Office established the following facts in its indictment⁴: the defendant in the second degree, who was the general manager of the N. Rt., entered with the stocks of the Rt. into the operator trade market of the Foreign Stock Exchange. He was engaged in negotiations with a local brokerage firm about the

¹ This paper was supported by the János Bolyai Research Scholarship of the Hungarian Academy of Sciences.

² Kaszás Ágnes Roxán: The theory and practice of insider trading. Pécs, 2006. (kézirat) p. 3.

³ Kaszás Á. R. op. cit. pp. 10-13.

⁴ Fővárosi Főügyészség G.7465/1994.

introduction, which was expected to cause price increase for the stocks, but he made a submission about this matter for the board of directors only two months later, which was approved with a decree that day. Before nine days to the submission, the defendants in the first and second degree entrusted the L. B. Rt. and G. Rt. to buy 15000 amount of stocks between 900 Ft to 1800 Ft limit prices for N. Rt., which was based on pre-calculation and their aim was to achieve gain in rates. Prior to the assignments, there were only a few business transactions for the stocks of the N. Rt. in the market of the Budapest Stock Exchange.

As a result of the security purchase by the defendant in the first degree, based on the insider information provided by the defendant in the second degree, the stocks' price of the N. Rt. increased – from 600 Ft to 2400 Ft - from the begin of the purchase till the publication of the State Security Supervision's licence about placing them into the market of the Foreign Stock Exchange. After six days of the purchase, they sold 7370 amount of stocks with 3600 Ft/piece price via the joint venture of the defendants called P. Kft. and P. Ltd. – which company was registered in Maldives – for the E. M. N. Értékpapírkereskedelmi Kft. They divided the achieved profit based on the pre-calculation of the defendant in the first degree. The defendant in the first degree sold 7080 amount of stocks – which was bought via the L.B. Rt. – on behalf of his wife and mother. On the grounds of his acts, the Chief Prosecutor's Office accused the defendant in the first degree as perpetrator, the defendant in the second degree as accomplice of breach of bank secret under 300/A § of the Hungarian Criminal Code.

The established facts in the sentence of the Court of First Instance⁵ was almost the same as the indictment but it contained also plus information. For example in the beginning of the 1990s, N. Rt.'s resources ran out, had an increasing credit volume along with contraction of the markets. The company tried to launch a consolidation programme in order to ameliorate its position. At the end of 1993, the firm got rid of the bank loans, the associate companies gained improvement in the field of efficiency, however the market did not respond to the positive changes occurred in the N. Rt.'s economic position, the company ensured the publication of its balances and economic data in vain. Owing to the defendants' conducts, 17 million Ft price profit was generated and the N. Rt. was able to perform share capital increase. Due to this, the company managed to cease its 300 million Ft debt against B. Bank, because the bank

⁵ Pesti Központi Kerületi Bíróság 2.B.5401/1994/16.

was willing to subscribe the stocks in exchange of the debt. The defendants lived in a semi-detached house and they established the companies jointly, which were involved in the purchase of the stocks. They denied committing the crime, the defendant in the first degree claimed that he did not buy the stocks based on insider information. He saw that the defendant in the second degree helped the company out from its bad position, collected the debts, therefore, he was sure about that the price of the stocks would rise and he started to purchase the stocks without any information from the defendant in the second degree. The another defendant also denied providing insider information to the primary defendant and alleged that he did not get a share from the profit. Though he admitted that the found notes were written by him, but it was only subsequent account and not a pre-calculation for the business of the defendant in the first degree. The court did not accept the defence of the defendants. According to the argument, the timing of the purchase and the introduction of the N. Rt.'s stocks into the Foreign Stock Exchange market was not a coincidence. It was also not accidental when the defendant in the first degree – who used once his first forename then his another one during the transactions - entrusted more companies, which are associated with N. Rt., to purchase, notwithstanding the witnesses warned him about the consequence which would be an artificially created price increase. The court accepted the opinion of M. Péter who stated five weeks before the introduction the pace of the price increase started to be significantly faster than the typical rise of entire period and it would have not happened due to simple “fundamental information”.

The argument of the court included the definition, brief history and function of the Stock Exchange after the personal data of the defendants, which presents that the operation of the stock exchange was in an early stage yet. The court also took into account as an aggravating circumstance the fact that „the Budapest Stock Exchange had a relatively underdeveloped condition.”

The Court of First Instance sentenced the defendant in the first degree as perpetrator to 10 months imprisonment in prison and 100.000 Ft fine as an ancillary punishment, the court decided on the suspension of the imprisonment sentence on probation for 2 years. The court found more grievous the conducts of the defendant in the second degree thus he was sentenced as abettor to 1 year and 2 months imprisonment in prison and 200.000 Ft fine as an ancillary punishment, the court decided on the suspension of the imprisonment sentence on probation for 2 years. The court established that the defendant in the second degree had determinative influence on the

defendant in the first degree and this establishment was different than, the content of the indictment.

The Chief Prosecutor's Office filed an appeal against both defendants because of the incorrect application of the substantive criminal provisions. The prosecution also wanted aggravation since the danger to the society of the crime added to the charges means that it leads to the loss of trust towards the operation of the stock exchange, which involves damaging consequences for the entire economy and the passed sentence in such case would be a precedent. The prosecution found necessary to set an example and everybody should see whether it is worth to commit or not. The attorneys of the defendants filed an appeal for acquittal and in case of the defendant in the first degree they motioned to overturn judgment of the first instance, because according to his attorney the court fulfilled its argument obligations only partly and this misdemeanour proceedings affected significantly the sentence.

The Court of Second Instance found valid the established statement of facts by the Court of First Instance in its sentence, the defendant in the second degree was responsible as accomplice, since it could not be proved that he has a determinative effect on the defendant in the first degree.⁶ The court completed the statement of facts with the following: the defendant in the first degree obtained the expended amount of money on purchase from loans, which he asked from family members and creditors. The creditors were aware of that what the defendant asked the money for, they did not set a deadline for the pay back and entered the stock exchange market along with him. The court stated that the defendant in the first degree would not take out loans if he did not have insider information. The notes of the defendant in the second degree could not be subsequent account since it did not contain exactly the number of the stocks. At the same time, the court found unreasonable the duration of the sentenced imprisonment, so it was reduced to 6 months with the same probation time. The extent of the fine was increased based on the committed value, the earnings and financial circumstances of the defendants, since the court found the first sentence mild.

⁶Fővárosi Bíróság 26.Bf.8686/1995/4.

The background of the regulation

The current Hungarian regulation on insider trading can be found under Section 410 of the Act C of 2012 on the new Hungarian Criminal Code.

Section 410.

Any person who:

- a) uses insider information to conclude a transaction involving financial instruments;*
 - b) entrusts another person to conclude a transaction on the basis of insider information in his possession for the financial instruments to which the information pertains; or*
 - c) discloses insider information to any unauthorized person for financial gain or advantage;*
- is guilty of a felony punishable by imprisonment not exceeding three years.*

In Hungary, this crime was unknown before 1990, but we are not at all late. In the United States there has been legal regulation related to insider trading since 1934, and since 1981 in the United Kingdom. In Germany (where the stock market bears old traditions) the regulation came into force only in 1994. The European Union declared its principles including the ban of insider trading in 1989.⁷

The statement of facts of insider trading got its current form in 2005. It became shorter than the former ones (for example the ‚forbidden security-trading‘ and the ‚insider security-trading‘), but it also widened the range of objects on which this crime can be committed (not only on securities but also on ‚other financial means‘), and at last it does not contain the definition of insider information anymore, since that is included in one of the background norms.

The Act on Capital Market of 2001 (Tpt.) provides the background regulation for this crime. This statute provides a vigorous competence for the State Supervision of Financial Organisations, where today a separated department deals with the cases of insider trading (Market Controlling Department). The National Bank of Hungary is authorised to charge the perpetrator of insider trading and market influencing with a penalty, if he/she violates, eludes, omits or performs late one of the provisions written

⁷ István Vajda: Insider Trading. *Economical Journal*, 50. year, 2003, p. 235-253.

in the Tpt. or in other law derived from it, or one of the National Bank of Hungary's orders or its own by-law.⁸

The penalty in the case of insider trading or market influencing can be between 100.000 and 100.000.000 Forints (400 and 400.000 Euros) or maximum the 400% of the traceable financial benefit. This could have a strong dissuasive force in several cases. The announcement making obligation is also a new element in the regulation in the case of suspicion of insider trading (and this must be fulfilled by the investment service providers), but there is no criminal sanction attached to the omission of this obligation, so it is not a crime, but it also can result a penalty. The service providers are obliged to name an assigned person, just like in the case of money laundering, but here the announcement has to be sent to the National Bank of Hungary. The National Bank of Hungary decides whether it submits an accusation to the police or settles for a penalty in its own competence.

The object of the crime is the equality of chances, which is essential for stock market transactions and indirectly to fair market attitude.

The offender's behaviour is the sealing of a transaction, the crime can be committed outside the stock market. The phrase "sealing a transaction" does not mean that only the perpetrator himself must seal the transaction, in fact it is not the typical case; usually they use the assistance of some kind of a broker or commission merchant. The investment service provider – if he is unaware of the insider character of the transaction – is exempted from criminal liability on behalf of his mistake. (If only under ordinary care he should have recognised the insider transaction, the State Supervision of Financial Organs may fine him.) In the first two phrases neither the result (gaining benefit), nor the aim of gaining benefit are elements of the statement of facts, so the crime is carried out even if the perpetrator suffers losses from the transaction. The handing over of insider information to gain benefit practically means the selling of such information.

(There are disputes in the scientific literature, whether the benefit can only be a financial type or for example a moral acknowledgment (e.g. promotion) or the possibility of a sexual relationship. We are willing to accept this concept, but adding, that in practice it is not the usual behaviour of a perpetrator.)

⁸ Organisations dealing with investment service providing must conclude a separate by-law on the questions related to insider trading, similarly to money-launder prevention by-laws.

The method of perpetration in the first phrase is “with the use of insider information”, in the second is “according to the insider information in his possession”. To interpret this, we need to specify the definition of insider information, which we can find in the Act on Capital Market.

Insider information:

1. such important information⁹ concerning a financial instrument (not including the goods-based derived transaction)
 - that is not yet publicised
 - that is directly or indirectly connected to the financial instrument or to the issuer of the financial instrument
 - that in the case of publication would be capable of significantly influence the price of the financial instrument¹⁰
2. such important information in the case of persons, who are assigned to execute any assignment concerning the financial instrument -excluding the ones listed in a. - that is connected to the current assignment given by the client-
3. such an important information concerning a goods-based derived transaction, which
 - was not yet publicised
 - is directly or indirectly connected to a goods-based derived transaction
 - according to the accepted market practice should be shared with the market actors
 - information is regularly shared with the market actors

The perpetrator can be anyone, so anyone can commit insider trade, who possesses insider information. The circle of so-called insider persons, who possess insider information, can be found in the background norm.

Insider person:

1. leading official and member of the supervising committee of the issuer
2. manager, leading official and member of the supervising committee of the legal person or economical partnership without a legal personality in that the

⁹ important information: all information concerning an event or circumstance, that has already occurred or its occurrence is reasonably expectable, and specific enough, to enable to draw a conclusion on the possible influence of an event or circumstance on a given financial instrument's price

¹⁰ information capable of influencing the rate: all information that would likely be used by an investor at time of making an investment decision

- issuer owns directly or indirectly twenty-five or more percent of the shares, or has a right to vote
3. leading official, member of the supervising committee and manager of a legal person or economic partnership without legal personality that directly or indirectly owns ten or more percent in the issuer or has a right to vote
 4. manager, leading official and member of the supervising committee of any organisation participating in the distribution or in organising the public buying offer according to the VII. Article; furthermore any employee of these organs or the issuer, who participated in the distribution or in the issue, who got insider information during his work within a year from the distribution
 5. a natural person who directly or indirectly owns ten or more percent of the issuer's capital
 6. manager, leading official and member of the supervising committee of the issuer's accounting credit institute
 7. who received insider information because of his work or duties, during his work or exercising his regular assignments, or in any other way
 8. who received insider information through crime
 9. a person living in a common household or closely related to a person listed in points a.-h.
 10. a person acting on behalf of such a company, where a an insider person listed in points a.-i. owns a significant share

This crime can only be committed intentionally, in the first two phrase with *dolus eventualis*, in the third – according to the aim- only with *dolus directus*.

It makes more difficult the judicature, when some important theoretical questions, which are important in the practice aren't specified perfectly. Because of this for example there are just few criminal processes in insider transaction.

The first question is the definition of the benefit. There are two absolutely opposite opinions in the definition of benefit. One of the opinions says that the desired benefits can be a service like sexual contact, moreover a moral admission, like an improvement, not just a pecuniary thing.¹¹

The justification of the minister proves this opinion. The justification says that it is not important, that the transmitter or the beneficiary got the benefit, or the benefit is a

¹¹ Erdősy-Földvári-Tóth: Hungarian Criminal Law Special Part. Osiris Kiadó Budapest, 2007.

pecuniary thing or it is a kind of personal benefit. The justification of the minister is a type of the jurisprudential interpretation, so it is not binding in Hungary. It is a kind of help for the judicature, so it has a big effect for the judicature, all the same that is not binding.

It is confirmed by the justification of the minister in which the legislative intention is explained.¹² Even so, it confounds the law in practice, because it has an opposite aspect. The judicature aspect is that the benefit can be only a pecuniary thing, because the perpetrator intention aims for a big profit-taking, or to avoid a price loss. They support this aspect of the construction of the crime, because they say if the insider's breach of duty is intent for other benefits, it is effect a kind of corruption crime.

The other important question is the count of the crime, there are also opposite opinions in this topic. One group states that the count of the crime is defined by the numbers of economic organizations that is concerned by the insider information until they join a company as a stake or shareholder. This statement means that use more insider information, or do more transactions it is a natural unit. To reckon with the disposable time for the perpetrator we can exclude cumulatively. The opposite opinion states that the count of the crime is determined by the number of the information, not by the number of the transactions, do continually transactions with the same insider information it effects cumulatively.¹³ Naturally, we cannot define exactly what is that time that is already, or yet enough for determining cumulatively, and this can be diverse in different crimes.¹⁴ The insider transaction is that kind of crime, in which the resulation of the big profit-taking can inspire the perpetrator very much, to use one insider information in a short time to do many transactions with one determination, for the harm of similar investors. For the judicature it is a problem to determine insider information definition, all the same that the Tpt. determine it exactly. The problem is that the definition contains two not real exact expressions. One is the assumption of "not publicized information". The insider is workaround this in the following way: the insider brings out the important information in a website, which is not frequently visited by the investors and they usually don't get the information from this website. In this situation, we cannot impeach the insider

¹² József Földvári: Hungarian Criminal Law General Part. Osiris Kiadó Budapest, 2006.

¹³ Erdősy-Földváry-Tóth: op. cit. p. 443.

¹⁴ József Földvári: op. cit. p. 220.

because he/she published the information and it is accessible for everybody, although he/she knows that not too much investor will get that information.

Ideally, the insider's intention cannot intent to select the investors who are get the information¹⁵, but it is very hard to prove that what was the intention of the insider.

The definition of price sensitive information is also a problem, it is not sure that in a moment an information what effects in the market.¹⁶ The price sensitivity of the information depends of the activity of the company, and of the function of the company.¹⁷

There is a more significant problem than the above mentioned: the lots of insider information, because from these carefulness, not well prepared, trifling, bad habitudes, the belief into the sufficient financial materials, or because in default of ideas in criminal law the information do not get into the criminal investigation authorities.

The other relative problem is to analyse, and to prove of the intention of the accused. Was the kitchen cooking employee be aware that he/she get an insider information when he/she questioned the headmaster of the company? There are some simple case when it is easy to decide this, but in most of the cases it is hard task. Because of this, maybe it will be practical to penalize incautious form of the insider transaction, like the Tpt. says in the 201. § (1) section.

The instruments of the National Bank of Hungary in now days are able to recon effective, and to sanctioning the insider transaction in Hungary, in the last years it was sensible that the cases in insider transaction were multiply. In now days the work of the stock market has traditions. In the form as the insider transaction is in the Hungarian Criminal Code is inopportune to impeach, it is necessary to clear the question of the count of the insider transaction, the benefit snatching, and to solve the problem of the difficulty of prove. It is meritorious to make all these if we are believe seriously that the insider transaction can effect big harms in the economic life in a state.

In 2016, new EU rules to fight against insider dealing and market manipulation in Europe's financial markets took effect in order to ensure a more efficient and

¹⁵ Mihály Tóth: Economic crimes in the shaping judicature ELTE Law Continuation Istituation

¹⁶ István Vajda: Insider Transaction. Economic Review L. year 2003. March p.254.

¹⁷ Laura N. Beny: Insider Trading Laws and Stock Markets Around The World: An Empirical Contribution To The Theoretical Law and Economics, John. M. Olin Center of Law and Economics, University of Mitchigan, 2006. p. 335.

transparent EU financial market and increase investor protection as well as confidence. The Directive 2014/57/EU of the European Parliament and of the Council on criminal sanctions for market abuse set minimum rules for the Member States and oblige them to adopt or maintain more stringent criminal law rules for market abuse. Hungary accepted a law (the Act CIII of 2016) to meet the directive's judicial harmonization requirements. Thus, they added two new offences for the Hungarian Criminal Code and came into force on 28th of October in 2016: under Section 410/A unlawful disclosure of inside information and under Section 411 unlawful market manipulation. The former c) point of insider trading has become a separate crime as unlawful disclosure of inside information and it is punishable only as a misdemeanour from now on.¹⁸

Section 410/A

Any person who discloses inside information to an unauthorized person or persons in order to gain unlawful advantage or to cause unlawful disadvantage is guilty of a misdemeanor punishable by imprisonment not exceeding two years.

Section 411

Any person who:

a) enters into a transaction, places an order to trade or cancels or amends such order, makes, cancels or amends a recommendation in own account trading, which gives false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot commodity contract, secures the price thereof at an abnormal or artificial level;

b) employs a fictitious device or any other form of deception relating to a transaction in financial instrument, which affects the price of one or several financial instruments or a related spot commodity contract;

c) transmits or disseminates false or misleading information or provides false or misleading inputs or involved in any other behaviour which manipulates the calculation of a benchmark; is guilty of a felony punishable by imprisonment not exceeding three years.

(2) Any person who disseminates information to the public at large, with the purpose of financial gain, which gives false or misleading signals as to the supply of, demand for, or price of a financial instrument, or a related spot commodity contract, or

¹⁸ http://europa.eu/rapid/press-release_IP-16-2352_en.htm (02.11.2016)
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0057> (02.11.2016)

secures the price thereof at an abnormal or artificial level, shall be punishable in accordance with Subsection (1).

(3) Any person who induces other persons to make a new capital investment or to increase an existing one, or to sell or reduce a capital investment by disclosing or broadcasting false information concerning the financial position of an economic operator or the executive officer of such economic operator in connection with his office, or concerning financial instruments in relation to the economic operator, or by concealing information shall be punishable in accordance with Subsection (1).

The Questor case

In the most cases, broker scandals are in connection with insider trading. The most famous broker scandal case in Hungary is the Questor case, this is out of question.

A Hungarian company accomplished a series of financial frauds which affected lots of clients and generated a huge amount of damage. It was led by Csaba Tarsoly and in the Quaestor group they built a pyramid scheme, while on paper the company had zero equity. They offered high, attractive profits comparing to the average market yields (offered around 3% interest premium). The group tried to cover the extensive operation of the company (real estate projects) from the savings of small investors. It got bankrupt in 2015. According to the Hungarian National Bank the bankruptcy of the Quaestor group happened because they sold more bonds than as much as they issued. They had 70 billion Forints worth bond programme while they issued 60 billion Forints worth bonds and sold 210 billion Forints worth bonds (which is equal to the 1% of the Hungarian GDP), so Quaestor issued 150 billion Forints worth fictive bonds. In accordance with the bond issue prospectus Quaestor didn't have to guarantee liquid secondary market for the securities, however, in order to maintain trust – and cover risks related to the bonds - they were subscribing price continuously and withdrew their bonds. In case of panic, when many clients wanted to get their money back, they should have suspended the repurchases, but they didn't do it so they couldn't fulfil the demands in the end. The number of the injured parties may be over

30 thousand investors and among them can be found local governments and administrative agencies.¹⁹

¹⁹ <http://www.eco.hu/hir/brokerbotrany-osszefoglalo/> (30.08.2016)
http://www.portfolio.hu/vallalatok/ki_az_oroszag_legnagyobb_penzugyi_csaloja.212879.html
(30.08.2016)