# AN ANALYSIS OF INSIDER TRADING IN INDIA

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***ABSTRACT***

*Insider trading is more than a theft of information. It is not always clear who are the guilty insiders and who are the victims; and insider trading has benefits as well as costs. Insider trading has received a bad name in recent decades. The popular press makes it sound like an evil practice where those who engage in it are totally devoid of ethical principles. Yet not all insider trading is unethical and some studies have concluded that certain kinds of insider trading are actually beneficial to the greater investment community. Some scholars in philosophy, law and economics have disputed whether insider trading should be punished at all while others assert that it should be illegal in all cases. Finance ethics have drawn increasing attention from both government regulators and researchers. This paper addresses the issue of insider trading, its evolution in India and the measures adopted by SEBI in order to curb insider trading.*

## INTRODUCTION

With enhanced competition caused by deregulation, technological advances, and economic process, the organization of stock exchanges is at a crossroads. Traditionally, stock exchanges were organized as not-for-profit organizations, founded and owned by brokers and dealers who managed "their" stock exchange like an exclusive club, with high barriers for new entrants and a regional or even national monopoly, comparable to a medieval gild. The worldwide rise in stock exchange trading volume, global integration of the capital markets and competition for trading profits have triggered a disintermediation comparable to the unfixing of commission rates.[1]

[1] Stock Exchanges at the Crossroads, Fordham Law Review, Vol. 74, pp. 2541-2620, 2006.

The formal operations of stock exchanges in India commenced in 1875 but the securities market was largely unregulated particularly prior to independence. Therefore, the thrust of securities market reforms has been on the improvement of the operations and efficiency of the markets. Realizing that, capital market may find it difficult to develop in a healthy manner without the presence of effective regulators, Securities and Exchange Board of India was established under the SEBI Act, 1992. The purpose was to safeguard the interests of investors in securities and to promote the development of, and to regulate the securities market and other matters connected therewith or incidental thereto.

The first organised securities market in India was started in 1875 at Mumbai and it is stated to be the oldest in Asia. In 1894 the Ahmedabad Stock Exchange was started to facilitate dealings within the shares of textile mills there. The Kolkata Stock Exchange was started in 1908 to supply a market for shares of plantations and jute mills. Two others set up in the reform era, viz., the National Stock Exchange (NSE) and Over the Counter Exchange of India (OICEI), have mandate to have nation-wise mercantilism.[2]

## INSIDER TRADING

Insider trading essentially denotes dealing in a company's securities on the basis of confidential information relating to the company which is not published or not known to the public (known an unpublished price sensitive information), used to make profits or avoid loss, it is fairly a breach of fiduciary duties of officers of a company or connected persons as defined under the Securities Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, towards the shareholders.[3] An insider deals in shares of a corporation to form unwarranted gains by virtue of his employment or such other connection, thereby rendering the underlying principle of fair and free transferability of shares unaccomplished in the capital market. This is the primary reason for the formation of these regulations which is to promote free and fair transferability of stocks in the capital market wherein the investors can deal in the securities in an unperturbed manner.

[2] History of Stock Exchange in India, http://www.yourarticlelibrary.com/stock-exchange/history-of-stock-exchange-in-india/23488 ( last visited Mar 1, 2019)
[3] Himanshu Chahar, Insider Trading in India, http://www.legalserviceindia.com/article/l199-Insider-Trading.html ( last visited Feb 28, 2019)

The aim of insider trading laws and regulations is to assure that no one would gain by trading on 'insider' or 'unpublished' information -information that is not available to all market participants. The ultimate goal is to create a level playing field by making information accessible to all market participants. The enforcement of insider trading laws increases market liquidity and decreases the cost of equity[4]. This has been found to be the objective in the developed countries where stringent insider trading regulations are adopted. Insider trading laws exists on the strong foundation of equity and efficiency.

Insider trading laws encourage the free distribution of securities related information which helps to ensure more efficient pricing of stocks. However, when insider trading regulations discourage insiders from buying or selling based on inside information that only results in stock being priced in a manner consistent with all available information.

Evolution of insider trading regulation in India

The history of stock exchanges in India is almost 134 years old although insider trading regulatory regime is only 17 years old[5]. For most part of those 134 years, insider trading went unhindered in India. The first attempt that was made to curb insider trading in India was in the shape of a disclosure requirement by company directors of their shareholdings. Provisions were incorporated in sections 307 and 308 of the Companies Act 1956 on the recommendation of the Company Law Committee[6]. It was only in the late 1970's insider trading, for the first time, was officially recognised as an undesirable practice. A series of committee reports recommended its strict regulation; as a result, a regulatory authority was set up in 1992.

A. Sachar Committee (1979): The High-powered Expert Committee on Companies and Monopolies and Restrictive Trade Practices Act (MRTP) (Sachar Committee) was constituted in June 1977 for reviewing of the Companies Act, 1956 and the MRTP Act, 1969[7]. In 1979, the Sachar Committee submitted its report. The Committee made two-fold recommendations - one relating to full disclosure of transactions by those who have made price sensitive information and another, prohibition of transactions by

[4] Bhattacharyya Utpal and Daouk Hazem, (2002) "The World Price of Insider Trading", Journal of Finance , Vol-54, pp- 75-108

[5] Bombay Stock Exchange was established in 1875 and insider trading regulation in India first implemented in 1992.

[6] Report of the Company Law Committee, 1952.

[7] The Institute of Company Secretaries of India, (2007), "Prohibition of Insider Law and Practice ", New Delhi, p-9

such persons during certain specified period unless there are exceptional circumstances. Among the insiders, a company director, statutory auditor, accountant, tax and management consultant or advisor and legal advisor etc. could indulge in such activities. All public companies are required to maintain a register disclosing dealings in shares of the company by the above persons including dealings by their spouses and dependent children and also of those persons who are in full time employment of the company and drawing a salary of three thousand rupees or more per month[8].

B. Patel Committee (1987): The Government of India constituted a High-powered Committee (Patel Committee) in May 1984, to make a comprehensive review of the functioning of the stock exchanges and to make recommendations in the matter. The committee's final report took a serious view of the absence of specific legislation in India curbing misuse of insider information and recommended strict penalties for the offence of insider trading. In its report it has been found that insider trading is rampant in stock exchanges in the country and is one of the principal cause of excessive speculative activity[9]. Even persons employed in the office of the solicitors, auditors, financial consultants and financial institutions in possession of undisclosed price sensitive information are reported to be indulging in such activity.

C. Abid Hussein Committee (1989): The Working Group on the 'Development of the Capital Market' which was popularly known as Abid Hussein Committee was formed in 1989. The group recommended that the insider trading should be made as a major offence punishable with civil penalties as well as criminal proceedings. The problems of insider trading and secret take-over bids could be tackled largely by appropriate regulatory measures. It was suggested that the SEBI might be asked to formulate the necessary legislation and be equipped with the authority to enforce the provisions.

It is imperative that investors should get an opportunity to transact at minimum transaction costs. There is general agreement that both companies and society enjoy the benefit from accurate pricing of securities. The 'correct' price of security is that which the market sets if all information relating to the security had been publicly disclosed. Accurate pricing benefits the society through rational allocation of capital investment and reduction in the volatility of security prices[10]. Level of corruption also gets reduced due to accurate pricing of its securities

[8] Sachar Committee Recommendations, No-18.104 (iv)
[9] Patel Committee Recommendations, No-7.26
[10] Bainbridge M. Stephen (1999), "Securities Law: Insider Trading", Foundation Press, New York, p-129

through reduced investor uncertainty and improved monitoring of management's effectiveness. Persons who are closely associated with the companies play a vital role in creating uncertainty in the market.

This unfairness of insider trading practices can be judged from two distinct aspects. First, the insider is presented to have an advantage over others who cannot obtain the same information. Second the information was produced not for the benefit of the inside trader, but as a result of his employer's quest for gain[11].

Many investors believe that insider trading is illegal. This confusion arises because some transactions made by insiders are illegal while others are perfectly legal i.e. within the permissible limit. The law only prohibits certain types of transactions by insiders, while majority of insider trading falls within legal bounds. Some observers erroneously believe that if insiders make money then it must be illegal[12]. These people also believe that to avoid prosecution, insiders only report their unprofitable transactions and they camouflage any transactions motivated by exploiting non-public information.

Insider trading is not more beneficial to the company than other compensation schemes. With unregulated insider trading as a form of compensation, it is neither possible for the shareholders to determine in advance how much they actually pay for managerial services, or make cost-effective choices on how to ran the firm. Insider trading may be classified on the basis of legalry. There are some misconceptions that whenever an insider trading takes place it is illegal and unfair. Some economists and legal scholars have argued in favour of insider trading. However, main focus of our present endeavour is on illegal insider trading.

## ROLE OF SEBI IN CURBING INSIDER TRADING

The role of a regulatory body of stock market in a country is determined by the stage of development of stock market in that country. In the Indian context, having reference to the rising nature of the market, the regulatory body must necessarily have the twin role of

[11] Brudney (1979), "Insiders, Outsiders and Informational Advantages under the Federal Securities Law", Harvard Law Review, VoL-322, pp-356-357

[12] Seyhun Nejat H. (1998), " Investment Intelligence from Insider Trading" , The MIT Press, p-xxvi

development and regulation. Whether or not Rajat Gupta[13], accused of insider trading in the United States, derived any financial benefit from doing so is a matter that will need to be proved at his trial in the US. But the key point here is that Gupta was brought to trial. This had significant implications for Indian regulatory approaches to insider trading.[14]

Regulatory and development functions are strongly interlinked and have almost the same objectives. Rapid and healthy developments in most of the cases are outcomes of well-regulated structures. SEBI is a.statutory body, which operates within the legal framework of Securities and Exchange Board of India Act 1992. Powers and functions of SEBI are discussed in section 11 of the SEBI act.

The duty of the SEBI is to protect the interest of investors and to regulate the securities market. Prohibition of insider trading is one of the important regulatory measures of securities market of the SEBI. [15] SEBI might investigate into the complaints received from investors, intermediaries or any other person on any matter having relation on the allegations of insider trading. In this connection, SEBI may appoint one or more officers to inspect the books and records of insider(s) or any other persons for the purpose of investigation[16]. Before undertaking an investigation the Board shall give a reasonable notice to insider for that purpose. The investigating authority may examine any books, records, documents and computer data or other relevant statements of any member, director, partner, proprietor or employee of the insider or other persons.

Measures and punishment

In Infosys Technologies Ltd., the first instance in India where the offence of insider trading was detected, Sri Gopalkrishnan its Chief Executive Officer was penalised. Besides Gopalkrishnan, Jeffrey Lehman, an independent director, also has been fined $2000 for the same violation. Mr. Lehman was also imposed a penalty for failure to correctly follow the procedure on sale of shares and that amount, too had been given to another charitable institution[17].

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[13] United States v. Gupta, 747 F.3d 111, 115 (2d Cir. 2014)

[14] Satvik Varma, “Is India too soft on insider traders?” https://economictimes.indiatimes.com/slideshows/economy/is-india-too-soft-on-insider-traders/insider-trading-is-a-criminal-offence/slideshow/11066581.cms (last visited on Mar 1, 2019)

[15] Section 11(g) of the SEBI Act 1992.

[16] Regulation 4(A) of SEBI ( Prohibition of Insider Trading) Regulations, 1992.

[17] The Economics Times, January 03, 2008.

Insider Trading in India is an offense according to Section 195 of the Companies Act, 2013 and Sections 12A, 15G of the Securities and Exchange Board of India Act, 1992. Insider trading is when one with access to non public, price sensitive information about the securities of the company subscribes, buys, sells or deals, or agrees to do so or counsels another to do as principal or agent. Price sensitive information is information that materially affects the value of the securities. The penalty for insider trading is imprisonment, which may extend to five years, and a minimum of five lakh rupees (five hundred thousand) to twenty five crore rupees (two hundred and fifty million) or three times the profit made, whichever is higher. [18]

Means of controlling insider trading

Criminal: One way of dealing with insider trading is by passing regulations prohibiting such trades, making them penal and enforcing criminal actions against violators. As any penal provision, this is supposed to deter others from violating the regulations. However, experience has shown us that this method provides only a small amount of relief even in more heavily regulated countries.

Civil and administrative penalties: Civil monetary penalties and issue of various administrative actions like bar from the industry without going to courts is a more effective remedy and with the enhanced powers granted to the regulator to impose penalties of 25 crores or three times the gain made, an economic harm can more easily be inflicted and deterrence more effectively administered. Unfortunately the wordings of the civil monetary penalties are drafted in such a poor manner that, the penalties are certain to be struck down (or diluted) as unconstitutional.[19]

A recent U.S. case is illustrative of a typical civil penalty charged by the Securities and Exchange Commission. In SEC v. Steve Madden, the Commission filed a settled injunctive action against shoe designer Steve Madden alleging that he engaged in insider trading. The complaint alleged that when Madden learned from the criminal authorities that he was the target of a criminal investigation and would be indicted or otherwise charged for securities fraud, he sold 100,000 shares of stock in his company, Steven Madden Ltd. Madden sold this stock without disclosing to the public the information he had learned regarding the criminal

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[18] The Companies Act (PDF), Ministry Of Corporate Affairs, Government of India, 2013.

[19] The penalty provides for the higher of three times the gain made or 25 crores. Effectively, that imposes a minimum penalty of 25 crores on an insider trader.

investigation. After Madden was arrested, the company's stock value sank and Madden avoided losses of $784,000. Madden consented to an order of permanent injunction and agreed to disgorge $784,000 of illegally avoided losses, plus prejudgment interest, and to pay $784,000 in civil penalties.

## SHORTCOMING OF SEBI ON INSIDER TRADING

There are many lacunae within the SEBI insider trading laws that have been discovered over the years, eventually making it tough for the investors to repose their confidence in the laws designed to safeguard their rights and interests against the practice of insider trading. SEBI has time and once more encountered difficulties in establishing and proving a case (beyond reasonable doubts in case of criminal proceedings) to convict the person/s accused of insider trading, substantially owing to the lack of evidence.

One of the foremost celebrated cases highlighting the vulnerability of the SEBI's 1992 regulations during this regard is Rakesh Agarwal vs. SEBI[20]. In this renowned case, Rakesh Agarwal, the Managing Director of ABS Industries Ltd. (ABS), was concerned in negotiations with Bayer A.G, regarding their intentions to takeover ABS. He had access to this unpublished price sensitive data. The SEBI directed Rakesh Agarwal to deposit Rs. 34,00,000 with investor Education & Protection Funds of stock exchange, Mumbai and NSE (in equal proportion i.e. Rs. 17,00,000 in every exchange) to compensate any investor which may create any claim later on. along with a direction to (i) initiate prosecution under section 24 of the SEBI Act and (ii) adjudication proceedings under section 15I read with section 15 G of the SEBI Act against the Appellant. On an appeal to the Securities appellate tribunal (SAT), Mumbai, the tribunal held that the a part of the order of the SEBI guiding Rakesh Agarwal to pay Rs. 34,00,000 couldn't be sustained, on the grounds that Rakesh Agarwal did that in the interests of the company (ABS). It was further held that intention /motive of the insider has to be taken cognizance of even though the SEBI Regulations do not specifically bring in mens rea as an ingredient of insider trading.

Similarly, in the case of Samir.C.Arora vs. SEBI[21], Mr. Arora was prohibited by the SEBI in its order to not purchase, sell or deal in securities, in any manner, directly or indirectly, for a period of five years. Also, if Mr. Arora desired to sell the securities held by him, he required

[20] (2004) 1 CompLJ 193 SAT, 2004 49 SCL 351 SAT
[21] [2005] 59 SCL 96 (SAT-Mum)

a prior permission of SEBI. Mr. Arora in the Securities appellate tribunal opposed this order of SEBI. SAT put aside the order of SEBI on grounds of inadequate proof to prove the charges of insider trading and professional misconduct against Mr. Arora.

## REMEDY FOR INVESTORS

The insider is more often than not, acquitted scot-free. Even in the cases wherever they're found guilty, they're needed to pay a sum of cash much less than the amount of profits that they may have actually made or they have to undergo a prohibition of dealing in securities for a period of time stipulated within the order. The end result is that the insider walks away happy with the profits he eventually is left with. [22]

In order to supply the compensation to the investors, the primary step would be to determine the number of aggrieved investors and additionally to calculate how much losses they may have suffered relatively, due to an act of insider trading. It is therefore advised that after convicting an individual of insider trading and ordering him to pay the penalty in consequence of his indictment, a public notice to be issued for a definite amount of time, asking the aggrieved investors to demand compensation for the losses that they could have suffered because of a biased trading activity by the insider.[23] The compensation would be paid out of the amount recovered from the person indicted. The investors not acknowledging to such a notice would merely lose their right to ask for reimbursement. After the number of investors has been determined, SEBI would need to calculate and decide what proportion of cash every investor will separately need to get. Calculating this amount can prove to be a tedious task however very helpful howsoever.

## CONCLUSION

As noted above, the insider regulations in India prohibit dealing, communicating or counselling on matters relating to insider trading. Violations of these prohibitions are considered as committing the offence of insider trading. SEBI has power to initiate criminal prosecution under section 24 of SEBI Act 1992. There was no specific provision in the Indian Companies Act or Income Tax Act to combat insider trading in India. However, Sachar Committee (1979), Patel Committee (1987) and Abid Hussein Committee (1989) have made

[22] Comparative study of the Insider Trading regulations prevailing in the different countries e.g. USA & UK, https://wirc-icai.org/downloads/BFSIcM-Comparative-study-of-the-Insider-regulation.pdf
[23] Supra.

various recommendations to curb insider trading in India. After enactment of the SEBI Act in 1992, insider trading regulations has been framed by SEBI which is called SEBI (Insider Trading) Regulations. The SEBI has strengthened the anti-insider trading laws by the amendment introduced in the year 2002.

The analysis of insider trading as a signaling means has important implications for both government regulators and academic researchers. From the government's perspective, it seems desirable to regulate insider trading before the question of the economic impact of insider trading on firm and society is resolved. However, we must take care not to over-regulate insider trading activities.

Upon the detailed research with respect to insider trading, I have come to the conclusion that whatever laws or the mechanisms be devised by the regulatory bodies, for the preservation of price-sensitive information and for the prevention of insider trading, the situation can never be made foolproof. This is because for the efficient conduct of the affairs of a company or a firm, it is essential that certain people be in possession of the price sensitive information and other trade details which are not disclosed. And, it becomes the duty as well as the responsibility of these people to ensure that this information is not leaked or are not used for making undue profits.

The company issuing IPO must take care that it is not indulged in activities like insider trading because it not only affects the IPO price in market but also spoils the image of company and intern, the investor loses confidence in the market. The business works with the aim of long term growth and wealth maximization, which is not possible if the company indulges in unethical activity. In addition to monetary punishment, the law should explicitly authorize courts to disqualify or demote such traders from any position as insiders- that is, any position that enabled them to gain, find out, or receive inside information.

In order to curb the menace of insider trading and for the preservation of price sensitive information, the people holding the concerned positions i.e., the directors, officers and other members of the company should themselves take voluntary steps and should set high standards of ethical behavior.

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