The Indian Journal for Research in Law and Management

Open Access Law Journal – Copyright © 2024

Editor-in-Chief – Dr. Muktai Deb Chavan; Publisher – Alden Vas; ISSN: 2583-9896

This is an Open Access article distributed under the terms of the Creative Commons Attribution-Non-Commercial-Share Alike 4.0 International (CC-BY-NC-SA 4.0) License, which permits unrestricted non-commercial use, distribution, and reproduction in any medium provided the original work is properly cited.

INSIDER TRADING AND MARKET INTEGRITY

ABSTRACT

Insider trading is a contentious practice that has long piqued the interest of regulators, investors, and members of the public. Buying or selling shares based on significant confidential information that provides certain individuals with an unfair advantage in the financial sector is one example of this illegal conduct. These individuals, who are frequently referred to as insiders, possess unique access to knowledge that may include upcoming financial results, corporate statements, or noteworthy occurrences that could have a big influence on the share price of a company. Insider trading undermines the concepts of fair and open markets and puts the integrity and dependability of the financial system at large in jeopardy. In this paper, we will look at insider trading, its laws and its effects on the market in detail.

INTRODUCTION

Insider trading means trading in securities by a company's insiders who have access to sensitive and exclusive information about the issuer of a particular security before such information is made available to the public. This acts as an advantage to them to buy or sell shares before their price fluctuates and at the same time is unfair to other investors. Insider trading has always been present in India, ever since the stock markets have come into existence. As the securities market grew, the concern for increasing insider trading activity also grew. Although, insider trading is legal if the transaction is reported to the Securities and Exchange Commission but it is illegal when the information is still unknown to the public. Insider trading is an offence and those who commit it face repercussions.

The Securities and Exchange Board of India (SEBI) was established as the regulatory authority to oversee such activities in the securities market. The objective of insider trading laws is to ensure fair competition by producing data that is available to all market players and keep the market integrity intact. These laws support the open exchange of information pertaining to securities, which contributes to more accurate stock pricing.

INSIDER TRADING

Insider trading happens when someone buys or sells stock in a company and has access to non-public information about it. In the previous two to three decades, insider trading has become more and more common in the financial markets.

Insider trading involves people who take advantage of their position to get information that is not publicly available but is price-sensitive, like share value. When people have direct contact with a company or corporate entity, this happens. These people use their privileged positions (as a director, a professional consultant, or an employee of that business) to get price-sensitive information about the value of securities that is kept confidential. All price-sensitive information must be kept confidential by directors and employees. Price-sensitive information must be handled according to the "need to know" principle, with access granted only to those employees who need it in order to carry out their responsibilities. It is against the law for anyone to directly or indirectly recommend the buying or selling of securities based on this information. The corporate insider has taken on a legal obligation to the shareholders to put the interests of the shareholders ahead of their own in business dealings on accepting employment. An insider breaches his obligation to shareholders when he purchases or sells shares using information that is owned by the company. Insiders violate their fiduciary duty to shareholders when they trade the company's stock using material non-public knowledge, which is regarded as fraudulent.

It takes a healthy and well-functioning stock market to create favourable conditions for investments and economic expansion. The Indian stock market has experienced tremendous growth during the last twenty years.

India's stock market has been challenged by numerous manipulative factors, such as insider trading, price-rigging, a lack of transparency in company accounts and expensive transaction costs, despite its extraordinary growth. Insider trading has become the most difficult issue out of all of them, mostly because there isn't any supporting evidence to hold the insider liable.

WHO IS AN INSIDER?

"Insiders" are individuals associated with the company who possess access to sensitive and confidential information at a discounted price. Before the general public finds out, they use this information to their advantage to deceive ignorant investors and reap enormous profits. A wide range of people are considered "insiders," including stockholders, government officials, employees of stock exchanges, professionals in the business world (such as bankers, brokers, auditors, consultants, and officers), and partners, directors, officers, and staff of a company and its related companies. Price-sensitive information is directly accessible to the board of directors and staff, giving them the freedom to use it however they see fit.

TYPES OF INSIDER TRADING

- Classic insider trading- Purchasing or selling securities on the basis of price sensitive information.
- Tipper-tippee trading- When the insider gives others access to confidential information which they can use for trading.
- Trading during blackout periods- Insider trading in times when certain people are barred from trading.
- Front-running- Trading on behalf of customers or the company before any significant orders.

EFFECTS OF INSIDER TRADING

The effects of insider trading are-

- Insiders gain an unfair advantage, which leads to unfair market conditions.
- Investors’ diminished trust in the financial markets’ impartiality and integrity.
- The manipulation of stock prices and the possible damage to investors who do not have access to private information.
- Diminishing the openness and efficiency of the market.

EVOLUTION OF INSIDER TRADING IN INDIA

It took several decades to establish legal regulations regarding insider trading. Prior to the end of World War II, it was considered normal for company personnel, including directors, officers, and employees, to buy and sell stocks and shares based on confidential information that was price-sensitive and not widely known. This was regarded as common, customary, and acceptable behaviour. However, taking personal profit at the expense of the majority of shareholders started to be seen as dishonest after World War II and persisted until the late 1950s. Surprisingly, insider trading returned to be common during the 1960s and early 1970s. Globally, insider trading is becoming a more and more serious problem. But over time, the policies put in place to combat insider trading have progressively evolved and improved.

The history of securities trading in India dates back to the 18th century, when the East India Company issued loan securities. By the 1830s, the industry was experiencing both quantitative and qualitative boarding, and shares of cotton presses and banks like Charted Bank, Oriental Bank, and Bank of Bombay started trading in Bombay.

In 1840, banks and merchants in Bombay recognised only six brokers for stocks and shares. There were local stock and share brokers by 1887. India's first stock market was founded in 1875 by the Association of Bombay, which is currently known as the Bombay Stock Market.

The largest in terms of paid-up capital, capitalization, volume of the secondary market, listed companies, and fresh capital raised is the Bombay Stock Exchange (BSE). In addition, it is the oldest market, having been accredited permanently, whereas the other exchanges have to reapply for recognition every five years.

Insider trading in India began in the 1940s when US regulations on short-swing profits under Section 16 of the Securities Exchange Act were examined by government committees such as the Thomas Committee in 1948. Directors and managers of companies are required by Sections 307 and 308 of the Companies Act 1956 to disclose their shareholdings in order to combat insider trading. A number of committees were established by the government to monitor securities and deter insider trading. The establishment of legal prohibitions against insider trading was greatly aided by these committees. The Committees play a role in providing insight into the development of insider trading in India. The following committees were formed:

Morrison Committee- In 1936, the Morrison Committee was formed in response to the need for a thorough and authoritative legal framework to handle contracts related to the securities market. This endeavour aimed to address the shortcomings present in earlier legislative actions.

Sachar Committee- The Companies Act of 1956 and the Monopolies and Restrictive Trade Practices Act (MRTP) of 1969 were to be reviewed by the committee, which was established in June 1977. The committee filed its report with the following recommendations: Insiders must notify the company of their intention to trade; insiders are prohibited from trading securities before and after the end of the accounting year; insider transactions involving shares must be recorded in a company register; and there must be provisions for compensation and civil remedies.

Patel Committee- The committee was established in May 1984 with the intention of carrying out an exhaustive examination of stock exchange operations and providing recommendations accordingly. The committee determined that the lack of insider trading laws in the nation was the main factor behind these activities and that laws were therefore imperative.

Abid Hussain Committee- It was established in 1989. The committee suggested that insider trading be declared both a criminal and a civil offence. It recommended that SEBI create regulations in this area. In compliance with the committees' recommendations, SEBI implemented regulations aimed at reducing insider trading. The regulations are namely-

- SEBI (Insider Trading) Regulation, 1992
- SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1994
- SEBI (Prohibition of Fraudulent and Unfair Trade Practice relating to securities market) Regulation, 1995

SEBI improved the Insider Trading Regulations, 1992, which were in place at the time, by implementing a number of noteworthy changes. In order to close some of the gaps that were brought to light by the SEBI cases of Hindustan Lever Ltd. v. SEBI and Rakesh Agarwal v. SEBI, the regulation was changed. "SEBI [Prohibition of Insider Trading] Regulations 2002" is the name of the new law. "A person who is a "intermediary," "investment company," "trustee company," "Asset Management Company," or a "employee" or "director" thereof, as well as a "official of stock exchange," "of clearing house," or "corporation," is now included in the definition of "deemed to be connected person" (Insider)." In 2008, the term "insider" was redefined once more. 2015 saw the publication of the SEBI (Prohibition of Insider Trading)

Regulations, 2015, which were later revised in 2018 as SEBI (Prohibition of Insider Trading) (Amendments) Regulations, 2018.

HINDUSTAN LEVER LTD. v. SEBI[1]

One prominent insider trading case is Hindustan Unilever v. SEBI and several changes were made as a result of the decision. It is among the most renowned instances of insider trading. The purchase of 8 lakh Brook Bond shares by Hindustan Unilever two weeks prior to the official announcement of the merger between Brook Bond and Hindustan Unilever gave rise to the controversy. Just 25 days prior to the announcement of the Hindustan Lever Ltd.- Brooke Bond Lipton India Ltd. merger on April 19, 1996, this transaction occurred on March 25, 1996. After looking into insider trading allegations for almost 15 months, SEBI sent a show-cause notice to the Chairman, all Executive Directors, the Company Secretary, and the then-Chairman of HLL in August 1997. Later that year, in March 1998, SEBI filed an insider trading charge against Hindustan Unilever. The five common directors of Hindustan Unilever and Brook Bond were accused of crimes, and SEBI ordered Hindustan Unilever to reimburse United Trust of India. Following that, Hindustan Unilever appealed to the appellate board, which upheld its ruling. The decision made by SEBI stunned everyone in the business community. SEBI was trying to prove, on the one hand, that insider trading had taken place at Hindustan Unilever. Conversely, Hindustan Unilever was making an effort to defend itself.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)- THE REGULATORY BODY

The regulatory body that oversees all Indian stock exchanges is called SEBI. It has an obligation to safeguard investors' interests in the securities market and to control the stock market by enacting any laws it sees fit. As the share market's regulator, SEBI works to bolster investor confidence by implementing all necessary preventative measures. The task of conducting an investigation into shareholder complaints regarding share market malpractice falls under the purview of SEBI. Additionally, SEBI has a duty to outlaw unfair and fraudulent trade practices in connection with the securities markets. The Securities and Exchange Board

[1] Hindustan Lever Limited V SEBI (1998) 18 SCL 311 MOF

of India Act, 1992, defines the roles that SEBI, as an independent body performs. Any further appeal on an order passed by SEBI is to be raised before the Securities Appellate Tribunal.
The SEBI Act, 1992's Section 12-A gives the agency the authority to control insider trading-related issues and to publish regulations pertaining to insider trading regulation. As a result of the authority granted to SEBI by this section, the SEBI (Prohibition of Insider Trading) Regulations, 2015 were implemented. Due to a number of flaws, the initial regulations pertaining to the same were published in 1992 and lacked a reliable system for tracking down cases of insider trading. The PIT Regulations[2], 2015, which were further amended in 2018, were developed as a step towards resolving this issue by providing a more thorough and extensive mechanism to check for insider trading and guarantee that no such instances are left unattended.

SEBI REGULATIONS

SEBI considers some information to be sensitive, which is also called as Unpublished Price Sensitive Information or UPSI. Having access to such information is said to be illegal unless permission for the same is taken. Such information includes-

- Intended dividend declarations,
- Periodic financial reports,
- Buy-back or issuance of securities,
- Any changes in company plans,
- Any upcoming takeovers/ mergers.

Regulation 4 of SEBI Regulations 2015 clearly states that no person in possession of UPSI shall be allowed to trade in securities.

Sec 12A of the SEBI Act[3]- prohibits manipulative and deceptive devices, insider trading and substantial acquisition of securities against the regulations of SEBI.

[2] SEBI (Prohibition of Insider Trading) Regulations, 2015
[3] Securities and Exchange Board of India Act, 1992, S.12-A

Sec 15[4]- SEBI provide for penalties in cases of insider trading, nondisclosure of shares, failure to refund moneys to investors and also for fraudulent and unfair trade practices.

EXCEPTIONS

There are exceptions to certain people who can know UPSI-

- Disclosure is permitted when carrying out tasks, fulfilling legal requirements, or serving other justifiable objectives. "People like lawyers, accountants, etc. who are actually outsiders will be construed as insiders from the point at which the UPSI was shared with them under ordinary course of business," the ruling in Dirks v. SEC[5] stated.

- When making an open offer is mandated, disclosure is permitted; additionally, disclosure is necessary when it serves the company's best interests. In the Samir Arora v. SEBI[6] case, it was decided that true unpublished private information is required to trigger an insider trading provision.

PENALTY

Section 15-G[7] of the SEBI Act, 1992 states that any individual violating these guidelines shall be held liable and a fine of not less than 10 lakhs but extending up to 25 cores or three-times the profit made out from the insider trading transaction, shall be imposed on him.

SECURITIES APPELLATE TRIBUNAL

Established under Section 15K of the SEBI (Securities and Exchange Board of India Act), 1992, it is a statutory body tasked with hearing appeals against orders rendered by the Securities and Exchange Board of India, regarding the imposition of penalties, or by an adjudicating

[4] Securities and Exchange Board of India Act, 1992, S.15
[5] Dirks v. SEC, 463 U.S. 646 (1983)
[6] Samir Arora v. SEBI, 2004 SCC Online SAT 90
[7] Securities and Exchange Board of India Act, 1992, S.15-G

officer under the Act. It also has the authority to exercise any jurisdiction, powers, or authority granted to it by this Act or any other currently enacted law.

REAL LIFE EXAMPLES OF INSIDER TRADING

1. Reliance Industries- It was started by Dhirubhai Ambani in 1960. It has since become one of India's most giant and valuable corporations. Petrochemicals, refining, oil and gas exploration, telecommunications, retail, and media are just a few industries in which Reliance works. The Securities and Exchange Board of India fined Reliance and prohibited the company from operating in the derivatives market for a year. SEBI accused the company of trying to make money by lowering the cash market value of its shares and evading restrictions on its legally permitted trading limits.

2. Amazon- In September 2017, Brett Kennedy, a former financial analyst for Amazon.com Inc. (AMZN), was charged with insider trading. Authorities claim that prior to the announcement, Kennedy gave information on Amazon's first-quarter 2015 financial results to Maziar Rezakhani, another University of Washington alumnus. Rezakhani gave the data to Kennedy in return for $10,000. Rezakhani made $115,997 trading Amazon shares, according to the SEC, following a tip from Kennedy in a related case.

3. Infosys- The IT company was found to have violated SEBI's insider trading regulations by withholding information about a company insider's alleged illegal trading. Although the initial complaint was submitted on September 20, 2019, it wasn't until the whistleblower sent a copy of it to the media in October, a month later, that the situation became public. Kiran Mazumdar Shaw, the lead independent director of Infosys, settled the charges in November by giving SEBI a fine of Rs. 3 Lakh.

4. Acclaim Industries- SEBI found out that Mr. Abhishek Mehta, who was heading Acclaim Industries when the insider trading case happened, was fined with 42 lakhs by SEBI. The investigation took place from January 2012 to December 2012, which revealed that Mr. Mehta’s change in share ownership during that period. This had

happened after the board had approved a merger plan with Database Software Technology Pvt. Ltd. in January 2012. SEBI discovered that in February 2012, Acclaim's board decided not to go forward with the merger. This information was not made available to the Indian Stock Exchange. Mr. Mehta was accused of selling shares and decreasing his share ownership in Acclaim Industries while knowing about non-public information. This led to SEBI imposing penalty on Mr. Mehta.

CHALLENGES

The Indian authorities have faced significant challenges in regulating the practice of insider trading. According to SEBI's Annual Report for the year 2016–2017, out of all the investigations the agency conducted, 14% (or 34 cases) involved insider trading, compared to 12 cases in the previous year. Insider trading is becoming a much bigger crime with every year that goes by, and this is driving up the demand for more stringent laws. A significant worry is the number of cases still pending; out of 34 cases that were looked into, only 15 were resolved. The accusations of insider trading are based primarily on circumstantial evidence, and it is challenging to identify and establish the offence in the absence of hard evidence. Despite the strong regulatory framework, there are relatively few successful cases. This is a result of SEBI's lack of the necessary technological know-how to carry out investigations efficiently. Another factor contributing to SEBI's failure is the severe lack of funding and personnel. Furthermore, situations in which a foreign national has committed the crime of insider trading are not covered by Indian law. In these situations, there is no provision for a penalty or an investigation.

CONCLUSION

Insider trading is a serious offence that compromises the trust of investors and the integrity of the market. Encouraging a fair and reliable market environment requires battling insider trading. To stop insider trading, a combination of corporate policy, outreach, enforcement, and governmental measures is required. One of the main issues affecting the market as a whole is insider trading, which SEBI has been regulating since 1992. To make sure every gap in the regulatory framework is filled, the Regulations are periodically amended and circulars on the subject are published. This is beneficial to all the players in the market, from individual investors to investing companies, to make sure that there is a level-playing field and healthy financial growth.