AN ANALYSIS OF INSIDER TRADING IN INDIA

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ABSTRACT

Insider trading has been present throughout the history of financial markets, and was particularly prevalent during periods of elementary years of Indian stock markets. Insider trading is common in developing countries like India, where it is practiced by a wide range of market participants, corporate officers and regulative authorities. Primary insiders gain access to information by virtue of their position, employment or responsibility. They include controlling shareholders, corporate executives and officers, as well as financial-market professionals who compile information on a firm’s operation. Government officials with access to insider information also fall into this category. Secondary insiders are friends or relatives of primary insiders. Dynamic regulations not only help reduce the impact of such events but also help in restoring stability.

Keywords India, Emerging markets, Insider trading, Legal trading, Regulatory ambiguity, Trade on disclosures.

Purpose – The purpose of this paper is to study the effectiveness of insider trading enforcement actions in India and international dimensions.

Design/methodology/approach – The research is based on the insider trading regulations and amendments made during the period 1992-2015. Findings – The notable observation of the study is the dearth of insider trading conviction and the paucity of prosecution for insider trading offences in India. It is difficult to resist the conclusion that surveillance and enforcement matter more than the drafting of the relevant statutes and regulations in emerging markets. Whereas, developed countries have a better record of prosecution than emerging markets.

Research limitations/implications – Future research may explore the factors that hinder effective regulation and recommend new methods to increase the impact of Securities and Exchange Board of India insider trading regulation.

Originality/value – The current paper presents guidance for the foreign institutional investors, regulators and market participants on insider trading regulation and prosecution in India.

I. INTRODUCTION

Insider Trading is one of India’s most prominent financial crime, which was prevalent since the early 1920’s. The term ‘Insider Trading’ can be defined as the illegal use of non-public information derived from a person associated with the company to profit/gain by purchasing/selling listed securities on the share market. The seriousness of the crimes relating to Insider Trading cannot be overlooked. Such crimes create a huge problem for the regulating authorities in tracing those involved in sharing and benefitting the information. All those benefitted are very well-connected thereby giving them the leverage to escape the liability and make enormous profit at the cost of other traders. In year 1986, the definition of Insider Trading was laid down by the Patel Committee, as “Trading in the shares of a company by the person who are in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others.” In the year 1940, the very first recommendation of implementing
Insider Trading Regulation was received in India. Thereafter in the year 1948, a report was submitted by the Thomas Committee stating that all the directors, agents, officers, auditors should make proper disclosures. In 1956, with the enactment of the Companies Act, provisions to prevent Insider trading was introduced. According to Section 307 and 308 of the said Act, the directors and all the major key managerial persons were required to maintain a record of their shareholdings in the register and to make the complete disclosures of their shareholdings. However, these provisions were not stringent enough to prevent the crimes of Insider Trading.

By this time, the effects of insider trading were already been seen in the market. Not only the shareholders were losing confidence in the functioning of the markets, but were also refraining themselves from investing. And not too much surprise, even the foreign investments were adversely affected. As a result of all these the Indian Economy started suffering losses, leading the government to introduce various Committees in order to have a check on and curb such practices.

In the year 1979, the Sachar Committee submitted a Report stating that, “Insider Trading practices are being carried out in the markets and there is a need to have specific provision to restrict and prohibit such practices”. Subsequently, in the year 1986, the Patel Commission put forth the need to make several changes to the Securities Contract Regulation. Further in the year 1989 the report by Abdul Hussain Committee suggested that the offence of Insider Trading should be made liable under Civil and Criminal laws. It also suggested for the formation of a body known as SEBI to regulate and keep a check on the working of the markets.

On the basis of the reports submitted by the aforementioned committees, Securities and Exchange Board of India (SEBI) was established with the aim to regulate the market transactions and dealings. The provisions of the SEBI Act further empower it to carry out investigations, trials and impose a penalty upon those who breach the laws and carry out unlawful activities.

Recent Amendments to the Insider Trading

Since overhauling the insider trading regime with the introduction of the SEBI (Prohibition of Insider Trading) Regulations, 2015 (“PIT Regulations”), the Securities and Exchange Board of India (“SEBI”) has continually sought to fine tune and tweak the regulations through amendments in 2018 and 2019. On July 17, 2020, SEBI notified the Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2020 (“PIT Amendment”), to introduce further changes to the PIT Regulations.

The PIT Amendment, approved by SEBI at its board meeting held on June 25, 2020, include the following key changes:

- Enhancement of the structured digital database towards seeking and storing additional details of persons sharing unpublished price sensitive information (“UPSI”)
- Automation of shareholding disclosures and change in reporting authority for making disclosures of PIT violations by listed entities, market intermediaries and fiduciaries.
- Introduction for additional transactional mechanisms as an exception to trading window restrictions.

Changes Introduced to the PIT Regulations

A. Structured digital database

Prior to the PIT Amendment, the board of directors of a listed company were required to simply maintain a structured digital database containing names and Permanent Account Number (“PAN”) (or any other identifier, where PAN was not available) of UPSI recipients. This directive had given rise to queries on the manner in which listed entities were supposed to record details where the UPSI recipient comprised an intermediary or fiduciary, given that listed companies often interact with them. SEBI had answered this through its FAQs issued in November 2019, wherein it was clarified that in cases where UPSI has been shared with intermediaries/ fiduciaries, the listed company would be required to maintain details of the recipient entity while the intermediary/ fiduciary would, at their end, be required to maintain a list of individuals having access to UPSI, in accordance with the PIT Regulations.
Now, in an attempt to bolster the level of compliance, SEBI has, through this PIT Amendment, directed all entities handling UPSI to maintain such a structured digital database.

In addition, SEBI has also ensured that additional details are sought and stored in this database, including the nature of the UPSI and the names of persons who have shared it with others (in addition to details of the recipients).

From an internal administrative perspective as well, SEBI has incorporated the following necessary amendments:

- Maintenance of structured digital database for a period of 8 (eight) years after completion of the relevant transaction, except in case of any pending enforcement or investigative proceeding by SEBI: While, optically, this duration may seem excessive in comparison to the typical regulatory requirement of 5 (five) years under AML laws, SEBI has chosen to align this period with SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015:

  “Preservation of documents –The listed entity shall have a policy for preservation of documents, approved by its board of directors, classifying them in at least two categories as follows:

  (a) documents whose preservation shall be permanent in nature;

  (b) documents with preservation period of not less than eight years after completion of the relevant transactions:

  Provided that the listed entity may keep documents specified in clauses (a) and (b) in electronic mode.”

- Similarly, Section 128 of the Companies Act, 2013 incorporated the following amendments:

  Section 128(5), Companies Act, 2013: “(5) The books of account of every company relating to a period of not less than eight financial years immediately preceding a financial year, or where the company had been in existence for a period less than eight years, in respect of all the preceding years together with the vouchers relevant to any entry in such books of account shall be kept in good order”

This move would also avoid any roadblocks or challenges in obtaining information during investigations conducted by SEBI.

- Prohibition on outsourcing maintenance of the internal database: While entities routinely outsource their technology and IT functions, SEBI has strictly restricted outsourcing this database to third party service providers. Given that this database will hold a growing number of personal details of UPSI providers and recipients coupled with the listed entity’s own UPSI, the maintenance of the database itself would be sensitive operation and would have to be handled by entities in-house.

B. Reporting of violations of the Code of Conduct

SEBI has always viewed breach of an entity’s code of conduct on insider trading as a serious issue and has hence been constantly tweaking its laws to encourage and mandate reporting violations of the same. In 2010, SEBI held that a violation of the Code of Conduct would in fact amount to a breach of the Insider Trading Regulations, since the Code of Conduct has been incorporated into the regulations. In July 2019, SEBI first prescribed the format and procedure for reporting violations of the Code of Conduct to it.

While the recent SEBI circular dated July 23, 2020 ("Circular") slightly modifies the standard format for reporting violations which was set in July 2019, the PIT Amendment and this Circular also bring forth a substantial shift in the reporting matrix. With effect from this amendment, all listed entities, intermediaries and fiduciaries are required to submit the standard format identifying the violation to stock exchange(s) where the concerned securities are traded, and not to the securities market regulator anymore.

For listed entities, this change of guard from SEBI to stock exchanges continues to be relevant, from a price movement or surveillance perspective. However, the requirement for unlistered intermediaries/ fiduciaries to inform stock exchanges regarding any violation of their Code of Conduct seems to be an incongruous stipulation for all parties concerned, given that such entities (unlike listed companies) would typically not have any
interaction with stock exchanges. It remains to be seen how these proposals will be implemented and whether the stock exchanges themselves issue any circulars or guidance in this regard.

In terms of the format itself, the PIT Amendment does not clarify the mechanism for such intimation to stock exchanges and whether such information would be disclosed to the public or simply maintained by the stock exchanges. It is pertinent to note that the violations reported to SEBI previously were not generally required to be published in the public domain.

Separately, the Circular also provides payment details for remittance of penalty imposed by entities on their designated persons violating the Code of Conduct to the Investor Protection and Education Fund administered by SEBI. Previously, as part of the action taken upon identification of the violation, entities would often penalise their designated persons without proper clarity from SEBI regarding where such amounts are to be deposited. With this Circular in place, all such proceeds will have to transferred towards investor interests.

C. Trading Window Restrictions

The SEBI (Prohibition of Insider Trading) Amendment, 2019 introduced certain transactions to Schedule B which would be exempted from trading window restrictions. This list includes defences to allegations of insider trading covered under Regulation 4 of the PIT Regulations (transactions carried out as a result of statutory obligations, off market trade between insiders) as well as further public offer, subscribing to a rights issue, or tendering of shares in an open offer. This list under Schedule B was an indicative list and could not hence be extended to include transactions not included in the same.

Hence, the PIT Amendment has created room for SEBI to consider and recognise additional categories of transactions/ mechanism as an exception to the closure of trading window related restrictions. Following the PIT Amendment, and moving away from the SEBI board meeting takeaways, SEBI recently issued another circular on July 23, 2020, through which it has now permitted offer for sale and rights entitlement transactions to be carried out while the trading window is closed.

With each of these amendments, while SEBI has chalked out additional responsibilities for intermediaries and fiduciaries, as well as streamlined its own regulatory powers with stock exchanges, the overall impact on the market hygiene remains to be seen. While there seem to be concerns regarding the degree and extent of control that may be exercised by stock exchanges over unlisted entities, the same will depend on successful implementation of the PIT Amendment and issuance of further clarifications and circulars by SEBI.

As noted above, the requirement of maintaining an enhanced digital database is in line with SEBI’s investigation and surveillance procedure. However, the same may lead to certain operational challenges and issues for the listed company, intermediary or fiduciary, because in addition to maintaining more data for a longer period of time, the entity is no longer permitted to outsource the task of maintaining the database to a third party.

Regulations in India Regarding Insider Trading

The regulatory body that ensures proper corporate governance in India is the Securities and Exchange Board of India. This body keeps a watch for any unusual transaction related to purchase or sale of listed securities. The TISCO Case of 1992, paved the way for formation of the Securities and Exchange Board of India in the year 1992. In the Tisco, case the profits of the company sharply fell and there was a sale of shares in small quantities before the announcement of the half yearly results. The Court held that there was no insider trading as there is no evidence for the same. As there was a lack of regulations and procedures the culprits could not be made liable. This finally led to the forming of Securities Exchange Board of India (Insider trading) Regulations, 1992. After the Regulation of 1992, a significant change was made to Insider Trading laws in India in the year 2015. Hence the “SEBI (Prohibition of Insider Trading) regulation, 2015”, was enacted to resolve the flaws in the earlier regulation as the unlawful transaction were not covered with thin ambit of the regulation. Another, significant amendment has been carried out in the year 2019 where efforts have been made to cover direct and indirect transactions. The Companies Act of 2013 also had a provision to restrict Insider Trading. Section 195 of the Act prohibited any communication of sensitive information by the key managerial persons. Later, this section was omitted as section 458 of the Companies Act delegates the power to SEBI to conduct trials against the accused persons and therefore there was a confusion that the accused should be held under the Companies Act or the SEBI regulations and therefore in 2017 the section 195 was omitted by a notification. Hence, the current
regulations regarding Insider Trading in India are the SEBI (Prohibition of Insider Trading) Regulations, 2015 and Section 12A (Prohibition of Insider trading) and 15G (Penalty for Insider Trading) of the SEBI Act.

Insider trading regulations around the world

There is a considerable cross-country variation in the quality and quantity of corporate reporting, information intermediation and information dissemination structures. The USA has strict insider trading regulations in the world today. The US Securities Exchange Act of 1934 was the first to enact the insider trading law to place restrictions on insider trading. The Securities Exchange Commission (SEC) of USA has zero tolerance for insider trading activities. The verdicts for the culprits of insider trading will be imprisonment and huge penalties. Thereafter, most developed economies as well as several emerging markets have followed and prohibited insider trading. Eradicating insider trading has become one of the most important goals of market regulators. Bhattacharya and Daouk (2002) collected information on the existence of insider trading laws from 103 countries. The existence and enforcement of insider trading laws were first established in the USA in 1934, and it is the first nation to prosecute the insider trading case in 1961; however, it took 27 long years to report its first insider trading case for prosecution. Malaysia has taken 23 years to report their first insider trading prosecution among all the other nations. Canada and France have framed insider trading regulations in the 1970s, and the prosecution was reported during 1970s only. The UK and Germany have prosecuted insider trading cases within one year of their insider trading regulations, whereas Sweden and Canada have taken 19 years and 10 years, respectively, in the first prosecution of insider trading case. Whereas, India has framed its insider trading regulations in 1992, and in 1998, it has reported the prosecution of insider trading, that is in six years of framing such regulations. By 2000, 87 countries had passed insider trading laws and 38 had prosecuted at least one insider trading case (Bhattacharya and Daouk 2002).

The following are the three sections which infer the insider trading regulations in the various nations. These imply the strength of the stock markets of a nation:

1. Level playing field: The market should be fair to all the participants. The regulatory bodies in all countries aim primarily at a level playing field by promoting fair and full disclosure of all material information by the listed companies, so that insiders will not have any unfair advantage.

2. Investor confidence: Restricting insider trading will increase the investor confidence in financial markets. Permitting insider trading does not seriously threaten the investor’s confidence. Further, investor participation depends not only on the laws in place but also on the confidence that they will be enforced fairly.

3. Market efficiency: Fama (1970) used the concept of strong-form efficiency in his Efficient Market Hypothesis (EMH) to characterize a market where private information is fully reflected in stock prices. EMH states that most of the developed countries’ stock markets fall under the semi-strong category. The securities markets are informational efficient, and the securities prices reflect all the publicly available information but not the private information. The insiders’ private information will affect the securities prices positively/negatively on the markets.

Judgments on Insider Trading

The case of Hindustan Lever Limited (HIL) Vs SEBI, was one of the earliest cases where SEBI acted against Insider trading, in this particular case around 8 lakhs shares were bought by HIL from the Unit Trust of India, and after some weeks a merger was announced between HIL and the other subsidiary. SEBI carried out an investigation and it was held that it was a case of Insider Information, an appeal was made to the Appellate authority and they confirmed the order of the SEBI rejecting the arguments given by HIL denying having the information or knowledge for the same. After this case SEBI made an amendment to the regulations and added and defined the word ‘unpublished’. This was the origin for the definition of the term ‘Unpublished Price Sensitive Information in India’. In another case of Reliance Industries limited (RIL) Vs SEBI, RIL had a stake of around 5% in the L&T company and further there were two nominees for the company Mr. Mukesh and Anil Ambani. Further, RIL went on purchasing stake in L&T and almost got around 10%. RIL further made a sale of these shares above the market price to Grasim Industries as a result of which the two nominees were removed and RIL was prohibited from further trading in shares of L&T. SEBI carried out an investigation and a case was filed against RIL in which they were held to be guilty of Insider trading. In an appeal the Appellate Tribunal reversed the order of SEBI stating that the information was not passed by the nominees of L&T and the same had no relation in communicating or passing of the information. L&T was not even aware of the deal and there was no evidence to prove the same. Therefore, RIL was not made liable for Insider trading.

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As we can observe from these cases the conviction by SEBI for Insider trading is very less and the penalty imposed upon the convict for the commission of such illegal activities is way to less. Hence, in the next part of this Article we will discuss the problems with SEBI and the regulations in dealing with Insider Trading.

Problems Regarding Insider Trading in India

There have been many arguments about the legality and the illegality of Insider Trading. But most of the scholars and investors state that Insider Trading is against the integrity of the market. This is because the it gives an unfair advantage to the people having access to such information as there is no risk or losses that such people suffer. Also, it causes the investors to lose their money as the people having such sensitive information carry out certain malpractices of manipulating and spreading rumours which leads to change the mind of many investors while trading in the stock markets. This further leads to loss of confidence of investors to invest in markets which is a very big concern for the economy and it also affects foreign investments. Therefore, the practice of Insider Trading is very harmful for the markets and there needs to be a regulating authority to keep a check and prevent such malpractices.

Also, another problem that is faced by SEBI is proving the cases of Insider trading as there is not always sufficient evidence to prove that a particular trade was a result of Insider Trading. As the people having access to such UPSI use third parties or make some other transactions through which they escape the liability and are held not guilty. Also in many cases the court has not been able to give proper judgment as the regulating authority has failed to prove any direct relations between the Information and the trade. As a result of this the investors lose their money, and the markets suffer the loss.

Another difficulty is that although there are provisions for Criminal Liability in the SEBI regulations but implementing them is difficult. As there is a need for Mens Rea to hold a person liable under Criminal law. It becomes very difficult for SEBI to prove the case of Mens Rea and so the accused often escape criminal liability and are held liable under civil law. Therefore, there is no fear in the markets and so this sensitive information is freely circulated. For instance there have been cases that such information is being passed through WhatsApp messages on various groups. The SEBI has been trying to investigate these matters but have found no solid proof to make a case against the persons passing such sensitive information.

Lastly, the Indian judiciary system takes many years to pass a judgment and the option of appeals gives the offenders enough time to manipulate the evidence and escape such liability under the SEBI regulations.

II. CONCLUSION AND SUGGESTION

It would be safe to conclude that, Insider Trading is no more a White-collar Crime. Countries across the globe have taken stringent measure to check and prevent on practices such as Insider Trading. In the United States of America, the Federal Court convicted Rajat Gupta the director of Goldman Sachs for Insider trading. The facts of the case stated that, Rajat Gupta was found guilty of passing sensitive information about the market to Raj Rajaratnam, a co-founder of the Galleon Group LLC hedge fund. The ruling by the Court sentenced him to two years of imprisonment and a fine.

It is a high time for India to implement such measures for the persons who have been found guilty and not treat Insider Trading just as a white-collar crime. As there is only a less than three percent conviction rate in such crimes in India there is a need to amend the regulations and to add strict criminal proceedings and awards against such offences. There also needs to be another regulatory body along with SEBI to track down high profile cases and prevent such sensitive information flowing in the market.

Also, the SEBI as a regulatory body needs to increase their staff as there is only one official having a look over six companies and so it is not possible for SEBI to track and regulate every such function of the companies.

Further, as the number of cases is increasing every year, the Indian Judiciary needs to set up fast track courts for certain high-profile cases that involve a huge stake of the market as it would not only save the investors and the markets money but would also curb the illegal practice of Insider Trading.
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