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STOCK MARKET MANIPULATION AND INSIDER TRADING: THE DEVILISH BIDENT.

AUTHORED BY - AMAN BANSAL
& VARUN THANAWALA.

The technological advancements and the process of globalization and liberalization has led the world to become a global village and with this, there has been a great advancement of various economies all around the world. An economy is the mechanism that determines how limited resources are used to generate and utilize products and services.¹ With the advancement and development of the economies of the countries, businesses have flourished and companies operate overseas with ease. One of the major benefit has been experienced by the stock markets all around the world with the help of globalization and liberalization. The phrase “stock market” is frequently employed when referring to a group of exchanges and other locations where equity shares in publicly traded firms can be purchased, sold, or issued. These monetary transactions are conducted through either formalized physical or electronic platforms, or through the Over-the-Counter (OTC) sector, which is governed by a certain set of rules and regulations.(1) One of the major advantages of the stock market is that people can invest their money into companies and become shareholders of huge corporations, even with a small amount of money. The term “company” may be understood to mean an association of people working towards a shared goal or goals, which is often to make profits. There are several types of companies, two of which include private company and public company. The major difference between a private limited company and a public company is that a private limited company is owned by a group of private investors and on the other hand, a public company is listed on the stock market and is owned by a large set of retail investors as well as various corporations and institutional investors as well as foreign investors (FII). Many retail investors often invest a very less share of their income in the stock market and often gain benefits and profits over a period of time, which is often termed as ‘long term investing’. But buying and selling of stocks or securities often leads to great losses to retail investors when big players, huge cartels such as the bear and the bull cartel, institutional investors and corporate syndicates try and manipulate the market for their personal gains. It is possible to manipulate the value of a security by engaging in behaviour that is either intentionally or wilfully structured to

¹ Reserve Bank of Australia. What Is the Economy? - Reserve Bank of Australia.
<https://www.rba.gov.au/education/resources/presentations/pdf/what-is-the-economy.pdf>.

mislead or defraud shareholders by influencing or artificially impacting the stock's value, or by engaging in behaviour that is specifically intended to tamper with the free market forces of demand and supply. Trading on non-public information, often known as insider trading, is unethical because it compromises the fairness of the market, which requires that prices be determined by the uninfluenced consensus of buyers and sellers. In addition to this, it erodes markets that are genuine, equitable, and well-ordered, and investors will steer clear of the market if they believe it to be unfair and susceptible to manipulation.²

Insider trading and stock market have been equidistant since incorporation. Judiciary, SEBI and legal scholars have propounded upon the effect of insider trading upon individual investors but it has not been examined under the lens of the impact on economy. It is believed that stock market is a cribbed, cabined and confined phenomenon but at heart as the paper would discuss the stock market is quintessence of economy. This paper will focus on answering the question that “ What are the repercussions of stock market manipulation and insider trading?”

A country's economy is dependent on various factors and industries and businesses play a vital role in the economic advancement as well as affect the Gross Domestic Product (GDP). The sum of all value added produced inside an economy is measured by the GDP and when the GDP of a nation increases, so does cash flow.³ In the financial system, cash flow has a big impact on consumer spending, business investment, and total economic expansion.

Thus, higher cash flow increases the purchasing power of the consumers and this in turn leads to increased business opportunities and overall economic development. With increased purchasing power, the general populace makes various kinds of investments and this in turn affects the stock prices as the retail investors add money to the stock market by buying equities, mutual funds, bonds, index funds or other financial instruments, which leads to an increase in the overall stock market index. Negative cash flow, on the other hand, may cause investors to pull back, stock prices to fall, and the economy to slow down. As a result, the country's economy, GDP, and cash flow are important factors that influence stock prices or the stock market index as a whole.

2 Securities Exchange Commission, USA. “Market Manipulations and Case Studies.” SEC Emblem, <https://www.sec.gov/file/market-manipulations-and-case-studies>.

3 Callen , Tim. “Gross Domestic Product: An Economy's All.” IMF, 15 June 2019, <https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/gross-domestic-product-GDP>.

With an increase in the stock prices, the companies often become more appealing and more often than not represents that the operations conducted by the company's executives are profitable and that the company is riding itself on the path that leads to success. A company usually dilutes its shareholdings and goes public in order to accumulate or raise money from the retail investors in order to expand its business, increase its production, technologically advance itself, increase its buying power and generate more revenue. It further boosts the investor confidence and it encourages people to join the market and start their investment journey. This increased investment by the retail investors oft-times leads to an embarkment of a cycle that increases the cash flow in the market. The increased money in the stock market by the retail investors boost the company's reputation and goodwill, which benefits the company in acquiring and building a solid clientele and in the process of this, the company's cash flow increases due to the increased business from the newly established demand from the acquired clientele. The increased business leads to increased profits which in turn leads to declaration of higher dividends and bonus issue, which in the end proves to be advantageous for the investors and shareholders of the company. This whole cycle successively pumps more money in the economy and the purchasing power further increases and so does the GDP. The increase in the stock prices of the company and the goodwill and reputation build by it often helps the company to raise or accumulate more money from the market by the means of further public offer (FPO) and thus, whenever the company in a need of capital, the company can raise it easily by diluting the shareholding due to the increased confidence of the market towards the company's management and style of conducting business.

With reference to the aforementioned information, it can be often concluded that the stock market is all rosy and awe-inspiring but this all reverie shatters like glass when the devilish bident strikes the stock market. The devilish bident that shatters the hope of the investors has two prongs, namely stock market manipulation and insider trading. Artificially affecting the demand and supply of the securities is known as stock market manipulation and it can be orchestrated using two strategies, namely action-based manipulation and trade-based manipulation. The strategy of action-based manipulation works when the manipulator takes certain actions related to the company, other than trading its stocks, which generates a news or information which is more often than not is erroneous. Based on this erroneous information or news, the retail investors dive in the market and affect the share price of the company, either positively and, oft-times negatively. Due to such acts, the share price either pumps or plummets and the manipulator thus gains profits from it based on his long or short position. On the other hand, when a prominent trader has the ability to dramatically alter the order flow to the market maker, they can influence prices using the other

trade-based manipulation approach. He outlines the circumstances in which such manipulation of the equilibrium price process is profitable. This method of influencing the stock price is frequently used by traders to strengthen their position in the futures market.⁴ Stock market manipulation oftentimes goes hand in hand with, the second prong of the devilish bident, insider trading.

Insider trading refers to dealing in or trading shares or securities such as bonds on the basis of the unpublished price sensitive information that only certain personnel of a company possess. Insider trading is one of the biggest dereliction of the corporate personnel, who, for personal gain, breach their fiduciary duty and become a threat to the sanctity of the stock market. Insider trading not only burns holes in the pockets of the retail investors but also damages the reputation of the company, the stock exchanges as well as that of the SEBI.⁵ Due to price fluctuations of the stock prices and loss booking by various retail investors, forced due to compulsion, many people shun away from the stock market and many people consider stock market to being similar on the lines of gambling.⁶

As per the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 2 (e), “an insider is any person who is a connected person or is in possession of or has access to unpublished price sensitive information (UPSI) or has received or has had access to such unpublished price sensitive information”.⁷

In order to prevent such market malpractices and regulate the stock market, the SEBI (Securities and Exchange Board of India) acts as a regulator and keeps a track of the everyday trading volumes of the market. If the SEBI finds a certain trade suspicious and conjectures it to be a trade based on mala fide motives, it scrutinizes such trades and often such investigations by the SEBI leads them to the doorsteps of major broker houses or powerful corporate personnel who might have indulged in either insider trading or stock market manipulation.

Further, the Hon’ble court stated in its judgement in the case of SEBI v. Hindustan Lever Ltd. that

4 John, Kose, and Ranga Narayanan. “Market Manipulation and the Role of Insider Trading Regulations.” Market Manipulation and the Role of Insider Trading Regulations, The University of Chicago Press, Apr. 1997, <https://www.jstor.org/stable/10.1086/209716>.

5 Business Standard. “Insider Trading: What Is It?” Business Standard, 8 Apr. 2023, <https://www.business-standard.com/about/what-is-insider-trading>.

6 Carlton, Dennis W., and Daniel R. Fischel. “The Regulation of Insider Trading .” The Regulation of Insider Trading, Stanford Law Review, 5 May 1983, <https://www.jstor.org/stable/1228706>.

7 Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 2 (e).

“ The SEBI Regulations on insider trading seek to prohibit persons who by virtue of their connection with a company received unpublished sensitive information from using such information/dealing in the securities of the company on the basis of such information to make secret profits/person gains.”⁸

Furthermore, there have been various examples of how the money games played by big players have always affected the retail investors and some of which have costed the retail investors their life savings. One of the infamous incidents that dilapidated the savings of various investors was that of the Crash of 1982. The tussle of shares between the corporate giant Reliance and the Kolkata Bear Cartel, where the latter shorted shares of the former in order to bring its price down, led to a great crash and the BSE was shut down for three trading days in order to settle the ‘Badla’ trade between Reliance and the Kolkata Bear Cartel. Due to this crash, a lot of people lost their money that they had invested in the market and the ‘Friends of Reliance’ association of brokers and Dhirubhai Ambani made their profits. This is a classic example of how corporate wars and stock price manipulation leads to great losses for the small time traders and the retail investors.(cite)

Another incident of insider trading that occurred in late 1929 in the United States of America was that of Albert H. Wiggin, who was the head of Chase National Bank. Wiggin shorted the shares of his own company and after the Wall Street Crash of 1929, he made a little over \$4 million. He shorted the shares using the businesses owned by his family and close relatives and even created a Canadian shell company in order to avoid paying taxes on his profit. The fact that he was not prosecuted for his act is even more shocking due to the fact that there existed no regulation during those times that prevented Wiggin from doing so. But the SEC (Securities Exchange Commission) learned from their mistake and introduced the ‘Wiggin Provision’ under the Securities Exchange Act, 1934. The "Wiggin Provision," introduced by the SEC, forbade corporate directors from shorting their own shares in order to benefit when their business was in peril. But the fact that a corporate head, who possessed certain classified information, made money off a crash when the whole of the investor community suffered, lays an emphasis on the fact that insider trading is truly harmful for the investors and the businesses who invest and operate with bona fide intentions.⁹

⁸ 1998 (18) SCL 311 (AA).

⁹ Hall, Phil. “Wall Street Crime and Punishment: Albert H. Wiggin, an Old-School Banker Whose Stock Prescience Got Him in Trouble.” Yahoo! Finance, Yahoo!, 2 Apr. 2021, <https://finance.yahoo.com/news/wall-street-crime-punishment-albert-134017633.html>.

When question of mens rea arises as an argument in order to prove that a trade on the basis of insider information was conducted with a legitimate reason, the Hon'ble court has stated that mens rea needs to be checked, in the case of SEBI v Abhijit Rajan¹⁰, but it is also important to take into consideration that "... Public confidence in directors and others closely associated with companies requires that such people should not use inside information to further their own interests. Furthermore, if they were to do so, they would frequently be in breach of their obligations to the companies, and could be held to be taking an unfair advantage of the belief with whom they were dealing". Attorney- General's Reference (1) of 1988, (1988) IAC 971.¹¹

It is oft-times argued by the critics that Albert Wiggin acted on the dealings of the securities in a way that also contained certain legitimate reasons, but this critique can be challenged by the judgement of SEC v. David E. Lipson (U.S. Court of appeal (7th circuit) Docket No. 01-1226). In the case of SEC v. David E. Lipson, it was determined that just because an insider dealt in securities for two reasons—one of which was legal and the other was solely to make money illegally—having the legal reason did not "sanitize" the illegal reason.¹²

There are multitudinous examples of how powerful people have abused the stock market and filled their pockets with money at the expenses of the corporate houses and the general public investors, but only lamenting about such malpractices and manipulations is not the solution to the persisting problems caused by the devilish bident. In order to bring a change, the below mentioned propositions regarding certain modifications and initiatives are of absolute necessity.¹³

The suggested propositions are as follows:

1. Although the SECURITIES AND EXCHANGE BOARD OF INDIA (PROHIBITION OF INSIDER TRADING) REGULATIONS, 2015 under institutional mechanisms to control insider trading mandates companies to reward whistle-blowers, the whistle-blowers must be rewarded by SEBI as well. SEBI can easily procure funds as the punishment under section 15G of Security Exchange Board of India Act 1992 is punitive in nature.¹⁴ Draft section for the same can be as:

¹⁰ Civil Appeal No.563 of 2020.

¹¹ (2004) 1 CompLJ 193 SAT, 2004 49 SCL 351 SAT.

¹² 129 F. Supp. 2d 1148 (N.D. Ill. 2001).

¹³ Leland, Hayne E. Insider Trading: Should It Be Prohibited?, The University of Chicago Press, 4 Aug. 1992, <https://www.jstor.org/stable/2138691>.

¹⁴ Security Exchange Board of India Act 1992, Section 15(G).

Reward for providing information related to insider trading

If any whistle-blower who-

- (i) Either directly or indirectly informs the board about dealings in securities of a body corporate listed on any stock exchange on the basis of any unpublished price-sensitive information; or
- (ii) Knowingly directs, counsels or procures any other person to inform about dealings in securities of a body corporate listed on any stock exchange on the basis of any unpublished price-sensitive information;

shall be entitled to reward which shall be ten percent of the penalty imposed under Section 15G.

provided the penalty imposed was direct effect of information derived from whistle-blower.

2. Ease of business: Company law regulations in India have been stringent and with onset of cheque book wars, India has paid even more attention to financial frauds. Stringent laws deter mischief but also terrify the investor as mistakes can also be prosecuted. It is evident from the World Bank's ease of doing business report wherein India ranked 131 out of 189 economies. The actions of employees of SEBI are protected under Section 23 of Securities and Exchange Board of India Act, 1992, similarly a safe harbour clause must be provided for the actions of company executives if acts are undertaken under good faith.
3. Introspection: Public employees have been fathomable and SEBI employees are ejusdem generis. In considerable cases it has been devised that employees were lubricated successful insider trading and scapegoated smaller entities. Although achieving honesty is arduous, the authority must self-regulate and ensure the board does not end up as bug bear.
4. Effective monitoring: SEBI must engage in exhumation. It has record of every trade and the insider trading is done right before strike. The insider or connected person does not involve in small quantity so all significant transactions can be censored. It is also rule of common parlance that directors trade in the name of third party so it must draw connections like Enforcement Directorate.

5. SEBI must look into quality litigation and not quantity: Income tax department learnt the lesson that tapping mundane frauds lead to wastage of resources so a 5 crores bar was set. Similarly the SEBI must not act on minute frauds. This does not mean that it should not vet every transaction but pursuing all is haste of time. Just because preliminary enquiry has been done doesn't mean case has to be filed. It has been assigned the task to separate shaft from the chaff, although at times the relativity leads to injustice it must take up pressing cases as the resources are limited.
6. Satisfaction of officer: Although the required level of proof to hold one guilty is preponderance of probability as established in V.K. Kaul v SEBI¹⁵, the authority must not charge and initiate proceedings just because it is doubtful. It must indulge in thorough investigation and file case once it has reason to believe.
7. Frivolous litigation: The agency must not take the unfavourable judgement of SAT as a personal defeat. As noticed in Vodaphone case¹⁶, it is human psychology that no one wants to take the blame on oneself so they keep pursuing the matter to the extent that the government disregarded the decision of its own supreme court. It has been noticed that after losing in SAT proceedings which is a special tribunal the agency files appeal in Supreme court. Apart from wastage of departments resources it dwindles the confidence of national and international investor as mere satisfaction of a bureaucrat makes him invest majority time in litigation hence hindering business.
8. Increasing transparency: Companies must be required to disclose more information to the public, such as information on compensation to executive, trade etc. When the information will not be exclusive and live updates will be provided the scope for wrongful gain will be minimal. It will act as transplantation without amputation.
9. Resource allocation: The regulatory body is responsible for monitoring insider trading covered in millions of transactions so for effective enforcement of laws it should be given more resources. It has been bestowed with sufficient authority to detect and prosecute instances of insider trading but to enforce the laws it needs more resources.

¹⁵ (2013) 2CompLJ583 (SAT).

¹⁶ 2012 SCC 6 613.

10. Penalty: the punishment is supposed to deter insider from committing the crime but since the quantum of penalty is low it does not leave a hole in the pocket of wrongdoers. The quantum of penalty must be increased as the ones who commit have more resources. Low penalty makes the crime more lucrative and susceptible to atavism.

11. Mens rea: Legislature needs to amend Section 15G to clear the confusion pertaining to the element of mens rea. Under the section Actus reus is sufficient to hold one liable but judicial interpretation has not been in lines. In Rakesh Agarwal v SEBI¹⁷ the court checked the background and required guilty mind. In later judgements it was overruled the requirement. In Kanaiyalal Baldevbhai Patel¹⁸ the volume, the nature of the trading and the timing of the transactions are to be taken into account but it is not an indispensable requirement to attract the rigor. In recent caselaw i.e. SEBI vs Abhijit Rajan¹⁹ court held circumstances under which shares were sold as permissible and acts done under necessity and good faith vitiated the proceedings. A proviso providing immunity can be added.

12. Increasing public awareness: it is often clerical staff that holds secrets of management but the benefit of whistleblowing remain unknown to them. SEBI post setting rewards and immunity must advertise the provisions and educate the side effects of insider trading to public at large.

Withal, the need for an regulated yet free stock market is very crucial in the present changing times when the world is evolving and the companies and start-ups are getting support and boost that they deserve. With a stock market that is free from manipulation and insider trading, new prospective investors can be attracted and thus, the vision of a financially stable and a self-sufficient economy can be achieved. Furthermore, more participation from the public end can boost the GDP and further enhance the financial world with increased cash flow and an increased investor confidence. Therefore, in order to make the stock market a safe haven for all, the devilish bident needs to be melted and a safe, secure and sacrosanct environment must be created in and around the stock market.

¹⁷ (2004) 1 CompLJ 193 SAT, 2004 49 SCL 351 SAT.

¹⁸ (2017) 15 SCC 753.

¹⁹ Civil Appeal No.563 of 2020.