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CORPORATE GOVERNANCE IN INDIA: IMPACT **OF GOOD CORPORATE GOVERNANCE ON** **INSIDER TRADING**

By: Arushi Jain

INTRODUCTION

Corporate Governance and transparency of high standards are essential for the development of capital markets. Disclosure of information about a company allows the investors to make a prudent and informed decision about investing in that company's securities. Of course, market distortions occur if the insiders of a company have in their possession some information which is superior that they can use in order to trade in company's securities, which information is generally not available in the market or to the counterparties with whom they trade. Thus, countries usually tend to put in force the law that bans Insider Trading.¹

The relevance of insider trading is increasing in Indian context considering the corporate governance crises that is faced in the contemporary era. Insider trading is considered to be the most heinous misconduct in the stock market, it is the most troublesome to deal with by regulatory authorities around the globe. Insider trading is dependent upon innumerable meanings and definitions and includes both the prohibited as well as legal actions. On a daily basis insider trading happens legitimately by the Corporate insiders i.e., company officials, directors and employees, when they buy and sell stock within the confines of the company policy and the guidelines administering this trading. Simply put, "insider trading" is the buying or selling of securities, in

¹ALAN D. JAGOLINZER,* DAVID F. LARCKER,t AND DANIEL J. TAYLOR ;Corporate Governance and the Information Content of Insider Trades

https://www.jstor.org/opj/remotlog.com/stable/pdf/41328958.pdf?ab_segments=0%2Fbasic_search_gsv2%2Fcontrol&refreqid=fastly-default%3A03407aa0074ccabba9e7ed973b7888f9

violation of a fiduciary duty or any other relationship of trust and confidence, while in possession of some important non-public information with regards to the security.

It is not against the law for a company insider to trade company stock. In fact, trading insiders, including directors, officers, and employees of a company in its own stock, is a positive trait that companies encourage because they align their own interests with those of insiders. Trading in the company's stock by insiders based on non-public information other than by others is prohibited. Therefore, insider trading is one of the most powerful crimes against market fairness.

Insider trading essentially means trading the securities of a company on the basis of undisclosed or confidential information relating to the company and such information is not publicly known and is treated as undisclosed price-sensitive information which is used to make profit or to avoid a loss. This is a fair violation of the fiduciary duty towards the shareholders by a company's officer or any connected person as defined in the SEBI (Prohibition of Insider Trading) Regulation, 1992,

UNDERSTANDING CORPORATE GOVERNANCE

“Corporate governance is about promoting corporate fairness, transparency and accountability”²

The system of rules, processes and practices by which an enterprise is controlled and directed is Corporate governance. The concept of corporate Governance mainly demands the balance of interest of the stakeholders of the company, these stakeholders include Shareholders, customers, senior management executives, financiers, community and the government.

Corporate governance also covers every area of Governance, from action plans and internal controls to performance measurement and public offerings, as it provides the foundation for achieving corporate objectives.

The shareholders of a company and its advisors play a very vital yet indirect role in influencing corporate governance and they themselves are not corporate governance. However, the board of directors of a company play a key role in governance and can have a significant impact on equity valuation. Corporate Governance is important to investors for the reason that it shows the direction and integrity of the company. Good Corporate Governance helps the companies to earn trust of investors and society resulting in improved financial viability by creating long-term investment opportunities for the market participants.

Corporate governance is the guiding principle established by a company to take control of all its

²J. Wolfensohn, president of the World Bank, 1999; <https://www.mbaknol.com/strategic-management/definitions-of-corporate-governance/>

operation from risk management to compensation and employee treatment and it also includes the reporting of unfair practices its impact and more. It is encouraged that a company shall have strong and transparent corporate governance as it results in, a company adopting ethical decisions and solutions that benefits all the stakeholders by making it an attractive option for the investors if it also performs well in the financial terms. Whereas, poor corporate governance leads a company to face corporate breakdown which as a result leads to scandals and bankruptcy.

“The system by which companies are directed and controlled Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society”.³

Factors Influencing Corporate Governance in the Indian Context

1. Role of Independent Directors

The corporate structure in India places great emphasis on the role of the Independent directors in ensuring good corporate governance. Article 49 of the listing agreement with the stock exchange stipulates that non-executive directors must constitute a minimum of half of the board of directors. Further, it also defines “Independent” director and requires that in the chairman is an executive director then in that case the independent directors shall comprise of a minimum of half of the total Board of Directors. And if in case the chairman is a non-executive director then at least one-third of the total number of directors shall be the independent directors. It has been mandated by the companies Act, 2013 that each listed company shall have a bare minimum of one-third of the total directors as independent directors and the minimum number of independent directors for a public company shall be notified by the central government. Also, it is crucial and even the law requires that the independent directors shall not not have any material relationship with the officers of the company as it could affect their independence during the ongoing fiscal year or the preceding two years.

2. Directors remuneration

In accordance with the SEBI Code on Corporate Governance, the Board of Directors determines the amount of remuneration for non-executive directors. Full disclosure of elements of

³ Sir Adrian Cadbury, <https://www.mbaknol.com/strategic-management/definitions-of-corporate-governance/>

compensation packages, incentives, service contracts, and stock options should be made public.⁴ Companies Act 2013 requires each publicly traded company and the company referred to in the rule to form a nomination and compensation committee which shall consist of at least three non-executive directors and a majority of independent directors. It will formulate the criteria for determining the qualifications, positive qualities and independence of directors, as well as formulate board recommendations for remuneration policies for directors, and all other employees and the committee's policies will be disclosed in the report of the Board of Directors. Such level of transparency helps to avoid any conflicts of interest and remuneration that affect the effectiveness of the non-executive director's role.

3. Competency of Board of Directors

The manner in which a company is managed and controlled is greatly influenced by its Board of Directors. All the strategies that have to be adopted are made and executed by the Board of Directors of that company and the Board of Directors have the right to contest and question the strategy put forward by the management if in case it goes against the path of Good Corporate Governance.

4. Role of Shareholders committee

The SEBI Code of Corporate Governance stipulates that a shareholders' committee, chaired by a non-executive director, must be formed to properly receive and resolve shareholders' complaints. Institutional investors can play an active role in ensuring good corporate governance. It can serve as a communication channel for individual shareholders to express concerns to company management.

The 2013 Companies Act requires all publicly traded companies or those with more than 1,000 shareholders, bondholders, depositors and other securities holders to form a stakeholder engagement committees at any time during the fiscal year. The non-executive director will be the chairman. The board will make decisions about other committee members. The Committee reviews and resolves complaints from owners of company securities.⁵

5. Transparency and Full Disclosure

Companies are required to disclose complete and accurate information in their mandatory

⁴ International Journal of management and social sciences Research (IJMSSR) ISSN: 2319-4421; VOL 3, NO. 5,(May,2014); https://www.academia.edu/28612654/Corporate_Governance_Conceptualization_in_Indian_Context

⁵ The Companies Act, 2013 sourced at <https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>

disclosures on the stock market and in their annual reports as This increases the trust of shareholders. The Company Act 2013 requires that Board of Directors reports shall include information on meetings, attendance, remuneration of directors and key executives. Apart from that it shall also include any fines or penalties imposed on the company or its officers. The company's policies regarding the appointment and remuneration of directors, such as criteria for judging the independence of directors, merits of outside directors, and remuneration policy for KMP, will be determined. The report also lists the Board's comments on each disclaimer, negative comment or disclaimer made by the auditors and company secretaries. "The company shall also have a Corporate Social responsibility policy".⁶

The corporate governance spirit guarantees fairness, transparency and accountability. The appointment of a Chief Ethics Officer and to have a clear Code of Ethics will go a long way in ensuring good corporate governance. India's corporate system has shifted from a public sector-led economy in the socialist era to a dynamic, private sector-led economy. The law developed slowly. However, the 2013 Start-up Act and SEBI's aggressive actions paint a positive future for Indian corporate governance. India's corporate governance system is characterized by strict laws but poor implementation. Independent directors can play a very important role in this process. The 2013 Act established binding and clear regulations in this regard and made it a very effective corporate governance structure. "A timely and accurate flow of information to shareholders is essential as shareholders can play a critical role in ensuring good corporate governance."⁷ The new law did this by broadening the scope and area of board reporting and updating the financial statements on the company's website by each company. There have also been positive developments in law enforcement with the establishment of the Serious Fraud Investigation Office with legal status. Auditors are also provided with clear guidance in the new law. Control of credit rating agencies' fair practices and effective whistleblowing mechanisms will further strengthen India's corporate governance. In a dynamic economic environment, laws are constantly changing and adapting.

INSIDER TRADING AND THE ROLE OF CORPORATE GOVERNANCE

A key question arises as to whether good corporate governance alleviates insider trading and influences the decisions of an insider to use confidential information which is not available

⁶ Sharma J P, 2011 Corporate Governance, Business Ethics and CSR.

⁷ Varma J V, 1997, Corporate Governance in India: Disciplining the Dominant Shareholder, IIMB Management Review, Bangalore.

publicly, in trading.

opportunistic insider trading is defined as “trade was corporate stock by corporate insiders that is motivated by non-public information and while such trading was undertaken by the insiders for their own financial gain, it potentially imposed significant costs on the firm and the outside shareholders.”⁸

Even though the jurists and the economists try weighing the benefits of Insider trading, the companies are interested in limiting information-based insider trading for numerous reasons. Firstly, the information anamorphism associated with insider trading reduces liquidity by imposing a direct cost on external investors. (Manove, 1989; Chung and Li, 2003); Second, such insider trading dwindles the confidence amongst the investors in the capital markets who are of elementary belief that insider trading is incompatible with the principle of justness or that inside information is the exclusive asset of a company (Bainbridge, 2001). A lack of confidence amongst the investors can increase the cost of capital and reduce the value of a business; and lastly, informed insider trading increases the risk of litigation, loses core leadership, and sends negative signals with regard to the company's compliance and internal control systems.

There is another view amongst the jurists, and as per them Information-based insider trading promotes efficient securities pricing by transferring non-public information to capital markets.⁹ For example, companies often have to hide certain strategic information from the public, and information-driven insider trading can capture this non-public information at a stock price while maintaining the confidentiality of the information itself (Manne, 1966). Milton Friedman stated, "You want more insiders trading, not less" (Harris, 2003).

While insider trading does not typically account for a significant portion of trading volume, insider trading has been shown to affect price, suggesting that privacy is indeed limited by price (Keown and Pinkerton, 1981; Meulbrock, 1992). Despite the potentially negative impact of insider trading on external shareholders, corporate insiders have been involved in such trading. Corporate insiders are making unusual gains from trading corporate stocks, while regulators and capital market participants have expressed concerns about the proliferation and scale of insider-based trading (Ortega and Sheer, 2007). The relentless concerns of regulators and capital market participants

⁸ Rozanov (2008);Eric Opiyo; Effects of Corporate Governance on insider Trading (2013); https://www.academia.edu/8083889/Effects_of_Corporate_Governance_on_Insider_Trading

⁹ Manne, 1966; Carlton and Fischel, 1983; Eric Opiyo ;Effects of Corporate Governance on insider Trading (2013); https://www.academia.edu/8083889/Effects_of_Corporate_Governance_on_Insider_Trading

about informed insider trading suggest that proactive efforts alone are not sufficient to curb the use of personal information when trading in corporate stocks. Good corporate governance that complements legal and market mechanisms could help reduce the risk of opportunistic insider trading for the companies. There was reason to believe that good corporate governance could reduce the risk of opportunistic insider trading. Modern SOEs are characterized by a separation of ownership and control (Berle and Means, 1932). Agency theory suggests that managers can pursue self-interest at the expense of other shareholders when there is information asymmetry in (Jensen and Meckling, 1976). Insider trading is an agency problem in which the CEO of the companies benefits from trading, which can incur costs to external shareholders. According to the neoclassical firm's view, the most important role of corporate governance is to maximize shareholder wealth by lowering agency costs and protecting external investors from opportunistic management behaviour (Fama and Jensen, 1983). In fact, previous financial and accounting literature has shown that good corporate governance reduces agency costs associated with separating ownership and control (Shleifer and Vishny, 1997; Bushman and Smith, 2004). There are several factors for which we did not find evidence of a link between corporate governance and insider trading. A key challenge in analysing the impact of corporate governance on insider trading was the ability to distinguish opportunistic insider trading from trading that is not based on proprietary information. This was very important because corporate governance was less likely to mitigate non-opportunistic insider trading. However, in particular, in companies that use equity compensation, business owner transactions by insiders are inevitable. A potential problem is that even though good corporate governance generally reduces opportunistic insider trading, it cannot find a link to certain characteristics of corporate governance. Larker et al. (2007) argued that many of the controls used in previous studies had very low levels of robustness and constructive validity.¹⁰ Another problem arises because corporate governance is largely irrelevant. Among other things, proponents of the management theory argued that existing controls, including corporate governance, did not prevent managers from pursuing their own interests at the expense of shareholders (Weisbach, 2007). The argument that weak corporate governance delays the stock market was Re-examined.¹¹ Gompers et al. (2003) found evidence that does not support this

¹⁰Eric Opiyo; Effects of Corporate Governance on insider Trading (2013); https://www.academia.edu/8083889/Effects_of_Corporate_Governance_on_Insider_Trading

¹¹ Core et al. (2006); Eric Opiyo; Effects of Corporate Governance on insider Trading (2013); https://www.academia.edu/8083889/Effects_of_Corporate_Governance_on_Insider_Trading

hypothesis. Instead, the authors conclude that differences in returns or expected returns over time are likely to explain the documented anomalous returns of well-managed companies. Unless good corporate governance does not prevent managers from exhibiting opportunistic behaviour in general, it will not affect opportunistic insider trading.

CONCLUSION

This paper examines the ability of the insiders to use the non-public, confidential information in order to extract rents from the shareholders of the company. Corporate governance shall appear as limited control over the company if an Insider trading transaction is deemed undesirable or illegal by a shareholder or the regulators. The laws regarding insider trading have been significantly added strength and support over the past few years. SEBI also gained broader enforcement powers given the potential for insider trading to seriously compromise market integrity. The decisions of the SEBI, the enforcement of the SEBI, and the judgments of various courts have highlighted the need for businesses to take the issue of insider trading seriously.

The main idea of the securities rules is to implement the goal that all investors should have equal access to rewards for participating in securities trading. This means that all investor representatives must be exposed to the same market risk and must have the same amount of information available to them. Injustice based on unequal access to knowledge should not be ignored as an inevitable part of our way of life. Therefore, it is important that the market is free of all types of fraud, especially insider trading. This prevents the regular investor from running the market as if they were invited to play with someone loaded with information. Unfortunately, India is not the only country with major fraud exposed, but the corporate concept of good governance has been defeated. As a result, the government shifted to micromanagement and over regulation by way of turning good governance into legislative provisions. We tend to forget that micromanagement cannot eradicate fraud. This can only be mitigated by effective enforcement of the law, which should ban overt violations of the law. Corporate Governance Standards are the responsibility of company managers. Regulators are required to set out in Rule a list of additional procedures for limiting insider trading opportunities. What is to be stipulated must be a statement of the annual report of compliance with the standards set out. Therefore, in effect, any company that does not comply with the Corporate Governance Principles shall be punished by its shareholders. It can be said that insider trading is hugely affected by corporate governance. The principles of good

corporate governance were focused at fulfilling the key function of separating company agents and managers, and also the management of the company and its board of directors, and most agency issues were related to shareholders and managers.

The independence of the board of directors affects insider trading in a company, the board of directors made out of independent directors are more likely to protect the interest of the shareholder of the company from insider trading than those made up primarily of the corporate insider and affiliates as the outsider- dominated board gives a better control over the managers of the company. The independent directors are more motivated to keep a check on the management as for them the external interests like reputation is at a higher pedestal than their benefits.