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LAWS GOVERNING INSIDER TRADING: INDIAN PERSPECTIVE

Authored By - MERIN P G

ABSTRACT

To increase the confidence of both domestic and foreign investors that their money is secure in a fair and transparent securities market, India's position as a global economic force, among other things, requires the need for a strong regulatory framework for its securities. The recent huge price swings in public company shares in India during periods of mergers and acquisitions as well as unlawful trading based on undisclosed price sensitive information have greatly alarmed the country's securities market. There arises the concept of "Insider Trading" in the process of trading market. The term insider trading simply means the trading of public company's securities by the employees based on the confidential information regarding the company. It may be legal or illegal depending upon the circumstances of trade and regulations of the nation. The goal of this research paper is to evaluate the regulatory framework of India's insider trading laws and choose a course of action to enhance the current system. This paper firstly speaks about the fundamentals of insider trading, the necessity for regulation on insider trading, various theories support a ban on insider trading as well as the viability of the critical stage that insider trading increases market efficiency. The paper also examines the evolution of insider trading regulations in India as well as case law that has been resolved by SEBI and appellate authorities. It analyzes the various sanctions and means of enforcement offered by Indian law regarding the aspect of insider trading. It also focuses on white collar crimes with respect to insider trading. The paper further talks about the sufficiency of India's regulatory framework. In spite of some ambiguities, legislative inconsistencies, and complexity in the definitions, the investigation into the history of India's insider trading laws, the nation's current system, including statutory provisions and case laws has shown that insider regulations in India are progressive, strong, and conclusive. Thus, on the basis of an examination of the worldwide experience, recommendations about changes to the rules on insider trading and its enforcement mechanism in India have been explored while highlighting the shortcomings and gaps in the

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current legal system the shortcomings and gaps in the current legal system.

KEYWORDS

Insider Trading, Insider, Securities Market, Regulatory Framework, SEBI, International Trade.

INTRODUCTION

The concept of Insider trading involves the trading in the stock or other securities of a publicly traded firm by workers who have access to important, non- public information about the company. Insider trading may be legal or illegal based on whether it complies with SEC (US Securities and Exchange Commission) regulations or not. It turns into a horrible crime when the fiduciaries who manage businesses for the interest of the shareholders obtain unjust enrichment at the expense of the enterprise and its shareholders. Asymmetry of information has a detrimental effect on the market since the Indian market lacks ideal competition or a fair playing field. Because of this, it is crucial that laws against insider trading be adequate and has a strong enforcement system in place to deter manipulators and fraudsters from exploiting the knowledge imbalance. The provisions of Insider trading have greater applicability in worldwide. Thus, insider trading is one of the important aspects in the concept of International Trade law.

CONCEPTUAL FRAMEWORK

Most nations have regulations that forbid or restrict insider trading. By the end of the 20th century, around 87 countries had appropriate insider trading laws[1]. Along with other regulatory measures that the international markets occasionally employ, insider trading regulations have changed through time. The two largest nations with an established insider trading regulation framework are the United States and the United Kingdom. The regulatory systems of these nations have served as a source of inspiration for many global economies.

[1] Bhattacharya and Daouk, "The World Price of Insider Trading", Journal of Financial Economics vol. 57 p. 75

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ESSENTIALS OF INSIDER TRADING

All investors are aware with the phrase "insider trading", which is typically linked with unethical behavior. However, this term refers to both legal and unlawful behaviour. Insider Trading is the act of a corporate insider trading in the stock or other securities of a firm. This can also be described as legitimate insider trading. A corporate insider, sometimes known asa classical insider, is often a director or other high-ranking employee of a corporation. The term "constructive insiders" refers to individuals who gain access to business information legally as a result of their connections to the firm. A corporate or constructive insider's trading in the company's stock only becomes illegal if they do so while aware that they are inpossession of unreleased price-sensitive inside information. Therefore, it's possible that insider trading is not always against the law. The U.S courts have used a variety of theories ofresponsibility to evaluate an insider's liability in insider trading cases. Currently, there are three theories and they are as follows:

1) Abstain or Disclose Theory:

This theory states that an insider should either disclose price-sensitive business information to the market or refrain from dealing in the company's shares if they intend to trade in the company's stocks using that information, which may alter the price of the securities.

2) Fiduciary Duty Theory:

The U.S courts recognized the concept of fiduciary duty theory in the case of Oliver v.Oliver[2]. According to this theory, insiders have a duty to the company, the investors, or the source of material price-sensitive information when they are in a fiduciary relationship with them.

3) Misappropriation Theory:

According to this theory, when an insider trade using inside information about a firmthat was obtained from a source other than the company where the insider first shared the information without violating their fiduciary obligation, they are liable for insider trading.

LAWS ON INSIDER TRADING IN INDIA:

[2] [45 S.E.232 (Ga 1903)]

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HISTORICAL DEVELOPMENT

In India, loan securities issued by the East India Company in the 18th century were theoldest recorded instance of securities transactions. By the 1830s, the business had expanded both qualitatively and quantitatively and the shares of various banks at that time started trading in Bombay. The Bombay Securities Contract Act, 1925 which was passed on January 1, 1926 was the first piece of Indian law to govern the stock market. However, there arise a number of problems with this legislation, which led to several unrecognized stock exchanges and people engaging in forward contract trading. Due to this, Investors suffered significant losses over the years 1928 to 1938. Consequently, the government was driven to establish specific committees[3] to evaluate the flaws in the laws and rules governing stock exchanges. After that, a clause addressing capital issues was incorporated in the Defense of India Act, 1939. Various stages of the stock market were visible between 1946 and 1947. In 1948, the government established the Thomas Committee with P.J.Thomas serving as its chairman and the Finance Ministry's Economic Adviser at the time. This Committee was tasked with drafting a comprehensive law to govern stock market activity as well as creating a capable governmental agency to carry out the drafted laws. The Gorwala Committee was established by the government to examine regulatory concerns in the securities market, and its recommendations led to the creation of the current SecuritiesContracts (Regulation) Act, 1956 (SCRA). There were no rules pertaining to insider trading under the SCRA.

FIRST INSIDER TRADING ENCOUNTER WITH INDIA

The 1940s saw the first mention of insider trading in India. It was discovered that directors, agents, auditors and other company executives were profitably trading inthe stock of their own companies[4]. The Thomas Committee had reasoned out the instances due to which insider trading occurs. They are a) information possessed by the people who are inside the company b) before it reaches everybody else c) companies economic conditions and the size of the

[3] Morrison Committee in 1936, the Thomas Committee in 1948, and the Gorwala Committee whose report wassubmitted in 1951

[4] At paragraph 63 of Chapter VI titled 'The Indian Security Market as It Is' of Thomas Committee Report.

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dividends in which is to be declared, or of the issue of bonus shares or the imminent conclusion of a favourable contract. In 1947, the president of the Bombay Stock Exchange noted examples of top corporations failing to issue bonus shares and declare dividends publicly promptly. As a result, the bonus and shares were granted and the information was leaked to the public. On such circumstances, "inspired" operators frequently reaped unfair profits. However, this planned deception did not receive the "public anger" it merited in the 1940s.

ISSUE INVOLVED

- **NEED TO REGULATE INSIDER TRADING**

The primary goals of the laws against insider trading are to safeguard the interests of investors and the integrity of the securities market. A perfect securities market would fairly represent both the dangers of trading and the potential rewards for investors. Those who favoured laws against insider trading did not see all cases as unlawful, but instead wanted to outlaw specific instances of insider trading involving substantial non-public knowledge. This is done to guarantee that all market participants, including traders in the securities market, have access to the same information. Most lawmakers intended to pass legislation that would let an honourable director of a corporation to trade in the firm's stock while also managing the company in good faith. However, it found out to be not possible and before engaging in any trading in the company's shares, the insider director was expected to publicly disclose all important information that would have an impact on the price of the stock in their possession. There are various economic and non-economic reasons are developed for the regulation of insider trading. The main economic factors include issues pertaining to information property rights as well as financial harm to investors and businesses. The preservation of the required disclosure system and the aspects of fairness in insider trading are two examples of non-economic factors.

Mandatory disclosure is one of the important non-economic factor. The ban of insider trading guarantees that insider's confidentiality duties to the firm are not violated for their own personal gain, which makes it essential important for the mandated disclosure system to function effectively.

According to India's primary laws governing the regulation of enterprises and the securities

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market, all material information by corporations must be disclosed to the public. Some of those legislations are Indian Companies Act, 1956, the Listing Agreement under the Securities Contract Regulation Act, 1956, the insider trading- specific regulation, the SEBI Regulations (Prohibition on Insider Trading) 1920[5]and the SEBI Regulations (Substantial Acquisition of Shares and Takeovers), which require businesses to provide authorities with a variety of information. India, like other nations, has therefore worked to maintain the disclosure system by including disclosure-related clauses in most of the relevant laws. To ensure ethical conduct inthe securities market is the other non-economic factor for insider trading regulation. The other economic reasons for prohibiting insider trading are injury to investors, injury to the company, delay, interference with corporate plans, property rights and injury to reputation of the company. Thus, insider trading is considered as the white-collar crime in India.

LEGAL REGIME

❖ INSIDER TRADING PROVISIONS AND THE COMPANIES ACT

The company Law of India was adopted in 1956. It did not contain any measures for bringing legal action against company directors and management agents who used inside knowledge improperly. Even though the Thomas Committee had pointed out the lack of a specific law to address the "unfair use of inside information" in 1948, it took a few decades to actually draught a law to limit insider training. Various committees were occasionally established in India to evaluate the country's business regulation framework. The investing public in India, on the other hand, was unaware of the degree ofthe financial damage inflicted to them by a company's directors, managers, etc. using information unfairly because there was no equivalent framework in place there. In 1948, many committees made very clear recommendations on the adjustments that needed to be made to the business law to prevent insider training. Although the efficacy of such disclosures was not guaranteed, the committees had also advised that the corporations listed on the stock markets be forced to make key events like dividend declarations public. It is remarkable that every committee was forward thinking and that every recommendation was directed at disclosure.

Thus, measure was undertaken to stop the practice even before explicit rules against insider

[5] Chapter IV: Policy on Disclosures and Internal Procedure for Prevention of Insider Trading under SEBI(Prohibition of Insider Trading) Regulations, 1992.

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trading were drafted in India, with a particular emphasis on insider trading was made as early as 1952, one of the reasons lawmakers wereunable to do so was the committee member's unwillingness to define "speculative profits".

❖ INSIDER TRADING AND DISCLOSURES UNDER SECTIONS 307AND 308 OF THE COMPANIES ACT

The Companies Act, 1956 were included Section 307 and Section 308. In accordance with Section 307, corporations were required to keep a register detailing the stock interests of its directors. The requirement to disclose one's ownership interests in the corporation was outlined in Section 308 for both actual and potential directors. The Companies Amendment Act of 1960 later expanded this need to include the shareholdings of a company's managers. A powerful body, the Sachar Committee[6], was established in 1977 to evaluate the terms of the Monopolies and Restrictive Trade Practices Act of 1969 (Current Competition Act, 2002) and the Companies Act. According to this Committee, Section 301 and 308 of the Companies Act are insufficient to prevent insider trading. The committee believed that the statutory provisions requiring disclosures to shareholders regarding the sales and purchases of shares by directors and other key managerial individuals fall short of effectively addressing the issue of a particular class of people obtaining unfair profits through the use of non-public confidential information. The Committee's two main recommendations were to a) require maximal disclosure of transactions made by those with "price-sensitive knowledge and b) forbid people from making transactions while in possession of such information, unless there are exceptional circumstances.

❖ INSIDER TRADING AND THE SEBI

The Commodity Channel Index (CCI) was the first organization to sanction the issuance of securities as well as their quantity, kind and price. The CCI was formed in 1947 under the Capital Issues Act. However, the SEBI (Securities and Exchange Board of India) was established in April 1988 with the goal of promoting investor safety and a healthy expansion of the capital market, and the CCI was likewise repealed along with the Capital Issues Act. The SEBI had established as a regulatory agency to safeguard the interests of security investors, foster the growth of the securities market, and govern the securities market. In July

[6] This committee was headed by Justice Shri Rajindar Sachar, the then judge of the High Court of Delhi

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1988, the SEBI had drafted a proposal paper on a comprehensive legal framework for the securities industry that includes controls for unethical and fraudulent behaviour. The Cohen Committee's emphasis on a "high standard of behaviour" with regard to insider trading led the SEBI to publish a press statement on August 19,1992, recommending that corporations create a "internal code of conduct" to prevent the practice of insider trading. After the enactment of SEBI (Prohibition of Insider Tradingin the Securities Market) Regulations, 1992, the Insider Regulations were framed by the Indian Parliament. The Insider Regulations are a condensed set of rules that are divided into three chapters and contain 12 clauses.

According to Regulation 4 of the Insider Trading Regulations, Insider Tradingis a crime. Regulation 4 states that any insider who transacts in securities in violation of Regulation 3(or 3A), is guilty of "Insider Trading".

❖ FIRST CASE OF INSIDER TRADING IN INDIA

The Hindustan Lever Case[7] was the first instance in which SEBI took enforcement action against those who violated insider trading regulations. In this case, Hindustan Lever Limited (HLL) and Brooke Bond Lipton India Ltd (BBLIL) were both subsidiaries of the parent company. On 1996, BBLIL AND HLL announced their intention to merge. The market and the media both alerted SEBI to the leak of the merger information and the insider trading. As a result, the SEBI has started looking into the matter. During the investigation, SEBI found out that the HLL as an insider violated the provisions of insider trading by making fraudulent transaction from the UTI. The SEBI also alleged against BBLIL. Both of them make appeals against SEBI's order before the appellate authority, the central government. Thus, the SEBI's decision to prosecute HLL was set aside by the appellate authority.

ANALYSIS

❖ DEREGULATION OF THE INSIDER TRADING

[7] Order passed by SEBI dated March 11, 1998

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Many academicians and researchers in the U.S have firmly argued for the sanctioning of insider trading. According to Henry Manne[8], a prohibition on insider trading might have a negative impact on market efficiency and make it more difficult to reward managers in an efficient manner. He asserted that insider trading strikes a balance between the need to keep correct information and the need to preserve incentives to supply it. It also contended that insider trading can establish accurate price discovery and become an efficient compensation system. After assessing the advantages and disadvantages of insider trading, the majority of nations have outlawed it. Therefore,it may be inferred that the negative effects of insider trading have led all significant governments to criminalize it.

❖ REASONS FOR INDIA'S INSIDER TRADING REGULATIONS

In India, the Insider Trading has to be regulated according to the Patel Committee[9], which was established by the Indian Government to evaluate how stock exchanges operate. One of the arguments given was that insider trading is unethical because it violates the insider's fiduciary duty to act in the company's best interests and includesthe misuse of sensitive knowledge. However, until 1992, no particular legislation was created. The SEBI Regulations 1996 govern price manipulation proceedings in India, whereas the Insider Regulations govern insider trading cases. Insider Trading in India isunquestionably a distinct kind of fraud. Additionally, the SEBI has maintained its position that severe responsibility applies when insider regulations are broken. According to the Patel Committee's findings, insider trading entails the exploitation of sensitive information and thus immoral since it involves the transgression of the fiduciary position of trust and confidence.

CONCLUSION AND SUGGESTIONS

The concept of Insider Trading is one of the punishable offenses which is relatively high in

[8] Henry Manne is the Dean Emeritus of the George Mason University School of Law

[9] This committee, headed by G S Patel, was set up in May 1984 to make a comprehensive review of thefunctioning of the Stock Exchanges and make its suggestions

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India. Insider trading means the trading of stocks by the employees who have access to the confidential information of the company. Various laws and regulationsto regulate insider trading is mentioned but the main challenge is to make an effective enforcement of laws and regulations. Even though, various agencies and experts try to monitor an effective legal framework for insider trading but there is no complete solution to prohibit insider trading. Thus, it can be stated from the analysis that India has sufficient laws and regulatory framework equivalent to those of the U.S and the U.K which are recognized as having the most advanced and extensive insider trading enforcement regime.

In light of this context, an examination of the efficacy of the Indian regulatory system exposes a number of problems that call for serious thought ad adjustment:

1) India does not have any particular statute governing insider trading.
2) The definition of the term "insider" under Regulation 2 (e) of the Insider Regulations seems to be complex.
3) Individuals and other securities market participants who lack the same legal structure as the firm are not eligible to use the defences provided by Regulation 3B of the Insider Regulations.