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A Critical Evaluation of India's Regulatory Framework and Its Initiatives to Combat Insider Trading

SWATI V.[1]

ABSTRACT

Insider trading has become a widespread issue in many countries. It refers to the buying or selling of a company's securities by individuals who have access to confidential, non-public information about that company. An "insider" is someone who has received or had access to this unpublished, price-sensitive information. This practice represents a violation of fiduciary duty and is considered an economic crime. If left unchecked, insider trading can hinder economic growth, reduce capital inflows and foreign investments, and tarnish the reputation of India's securities market. Ultimately, it poses a significant threat to the development of a robust securities market and undermines its integrity.

***Keywords**: Insider Trading, SEBI, Connected Person, Price Sensitive Information, Shares and Securities.*

I. INTRODUCTION

The effective operation and governance of a corporate organization rely on ensuring transparency, openness, and proper disclosure. Achieving these qualities requires fostering positive relationships between management and stakeholders, while also building investor trust. Good corporate governance attracts investors and enhances their confidence in companies. The Board of Directors plays a crucial role in shaping the company's future, as their decisions can significantly influence market reactions. Consequently, board meetings and their decisions involve confidential information, which should only be shared when necessary for the company's benefit. Maintaining the confidentiality of such information until it is publicly disclosed is essential. Over the years, however, individuals within organizations have sought to exploit confidential information for unfair advantages, often engaging in unethical trading practices. This behavior is both unfair and morally questionable, leading to detrimental consequences. Therefore, it is vital to address these issues on a global scale. Various governments have implemented regulations to combat such practices, and the issue of insider

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trading arose with the emergence of securities trading in the global market.

(A) Insider Trading: Meaning

Insider trading involves buying or selling securities of a publicly-traded company while possessing material information that is not publicly available. This practice is considered an abuse of trust and can harm the integrity of the securities markets. Non-public information refers to details not yet legally accessible to the public, typically held by a select group of individuals directly connected to the information, such as corporate executives or government officials with early access to economic reports.

The regulations surrounding insider trading are complex and vary significantly between countries. Definitions of an "insider" can differ widely; some jurisdictions restrict the term to individuals within the company who have direct access to sensitive information, while others may also include relatives of company officials.Insider trading encompasses both legal and illegal activities. Legally, corporate management and board members may buy or sell their own company's stock in compliance with company policies and relevant regulations. However, when individuals breach these policies or act on confidential information, it constitutes illegal insider trading and undermines trust within the company.

EXAMPLES - A CEO shares confidential information about an upcoming acquisition with a friend who holds a significant stake in the company. The friend sells his shares before the information becomes public.

- A government employee uses knowledge of an impending regulation that will favor a sugar-exporting firm to purchase shares prior to the public announcement.
- A high-ranking employee overhears discussions about a merger, understands its potential market impact, and buys shares under his father's name.

(B) Definition

Henry G. Manne defines Insider Trading as "Insider trading generally refers to the practice of corporate agents buying or selling their corporation securities without disclosing to the public significant information which is known by them but which has not affected the price of the security"[2]

The Securities and Exchange Board of India (SEBI) outlines in its 1992 regulations that while the term "insider trading" is not explicitly defined, it does define key terms such as "Insider,"

[2] Henry G. Manne, "Definition of Insider Trading" in Fred S. McChesney (ed.) The Collected Works of Henry G. Manne 364 (2009).

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"Connected Person," and "Price Sensitive Information."

Insider Trading refers to the buying or selling of a company's securities by an insider who utilizes non-public, price-sensitive information, potentially resulting in personal profit or losses for the company.

Insider: According to the regulations, an "insider" is any individual who is or was connected to the company or is considered connected, and who is expected to have access to unpublished price-sensitive information regarding that company.

(C) Connected Person: This term includes anyone who:

1. Is a director as defined by the Companies Act, 1956, or is deemed to be a director under certain provisions.

2. Holds a position as an officer or employee of the company, or has a professional or business relationship with the company temporary or permanent and is likely to access unpublished price-sensitive information.

(D) **Price Sensitive Information**: This refers to any information that directly or indirectly pertains to a company and, if made public, could significantly influence the price of its securities. Examples of price-sensitive information include:

1. The company's financial results.
2. Plans for dividend declarations.
3. Issuance of shares through public rights or bonuses.
4. Major expansion initiatives or new project developments.
5. Mergers, amalgamations, or takeovers.
6. Disposal of all or a substantial part of the company's assets.

II. HISTORY AND EVOLUTION OF INSIDER TRADING

Insider trading has existed in the United States since 1792, leading to the establishment of strict laws against it. Understanding insider trading from an American perspective is crucial.

The stock market crash of 1929, attributed to a prolonged "lack of investor confidence," followed by the Great Depression, prompted the enactment of the Securities Act of 1933. The groundwork for insider trading laws was laid by the U.S. Supreme Court in the case of Strong vs. Repide. The first statutory insider trading laws were established in 1933, followed by the Securities Exchange Act of 1934, which created the Securities and Exchange Commission

(SEC) to oversee secondary trading of securities. These acts aimed to enhance transparency for investors and imposed due diligence on those responsible for preparing detailed security-related documents.

In the 1984 case of Dirks vs. SEC, no parties were found liable for insider trading because they disclosed information to expose fraud without seeking personal gain. This case introduced the concept of "constructive insiders," which includes lawyers, investment bankers, and others who obtain confidential information while providing services to a corporation.

In the 1986 case of United States vs. Carpenter, the Supreme Court ruled that information obtained through a confidential relationship must not be disclosed or used, and doing so can lead to insider trading charges.The 1997 O'Hagan case recognized that a company's confidential information is considered its property, asserting that the unauthorized misappropriation of such information, in violation of fiduciary duty, constitutes fraud similar to embezzlement. In 2007, Representatives Brian Baird and Louise Slaughter introduced the "Stop Trading on Congressional Knowledge Act" (STOCK Act) to address insider trading in Congress.

(A) Insider trading Law in India

The history of securities trading in India dates back to the East India Company, with the first significant legislation being the Bombay Securities Contract Act of 1925.

1. Bombay Securities Contract Act 1925

Enacted with the assent of the Governor-General on December 29, 1925, under section 80(A) of the Government of India Act, this law aimed to regulate contracts for the buying and selling of securities in Bombay and its presidency. It primarily focused on the registration and recognition of stock exchanges, along with the rules governing securities transactions. After India gained independence, these regulations were incorporated into the Capital Issues (Control) Act of 1947.[3]

2. Capital Issues (Control) Act 1947

Passed just four months before India’s independence, this act restricted companies from issuing capital without the central government’s approval. Enacted on April 18, 1947, it included rules for the purchase and sale of securities and was later amended in 1957. The act established the Office of the Controller of Capital Issues to oversee the approval of security issuances and pricing. Recognizing the threat of insider trading, the Indian government formed the Thomas Committee in 1948, inspired by the U.S. market crash of 1929 and the subsequent Securities

[3] Bombay Act No. VIII of 1925.

Exchange Act of 1934, which sought to protect investors and ensure market fairness.

3. Thomas Committee Report 1948

The Thomas Committee urged the Indian government to take immediate action regarding the securities market, highlighting that company directors were exploiting the market for personal gain. Their 168-page report called for urgent regulations to curb objectionable practices and suggested the creation of rules and bylaws. In response, sections 307 and 308 were added to the Companies Act of 1956, requiring directors to disclose their shareholdings. However, these provisions proved insufficient to effectively prevent insider trading[4]

4. Sachar Committee Report 1979

Established in 1978, the Sachar Committee submitted its recommendations in 1979, advocating for measures to combat malpractice in the securities market.[5]

5. Patel Committee Report 1986

The Patel Committee was formed in 1986 to propose changes related to insider trading regulations.[6]

6. Abid Hussain Committee Report 1989

Constituted in 1989, this committee recommended that insider trading be punishable under both civil and criminal law, advocating for a dedicated statute to prevent insider trading. Their suggestions laid the groundwork for comprehensive legislation following the TISCO case in 1992.[7]

7. Securities and Exchange Board of India (SEBI) Act 1992

Established in 1988 to regulate the securities market amid rising fraud and malpractice, SEBI was given statutory authority on January 31, 1992. Its protective functions include safeguarding investor interests, limiting price rigging, and preventing insider trading. Section 11 of the SEBI Act outlines its powers and responsibilities, with Section 11(2)(g) specifically mandating the prevention of insider trading. The act's amendment in 2002 explicitly prohibits insider trading for listed companies.[8]

8. SEBI (Insider Trading) Regulations 1992

In response to growing insider trading cases, SEBI enacted these regulations under its powers

[4] The capital issue (Control) Act 1947, Act of 29 of 1947.
[5] Sachar committee report 1979
[6] Patel committee report on stock exchange reforms 1986.
[7] Abid Hussain committee report 1989.
[8] Securities and exchange board of India Act 1992, No. 15 of 1992.

from the SEBI Act. They include provisions on the prohibition of insider trading, investigation procedures, and definitions of key terms.[9]

9. SEBI (Insider Trading) Amendment Regulations 2002

Following the Kumar Mangalam Birla Committee's recommendations, these amendments expanded the definition of price-sensitive information and introduced a model code of conduct for preventing insider trading, requiring continuous disclosure of shareholdings by insiders.[10]

10. SEBI (Prohibition of Insider Trading) (Amendment) Regulations 2003

This amendment introduced various forms for directors and insiders to report their holdings to SEBI, aiming to enhance transparency and accountability.[11]

11. SEBI (Prohibition of Insider Trading) Regulations 2008

This amendment broadened the definition of an insider and reiterated the model code of conduct, stipulating strict timelines for informing SEBI and stock exchanges about acquisitions and takeovers, and introduced e-filing.[12]

12. SEBI (Prohibition of Insider Trading) Amendment Regulations 2014

This amendment included promoters and their groups in disclosure requirements regarding company securities, ensuring greater transparency.[13]

13. Justice N.K. Sodhi Committee Report on Insider Trading 2013

This committee expanded the definitions of insider and connected person, recommending stricter access controls to unpublished price-sensitive information and suggesting companies establish codes of conduct to regulate insider trading activities.[14]

14. Insider Trading Under Companies Act 2013

Section 195 of the Companies Act 2013 prohibits insider trading by any insiders, including directors and key managerial personnel. However, conflicts arose between this act and SEBI regulations, leading to its omission in the Companies (Amendment) Act 2017. Section 458 delegates powers to SEBI for prosecuting insider trading in listed companies and applies even before listing.[15]

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[9] SEBI (Prohibition of Insider trading) Regulations 1992.
[10] SEBI (Insider trading) Amendment regulations 2002
[11] SEBI (Prohibition of Insider trading) (Amendment) regulations 2003.
[12]SEBI (Prohibition of Insider trading) regulations 2008.
[13] SEBI (Prohibition of Insider trading) (Amendment) regulations 2011.
[14]Report of High-level committee to review the SEBI (Prohibition of Insider trading) regulations 1992 by N.K. Sodhi.
[15] Companies Act 2013.

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III. Rationale for Controlling Insider Trading

Controlling insider trading is crucial for several reasons:

Protection of General Investors: Insider trading often results in significant losses for companies and unfair profits for insiders, depriving regular investors of potential gains. This manipulation undermines the fairness of the market.

Safeguarding Company Interests and Reputation: When a company is embroiled in insider trading issues, investor confidence plummets. This can lead to a withdrawal of investments and a sell-off of company stocks, damaging the company's standing.

Maintaining Confidence in Stock Exchange Operations: The presence of effective regulation by SEBI is vital. If insiders exploit loopholes, it erodes trust in the integrity of stock exchanges themselves.

Public Confidence in the Financial System : A healthy economy requires a robust financial system, and investor confidence is essential for stimulating domestic investment, which remains low in India. Trust in the market is critical for its overall health and development.[16]

Integrity of the Securities Market : The stability and growth of the securities market depend largely on its quality and integrity. A trustworthy market fosters confidence among investors.

Level Playing Field : Insider trading creates an uneven playing field, leading to investor skepticism about market fairness. To sustain confidence in the securities market, it is imperative to prohibit insider trading practices.[17]

Beyond capital market efficiency, there are additional justifications for regulating insider trading. It creates unfair advantages for those with privileged information, undermines overall investor trust, and is often viewed as a form of theft or misappropriation of information. While some argue that insider trading can enhance market efficiency and serve as a compensation method for employees, these points have not overshadowed the need for fairness in the market. Research indicates that stricter insider trading laws correlate with broader equity ownership, improved stock price accuracy, and greater market liquidity.[18]

In summary, insider trading fundamentally erodes trust in the capital markets, leading to substantial losses for companies and investors alike. It is essential for company directors to

[16]Baishali Das, Insider Trading Law in India, Pg.3,
[17] Umakanth Varottil, "The Long and Short of Insider Trading Regulation in India",2, No.13,2016
[18] Laura Nyantung Beny, "Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate", (2007) Journal of Corporation Law 237, http://ssrn.com/abstract=193070

protect both the interests and reputation of their organizations. When insider trading becomes evident, it can significantly damage investor confidence, prompting them to withdraw their investments and divest from the company. Therefore, market regulators must uphold confidence in stock exchange operations and the broader financial system, which is vital for fostering a healthy economic environment.[19]

IV. IMPACT OF INSIDER TRADING

Illegal insider trading has far-reaching effects that extend beyond individual companies to impact a nation's economic growth. Here are the primary consequences:

Loss of Investor Confidence : Illegal insider trading erodes trust in financial markets. Investors may lose faith in the fairness of the securities market, leading to a reluctance to invest. This decrease in capital flow can harm the overall economy. To restore investor confidence, protection against insider trading is essential, encouraging cautious investment practices.

Integrity of the Market : Insider trading undermines the integrity of the securities market. The fear of being deceived may deter investors from participating, resulting in diminished trust and interest in market activities. Consequently, investors may choose to invest in other sectors.

Economic Consequences : Insider trading significantly impacts a country's economy. Insiders with access to non-public, price-sensitive information can reap substantial profits, leaving regular investors at a disadvantage. This disparity can lead to decreased overall investment, forcing companies to seek alternative capital sources. Since economic growth relies on industrial development, a lack of capital can be detrimental to the economy.

Damage to Company Reputation : When insiders engage in illegal trading practices, it severely tarnishes a company's reputation. This loss of trust can deter investors from considering such companies for investment. Consequently, companies must take proactive measures to prevent insider trading, as a damaged reputation can lead to declining stock prices and investor hesitance.

Unfair Advantage for Insiders : Insiders who possess unpublished, price-sensitive information can gain significant returns by trading on that knowledge. This creates an unfair advantage, while common investors suffer losses due to their lack of access to such information. Insiders can strategically buy and sell stocks, which discourages regular investors and disrupts market fairness.[20]

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[19]Sakshi Rewaria, “An Analysis of Insider Trading in India”, 815-816, Vol 2, Issue 7, 2021

[20] V.R. maheswarararao. Paleti, Dr. Sapna Bansal, Anu Solanki, “Critical Analysis on Illegal Insider Trading and It’s Impact Actions to Curb Insider Trading in India”,30-31, Volume 10, issue 8(1), 2021

Impact on Foreign Investments: Illegal insider trading can severely affect a country's reputation and its securities market. Foreign investors seek transparency and trust in the markets they invest in. Unethical practices deter foreign investment, which is crucial for economic growth. If legal protections for foreign investors are perceived as inadequate, they will be less likely to invest, further weakening the economy.

Market Crashes : Numerous cases of illegal insider trading have contributed to market crashes in various countries. A decline in investor confidence can trigger panic selling, leading to sharp drops in share prices. Historical examples, such as the U.S. market crash of 1929, demonstrate the long-lasting repercussions of such events, resulting in significant economic downturns.

In summary, the ramifications of illegal insider trading are extensive, affecting not just individual investors and companies but also the broader economic landscape.

V. SEBI – The Regulator

The role of a stock market regulatory body is influenced by the development stage of the market within a country. In India, given the market's growth trajectory, the regulatory authority must focus on both development and regulation. A notable case is Rajat Gupta, [21]accused of insider trading in the U.S.; the fact that he faced trial highlights the accountability necessary in insider trading[22], which has implications for Indian regulatory frameworks. Regulatory and developmental functions are closely intertwined, often leading to positive market outcomes through effective regulation. SEBI (Securities and Exchange Board of India) operates under the Securities and Exchange Board of India Act of 1992, with its powers and responsibilities outlined in Section 11 of the Act.

SEBI's primary mission is to safeguard investor interests and regulate the securities market, with prohibiting insider trading being a crucial measure. SEBI has the authority to investigate complaints related to insider trading from investors, intermediaries, or other parties. It can appoint officers to examine the records of suspected insiders, providing reasonable notice before initiating an investigation. This allows SEBI to review relevant documents and data comprehensively. To identify insider trading, SEBI first determines who qualifies as an insider, focusing on key personnel such as board members, auditors, and those with access to sensitive information. Close relatives of these individuals are also scrutinized to assess their potential access to confidential information.

Another important factor is defining what constitutes unpublished price-sensitive information

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[21] United States v. Gupta, 747 F.3d 111, 115 (2d Cir. 2014)
[22] Satvik Varma, "Is India too soft on insider traders?"

(UPSI), which can range from major contract acquisitions to positive financial disclosures. SEBI also investigates who has traded based on this information.

SEBI can exercise its investigative powers for two primary reasons:

1. To investigate complaints regarding insider trading from investors or intermediaries.

2. To act on its own initiative to protect investors' interests against regulatory violations.

Promoters can be held liable for insider trading violations involving UPSI, regardless of their shareholding status, unless they can demonstrate a legitimate purpose for the information.

There are exceptions to these prohibitions:[23]

Disclosure is allowed for legitimate business purposes, including the performance of duties or fulfilling legal obligations. In Dirks v. SEC , it was determined that outsiders like lawyers or accountants become insiders when they receive UPSI in the normal course of business. Disclosure is also permissible when there is an obligation to make an open offer or when it serves the best interests of the company. In Samir Arora v. SEBI, it was established that unpublished private information must be accurate to invoke insider trading provisions.

(A) Regulations Overview

The new Insider Trading Regulations introduce several significant changes through revised definitions and frameworks. The regulations consist of five chapters, two schedules, and twelve sections. [24]

Chapter 1-focuses on definitions.

Chapter 2- outlines restrictions on communication and trading by insiders.

Chapter 3- covers disclosure requirements for companies.

Chapter 4- establishes a code of disclosure and conduct.

Chapter 5-details powers and sanctions.

(B) Salient Features

Definition of Insider : The term "insider" now includes all connected persons, such as relatives and public servants, who are expected to have access to Unpublished Price Sensitive Information (UPSI).

Updated Definition of UPSI : UPSI now refers to information that is not publicly available and

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[23] Shoronya Banerjee, “Insider trading in India: Regulations and Controlling Authority”, 6-8, 2021

[24] SEBI (Prohibition of Insider Trading Regulations) 2015

could materially influence the price of securities. This includes items such as financial results, dividends, capital structure changes, mergers, demergers, acquisitions, delisting, disposals, business expansions, and changes in key managerial personnel.

Trading Plans : New provisions allow insiders who typically possess UPSI to create trading plans with appropriate safeguards.

Code of Practices : All listed companies are required to develop and publish a code of practices for safe and fair disclosure of UPSI, following the principles outlined in Schedule A of the regulations.

Trading Windows : Notional trading windows are established, allowing trading 48 hours after UPSI is made public.

Due Diligence : The Board may conduct due diligence when it believes that a merger or transaction is in the company's best interest.

The primary aim of the new regulations is to enhance the legal and enforcement framework, incorporate international best practices into the Indian securities market, clarify definitions, and regulate legally permissible transactions. The updates address confusion stemming from numerous amendments, circulars, and notifications related to SEBI's (Prohibition of Insider Trading) Regulations 1992.

(C) Chapter Breakdown

Chapter 1 : Contains definitions, with many terms broadened, particularly "connected persons."

Chapter 2: Details restrictions on communication and trading:

Section 3- limits the communication and procurement of UPSI.

Section 4-prohibits trading while in possession of UPSI.

Section 5-requires insiders to submit trading plans to a compliance officer.

Chapter 3: Discusses disclosure obligations:

- Section 6- mandates trading disclosures from insiders and their immediate relatives.
- Section 7- outlines initial and ongoing disclosure requirements for insiders and connected persons.

Chapter 4: Focuses on codes of conduct:

- Section 8- prescribes a code of fair disclosure based on principles in Schedule A.
- Section 9 - establishes a code of conduct for companies to monitor and report trading

according to standards in Schedule B.

Chapter 5 : Contains miscellaneous provisions:

- Section 10 - sets forth sanctions for violations of the regulations.
- Section 11-SEBI the authority to resolve difficulties.

From the Bombay Securities Contracts Act of 1925 to the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, a comprehensive history of laws and regulations has been established to combat insider trading in India. Despite these efforts, incidents of illegal insider trading persist, as will be discussed in the following chapter.

(D) Shortcomings of SEBI on Insider Trading

Over the years, several shortcomings in SEBI's insider trading regulations have emerged, undermining investor confidence in the laws intended to protect their rights and interests. One major challenge SEBI faces is the difficulty in establishing and proving cases of insider trading beyond a reasonable doubt, particularly in criminal proceedings, often due to insufficient evidence.[25]

A notable case illustrating the vulnerabilities of SEBI's 1992 regulations is Rakesh Agarwal vs. SEBI [26] In this case, Rakesh Agarwal, the Managing Director of ABS Industries Ltd., was involved in negotiations with Bayer A.G. regarding a potential takeover, giving him access to unpublished price-sensitive information. SEBI directed Agarwal to deposit ₹34,00,000 into the Investor Education and Protection Fund of both the Bombay Stock Exchange and the NSE (₹17,00,000 for each exchange) to compensate any future claims from investors. SEBI also initiated prosecution and adjudication proceedings against him.

However, upon appeal to the Securities Appellate Tribunal (SAT) in Mumbai, the tribunal ruled that part of SEBI's order requiring Agarwal to pay the ₹34,00,000 could not be upheld, arguing that Agarwal acted in the interest of ABS. The tribunal emphasized that the insider's intent or motive should be considered, even though SEBI's regulations do not explicitly require mens rea as a component of insider trading.

Similarly, in the case of Samir C. Arora vs. SEBI[27] , Mr. Arora was prohibited by SEBI from buying, selling, or dealing in securities for five years. He was also required to seek SEBI's permission to sell any securities he held. Arora appealed this decision to the SAT, which

[25] Shradha Rajgiri, "An Analysis of Insider Trading in India", 143-144, Volume 9, Issue 3, 2019
[26] (2004) 1 CompLJ 193 SAT, 2004 49 SCL 351 SAT
[27] [2005] 59 SCL 96 (SAT-Mum)

overturned SEBI's order due to a lack of adequate proof to substantiate the charges of insider trading and professional misconduct against him.

These cases highlight the challenges SEBI faces in effectively enforcing insider trading regulations and the need for clearer frameworks and stronger evidence to support its actions.

(E) Methods of Prevention

a. Disclosure of Interest by Corporate Insiders

i. Listed Companies:

- Changes exceeding 2% of total voting rights for individuals holding over 5% of shares/voting rights must be disclosed.
- Changes exceeding ₹5,00,000, 25,000 shares, or 1% of capital by directors and officers must also be reported.
- Other Entities:

Initial statements of holdings and periodic updates can reveal any suspicious trading activities by insiders.

b. Disclosure of Price Sensitive Information:

Access to price-sensitive information should be restricted to a need-to-know basis.

Information should be disseminated through the stock exchange and transmitted to news agencies promptly.

- Chinese Wall: Establishing a clear separation between insider areas and public areas within an organization to prevent information leakage.
- Trading Window Facility: The company determines when trading windows are open or closed. Trading is restricted during periods when price-sensitive information is not yet public, reopening 24 hours after the information is disclosed. This policy also facilitates the exercise of Employee Stock Ownership Plans (ESOPs).
- Minimum Holding Period: Securities must be held for a minimum of 30 days to be classified as investments. This rule applies from the date of IPO allotment, with exceptions only for personal emergencies.
- Pre-clearance of Trades: Requiring pre-approval for trades helps prevent front running and ensures compliance with insider trading regulations.

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c. Protection Under General Laws

The regulations outline specific exclusions where insider trading charges do not apply, including:

- Conduct of Due Diligence: Communication and information procurement related to transactions such as private investments in public equity (PIPE) and mergers and acquisitions, provided certain conditions are met.
- Off-Market Transactions: Transactions between promoters who possess the same information and make informed, conscious decisions.
- Non-Individual Insiders: When different individuals are in possession of unpublished price-sensitive information compared to those making trading decisions, and the decision-makers do not have access to that information at the time of trading.
- Trades executed without any information leakage, acknowledging the concept of “Chinese walls” within large organizations.
- Trades carried out according to pre-established trading plans.
- Legal Insider Trading

Some economists and legal scholars, including Henry Manne, Milton Friedman, Thomas Sowell, Daniel Fischel, and Frank H. Easterbrook, argue against the prohibition of insider trading. They believe that trading based on material non-public information can benefit investors by swiftly incorporating new information into the market. Friedman, a Nobel Prize-winning economist, stated, "You want more insider trading, not less," suggesting that those with insider knowledge should be incentivized to inform the public about a company's deficiencies. He argued that traders should not be required to disclose their trades because the resulting buying or selling pressure itself provides market information. Critics of insider trading laws often assert that such trading is a victimless act. In this view, a willing buyer and seller are simply exchanging property that the seller rightfully owns, without any prior agreement to refrain from trading based on asymmetric information. The Atlantic has characterized this scenario as akin to a victimless crime.

Proponents of legalizing insider trading sometimes invoke free speech arguments. They suggest that penalizing individuals for sharing significant information that could affect stock prices amounts to suppression of speech. If proprietary information is disclosed in breach of a contract, the disclosing party loses their right to keep that information confidential. In the commodities markets, there are very few regulations against insider trading, as the concept of an "insider" is

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less clear-cut compared to securities. However, similar actions, such as front running, are illegal under U.S. commodity and futures trading laws. For instance, a broker can be charged with fraud if they buy a commodity ahead of executing a client's large order that is expected to affect its price.[28]Legal insider trading is common, as employees of publicly traded companies often hold stocks or stock options. These transactions are publicly disclosed in the U.S. via Securities and Exchange Commission (SEC) filings, particularly Form 4. Before 2001, U.S. laws restricted insiders to trading only when their information was public, such as after earnings announcements.

SEC Rule 10b5-1 clarified that possession of material non-public information is sufficient to violate insider trading laws, without needing to prove that the insider actually used that information for their trades. However, this rule also allows an affirmative defense for insiders who can show that their trades were part of a pre-existing written plan .For example, if an insider plans to retire and establishes a written plan to sell a set amount of company stock each month for two years, trades made according to this plan even after acquiring material non-public information—may not be deemed illegal insider trading.

(F) Defenses and Exceptions in Insider Trading

In India, the strict regulations governing insider trading incorporate specific defenses that enable parties to conduct legitimate transactions without being considered illegal. The following types of trades are exempt from insider trading allegations under the current framework:

Off-Market Transfers : Transfers conducted between promoters who have access to the same unpublished price-sensitive information (UPSI).

Separate Decision-Making : In organizations, if the individuals who possess UPSI are distinct from those making trading decisions, and safeguards (like "Chinese walls") are implemented to prevent the flow of UPSI to decision-makers.

Trading Plans: Trades executed according to a predetermined trading plan. This provision permits insiders, especially employees holding shares, to buy and sell company stock under specific conditions. The trading plan must be established when the insider does not possess UPSI, allowing trading even if the insider later acquires such information. A six-month cooling-off period is required between the creation of the trading plan and the commencement of trades. Additionally, trading is prohibited around the time of financial announcements.[29]

[28] Tanya Pahwa, Simone Reis, Nishchal Joshipura and Prtibha Jain, "India's New Regulations on Insider Trading", 2-3, Volume 21, Number 2, 2015

[29] Nishith M. Desai & Krishna A. Allavaru, "Insider Trading: A Comparative Study" 7-9, 1997

The introduction of trading plans aims to clarify the process for insiders who wish to trade, especially since previous regulations often led to claims that trades were part of routine investment activities rather than influenced by UPSI. This approach formalizes the process with clearer guidelines. However, there are concerns about whether the trading plan will be effectively utilized and safeguarded against misuse, as the strict criteria for this defense might deter its application.

Another significant defense involves the communication of UPSI. Insiders are permitted to disclose this information if it is necessary for legitimate purposes, fulfills duties, or meets legal obligations. This principle has been interpreted in other jurisdictions, such as the European Union. In India, it is crucial to carefully evaluate the circumstances that could legitimize selective disclosures. Given that many Indian companies are predominantly owned by promoters, issues may arise regarding the appropriateness of sharing information with a promoter or parent company. To navigate these challenges, corporate groups might develop policies to govern intra-group disclosures of UPSI concerning listed companies.

(G) Penalties

1. The Regulations do not specify separate penalties; instead, they refer to the penalty provisions outlined in the SEBI Act of 1992, which apply to insider trading violations. Under the Act, penalties for insider trading can include a fine of up to INR 250,000,000 (approximately USD 4,166,667) or three times the profit gained from insider trading, whichever amount is greater.

2. Additionally, SEBI has the authority to prohibit an insider from investing in or trading securities, declare violative transactions void, and mandate the return of any securities involved in such transactions.

3. Individuals who contravene, attempt to contravene, or aid in the contravention of the Act may face imprisonment for up to 10 years, fines up to INR 250,000,000 (around USD 4,166,667), or both.

4. The Regulations also provide for various disciplinary actions that companies or market intermediaries can enforce to ensure compliance. SEBI may impose a penalty of not less than INR 25 crores or three times the profits gained from insider trading, whichever is higher.

5. SEBI can initiate criminal prosecution and issue orders declaring transactions involving unpublished price-sensitive information invalid. Moreover, SEBI may prohibit an insider from dealing in the securities of the company. The prevention of insider trading

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is considered a vital aspect of securities regulation. While Section 11(2)(e) of the Companies Act, 1956 prohibits insider trading, it does not provide a specific definition of the term.

VI. INSIDER TRADING LAW IN THE U.S.

The U.S. boasts one of the most regulated stock markets globally, having faced significant securities scandals that have impacted market confidence. High-profile firms like Marcus Schloss & Co. and Drexel Burnham Lambert, along with notable figures such as Michael Milken and Ivan F. Boesky, have been implicated in large-scale insider trading activities.U.S. federal securities regulations do not have a specific code for insider trading; instead, the legal framework has evolved through case law linked to the anti-fraud provision of Rule 10b-5. The Securities Exchange Act of 1934 empowers the SEC to uphold market integrity and foster investor trust. Section 10(b) of the Act states:

"It shall be unlawful for any person, directly or indirectly, ... to use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

In line with this, Rule 10b-5 prohibits:

- Employing any device, scheme, or artifice to defraud.
- Engaging in acts or practices that operate as fraud or deceit in connection with securities transactions.

Key prohibitions include:

- Insiders using unpublished price-sensitive information to buy or sell securities.
- Insiders recommending or facilitating transactions for third parties based on inside information.
- Insiders disclosing confidential information (usually with intent) to third parties outside the scope of their professional duties.

Unlike many jurisdictions that limit insider trading prohibitions to publicly available securities, Rule 10b-5 applies to any security transaction, whether or not it is listed. The U.S. maintains some of the most robust and effective insider trading regulations, with enforcement dating back to 1934. The SEC actively pursues violations, even extending its reach internationally.

(A) The Traditional or Classical Theory

Under the classical theory of insider trading liability, violations occur when a corporate insider trades in their company's securities based on material non-public information. This theory posits that insiders should either disclose such information or refrain from trading. It is founded on two key ideas:

1. There is a relationship that grants access to confidential information for corporate purposes.

2. It is fundamentally unfair for someone to exploit this information while knowing it is unavailable to others involved in the transaction.

The U.S. Supreme Court has affirmed that a fiduciary relationship exists between a corporation's shareholders and its insiders, creating an obligation to disclose or abstain from trading to prevent the insider from taking undue advantage of uninformed investors. This theory applies not just to corporate executives and directors, but also to others like attorneys and consultants who have temporary fiduciary roles.

(B) The Misappropriation Theory[30]

The misappropriation theory broadens the SEC's enforcement capabilities by holding that an individual commits fraud "in connection with" a securities transaction when they misappropriate confidential information for trading, violating a duty owed to the information source.

This theory requires two key elements for liability:

3. A fiduciary-type relationship must exist between the trader and the information source.

4. The trading must breach the duty not to misuse that information.

Thus, merely receiving information is insufficient; there must be a justified expectation from the source that the recipient will not exploit the trust placed in them. Both theories are complementary: the classical theory targets insiders' breaches of duty to their shareholders, while the misappropriation theory addresses the misuse of non-public information by outsiders in breach of their duty to the information source.

VII. Indian Case Laws on Insider Trading

The case of Hindustan Lever Limited (HIL) vs. SEBI [31] marked one of SEBI's first significant actions against insider trading. In this instance, HIL purchased approximately 800,000 shares

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[30] United States v. O'Hagan, 1997 WL 345229 (US)

[31] Hindustan Lever limited (HIL) Vs SEBI, (1998) 18 SCL 311 MOF

from the Unit Trust of India. Shortly thereafter, a merger with a subsidiary was announced. SEBI conducted an investigation and concluded that insider information had influenced the trades. HIL appealed to the Appellate Authority, which upheld SEBI's decision, dismissing HIL's claims of ignorance regarding the information. This case led to amendments in the regulations, including a formal definition of "unpublished," which became foundational for defining "Unpublished Price Sensitive Information" in India.

In another significant case, Reliance Industries Limited (RIL) vs. SEBI [32], RIL initially held a 5% stake in Larsen & Toubro (L&T), with Mukesh and Anil Ambani as nominees on the board. RIL later increased its stake to nearly 10% and subsequently sold shares to Grasim Industries at a premium. This transaction resulted in the removal of the Ambani nominees from L&T's board, prompting SEBI to investigate RIL for insider trading. However, the Appellate Tribunal later reversed SEBI's decision, determining that the information had not been communicated by the nominees, and L&T had no knowledge of the transaction. As a result, RIL was not found liable for insider trading.

More recently, in January 2020, Rakesh Jhunjhunwala was investigated by SEBI for alleged insider trading related to his family's trades in Aptech, a firm where he held managerial control. SEBI also questioned Jhunjhunwala's family members, including his wife, brother, and mother-in-law. This wasn't Jhunjhunwala's first brush with insider trading allegations; he was previously questioned in 2018 over suspicions regarding shares of Geometric. In that case, he resolved the matter through a consent order.

VIII. Conclusion

Insider trading remains a significant issue in the securities market, undermining investor trust and confidence. It negatively impacts the reputation of companies and highlights the need for transparency, stability, and efficiency to restore investor confidence. To combat these issues, regulatory frameworks must be strengthened with robust monitoring mechanisms, stringent penalties, continuous surveillance, timely interventions, and expedited trials. India has witnessed numerous insider trading incidents, leading to substantial losses for both investors and companies. A major challenge lies in the prolonged investigation and adjudication processes, which can take decades, leaving cases unresolved for years. The current system struggles with high rates of violations coupled with low penalties. While SEBI works diligently to address malpractices within the securities market, limited resources hinder its effectiveness.

[32] Reliance Industries limited (RIL) Vs SEBI, 2004 55 SCL 81 SAT

Insiders who leak unpublished price-sensitive information exploit their access for personal gain, often at the expense of other investors. Although SEBI has implemented regulations to prohibit insider trading, promote codes of conduct, require pre-approval of trading plans, and impose fines, these measures only partially deter such behavior. Companies must also take proactive steps to enforce these regulations effectively. For capital markets to thrive, investor confidence is crucial, and this confidence hinges on effective regulation and enforcement of penalties against violators. Currently, SEBI's lack of advanced technological surveillance capabilities, such as the inability to tap phone calls, hampers evidence collection. This reliance on circumstantial evidence complicates the prosecution of offenders.Additionally, globalization has blurred jurisdictional lines, but Indian laws lack extraterritorial application, creating a significant gap in enforcement. Allowing offenders to compound offenses by merely paying fines undermines the seriousness of insider trading and diminishes the deterrent effect.

SEBI's wide-ranging functions, including auditing, inspecting, investigating, and enforcing regulations, contribute to an overwhelming workload that hampers efficiency. The commission faces challenges due to insufficient human, financial, and technical resources, which limits its capacity to effectively tackle insider trading and uphold market integrity.

(A) Suggested Actions to Curb Insider Trading

a. Key Measures for SEBI

i. Enforce Strict Compliance with Disclosures

SEBI should ensure rigorous adherence to initial and ongoing disclosures, requiring compliance officers to oversee trading plans, fair disclosure of unpublished price-sensitive information (UPSI) to stock exchanges, and reporting of any violations. System-driven disclosures and verification processes will streamline SEBI's oversight. Family members and connected persons must also be subjected to thorough verification.

ii. Implement Trading Restrictions for Insiders

To prevent insiders from acting on non-public information before it is publicly acknowledged, trading windows should be closed for a specified period after such disclosures. This measure aims to reduce the risk of unfair trading practices.

iii. Appointment of Compliance Officers by SEBI

Compliance officers play a crucial role in monitoring company operations and ensuring adherence to SEBI regulations. They should report any non-compliance directly to SEBI. These officers are responsible for implementing effective codes of conduct, preventing leaks of UPSI,

and managing trade approvals for designated persons and their immediate relatives.

For independence, compliance officers should be appointed by SEBI rather than the company's board, allowing them to operate without conflicts of interest. This independence is essential for effectively curbing insider trading.

b. Actions by Companies to Combat Insider Trading :

i. Establish a Robust In-House Vigilance System

Companies must create an internal system to monitor the activities of insiders who have access to UPSI, thereby deterring illegal insider trading.

ii. Educate Employees on Insider Trading Regulations

Comprehensive training should be provided to all employees and directors about the laws against insider trading, including the associated penalties and codes of conduct. This education can help reduce the likelihood of engagement in illegal trading practices.

iii. Conduct Prompt Investigations of Allegations

Upon receiving allegations of insider trading, companies must initiate investigations swiftly to protect their reputation and inform the market regulator as soon as possible.

iv. Leverage Technology for Monitoring

Utilizing advanced technologies, such as Insider Trade Management Systems (ITMS), can help detect insider trading activities. Artificial intelligence can process vast amounts of data and develop algorithms to identify suspicious trading patterns.

c. Additional Measures

Training programs should also be extended to investors regarding the implications of insider trading. SEBI should enhance its capabilities with skilled personnel and technological support, ensuring it remains independent from political influences. Stricter penalties and harsher punishments, including imprisonment, are necessary to instill a deterrent effect on wrongdoers.

In summary, compliance officers must be independent, with SEBI appointing them to ensure they can act transparently. Companies need to fortify their vigilance systems, respond swiftly to incidents, and recognize the broader implications of insider trading on market integrity and corporate reputation. The current legal framework in India requires improvement to effectively manage the complexities of its vast securities market, given SEBI's limited resources. Enhanced regulations and stringent enforcement are essential to address insider trading effectively.

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