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Nailing the Insider: A Hard-Won Fray

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ABSTRACT

The revelation of high profile frauds and scams in Indian and International Capital markets has drawn the attention of the regulators of these markets towards the necessity of setting up the corporate governance standards along with the sanctions in case of violation of the regulations or guidelines prescribed by the regulators and legislatures. Despite of having abundant legal machinery, the laymen investing their money in the market to get economic stability are suffering in the hands of big corporate mafias. The Corporate crimes in the face of cheating, misappropriation, fraudulent practices and insider trading practices victimizes the small investors and has shaken up the confidence of public in probity of the capital market. For attaining greater heights and development in capital market, the need of introducing the high level of corporate governance and transparency into the business sector is indispensable. The information must be equally available to the participants of market. Generally, the primary reason of distortion of market is the availability of material information to the insiders and its usage to trade in the market which is not available to the other counterparties. The rationale behind regulating such practices is to prevent the unfairness and injustice done to the investors deprived of the UPSI. This research undertakes an analytical study of the novel legal regime introduced by which prohibition of Insider Trading is affected and the rate of compliance of the present regime. The aim of this research is to assess the specific views on the regulation of insider trading and the disparity between enactment and enforcement of insider trading regulations and lastly, to see why India lags behind world's developed economies, in order to suggest different measures which may be integrated in the Indian securities market to curb this widely prevalent practice.

Keywords: *Prohibition, Unfair Trade Practices, Insider Trading, SEBI, Ineffective regulation, Enforcement.*

I. INSIDE OF INSIDER TRADING:

The Insider Trading practices emerged ever since the dealing in securities in India became prevalent and now this practice has become a threatening challenge for investors worldwide. Insider Trading implicitly implies executing trading practices relating to a

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company's shares with the aid of knowledge based on information relating to the company undisclosed or not released in the public domain in order to create unfair gains or prevent losses therefrom.

The primary reason behind the formulation of the Insider Trading Regulations was to encourage free transferability and fair exchange of securities on the stock market in which the public (investors) would trade in securities in a tranquil manner. However, the opponents of regulation of insider trading argues upon the fact that it is a form of compensation to the employees, perks of being an insider which stimulates them to enhance corporate performance eventually benefitting the shareholders of the company. But the fairness objective has knocked spots-off every perceived argument which was given in favour of insider trading. A fine line between legal trading and illegal trading is required to be drawn to understood and draw a distinction between what is permissible and what not. It is natural to make a presumption that insider have easy access to the advantaged information due to their involvement in management and corporate affairs. It is unreasonable and irrational to preclude the insiders from acquisition or severance of shares and contravenes the principle of free tradability, further violating the legal rights of insiders.

There were two main reasons recognized behind prohibiting the insider trading practices. First one was to ensure fair and unbiased securities market, hence promoting the investor’s confidence. Even though, disparity in information is inevitable in capital market but this results in distrust and hesitation amongst the investors to pool in their minimal resources in the market where such unfair trading is left unchecked by legislation or regulators. This is not a mere luck but a contrivance which leads the investors or general public to disadvantageous position. Second justification was built on the reasoning that 'information as a property' belonging to the company and misappropriation of such sensitive information in breach of fiduciary duty is no less than a fraud perpetrated against the company by the insiders.

Because of the asymmetry of information between investors and insiders, the general populace is in deprivation of the advantageous information in comparison to the insiders, who possess such material information by virtue of their role in the company; who exploit it for improper benefit and generates false and unrealistic expectations for investors to sell at the wrong price. Inequality of access to information enables the informed investors i.e. insiders get unlawfully enriched at the expense of uninformed investors and prevent them from taking informed trading decision.

(A) KEY DEFINITIONS PERTAINING TO INSIDER TRADING:

1. INSIDER:

The scope of the term insider is very wide; typically senior executives, directors and employees who have direct access to the company's sensitive information are known as insiders. But there are people who are connected to; or associated with these insiders, and if leaked via their connections inside the organization, they may take undue advantage of the data. Therefore for the matter of creating liability under insider trading regulation they are also deemed as the insiders.

The SEBI (PIT) Regulation of 1992 covered only the person who have access to or obtained confidential price sensitive information. But the new regulation 2015 has widened its ambit to cover all sorts of insiders within the regulation's purview. "Regulation 2(1)(g) of the Insider Trading Regulations define an *'insider' as any person who is:*

(i) a connected person; or

(ii) in possession of or having access to unpublished price sensitive Information"[2]

2. CONNECTED PERSON:

Connected Person is one who is or has been associated with the company in any capacity be it as a director, or officer or employee or whether in a contractual or fiduciary relationship; and inclusive of the list of "deemed connected persons".[3]

3. UNPUBLISHED PRICE-SENSITIVE INFORMATION (UPSI):

'UPSI' has been defined under Regulation of 2015 as information which is available generally and have the potential of materially affecting the price of securities on coming into public domain.[4] The words 'un-published' and 'price sensitive information' were defined individually under the Regulation of 1992[5] which has been combined under the new Regulation of 2015.

(B) BASIS OF REGULATION:

The basis for regulating insider trading and whether it should be prohibited or legalized has been a topic of debate, since there was a time when it was considered to be a "perk"

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[2] *SEBI (PIT) Regulations*, 2015.

[3] "*The Long and Short of Insider Trading Regulation in India", Available at*: https://www1.nseindia.com/research/content/res_QB13.pdf, last accessed (2nd April, 2020).

[4] *SEBI (PIT) Regulation*, 2015, Reg. 2(1)(n).

[5] *'Price Sensitive Information'* under Regulation 2(ha) &'*Unpublished*' under Regulation 2(k).

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of being the insider. However the need of regulating it was realized to ensure level playing field in the market. Majorly, Insider Trading is regulated on the basis of two theories i.e. theory of fairness and theory of fraud.

Theory of Fairness is based upon the principle of '*parity of information*' which signifies that the practice is unethical, unfair and morally unjustifiable. It ensures that the parties to trade must have equal accessibility to information about the securities being traded otherwise trade would be considered unfair.

Theory of Fraud connotes the *breach of fiduciary duties* towards the company and its shareholders. United States rationalizes the necessity of regulating insider trading practices on the basis that it causes violation of corporate information rights.

II. Headway Of Insider Trading Regulations:

Capital market is a significant source of growing corporate funds and an effective avenue for investors to spend their surplus and hard-earned capital in the economy. But a fairness and stability in the stock market is required to ensure performance in this system. But it is adversely affected by several malpractices which in effect hinders capital market growth and generates a sense of uncertainty among the general public before making any stock market investments.[6]

The traces of Indian securities market evolution can be found in the time when in the absence of proper infrastructure; meetings of stockbrokers were conducted under the banyan trees in town hall.

The very first occasion when India encountered insider trading was in 1940s, when the government made their attempt to eliminate such practice and make a concrete regulation for the same through the formulation of *Thomas Committee* in 1948.

However the changes brought as per the recommendation of the committee did not prove to be effectual in curbing the insider trading practices and the directors and the person holding inside information continued reaping the unjust profits and go scot free.

The inadequacy of the enforcement provisions in the companies Act, 1956 further led to the formation of the Committees in 1979, in 1986 and in 1989 who proposed to have a separate statute to regulate Insider Trading.[7] The recommendation of the abovementioned

[6] ___Available at https://www.corporateprofessionals.com/articles/insilysis-an-analysis-of-insider-laws/(last accessed 26 April 2020)

[7] "*Insider Trading in India*", Available at: http://www.legalserviceindia.com/article/l199-Insider-Trading.html, last accessed on (6th April, 2020).

committees and the extremity of rapidly progressing securities market led to the promulgation of a comprehensive legislative framework, *'SEBI (Insider Trading) Regulations, 1992'.* India had, for the first time, comprehensive legislation explicitly banning this fraudulent activity and making the person convicted of such a crime punishable under Section 24 and Section 15 G of the SEBI Act 1992.

The continuous shortfall in the structure of the regulation, co-operation between regulatory authority and lack of effective investigative machinery led SEBI to appoint High Level Committee (HLC) under the chairmanship of Justice N.K. Sodhi for an overhaul of insider trading regulation to replace the 1992 Regulations with a new set of regulation to modernize the insider trading regulations regime. Finally introducing the SEBI (PIT) Regulations,2015.

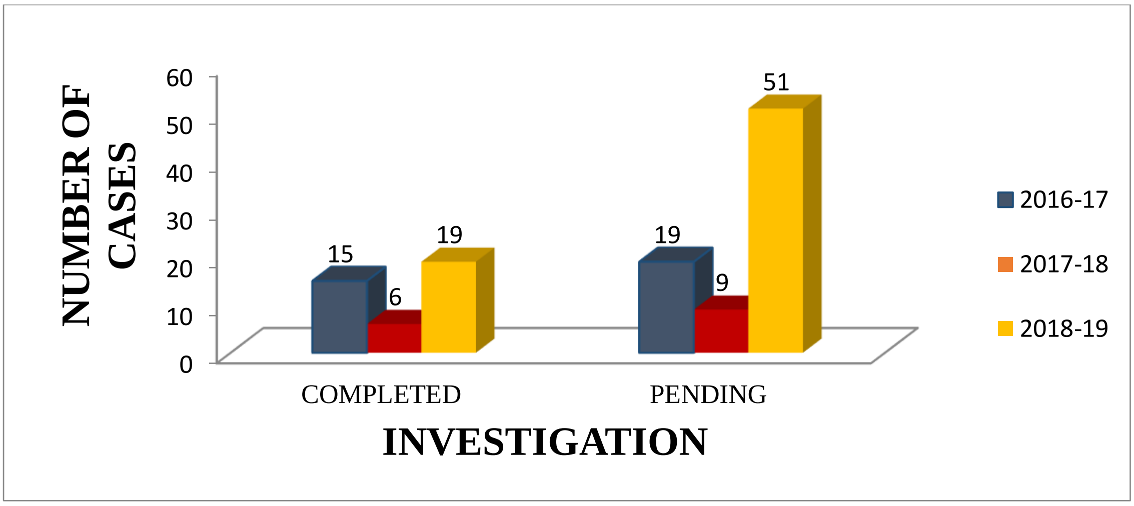
Recently the new informant policy been introduced through the SEBI (PIT) (Third Amendment) Regulations, 2019 which has inserted Chapter III-A in the 2015 Regulations. This amendment was implemented to allow individuals to come forward and report SEBI of infringements of insider trading laws. Where, on one hand Informants are incentivised with rewards, confidentiality and safeguards on reporting of the insider trading practice. The regulations also bear in mind the interests of the listed firms, and by enforcing fines and sanctions to preclude malicious and misleading allegations.

III. Gulf Between Enactment And Enforcement:

Insider Trading tend to be a White Collar Crime which seems to be quiet challenging for the regulators worldwide to cure and ensure effective compliance of the laws relating to it. While the white collar criminals are inflicting much harm upon the society, the fact is that very few amongst them are convicted or charged which shows the inability on part of the regulatory authorities responsible for enforcement of the law and to deter or catch such criminals. The criminal justice system that operates in different jurisdictions appears to handle white collar criminals with greater relaxation and less fairness than the street criminals. Till date, India has not been able to set much of the precedents for the successful and effective prosecution of insider trading cases that could serve as a deterrent against future violators.

In various occasions majority of insider trading cases failed to be exposed and even if it was detected the prosecution failed to establish the case against the offender. While SEBI has been investigating number of insider trading cases since 1992, the percentage of successful prosecution has been incredibly low.

FIGURE NO.1: ANALYSIS OF INVESTIGATION IN INSIDER TRADING CASES[8]



The above figure presents the analysis of investigating activities conducted by SEBI and depicts the incompletion of investigation in most of the cases relating to insider trading. In order to ensure efficient and more successful implementation and enforcement of insider trading regulation, there are certain issue which need to be addressed such as:

- Lack of technologically advanced surveillance and monitoring system due to which the perpetrator cannot be identified, it hampers the effectiveness of the inquiry.
- Challenge of proving the case on the basis of circumstantial evidence. To establish a link between the offenders, telephone records and transcripts are in most instances the only proof available. But it is denied to SEBI on the ground that it might get misused.
- Lack of performance assessment concept for SEBI leads to the same defects making way in the investigation over and over again giving us a low rate of completed/ successful investigations.
- SEBI oversees the stock market by performing various types of functions be it legislative, executive or that of judicial function, hence overburdening a single body with the multiple task results in diminishing its efficacy.
- Another problem in Indian insider trading cases has been shortage of infrastructure and trained manpower.

[8]SEBI ANNUAL REPORT (2017-18) AND (2018-19), at https://www.sebi.gov.in/sebiweb/home/HomeAction.do?doListing=yes&sid=4&ssid=80&smid=101(last accessed 21 May 2020)

Professor Barry A.K. Rider asserts, "Whilst jurist and philosophers may argue that the validity of law is a matter wholly independent from the ability to enforce it, in the real world a law which is not enforceable is of doubtful value".[9]

Mary Jo White, the ex-SEC chairman rightly stated that:

"*Investors do not want someone who ignores minor violations, and waits for the big one that brings media attention. Instead, they want someone who understands that even the smallest infractions have victims, and that the smallest infractions are very often just the first step toward bigger ones down the road*."

IV. CONCLUSION AND SUGGESTION:

Despite the apparent fact that the law has been updated from time to time to resolve various circumstances in the capital markets, and that the judiciary and regulators have constantly reviewed the effectiveness of the legal system and even recommended necessary improvements from time to time, but still there is no complete solution to ban insider trading.

This research did not seek to make any prescriptive about whether or not insider trading should be regulated, but the overall scenario creates doubts as to whether prohibition is a feasible option as there is a lack of concrete grounds for prohibition, the low compliance rate and the high cost of securities market policing.

Identifying the problem is the main and most critical step of dealing with a problem; everything will go in vain, unless the comprehension of the solutions for the path ahead is complemented. To curb the difficulties posed in enforcing insider trading regulations SEBI must consider the following suggestions:

- The first and foremost is to create awareness amongst the public who are victimized by this practice without their notice. Spreading awareness among the masses about the practice of insider trading and its adverse effects will go far towards curbing this ill-practice.
- The introduction of new informant mechanism by SEBI on the line of US laws is undoubtedly a progressive step but its effective implementation would rely on recognition by both the workers and the public about the system. Person may fear to come forward unless there is an assurance that the whistle blowers will

[9] Professor P.W. Alldridge, "*Prohibition on Insider Trading: A toothless Law*", SSRN, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1400824(last accessed 18 April 2020).

be guarded by adequate program in place which is dependent upon Office of Informant Protection.

- There is vagueness as to whether it is criminal in nature to breach the Insider Regulations or not. This needs to be explained in order to assess the extent of the breach and recommend legislative and compliance measures to discourage insider trading offenses.
- SEBI should only take on the role of regulator. Special courts could be set up to dispose of cases more quickly and effectively.
- To assist SEBI in its investigations and to implement effective action against insider trading, stronger and more efficient investigative and prosecutorial techniques are needed.

For attaining greater heights and development in capital market, the need of introducing the high level of corporate governance and transparency into the business sector is indispensable. The information must be equally available to the participants of market. Generally, the primary reason of distortion of market is the availability of material information to the insiders and its usage to trade in the market which is not available to the other counterparties.

The rationale behind regulating such practices is to prevent the unfairness and injustice done to the investors deprived of the UPSI. This research undertakes an analytical study of the novel legal regime introduced by which prohibition of Insider Trading is affected and the rate of compliance of the present regime. The aim of this research is to assess the specific views on the regulation of insider trading and the disparity between enactment and enforcement of insider trading regulations and lastly, to see why India lags behind world's developed economies, in order to suggest different measures which may be integrated in the Indian securities market to curb this widely prevalent practice.

Preventing insider trading is not about enforcing a set of rules or suspected flaws. It's about going after illegal transactions and the ability to prosecute and punish the offenders. The practice will continue unchecked until the regulators prove that they are serious about investigating insider trading.

It is critical in today's fast-moving, dynamic, and evolving markets that we aim to be everywhere to implement our securities laws and protect investors. It is important because investors in our markets want to know that a good cop is on the beat – not just someone sitting in the station house waiting for a call, but walking the streets and checking things out.[10] To send a message of law and order and to prevent a dysfunction in the environment which promotes the flourishing of more serious crimes it is necessary that even the smallest infringements of law must be prosecuted at every level – from street corner to the city's biggest crimes. The guiding principle of this technique is explained in an article, titled as "Broken Windows" where the idea is that when a window is broken and someone repairs it, it is a sign that dysfunction will not be accepted. But, when a broken window isn't fixed, it's "a signal that no one cares about, so breaking more windows doesn't cost anything".[11]

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[10] Chair Mary Jo White, "*Remarks at the Securities Enforcement Forum*", Oct. 9, 2013, at https://www.sec.gov/news/speech/spch100913mjw(last accessed 21 May 2020)
[11] George L. Kelling & James Q. Wilson, "*Broken Windows*", at https://www.theatlantic.com/magazine/archive/1982/03/broken-windows/304465/(last accessed 29 May 2020)

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