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The Role of SEBI in Promoting Transparency and Controlling Insider Trading

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ABSTRACT

Insider trading refers to the unlawful practice of buying or selling securities based on non-public, material information, granting certain individuals an unfair advantage and undermining market integrity. This practice violates the principles of transparency and fairness, as it allows insiders, including corporate executives, government officials, and financial professionals, to exploit confidential information for personal gain. The legality of insider trading is determined by whether the material information has been publicly disclosed; transactions based on undisclosed information are deemed illegal. In India, insider trading has been a persistent challenge since the 1940s, driven by corporate officers leveraging privileged information. Over the decades, the regulatory framework has evolved significantly, with the Securities and Exchange Board of India (SEBI) at its forefront. Since its establishment in 1988, SEBI has played a pivotal role in regulating insider trading by fostering fairness, ensuring equitable access to information, and maintaining the integrity of India's securities market. This paper examines the role of SEBI in preventing insider trading, with a focus on the SEBI (Prohibition of Insider Trading) Regulations introduced in 1992 and their subsequent amendments in 2015 and 2022. These regulations define insiders, prohibit the misuse of price-sensitive information, and promote the transparent dissemination of information to ensure market fairness. While SEBI's initiatives have strengthened its ability to detect and prevent insider trading, challenges persist in ensuring comprehensive enforcement, particularly in developing markets like India. This paper highlights the continued prevalence of insider trading during periods of economic liberalization and the integration of global markets. It emphasizes the importance of dynamic regulatory updates and robust enforcement to maintain market integrity. SEBI's evolving framework has been instrumental in building investor trust and ensuring a level playing field for all participants.

Keywords: *SEBI, Insider Trading, Securities, Investors.*

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I. Introduction

Insider trading involves buying or selling a publicly traded company's stock based on non-public, material information and can be either legal or illegal. Legal insider trading occurs when corporate insiders trade their company's stock in compliance with regulatory requirements, while illegal insider trading happens when such actions breach trust or fiduciary duties. The practice, often associated with illegal conduct, impacts market fairness and transparency by undermining equal access to information, distorting market dynamics, and eroding investor confidence. This issue is particularly critical in India, where the stock market plays a vital role in economic growth and attracting domestic and international investments. Historical incidents of insider trading in India, such as leaks from prominent financial entities, highlight the vulnerabilities in regulatory frameworks, leading to financial losses and reputational damage. As India's stock market evolves with greater retail and global participation, robust regulations and enforcement are essential to ensuring market integrity, protecting investors, and fostering a stable, transparent financial environment conducive to national economic progress.

II. Evolution of insider trading regulations

Insider trading has long been a concern for regulators in financial markets worldwide, and India’s securities market has had its own share of challenges in dealing with this unethical and illegal practice. Insider trading occurs when an individual with access to non-public, price-sensitive information about a company uses this information to gain an unfair advantage in trading the company’s securities. This practice is widely recognized as undermining investor confidence and market integrity, which is why robust regulation and enforcement are critical.

In India, insider trading was largely unregulated until the 1970s, even though the country’s stock market has a history dating back over 130 years. The earliest records of securities dealings in India date back to the time of the East India Company. However, formal legislative steps to regulate the securities market began with the Bombay Securities Contract Act, 1925, which aimed to govern the buying and selling of securities. Despite this initial step, the legislation had several shortcomings, particularly during the period between 1928 and 1938, which saw significant investor losses. As a result, the government found it necessary to appoint committees to evaluate and address these deficiencies[3].

The government introduced more comprehensive regulation during World War II. The Defense

[3] taxguru_in & Bhatt & Joshi Associates, *Insider Trading in India: Evolution, Regulation and Challenges*, TaxGuru (2024), https://taxguru.in/sebi/insider-trading-evolution-regulation-and-challenges.html (last visited Jan 1, 2025).

of India Act, 1939, included provisions relating to capital issues, which required prior approval from the government before companies could issue securities. This provision continued under the Capital Issues (Control) Act, 1947, after India gained independence. The act created the office of the Controller of Capital Issues (CCI), which held the authority to approve the issuance of securities, their types, prices, and quantities[4]. However, the government repealed this act in 1992 as part of the liberalization process aimed at opening up India's financial markets.

During the mid-20th century, insider trading began to surface more clearly. Instances of directors, agents, auditors, and other officers using insider information to speculate on the securities of their own companies were first reported in the 1940s. The Thomas Committee, formed in the post-independence period and headed by P.J. Thomas, was tasked with investigating these practices. The committee found that insider trading occurred when individuals with privileged access to crucial business information used this advantage for personal profit before such information became publicly available. Common examples included knowledge about upcoming dividends or bonus issues.

The Thomas Committee's recommendations laid the groundwork for future regulations. It highlighted the need for an independent, quasi-judicial body to oversee the stock market and prevent abuses like insider trading. This led to the formation of the Securities and Exchange Board of India (SEBI) in 1988, which was given the mandate to regulate the securities market and protect investors.

SEBI's role in tackling insider trading became particularly prominent with the introduction of the SEBI (Prohibition of Insider Trading) Regulations in 1992, which were later amended and consolidated into the 2015 regulations. These regulations define key terms like "insider" and "unpublished price-sensitive information" (UPSI), which are crucial for determining whether insider trading has occurred. According to the SEBI (Prohibition of Insider Trading) Regulations, 2015, an "insider" is defined as any person who has access to UPSI. UPSI is information related to a company that has the potential to influence the company's stock price once it is made public, such as earnings reports, mergers, or changes in dividend policy[5].

Under these regulations, insiders are prohibited from trading based on UPSI, and any act of trading based on this information can lead to severe penalties. SEBI's regulations provide a framework that seeks to detect and prevent insider trading by focusing on two essential criteria:

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[4] Abolition of Controller of Capital Issues and Emergence of SEBI - Business Ethics and Corporate Governance, Second Edition [Book], https://www.oreilly.com/library/view/business-ethics-and/9789332511255/xhtml/c22s9.xhtml (last visited Jan 1, 2025).

[5] Prohibition of Insider Trading Regulations, 2015, https://www.legalservicesindia.com/article/2028/Prohibition-of-Insider-Trading-Regulations,-2015.html (last visited Jan 2, 2025).

the definition of an insider and the characterization of unpublished price-sensitive information. These regulations are part of SEBI's broader objective of maintaining the integrity and transparency of India's financial markets.

Despite the relatively clear legal framework, the effectiveness of these regulations in curbing insider trading has been a subject of debate. One key criticism is that the SEBI regulations do not fully address the ethical and intentional aspects of insider trading. While the definition of an insider and UPSI are clear, the regulations do not explicitly consider the profit motive (mens rea) of the accused individuals, which makes it difficult to prove intentionality in insider trading cases. This limitation has been pointed out as a potential gap in the regulatory framework, as it might make it harder to prosecute individuals involved in insider trading, especially in cases where the financial gain or intention is not easily established.

The absence of mens rea as a requirement could also potentially undermine efforts to deter insider trading, as the focus remains on the technical aspects of whether information qualifies as UPSI and whether an individual qualifies as an insider. By not addressing the mental state of the accused, the regulations may fail to capture the full scope of ethical violations that occur in the securities market.

SEBI's insider trading regulations have brought much-needed clarity and structure to the regulation of market abuses in India, challenges remain in addressing the ethical and intentional elements of insider trading. The early history of India's securities market, from its colonial origins to its post-independence regulatory evolution, shows the increasing need for stringent laws to maintain fair and transparent markets. Moving forward, regulators may need to refine the existing framework to better capture the motives behind insider trading and strengthen the deterrent effect of the regulations, ensuring a more ethical and secure trading environment for all investors.

III. INSIDER TRADING IN THE INDIAN MARKET

Insider trading refers to the practice of individuals making profits from the stock market using confidential, non-public information about a company. This information can include anything that may influence a company's stock price such as expected dividends, anticipated changes in profits, news about potential mergers or acquisitions, or even threats that could affect the company's market position. In essence, insider trading involves taking advantage of material, non-public information (MNPI) to gain an unfair advantage in buying or selling securities[6].

[6] Material Nonpublic Information (MNPI)? Definition and Laws, Investopedia, https://www.investopedia.com/terms/m/materialinsiderinformation.asp (last visited Jan 2, 2025).

In the Indian context, insider trading has become a significant concern due to the growing financial markets and the need for maintaining transparency and fairness in securities trading. The term "insider" refers to individuals who have access to unpublished price-sensitive information (UPSI) that can affect the price of the company's securities. These insiders can be connected persons, employees, directors, relatives, or even individuals with indirect access to such sensitive information.

IV. Defining an insider in the Indian legal context

In India, the legal definition of an insider is outlined in the Securities and Exchange Board of India (SEBI) (Prohibition of Insider Trading) Regulations, 2015. According to these regulations, an "insider" is any person who is connected to a company and has access to unpublished price-sensitive information[7]. This includes not only executives and directors but also individuals who may have direct or indirect relationships with the company and its operations.

The concept of "connected persons" expands the scope of insider trading laws[8]. A connected person may include individuals who hold influential positions in the company or have business relationships that allow them to access sensitive information. Furthermore, insiders can be individuals who have access to sensitive information due to their work with entities that have business dealings with the company in question[9].

Key to understanding insider trading is recognizing that the mere possession of unpublished price-sensitive information (UPSI) by an individual constitutes potential insider trading, even if that information is not yet public. The definition emphasizes "accessibility" to such information, rather than the actual misuse of it. Hence, even a person who has access to sensitive data about a company but does not trade on that information may still be categorized as an insider under Indian law[10].

V. Price-sensitive information: the core of insider trading

Price-sensitive information refers to any non-public information that, if disclosed, could materially affect the market price or value of a company's securities. This type of information is critical because it influences investor decisions and market behavior. Examples of price-

[7] SEBI (Prohibition of Insider Trading) Regulations, 2015, Sec 2(1)(g)
[8] SEBI (Prohibition of Insider Trading) Regulations, 2015, Sec 2(1)(d)
[9]Utpal Bhattacharya, *Insider Trading Controversies: A Literature Review*, 6 Annu. Rev. Financ. Econ. 385 (2014), https://www.annualreviews.org/doi/10.1146/annurev-financial-110613-034422 (last visited Jan 2, 2025).
[10] SEBI Prohibition of Insider Trading Regulations 2015-Connected Person, https://abcaus.in/sebi/sebi-prohibition-of-insider-trading-regulations-2015-definition-insider-connected-person.html#google_vignette (last visited Jan 2, 2025).

sensitive information include announcements about forthcoming dividends, anticipated changes in a company's financial performance, strategic moves such as mergers, acquisitions, or joint ventures, as well as risks, threats, or legal actions that may adversely impact the business's future prospects.

The concept of price-sensitive information lies at the heart of financial market regulation because its misuse leads to insider trading—a serious violation of market integrity. Insider trading occurs when individuals with access to confidential, price-sensitive information use it to make investment decisions or influence transactions before this information is made public. Such actions provide an unfair advantage to those with privileged access, effectively excluding ordinary investors from equal participation. This disparity creates an uneven playing field, undermining the fundamental principles of market transparency and fairness.

The repercussions of insider trading extend beyond individual transactions. It erodes public trust in the fairness of financial markets and discourages investor participation, thereby impacting market liquidity and stability. When markets are perceived as being manipulated or unfair, investors—particularly retail investors—may withdraw their participation, which can have long-term adverse effects on capital formation and economic growth.

To address this issue, regulatory bodies such as the Securities and Exchange Commission (SEC) in the United States, the Financial Conduct Authority (FCA) in the UK, and the Securities and Exchange Board of India (SEBI) have implemented strict guidelines and penalties to prevent insider trading. Measures include mandatory disclosures, restrictions on trading during blackout periods, and stringent enforcement mechanisms to deter potential violations.

Ultimately, safeguarding the integrity of financial markets requires not only robust legal frameworks but also a culture of ethical conduct and accountability among market participants. Ensuring equal access to price-sensitive information fosters investor confidence and promotes a fair and transparent marketplace, which are essential for the sustained growth and stability of global financial systems.[11]

VI. REGULATORY FRAMEWORK IN INDIA

In India, the Securities and Exchange Board of India (SEBI) plays a pivotal role in regulating insider trading and ensuring that the securities market remains fair and transparent. The SEBI (Prohibition of Insider Trading) Regulations, 2015, is the primary law governing insider trading

[11] SRISTI NIMODIA, *SEBI Regulations on Insider Trading and UPSI*, TaxGuru (2024), https://taxguru.in/sebi/sebi-regulations-insider-trading-upsi.html (last visited Jan 2, 2025).

in the country.

The regulation of insider trading in India is primarily governed by the SEBI (Prohibition of Insider Trading) Regulations, 2015, as amended over time. These regulations are further supported by the SEBI Act, specifically through the provision, which prohibits insider trading[12], and the provision which prescribes penalties for such violations[13].

The regulations mandate initial and continual disclosures of trading activities by insiders and require listed companies and market intermediaries to establish a code of conduct to regulate, monitor, and report insider trading. Violations can result in severe monetary penalties and criminal prosecution, reinforcing the seriousness of compliance.

SEBI adopts a comprehensive approach to identifying potential cases of insider trading, employing multiple strategies to detect and investigate violations. The process begins with identifying insiders, including key managerial personnel, board members, auditors, promoters, their associates, and close relatives who handle sensitive financial information. SEBI also defines what qualifies as unpublished price-sensitive information (UPSI), encompassing data such as major contract acquisitions or significant financial developments.

Trading patterns are closely analysed to uncover suspicious activities, particularly those coinciding with critical corporate events or announcements. Furthermore, SEBI investigates potential connections between traders and individuals with access to inside information, often unravelling intricate networks of relationships. While this multifaceted approach enables SEBI to identify potential violations, the secretive nature of insider trading continues to pose challenges in proving such cases.

VII. Key disclosure requirements

The Indian regulatory framework imposes stringent disclosure requirements to promote transparency and prevent the misuse of insider information. Promoters, directors, and key managerial personnel (KMPs) must make an initial disclosure of their shareholdings within 30 days of joining a listed company. For continual disclosure, any change in their shareholding exceeding 2% of the company's total must be reported annually, ensuring transparency in ownership structure[14].

Additionally, trades involving shares worth over INR 10 lakh in a calendar quarter require

[12] SEBI (Prohibition of Insider Trading) Regulations, 2015, Sec 12A
[13] SEBI (Prohibition of Insider Trading) Regulations, 2015, Sec 15G
[14] https://twitter.com/taxguru_in & T. G. Team, *Disclosures of Shareholding & Control Under SEBI Regulations*, TaxGuru (2015), https://taxguru.in/sebi/disclosures-shareholding-control-sebi-regulations.html (last visited Jan 2, 2025)

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disclosure within two days to prevent price manipulation through insider information. SEBI also mandates an insider trading plan, requiring insiders to create and submit a pre-scheduled trading plan to the company's compliance officer for approval and public disclosure, thus deterring impulsive exploitation of unpublished price-sensitive information[15].

Finally, listed companies must implement a code of conduct for fair disclosure of unpublished price-sensitive information, which must be published on their official website, reaffirming their commitment to fair and transparent practices.

VIII. Legal defenses against insider trading allegations

While insider trading is strictly prohibited to maintain fairness and integrity in financial markets, individuals accused of engaging in such activities may rely on certain legal defenses to justify their actions. These defenses aim to demonstrate that the alleged insider did not misuse confidential information or acted within legal and ethical boundaries.

One widely recognized defense is the implementation of a "Chinese Wall" arrangement within organizations. A Chinese Wall refers to the creation of strict information barriers or internal protocols designed to prevent the unauthorized flow of price-sensitive information between departments or individuals. For instance, in financial institutions, employees working in investment banking are often segregated from those in equity research or trading to ensure that sensitive information about upcoming mergers, acquisitions, or financial reports does not influence trading decisions. Regulatory authorities often view a well-implemented Chinese Wall as evidence of good corporate governance, and it may serve as a robust defense against accusations of insider trading.[16]

Another potential defense is the concept of "information parity." This defense revolves around proving that the information used in making the trade was already in the public domain or was not material enough to significantly impact the stock price. For example, if the alleged insider can demonstrate that the information was disclosed through official channels such as press releases, public filings, or company announcements before the trade occurred, they may argue that their actions did not constitute insider trading. However, establishing information parity is challenging, as insiders are often assumed to have access to non-public, material information

[15] Compliance under SEBI Insider Trading Regulations – Practising Company Secretary – Kolkata, Mumbai, Chennai, Agartala, https://www.nehasinghi.com/compliance-under-sebi-insider-trading-regulations/ (last visited Jan 2, 2025)

[16] Diganth Raj Sehgal, *Legitimate Defences for Trading by an Insider under the PIT Regulations, 2015*, iPleaders (Apr. 6, 2021), https://blog.ipleaders.in/legitimate-defences-trading-insider-pit-regulations-2015/ (last visited Jan 2, 2025)

that could provide them with an unfair advantage over regular investors.

Additionally, individuals may invoke defenses based on pre-scheduled trades under Rule 10b5-1 of the U.S. Securities Exchange Act. This rule allows insiders to set up a predetermined trading plan for buying or selling securities, as long as the plan is established when the individual is not in possession of material non-public information. If the trades comply with the plan's terms, the insider may use this defense to refute allegations of trading on confidential information.

While these defenses provide mechanisms for accused individuals to protect themselves, they require substantial evidence, rigorous documentation, and strict adherence to legal and regulatory frameworks. Moreover, courts and regulatory bodies often scrutinize these defenses closely to ensure they are not being misused to justify unethical behavior. Ultimately, maintaining transparency, adhering to compliance protocols, and fostering a culture of ethical trading are the best ways to mitigate the risks associated with insider trading accusations.

IX. Challenges in the enforcement of insider trading laws

Enforcing insider trading laws presents significant challenges, particularly because of the difficulty in identifying and proving that a trade was made based on undisclosed, sensitive information. Insider trading is often based on subtle actions and information that is not directly linked to any formal documents or announcements. As a result, detecting and prosecuting insider trading can be a lengthy and complex process, often involving sophisticated investigative techniques. Furthermore, the globalization of financial markets and the rise of digital platforms have created new opportunities for insider trading. Information can be transmitted quickly across borders, making it harder for regulators to track and prevent such activities. Therefore, the implementation of more advanced technologies and collaborative efforts between international regulators is vital in tackling these issues effectively.

Despite significant progress in establishing a robust regulatory framework, several persistent challenges hinder the effective enforcement of insider trading regulations in India. One of the key obstacles is evidentiary hurdles, as proving insider trading often requires direct evidence, which is difficult to obtain due to the secretive nature of such transactions. The challenge of establishing a clear link between possession of inside information and subsequent trading activity continues to undermine enforcement efforts.

Criminal liability provisions exist, but applying them has been problematic, particularly due to difficulties in proving mens rea (criminal intent). This often results in accused individuals evading criminal prosecution and instead facing only civil penalties. Judicial delays further

exacerbate the issue, with lengthy legal processes providing ample opportunity for accused parties to manipulate evidence or prolong the proceedings, ultimately undermining justice. The increasing complexity and globalization of financial markets have led to more sophisticated insider trading schemes, requiring regulators to continuously adapt their methods to stay ahead of new trading strategies and information exchanges[17]

Cross-border issues also pose significant challenges, as insider trading frequently transcends national boundaries, complicating jurisdictional cooperation and international enforcement efforts[18]. The debate over balancing regulation and market efficiency remains ongoing. While stringent regulations are crucial for maintaining market integrity, overly rigid rules may hinder market efficiency and liquidity, creating a delicate balance for regulators. Additionally, investor protection and compensation remain areas of concern, as current regulations often fail to adequately address how investors suffering losses due to insider trading can be compensated[19].

Regarding the debate on legalizing insider trading, while the dominant global perspective supports its prohibition, there exists a minority view advocating for its legalization. This debate, though not mainstream in India, raises important questions about market efficiency, information dissemination, and the potential impacts on financial markets.

X. Conclusion

Insider trading, the illegal practice of trading securities based on confidential, non-public information undermines the fairness and transparency of financial markets. Individuals with access to such privileged information, called insiders, exploit it for personal gain before it becomes public, distorting market equilibrium. In India, insider trading has been a concern for decades, with its regulation evolving significantly over time.

Insider trading remains a complex and persistent challenge for India’s financial markets. Although significant strides have been made in establishing a comprehensive regulatory framework, ongoing difficulties in detection, enforcement, and prosecution underscore the need for continued evolution of the insider trading regime. The multifaceted nature of insider trading demands a holistic approach that goes beyond mere regulation. This includes strengthening

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[17] Navigating the murky waters – SC redefining the scope of mens rea in insider trading cases, The Law Blog (Mar. 12, 2023), https://thelawblog.in/2023/03/12/navigating-the-murky-waters-sc-redefining-the-scope-of-mens-rea-in-insider-trading-cases/ (last visited Jan 2, 2025)

[18] Regulation And Analysis Of The Concept Of Insider Trading: A Critical Analysis, http://legalserviceindia.com/legal/article-16704-regulation-and-analysis-of-the-concept-of-insider-trading-a-critical-analysis.html (last visited Jan 2, 2025).

[19] Nyayasastra, *Investor Protection: A Pillar of India’s SEBI Regulations*, Nyayasastra (2023), https://www.nyayasastra.com/post/investor-protection-a-pillar-of-india-s-sebi-regulations (last visited Jan 2, 2025).

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legal frameworks, enhancing detection mechanisms, improving corporate governance practices, fostering international cooperation, and promoting investor education and awareness.

As India's markets continue to grow and integrate with the global financial system, maintaining market integrity through effective insider trading regulations becomes increasingly critical. It is essential for regulators, market participants, and policymakers to remain vigilant and adaptable in the face of evolving market practices and technologies. By drawing on international best practices, leveraging technological advancements, and fostering a culture of ethical behaviour and transparency, India can enhance its defences against insider trading. This effort will not only protect individual investors but also contribute to the overall integrity and efficiency of India's financial markets, supporting their long-term growth and stability.

Ultimately, the goal of insider trading regulation is to ensure a level playing field where all market participants have equal access to information and opportunities. While challenges persist, the ongoing refinement and enforcement of insider trading regulations in India are vital steps toward achieving this objective and fostering a robust, transparent, and trustworthy financial market ecosystem.

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