

INTERNATIONAL JOURNAL OF LAW
MANAGEMENT & HUMANITIES
[ISSN 2581-5369]

Volume 6 | Issue 2
2023

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Understanding Insider Trading in India: Shortcomings and Recommendations

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ABSTRACT

Knowledge is power. This is a saying that has been around for time immemorial and even to this day, it continues to hold true. You are bound to get a head start when you know more than your opponents. The philosophy of “by any means” is applicable in certain scenarios even today, but the reason why we have laws is to ensure equality and fair spirit of competition.

Trading in securities of companies is one of the most lucrative fields today and it is one of the fields where getting access to information before the rest works in your favour as one piece of information can result in one yielding millions in profits. It is because of this that people go above and beyond to acquire what is referred to as UPSI or Unpublished Price Sensitive Information which in the simplest of terms refers to the type of information regarding the workings of a company or some sort of inside information which would give those who have access to it an unfair advantage over others and ensure profits to them or protect them from losses. This is, Insider Trading.

Insider trading refers to the illegal practice of buying or selling securities of a publicly traded company based on unpublished price sensitive information. In India, insider trading is prohibited by the Securities and Exchange Board of India (SEBI) under the Prevention of Insider Trading Regulations, 2015.

Now, although we have better legislations in present day and age to prevent Insider Trading to an extent but there exist various shortcomings in execution of the same.

The paper aims to provide the reader an insight into the concept of Insider Trading and how it's perceived in the Indian Context and then analyse the same and elucidate upon the shortcomings and present certain recommendations.

Keywords: *Insider Trading, India, Shortcomings, Recommendations.*

I. INTRODUCTION

In today's day and age, companies play a vital role in our everyday lives. Everything around us, everything that we eat, use or consume is produced or owned by some company or the other.

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The word “Company” is derived from the combination of Latin Words “Com” and “Panis.”³ The former meaning together and the latter meaning bread i.e., coming together for meals. Therefore, a company can be said to be a group of or an association of individuals with a common goal or with the aim to pursue a common venture together.

As stated, companies have gained vast prominence in today’s day and age and the Indian Scenario is no such exception. In 1991 when India introduced the policies of Liberalization, Privatisation and Globalization in their economy, we saw a tremendous increase in the power, influence and number of companies trying to conduct their business in India. If left unchecked, the influence of Companies would turn grossly arbitrary and for the same Post Independence, India enacted the Companies Act, 1956 with the aim to regulate and monitor the functioning of Companies in India. But post 1991 it became evident that the 1956 Act is not compatible with the changing times and there arose the need for a new legislation which would cater to the present situation, and thus came about the Companies Act of 2013.

The new act was no short of revolutionary, although it did not address certain issues with complete clarity, it did provide a base for them. One such issue was that of Insider Trading.

The practice of Insider Trading came into existence ever since the very concept of trading of securities of a company became prevalent among the investors worldwide and has now become a formidable challenge for investors all over the world. Insider trading refers to the practice of trading securities on the basis of non-public information, which gives a trader an unfair advantage over other market participants. The basis of insider trading is the use of material non-public information by an individual to gain an advantage in trading securities. This information could include details of upcoming mergers and acquisitions, earnings announcements, or other significant corporate events that could impact the price of a company's stock. An individual with access to such information, such as an executive or employee of a company, could profit by trading on this information before it becomes public knowledge. This not only provides an unfair advantage to the individual trader but also damages the market's integrity.

Both the 1956 and 2013 Companies Act discussed the issue of Insider Trading in brief but there was not a detailed structure to counter the problem. However, after a series of deliberations spanning for decades, today we have the SEBI (Prohibition Of Insider Trading) Regulations, 2015 which discusses the problem in detail and provides a proper mechanism and structure to counter the problem and discusses various scenarios where the Application of Act will be sought.

³ Dr. S.C. TRIPATHI, NEW COMPANY LAW 06-07 (CENTRAL LAW PUBLICATIONS, 2021)

The Judiciary has also played a vital role in improving the application of laws and providing clarity as to how issues of Insider Trading are to be dealt with in India by passing various Precedents.

However, even today there remain certain areas which need to be addressed by the Legislature in the context of Insider Trading.

The following paper aims to discuss the concept of Insider Trading and how it is perceived and dealt with in India by talking about the various Legislations and Judicial Decisions. Also, the paper aims to highlight certain inconsistencies which exist even today in dealing with the issue and suggest how such shortcomings can be dealt with.

(A) Research Methodology

This research paper is based on the doctrinal method in which data is collected from secondary resources. In the secondary resource some of the research papers, articles, and acts. have been referred to. After collecting data from these resources the materials were filtered and included in the research paper in such a way that the objective of our research would be attained.

II. INSIDER TRADING: WHY IS IT SUCH A BIG PROBLEM?

(A) About Insider Trading:

In simple words we can understand the insider as a person who has control over the affairs of the management of the company and who has deep knowledge of the internal affairs of the company. Such a person holds knowledge about "price sensitive information" which is related to the affairs of the company and if such information is used for personal gains and profits or is further distributed by such an insider to other people impacts the prices of the shares of the particular company. It means the insider is in a fiduciary position and using or disseminating such information is against the corporate governance. On the other hand, the action or activity of buying and selling securities of a company is trading.

Hence, insider trading can be understood as trading by those who are insiders to an organization and its decision-making process, on the basis of material, undisclosed information about the securities of that organization. Tipping of such information to another for the purpose of trading on the basis of such information also comes under the ambit of the term insider trading.

(B) Why is Insider Trading a Problem?

- Breach Of Fiduciary Relationship And Trust: When an insider uses material, undisclosed price sensitive information to make a profit they violate their duty towards the company and also breach the fiduciary relation and trust that the shareholders and

all the other stakeholders have in the company and its management.

- Increases Corruption: Allowing insider trading creates a culture of corruption and self-dealing in which people in positions of power abuse their position for personal gain. This can have far-reaching consequences, damaging institutions and harming innocent people who become caught up in this cycle of corruption.
- Damage To Market Liquidity And Efficiency: When the insiders share confidential information, it prevents the prices from responding normally to new information. This damages market liquidity and efficiency causing a ripple effect, making it more difficult and costly for the investors to trade.
- Creates A Sense Of Unfairness Among Other Investors: When some investors are able to profit from inside information while others are not, it creates a perception of unfairness. This damages the faith and confidence in the markets and discourages participation. Since inside traders profit from privileged access to information rather than work, this makes people believe that the system is rigged. Market professionals such as securities analysts, investment bankers, and money managers may be less likely to share their own valuable insights if they believe that others may be using insider information to trade against them.

III. EVOLUTION OF INSIDER TRADING AND THE LEGISLATIONS TO COUNTER THE PROBLEM IN INDIA

Initially the Companies Act 1956 did not have any provisions, to hold directors and managing agents of the company accountable for using confidential information unfairly. With the passing of time and the rampant increase of insider trading in the Stock exchanges, various concerns were raised regarding the same, and finally, legislation to curb insider trading was framed. The provisions relating to Insider Trading were incorporated in the Companies Act, of 1956 under Sections 307 and 308⁴, which required shareholding disclosures by the directors and managers of a company. Various committees proposed recommendations for a separate statute regulating Insider Trading.

1) The Sachar Committee

In 1977, Sachar Committee⁵ was set up to review the provisions of the Companies Act and the Monopolies and Restrictive Trade Practices Act, of 1969 (the current Competition Act, 2002).

⁴ Companies Act, 1956, No. 01 of 1956

⁵ Government of India, "Report of the High-Powered Expert Committee on Companies and MRTP Acts"

This Committee opined that Sections 307 and 308 of the Companies Act were insufficient to curb insider trading. The Committee highlighted a few drawbacks regarding the statutory provisions mentioned under the Companies Act, of 1956. They were as follows:

- The provisions that mandated disclosures to the shareholders regarding the transactions in the sale and purchase of shares by the directors and other key managerial persons are insufficient to solve the problem of a certain class of people securing unfair profits by the use of non-public confidential information.
- The Committee also recognized that certain categories of persons may be included in the category of insiders, such as the company's directors, statutory auditors, cost auditors, financial accountants or financial controllers, cost accountants, tax management consultants or advisors, and the whole-time legal advisors or solicitors who would generally have access to the price-sensitive information not available to the outsiders.

2) The Patel Committee

In 1984, for the review of the functioning of stock exchanges, the Patel Committee⁶ was instituted. The Patel committee in 1986 in India defined Insider Trading as: “Insider trading generally means trading in the shares of a company by the persons who are in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others.”⁷

The Committee was of the view that the Stock exchanges should take effective steps to check this menace of insider trading. A few recommendations of the Patel committee were:

- That there should be a specific statutory prohibition of insider trading. Codified legislation to counter insider trading in India should be drafted. The committee also submitted draft legislation prohibiting insider trading.
- Any person found guilty of the offense of insider trading should be fined heavily for the first offense and imprisonment for up to 5 years for the second and subsequent offenses.
- Surprise inspections should be conducted of the books of accounts of the stockbrokers to check and verify their indulgence in overtrading or any other area or source of excessive trading.

3) SEBI (Prohibition Of Insider Trading) Regulations, 1992

⁶ Government of India, “Report of the High-Powered Committee on Stock Exchange Reforms” (1984).

⁷ Para 7.25 of Government of India, “Report of the High-Powered Committee on Stock Exchange Reforms” (1984).

Several recommendations of these committees led to the formation of the first comprehensive legislation against insider trading in the year 1992. In accordance with the powers granted to the SEBI under section 30 of SEBI Act, 1992, it framed the SEBI (Prohibition of Insider Trading) Regulations, 1992 for prohibiting the offense of 'insider trading'. Despite various amendments to the 1992 regulations the issue of insider trading was still a matter of concern. SEBI found it difficult to investigate, enforce and prosecute the cases involving insider trading. Hence to resolve this problem a new High-level Committee to review these regulations (regulations of 1992) was instituted under the chairmanship of N.K. Sodhi to bring insider trading regulations in line with the global best practices.

4) Provisions Relating To Insider Trading In Companies Act, 2013

The Companies Act, 1956⁸ provided with the provisions related to insider trading. But since it proved to be unable to control the problem of insider trading it became a necessity to add much more stringent laws with rigorous punishment. Hence, under the Companies Act, 2013, Section 194 and 195 were added to deal with prohibition on insider trading of securities. These provisions laid down that no person including any director or key managerial personnel shall enter into insider trading unless it was required in the ordinary course of business or profession or under any law. Further it provided for the penalties/punishment for contravention of the provisions of this section.

Although these provisions were necessary and dealt with insider trading, after the Companies (amendment) Act, 2017 Section 194 and 195 were omitted because it is believed that the SEBI regulations are wide enough to deal with insider trading and all such other frauds.

5) Sodhi Committee

To review the SEBI (Prohibition of Insider Trading) Regulations, 1992 a committee⁹ was established under the Chairmanship of Justice N.K. Sodhi, former Chief Justice of Kerala and Karnataka High Courts. The committee was of the view that the prohibitions contained in the Proposed Regulations would apply to trading in securities issued by a company which are listed on a stock exchange. The highlights of the proposed guidelines/recommendations as given by the committee were as follows:

- The committee made clear the meaning and scope of various terms connected to the practice of insider trading such as connected person, generally available information,

⁸ Companies Act, 1956, No. 01 of 1956

⁹ N.K.Sodhi, "Report of the High level committee to review the SEBI (Prohibition of Insider Trading) Regulations, 1992, (December 7, 2013), https://www.sebi.gov.in/sebi_data/attachdocs/1386758945803.pdf?QUERY

unpublished price sensitive information, usage of the word trading or dealing for the purposes of prohibiting insider trading etc.

- The committee recommended that the insiders would be denied from imparting, giving, or permitting access to UPSI except if required for release of obligations or consistent with the law.
- The committee recommended that the board of directors of every company and the market intermediary formulate a proper Code of Conduct to control and monitor the trading activities. Every other individual, for example, inspectors, law offices, bookkeeping firms, experts and specialists, and so on who handle UPSI throughout business activities may define a set of accepted rules and the presence of a code.
- While making these guidelines the committee kept in mind to clarify the view on who will have the burden of onus of proof. The onus of showing that a certain person is an insider and that he was in possession of UPSI at the time of trading would be on the person leveling the charge. While the onus of proving the defense would be on the person accused of violating the prohibition.

There were a few more recommendations made by the committee and after several debates and deliberations a new SEBI (Prohibition of Insider Trading) Regulations, 2015 was laid down.

6) SEBI (Prohibition Of Insider Trading) Regulations, 2015

Currently in India insider trading is regulated by the SEBI (Prohibition of insider trading) Regulations, 2015¹⁰. It is divided into:

*Chapter I- Preliminary

*Chapter II- Restrictions on communication and trading by insiders.

*Chapter III- Disclosures of trading by insiders.

*Chapter III-A

*Chapter IV- Codes of Fair Disclosure and Conduct.

*Chapter V- Miscellaneous

and there are 5 Schedules- A,B,C,D, and E.

The SEBI Regulations, 2015 have broadened the scope of definitions of unpublished price-sensitive information, insider (UPSI), connected persons, and trading. Overall the 2015

¹⁰ SEBI (Prohibition of insider trading) Regulations, 2015 (India)

Regulations are much more exhaustive and effective in comparison to any other previous legislations concerned with insider trading.

Further discussing the few important definitions of the regulation are as follows:

- Connected Person: The regulation¹¹ defines “connected person” in regulation 2(d) as any person who is or had during the last 6 months prior to alleged act, been associated with the company in any capacity by reason of frequent communication with the officers or being in any contractual, fiduciary or employment relationship or by being a director or officer or an employee of the company, or if he holds any position, including a professional or business relationship with the company, either temporarily or permanently that allows such person access to UPSI or when he is reasonably expected to have such an access. The SEBI Regulations of 2015 broadened the scope of the term connected person and included a category of people who would be deemed to be as connected persons until proven contrary. To mention a few this shall include the immediate relative of the connected person; a holding or subsidiary or associate company; an intermediary or employee or director thereof; an investment company, trustee company, asset management company or director or employee thereof etc. among others.
- Insider: The regulation¹² defines “insider” as any person who is either a connected person or in possession of or having access to Unpublished price sensitive information (UPSI).
- Unpublished price sensitive information: The regulation¹³ defines an “UPSI” as information relating to a company or its securities that is not generally available and which upon becoming generally available is likely to materially affect the price of the securities.
- Trading: The regulation¹⁴ defines “trading” as subscribing, buying, selling, dealing or agreeing to do any of these acts in regards to any securities.

Further, there are comprehensive regulations related to:

- The code of conduct for every listed company or intermediaries;
- Proper disclosure mechanism;

¹¹ SEBI (Prohibition of Insider Trading) Regulations, 2015, Regulation 2(d)

¹² SEBI (Prohibition of Insider Trading) Regulations, 2015, Regulation 2(g)

¹³ SEBI (Prohibition of Insider Trading) Regulations, 2015, Regulation 2(n)

¹⁴ SEBI (Prohibition of Insider Trading) Regulations, 2015, Regulation 2(l)

- Various prohibitions concerning communication of UPSI and exceptions if any;
- The offenses and penalties for the same.

IV. JUDICIAL PERSPECTIVE

In India, insider trading is considered a serious offense that is punishable under the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (SEBI PIT Regulations). The regulations prohibit insiders from trading in securities of a company based on unpublished price-sensitive information (UPSI) that they possess.

From a judicial perspective, the Supreme Court of India has upheld the SEBI PIT Regulations and has taken a strict view on insider trading cases.¹⁵ In 2019, the court upheld the conviction of two individuals in the infamous Rajat Gupta insider trading case, stating that insider trading not only undermines the integrity of the market but also erodes public trust in it. The court also emphasized the need for strong deterrence to curb insider trading.¹⁶

The Securities Appellate Tribunal (SAT) also plays a significant role in insider trading cases in India. It is the appellate authority for appeals against SEBI orders and has been instrumental in upholding SEBI's actions in insider trading cases. For instance, in 2020, SAT upheld SEBI's decision to impose a penalty of Rs 50 lakh on a director of a listed company for insider trading.

Overall, the judiciary in India takes a stern view of insider trading and has been proactive in upholding SEBI's regulations and actions to curb the practice.

V. SHORTCOMINGS/ANALYSIS

Insider trading is the act of buying or selling securities based on non-public information, which can be illegal in many countries including India. The approach to insider trading in India has several shortcomings, some of which are:

- Lack of clear regulations: The Securities and Exchange Board of India (SEBI) has regulations against insider trading, but they are not comprehensive enough to cover all forms of insider trading. Moreover, there is a lack of clarity on what constitutes insider trading, leading to confusion and difficulty in enforcing the regulations.
- Ineffective enforcement: Even though insider trading is illegal, it is difficult to detect

¹⁵ Manish Yadav, Indian Law With Respect To Insider Trading: An Analysis Of Landmark Judgements, LAWYERS CLUB INDIA (Oct. 11, 2022) <https://www.lawyersclubindia.com/articles/indian-law-with-respect-to-insider-trading-an-analysis-of-landmark-judgements-15226.asp>

¹⁶ Rajat Gupta and Goldman's Insider Trading Bombshell: https://www.mof.gov.np/uploads/document/file/Training%20Material%20Rajat%20Gupta%20Insider%20Trading%20Case%20File_20150723073207.pdf

and prove. The enforcement agencies in India lack resources, expertise, and technology to effectively investigate and prosecute insider trading cases. As a result, many insider trading cases go undetected, and even if detected, the enforcement agencies are unable to bring the culprits to justice.

- Lack of deterrence: The penalties for insider trading in India are not severe enough to act as a deterrent. The maximum penalty for insider trading is a monetary fine of Rs. 25 crore or three times the amount of profits made from insider trading¹⁷, whichever is higher. This is not a significant deterrent for wealthy individuals who can afford to pay the fine.
- Limited scope of regulation: The regulations against insider trading in India apply only to listed companies, leaving out unlisted companies and other market participants such as investment bankers, auditors, and lawyers. This creates a regulatory gap and allows for potential insider trading by these market participants.
- Lack of awareness: Many market participants in India are not aware of the regulations against insider trading, making it difficult to enforce them effectively. This lack of awareness also makes it easier for insiders to engage in illegal insider trading activities.
- Insufficient Staff: Based on SEBI's Annual Report (FY 2017), it appears that SEBI has one employee for six listed companies. Due to such a reason it becomes difficult in identifying Insider Trading Practice. There is a high chance for connected persons of a company to involve themselves in such malpractices.¹⁸
- Whistleblowers: The fact that Whistleblowers play an extremely vital role in uncovering Insider Trading cases somewhat seems to be neglected when we look at the policy for the same. Whistleblowers once they bring the information of such malpractices to light they are constantly under threat, and it seems obvious that the best way to protect such people is by hiding their identity. But this anonymity is not provided to them as they are supposed to reveal their name and details while they file such a complaint by filling out the necessary forms. This prevents a lot of people with such information from coming before the appropriate authorities as they are aware of the consequences which may follow if they do so.

Overall, the approach to insider trading in India has several shortcomings that need to be

¹⁷ The Securities And Exchange Board Of India Act, 1992, No. 15 of 1992

¹⁸ Abhirami B & Arya Kuttan, Insider Trading Laws In India - Pertinence And Problems, 4 International Journal Of Legal Developments And Allied Issues 443, 443-463, 2018

addressed to effectively curb insider trading and ensure fair and transparent markets.

VI. RECOMMENDATIONS

After analysing the shortcomings of the present approach against Insider Trading in India, the possible solutions are very evident. In order to not only better counter the issue of Insider Trading in India but to bring more uniformity in it the following recommendations are suggested:

- Increase the number of employees or regulator appointed by SEBI to monitor the working of listed companies to an extent that there is adequate staff to monitor each company individually.¹⁹
- Bring change into the Whistleblower Policy in terms of anonymity. As providing the whistleblowers with an assurance that their identity will be secure after they bring their intel to light will instil confidence in the people who come across such information. This will result in more cases being brought to light and a much better intel collection operation.
- Improve upon the aspect of Territorial Jurisdiction. As Foreign internationals who are indulged in insider trading activities cannot be punished as there is no mention in the Regulation about the same. Therefore, it is advisable to include provisions for penalizing even the foreign companies listed in the Indian stock markets if found indulging in such prohibited activities.
- Grant more extensive powers to SEBI. Many times SEBI is stuck behind the Bureaucratic/Administrative Red Tape is unable to implement its actions swiftly. Therefore, it would make the job of SEBI a whole lot easier if the powers of SEBI could be made much wider so that SEBI is able to conduct a smooth investigation without any hindrance. A major suggestion for the same would be that SEBI should be given more discretion when it comes to monitoring those who are suspected of committing Insider Trading.

VII. CONCLUSION

It can be said without a doubt that the Indian Administration in terms of Insider Trading has come leaps and bounds from the previous mechanisms that were in place to deal with such issue. But there remains a lot of areas where we see inconsistencies in the implementation of the same.

¹⁹ Abhirami B & Arya Kuttan, Insider Trading Laws In India - Pertinence And Problems, 4 International Journal Of Legal Developments And Allied Issues 443, 443-463, 2018

The SEBI 2015 Regulations have indeed brought about a major change in the way these issues are dealt with but issues such as lack of staff and the administrative red tape get in the way of the actual execution of the Act.

The aim of the following paper was to understand the manner in which Insider Trading is dealt with in India but more importantly throw light upon the shortcomings that are witnessed in the same. The paper has also suggested certain reforms which may be implemented to bring about change and better the manner of dealing with Insider Trading in India as the current system in place is adequate, but it has potential to be much better.

Now it is obvious that the issue of insider trading will continue to persist as long as trading of securities is a lucrative field but if there are mechanisms in place to counter such an issue we can at least ensure proper functioning of the Securities Market and growth of the economy.

Thus, for the same there needs to be certain changes in the present regime in dealing with Insider Trading in India.
