Insider trading in India – regulatory enforcement

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Abstract

Purpose – The purpose of this paper is to study the effectiveness of insider trading enforcement actions in India and international dimensions.

Design/methodology/approach – The research is based on the insider trading regulations and amendments made during the period 1992-2015.

Findings – The notable observation of the study is the dearth of insider trading conviction and the paucity of prosecution for insider trading offences in India. It is difficult to resist the conclusion that surveillance and enforcement matter more than the drafting of the relevant statutes and regulations in emerging markets. Whereas, developed countries have a better record of prosecution than emerging markets.

Research limitations/implications – Future research may explore the factors that hinder effective regulation and recommend new methods to increase the impact of Securities and Exchange Board of India insider trading regulation.

Originality/value – The current paper presents guidance for the foreign institutional investors, regulators and market participants on insider trading regulation and prosecution in India.

Keywords India, Emerging markets, Insider trading, Legal trading, Regulatory ambiguity, Trade on disclosures

Paper type Research paper

1. Introduction

The stock exchanges of a nation are the key segment of its capital market. A healthy capital market can be created if the stock exchanges are well regulated. In the current economic environment around the world, an active enforcement of criminal laws and regulations has increased its focus on punishing and preventing insider trading and market abuse. The insider trading prosecution has to expose the evidence of insider trading by using forceful devices such as wiretaps. The US Court juries have frequently been sentencing those who have chosen to go to tentative and dishing out severe fines to the guilty defendants. Insider trading means trading by any individual in the securities of a company by having price-sensitive information of the company before it is available to the general public with an intention of making abnormal profits or avoiding losses. "Insider means any individual who has access to unpublished price sensitive information with respect to securities of a company", conferring to Securities and Exchange Board of India SEBI (Prohibition of Insider Trading) Regulations (1992). In a similar vein, Section 195 of The Companies Act (2013) states that insider trading is an act of buying, selling, subscribing or agreeing to subscribe in the securities of companies directly or indirectly by the key management personnel or the director of the company and sensibly anticipated to have access to Unpublished Price Sensitive Information[1] (UPSI) with reference to the company as well as its securities is deemed to be insider trading.

The term insider trading is subject to many definitions and connotations, and it encompasses both legal and prohibited activity. When a corporate insider trades by adhering

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to all the regulations, it is called legal insider trading, and any violation of that amounts to prohibited activity. However, general public holds a misperception that insider trading is a prohibited activity. The past several decades have witnessed an increase in insider trading. To discourage trading on material non-public information, corporate insiders face several restrictions on their trading.

Insider trading is a word generally associated with prohibited behavior. It is an action of purchasing and selling of securities by an individual having UPSI of the company before it is accessible to the common public with an objective of creating abnormal earnings and evading losses (Corporate Governance an Emerging Scenario, published by National Stock Exchange, 2010).

Corporate insiders are allowed to trade in their own company's stock, but are required to disclose these transactions to avoid the misuse of any non-public price-sensitive information. SEBI has framed numerous disclosure regulations for insiders to build investor confidence and increase the transparency in securities trading. The aim of these disclosures is to create a level playing field to all the participants in the market. When a corporate insider trades by adhering to all the regulations, it is called legal insider trading, and any violation of that amounts to illegal insider trading. Therefore, to monitor insider trading activities, they are required to disclose their legal trades to SEBI in a timely manner.

The Companies Act (2013) passed by the Indian parliament also devised the code of conduct for the administration of these regulations. The listed companies in India are guided by Clause 36 of the Listing Agreement of the stock exchanges, which states that the issuer will inform to the stock exchanges, where the company is listed, immediately of events such as closure on account of power cuts, lockouts and strikes, and all events that have a posture on the operations/performance of the firm as well as price-sensitive information together at the period of happening of the event and consequently after the end of the event to facilitate the shareholders and the public to assess the position of the issuer and to avoid the creation of a false market in securities. To improve the fairness and transparency in the capital markets, SEBI has made several amendments to its SEBI (Prohibition of Insider Trading) Regulations (1992).

Insider trading takes place lawfully daily, when the employees, directors or officers and corporate insiders purchase or sell securities of their own businesses within the restrictions of the company policy and the code of practice prevailing for listed companies. The mandatory disclosures which are to be made to SEBI are as follows: disclosure to the stock exchange by the listed company, disclosure to the stock exchange by an individual who is a director or officer of a listed company and disclosure to the stock exchange by a person who is a promoter or portion of the promoter group of a listed company.

The liberalization of India's economy in 1991 made a considerable development of capital market and regulatory reforms. The stock market crash in India at the beginning of 1992, stock manipulation by Harshad Mehta, has highlighted the issues of transparency and motivated the enforcement of insider trading laws in India to regulate and supervise by SEBI. The current paper centers on the way the SEBI has been aspiring to fulfill the regulatory objectives established on this merge. The research is based on the SEBI (Prohibition of Insider Trading) Regulations (1992) and amendments made during the period 1992-2015. The notable observation of the study is the dearth of insider trading conviction and the paucity of prosecution for insider trading offences in India. SEBI in the year 2015 has shown interest to increase the enforcement actions in line with the international standards.

The purpose of this paper is to conduct a comprehensive overview of insider trading regulations in India. We divide our study into four sections. First, we present the insider trading regulations around the world, and in the second section, we present an overview of

SEBI (Prohibition of Insider Trading) Regulations (1992 and 2015). The third section discusses insider trading investigations by SEBI, and the paper is concluded in the final section.

2. Insider trading regulations around the world

There is a considerable cross-country variation in the quality and quantity of corporate reporting, information intermediation and information dissemination structures (Bushman *et al.*, 2004). The USA has strict insider trading regulations in the world today. The USA Securities Exchange Act of 1934 was the first to enact the insider trading law to place restrictions on insider trading. The Securities Exchange Commission (SEC) of USA has zero tolerance for insider trading activities. The verdicts for the culprits of insider trading will be imprisonment and huge penalties. Thereafter, most developed economies as well as several emerging markets have followed and prohibited insider trading. Eradicating insider trading has become one of the most important goals of market regulators. Bhattacharya and Daouk (2002) collected information on the existence of insider trading laws from 103 countries. The existence and enforcement of insider trading laws were first established in the USA in 1934, and it is the first nation to prosecute the insider trading case in 1961; however, it took 27 long years to report its first insider trading case for prosecution. Malaysia has taken 23 years to report their first insider trading prosecution among all the other nations. Canada and France have framed insider trading regulations in the 1970s, and the prosecution was reported during 1970s only. The UK and Germany have prosecuted insider trading cases within one year of their insider trading regulations, whereas Sweden and Canada have taken 19 years and 10 years, respectively, in the first prosecution of insider trading case. Whereas, India has framed its insider trading regulations in 1992, and in 1998, it has reported the prosecution of insider trading, that is in six years of framing such regulations. By 2000, 87 countries had passed insider trading laws and 38 had prosecuted at least one insider trading case (Bhattacharya and Daouk 2002).

The following are the three sections which infer the insider trading regulations in the various nations. These imply the strength of the stock markets of a nation:

(1) *Level playing field*: The market should be fair to all the participants. The regulatory bodies in all countries aim primarily at a level playing field by promoting fair and full disclosure of all material information by the listed companies, so that insiders will not have any unfair advantage.

(2) *Investor confidence*: Restricting insider trading will increase the investor confidence in financial markets. Permitting insider trading does not seriously threaten the investor's confidence. Further, investor participation depends not only on the laws in place but also on the confidence that they will be enforced fairly (Eleswarapu, 2006).

(3) *Market efficiency*: Fama (1970) used the concept of strong-form efficiency in his Efficient Market Hypothesis (EMH) to characterize a market where private information is fully reflected in stock prices. EMH states that most of the developed countries' stock markets fall under the semi-strong category. The securities markets are informational efficient, and the securities prices reflect all the publicly available information but not the private information. The insiders' private information will affect the securities prices positively/negatively on the markets.

2.1 Evolution of insider trading regulation in India

Evolution of insider trading regulation dates back to 1978 when The Sachar Committee stated that company personnel such as board members, accountants and company secretaries might have certain price-sensitive information. Such information may be used to

influence stock prices, which could affect the market sentiments of the capitalizing public. The Committee suggested that the Companies Act, 1956 must be amended to prevent such practices. In 1986, The Patel Committee recommended amendments to Securities Contracts (Regulation) Act, 1956 to *en route* for restraining insider trading through the supervisory machinery. In 1989, the Abid Hussein Committee suggested that insider trading actions could be fined by civil and criminal actions. Besides, it put forward that SEBI has to formulate the guidelines and regulations to avoid insider trading (Misra, 2011).

In light of the recommendations of various Committees by means of the endorsements, SEBI formulated the SEBI (Prohibition of Insider Trading) Regulations (1992) and outlawed this misconduct. All the listed companies and market intermediaries have to act in accordance with the directions of these regulations.

3. Insider trading regulation in India

3.1 An overview of SEBI (Prohibition of insider trading) Regulations (1992)

SEBI has framed insider trading regulations through SEBI (Prohibition of Insider Trading) Regulations (1992) which came into force in 1992. It has imposed several restrictions on insider trading. The listed companies must have a compliance officer and preserve the price-sensitive information. It has introduced a trading window for the insiders to trade and timely report their transactions in securities to the compliance officer and stock exchanges. The disclosures made by the listed companies or their directors/officers have to be displayed by the respective stock exchange on their official websites instantly or by way of an alert on trading terminals.

SEBI has amended its regulations in February 2002 by mandating the policy on disclosures and internal procedures for prevention of insider trading. It is mandatory for any individual who holds more than 5 per cent shares or voting rights in any listed company to disclose their holdings to the company within four working days. It also made compulsory continual disclosures by the director/officer whenever there is a change in their holdings exceeding INR 5 lakh in value or 5,000 shares or 2 per cent of the total shareholding or voting rights, whichever is lesser. All the listed companies have to report to the respective stock exchanges where the company is listed within five days of such disclosures. SEBI has prepared a model code of conduct for deterrence of insider trading for other entities and also introduced penalties for contravention of the code of conduct.

In July 2003, SEBI has made further amendments with introduction of disclosure forms 'A' 'B' 'C' and 'D' for directors/officers. Form A consists of the details of the acquisition of shares in a listed company in respect of individuals holding about 5 per cent or more. Form B contains details of the listed company shares held by the director or officer. Form C entails the details of change in listed company shareholding in respect of individuals holding more than 5 per cent shares. Form D comprises details of listed company shareholding of directors or officers.

SEBI added regulation 11A, that is the manner of service of summons and notices issued by the board in case of insider trading in April 2007.

SEBI has amended its regulations in November 2008, added e-filing of the disclosures to the stock exchanges and regulation 14 involving the actions in case of default. It made obligatory for a director/officer and his dependents to disclose to the company the holdings of derivative contracts in a listed company in Form B within two working days of becoming a director. They also cannot take positions in derivative contracts in the shares of the company. The directors/officers/designated personnel of the listed companies who buy or sell any number of shares will not take the reverse position, that is sell or buy any number of shares through the next six months subsequent to the prior transaction. In the case of Initial

Public Offering, they have to hold the share(s), if allotted, for a minimum period of 30 days. It also made compulsory continual disclosures by the director/officer whenever there is a change in their holdings beyond INR 5 lakh in value or 25,000 shares or 1 per cent of the total shareholding or voting rights, whichever is lesser. All the listed companies have to report to the respective stock exchanges where the company is listed within two working days of such disclosures. Measures were taken to prevent insider trading and to strengthen disclosure requirements for the insiders which were implemented.

In order to bring uniformity in disclosure requirements among several SEBI regulations, it has amended the Act in August 2011, the disclosure requirement with respect to continual disclosures by the director/officer whenever there is a change in their holdings beyond INR 5 lakh in value or 25,000 shares or 1 per cent of the total shareholding or voting rights, whichever is lesser. Takeover regulations have been amended in line with SEBI (Prohibition of Insider Trading) Regulations (1992). Form B and Form D were also amended accordingly in relation to the promoter and his/her dependent holdings in derivative contracts of the listed companies.

SEBI constituted the high-level committee to review insider trading regulations with a retired Chief Justice of Karnataka High Court and a former presiding officer of the Securities Appellate Tribunal (SAT) Mr N.K. Sodhi, in March 2013.

Later on in December 2013, the high level committee under the chairmanship of N.K. Sodhi submitted a report on SEBI (Prohibition of Insider Trading) Regulations (1992) to the SEBI Chairman, Shri U.K. Sinha. The Committee recommended strengthening the legal and enforcement framework, aligning insider trading norms with international standards and clarity in the definitions and concepts of insider trading. As an outcome of which, the new regulations originated into practicality, that is SEBI (Prohibition of Insider Trading) Regulations (2015) which has come in the gazette on 15th January, 2015, and came into force with effect from 15th May, 2015.

3.2 An overview of SEBI (Prohibition of insider trading) Regulations (2015)

SEBI (Prohibition of Insider Trading) Regulations (2015) seem to be more optimistic, pragmatic and substantially in line with the global perspective to insider trading. They also seem to be equipped to strengthen superior compliance and prosecution. It has improved the insider trading norms with clarity in the definitions and concepts of insider trading. It has widened the scope of who is a connected person and also clearly detailed about the UPSI. It has imposed restrictions on communication and trading by insiders. Insiders with price-sensitive information can trade with pre-scheduled trading plan, which has to be disclosed to the public six months in advance. Under Regulation 5(2)(ii), insiders are not allowed to trade 20 days prior to the interim financial results and two trading days after such announcements (even under trading plan). The initial disclosures of holdings have to be made to the stock exchange by the promoter/director within seven days of their appointment with the company. Under continual disclosures, Regulation 7(2)(a) made it mandatory for every listed company's promoter/employee and director to disclose the number of shares/derivatives purchased or sold within a period of three months valuing INR 10 lakh or more and report within two trading days. It has formulated minimum standards for the code of conduct to regulate, monitor and report trading by insiders. SEBI is empowered to investigate any complaint received from the investors, intermediaries or any other individuals on any matter having a bearing on allegations of insider trading.

SEBI (Prohibition of Insider Trading) Regulations (2015) ban an insider from dealing on his/her behalf or on behalf of any other individual in the securities of a firm listed on any stock exchange when he/she is in ownership of UPSI. Additionally, it also prohibits any

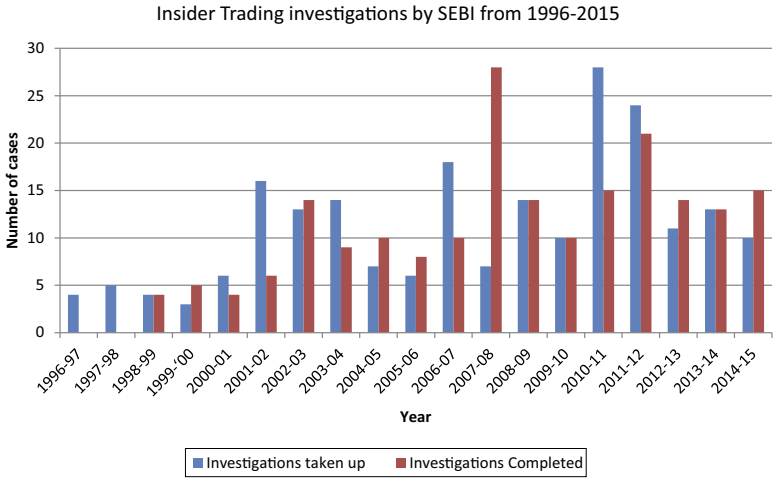
insider from communicating, recommending or providing (directly or indirectly) any UPSI to any individual who, while in the ownership of such UPSI, should not trade in securities. Price-sensitive information means any information that is related directly or indirectly to a business concern, and if published, is expected to substantially affect the price of the securities of a company. It includes information such as the financial results, dividends, change in capital structure, mergers, de-mergers, acquisitions, delisting, changes in key management personnel and disposals and expansion of business. The penalties upto INR 25 crore or three times of the amount of profits made out of fraudulent and unfair trade practices or 10 years imprisonment can be imposed.

There have been cases where certain listed companies were given monthly disclosures of certain price-sensitive information such as production/turnover/sales to their relevant industry associations, without disclosing the same to the stock exchanges. To limit this exercise, SEBI has made it obligatory for the listed companies to disclose such price-sensitive information first to the stock exchanges (Indian Securities Market a Review, 2013, published by National Stock Exchange of India Ltd (NSE)).

4. Insider trading investigations by SEBI

The first insider trading case in India was reported in the year 1996-1997. The total number of insider trading cases registered since 1996 to 2014 are 203, out of which 185 investigations are carried out by the end of March, 2014. The number of investigations carried out in 2007-2008 was 28, and 28 more insider trading cases were registered in 2010-2011. It was found that SEBI has not resolved any cases during 2008-2009, 2009-2010 and 2013-2014 among its investigations (Figure 1).

The insider trading prosecutions and convictions in the USA will be done by the Justice Department and SEC. They had set criminal and civil charges for the ruling for insider trading to ensure the integrity of securities markets. In 2014, the SEC imposed a penalty of $13.9m on an Indian-born former Goldman Sachs director Rajat Gupta in civil insider trading



Source: Handbook of statistics on Indian Securities Market and SEBI Annual Reports

Figure 1.
Insider Trading investigations by SEBI

conviction of 2012. He was banned for life from serving as a director of a public company. Under criminal charges, two years of imprisonment and $5million penalty was also imposed.

In India, the capital market regulator SEBI has investigated insider trading cases. In 2007, SEBI has initiated insider trading charges against Reliance Industries Limited (RIL) erstwhile arm Reliance Petroleum in the futures market segment. RIL has appealed to the SAT against SEBI in the insider trading case. In India, the individuals and companies can settle disputes by paying penalty without admitting or denying the alleged wrong doing, through consent settlement allowed by SAT. In May 2012, SEBI has tightened the consent mechanism framework.

SEBI in its probe against foreign hedge fund Factorial insider trading case, Bloomberg has refused to share information with SEBI. So, it has sought help from the SEC.

5. Conclusion

Although the debate about the pros and cons of allowing insider trading in stock markets has been quite contentious in the law and finance literature, to retain market integrity and investor confidence, insider trading prohibitions are crucial. Developed countries have a better record of prosecution than emerging markets (Bhattacharya and Daouk, 2002). Meanwhile, in the mid-1990s, several cases of insider trading comprising reputed business groups were probed and brought to court by SEBI, but unlike the USA SEC, the Indian regulator was unable to secure a conviction in most of them. In the USA, insider trading activities are generally detected premature through various stock watch mechanisms of individual exchanges as well as the SEC. Both the exchanges and SEC examine any suspicious transactions, and heavy penalties are imposed on the violators either by the exchanges or SEC.

It is difficult to resist the conclusion that surveillance and enforcement matter more than the drafting of the relevant statutes and regulations. Publicized cases of insider trading are remarkably rare in India. However, tougher laws work better in reducing the incidence of illegal insider trading and delayed disclosures to the regulating bodies. We thus suggest SEBI to design detection mechanisms to eliminate illegal insider trading. It has to impose huge penalties on those who violate the law. Future research may explore the factors that hinder effective regulation and recommend new methods to increase the impact of SEBI insider trading regulation.

Note

1. As per SEBI (Prohibition of Insider Trading) Regulations (2015), it is referred as "generally available information".

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