

Chapter: 11 Insider Trading

Insider trading refers to the practice of purchasing or selling a publicly-traded company's securities while in possession of material information that is not yet public information. Material information refers to any and all information that may result in a substantial impact on the decision of an investor regarding whether to buy or sell the security.

By non-public information, we mean that the information is not legally out in the public domain and that only a handful of people directly related to the information possess. An example of an insider may be a corporate executive or someone in government who has access to an economic report before it is publicly released.

Detailed rules regarding insider trading are complicated and generally, vary from country to country. The definition of an "insider" can differ significantly under different jurisdictions. Some may follow a narrow definition and only consider people within the company with direct access to the information as an "insider." On the other hand, some may also consider people related to company officials as "insiders."

Hypothetical Examples of Insider Trading

- The CEO of a company divulges important information about the acquisition of his company to a friend who owns a substantial shareholding in the company. The friend acts upon the information and sells all his shares before the information is made public.
- A government employee acts upon his knowledge about a new regulation to be passed which will benefit a sugar-exporting firm and buys its shares before the regulation becomes public knowledge.
- A high-level employee overhears some conversation about a merger and understands its market impact and consequently buys the shares of the company in his father's account.

Definitions of 'Insider Trading'

Definitions: Insider trading is defined as a malpractice wherein trade of a company's securities is undertaken by people who by virtue of their work have access to the otherwise non-public information which can be crucial for making investment decisions.

Description: When insiders, e.g. key employees or executives who have access to the strategic information about the company, use the same for trading in the company's stocks or securities, it is called insider trading and is highly discouraged by the Securities and Exchange Board of India to promote fair trading in the market for the benefit of the common investor.

Insider trading is an unfair practice, wherein the other stock holders are at a great disadvantage due to lack of important insider non-public information. However, in certain cases if the information has been made public, in a way that all concerned investors have access to it, that will not be a case of illegal insider trading.

Definition by SEBI: The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 1992, does not directly define the term Insider Trading. But it defines the term "Insider", "Connected Person" and "Price Sensitive Information".

Insider Trading is the trading of securities of a company by an Insider using company's non-public, price-sensitive information while causing losses to the company or profit to oneself.

Insider: According to the Regulations, "Insider" means any person who is or was connected to the company or is deemed to have been connected with the company and who reasonably is expected to have access, connection to unpublished price sensitive information in relation to that company.

Connected Person: The Regulation defines that a "connected person" means any person who-

- (i) is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 of a company, or is deemed to be the director of the company by virtue of sub-clause (10) of section 307 of the Act.
- (ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company, whether temporary or permanent and who may reasonably be expected to have an access to unpublished, price sensitive information in relation to that company.

Price Sensitive Information: means any information, which relates directly or indirectly to a company and which if published, is likely to materially affect the price of securities of the company.

Following are some examples of Price Sensitive Information:

1. Financial results of the company.
2. Intended declaration of Dividends.
3. Issue of shares by way of public rights, bonus, etc.
4. Any major expansion plans or execution of new projects
5. Amalgamation, mergers and takeovers.
6. Disposal of the whole/substantial of the undertaking.

HISTORY AND EVOLUTION OF INSIDER TRADING

Insider Trading has been around the United States from 1792. Hence, Laws against Insider Trading was formed strictly in the United States of America. Therefore, it is very important to understand Insider Trading from American point of view.

The market crash in 1929 due to prolonged "lack of investor's confidence" in securities market followed by the Great Depression of US Economy, gave rise to the enactment of the Securities Act of 1933. The foundation of Insider Trading law was laid down by the Supreme Court of US in *Strong vs Repide*. Statutory Insider Trading Laws were first passed in the year 1933 and the Securities Exchange act in 1934. The second act created SEC (Securities Exchange Commission) to regulate the secondary trading of securities. These Acts were meant to create more transparency among the investors and placing due diligence on the preparers of the documents containing detailed information about the Security.

In 1984, the case of *Dirks vs SEC*, no one was termed liable of Insider Trading as they disclosed the information for exposing a fraud and for no personal gains. This gave rise to the concept of "constructive insiders". Constructively Insiders are Lawyers, Investment Bankers and others who receive confidential information from a corporation while providing service to the corporation.

In the *United States vs Carpenter*, 1986, the Supreme Court cited that the usage of Inside Information received by virtue of confidential relationship must not be used or disclosed and by doing so, the individual gets charged for Insider Trading.

In 1997, *O'Hagans Case*, the court recognised that a company's information is its property: " A Company's confidential information qualifies

as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of fiduciary duty constitutes fraud akin to embezzlement-the fraudulent appropriation to one's own use of money or goods entrusted to one's care by another."

In 2007, representatives Brian Baird and Louise Slaughter introduced a bill "Stop Trading on Congressional Knowledge Act or STOCK Act".

Insider Trading in India:

1. In 1948, First concrete attempt to regulate Insider Trading was the constitution of Thomas Committee. It helped restricting Insider trading by Securities Exchange Act, 1934.

2. In 1956, Sec 307 & 308 were introduced in the Companies Act, 1956. This change made it mandatory to have disclosures by directors and officers.

3. 1979, the Sachar Committee recognized the need for amendment of the Companies Act, 1956 as employees having company's information can misuse them and manipulate stock prices.

4. 1986, Patel committee recommended that the Securities contracts (Regulations) Act, 1956 be amended to make exchanges reduce Insider Trading.

5. 1989, Abid Hussain Committee recommended that the Insider Trading Activities be Penalized by civil and criminal proceedings and also suggested that SEBI formulate the regulations and governing codes to prevent unfair dealings.

6. 1992, India has prohibited the fraudulent practice of Insider Trading through "Security and Exchange Board of India (Insider Trading) Regulations Act, 1992. Here, a person convicted of Insider Trading is punishable under Section 24 and Section 15G of the SEBI Act, 1992.

7. 2002, the Regulations were drastically amended and renamed as "SEBI (Prohibition of Insider Trading) Regulations, 1992.

Why to Control Insider Trading?

□ **To protect general investors.** The manipulation of market by using Insider trading generally causes great losses to a company, thus leading to loss

for investors or great profit only for the Insiders and no investor. It steals away the possibility of earning profit from an investor.

□ **To protect the interest and reputation of the company.** Once a company faces a problem of Insider Trading, investors tend to lose confidence in the company and stop investing in the company and also selling all the stocks of the company.

□ **To maintain confidence in the stock exchange operations.** With SEBI also regulating all the trading's, if any Insider gets a chance to get past the laws, it decreases the investors' confidence in the stock exchange operations itself.

□ **To maintain Public confidence in the financial system as a whole.** Indian Financial Market is still very low in the domestic investment rate. To have a healthy economy, a proper financial system is a must and for that, confidence in the market is of utmost importance.

Rationale behind Prohibiting Insider Trading:

Securities market deals with the allocation of capital in an economy. This function enables market efficiency, where market's price reflects the risk and future returns accurately. Insider trading appears biased to investors as insiders have additional price sensitive information before them and can use it to make profits while the late reception of information makes investors suffer loss or not gain the deserved profits. If a market is integrated and free of illegal trading, it may lead to healthy growth of the market and such markets can inspire the confidence of the Investors.

Insider trading leads to loss of confidence of Investors on the market which can lead to a halt in market dealings thus causing a situation similar to the Great Economic Depression of the United States. Besides, a company's information is its property and no one but the company must profit from it.

Significant Penalties:

- SEBI may impose a penalty of not more than Rs. 25 Crores or three times the amount of profit made out of Insider Trading; whichever is higher.
- SEBI may initiate criminal prosecution; or
- SEBI may issue order declaring transactions in Securities based on unpublished price sensitive information; or
- SEBI may issue orders prohibiting an insider or refraining an insider from dealing in the securities of the company.

Methods of Prevention of Insider Trading:

1. Disclosure of Interest by corporate insiders.

a. Listed companies:

-If change exceeds 2% of the total voting right of persons holding more than 5% of the shares/voting rights.

-If change exceeds Rs.5,00,000/25000 shares/ 1% of capital by Directors and officers.

b. Other entities:

-Initial statement of holdings.

-Periodic statement of holdings.

This can show any suspicious time based and trading based activities by Insiders.

2. Disclosure of Price Sensitive Information:

Limited access to price sensitive information, for ex.: Need to know basis.

Dissemination of information by the Stock Exchange.

Transmitting information to news agency.

3. Chinese Wall:

Separate inside area from public areas.

Bringing over the wall.

4. Trading Window Facility:

Decided by the company.

Closed during the time price-sensitive information is not published.

Opened 24 hours after the information is made public.

Allowing the exercise of ESOP.

5. Minimum holding period:

-Securities to be held for minimum period of 30 days to be considered investment.

-30 days holding from the date of IPO allotment.

-Only personal emergency cases be excluded.

6. Pre-clearance of trades prevents Front Running.

Legal and illegal Insider Trading

The issue of insider trading is as old as trading on equity markets itself. In all developed markets around the world it is seen as the biggest offense against the ethics of business and is also seen as a potential destroyer of public confidence in the stock exchange. Therefore, it should be legally regulated. This does not mean that insider trading is always associated with illegal conduct.

1. It is perfectly legal for insiders to buy and sell stock in their company. Infact, there are thousands of insider trading reports every day. As long as the insider is trading on information that is generally available to the public no laws are broken.
2. Illegal insider trading is trading based on non-public information and may include "tipping" such information. For example, if the CEO knows the company is not going to get a big contract and sells before telling the world, that's illegal. Yet illegal insider trading is very difficult to prove.

Exceptions to Insider Trading-

The distinction between legally permitted trading and illegal insider trading must be carefully understood. It is quite natural for an insider who is working in a company to come across some inside information. It would be violation of human rights and would defy the logic of freely tradable securities, if Insiders are not permitted to trade for themselves. That would be unreasonable. It would be irrational to stop promoters of a company from dealing in their securities. Thus, the restriction on the corporate insider is directly or indirectly using the price sensitive information that they hold to the exclusion of the other shareholders in arriving at trading decisions. There is absolutely no restriction on insiders in trading in securities of the company if they do not hold any price sensitive information that the public is not already aware of. During the short while promoters and insiders can use the information to their advantage by guessing market reaction to the news or information.