Insider Trading Law in India

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What is Insider Trading?

Insider Trading or Insider Dealing is the illegal practice of trading on the stock exchange to one's own advantage through having access to confidential information.
Insider trading is the buying or selling of a security by someone who has access to material nonpublic information about the security. Insider trading can be illegal or legal depending on when the insider makes the trade. It is illegal when the material information is still nonpublic.
Illegal insider trading includes tipping others when you have any sort of nonpublic information. Legal insider trading happens when directors of the company purchase or sell shares, but they disclose their transactions legally.

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.

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.

Because insider information gives an investor an advantage over others, it is illegal and punishable by law. Mechanisms in place to prevent insider trading include quiet periods, during which corporate insiders are prohibited from selectively divulging information to some investors

before it is made public, and blackout periods, which prohibit trading by insiders at similar times and for similar reasons.

Insider trading occurs when someone who has a fiduciary duty to another person, institution, corporation, partnership, firm, or entity makes an investment decision based upon information related to that fiduciary duty that is not available to the general public. This insider information allows them to profit in some cases and avoid loss in others. **(In the Martha Stewart/ImClone scandal)**.

Insider trading can also arise in cases where no fiduciary duty is present but another crime has been committed, such as corporate espionage. For example, an organized crime ring that infiltrated certain financial or legal institutions to systematically gain access to and exploit non-public information, perhaps through the use of computer viruses or recording devices, might be found guilty of insider trading among other charges for the related crimes.

Insider trading was not considered illegal at the beginning of the twentieth century; in fact, a Supreme Court ruling once called it a "perk" of being an executive. After the excesses of the 1920s, the subsequent decade of deleveraging, and the resulting shift in public opinion, it was banned, with serious penalties being imposed on those who engaged in the practice.

Insider trading is a term subject to many definitions and connotations and it encompasses both legal and prohibited activity. Insider trading takes place legally every day, when corporate insiders – officers, directors or employees – buy or sell stock in their own companies within the confines of company policy and the regulations governing this trading. In simple terms 'insider trading' buying or selling a security, in breach of a fiduciary duty or other relationship of trust , and confidence , while in possession of material , nonpublic information about the security. Thus , in nutshell , insider trading is the buying , selling or dealing in securities of a listed company by a director , member of management , employee of the company , or by any other person such as internal auditor , advisor , consultant , analyst etc, who has knowledge of material inside information which is not available to general public.

For instance,

- prior knowledge of a bonus issue would result in the insider acquiring a significant exposure in particular scrip, knowing that his holding would increase significantly after the bonus is announced.

- Corporate officers , directors and employees who , traded the company's securities after learning of significant, confidentiality corporate developments.
- Employees of law, banking , brokerage and printing firms- who were given such information to provide services to corporation whose securities they traded.
- Government employees – who learned of such information because of their employment by the government.

Rational Behind Prohibition of Insider Trading

The smooth operation of the securities market and its healthy growth and development depends on a large extend on the quality and integrity of the market .Such a market can alone inspire confidence in investors

Insider trading leads to loose of confidence of investors in securities market as they feel that market is rigged and only the few, who have inside information get benefit and make profits from their investments . Thus, process of insider trading corrupts the 'level playing field'.Hence the practice of insider trading is intended to be prohibited in order to sustain the investor's confidence in the integrity of the security market.

The first country to tackle insider trading effectively however was the United States. In the USA, the Securities and Exchange Commission is empowered under the Insider Trading Sanctions Act, 1984 to impose civil penalties in addition to criminal proceedings.

Most countries have in place suitable legislation to curb the menace of insider trading.

In India, SEBI (Insider Trading) Regulations 1992, framed under Section 11 of the SEBI Act, 1992, are intended to prevent and curb the menace of insider trading in Securities. Now SEBI has with effect from 20th February 2002 amended these Regulations and rechristened them as SEBI 9 Prohibition of Insider Trading Regulation , 1992 . These Regulation have been further amended in November 2002.

Case Analysis: Hindustan Lever Limited v. SEBI

The facts of the case concerned the purchase by HLL of 8 lakh shares of BBLIL from the Unit Trust of India (UTI) on March 25, 1996. This purchase was made barely two weeks prior to a

public announcement for a proposed merger of HLL with BBLIL. Upon investigation, SEBI by its Order dated March 11, 1998 (Order) found that, at the time of the purchase of shares of BBLIL from UTI, HLL was an "insider" as under Section 2(e) of the 1992 Regulations.

The relevant extract of which describes an insider as any person who:

"(i) is or was connected with the company or is deemed to have been connected with the company and is reasonably expected to have access by virtue of such connection to unpublished price sensitive information in respect of securities of the company, or

(ii) has received or has had access to such unpublished price sensitive information."

SEBI held that, since, HLL and BBLIL were subsidiaries of the same London based Unilever, and were effectively under the same management, HLL and its directors had prior knowledge of the merger. Thus HLL was covered under the definition of an insider as above defined.

Samir C Arora v. SEBI

It was observed that activities like insider trading fraudulent trade practices and professional misconduct are absolutely detrimental to the interests of ordinary investors and are strongly deprecated under the SEBI Act,1992 and the Regulations made there under. No punishment is too severe for those indulging such activities.

In **India** Section 12A (d) & (e) of the SEBI Act, read with the Insider Regulations and Section 15G of the SEBI Act regulates insider trading in India. However, none of these provisions give a specific definition of 'insider trading'. Section 15G is an enabling provision for SEBI to impose penalty in insider trading cases and the SEBI relies on the nature of the violation and description of the prohibited activities under this provision for imposing such penalties. The cases of violation are defined within the provision itself. On the other hand, Section 12A of the SEBI Act lists prohibited activities that primarily include manipulative trades, insider trading activities and substantial acquisition of securities.

Regulation 3 of the SEBI Regulations seeks to prohibit dealing, communication and counseling on matters relating to, insider trading. Regulation 3 provides that no insider shall either on his own behalf of any other person deal in securities of a company when in possession of any

unpublished price sensitive information on communicate, counsel or procure , directly or indirectly any unpublished price sensitive information to any person , who while in possession of such unpublished price sensitive information shall not deal in securities. However, these restrictions are not applicable to any communication required ordinary, course of business or profession or employment or any law. Further 3A prohibits any company from dealing in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

Insider Trading Regulations have been tightened by SEBI during February 2002. New rules cover 'temporary insiders' like lawyers, accountants, investment bankers etc.

Directors and substantial shareholders have to disclose their holding to the company periodically. The New Regulations have added relatives of connected persons, as well as, the companies, firms, trust, etc.in which relatives of connected persons, bankers of the company and of persons deemed to be connected persons hold more than 10%. The definition of relative under the New regulations is in line with that of the Companies Act, 1956, which ranges from parents and siblings to spouses of siblings and grandchildren. The term “connected person” is defined to mean either, i) a director or deemed to be a director, ii) occupies the position as an officer or an employee or having professional or business relationship whether temporary or permanent, with the company.

Thus, there are two categories of insiders:

Primary insiders, who are directly connected with the company and secondary insiders who are deemed to be connected with the company since they are expected to have access to unpublished price sensitive information.

The **secondary insider**, who would have traded with an unfair informational advantage, may escape from being caught simply because there can be no trace of how he derived this information in the first place. insider by reason of his connection with the company.

In reality, much of the flow of the price-sensitive information often does not operate by way of such established networks of relational links between individuals. Very often, such price-sensitive information is communicated and spread out through very loosely connected and

informal networks of brokers, clients and even between friends and through electronic networks etc. or an elaborate nexus of company official, brokers, traders. These individuals are very often privy to strategic policy decisions or developments that may influence the valuation of a company's scrip on the bourses.

Duties/ Obligations Of the company

Every listed company has the following obligations under the **SEBI(Prohibition of Insider Trading)Regulations** , 1992 :-

- To appoint a senior level employee generally the Company Scecretary , as the Compliance Officers;
- To set up an appropriate mechanism and to frame and enforce a code of conduct for internal procedures,
- To abide by the Code of Corporate Disclosure practices as specified in Schedule ii to the SEBI (Prohibition of Insider Trading)Regulations , 1992
- To initiate the information received under the initial and continual disclosures to the Stock Exchange within 5 days of their receipts;
- To specify the close period;
- To identify the Price Sensitive Information
- To ensure adequate data security of confidential information stored on the computer;
- To prescribe the procedure for the pre- clearance of trade and entrusted the Compliance Officers with the responsibility of strict adherence of the same

Penalties

Following penalties /punishments can be imposed in case of violation of **SEBI (Prohibition of Insider Trading)Regulations** , 1992 :-

- SEBI may impose a penalty of not Rs 25 Crores or three times the amount of profit made out of insider trading; whichever is higher
- SEBI may initiate criminal prosecution

- SEBI may issue orders declaring transactions in securities based on unpublished price sensitive information
- SEBI may issue orders prohibiting an insider or refraining an insider from dealing in the securities of the company

The prevention of insider trading is widely treated as an important function of securities regulation.

Section11(2)(e) of companies act,1956 prohibits the insider trading but does not define it.

Legal insider trading

Legal trades by insiders are common, as employees of publicly traded corporations often have stock or stock options. These trades are made public in the United States through Securities and Exchange Commission filings, mainly Form 4. Prior to 2001, U.S. law restricted trading such that insiders mainly traded during windows when their inside information was public, such as soon after earnings releases.

SEC Rule 10b5-1 clarified that the prohibition against insider trading does not require proof that an insider actually used material nonpublic information when conducting a trade; possession of such information alone is sufficient to violate the provision, and the SEC would infer that an insider in possession of material nonpublic information used this information when conducting a trade. However, SEC Rule 10b5-1 also created for insiders an affirmative defense if the insider can demonstrate that the trades conducted on behalf of the insider were conducted as part of a pre-existing contract or written binding plan for trading in the future.

For example, if an insider expects to retire after a specific period of time and, as part of retirement planning, the insider has adopted a written binding plan to sell a specific amount of the company's stock every month for two years and later comes into possession of material nonpublic information about the company, trades based on the original plan might not constitute prohibited insider trading.

Conclusion

The new 2002 regulations in India have further fortified the 1992 regulations and have increased the list of persons that are deemed to be connected to Insiders. Listed companies and other entities are now required to frame internal policies and guidelines to preclude insider trading by directors, employees, partners, etc. In the past, it has been observed that insider trading legislation is ineffective and difficult to enforce and has little impact on securities markets.

Low enforcement rates and few convictions against insiders have been cited as evidence of this ineffectiveness. Irrespective of whether or not the SEBI was bestowed with wide ranging powers, it has been a clear failure when it came to the task of administering the law.

The importance of policing insider trading has also assumed international significance as overseas regulators attempt to boost the confidence of domestic investors and attract the international investment community. So, SEBI now should take the role of a regulator only. Special Courts could be set up for faster and efficacious disposal of cases.