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SEBI's Impact on Curbing Insider Trading - Strategies and Outcomes

Devanshi Dwivedi, (LL. B, Student)
Aradhana Yadav, (Assistant Professor)
Amity Law School
Amity University
Uttar Pradesh Lucknow Campus

Abstract

Insider trading involves the transaction of securities by individuals possessing access to confidential, material information concerning the securities. The legality of such trade’s hinges on the timing relative to the public disclosure of this information. Insider trading is deemed illegal if the transaction occurs while the information remains undisclosed to the public. In India, the regulatory framework for insider trading is established by SEBI, which oversees activities on both the public securities market and the Bombay Stock Exchange. The primary objective of these regulations is to ensure that all market participants operate on a level playing field, with no individual or entity benefiting unduly from trading based on undisclosed, material information. Furthermore, these regulations aim to ensure that relevant information is uniformly accessible to all market participants. The enforcement of insider trading rules serves to enhance market liquidity and reduce the cost of capital, reflecting practices observed in developed nations with stringent trading regulations. The overarching goal of such regulations is to ensure equitable information distribution among all market participants. The advent of economic liberalization and the opening of the securities market to foreign institutional investors prompted a desire among domestic investors for swift financial returns. In response, SEBI (Prohibition of Insider Trading) Regulation of 1992, & its Amendment in 2015 & 2022, was introduced to mitigate the risks associated with insider trading. This regulation defines an insider as a person who, by virtue of their position or membership within an organization, possesses privileged information concerning the entity.

Keywords: SEBI, Insider Trading, *Stock Exchange*, *economic liberalization*

Introduction:

Insider trading is practice of someone with access to proprietary, non-public information about a publicly listed corporation purchasing or selling its stocks, bonds, or other instruments. Due to the substantial ethical and legal discussions this activity has generated throughout the world, some nations have implemented stringent rules to protect the integrity of the financial markets. The core issue with insider trading lies in unfair advantage it provides to that privy to sensitive information not yet available to the general public. This disparity can lead to significant financial gains for insiders at the expense of regular investors, undermining trust in fairness & transparency of financial markets. Essentially, insider trading can distort market prices & erode investor confidence, as decisions are not made on a level playing field.

Recognizing the potential harm caused by insider trading, jurisdictions worldwide have enacted laws and regulations to combat this practice. For instance, the SEBI has been at the forefront of this battle within the Indian capital markets. Established regulations, notably SEBI (Prohibition of Insider Trading) Regulations, 1992, are designed to prevent misuse of unpublished price-sensitive information for personal gain. These regulations are critical in ensuring that all market participants have equal access to information, fostering a more equitable trading environment. The said regulations has been amended in 2015 & then, in 2022. (Singh, Shaurya. (2022)

SEBI's role extends beyond the creation of regulations; it also includes the investigation of alleged insider trading violations and the imposition of penalties on those found guilty. The dynamic nature of financial markets and the evolving tactics employed by individuals to engage in insider trading have necessitated continuous updates and amendments to regulatory frameworks. These adjustments aim to close loopholes exploited by offenders and to strengthen SEBI's ability to maintain market integrity.

Globally, the rules surrounding insider trading are diverse and complex, reflecting variations in legal systems, market structures, and enforcement capabilities. Definitions of what constitutes an insider can vary significantly, potentially encompassing a wide array of individuals connected to the insider, such as family members, business associates, and brokers. The breadth of these definitions underscores the challenge of regulating insider trading effectively across different jurisdictions. (Chakraborty, Saurabh. (2022)

Enforcement of insider trading laws also varies widely, influenced by factors such as the resources available to regulatory bodies, the legal framework within each country, and the willingness of governments to pursue violations aggressively. The effectiveness of these efforts plays a crucial role in determining the level of market integrity and investor confidence in each jurisdiction.

Conceptual Framework of Insider Trading

The concept of insider trading encompasses a wide range of practices that involve the buying, selling, or dealing in securities by individuals who have access to non-public, materially significant information about a company. This practice is regulated and scrutinized because it has the potential to undermine the fairness and integrity of financial markets. At its core, insider trading is the exploitation of confidential information for financial gain, a practice that can be both legal & illegal depending on circumstances under which it is conducted.

Legal insider trading occurs within a framework that is carefully outlined by corporate policies and regulatory guidelines. This framework ensures that any trading conducted by insiders, such as members of the company's management, board of directors, and other employees with access

to strategic information, does not exploit non-public information in a manner that would be unfair to the general investing public. For instance, insiders are required to report their trades, adhere to corporate blackout periods, and follow other guidelines that aim to prevent the misuse of material information. These measures are designed to maintain transparency and fairness, allowing insiders to buy or sell stocks in their own companies without undermining investor confidence or market integrity. (Puthran, Gayatri. (2021)

On the other hand, when people trade stocks or other assets based on significant information that is not public knowledge, it is known as unlawful insider trading. Insider trading of this kind violates the rules and regulations intended to safeguard investor interests and market integrity. It also betrays a betrayal of trust. Illegal insider traders undermine confidence in the financial system and disadvantage regular investors who do not have access to the same information by using confidential information to obtain an unfair edge in the market.

The SEBI, along with other regulatory bodies around the world, plays a crucial role in combating illegal insider trading. SEBI's mandate includes promoting fair and efficient markets and protecting investor interests, which it accomplishes in part by enforcing regulations that prohibit the misuse of non-public information. These regulations are intended to ensure that all market participants have equal access to information, thereby fostering a level playing field and promoting overall market health. (Anil Kumar Manchikatla & Rajesh H. Acharya)

Understanding the nuances of insider trading, both its legal and illegal variants, is vital for anyone involved in the financial markets. Legal insider trading is a regulated activity that allows insiders to engage with the market in a transparent manner, while illegal insider trading is a deceptive practice that undermines market fairness & investor trust. Regulators like SEBI work diligently to deter and penalize illegal insider trading, thereby safeguarding the market's integrity and ensuring that it functions efficiently and equitably for all participants.

Controlling Insider Trading

Controlling insider trading is a critical aspect of ensuring a fair, transparent, and efficient marketplace, which protects all stakeholders involved, from individual investors to the larger financial ecosystem. The reasons for regulating and seeking to control insider trading are manifold and are rooted in both ethical considerations and pragmatic financial health.

- *Protection of General Investors* - Insider trading can skew the playing field, giving those with privileged information (insiders) an unfair advantage over the general investing public. When insiders use unpublished, price-sensitive information to make trades, they can secure disproportionate profits or avoid losses, at the expense of ordinary investors who lack such information. This not only results in financial losses for these investors but also erodes trust in fairness & integrity of financial markets. Ensuring that no participant has an unfair advantage is crucial for the protection of general investors and the preservation of equitable market conditions.

- *Safeguarding Company Interests and Reputation* - The revelation of insider trading within a company can severely damage its reputation, eroding investor confidence and trust. This loss of confidence can prompt investors to withdraw their investments and discourage potential investors, adversely affecting the company's stock price and its ability to raise capital. In the long term, this can hinder the company's growth and operational capabilities. Thus, controlling insider trading is essential for maintaining a

company's credibility and attractiveness to both current and potential investors. (Patkar, Armaan, & Mehra, Uday Rai. (2018)

- *Maintaining Confidence in the Financial System* - The overall health of the economy is significantly influenced by public confidence in the financial system. Insider trading undermines this confidence by creating a perception of inequality and manipulation, suggesting that the financial markets are rigged in favour of a few at the expense of the many. To foster a healthy economy, it is imperative to ensure that financial markets are perceived as stable, fair, and transparent entities where investments are made based on merit rather than privileged information. The control of insider trading is thus central to maintaining public trust in the financial markets, encouraging participation, and promoting economic growth. (Ibid)

Rationale Behind Prohibiting Insider Trading

At its core, the securities market facilitates the efficient allocation of capital in the economy. Insider trading distorts this process by allowing insiders to exploit their access to material, non-public information for personal gain. This not only hurts other investors but also calls into question the core values of openness and justice that support the market. By outlawing insider trading, one may guarantee equal access to information for all market players and promote an atmosphere in which investment decisions are based on information that is readily available to public. This promotes healthy, competitive market that can attract and retain investor confidence, thereby facilitating capital growth and economic development.

Penalties under SEBI (Prohibition of Insider Trading) Regulations

To deter insider trading and enforce regulations, SEBI has established stringent penalties under SEBI (Prohibition of Insider Trading) Regulations. These include:

- *Monetary Penalties:* SEBI may impose a hefty fine on individuals or entities found guilty of insider trading. The penalty can be as much as ₹25 Crores or three times profit gained from the insider trading, whichever is higher, providing a strong financial deterrent against such practices.

- *Criminal Prosecution:* Beyond financial penalties, SEBI can pursue criminal charges against those involved in insider trading, leading to possible imprisonment. This underscores the severity with which insider trading is viewed and the comprehensive approach taken to prevent it.

- *Transaction Declarations:* SEBI has the authority to declare transactions based on unpublished price-sensitive information as void, effectively nullifying the trades made by insiders, thereby mitigating their unjust gains.

- *Prohibitory Orders:* SEBI can issue directives that bar insiders from trading in the securities of implicated company, preventing further misuse of insider information.

These penalties and regulations underscore the commitment to maintaining the integrity of the securities market, protecting investor interests, & ensuring level playing field for all market participants.

Origin of Insider Trading

The evolution marks a pivotal journey in the realm of financial regulation, with its roots tracing back to the early economic history of the US. The conceptualization of insider trading as a regulatory concern emerged in 1792, setting the stage for the US to become a global pioneer in the formulation and enforcement of insider trading laws. This journey began in earnest with a landmark judgment by the Apex Court of the US in the case of *Strong vs. Repide*, which underscored the legal foundations of insider trading law, establishing precedent and principles that would guide future legislation and enforcement. (213 U.S. 419 (1909)

The statutory framework for combating insider trading began to take shape with the passage of two critical pieces of legislation in the early 20th century. In 1933, US Congress passed Securities Act, followed by Securities Exchange Act, 1934. These acts were instrumental in fostering a transparent and fair marketplace for investors, embodying a commitment to the principles of equity and integrity in the financial markets. The enactment of these laws marked a significant advancement in the regulatory approach to securities, with the prevention of insider trading emerging as a cornerstone of securities regulation. This regulatory ethos reflected a recognition of the inherent unfairness and potential for market distortion posed by insider trading, setting a precedent for other nations to follow.

As the regulatory framework for insider trading in the US matured, its influence extended globally, with various countries adopting similar measures to curb the malpractice of insider trading. Among these nations, India's journey toward establishing a robust regulatory mechanism against insider trading offers a noteworthy case study. (Prasad Ganesh & Sanjay Khan)

The phenomenon of insider trading in India, albeit in a nascent form, can be traced back to the pre-independence era, with the earliest recorded instances dating to the 1940s. During this period, individuals in positions of privilege and access within corporations, such as directors, agents, auditors, and officers, were found to exploit confidential information for personal gain, engaging in speculative activities that undermined the integrity of the securities market. In response to these early manifestations of insider trading, the Indian government enacted the Controller of Capital Issues Act in 1947, establishing a regulatory authority, the Controller of Capital Issues, to oversee the securities market and promote its orderly and healthy growth.

Despite these initial efforts, the challenge of effectively curbing insider trading persisted, leading to the eventual repeal of the Controller of Capital Issues Act in the late 1980s due to its inability to fully achieve its regulatory objectives. This pivotal moment paved the way for the establishment of the SEBI in 1988 through the SEBI Act, marking a significant evolution in India's approach to securities regulation.

SEBI's emergence as the market regulator in 1992 was a critical development, ushering in a new era of regulatory oversight and enforcement against insider trading. The institution of the SEBI (Insider Trading) Regulations Act, 1992 represented a decisive step toward prohibiting and penalizing insider trading practices. Under this regulatory framework, individuals found guilty of insider trading faced stringent penalties under Sections 24 and 15G of SEBI Act, 1992. The regulatory landscape underwent further refinement in 2002 with significant amendments to the regulations, culminating in SEBI (Prohibition of Insider Trading) Regulations, 1992, which reinforced SEBI's commitment to eradicating insider trading from the Indian securities market. (Mishra, Rachna, & Mishra, Utkarsh. (2022-2023)

Role of SEBI in Eliminating Insider Trading

The SEBI instituted Prohibition of Insider Trading Regulations in 1992 as a decisive step towards ensuring the integrity of the financial markets in India. These regulations, effective from November 19, 1992, are foundational in preventing insiders from exploiting unpublished price-sensitive information for personal gain. Such stringent measures are crucial in maintaining public trust and fairness in the operations of the stock market, extending their applicability to all listed companies mandated to disclose price-sensitive information.

Under Regulation 2(e), 'insider' is comprehensively defined to include any individual who is either directly connected or deemed to be connected with company & is expected to have access to unpublished price-sensitive information regarding company's securities, including shares, debentures, etc. This definition extends to encompass directors, officers, employees, and even those in professional or business relationships with the company, such as chartered accountants and lawyers, as outlined in Regulation 2(c). However, merely holding a position within a company does not automatically categorize one as a connected person. It's the engagement in insider trading that marks an individual as a connected person under these regulations. (Lesley, Trisha. (2022)

Price-sensitive information, as described in Regulation 2(ha), refers to any data related to a company that, upon becoming public, could significantly influence the company's security prices. This includes information that has a direct impact on the company's current and future performance.

Insiders who hold price-sensitive information that has not been released are expressly prohibited by Regulation 3 from dealing in the securities of any listed firm, either on their own behalf or on behalf of others. In a similar vein, Regulation 3A prohibits businesses from trading in the securities of a third party or an affiliate when they have access to such information. However, Regulation 3B offers a defence for companies, stating that if a transaction was conducted without the officer's knowledge of such information, the company cannot be held liable for insider trading. This regulation also outlines potential defences a company might use in proceedings related to insider trading violations.

The consequences of contravening these regulations are severe. As per section 24 of the SEBI Act, 1992, violators face penalties up to three times the profits gained from insider trading, with a minimum fine of ₹25 crores. Regulation 13 mandates any person holding more than 5% shares or voting rights in any listed company to disclose their holdings to company, which in turn must inform stock exchanges where it is listed.

Moreover, Regulation 12 requires all listed companies to establish code of internal procedures in line with a model code provided by SEBI. This includes appointing a compliance officer to oversee the adherence to rules regarding the preservation of price-sensitive information and enforcing trading restrictions. (Aparajita, Shubham, & Rhudra, Rishee. (2013)

Concluding the regulations, the SEBI Act stipulates that individuals found guilty of insider trading are subject to a penalty not exceeding five lakhs. Furthermore, SEBI reserves the right to conduct inquiries into suspected violations and inspect the books and records of the insider or any involved party. The 2002's amendment empowered SEBI with the authority to issue directives to insiders, including prohibiting them from dealing in securities. Importantly, criminal prosecution against an insider is contingent upon establishing the commission of the

offence 'beyond reasonable doubt,' emphasizing the need for incontrovertible evidence in such cases.

These regulations collectively underscore SEBI's commitment to maintaining a transparent, fair, and efficient market, deterring malpractices, and safeguarding investor interests. By delineating clear definitions, imposing prohibitions, and outlining punitive measures, SEBI aims to uphold the principles of integrity and fairness in the Indian securities market.

Conclusion

Insider trading presents significant challenges to the stability and integrity of financial markets. Howard identifies several adverse effects stemming from insider trading, including escalated inflation rates, erosion of investor confidence, and inaccurate stock market valuations, among others. Moreover, companies compromised by insider trading exhibit decreased efficiency and deteriorate in economic performance over time. It is imperative for the longevity and efficiency of financial markets that the shortcomings in current legislation addressing insider trading are rectified. This entails not only the refinement of existing laws but also their rigorous enforcement, as mere statutory presence without application is insufficient for curtailing such practices.

The issue of insider trading has engendered ongoing discourse within global securities markets. Unauthorized disclosure of sensitive information can disproportionately benefit certain investors, allowing them to secure significant profits at the expense of less informed parties. It is crucial to safeguard these uninformed investors from exploitation by individuals possessing non-public information.

The SEBI has taken a commendable approach in crafting the Prevention of Insider Trading regulations, meticulously covering potential instances of insider trading and implementing preventive measures. SEBI's efforts have been instrumental in creating an equitable environment for all corporate shareholders, who might otherwise be disadvantaged in the absence of such regulatory frameworks. These measures are designed to protect the interests of minority shareholders, ensuring that those with insider knowledge cannot exploit their position for personal gain or to mitigate potential losses, thereby maintaining the market's fairness and integrity.

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