INSIDER TRADING AND ITS LEGAL IMPLICATIONS IN INDIA: A CRITICAL ANALYSIS

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ABSTRACT

Insider trading is a process of trading securities by people who have certain material information not known or available to the public. It has heavy legal ramifications as well as ethical. Although insider trading is prohibited in India, still it has not gained the desired strength of enforcement. This paper involves an in-depth analysis of insider trading in India. Majors discussed are the regulatory framework, ethical considerations, famous cases, enforcement issues, and international comparisons. This analysis, in terms of the current approach in India and subsequent suggestions for improvement, will contribute to building a transparent and fair financial market and causing confidence among investors.

Introduction to Insider Trading and Its Ethical Dilemmas

Insider trading is described as an act of buying and selling securities of a publicly traded company based on material information that is not made public, commonly referred to as unpublished price-sensitive information (UPSI). The ethical bone structure of insider trading issues relates to the fact that this creates an unlevel playing field in the financial market. In it, the inside people who have confidential information about a specific company have the kind of unfair advantage in the investment competition over other investors who rely solely on publicly available information. Such disparity not only violates the rudiments of fair play and transparency but also turns much havoc with the confidence of investors in the market. In a country like India, where the financial markets are accelerating fast and attracting a host of local as well as international investors, such transactions in finance need to be pure. As such, insider trading is certainly not merely an issue of legality but an extremely grave ethical concern that goes against the very basic principles of trust and fairness in market practice.

In the global context, insider trading is seen as an omnipresent menace against transparency in financial markets. Such developed economies have stringent laws against such activities to safeguard the interest of investors. In India, SEBI[1] has a legal framework to curb the activities of insider trading but still remains on low-to-medium enforcement skills level. This article is to briefly elaborate on the legal framework, regulatory challenges, ethical considerations, and the way forward towards strengthening India's approach towards insider trading.

Defining Insider Trading in Legal Terms

Under law, insider trading is defined as an abuse or misuse of UPSI to trade in the securities of any company.[2]

> *"Insider dealing occurs when a person with access to information that is precise and not generally available improperly discloses that information or uses it to deal to his advantage in financial securities in public market."*[3]

SEBI has classified an "insider" as anyone connected with a company holding confidential, nonpublic information likely to impact on price of the company's stocks. These are the

[1] Securities and Exchange Act, 1934
[2] Mr. Thomas C. Newkirk, Associate Director, Division of Enforcement, SEC
[3] Peter Cane (ed.), The New Oxford Companion to Law

company's executives and employees, consultants, and any "connected person" in access of such information. Even those who, through the influence or connection of an insider, may have access to UPSI include family members and close business associates, as defined by the 2015 SEBI (Prohibition of Insider Trading) Regulations.

UPSI means any information relating to a company which, when available to the public, would or is likely to materially affect the price of the securities of that company. This includes mergers, acquisitions, earnings reports, or a drastic change in corporate strategy. SEBI has declared that even though not producing an immediate profit, misuse of UPSI is not tolerated as the possession itself offers an unfair advantage. While insiders are allowed to trade their own company's equity under specific limitations, all the transactions based on UPSI are illegal. The regulation ensures that all those who may have managed to gain an unfair advantage from UPSI are brought to account, thus adding a transparency layer which deters marketplace manipulation.

Types of Insider Trading

Insider trading can be described in two broad categories: Illegal insider trading and Legal insider trading. This helps distinguish how the regulatory bodies determine the intent, access to information, and compliance while drawing lines between the actions.

1. **Illegal Insider Trading**

Illegal insider trading is considered to be the buying or selling of securities by a person having access to material, non-public information about a company. It has been referred to in law as unpublished price-sensitive information (UPSI). UPSI represents the prime method through which insiders are able to have unfair access to such details, undermine the integrity of the marketplace, and erode investor confidence. Illegal insider trading remains generally prohibited under the law in most jurisdictions, except India, wherein the SEBI Prohibition of Insider Trading Regulations, 2015 govern its implementation.

For instance, this can be further sub-divided into categories based on how the information is acquired and misused. Each of these categories poses unique challenges in regard to enforcement and regulation. These include *classic insider trading*, *misappropriation of information*, and *tipping* and *tipping chains.*

a) *Classic Insider Trading* - In traditional insider trading, company insiders, who may be the executives, employees, or even directors, trade using UPSI related to their position in that company. This is the most straightforward form of illegal insider trading where incumbents exploit a position within a corporation for financial gain over information that has been kept inside.[4]

b) *Misappropriation of Information* - Misappropriation of information occurs when a consultant, lawyer, accountant, or anyone else not considered an insider has a fiduciary duty and uses confidential, undisclosed information of the company reposed in them for their personal trading.[5] This thus expands the term insider to also include someone who has access to UPSI via a fiduciary or a similar relationship.

c) *Tipping and Tipping Chains*[6] - Tipping is also the practice whereby insiders pass UPSI to third parties who trade based on such information. Many times tipping leads to intricate trading networks or "tipping chains," whereby the first tipper passes information down the line to so many people, creating several layers of insider trading. Such insider trading becomes very complex for enforcement because not one person but a network of traders has violated insider trading rules.

d) *Accidental or Unintentional Insider Trading* [7]- Accidental or unintentional insider trading occurs when a person acts based on information without knowing they were dealing with UPSI or when they think they are trading on public information, which is really UPSI. This is this "grey area" where sometimes even accidental insiders may end up in court because they intended not to commit insider trading.

2. <u>Legal Insider Trading</u>

Legal insider trading is defined as those trades executed by company insiders like its officers, board members, and other employees using public information or within specified legal windows. SEBI regulates legal insider trading in India through timely disclosure, lock-up periods, and restrictions on trading windows. Legal insider trading allows executives and employees to hold shares in the companies that they are employed with, thus causing executives

[4] Cady Roberts & Co, 40 SEC 907 (1961)
[5] United States v. Vincent F Chiarella, 445 U.S 222 (1980)
[6] Finkelstein v. Ontario Securities Commission
[7] 80 Brook. L. Rev. 1419

and employees to be better aligned with shareholder interests.

SEBI 2015 has mandated the insiders disclosing the trades within specific timeframes, making the information flow into the public domain. Besides, trade window restrictions restrict the trading of insiders during corporate announcements or certain events that could create prices in companies. Since SEBI is attempting to legalize the insider trading by preventing the misuse of information while allowing the insiders to engage in the financial performance of their firms, regulatory safeguards are very important.

Evolution of Insider Trading Laws in India

Insider trading regulation has come a long way in India in the last several decades, showing great evolution in the approach of the country in its fight against insider trading, mirroring advancement in its financial markets. The SEBI Act, 1992, was the first major step where SEBI was constituted as the main regulatory body with the power to check fraudulent practices and to protect investors. Of course, the SEBI Act formed the foundation, but since inaugural regulations were difficult to enforce, primarily due to SEBI's underdeveloped capacity and inherent complexity in tracking insider activities. Moreover, in the 1990s, lack of technological infrastructure made real-time surveillance almost impossible, thereby weakening the enforcement.

The turning point was brought about by SEBI (Prohibition of Insider Trading) Regulations, 2015, aimed at filling that gap. In these regulations, the definition of the insider and UPSI would be broad; therefore, their categorization and identification with respect to people likely to misuse confidential information were simplified. The disclosures were made tighter and prohibitions on certain trades within certain windows. Reforms in 2021 and 2023 also had the effect of bolstering the authority of SEBI even more with more detailed trades, very punitive punishments, and more regulations to be complied with by companies. Amendments give an indication of filling the regulatory gap and flexibility in the SEBI stance towards the problems of the dynamic financial market situation that it faces.[8]

The Legal Framework Regulating Insider Trading in India

The two pillars of the Indian law framework against insider trading are the SEBI Act of 1992

[8] 3 Indian J. Integrated Rsch. L. 1 (2023)

and the SEBI (Prohibition of Insider Trading) Regulations, 2015. This framework spans from any person who might be in possession of UPSI, which includes employees, directors, auditors, consultants, among others, and also their close family. Other particularly defined windows, that are periods when it is allowed to trade for insiders, have also been provided by SEBI to minimize the chances of UPSI trading. Companies also have compliance officers[9] who oversee compliance in such matters, such that the employees observing all applicable rules and disclosures comply accordingly.[10]

The insider mechanisms existing in India include mandatory disclosure by insiders of their trades, specified compliance measures, and internal auditing of any and all anomalies. The SEBI also requires companies to maintain the records of trades conducted by nominated employees, with all deviations reported. Penalties for noncompliance can be quite severe: from fines to imprisonment, and so on. However, the enforcing part becomes challenging since proving intent is indeed complex. Generally speaking, for SEBI to penalise an individual or organisation, it needs to first provide a direct nexus between possession of UPSI and trading activity, which at times involves complicated legal and financial analysis.

Notable Cases for Insider Trading in India:

Landmark cases account for the pivotal aspects of India's concerns with insider trading, the set of rules for its regulation, and the challenges in implementing such regulations. There are a number of landmark cases which can be accessed to exemplify the extents that complexities and enforcement challenges assume in relation to insider trading in India.

One was the *Hindustan Lever Ltd.[11] case* back in 1998 wherein the Hindustan Lever, then Hindustan Unilever, was charged with insider trading in their Merger with Brooke Bond Lipton. HLL was found to be alleged buying up shares in its own stock before an announcement had been made about the merger, therefore inflating the stock price significantly. SEBI conducted an investigation and proved that HLL was guilty of insider trading. Although HLL tried to justify its actions on the ground of it being technically in legal bounds, the case has become a precedent and has served notice that greater regulatory oversight needs to be maintained.

[9]SEBI (Prohibition of Insider Trading) Regulation, 2015
[10] Venkatachari Jagannatha, "Grey Areas in Insider Trading Regulation needs clarification"
[11] SEBI v. Hindustan Lever Limited (HLL) (2007) 6(2) Indian J Corp Governance 117.

Another prominent scandal came in the year 2009, *Satyam Scandal*[12], wherein the scam was for billions of dollars and involved a corporate fraud regarding the stock prices, where a corporate entity, Satyam Computer Services, allegedly used the facilities of insider information and enhanced their stock prices. In the aftermath of exposed fraud, it broke the Indian stock market's confidence and, therefore again, reaffirmed the requirement that the regulatory bodies must be more alert and proactive. The second, an example is that of the *Rajiv Gandhi Equity Savings Scheme case* in 2014 wherein penal actions were taken against cases of insider trading. In that case, SEBI imposed massive penalties upon the respondents and clearly indicated the commitment of the regulator towards transparency despite public outcry for delays in the enforcement mechanism.

In the last years, SEBI has penalized executives and employees quite actively for insider trading. Cases between 2020 to 2023 examples point to the fact that SEBI has been making use of good technology and analytical tools to catch suspicious trading patterns. However, the same examples revealed existing problems- intent proving is hard and judgments are always taking more time so less time is left to deter the culprits through the theory of deterrence.

Challenges of Law Enforcement of Insider Trading Laws

It's very difficult for India to implement the insider trading regulations despite having tough laws. One of the major reasons is to prove intent; it's very tough for SEBI to show, in an insider trading case, that an individual acted on UPSI with the intention of profiting- without clear evidence, it is much more challenging. It's also tough to establish the trail of communication, which would show information flow from the insider to the execution of a trade and requires considerable time and resources for investigation.

Resource constraints exacerbate enforcement problems. Although SEBI has been enhancing its surveillance apparatus, it still cannot monitor trades in real time to catch suspicious trades. Finally, technology innovations like algorithmic trading create an opportunity for insider traders to make trades at speeds that can't be tracked. In addition, India's judicial system often takes a rather long time to deliver a verdict on insider trading offenses. The process also has a negative effect on the deterrent value of SEBI's penalties. The exploitability of loopholes and deferment of consequences for almost prolonged periods can worsen matters. The mere idea of

[12] Satyam Computers Services Ltd vs. Union of India 2018 SCC Online Hyd 787 : (2019) 1 ALT 355 (DB) : (2019) 3 ALD 472 (DB)

a lengthy judicial process renders the effectiveness of penalties ineffective.

Cross-border trading makes it even more complex as it calls for collaboration with foreign regulatory authorities. Many incidents of insider trading have an international angle to them. Often, information crosses borders. Thus, in many cases, the offender is hard to trace or prosecute because the Indian regulators depend on international cooperation, which may be slow and complicated by differences in legal standards. These are some of the pressing reasons for a more robust and agile enforcement mechanism that can deal with insider trading effectively in Indian markets.[13]

Impact of Insider Trading on Indian Economy

Insider trading is thus directly giving significant implications to the overall Indian economy. It does affect the Indian economy in terms of investor confidence, market stability, and corporate governance. Investor trust may be eroded in case insiders are believed to be making improper gains out of their privileged access to secret information. Such a lack of trust will prevent both domestic and foreign investors from flowing into Indian financial markets, affecting market liquidity and growth. This kind of investment withholding due to feelings of unfairness takes the backseat and leads to a decrease in capital flow-a harbinger of negative economic growth.

Insider trading also leads to market volatility. Trades made on UPSI can lead to unexpected fluctuation in stock prices, weighing hard on smaller investors who might not have the financial muscle to withstand such volatility. This breeds uncertainty and discourages participation, especially from retail investors.[14] Further, it is violating the corporate governance norms. In corporations where the insiders have profited by using the secret information, it causes an ambiance of secrecy instead of transparency. It is difficult to build an equitable business culture in this kind of ambiance. This hurts the reputation of Indian businesses and makes Indian market less appealing for foreign investment.[15]

Role of SEBI in Controlling Insider Trading

As the main regulatory authority, SEBI plays a core role in tackling insider trading in India. Over the years, SEBI has developed multiple measures to track surveillance, such as using

[13] "Regulation of Insider Trading in India", 2 Part 2 Indian J. Integrated Rsch. L. 1 (2022)
[14] Anshuman Bhaskar, & Udayan Jash. (2023). Insider Trading in Bharat: Appraising the Repercussions on Economic Participants and the National Exchequer. *Journal of Scientific Research and Technology*, *1*(2), 16–24.
[15] *Ibid*

advanced data analytics to monitor unusual patterns of trading that suggests insider activity. The entire surveillance system of SEBI combined with the application of artificial intelligence helps better follow the trades. Despite these technological improvements, there are plenty of problems simply due to the low capital and high level of trading activity across India's more and more vibrant markets.

SEBI has also had programs in education and awareness. It tries to impart a sense of legal and ethical responsibility within the market participants through its programs on employees, corporate officers, and investors. The programs revolve around the legal implications of insider trading, including the market integrity required. Imposing heavy penalties recently and the intent to act swift on cases where high-profile offenders are involved, SEBI aims to bring out the message that they mean business. On the other hand, making all these measures public is part of the strategy of SEBI in creating an environment where the risks of insider trading appear to outweigh the benefits.

International Regulations Benchmarking

Comparative analysis suggests that India can borrow lessons from best international practices, which are implemented. The United States, for instance, has an effective structure led by the SEC that vigorously pursues cases of insider trading. With whistleblower programs and the Dodd-Frank Act, an attempt is made to empower those to confidentially report insider trading without getting retaliation. In the UK, FCA does not let up on insider trading and has response mechanisms in place, while its commitment to enforcement is transparent too.

These practices can be useful for India. Accelerating cases of insider trading, rewarding whistleblowers, and real-time surveillance can further build on SEBI's regime of regulation. Inter-governmental collaboration with other regulators around the world would help India better handle its crossborder-cases of insider trading. In this context, India can enhance its position and boost investor confidence in its financial markets.

Recommendations for the strengthening of India's approach to insider trading

To strengthen India's regulatory framework about insider trading, the following measures are required: boosting investment in modern technology, such as artificial intelligence, which would enable SEBI to assess suspicious trades faster and respond promptly, specialized financial courts completing insider trading cases faster, reduction in judicial delay, and hence enforcing efficiency.

This would also strengthen efforts by SEBI towards encouraging insider whistleblowers to report violations without any fear of reprisal. While improving coordination with the rest of the global regulatory bodies will lead to more streamlined information sharing in cross-border cases, thereby better prosecuting those individuals involved in international insider trading. Encouraging companies toward more comprehensive compliance initiatives and regular training programs on legal and ethical standards will also foster an accountability culture. These measures taken together would help to strengthen India's stand.

Conclusion

Insider trading still is a very sophisticated issue with illegal acts very often intertwined with legal trade and, sometimes, even without realizing the wrong-doing. Such an appropriate regulatory structure should ensure strict enforcement but also be transparent and fair in its exercise so that ethical involvement by insiders would be ensured while punishment through insiders would be aimed at wrongful activities by those who intend to use such information. How India's financial markets continue to evolve their own path forward through a proactive approach, modern surveillance, and learning best practices from other countries is what would shape SEBI's regulatory framework to boost confidence among investors and maintain market integrity.