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THE REDUNDANT NATURE OF PREVALENT INSIDER TRADING LAWS

ABSTRACT[1]

Insider trading, according to the Companies Act 2013, is described as an act of subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, or deal in any securities by any director, key managerial personnel, or other officers of a company, whether as a principal or an agent, if such director, key managerial personnel, or other officers of a company is reasonably expected to have access to any non-public price sensitive information regarding securities of a company.

It is further imperative to note that the Securities and Exchange Board of India (SEBI), via the introduction of Prohibition of Insider Trading Regulation, 2015 has widened the scope of insider trading. For instance, regulation 2 (d) (i) defines a connected person as any person who is or has during the six months prior to the concerned act been associated with a company, directly or indirectly, in any capacity including by reason of frequent communication with its officers has directly or indirectly, access to unpublished price sensitive information or is reasonably expected to allow such access. Moreover, all connected persons are referred to as insiders via regulation 2(g)(i).

The paper gives a brief introduction to section 195 of the Companies Act, 2013, and examines the concept of insider trading. The purpose of this paper, however, is to illustrate the fact that the prevalent insider trading laws are redundant. The paper would first discuss why the practice of insider trading is prohibited. Furthermore, it would examine the regulations enforced by SEBI and manifest their ineffectiveness by analysing the controversial judgment delivered by the Securities Appellate Tribunal in the case of Rakesh Agrawal v SEBI. Lastly, the paper would identify the loopholes present in the SEBI Act and further discuss why insider trading laws are ineffective.

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I. INTRODUCTION

Insider trading, according to the Companies Act 2013, is described as an act of subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, or deal in any securities by any director, key managerial personnel, or other officers of a company, whether as a principal or an agent, if such director, key managerial personnel, or other officers of a company is reasonably expected to have access to any non-public price sensitive information regarding securities of a company. Price sensitive information is further defined as any information that may relate directly or indirectly to a company and which if published is likely to materially affect the price of the securities of the company.[2] The aforementioned individuals are mandated by law not to reveal or use such sensitive information for personal gain.[3] Furthermore, under Section 195 of the Companies Act, 2013 such conduct is prohibited since it violates the principle of good governance[4].

It is further imperative to note that the Securities and Exchange Board of India (SEBI), via the introduction of Prohibition of Insider Trading Regulation, 2015 has widened the scope of insider trading. For instance, regulation 2 (d) (i) defines a connected person as any person who is or has during the six months prior to the concerned act been associated with a company, directly or indirectly, in any capacity including by reason of frequent communication with its officers has directly or indirectly, access to unpublished price sensitive information or is reasonably expected to allow such access.[5] Moreover, all connected persons are referred to as insiders via regulation 2(g)(i).[6]

The paper gives a brief introduction to section 195 of the Companies Act, 2013, and examines the concept of insider trading. The purpose of this paper, however, is to illustrate the fact that the prevalent insider trading laws are redundant. The paper would first discuss why the practice of insider trading is prohibited. Furthermore, it would examine the regulations enforced by

[2] Companies Act 2013, s (195).
[3] *S. Ramesh, S. Padmalata And Asis … vs Securities And Exchange Board* [2005] 59 SCL 521 SAT.
[4] Companies Act 2013, s (195).
[5] Prohibition of Insider Trading Regulation 2015, 2 (d) (i).
[6] Prohibition of Insider Trading Regulation 2015, 2 (g) (i).

SEBI and manifest their ineffectiveness by analysing the controversial judgment delivered by the Securities Appellate Tribunal in the case of Rakesh Agrawal v SEBI.[7] Lastly, the paper would identify the loopholes present in the SEBI Act and further discuss why insider trading laws are ineffective.

II. WHY THE PRACTICE OF INSIDER TRADING IS PROHIBITED?

It has long been argued that insider trading is a victimless crime. While it may seem that the victim of insider trading is the seller who sold his stock to an insider, it is imperative to note that the stock would have been sold regardless. Hence, whether the insider buys the stock from the seller or not, the same would not affect the proceeds received by the former from the sale. In fact, insider trading does not affect any identifiable group of individuals. Rather those sellers who sell to insiders receive a better price for the stock. Furthermore, insider trading has been deemed as a means of communication that makes market more efficient since any transaction of a large quantity of stock would develop a chain reaction, wherein the purchase or sale of large quantities of any stock would help investors predict the future price.[8] However, the aforementioned argument rests solely on the assumption that individuals won't misuse the power of insider information. For instance, a trader who is equipped with the purchasing power may drive the share prices of a company up merely by purchasing numerous shares in the said company. This would further create an impression in the market that the trader possesses some lucrative information regarding the company's financials and the same is bound to go up.

It is contended that shareholders too, contrary to popular belief, are not adversely affected by insider trading but rather benefit from the same since if in a given scenario, the insider information were to be in favor of the company, their shares would now be priced at a much greater value. Placing prohibitions or restrictions on insider trading will in effect block this information and insiders would attempt to hide their transactions in turn preventing other traders in the market to learn and benefit from the same.[9] Nevertheless, the aforementioned argument assumes that the information would be made available to the market as a whole, at

[7] *Rakesh Agarwal v SEBI* [2004] 49 SCL 351 (SAT).
[8] McGee R, "Applying Ethics to Insider Trading" (2008) 77 Journal of Business Ethics.
[9] ibid.

the same time. For instance, a trader may possess insider information regarding a company's financials and is aware of the fact that the share price may plummet once they post the quarterly or yearly results, would be the first one to sell his share of stock and restrict his loss. However, this would further cause a chain reaction that would compel other traders to sell their shares at a much-discounted rate and incur a heavy loss. Hence, the individual who first received the insider information would always have an unfair advantage over other investors in the market.

Additionally, it is imperative to note that if individuals were aware of the fact that they may trade with an insider, they would demand a premium to safeguard themselves from the risk they are undertaking, or they would be unwilling to invest. Moreover, the same individuals would be dissuaded to invest in a capital market wherein insider trading is rampant since the risk of investing would significantly increase and investors' confidence in the market would plummet. Hence, insider trading reduces market liquidity, in turn raising the cost of capital and ownership concentration.[10] The aforementioned argument can further be strengthened by the empirical evidence present that corroborates the fact that equity cost is higher, and the market is less liquid in countries where insider trading laws are not enforced compared to countries where such laws are in place.[11] Furthermore, permitting insider trading would incentivize managers to make short-term decisions to profit from price swings. [12]These decisions may not be in the best interest of the company since insiders would make a significant profit regardless of stock prices appreciating or depreciating, and decisions not in favor of the company would also harm the interest of the shareholders who are part owners of the same.

III. SEBI REGULATIONS AND ITS INEFFECTIVENESS

Section 11 of the Securities Exchange Board of India Act, 1992, entrusts the duty upon SEBI to protect the interests of the investors in securities by regulating the market as it deems fit.[13] Furthermore, violation of Section 12-A, which expressly prohibits insider trading either directly or indirectly, attracts a penalty of up to 23 crores or three times the amount of profits made because of insider trading, whichever is higher.[14] Additionally, under section 24 of the

[10] Padilla A, "Should the Government Regulate Insider Trading?" (2011) 22 Journal of Libertarian Studies.
[11] Bhattacharya U and Daouk H, "The World Price of Insider Trading" [2000] SSRN Electronic Journal.
[12] McGee R, supra note 7.
[13] Securities Exchange Board of India Act, 1992, s (11).
[14] Securities Exchange Board of India Act, 1992, s (15) (g).

Act, the accused would face imprisonment for a term that may extend to ten years or a fine, or both.[15]

However, even with the existence of such stringent laws, it is astounding that the SEBI has failed to achieve anything substantial apart from initiating probes, that too only when the issue has been raised by the media.[16] It is further imperative to note that in the past three decades, there has not been a single successful conviction for the offense of insider trading. Even though investigations were carried on for years, the accused were let off with mere suspensions or warnings. No individual was imprisoned and in most cases, the accused was mandated to pay a penalty.[17] The settlement of insider trading cases creates an impression that the crime does not involve a high risk of imprisonment. This in turn lowers the fear in the individuals who may be potential insider traders and thus the entire process is futile. Additionally, such resolutions or penalties restrict the development of insider trading laws since the process is put on an abrupt halt and the initial inquiry is scrapped.[18]

The following two cases will further highlight SEBI's incompetence in achieving a successful conviction with regard to proving allegations of insider trading.

In the case of Rakesh Agarwal v SEBI, Rakesh Agarwal, the managing director of ABS Industries Ltd., was engaged in takeover negotiations with Bayer A.G, wherein the latter would acquire 51 percent stake in the former. It is imperative to note that prior to the public announcement of the acquisition, Rakesh Agarwal, purchased shares of ABS through his brother-in-law. This in turn prompted SEBI to conduct a thorough investigation regarding this matter. The investigation revealed that Rakesh Agarwal possessed price sensitive information while purchasing ABS shares from the open market with the intention of making a substantial profit.

In pursuance of the above revelation, SEBI mandated Rakesh to deposit 3400000 rupees with Investor Education & Protection Funds of Stock Exchange Mumbai and NSE, in order to

[15] Securities Exchange Board of India Act, 1992, s (24).
[16] Naresh Kumar, "How Effective Are the Insider Trading Regulations" (2006) 75 *Corporate Law Adviser* 35.
[17] Sachar R and Wani A, "REGULATION OF INSIDER TRADING IN INDIA: DISSECTING THE DIFFICULTIES AND SOLUTIONS AHEAD" Journal On Contemporary Issues of Law (JCIL).
[18] Satvik Varma, "Insider Trading is a criminal offence" *The Economic Times*, Dec. 11, 2011.

compensate any investor which may make any claim subsequently. However, Rakesh appealed the aforementioned order in the Securities Appellate Tribunal, claiming that he acquired or purchased the shares from the open market bearing the interest of the company. He further contended that he was keen on ensuring that the takeover negotiations were successful and hence attempted to source the required number of shares, which were later to be sold to Bayer, through his brother-in-law.

Even though it is settled law that dealing in securities when in possession of price-sensitive information is prohibited, notwithstanding the intentions of the accused,[19] the SAT tribunal held that it is imperative to take cognizance of the motive of the insider regardless of the fact that the regulations do not mandate the existence of *Mens Rea* as an ingredient for insider trading. The Court further held that the order issued by SEBI mandating Rakesh to deposit 34,00,000 rupees would not be sustained since he acted in the interest of ABS. [20]

Similarly, in the case of Samir. C. Arora v SEBI, the latter prohibited the former from trading in securities in any manner, directly or indirectly, for a period of five years. The aforementioned order was only passed after a thorough investigation by SEBI which revealed that Samir did possess price-sensitive information regarding a de-merger and was successful in avoiding losses worth 23.57 crores at the cost of uninformed buyers, who did not have access to such information. However, Mr. Arora appealed against the order passed by SEBI and the same was overturned by the SAT on grounds of inadequate proof to prove the charge of insider trading.[21]

IV. IDENTIFYING THE LOOPHOLES IN THE SEBI ACT, 1992

It is a matter of growing concern that the SEBI, which has been entrusted with the duty of safeguarding the interests of the investors, has failed to achieve a single conviction in the past three decades.[22] While investigations are carried out for years, the eventual conviction is usually in the form of a mere fine. SEBI's practice of settling insider trading cases via consent orders creates an impression that the act of insider trading is not a penal offense and the

[19] *Hindustan Level Limited v. SEBI,* (1998) 18 SCL 311 (AA).
[20] *Rakesh Agarwal v SEBI* [2004] 49 SCL 351 (SAT).
[21] *Samir. C. Arora v SEBI* [2005] 59 SCL 96 (SAT).
[22] Upadhyay JP, "How India Cracks down on Insider Trading?" (*mint*January 28, 2020) <https://www.livemint.com/market/stock-market-news/how-india-cracks-down-on-insider-trading 11580199120367.html> accessed June 27, 2021.

probability of the accused being apprehended and imprisoned is low.[23] This in turn increases the confidence of potential insider traders. It is further imperative to note that once the alleged offender has duly signed the consent form, he or she is not mandated to admit or deny his guilt. The aforementioned practice allows the rich and influential to buy their way out after committing a heinous crime that affects the lives and savings of millions. In such a case, the inadequacy of SEBI's regulations serves as the cause behind investors losing confidence in the market.

Additionally, the Act only empowers the authoritative body once they find any intermediary or person associated with the market violating the provisions of the act or regulations.[24] However, in situations where the SEBI possesses knowledge regarding an anticipated occurrence of insider trading via an informer, it won't be able to take any action to stop the same since anticipatory action with regard to the practise of insider trading has not been provided for under the Indian law.[25]

Section 26 of the SEBI Act, 1992, states that no court shall take cognizance of any offense punishable under the Act except on a complaint filed by SEBI. Hence, the Act deprives investors of the ability to protect their interests through the institution of civil action suits.[26] The Act blatantly disregards the fact that the investor is the primary victim in this transaction and rather acts contrary to its objectives, by leaving the investors defenceless. It is further imperative to note that permitting private individuals to file civil action suits can act as a deterrent to the practice of insider trading.

While SEBI's regulations have sabotaged its attempts of eradicating insider trading from the market, we further have to be cognizant of the fact that successfully proving cases of insider trading is a challenge since the only option the prosecution has is to rely on circumstantial evidence. SEBI has been unable to secure the required authority to tap phone calls and even though they have approached the Central government numerous times, their appeal has been rejected on grounds of the power being liable to misuse.[27]

[23] Sachar R and Wani A, supra note 16.
[24] Securities and Exchange Board of India Act, 1992, s. 11 C.
[25] Sachar R and Wani A, supra note 16.
[26] Securities Exchange Board of India Act, 1992, s (26).
[27] Sachar R and Wani A, supra note 16.

The aforementioned power is crucial if the Indian government wishes to crackdown on insider trading cases. The evidence collected by using such power would be substantial in proving a case against the accused. For instance, the SEC in the United States relied extensively on the 18000 wiretapped telephone conversations and emails to hold Mr. Rajat Gupta guilty for insider trading.[28]

V. WHY LAWS REGULATING INSIDER TRADING ARE INEFFECTIVE

SEBI's inability to gather evidence and heavy reliance on circumstantial evidence is one of the primary reasons for the rampant insider trading that is taking place in India.

Once experienced traders are aware of the rules used by the regulators to detect insider trading, the traders who possess the price-sensitive information can strategically avoid investigations. It is common knowledge that in most cases the regulators' investigation is triggered once the price variation during a trading day exceeds a certain threshold. This in turn ensures that traders who are able to estimate the future price of the stock because of the price-sensitive information they possess would further be able to predict when the regulator may suspect that non-public information is circulating in the market. Thus the insiders adopt a strategy wherein they would dispose of the stock prior to it reaching the threshold and book their profits while remaining undetected.

Additionally, it is imperative to be cognizant of the fact that India's market liquidity has witnessed a steady increase over the past few years. India's stock market is now the 7th biggest in the world. However, with an increase in market liquidity, insiders are more able to successfully conceal their trades. With an increase in the number of trades conducted daily, the impact of insider informed trades is diluted amongst other trades. This in turn puts the regulating authority in such a position wherein it is unable to distinguish between informed or uninformed trades due to the sheer size of the number of transactions taking place. Hence, the more liquid a market is, the more ineffective is the use of circumstantial evidence with regard

[28] "Press Release" (*SEC Emblem* July 17, 2013) <https://www.sec.gov/news/press-release/2013-128-sec-obtains-139-million-penalty-against-rajat-gupta> accessed May 28, 2021.

to insider trading.[29] In the case of the Indian stock market, in November 2020, the National Stock Exchange reported that 9 crore trades were conducted during the day.[30] To make matters worse, SEBI only employs 867 individuals who have been entrusted with multiple tasks apart from insider trading.[31]

VI. CONCLUSION

The fact that the aforementioned discussion proves that government regulation of insider trading has been so far ineffective should not be interpreted as that government regulation cannot be effective and hence should be repealed. Regulation of insider trading is ineffective since information is not only intangible but also subjective in nature and it has become increasingly difficult for authorities to make use of tangible evidence to prosecute insiders. [32]

While it is a fact that insider trading cannot be completely eradicated from the market, the government must hold individuals accountable for their unlawful activities. The institution of civil suits against the accused can act as a powerful deterrent in cases of insider trading, while simultaneously protecting the rights of the investors. The same has been successful in the United States, wherein civil action suits can be instituted by individuals under Rules 10b-5 and Rule 14e-3 of Securities Exchange Rules, 1942 and Section 16-b and Section 20-a of the Securities Exchange Act.[33]

Additionally, it is imperative that SEBI is entrusted with additional investigating powers such as access to electronic records, particularly wiretapping, as in the United States. Electronic evidence in the form of telephonic calls, emails, and other forms of electronic evidence has been accepted as evidence by courts across the world, and change must be achieved in India as well to improve the status of the market.[34]

[29] Padilla A, supra note 9.
[30] "NSE Cash Segment Hits All-Time High Turnover of Rs 1.47 Lakh Cr on Last Trading Day of November" (*Business Today* November 30, 2020) <https://www.businesstoday.in/markets/stocks/nse-cash-segment-hits-all-time-high-turnover-of-rs-147-lakh-cr-on-last-trading-day-of-november/story/423384.html> accessed May 28, 2021.
[31] "Employee Profile In SEBI" (*SEBI*) <https://www.sebi.gov.in/department/human-resources-department-37/employee-profile-in-sebi.html> accessed May 28, 2021.
[32] Padilla A, supra note 9.
[33] Sachar R and Wani A, supra note 16.
[34] Ibid.

Lastly, we need to be cognizant of the fact that there exist no examples in India when the SEBI and other government investigating agencies (such as the Central Bureau of Investigation) have worked together to investigate insider trading cases. If there has been any assistance, it has been restricted to the exchange of primary data. While in the United States other official government investigative agencies such as the Federal Bureau of Investigation assist the Securities and Exchange Commission in inspecting instances of insider trading in a more comprehensive and timely manner.[35]

It is imperative that Indian government investigating agencies provide such support to SEBI and not only at the information level, but also at all levels, including for active investigation action.

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[35] Ibid.