

Insider Trading

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Abstract: To understand what is insider trading, know its legal implications, what impact it has on the investors and discuss top few cases of Insider Trading in India. 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. It is an unfair practice, wherein the other stock holders are at a great disadvantage due to lack of important insider non-public information.

Key Words: Insider, Investor, SEBI, Price Sensitive Information, Non Public Information

1. Introduction

1.1 What is Insider Trading?

Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information about the company. Insider trading is generally perceived negatively. Persons having access to price sensitive and unpublished information use the same for their individual gains.

1.2 Who is an Insider?

Insider is anyone who trades a company's shares based on material non-public knowledge. Generally an insider is a person who is or was connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of the securities of a company. Directors and other officers of the company are connected with the company for the purpose of insider trading. A person is deemed to be connected with the company if such person:

- Is a company under the same management or group
- Is an intermediary, investment company, asset management company or an employee or director thereof, or an official of a stock exchange, or of clearing corporation
- Is a merchant banker, share transfer agent, registrar to an issue, debenture trustee broker, portfolio manager, investment advisor, or employee thereof
- Is a member of the Board of Directors or employee of public financial institution
- Is a relative of any of the aforementioned persons
- Is a banker of the company

1.3 Price Sensitive Information

Under the Securities And Exchange Board Of India ([Prohibition Of] Insider Trading) Regulations, 1992 “**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 company. Price sensitive information shall include:

- a) Periodical financial results of the company
- b) Intention to declare dividend
- c) Issue or buy back of securities
- d) Expansion plans, projects mergers, amalgamations, etc
- e) Disposal of whole or part of undertaking
- f) Significant change in policies

All employees and directors must maintain the confidentiality of all **Price Sensitive Information**. They must not pass on such information to any person directly or indirectly by way of making a recommendation for the purchase or sale of securities. Price Sensitive Information is to be handled on a “need to know” basis and should be disclosed only to those within the company who need the information to discharge their duty.

1.4 Unpublished Information

Unpublished Information means any information which is not published by the company or its agent and is not specific in nature. The speculative information /reports published in the media are not considered as published information.

1.5 How does Insider trading works?

In insider trading, an insider in a company buys the stock, shares, with the help of price sensitive information along with small group of people who buy the stocks and spread the word. Soon a huge artificial demand is created for the particular stock resulting in higher prices. At a certain point when the prices hits the 'satisfactory level' the insider exits along with his small group of people or in other words sells the stocks and make profits. Soon the stocks plummet resulting in huge losses for the public investors.

2. Prohibition on Insider Trading

As per SEBI Regulations, 1992(amended, 2002) the prohibition of insider trading is twofold:

- i) Insiders cannot deal in the securities of a listed company when in possession of any Unpublished price sensitive information
- ii) Insiders cannot pass on the unpublished price sensitive information in any manner, to any other person, who deals in securities of a listed company when in possession of such unpublished price sensitive information. However, communication of unpublished price sensitive information required in the ordinary course of business or profession or employment can take place.

Any person who deals in securities in contravention of above provisions shall be guilty of insider trading and is considered to have breached SEBI regulations.

Powers of SEBI and Penalties on violation of the SEBI Regulations, 1992(amended, 2002)

SEBI is the market watchdog that is entrusted with the responsibility of monitoring and regulating the securities market in India. The Indian approach to insider trading is far more ferocious than any other country. The process of investigation of insider trading is structured under the Indian laws as follows:

1) Inquiries & inspection

If SEBI suspects any violation, it may conduct an enquiry into the books and records of the suspected parties. It may also examine the books and records of the stock exchanges, mutual funds, intermediaries, self-regulatory organizations and other associated persons. Based on this enquiry, it will form a prima facie opinion as to whether investigation is necessary and whether there is any violation of the Insider Trading Regulations.

2) Investigation

If further investigation is necessary, SEBI shall dispatch a notice to the insider for the said purpose. It may appoint an investigating authority for the purpose of investigation. This investigating authority has the power to call for any documents, records, accounts and information, relating to the transaction in the securities market, from the insider. The subject is to allow the investigating authority reasonable access to the premises and facilitate the examination of documents, records, accounts and information in possession. The investigation authority is also entitled to record and examine the statements of any member, director, proprietor or employee of the insider. After due consideration of the investigation report of the investigation authority, SEBI shall communicate its findings to the insider who shall reply within 21 (twenty one) days. On receipt of the reply, SEBI shall make its decision.

3) Appointment of Auditor

In addition to the investigation, an auditor may also be appointed by SEBI to investigate the books of accounts or other affairs of the insider.

4) Directions and Penalties

Depending on the outcome of the investigation, SEBI may inter alia prohibit the insider from investing in or dealing in securities, declare violative transactions as void, order return of securities so purchased or sold. SEBI may also transfer the proceeds equivalent to the cost price or market price of shares whichever is higher to the investor protection fund of

a recognized stock exchange. SEBI may also impose a penalty of **INR 250,000,000** (Rupees Two Hundred Fifty Million Only) or 3 times the profit made out of insider trading, whichever is higher. Further, under section 24 of the SEBI Act, SEBI has additional powers to punish any person contravening or attempting to contravene or abetting the contravention of the SEBI Act with imprisonment for a term which may extend to ten years or with fine which may extend to INR 250,000,000 (Rupees Two Hundred Fifty Million Only) or with both.

5) Powers under the SEBI Act

For the purposes of regulation of the market and matters incidental, SEBI has the same powers as a civil court. It can ask companies, intermediaries, brokers, trustees and any other person associated with the securities market to furnish any documents, accounts, information that it requires. It can conduct enquiry and investigation, on a complaint or suo moto. It can issue directions, cease and desist orders and impose fines.

3. Impact of Insider Trading on Markets and Investors

Publicly-traded companies rely on large numbers of people to purchase shares of their stock. Trust is implicit in this arrangement between a company and its investors. The corporation's officers are supposed to act in the best interest of the company's shareholders. Insider trading is a betrayal of that trust; by acting on information that shareholders aren't privy to for financial gain, officers of a corporation are acting purely in their own best interests. It's hard enough to regain trust when officers of a single company trade illegally. The impact of illegal insider trading is considered negative for both the small investors and for the markets. Illegal insider trading ensures that there is no fair play involved and there is no fair demand and supply of stocks, all detrimental to the functioning of a healthy capital market. When entire markets are widely perceived to be tainted by insider trading, average people who are also potential investors will avoid markets altogether. Insider trading undermines investor confidence in the fairness and integrity of the securities markets.

4. Popular Insider Trading Scams

1. Hindustan Lever Limited(HLL)- Brooke Bond Lipton India Limited (BBLIL)

The controversy involved HLLs purchase of 8 lakh shares of Brooke Bond Lipton India Ltd (BBLIL) from the Unit Trust of India (UTI, 1996-97 income: Rs 7,481 crore) at Rs 350.35 per share. This transaction took place on March 25, 1996, before the HLL-BBLIL merger was announced on April 19, 1996. A day after the announcement of the merger, the BBLIL scrip quoted at Rs 405, thereby leading to a notional gain of Rs 4.37 crore for HLL, which then cancelled the shares bought. SEBI, suspecting insider trading, conducted enquiries, and after about 15 months, in August 1997, SEBI issued a show cause notice to the Chairman, all Executive Directors, the Company Secretary and the then Chairman of HLL. Later in March 1998 SEBI passed an order charging HLL with insider trading.

However HLL stood against SEBI on the context that it was not as insider, thus the case was further took to the Appellate Authority of the Finance Ministry where HLL appealed to the Appellate Authority that it be absolved of the charges of insider trading. UTI also filed an appeal with the Appellate authority, claiming a higher compensation of Rs. 75.2 million (7.52 crore) on the grounds that it was not aware of the merger between HLL & BBLIL was on cards. But after its investigation HLL was not found guilty and the Appellate cited press reports which showed that knowledge of merger was already known in market.

2. ABS Industries vs. SEBI

The Managing Director of ABS Industries Ltd. (ABS) Rakesh Agarwal was involved in negotiations with Bayer A.G regarding their intentions to takeover ABS. It was alleged by SEBI that prior to the announcement of the acquisition, Rakesh Agarwal, through his brother in law, Mr. I.P. Kedia had purchased shares of ABS from the market and tendered the said shares in the open offer made by Bayer thereby making a substantial profit. The investigations of SEBI affirmed these allegations. He was an insider as far as ABS is concerned. By dealing in the shares of ABS through his brother-in-law while the information regarding the acquisition of 51% stake by Bayer was not public, the appellant had acted in violation of the Insider Trading Regulations.

Rakesh Agarwal contended that he did this in the interests of the company. He desperately wanted this deal to click and pursuant to Bayer's condition to acquire at least 51% shares of ABS, he tried his best at his personal level to supply them with the requisite number of shares, thus, resulting in him asking his brother-in-law to buy the aforesaid shares and later sell them to Bayer.

SEBI directed Rakesh Agarwal to “deposit **Rs. 34, 00,000** with Investor Education & Protection Funds of Stock Exchange, Mumbai and NSE (in equal proportion i.e. Rs. 17, 00,000 in each exchange) to compensate any investor which may make any claim subsequently.” On an appeal to the Securities Appellate Tribunal (SAT), Mumbai, the Tribunal, however, held that the part of the order of the SEBI directing Rakesh Agarwal to pay Rs. 34,00,000 couldn't be sustained, on the grounds that Rakesh Agarwal did that in the interests of the company (ABS) to help Bayer A. G acquire his company.

3. Alliance Capital Management-Fund Manager vs. SEBI

The former Asia-Pacific fund manager of Alliance Capital Management Samir Arora was banned by SEBI from trading because of the three main charges against him. One, that Arora played a pivotal role in thwarting Alliance Capital's efforts to sell its India operations by resorting to unethical means. Two, he did not make disclosures or sometimes made wrongful disclosures when some of Alliance's holdings in certain stocks breached limits that required informing the respective companies.

Third, he sold his entire holding in Digital Global Soft based on unpublished, price-sensitive information. In this case, SEBI conducted investigations into the management, conduct and other affairs of the Alliance Capital Asset Management (I) Pvt. Ltd. (ACAML). Samir Arora was the fund manager of the company. Knowing that the company was inviting bids for takeover of the same, he made special arrangement with Henderson Global Investors. For helping this company takeover his present company, he purchased shares and when the price rose sold off the shares to get a considerable profit. The Authority found him guilty and directed him not to buy, sell or deal in securities, in any manner, directly or indirectly, for a period of five years.

Conclusion

Insider Trading is a malpractice which has adverse impact on the genuine investor and on the market overall. It undermines the confidence of investor in investing his money in market wherein people having access to unpublished information make large profits on the stake of investors' money. Although in India SEBI has prohibited such activities, but still a lot of work is required to be done wherein SEBI should be vested with more powers and authority which would make people to think twice before doing such activities.

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