



# **INSIDER TRADING IN INDIA**

## **A ZERO TOLERANCE EVENT**

In today's day, business is expanding in the global markets and with it there is considerable amount of growth in the financial markets- Bond market, share market, derivative market and other markets. And with the increase in such trading, there has been a development in one particular form of trading- Insider Trading. Insider trading is trading in stock market while having a potential access to private, non-public information of a company.

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### ABSTRACT

In today's day, business is expanding in the global markets and with it there is considerable amount of growth in the financial markets- Bond market, share market, derivative market and other markets. And with the increase in such trading, there has been a development in one particular form of trading- Insider Trading. Insider trading is trading in stock market while having a potential access to private, non-public information of a company. If the trading is done without any profit to the trader and loss to the company, while not taking advantage of the non-public information, it can be legal.

Insider trading generally refers to fraudulent practices resorted mainly by top management of a Company that is listed in recognised Stock Exchange. Insider trading is a globally acknowledge problem that needs to be addressed soon to avoid major economic crisis.

## WHAT IS INSIDER TRADING?

Insider Trading as a term is subject to many definitions and it includes both legal and prohibited activities. Insider Trading happens on a daily basis, legally, when corporate management and Board of Directors buy or sell or deal with stocks of their own companies within confines of the company policies and regulations governing the trading. In other words, Insider Trading is buying, selling or dealing with a security while breaching the company policies or regulations, thus breaching the trust and confidence of a company while possessing material or non-public information about the securities.

### Definitions:

The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 1992, does not directly define the term Insider Trading. But it defines the term "Insider", "Connected Person" and "Price Sensitive Information".

## Indian Scenario

India has put great efforts in the enactment of Insider Trading. SEBI- to be at par with international standards of Insider Trading Laws has modifies the laws on Insider Trading under the chairmanship of Justice N. K. Sodhi and drafted the "Prohibition of Insider Trading Regulations, 2015."

The new Insider Trading Regulations has brought about several changes by amending definitions of various concepts. It comprises of Five Chapters, Two schedules and 12 sections.

First Chapter deals with the definitions, second deals with the Restriction on Communications and Trading by Insiders. Chapter 3 talks about the disclosures made by the company and four prescribes a Code of Disclosure and Conduct. Chapter 5 consists of Power and Sanctions.

Insider Trading is the trading of securities of a company by an Insider using company's non-public, price-sensitive information while causing losses to the company or profit to oneself.

**Insider:** According to the Regulations, "Insider" means any person who is or was connected to the company or is deemed to have been connected with the company and who reasonably is expected to have access, connection to unpublished price sensitive information in relation to that company.

**Connected Person:**

The Regulation defines that a "connected person" means any person who-

(i) is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 of a company, or is deemed to be the director of the company by virtue of sub-clause (10) of section 307 of the Act.

(ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company, whether temporary or permanent and who may reasonably be expected to have an access to unpublished, price sensitive information in relation to that company.

**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 the company.

Following are some examples of Price Sensitive Information:

1. Financial results of the company.
2. Intended declaration of Dividends.
3. Issue of shares by way of public rights, bonus, etc.
4. Any major expansion plans or execution of new projects
5. Amalgamation, mergers and takeovers.
6. Disposal of the whole/substantial of the undertaking.

## **HISTORY AND EVOLUTION OF INSIDER TRADING**

Insider Trading has been around the United States from 1792. Hence, Laws against Insider Trading was formed strictly in the United States of America. Therefore, it is very important to understand Insider Trading from American point of view.

The market crash in 1929 due to prolonged "lack of investor's confidence" in securities market followed by the Great Depression of US Economy, gave rise to the enactment of the Securities Act of 1933. The foundation of Insider Trading law was laid down by the Supreme Court of US in *Strong vs Repide*. Statutory Insider Trading Laws were first passed in the year 1933 and the Securities Exchange act in 1934. The second act created SEC (Securities Exchange Commission) to regulate the secondary trading of securities. These Acts were meant to create more transparency among the investors and placing due diligence on the preparers of the documents containing detailed information about the Security.

In 1984, the case of *Dirks vs SEC*, no one was termed liable of Insider Trading as they disclosed the information for exposing a fraud and for no personal gains. This gave rise to the concept of "constructive insiders". Constructively Insiders are Lawyers, Investment Bankers and others who receive confidential information from a corporation while providing service to the corporation.

In the United States vs Carpenter, 1986, the Supreme Court cited that the usage of Inside Information received by virtue of confidential relationship must not be used or disclosed and by doing so, the individual gets charged for Insider Trading.

In 1997, O'Hagans Case, the court recognised that a company's information is its property: " A Company's confidential information qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of fiduciary duty constitutes fraud akin to embezzlement- the fraudulent appropriation to one's own use of money or goods entrusted to one's care by another."

In 2007, representatives Brian Baird and Louise Slaughter introduced a bill "Stop Trading on Congressional Knowledge Act or STOCK Act".

### **Insider Trading in India:**

1. In 1948, First concrete attempt to regulate Insider Trading was the constitution of Thomas Committee. It helped restricting Insider trading by Securities Exchange Act, 1934.
2. In 1956, Sec 307 & 308 were introduced in the Companies Act, 1956. This change made it mandatory to have disclosures by directors and officers.
3. 1979, the Sachar Committee recognized the need for amendment of the Companies Act, 1956 as employees having company's information can misuse them and manipulate stock prices.
4. 1986, Patel committee recommended that the Securities contracts (Regulations) Act, 1956 be amended to make exchanges reduce Insider Trading.
5. 1989, Abid Hussain Committee recommended that the Insider Trading Activities be Penalized by civil and criminal proceedings and also suggested that SEBI formulate the regulations and governing codes to prevent unfair dealings.
6. 1992, India has prohibited the fraudulent practice of Insider Trading through "Security and Exchange Board of India (Insider Trading) Regulations Act, 1992. Here, a person convicted of Insider Trading is punishable under Section 24 and Section 15G of the SEBI Act, 1992.
7. 2002, the Regulations were drastically amended and renamed as "SEBI (Prohibition of Insider Trading) Regulations, 1992.



## Why to Control Insider Trading?

- To protect general investors. The manipulation of market by using Insider trading generally causes great losses to a company, thus leading to loss for investors or great profit only for the Insiders and no investor. It steals away the possibility of earning profit from an investor.
- To protect the interest and reputation of the company. Once a company faces a problem of Insider Trading, investors tend to lose confidence in the company and stop investing in the company and also selling all the stocks of the company.
- To maintain confidence in the stock exchange operations. With SEBI also regulating all the tradings, if any Insider gets a chance to get past the laws, it decreases the investors' confidence in the stock exchange operations itself.
- To maintain Public confidence in the financial system as a whole. Indian Financial Market is still very low in the domestic investment rate. To have a healthy economy, a proper financial system is a must and for that, confidence in the market is of utmost importance.

## Rationale behind Prohibiting Insider Trading:

Securities market deals with the allocation of capital in an economy. This function enables market efficiency, where market's price reflects the risk and future returns accurately. Insider trading appears biased to investors as insiders have additional price sensitive information before them and can use it to make profits while the late reception of information makes investors suffer loss or not gain the deserved profits. If a market is integrated and free of illegal trading, it may lead to healthy growth of the market and such markets can inspire the confidence of the Investors.

Insider trading leads to loss of confidence of Investors on the market which can lead to a halt in market dealings thus causing a situation similar to the Great Economic Depression of the United States. Besides, a company's information is its property and no one but the company must profit from it.

## Significant Penalties:

- SEBI may impose a penalty of not more than Rs. 25 Crores or three times the amount of profit made out of Insider Trading; whichever is higher.
- SEBI may initiate criminal prosecution; or
- SEBI may issue order declaring transactions in Securities based on unpublished price sensitive information; or
- SEBI may issue orders prohibiting an insider or refraining an insider from dealing in the securities of the company.



## Methods of Prevention of Insider Trading:

### 1. Disclosure of Interest by corporate insiders.

#### a. Listed companies:

-If change exceeds 2% of the total voting right of persons holding more than 5% of the shares/voting rights.

-If change exceeds Rs.5,00,000/25000 shares/ 1% of capital by Directors and officers.

#### b. Other entities:

-Initial statement of holdings.

-Periodic statement of holdings.

This can show any suspicious time based and trading based activities by Insiders.

### 2. Disclosure of Price Sensitive Information:

- ✓ Limited access to price sensitive information, for ex.: Need to know basis.
- ✓ Dissemination of information by the Stock Exchange.
- ✓ Transmitting information to news agency.

### 3. Chinese Wall:

- ✓ Separate inside area from public areas.
- ✓ Bringing over the wall.

### 4. Trading Window Facility:

- ✓ Decided by the company.
- ✓ Closed during the time price-sensitive information is not published.
- ✓ Opened 24 hours after the information is made public.
- ✓ Allowing the exercise of ESOP.

### 5. Minimum holding period:

-Securities to be held for minimum period of 30 days to be considered investment.

-30 days holding from the date of IPO allotment.

- Only personal emergency cases be excluded.

### 6. Pre-clearance of trades prevents Front Running.



# **INSIDER TRADING REGULATIONS, 2015 – AN OVERVIEW**

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The new Insider Trading Regulations has brought about several changes by amending definitions of various concepts. It comprises of Five Chapters, Two schedules and 12 sections. First Chapter deals with the definitions, second deals with the Restriction on Communications and Trading by Insiders. Chapter 3 talks about the disclosures made by the company and four prescribes a Code of Disclosure and Conduct. Chapter 5 consists of Power and Sanctions.

## **Salient features of the Regulations are:**

1. Every connected person is an Insider. The term includes Relatives and public servants also who have expected to have access to UPSI.
2. Definition of UPSI has changed. Any information not generally available to public, which when available may materially affect the price of the securities are included in UPSI. For eg.: Financial results, Dividends, Change in Capital structure, Mergers, demergers, acquisitions, delisting, disposals and expansion of business, changes in key managerial personnel, etc.
3. Trading Plans are novel concepts introduced in the regulations wherein Insiders who are liable to possess UPSI all-round the year are permitted to formulate trading plans with appropriate safeguards.
4. Every listed company must formulate and publish a code of practices to be followed for safe and fair disclosures UPSI in accordance to principles set out in Schedule A to the Regulations.
5. Notional trading windows are set to 48 hours after the UPSI information becomes public.
6. Due diligence may be conducted when the Board is of the opinion that the merger or transaction is in the best interest of the company.

## **Exceptions to Insider Trading**

The distinction between legally permitted trading and illegal insider trading must be carefully understood. It is but natural for an Insider to know some inside information of a company which is expected of their job. It would be violation of human rights and would defy the logic freely tradable securities if Insiders are not permitted to trade for themselves. That would be unreasonable. It would be irrational to stop promoters of a company from dealing in their securities.

Thus the restriction on the corporate insider is directly or indirectly using the price sensitive information that they hold to the exclusion of the other shareholders in arriving at trading decisions. There is absolutely no restriction on insiders in trading in securities of the company if they do not hold any price sensitive information that the public is not already aware of. During the short while promoters and insiders can use the information to their advantage by guessing market reaction to the news or information.

# LAND MARK CASES

## HINDUSTAN LEVER LIMITED VS SEBI

### Facts

Hindustan Lever Limited (HLL) and Brooke Bond Lipton India Limited (BBLIL) were subsidiaries of a common parent company called Unilever Inc in UK and were under the same management. HLL purchased 8 lacs shares of BBLIL from UTI on the 25<sup>th</sup> March 1996 at the rate of Rs.350.35 per share. A merger announcement was made 25 days after the purchase transaction had taken place. HLL announced its merger with BBLIL and notified the same to the stock exchanges. BBLIL's share price shot up by Rs. 50 per share after the merger.

SEBI was notified about the leakage of the merger information and insider trading by the market as well as the media. Therefore, SEBI had initiated investigations into the matter and found that HLL as an Insider had purchased the securities of BBLIL from UTI on the basis of the Unpublished Price Sensitive Information (UPSI) about the impending merger, thereby violating the provisions of the Insider Trading Regulations and the SEBI Act. As a result, UTI incurred losses.

SEBI in exercise of its powers under Section 11 B of the SEBI Act read with Regulation 11 of the Insider Trading Regulations had directed the HLL to compensate UTI to the extent the UTI had suffered losses. SEBI estimated the losses caused to UTI to the tune of Rs. 3.04 crores. The basis for this calculation was the difference between the market price of the shares of BBLIL at which the shares were sold by UTI to HLL before the announcement of merger and after the announcement excluding premiums. UTI and HLL filed separate appeals against the SEBI's order before the appellate authority.

### Question of Law:

The interpretation of the term "Insider" under Regulation 2 (e) of the Insider Trading Regulations was one of the key issues under consideration, before the appellate authority in this case. In this regard, the appellate authority observed that the definition of Insider should have three ingredients:

1. The person should be a natural person or legal entity.
2. The person should be a connected person or a deemed to be connected person.
- Acquisition of UPSI should be by virtue of the connection.

The SEBI had also interpreted in its order, the third requirement of acquisition of UPSI by the Insider by virtue of the connection with the company by envisaging two alternative situations:

- Where the Insider is reasonably expected to have access to UPSI by virtue of connection with the company.
- Where the Insider has actually received or had access to such

SEBI had concluded that if a connected person actually gains or receives such information independently, notwithstanding his position in the company, such person will fall within the definition of "Insider" and therefore SEBI regarded HLL as an Insider. This was upheld by the Appellate Authority.

### Judgement

However, the Appellate Authority overruled the SEBI's order on the following grounds:

1. The news about the merger was not a UPSI as it was generally known and acknowledged by the market.
2. The information relating to a merger could not have significant impact on the price at which the transaction was concluded.
3. SEBI's decision to award compensation to UTI suffered from procedural defects.
4. SEBI's direction to HLL to compensate UTI lacks
5. SEBI's direction for prosecution under Section 24 of the SEBI Act, was bad in law as the order did not state the reasons for prosecution and also SEBI did not state the reasons for prosecution and also SEBI did not invoke specific powers for adjudication under Section 15 G of the SEBI Act.



Therefore, SEBI's decision to prosecute HLL was set aside by the Appellate Authority.

### **DILIP PENDSE VS SEBI**

Nishkalpa was a wholly owned subsidiary of Tata Finance Ltd (TFL), which was a listed company. Pendse was the Managing Director of TFL. On 31<sup>st</sup> March 2001 Nishkalpa had incurred a huge loss of Rs. 79.37 crores and this was bound to affect the profits of Tata Finance Limited. This was basically an Unpublished Price Sensitive Information (UPSI) which Pendse was aware. This information was disclosed to the public only on 30<sup>th</sup> April 2001. Thus any transaction by an Insider within the period of 31/03/2001 and 30/04/2001 was bound to fall within the scope of Insider Trading. Dilip Pendse passed on this information to his wife who sold 2,90,000 shares of TFL held in her own name as well as in the name of the companies controlled by her and her father-in-law. SEBI levelled charges against Dilip Pendse for Insider Trading.

However, SAT in its recent ruling turned down the charges of Insider Trading as against Pendse on account of failure to adhere to the fundamental principle of permitting cross examination of a person on whose statements such charges were established and it lacked the necessary evidence.

This case testifies the fact that SEBI lacks a thorough investigative mechanism and a vigilant approach due to which culprits are able to escape from the clutches of law. In most of the cases, SEBI failed to adduce evidence and corroborate its stance before the Court. Unlike the balance of probabilities that is required in proving a civil liability, a case involving criminal liability requires the allegations to be proved beyond reasonable doubts. Therefore, there should be thread bare investigation and all loopholes if any should be properly plugged in.

### **SECURITIES EXCHANGE COMMISSION VS RAJAT GUPTA**

The Securities Exchange Commission's (SEC) complaint alleged that Rajat. K. Gupta tipped his business associate Rajaratnam who was the Founder and Managing Partner of Galleon Management certain confidential (insider) information worth billions which Rajat had learnt in the course of his duties when he was a member of the Board of Directors of the Goldman Sachs Group, Inc. The complaint alleged that Gupta disclosed material non- public information concerning Berkshire Hathaway Inc's 5 million US Dollars investment in Goldman Sachs in September 2008.

Rajaratnam used the information he learned from Rajat to trade profitably in Galleon hedge funds. By engaging in this conduct Rajat and Rajaratnam violated Section 10(b) of the Securities Exchange Act, 1934, Exchange Act Rule 10b-5 and Section 17(a) of the Securities Act of 1933. On June 15, 2012 in a parallel criminal case arising out of the same facts, Gupta was convicted on one count of conspiracy and three counts of securities fraud.

On October 24, 2012 Gupta was sentenced to two years in prison and one year of supervised release, and ordered to pay a fine of 5 million US Dollars.

The Securities Exchange Commission (SEC) ordered Rajaratnam to disgorge his share of profits gained and losses avoided as a result of Insider Trading plus pre-judgement interest.

## **CONCLUSION**

Insider Trading in India has been of great effect in the past few years and SEBI is dealing with it in a head on manner. The New Insider Trader Regulations, 2015 is much appreciated as it deals with a wide range of problems related to Insider Trading and also has severely reduced loopholes. The New Regulations would also build up trust and confidence of the investors and reduce fraudulent practices.

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