Insider Trading : An Overview

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INSIDER TRADING: AN OVERVIEW

INTRODUCTION:

On October 16, 2009, the FBI arrested Raj Rajaratnam, a Sri Lankan born American citizen of Tamil origin. He was arrested on charges of insider trading. He founded the Gallon Group, a hedge fund management firm in New York. On October 13, 2011, Rajaratnam was sentenced to 11 years imprisonment.

Insider Trading basically refers to buying, selling and dealing in shares and securities of a listed company by insiders, directors, designated officers of management team, employees of the company or any other connected persons such as auditors, consultants, lawyers, analysts who possess material inside information which is not available to general investors.

"Insider trading" is a term subject to many definitions and meanings and it envelopes both legal and prohibited activity. **Insider trading** is the buying and selling of a company’s stock or other securities (e.g. bonds or stock options) by people with adequate access to non-public information about the company.

For regulating insider trading, SEBI (Prohibition of Insider Trading) Regulations, 1992 have been passed. This Regulation contains 15 regulations and 3 schedules with 4 Forms portraying 2 model codes of conduct. The main aim of these regulations is to prevent misuse of any un-published price sensitive information by the insiders viz. the directors, officers, auditors, lawyers, bankers’ etc. and to stop taking unfair advantage by the aforesaid persons over other common investors of securities of a listed company. Insider information is one which is likely to have impact on the company’s shares and other securities in the market and trading based on such information is unfair and also legally and economically undesirable.

MEANING OF INSIDER:

The term ‘insider’ is defined in Regulation 2(e) SEBI (Prohibition of Insider Trading) Regulations, 1992 as follows:

(i) any person who is or was connected with the company or is deemed to have been connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of the company; or

(ii) has received or has had access to such unpublished price sensitive information.

Insider trading can be illustrated by the following case:

Mr. Rajiv Gandhi was the CFO of Wockhardt, a pharmaceutical company. On May 9, 2008, Gandhi along with his wife and sister were upheld as guilty of Insider Trading by the Securities Appellate Tribunal (SAT). The Gandhis were all designated insiders according to SEBI’s Insider Trading Regulations. They breached SEBI’s rules, which state that no insider can deal in shares on the basis of any unpublished price sensitive information. Between January and October 1999, Sandhya Gandhi and her sister-in-law Amishi bought and sold Wockhardt shares close to the occurrence of important financial events in the company. For example, on January 21, Amishi and Sandhya Gandhi sold Wockhardt shares only a few hours before an important company board meeting and then again a few minutes before results were disclosed to the stock exchanges the next day.
On April 22, Amishi Gandhi sold shares before a board meeting in which the demerger of Wockhardt’s businesses was announced and later purchased shares the next day after the meeting when the price had drastically fallen.

On this case, Ravi Kulkarni, Partner, Khaitan & Co said, “Who is the person who is trading, he is not some ordinary person, he is the CFO of the company and his wife and his sister traded in large quantities. So, there is absolutely a prima facie presumption that all this was being done on the basis of some previous knowledge.”

The Gandhis do not deny being insiders or having inside information but they deny trading on the basis of that information. They claimed that many of their trades resulted in losses.

SAT’s decision recapitulates the law that states, “The onus would be on the insider to show that he did not trade on the basis of price sensitive information and that he traded on some other basis. He shall have to furnish some reasonable or plausible explanation of the basis on which he traded.”

TEMPORARY INSIDER:

So does that mean that someone who is not on the company’s management team s not an insider? In a single word, ”No”.

The US Securities and Exchange Commission includes in its definition of insider those who have "temporary" or "constructive" access to the material information. If the CFO of a company informs you that the company's best hope for a breakthrough product isn't going to get regulatory approval, you are now every bit as much an insider as he is, with respect to that information. It is wrong on his part to trade based on that knowledge before it becomes public. In the same way, it is equally illegal for you to do so because you are now a "temporary insider". This remains true regardless of how many times the information is passed. If the President of a company tells A, who tells B, who tells C, who tells D, then A, B, C and D are all "temporary insiders".

Anyone who has material information about a company is prohibited from trading, on the basis of that knowledge, until the information is available to the common public. The US Supreme Court ruled , that this may apply to someone with no ties with the company. Possession of material information makes you an insider, even if the information was stolen.

THEORIES OF INSIDER TRADING :

There are two theories of insider trading -

Classical Theory: The classical theory of insider trading imposes liability on corporate insiders on the basis of confidential information obtained because of their position with the company. The liability is based on the idea that a corporate insider breaches a duty of trust and confidence to the shareholders of his company.

Misappropriation Theory: The misappropriation theory imposes liability on outsiders who trade on the basis of confidential information obtained because of their relationship with the person possessing such information, usually an insider. The liability under the latter theory is based on the idea that the outsider breaches a duty of loyalty and confidentiality to the person who shared the confidential information with him.
TAKING A LEAF OUT OF A LESSON FROM UNITED STATES:

The United States has been the leading country in preventing insider trading. It has set benchmarks in having regulations for insider trading. United States is the first country in the world to have a comprehensive legislation on insider trading in place. It has tackled these menacing problems effectively. Therefore it is important to have a conceptual understanding about insider trading from the American perspective. Unlike our country where the insider trading regulations came into being as late as 1992, insider trading regulations were in vogue in America from 1929. The year 1929 has a special significance because the great economic depression which engulfed the entire world came into effect from the same year. Due to the economic debacle Congress made a law to protect the investors and keep markets free from fraud. This catastrophe led to the enactment of the Securities Exchange Act of 1933 in the United States.

Section 17 Securities Exchange Act, 1933 contains prohibitions to deal with fraud in the sale of securities in the most stringent manner possible. The Act addresses insider trading through Section 16(b) and Section 10(b). Section 16(b) of the Act prohibits the purchase and sale of the shares within a six month period involving the directors, officers, stock holders owning more than 10% of the shares of the company. The rationale behind the laying down of this provision is that it is only the substantial shareholders and the persons concerned with the decision and management of the corporation who have access to the price sensitive information and therefore there should be a bar upon them to transact in securities. Section 10(b) of the Act, SEC Rule 10b-5 prohibits fraud related to trading in the securities. Further the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 provide for penalties for illegal insider trading. The penalties are burdensome and strict in nature. It may be as high as three times the profit gained or the loss avoided from the insider trading.

REGULATION OF INSIDER TRADING IN OTHER MARKETS:

European countries have specific and detailed legislations defining the contours of insider trading prohibition. The key terms constituting insider trading offense are set forth by statutes. Note that a lot of interpretive issues remain embedded in these statutes. The concept of materiality is connected to the information’s impact on market price. The laws of the following jurisdictions focus their inquiry on the information’s effect on the market price of the subject security: Canada, Mexico, United Kingdom, France, Germany, Italy, Australia. Many countries opt for an insider trading proscription premised on the “access” doctrine. As a generalization, this standard prevents insider trading by those who have unequal access to the material non public information. This general approach is implemented by United Kingdom, France, Germany, Italy, Canada, Mexico. There are other countries who have a more straight forward approach
than the U.S. standards. For instance, under German law, primary insiders neither may trade nor tip. A few jurisdictions opt for an expansive approach premised on the parity information principal. For example, Australia’s prohibition against insider trading extends to any person or entity who possesses confidential price sensitive information.

**ILLUSTRATIVE CASES:**

In the case of **Samir C. Arora vs. SEBI**, Mr. Arora was ordered by SEBI not to buy, sell or deal in securities, in any manner, directly or indirectly, for a period of five years. If Mr. Arora desired to sell the securities held by him, he required a prior consent of SEBI. Mr. Arora contested this order of SEBI in the Securities Appellate Tribunal. SAT set aside the order of SEBI on grounds of insufficient evidence to prove the charges of insider trading against Mr. Arora.

In **Rakesh Aggarwal Vs SEBI**, Rakesh Aggarwal, the Managing Director of ABS Industries Ltd. (ABS), was involved in negotiations with Bayer A.G (a company registered in Germany), regarding their takeover of ABS. Being the Managing Director with such high portfolio he had access to the price sensitive information. Rakesh Aggarwal in order to escape from the vigilant eyes of SEBI wanted to circumvent the provisions of law through a tactful manner. Before the merger is made public through announcement, he made a collusive agreement with his brother to take over the shares of ABS from the market. Then he tendered the same shares through the open offer making a huge profit. These clandestine agreements were traced by SEBI through their investigations. Bayer AG acquired ABS.

**PENALTIES :**

SEBI can impose the following penalties in case of violation of SEBI (Prohibition of Insider Trading) Regulations, 1992:

- It 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.
- It may initiate criminal prosecution
- It may issue orders declaring transactions in securities based on unpublished price sensitive information
- It may issue orders prohibiting an insider or refraining an insider from dealing in the securities of the company.

The securities market is concerned with the allotment of capital in the economy. This function is eased by market efficiency, the situation where the market price of each security accurately reflects the risk and return in its future. The most important function of the regulation policy is to improve market efficiency
thus, we should evaluate the impact of insider trading on market efficiency. The individual and institutional investors suffer badly due to insider trading and thus, insider trading should be prevented.

CONCLUSION:

In this era of liberalization, privatization and globalization, there is heavy flow of foreign direct investment where there is participation from foreign companies. The disclosure of price sensitive information before the publication really casts aspersion on the role of the SEBI. India has to strengthen its enforcement of recently amended insider trading act and prove to the domestic and foreign investors that this is a fair and transparent securities market, where strict compliance of the prohibition is ensured by the enforcement agencies. Further, there should be a provision of civil penalties, like in US, where the penalties are based on the profit made or loss avoided.

Preventing insider trading is not about a set of rules or filling loopholes. It is about a determination to prohibit illicit trades and the power to punish offenders. Until SEBI shows it is serious about checking insider trading, illegal trading will continue to thrive unchecked. For that the authorities have to ensure that the SEBI Regulations on Insider trading is a separate code by itself. Preferably, it must be made into a separate Act as a part of general law relating to frauds, like the US. This will determine that SEBI does not have to draw concepts and principles from the UK and US laws to strengthen its case. On the other hand, it must also avoid the impression that there is ambiguity or weakness in the Indian Insider Trading Regulations.