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Insider Trading Regulations: A Small Debate

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Abstract:
Insider Trading simply means that insider is trading in the securities of the concerned company. It is very well accepted that it is an unfair practice. But why an insider cannot trade in the companies' securities, when it makes sense for the members to feel an extent of belongingness towards the company they are working for? Doctors charge fees because of the knowledge they have; lawyers charge because of the skills and qualifications they possess; then why can't company members make profits because of the information they are privileged with? Such arguments and effectiveness of insider trading regulations are discussed in this paper.

Keywords: *Effectiveness, Information, Insider Trading, Regulations*

1. Introduction

Insider Trading simply means that insider is trading in the securities of the concerned company. To be precise, it deals with the time periods when insiders are in possession of non public price sensitive information. An insider is a person who is or was connected with the company or is deemed to have been connected with the company and is reasonably expected to have access to unpublished price sensitive information in respect of securities of the company; or has received or has had access to such unpublished price sensitive information (Section 2(e) of SEBI (Prohibition of Insider Trading Regulations) 1992). And 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 (Section 2(ha)). Here, I would like to mention that in India, insider trading is regulated by Companies Act' 1956 (now Companies Act' 2013) and SEBI (Prohibition of Insider Trading Regulations) 1992 (will soon be replaced by Regulations proposed in 2013). Moreover, it has been explicitly stated in Companies Act' 2013, that power to enforce the provisions on insider trading under the Act will be delegated to Securities and Exchange Board of India, with respect to listed companies. There are various benefits of regulating insider trading: good image of capital market, efficient allocation of resources, etc. If insider trading occurs frequently, this would create lack of belief in the fairness of capital market, thereby disabling companies to raise fresh capital. However insider trading leads to more accurate stock prices and reduces search costs for others. Greater involvement by courts increases the latitude for investors to trade on the basis of more privileged information that is not covered by law (Seyhun, April 1992). Now, let us discuss about the insider trading regulations in India followed by the effectiveness of such laws and conclusion.

2. Insider Trading Regulations in India:

There are two main sources of insider trading regulations in India: Companies Act under the administration of Ministry of Corporate Affairs and Regulations for prohibition of insider trading under the power of Securities Exchange Board of India (SEBI). Let us start discussing them one by one.

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2.1 Section 195 of Companies Act' 2013

Insider trading means,

(i) an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer of the company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or

(ii) an act of counselling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person;

If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.[1]

2.2 SEBI (Prohibition of Insider Trading Regulations) 1992

No insider shall either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange while in possession of any unpublished price sensitive information; or communicate or counsel or procure directly or indirectly any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information shall not deal in securities : Provided that nothing contained above shall be applicable to any communication required in the ordinary course of business. [2]If contravened, then penalty involves imprisonment up to 10 years.

2.3 Proposed Revisions in above regulations, 2013

In 2013, SEBI appointed an 18 member committee under the chairmanship of Justice N. K. Sodhi to remove the vagueness of existing regulations on insider trading. Under the proposed regulations, insider is broadly defined in two ways: as a connected person and as any outsider in possession of unpublished price sensitive information (UPSI). Connected persons even include the usual appointments of external consultants and advisors, along with a judge adjudicating a case of the company. Another feature is that information asymmetry prior to takeovers, amalgamation be removed by exercise of due diligence by the companies (by disclosing price sensitive information). However, exceptions are there.

3. Effectiveness of Insider Trading Regulations

United States was first country to legislate against insider trading via Securities and Exchange Commission (SEC). India took its first step in this area in 1948 by constituting a committee under the chairmanship of Dr. P. J. Thomas (Insider Trading Regulations - A primer, July 2013). SEC, USA has been playing an important role in shaping the insider trading regulations around the globe. Majority of the countries in the world provide provisions to penalise insider trading.

But, why it exists at all? As per an article (Beams, Brown, & Killough, July 2003) expected gain, cynicism, guilt and fairness of laws were the determinants of insider trading. These factors are self explanatory like if gain expected out of such buying and selling is high, then insider might take the pain of planning and executing the whole tension of insider trading. Also, if there is less belief in the fairness of laws, then chances of insider trading are greater. Moreover, it is done to avoid a loss rather than create an abnormal gain. The above mentioned article studied the issues that affect compliance with insider trading laws. On one hand insiders are encouraged to invest in the company where they work via personal buying and selling and/or stock options, but if they trade on the basis

[1] Website of Ministry of Corporate Affairs, available at http://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf, page 119
[2] Website of Securities and Exchange Board of India, available at http://www.sebi.gov.in/acts/ir1992.pdf

of non public price sensitive information, they land up themselves in illegal practice. All this arises because of information asymmetry which is necessary for the success of the company. SEC has changed some rules on insider trading in order to deal with increased cleverness of people. Firstly, it provides that if an insider trades during the period when he is in possession of non public price sensitive information, then it is believed that he traded on the basis of that information, except when such trading was part of some previous contract(when no such information was received). The second change is regarding duty of trust which extends to certain family relationships. E.g.: A stockbroker was convicted of insider trading on the basis of insider information which flew as: President to his sister to her daughter to her husband to the defendant (Burns 12-15-99).

Having discussed the regulations, now I come to the arguments against these regulations. The *first* argument against the effectiveness of insider trading regulations is that information is an intangible commodity and government cannot control its circulation unlike goods, services and factors of production. Law could ensure that an employee does not trade after knowing an important piece of information, but it cannot stop that employee from communicating such information to third parties. Cycle does not stop here, as third parties can communicate such information to further parties, thereby creating an untraceable complex network (Padilla, 2011). Suppose a company hires a printer to print a pamphlet on not yet announced take over, and such printer uses this information to trade in the securities of the company, thus engaging in insider trading. Thus, it is not necessary that only people inside the organisation can engage themselves in insider trading. Also, a friend of insider (Section 6 of Companies Act'1956 defines the term 'relative' which comes under 'connected person' to the company in defining an insider; and term relative does not include the word 'friend'.) might trade on the basis of information provided by insider, thus 'insider trading', can be said to be a misnomer. It is not only a misnomer, but also ambiguous, because if a director personally feels that long term prospects of the company are favourable and thereby invests in the stock of the company, then this is something which is desired by shareholders because they want company directors to have stake in the company; and legal if reported about the transaction to SEC. So, it is ambiguous in the sense that it symbolically illegalises the trading on the basis of non privileged information as well. Proper terminology would be 'trading on the basis of inside information' (Irvine, 1986)**.**

Secondly, intangible property of information raises another problem, that is, that it is difficult for law to prove that insider traded on the basis of inside information and not genuinely. SEC relies on informants, circumstantial and statistical evidence to detect and prosecute insiders. How is it done? SEC observes whether trading volume of an insider is abnormal than usual. Whether transaction took place prior to significant subsequent price movement? But, here is a problem. When insiders know how they are going to be traced, then they'll modify their behaviours strategically to have maximum gain (Padilla, 2011). ***Thirdly,*** as empirical studies show, insiders trade on inside information, months and sometimes years ahead of a takeover or a bankruptcy announcement, but as the announcement day nears, insiders reduce their transaction volume and, then, stop trading. ***Fourthly,*** while insiders have an informational advantage by holding information not yet available to the public when they are making their decision, the success of their expectations is conditional upon the other market participants' interpretations regarding the information and resulting expectations once the non-public information has been disclosed to them.[3] So, an insider might have undertaken planned trading but will remain outside the sight of law because of absence of any signal. Suppose there is a growth plan with the company and an insider on the basis of this information buys 1000 shares, believing that he'll sell them off after the hike in share prices (due to increase in demand after disclosure of growth plan). But, if demand does not increase as investors didn't deem it to be an appropriate plan and share prices remain same or fall instead of rising; then the initial insider trading

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3 Padilla, A. (2011). Should the government regulate insider trading? *Journal of Libertarian Studies* , *22*, 379-398.

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decision will remain outside the sight of law, because it then would remain a transaction prior to significant price movement. ***Fifthly,*** as per one article (Irvine, 1986); Mr. Winan was a reporter who used to give his opinion on the growth prospects of various companies. In 1983, he recommended the stocks of company-American Surgery Centres. He allegedly recommended so, so that his roommate, an owner of the shares in that company, could make profit. And this was accomplished successfully. Now, what would this be called? Law should focus its attention not on the insider traders but on the corporate secrecy that makes insider trading possible. So, we need to do is expand reporting requirements. ***Sixthly,*** the difference between legal trading by insiders and illegal trading is not clear; because of the fact that insiders are always in possession of some information which outsiders don't know and it is not possible to have a law which states that insiders are completely prohibited to trade in the securities of the company they work for. This distinction is required to be properly defined (Insider Trading Regulations - A primer, July 2013).

4. Conclusion

We discussed the meaning, merits and demerits of insider trading. Thereafter we discussed the insider trading regulations in India and briefly about SEC; followed by the effectiveness of such regulations. It emerged that effectiveness is close to partial. Then, who can regulate insider trading? Three options are there: corporations, stake holders or both. Corporations can restrict the access to information and both, like SEC, could require every manager, director owning more than 10& of equity, to report their stock portfolio and transactions. Stock exchanges can look at the abnormal price swings and trade volume to detect insider trading. They can make it mandatory for companies to have tight anti insider trading policies if they require to access primary funds (Padilla, 2011).

Other key measures could be: Disclosure(there can be two kinds of disclosure, one to prevent insider trading in the form of disclosure of material information and other to reveal any insider trading by disclosing the transactions undertaken.); trading restrictions when they are in possession of such information and for few days after that, this might include a measure that insiders are allowed to trade only through designated trading window monitored by a responsible stock exchange; pre clearance of trades: which means that insiders would always have to get prior approval from a regulatory or other body before trading and will be allowed to trade during the stipulated time period (Insider Trading Regulations - A primer, July 2013).

As we are thinking of other effective measures of prohibiting insider trading, this shows that this practice is not desirable. Satyam, for example, was subjected to a colossal fraud majorly on the basis of insider trading, and we all know that shareholders sufferings' have not yet been compensated. Therefore, it can be said in the end that this undesirable practice should be well regulated effectively by a combination of parties – government, companies and stock exchanges, along with inculcation of its disastrous effects in the education, training and growth programmes around the universe. It should be taught to the students from the early and appropriate stage that stock market becomes the game of 'greed and fear', if even one of the participants is not playing clean.

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