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INSIDER TRADING IN INDIAN STOCK MARKET AND IT'S IMPACT ON MARKET EFFICIENCY

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Abstract

Insider trading refers to illegal or unlawful trading of securities which includes buying and selling of a publicly traded company's securities while being in possession of the confidential material information which is not known to the public which results is disadvantage to the other stock holders. Insider trading or market manipulation is prohibited and is highly discouraged by the Securities and Exchange Board of India in order to promote fair trading of securities in the Indian stock market and for the general benefit of the common investor.

In simple terms, insider trading or market manipulation refers to the use of material information that is not open to public for trading securities. This material information refers to and includes all the information pertaining to the securities of the company which may have a substantial impact on the decisions of an investor regarding buying or selling of securities. All of the non-public information includes that information which are not legally available for the public and only a bunch of people are aware of it. For example, a high-level employee who have the knowledge about the merger of his company and its impact informs this piece of information to an outsider who decides to buy more shares of the company in order to gain additional profits.

The laws governing insider trading differ from country to country. In India the Securities and Exchange Board of India is responsible for regulating the capital market. Insider trading or market manipulation is prohibited by SEBI and the person found guilty of the same is charged with an imprisonment for a period of 5 years and a fine of Rs. 5 lakhs to Rs. 25 crores or three times the profit earned out of insider trading whichever is higher

Keywords - Securities and Exchange Board of India, Securities Contract Regulation Act, Insider, Unpublished Price-Sensitive Information

OBJECTIVE OF THE PAPER

The object of this paper is to analyse and review the concepts of insider trading and market manipulation in the Indian securities market. This paper also depicts the impact of insider trading on market efficiency and investor's confidence. This paper while clarifying the laws also pinpoints the modern trends and challenges regarding same.

RESEARCH QUESTIONS

There are primarily three qualitative research questions that are addressed in this paper. They are as follows:

- What impact does the insider trading have on the efficiency of the securities market in India?
- How has the development of technology and artificial intelligence helped in detection of insider trading?
- What are the modern trends and challenges regarding same?

RESEARCH METHODOLOGY

The research conducted for this paper is secondary and a qualitative approach for the same has been adopted. This research paper aims to explore the legal aspects of insider trading and its impact on the market efficiency and investment in the securities market. A qualitative approach was used for all the data collection. All the data was collected through various online sources like websites, scholarly articles, research papers, etc. The case laws are investigated from different sources such as Manupatra and SCC Online.

CHAPTERISATION

1. Historical Perspective on Insider Trading
2. Insider Trading
2.1. Who is an Insider?
2.2. Price Sensitive Information
3. Effects of Insider Trading
4. Legal Framework of Insider Trading
5. Impact of Insider Trading on Market Efficiency
6. Role of Corporate Governance in Preventing Insider Trading
7. Modern Trend and Challenges regarding Insider Trading
8. Suggestions
9. Conclusion

HISTORICAL PERSPECTIVE ON INSIDER TRADING

The history of insider trading in India dates way back in 1940s. Therefore, the Companies Act 1956 incorporated section 307 and section 308 which provided for maintenance of register of the company and directors to make disclosure regarding shareholdings of the company. However, the Companies Act 1956 was not sufficient enough to curb insider trading. Therefore, in absence of a specific regulation a major reliance was put on several committee reports like the Sachar Committee in 1979 that opined that Section 307 and 308 were not sufficient to curb insider trading or the Patel Committee Report in 1986 which recommended that Securities Contract Regulation Act or SCRA, 1956 should be amended in such in order to prevent insider trading and unfair stock dealings. The Patel Committee in 1986 also defined Insider Trading as, "*Trading in the shares of a company by the person who are in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others*".[1]

After the recommendations of various committees and the rapidly expanding securities market there was a need for establishing proper regulations to curb insider trading. Therefore, SEBI (Insider Trading) Regulations 1992 was passed. However, it was amended in 2002 after the discovery of certain loopholes in the case Hindustan Lever Ltd v SEBI[2] and Rakesh Agarwal v SEBI[3]. The regulation governing and prohibiting insider trading is currently known as SEBI (Prohibition of Insider Trading) Regulations 1992.

INSIDER TRADING

Insider trading refers to illegal or unlawful trading of securities which includes buying and selling of a publicly traded company's securities while being in possession of the confidential material information which is not known to the public.

As it is well established that market manipulation is strictly prohibited by SEBI and if it is detected by SEBI, individual may face serious civil liabilities such as securities market ban, imprisonment as well as fine. SEBI is the regulatory body for insider trading and it strictly prohibits insider trading and substantial acquisition of securities or control or the use of manipulative and deceptive devices for trading of securities.

The Abid Hussain Committee report in the year 1989 it was recommended that the act of insider trading amounts to civil as well as criminal offences and it was also further suggested that strict regulations are implemented by SEBI in order to ensure fair trading in Indian Capital Market.

Insider trading is the process of utilizing the confidential or unpublished price sensitive information regarding a company in order to trade securities. The unpublished price sensitive information is that information which

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[1] Sonakshi Das & Sanjana Sahu, 'The Know-All of Insider Trading – decades of Corruption Prevention' (Academike, 15 January 2015) < https://www.lawctopus.com/academike/know-insider-trading-decades-corruptive-prevention/#:~:text=India's%20encounter%20with%20insider%20trading,directors'%20shareholdings%20in%20the%20company. > Accessed on 14th September

[2] (1998) 18 S.C.L 311AA

[3] (2004) 1 Comp LJ 193 SAT

is not published and unavailable for general public. This information is considered as price sensitive as they relate to and has the power to influence the prices of the securities of the company.

Who is an insider?

An insider refers to the person who is in possession of such unpublished price sensitive information or other valuable information that might affect the prices of the company's securities in the market. Directors of the company or ither key managerial personnels of the company, bankers, substantial shareholders, auditors, stock exchange officials and any other person having fiduciary relation with the company may be consider as an insider. [4]

Price sensitive information

The following consists of price sensitive information of the company –

- Any decisions relating to the payments of dividends, bonus shares or right shares
- New Investment Decisions
- Any changes in the financial policies of the company
- Changes in key managerial personnel
- Any impending merger or acquisition, listing or delisting or any other transactions
- Exploration of new markets
- Any transactions relating to initiation of new sales or pricing policies
- Introduction of new products or technologies etc.

Effect of Insider trading

The practice of insider trading hampers market integrity. An efficient and effective stock market ensures and provides fair trading of securities. The following are the effects of insider trading on the market –

i. Insider trading erodes investor's faith in the integrity and fairness of the stock market.
ii. Only a handful of individuals enjoy the benefits, leaving regular investors to bear the brunt of the impact.
iii. Widespread insider trading discourages international investors from participating in the capital markets.
iv. Insider trading frequently involves manipulating stock prices to entice investors or deceive real investors into participating in transactions such as mergers and acquisitions. A dishonest investor will ultimately profit, whereas a genuine investor will ultimately lose.

[4] Akhilesh Ganti, 'What Is Insider Trading and When Is It Legal?' (Investopedia, 08 September 2023) <https://www.investopedia.com/terms/i/insidertrading.asp> Accessed 15 September 2023

LEGAL FRAMEWORK REGARDING INSIDER TRADING

The SEBI Act of 1992 and the Companies Act of 2013 forbid insider trading in India. The SEBI (Prohibition of Insider Trading) Regulations, 2015, established by SEBI, set down the guidelines for the restriction and outright ban of insider trading in India.

The regulatory authority for all Indian stock exchanges is SEBI. It has a responsibility to safeguard the interests of investors in the securities market and to control the stock market through any regulations it deems proper. By taking all necessary precautions to instill confidence in the market among investors, the SEBI fulfills its regulatory role in the share market. SEBI is in charge of conducting an investigation into complaints made by shareholders regarding any wrongdoing in the stock market. SEBI is also required by law to forbid unfair and dishonest business practices in relation to the securities markets. Any of the decisions of SEBI is challenged before the Securities Appellate Tribunal.

In the case of ***Hindustan Lever Limited v. SEBI***[5], about two weeks before a public announcement for a potential merger of HLL and Brook Bond Lipton India Limited (BBLIL), on March 25, 1996, HLL purchased 8 lakh shares of BBLIL from the Unit Trust of India (UTI).

Following an examination, SEBI determined in its Order dated March 11, 1998 (Order) that HLL qualified as an "insider" for purposes of Section 2(e) of the 1992 Regulations at the time she bought shares of BBLIL from UTI.

According to SEBI, as HLL and BBLIL were both subsidiaries of the same Unilever company with headquarters in London and practically operated under the same management, HLL and its board were aware of the merger in advance. As a result, HLL qualified as an insider under the definition provided above.

In addition, SEBI determined that HLL had UPSI, which is defined as information about mergers, acquisitions, and other corporate transactions that is not commonly known or published by such company for general information, but which, if published or known, is likely to materially affect the price of securities of that company in the market.[6]

Section 15G of the SEBI (Prohibition of Insider Trading) Regulations, 2015 provides penalty for insider trading. This Section states that any insider who,[7]

i. either on his own or on behalf of any other person deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or

[5] *Hindustan Lever Limited v SEBI* (1998) 18 SCL 311 MOF
[6] Billimoria, P, 'Insider trading: Hindustan Lever Limited v. SEBI' (Mondaq, 07 November 2017 <https://www.mondaq.com/india/securities/642056/insider-trading-hindustan-lever-limited-v-sebi> (Accessed 1st October 2023)
[7] SEBI (Prohibition of Insider Trading) Regulations, 2015

ii. communicates any unpublished price sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or

iii. counsels, or procures for any other person to deal in any securities of anybody corporate on the basis of unpublished price sensitive information

Then such a person shall be liable to a penalty which shall not be less than ten 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.

Additionally, SEBI has the authority to conduct investigations into cases of insider trading and similar issues. In order to protect the interests of investors in securities from violations of these regulations, SEBI may use its investigative powers for two main purposes -

- to look into complaints about alleged insider trading that have been made by investors, intermediaries, or other parties
- to conduct independent investigations based on its own knowledge or information.

According to the Regulations, if promoters of the company are found to have violated insider trading rules by using confidential, price-sensitive information about the company without a valid reason, they would be held accountable regardless of their shareholding level.

IMPACT OF INSIDER TRADING ON MARKET EFFICIENCY

Insider trading or market manipulation has a major impact on the Indian securities market not only in terms of market efficiency but also in terms of investor confidence.

Insider trading gives insiders an unfair edge over other investors since it gives them access to non-public information that other investors do not have access to. Because of this, the playing field in the Indian Stock market is uneven which allows the insiders a profit or a gain at the expense of loss to the general investors. This might result in the investors to lose faith in the securities market and as a result, believing that it is rigged in favor of these insiders. Therefore, the effectiveness and liquidity of the market can both be impacted by insider trading. The present laws need to be developed and enhanced to make them more suitable for the current situation.[8]

Additionally, these insiders may influence the price of shares to change in a way that does not accurately reflect the intrinsic value of the company as they trade by using the non-public information. Therefore, other investors may find it challenging to make wise investment decisions which in turn might result in distortion in the

[8] Garvit Tripathi, 'INSIDER TRADING LAWS IN INDIA: LACUNAE AND POSSIBLE SOLUTIONS' (Lexlife India, 2021) <https://lexlife.in/2021/07/08/insider-trading-laws-in-india-lacunae-and-possible-solutions/> accessed 19 September 2023

market's price discovery process. As investors may be reluctant to participate in a market that they believe is rigged in favor of insiders. Therefore, insider trading can also lower the volume of trades on the market.[9]

There have been several occasions in the past where insider trading has lowered investor trust and decreased market liquidity. For instance, in 2015 SEBI prohibited 59 firms from trading on the stock market due to insider trading, which caused the share prices of many of the affected companies to fall.

In the case of ***Rakesh Agarwal v SEBI***[10], A contract was struck in 1996 by Rakesh Agrawal, managing director of ABS Industries Ltd., and German company Bayer AG, which committed to buy 51% of ABS Industries Ltd. The accused liquidated a sizeable amount of his ABS Industries stock after UPSI announced the acquisition. He owned ABS Industries through his brother-in-law, Mr. I. P. Kedia. SEBI determined that Mr. Rakesh Agrawal had engaged in insider trading and ordered him to deposit Rs. 34 lakhs with the Investor Protection Funds of the Mumbai Stock Exchange and the New York Stock Exchange to cover any investors who might later file a claim.

An appeal was filed against aforementioned decision. The SAT determined in 2003 that an appellant who traded while in possession of UPSI was not guilty of insider trading because the trade was made for an authorized corporate purpose. A ban on insider trading, according to the SAT, would be pointless if the insider did not receive an undue advantage from his actions and it could not be argued that it was against the interests of the investing public. According to SAT, the 1992 Regulations were not meant to be an all-encompassing prohibition on trading and that genuine transactions made to further a company objective, fulfill a fiduciary responsibility, or act in the best interests of a group of public shareholders would not be forbidden.[11]

Implications of Insider Trading on Market Efficiency

Insider trading can have significant implications for market efficiency in India, as it does in any financial market. Market efficiency refers to the degree to which prices of financial assets reflect all available information, and insider trading can disrupt this efficiency by introducing unfair advantages for certain market participants. The following are some of the ways in which insider trading impacts market efficiency in India -

1. **Information Asymmetry**: Insider trading creates information asymmetry in the market, where insiders have access to non-public information about a company's financial health, performance, or other material information. This information is not available to the general public, leading to an uneven playing field.
2. **Distorted Prices**: When insiders trade on undisclosed information, it can lead to distorted stock prices. For example, if insiders know that a company is about to announce good earnings, they may buy shares before the announcement, driving up the price. Conversely, they may sell shares if they anticipate bad

[9] Andrew Sebastian, 'Arguments For and Against Insider Trading and Why should insider trading be illegal?' (Investopedia, 03 September 2023) <https://www.investopedia.com/terms/i/insidertrading.asp> Accessed 16 September 2023
[10] *Rakesh Agarwal v SEBI* 2003 SCC OnLine SAT 38
[11] Armaan Patka, 'Treatment of Bona Fide Trades under SEBI Insider Trading' (SCC Blog, May 11, 2023) <https://www.scconline.com/blog/post/2023/05/11/treatment-of-bona-fide-trades-under-sebi-insider-trading-regulations/> (Accessed 20 September 2023)

news, causing the price to drop. These price movements may not reflect the true value of the company's assets or prospects.

3. **Loss of Investor Confidence**: Insider trading erodes investor confidence in the fairness and integrity of the market. When investors believe that insiders have an unfair advantage, they may be less likely to participate in the market or allocate their capital to Indian stocks.
4. **Reduced Liquidity**: Insider trading can lead to reduced liquidity in the market as investors may be hesitant to trade when they perceive that they are trading against insiders with inside information. Reduced liquidity can make it more challenging for investors to buy or sell securities at desired prices.
5. **Impact on Capital Allocation**: Efficient markets are essential for the allocation of capital to its most productive uses. Insider trading can divert capital to companies or industries that may not deserve it based on their fundamentals, potentially leading to misallocations of resources.
6. **Regulatory Measures**: To counteract the negative effects of insider trading, regulatory authorities in India, such as the Securities and Exchange Board of India (SEBI), have implemented strict rules and regulations to deter and punish insider trading activities. These regulations are designed to level the playing field and promote fair and transparent trading practices.
7. **Market Repercussions**: High-profile cases of insider trading can have a severe impact on market sentiment and reputation. When insider trading scandals are uncovered, it can lead to negative publicity for the market and discourage both domestic and foreign investors.
8. **Legal Consequences**: In India, insider trading is illegal and punishable by law. Those found guilty can face fines, imprisonment, or both. These legal consequences are intended to act as a deterrent against insider trading activities.

In summary, insider trading in India, as in any other market, can undermine market efficiency, erode investor confidence, and distort price discovery. Regulatory efforts are crucial to maintaining a fair and efficient market environment and deterring insider trading activities. Investors should be aware of these risks and conduct thorough due diligence before participating in the Indian stock market.

ROLE OF CORPORATE GOVERNANCE IN PREVENTING INSIDER TRADING

Insider trading within a company can be prevented in a significant way by good corporate governance. Insider trading is the criminal act of purchasing or disposing of shares of a company based on substantial, non-public knowledge about that company. Effective insider trading prevention requires a strong corporate governance system.

A thorough code of conduct and ethics should be created by corporate governance that specifically forbids insider trading. It ought to have explicit policies and procedures for disclosing important information.

Corporate governance should enact stringent insider trading policies that specify what counts as insider trading, the consequences for infractions, and the confidential reporting procedures for workers. It should make sure that those who disclose insider trading or other unethical activities are shielded from punishment. Strong protections for persons who provide information should be part of corporate governance.

By establishing clear expectations, regulations, and processes, encouraging moral behavior, and fostering a culture of transparency and compliance inside the company, corporate governance plays a crucial role in avoiding insider trading.[12] Companies can lower the danger of insider trading and safeguard the interests of all stakeholders by adhering to sound governance standards.

MODERN TRENDS AND CHALLENGES REGARDING INSIDER TRADING

Insider trading has always been one of the acute issues in Indian securities market. Despite the stringent laws and rules in place to prohibit insider trading, insiders have occasionally participated in criminal acts of market manipulation for their own benefit. As India's securities market develops, there are emerging patterns and impending concerns in the field of trading of securities that need to be dealt with.[13]

Technological developments have significantly contributed in regulating the securities market in India. The application of technology by authorities to stop insider trading and uphold the law has consequences as well. With a wider selection of technological instruments at their disposal, authorities can employ technology more efficiently to monitor the securities markets and track any digital traces that perpetrators may leave behind.

The increased use of technology and advancement in artificial intelligence and machine learning for identifying and preventing insider trading have further led companies and firms to start using different algorithms that monitor and analyze trading patterns to detect any suspicious or criminal behavior.

The following are a few points which show case the modern trends and challenges related to insider trading –

1. **Technological Evolution:**
   With the passage of time many companies and firms use modern and advanced algorithms and high-speed data connections to execute trades within a span of few seconds which make it challenging to detect insider trading, as illegal trades can be executed and reversed quickly. Moreover, insiders may use encrypted and secure means of communication channels to share non-public information, making it difficult for regulators to monitor their activities.
2. **Cross-Border Trading:**
   The globalization of financial markets has made it more challenging to detect insider trading activities because it involves multiple jurisdictions and regulatory bodies. Thus, making the entire process very complex.

[12] Srivastava, A. (2023) 'Corporate Governance and Insider Trading in India', (Tax Guru, 14 March) <https://taxguru.in/corporate-law/corporate-governance-insider-trading-india.html#:~:text=Quoting%20%E2%80%9CUnder%20the%20provisions%20of,instructions%20in%20the%20interest%20of> (Accessed 19 September 2023)

[13] Kaif M. (2023) 'REGULATING INSIDER TRADING IN INDIA: EMERGING TRENDS & CHALLENGES', (TAX GURU, 5 March) <https://taxguru.in/sebi/regulating-insider-trading-india-emerging-trends-challenges.html#:~:text=The%20risk%20associated%20with%20Insider,regulators%20to%20identify%20insider%20trading> (Accessed: 30 September 2023)

3. **Digital currencies:**

   The emergence of digital assets like cryptocurrencies has introduced several new challenges in detecting insider trading in these relatively unregulated markets.

4. **Regulatory Challenges:**

   The established regulatory frameworks for trading are different for each country and therefore it becomes difficult to navigate through the complex web of regulations which further becomes challenging for both market participants and regulators. Moreover, there may be a gray area regarding what may be considered as a non-public or sensitive information. This creates a view of uncertainty regarding insider trading.

Addressing these modern trends and challenges regarding insider trading requires a collaborative effort among regulators, financial institutions, technology experts, and legal professionals. It involves a combination of regulatory enhancements, technological advancements, and proactive efforts to educate market participants about compliance and ethical trading practices.

SUGGESTIONS

The following are key suggestions that may help in curbing insider trading and promote a fair and transparent securities market –

- The regulators and other market players need to be on alert and keep an eye for insider trading in order to preserve the integrity of the securities market.
- With the development in the technology and emergence of tools like artificial intelligence, the future issues and developing trends must also be addressed.
- By implementing comprehensive compliance processes, citizens can jointly prevent insider trading and guarantee an honest and transparent securities market in India.
- Market players have a responsibility to do their part to protect the law and foster a setting of accountability and transparency.
- There are various strategies that can be implemented in order to handle the discrepancies in the current legal system such as dissemination of education, advice, and guidance regarding insider trading because if the general public is unaware of the actions being taken against them, they cannot be protected from them.
- Distributing guides or pamphlets and making sure it gets in reach with people who can be affected by insider trading are two things SEBI can help with.
- To make the current laws better fit the circumstances, they must be improved and developed.

CONCLUSION

Insider trading refers to the process where the individuals with privileged, non-public information about a company's securities trading those securities to gain an unfair advantage. It is generally considered illegal in most financial markets around the world, including India. It results in distortion of market prices, as those in possession of these sensitive information can make significant gains or avoid substantial losses which undermines the fundamental principle of a fair and level platform for investors.

Insider trading erodes investor confidence in the fairness and transparency of the market. When investors believe that insiders have an unfair advantage, they may be less inclined to invest in the market, reducing overall market participation.

In order to combat insider trading, several regulators like the Securities and Exchange Board of India (SEBI) have implemented stringent regulations and enforcement mechanisms. These measures aim to detect and penalize insider trading activities, thus enhancing market integrity.

In conclusion, insider trading has a negative impact on market efficiency in India, as it distorts prices, erodes investor confidence, and can lead to an inefficient allocation of capital. However, regulatory measures and enforcement efforts by authorities like SEBI are aimed at curbing insider trading and improving market integrity. Achieving and maintaining market efficiency requires continued vigilance in deterring and prosecuting insider trading activities.