REGULATION OF INSIDER TRADING IN INDIA: ASSESSING THE OBSTACLES AND POSSIBLE SOLUTIONS

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Methodology and Scope

This paper aims to assess the lacunae in the regulatory framework, legal regime and enforcement mechanisms that has brought about insufficiency in convictions and the severe paucity of insider trading prosecution in India. The same is done by analysing several material factors that hinder effective regulation, surveillance, and enforcement in the capital markets, in some instances by drawing a comparative analysis with the approach adopted by regulators in more advanced economies namely the Securities and Exchange commission (SEC) the regulatory agency for the United States.

Introduction to Insider Trading

Henry G. Mane a stalwart and founder of law and economics discipline defines Insider trading as the "*the practice of corporate agents buying or selling their corporation securities without disclosing to the public significant information, which is known to them, but which has not affected the price of the security"*[1]. In layman's language it refers to dealing in a company's securities on the basis of confidential information regarding the company that can materially affect the value of the securities referred to as "Unpublished Price Sensitive Information" or UPSI and which has not been published or made available to the shareholders of the company and the public at large. The "insider" therefore makes unjustly gains or manages to avoid a loss by engaging in this act which is in clear violation of the fiduciary duties of the personnel of a company, or the connected persons towards the shareholders as laid down under the "Securities Exchange Board of India (Prohibition of Insider Trading)

Regulations, 1992"[2]. The primary intend of Insider trading laws and regulation is to curtail "Insiders" from capitalising on UPSI and curb the information asymmetry arising due to the

[1] Henry G. Manne, "Definition of Insider Trading" in Fred S. McChesney (ed.) The Collected Works of Henry G. Manne 364 (2009)
[2] Securities Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992.

unavailability of the same to the other market participants with the overarching intent of levelling the playing field for all the stakeholders in the market.

Insider Trading Regulations in India

With the rapid expanse of the Indian economy and financial markets it is not surprising that there has also been a rampant increase of financial crimes especially Insider trading in the Indian capital markets. An ardent check on such crimes is imperative if India wishes to attain the status of a cohesive investor haven and rank amongst other major global economies.

With this as the backdrop it is shocking that as per an RTI reply dated 23rd November 2019[3] the number of "convictions under the ambit of Insider trading amounted to Zero for the period from 2014-2019"[4]. In a country like India wherein the "average daily traded equity value is in the tune of 70,000Cr Indian Rupees"[5] it is nearly impossible for this five-year period time frame to go by without any insider trading convictions. Insider trading remains within the ambit of the Securities Exchange Board of India (SEBI) which was set up in 1988 under the supervision of the Ministry of Finance with the objective to regulate the securities market as well as protect the interests of the investor, and yet the conviction rates evidence the fact that this regulatory authority has failed to effectively carry out the purpose for which the Prohibition of Insider Trading Regulations(herein after "PIT") ,1992 was laid down.

With the Indian market capitalisation crossing 1.6 trillion U.S dollars[6] there emerged a clear need to relook and revamp the laws on insider trading and the 18 membered Sodhi committee was tasked with this matter closing the gaps on the existing laws. This committee report was submitted to SEBI and upon approval lead to the introduction of the (Prohibition of Insider Trading) Regulations, 2015.

Analysing the Regulatory Lacunae

Insider trading remains the most taxing of issues for the regulator to effectively tackle, and such regulations in this regard often remain paper tigers rendered almost tokenistic due to poor

[3] Reference No.- SEBIH/R/2019/50846 Dated 23rd November 2019
[4] Pratyush Mohanti, *Insider Trading in India – Deficiency from Prosecution to Conviction,* (16 June 2021), Insider Trading in India – Deficiency from Prosecution to Conviction (taxguru.in)
[5] Niti Kiran, *NSE cash segment hits all-time high turnover of Rs 1.47 lakh cr on last trading day of November*, Business Today. In (30 November 2020) https://www.businesstoday.in/markets/stocks/story/nse-cash-segment-hits-all-time-high-turnover-of-rs-147-lakh-cr-on-last-trading-day-of-november-280130-2020-11-30
[6] *Investor wealth rises to record $1.6 trillion as markets surge* ,The Economic Times, (17 November 2014) Investor wealth rises to record $1.6 trillion as markets surge - The Economic Times (indiatimes.com)

enforcement measures and ambiguity of regulations. SEBI remains largely lackadaisical in its approach towards insider trading besides the initiation of probes often as a result of media outcry and even in such cases the rate of successful prosecution remains negligible. Thus, insider trading remains a largely lucrative venture in India in contrast to the western world. As per the SEBI annual report for 2018-2019, the authority pursued around "70 cases of investigation out of which only 19 were seen till completion"[7] that too with a negligible conviction rate owing primarily to the lack of extensive investigative powers and hinderances to gather important evidence. The year 2021 saw three decades since the introduction of the Prohibition to Insider Trading regulations but the statistics are clearly indicative of the fact that the Statutory authority is far from effectively realising the goal for which the legislation was introduced.

The legal regime surrounding Insider trading regulation in India evidently suffers from defects both in its prosecution and enforcement and this paper aims to analyse several pertinent lacune that needs to be addressed with regards to the same.

1. With the liberalisation and opening of world economies it is not surprising that financial offences such as insider trading have also started transgressing borders, however the Indian Judicial and regulatory safeguards in this regard have found little to no extra territorial applicability. This leaves the domestic market and the resident investors of the country in a vulnerable state against the illegitimate activities of foreign players. The current Indian regulatory regime provides for no scope to initiate probes let alone penalise foreign nationals who have indulged in Insider trading. The Insider trading regulation provides no scope for imposing criminal sanctions on the directors of foreign companies which are listed in the Indian stock exchanges as the SEBI Act shall not be applicable outside Indian territories therefore hindering its extra territorial applicability. This is in contrast to the regulatory provisos of more advanced economies such as that of the US which allow for extra territorial application with regards to transactions which involve foreign parties.

   Such a lacunae in regulations also remains detrimental to Indian authorities receiving any transnational support with regards to the procurement of evidence and assistance pertaining to investigative probes. Although SEBI has "MoU's and bilateral

[7] SEBI annual report 2018-2019. pg. 190, SEBI | Annual Report 2018-19

agreements"[8] in place to ease investigatory assistance these do not cover major territories and largely remains tokenistic, as major foreign authorities continue to decline investigative and informational corporation with regards to financial offences citing SEBI's lack of territorial jurisdiction.

2. Section 26 of the SEBI act,1992 lays down that "No court shall take cognizance of any offence punishable under this Act or any rules or regulations made thereunder, save on a complaint made by the Board"[9]. Such a provision does away with the rights of investors to ensue private action or class action suits against the wrong doer in cases of Insider trading and leaves the right of enforcement only to the statutory authority while they are forced to take a back seat. This is in contrast to the standing of the US legal regime which does provide for the maintenance of civil suits in this regard as provided under rule "Rules 10b-5"[10] and "Rule 14e-3"[11] of Securities Exchange Rules, 1942 and "Section 16-b"[12] and "Section 20-a"[13] of the Securities Exchange Act. A stance alike the US has been widely effective as a deterring factor in other countries which have allowed for the same as well.

3. Lack of modern surveillance and monitoring technology: Insider trading prosecution in India has been greatly ineffective against modern day financial offenders owing to the lack of contemporary technological resources and expertise which have become key in curbing Insider trading transitions and carrying out effective probes. In comparison the Securities and Exchange Commission (SEC) which is the controlling authority of the US stock exchange have been equipped with such technology thereby enabling them to carry out efficacious oversight over their capital markets.

4. As opined by Manish Agarwal and Harminder Singh in their paper "Merger Announcements and Insider Trading Activity in India: An Empirical Investigation"[14] , Mergers and Acquisitions between companies remain a hot bed for Insider trading

[8] SEBI Bilateral MoU's https://www.sebi.gov.in/sebi_data/internationalAffr/IA_BilMoU.html
[9] S.26, SEBI Act,1992
[10] Rules 10b-5, Securities Exchange Rules, 1942
[11] Rule 14e-3, Securities Exchange Rules, 1942
[12] S.16-b, Securities Exchange Act, 1934
[13] S.20-a, Securities Exchange Act, 1934
[14]Manish Agarwal & Harminder Singh, *Merger Announcements and Insider Trading Activity in India: An Empirical Investigation,* NSE Research Initiative , Paper No.8, (January 2006)

activities as such activities have a material impact on the price flow of the company's securities and provide for opportunities to illegitimately capitalise on the same. Rule 14e-3 of the Securities Exchange Rules in the U.S provides for an overarching safeguard against such a scenario by mandating "any person in possession of material, non-public information relating to a tender offer either to disclose the information publicly or to abstain from trading in the securities involved in the tender offer"[15].

Proviso 3(3) the Prohibition of Insider trading Regulations, 2015 provides for the exercise of due diligence which permits the communication of UPSI in order to allow companies to better gauge the potential benefits, difficulties and miscellaneous factors it will have to consider before deciding whether or not acquiring a target company will be a profitable venture or not. In cases wherein such transactions are aborted after sharing of UPSI in Regulation 3(3)[16] remains silent. As the UPSI shared with the prospective acquirer would make them an insider, no trade of the target company's security should be carried out by them unless the UPSI is made available to the public. Furthermore, a SEBI clarification must be issued in regard to how the law views the promoters and insiders of the target company who in compliance of the due diligence exercise shares UPSI with the prospective acquirer.

5. The nature of Insider trading crimes is such that circumstantial evidence are primarily relied on to make out the charges for the same. Therefore, telephone records, transcripts and wiretapping often serves as the most crucial pieces of evidence for establishing and building up a strong prosecution case and establishing the network of those who indulge in such illegitimate activity. Despite such investigative powers being a crucial determinant for effective probes in such cases, SEBI was not conferred with the powers to call for phone up until 2014 post the infamous *Sharda Case*[17] after which the central government made the requisite amendments to the Indian Telegraph rules. However, till date SEBI does not have the power to engage in wiretapping and intercept phone calls despite several expert panels, most prominently the Viswanathan Panel[18] providing detailed account of why such powers are necessary and stating that "that

[15] Rule 14e-3 of the Securities Exchange Rules,1942, https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=2446&context=wlulr
[16] Regulation 3(3) SEBI (Prohibition of Insider trading) Regulations, 2015
[17] Subrata Chattoraj Vs Union Of India& Ors, (2014) 8 SCC 768 ,(9 May 2014)
[18] https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html

telephone call interception may only provide information on a subset of potential evidence of wrongdoing, it still felt that call interception would be an improvement over the present case where no interception is possible"[19]. The central government has however continued to deny such powers under the rationale that such powers would be violative of the right to privacy guaranteed under article 21 of the constitution.

The benefits of such a power being conferred is evidenced by the landmark case of "Securities and Exchange Commission Vs Rajat K Gupta and Rajaratnam"[20]. In this case Mr. Gupta transfers confidential information about a 5-billion-dollar agreement between Warren Buffet and Goldman Sachs to Mr. Raj before the news was made public. Mr Raj then proceeds to use this Unpublished Price Sensitive Information (UPSI) to make illegitimate profits and avoid losses to the tune of 700 million dollars. The conviction in this case which is perhaps one of the largest financial frauds in history was largely possible only due to evidence accumulated via wiretapping and phone records.

6. Clauses 3 and 4 of the Regulations of the SEBI (Prohibition of Insider Trading) Regulations, 2015 made use of the wording "*Proposed to be listed*" in stating that

"No insider shall communicate, provide or allow access to any unpublished price sensitive information, relating to a company or securities listed or *proposed to be listed,* to any person including others except where…." [21](As specified by the respective clauses). The regulation however remains silent as to the exact definition and ambit of the aforementioned term thereby resulting in an ambiguity that allows such a term to encompass companies at different stages of development ranging from those that may have proposed for IPO's, have received approval for their respective Articles of Associations to those companies which are only in their precursory phases of discussions for listing. As long as SEBI provides a line of clarification and defines the actual scope of this term, there remains a glaring loophole at the very crux of such regulatory clauses.

[19] Pg.62 .https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html

[20] Securities and Exchange Commission v. Rajat K. Gupta and Raj Rajaratnam, Civil Action No. 11-CV-7566 (SDNY) (JSR)

[21] Regulation 3 and 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 https://www.sebi.gov.in/legal/regulations/jan-2015/sebi-prohibition-of-insider-trading-regulations-2015-issued-on-15-jan-2015-_28884.html

7. The (PIT) Regulations, 1992 did not make out mere communication of UPSI to be an offence per se and charges would be attracted only upon acting on such information by dealing in the securities if the respective company. An amendment was made to the Regulations of 1992 by SEBI vide a press release dated 22nd February 2002 which categorically laid out the same in stating that "only dealing in securities based on unpublished Price Sensitive Information has sought to be prohibited and communication of Price Sensitive Information per se is not an offence"[22]. The (PIT) Regulations of 2015 however have brought about a drastic change in this regime with mere communication of UPSI, even without dealing on the basis of the same being made out to be an offence. This continues to have hard hitting repercussions on Larger corporates that deal with massive personnel sizes to ensure no violation of regulation takes place.

8. "The SEBI annual report for the year 2020 shows a pendency of around 376 cases as of March 31st, 2020"[23], pertaining to only securities, furthermore as per the records released for the year 2018 with respect to the cases which were already adjudicated upon and where penalties were imposed upon various entities for committing various financial offences, "close to 2183 entities had evaded payment of the same despite some of these cases being decades old"[24]. This is clearly indicative of the poor enforcement mechanisms SEBI has in place and reflective of its inability to ensure a marketplace free from malpractice.

   SEBI's incompetency has received strong worded brickbats from the Securities Appellate Tribunal (SAT) as well. In the case of *Ashok Dayabhai Shah & Ors. vs Sebi*[25] which was a case that was kept pending for over six years the SAT explicitly states that "We have no hesitation in stating that SEBI as a regulator in the instant case has not performed its duties and has kept the complaint pending for more than six years, which

[22] Amendments to SEBI (Insider Trading) Regulations, 1992. Press release No 43/2002 https://www.sebi.gov.in/media/press-releases/feb-2002/amendments-to-sebi-insider-trading-regulations-1992_17768.html

[23] *Sebi probed 161 new cases in 2019-20*, The Economic Times (12 February 2021) https://economictimes.indiatimes.com/markets/stocks/news/sebi-probed-161-new-cases-in-2019-20/articleshow/80879699.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

[24] Pratyush Mohanti, *Insider Trading in India – Deficiency from Prosecution to Conviction*, (16 June 2021), Insider Trading in India – Deficiency from Prosecution to Conviction (taxguru.in)

[25] Ashok Dayabhai Shah & Ors. vs Sebi on 14 November 2019 before the SAT. Appeal No. 428 of 2019.

speaks volumes by itself. The tribunal fails to fathom why the complaint could not have been decided unless Sebi officials had a vested interest in not deciding the matter"[26].

There is an evident dearth of Human Resources in the SEBI which must be addressed. In contrast to the SEC around which employees around 4200 personnel[27] , SEBI has 867[28] personnel in toto. Such variation in personnel strength also has a material impact on effective enforcement. Furthermore, unlike the SEC which conducts a routine and comprehensive self-appraisal mechanism, SEBI follows no such practice thereby leading to the authority being obstructed and continuing with the same investigative deficiencies without engaging in a remedial practice to mitigate them.

Possible Solutions

For a developing economy like India, it is imperative that Investors have faith in the capital markets and the statutory bodies that safeguard the same, so as to be listed amongst the advanced economies of the world and create a conducive investor environment for both domestic and foreign investors. Many of the regulatory deficiencies SEBI faces with regards to Insider trading maybe mitigated to a certain degree through the measures of:

1. Expanding Technological Prowess and Scope of Investigative powers: SEBI must seek an effective revamp of its prosecutorial mechanism so as to better equip itself to successfully handle the investigation and enforce action in cases of Insider Trading. It must envisage a move beyond its traditional machinery and adopt contemporary technology and investigative mechanisms to attain the effective oversight of the capital markets for which it was instituted. The endowment of additional investigative powers such as access to phone records, wiretapping and other electronic communication is also a pressing need, that could aid SEBI to build strong prosecution cases and carry out more effective probes. In the Indian context investigative agencies like CBI have been conferred with such powers, but such agencies limit their assistance with SEBI to primary sharing of Intel rather than investigative assistance, contrary to the position in the U.S where the SEC works in tandem with enforcement agencies like the Federal Bureau of Investigation (FBI) to pursue a more comprehensive investigation.

[26] Ashok Dayabhai Shah & Ors. vs Sebi on 14 November, 2019 before the SAT. Appeal No. 428 of 2019. Para 20
[27] SEC.gov | SEC Employees
[28] SEBI | Employee Profile In SEBI

2. Issuance of a line of clarity as to the nature of offence Insider trading falls under: In the case of *Rakesh Agarwal v. SEBI*[29] the SAT proceeded to adjudicate on the matter on the basis that the offence of insider trading was of criminal nature, such a position is in contravention to the Bombay High Court's finding stance in *Cabot International v. SEBI*[30] in stating that "For breaches of provisions of SEBI Act and Regulations, according to us, which are civil in nature, mens rea is not essential"[31]. The supreme court upheld the same position as well in the case of *SEBI v. Shriram Mutual Fund and Another*[32]. A clarity in terms of the nature of offence as well as the elements required to be established to make out a charge of insider trading will go a long way in enabling SEBI to make effective prosecution cases. Proviso 32(a)[33] of the SEC in the US legal regime clearly lays out that indulgence of the defendant in insider trading qualifies as a criminal offence, and India may draw from such laws to solidify its position in the same.

3. Expansion of territorial jurisdiction: The need for extra territorial applicability of Insider trading laws is evident with modern day offenders transgressing borders. An effective regulatory framework as envisaged by the SEC in the US by means of proviso 27(b) of the SEC Act, 1934 which confers extraterritorial jurisdiction to the authority maybe drawn upon by the Indian legal regime as well. This will help SEBI clamp down on foreign parties who attempt to evade the law by indulging in insider trading from across the border. To ensure ease of investigational corporation across territories as previously mentioned ,MoU's and bilateral agreements in the same regard remain the most effective instrument and moving ahead SEBI will have to double down in its efforts to ensure that it onboards more territories that will partake in such a mutual exchange of legal aid.

4. Provide for Private right of action: As discussed previously (with respect to Rules 10b-5 and Rule 14e-3 of Securities Exchange Rules, 1942 and Section 16-b and Section 20-a of the Securities Exchange Act) the US legal regime has empowered individual investors to file maintainable civil suits to seek adequate redressal for the losses they

[29] Rakesh Agarwal v. SEBI, 2004 49 SCL 351 SAT
[30] Cabot International v. SEBI, 2004 51 SCL 307
[31] Cabot International v. SEBI, 2004 51 SCL 307, para.30
[32] SEBI v. Shriram Mutual Fund and others, Appeal (civil) 9523-9524 of 2003,(23 May 2006)
[33] S.32(a), Securities Exchange Act, 1934

have suffered due to instances of insider trading. Such an approach must also be adopted by the Indian legal framework, over the current system wherein enforcement rests only with SEBI. Under the current Indian legal regime insider trading remains a lucrative means as the annual reports of SEBI are indicative of the fact that most accused persons are acquitted and even those which are convicted pay measly settlement amounts with respect to the profits, they booked by indulging in such illegitimate activity.

5. Increasing awareness and spreading information: Educating all relevant stakeholders about the repercussions of insider trading and other financial crimes will always remain a relevant endeavour in order to promote fairness and mitigate malpractice in capital markets. SEBI may set forth suggestive guidelines for the dissemination of such information via NGOs, stock exchanges etc. Furthermore, effective implementation of Insider trading laws will only be possible if the management of every organisation takes sufficient care to self-regulate and follow practices of good corporate governance. They may instate self-adopted codes for ensuring that the primary barrier against insider trading is established from within the company itself, such efforts should be coupled with the monitoring of the compliance officer who ensures that the personal trading of securities by company personnel is at par with industry regulations.

6. Enabling Pre-emptive action: The general approach towards insider trading must be relooked from taking punitive action after the crime has taken place, to a mechanism wherein the same can be stopped at the point of its inception or as it shapes up. Working out a strong surveillance system that points towards a possibility of insider trading based on the evidentiary circumstances that present itself rather than detection of the same only after it has taken place will ensure the safety of investors to a far greater degree.

Conclusion

Insider trading supposedly seems like an “unwinnable “war which the government and the SEBI in its regularity role continue to fight. Despite the revision and redevising of various regulatory frameworks to deter Insider trading, such regulations have not been able to achieve the true extent of the goal for which it was laid down. The Lacunae in the regularity framework as well as functioning delved upon with the expanse of this paper outline a few of the major

the lapses that must be addressed so as to ensure that the confidence of the investor in the economy and the capital markets is not deterred owing to rampant practice of Insider trading. The mechanisms adopted by westerns regulators particularly the SEC in the U.S also provide a great reference point for assimilating effective enforcement mechanisms as well as positions of law necessary to effectively address the issue of Insider trading in India and achieve the heights that the Indian economy is capable of attaining.