

EMERGING TRENDS OF INSIDER TRADING: A LAW AND ECONOMICS INTERPLAY

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ABSTRACT

The legalisation for the practice of insider trading has always remained a bone of contention. But with the USA setting standards and the rest of the world ensuing it, a justified trend has been set- insider trading cannot be legal. With the advent of an era of internationalisation of securities market, the rush to regulate insider trading is witnessed as a worldwide phenomenon. India also followed trails by enacting the Securities and Exchange Board of India (SEBI) Regulations, 2015 and the SEBI (Amendment) Regulations, 2018. However, while the law holds great potential, what appears to be void is the enforcement mechanism. The law and economics analysis of the system corroborates the failure of the system in place of curbing insider trading. The enforcement mechanism in India acts as an infamous example for a system that has failed due to the interplay of various contributing factors. For India to truly deal with the problem of insider trading, what it needs, is an effective enforcement mechanism. It is high time that the law-makers of the country realise that change comes not only with the enactment of stringent laws, but also with the enforcement of the same.

I. INTRODUCTION

“Every Degree of Business has its Invitation to do Evil: 1. Necessity tempts the poor man. 2. Avarice tempts the rich” observed English writer Daniel Defoe in the eighteenth century.¹

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Media reports on professional misconduct like insider trading, tax fraud, embezzlement etc. have become a common phenomenon these days.² Historically these types of acts were not considered as a part of criminal milieu. However, the assessment of crimes committed by “business and professional men” began to change as sociologist Edwin Sutherland coined the term “White collar crimes” in 1939.³ It is very important to regulate them as they cause enormous economic damage mostly at the expense of the poorer sections of society.

The act of trading of securities of a company by an insider on the basis of unpublished price sensitive information (UPSI) is known as insider trading. An insider is 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have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information.⁴

Any information related to any state of the company (past, present or probable future) that has not been made public and has the potential to

¹ Hartmut Berghoff & Uwe Spiekermann, *Shady business: On the history of white-collar crime*, 60(3) BUSINESS HISTORY 289–304 (2018).

² *One-third of Indian businesses hit hard by internal, external fraud*, ECONOMIC TIMES, Oct. 1 2019, <https://economictimes.indiatimes.com/news/company/corporate-trends/one-third-of-indian-businesses-hit-hard-by-internal-external-fraud-report/articleshow/71393811.cms>.

³ Edwin H. Sutherland, *White-Collar Criminality*, 5 AMERICAN SOCIOLOGICAL REVIEW 1 (1940).

⁴ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India), § 2(e).

influence the value of securities of a company in the market is an ‘unpublished price sensitive information’. Access to such unpublished material information will help the insider himself or any other person to whom the information is made available to trade in securities of the company for their own benefit, thus putting those who do not possess such information at a disadvantage.

Despite this, there has always been a divisive opinion regarding the regulation of insider trading itself. While many economists contend that insider trading, in fact boosts the efficiency of the security market⁵, others argue the various economic and moral reasons that justify the prosecution of insider trading.⁶

The legalization debate is as old as insider trader trading regulations. Legal scholars and economists like Milton Friedman, Henry Manne, Daniel Fischer, Thomas Sowell, and Frank H. Easterbrook have been proponents of legalization of insider trading.⁷ Nobel Prize winning economist Milton Friedman said, “You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that”.⁸

⁵Hsiu Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUMBIA LAW REVIEW 260 (1968).

⁶Ronald Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency*, 70 VIRGINIA LAW REVIEW 549–629 (1984).

⁷Anthony Randazzo, *Legalize Insider Trading?*, REASON FOUNDATION (Jul 25, 2019), <https://reason.org/commentary/7256>.

⁸*Id.*

The difficulty in differentiating insider information and proprietary research is a main argument for legalization of insider trading. Trading on the basis of data or information of sales of a particular company collected by conducting market research through survey, analysis etc. is allowed, but the same becomes illegal when done on the basis of same or similar information received from an insider. The question here is that if the data is the same, should the methodology by which it is collected make a difference.⁹ Also, when insider trading has no identified specific victims, then the basis upon which it is termed as a crime is questionable.

However, these claims have been criticized as a level playing field and is fundamental to capital markets. Insider trading is a faceless crime but not a victimless crime. Further, corporate insiders will have the opportunity to make substantial gains by hiding the information from the public and their board of directors by maximizing their personal trade profits.¹⁰ On the basis of this rationale, the US was the first country to prohibit insider trading which was then followed by a multitude of countries.

The enforcement of insider trading laws has been a challenge globally. While countries like U.S and U.K have very stringent laws, the same is not the case with all countries.¹¹ The existence and enforcement

⁹ *It's time to legalize insider trading: Roth CNBC (2014)*, CNBC, (Jul 20, 2019), <https://www.cnbc.com/2014/06/17/its-time-to-legalize-insider-tradingwall-streetcommentary.html>.

¹⁰ George Dent, *Why Legalized Insider Trading Would Be a Disaster*, 38 DELAWARE JOURNAL OF CORPORATE LAW 247 (2013), <https://ssrn.com/abstract=2313456>.

¹¹ Kirthana Singh, *Insider Trading: Legal Position in India vis-à-vis the UK and the US*, 4 THE WORLD JOURNAL ON JURISTIC POLITY 25 (2018).

of insider trading laws in stock markets is a phenomenon of the 1990s. A study of the 103 countries that have stock markets reveals that insider trading laws exist in 87 of them, but enforcement-as evidenced by prosecutions-has taken place in only 38 of them.¹²

In India, insider trading is governed by the Securities and Exchange Board of India regulations which overlook the trading activities in the Bombay Stock Exchange and National stock exchange. There has been little and shoddy enforcement in India due to inadequacies in investigation and low level of penalties. This failure has been attributed to numerous reasons like lack of human resources for investigation or basic investigation tools.¹³

II. THE RUSH TO REGULATE INSIDER TRADING

The insider trading laws in India, especially after the 2018 amendment which has brought in stricter punishments including longer terms of imprisonment and higher rates of fines that are applicable, has become one of the strictest in the world,¹⁴ at least on record. Since the inception of the securities market and the setting up of SEBI, India has strongly asserted the need for regulation of insider trading. It has since the beginning followed the guidelines and principles of the International

¹² Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57(1) THE JOURNAL OF FINANCE 75–108 (2000), <https://ssrn.com/abstract=249708>.

¹³ DEVESH KAPUR & MADHAV KHOSLA, *REGULATION IN INDIA: DESIGN, CAPACITY, PERFORMANCE* 115 (Bloomsbury Publishing 2019).

¹⁴ Singh, *supra* note 11.

Organisation for Securities Commission (IOSCO)¹⁵ and the US¹⁶ which have been the pioneers in the regulation of insider trading.

But, given the long-standing inefficiency in the enforcement of existing laws and the not so rare incidents of huge insider trading cases, the sudden rush to regulate [Prohibition of Insider Trading Regulations, 2015 and the subsequent Amendment Regulations, 2018] is quite striking. Upon analysis of the trends, there appear to be three important elements that seem to have motivated this sudden rush to regulate:¹⁷

A. Global Competition Regulation in India: Design, Capacity, Performance

1. Global Competition

The globalisation of the world's securities market is considered as one of the most astonishing growth of cross-border transactions.¹⁸ Recent years, have especially witnessed a more dramatic globalisation of the securities markets as investors worldwide seek a wider range of portfolio

¹⁵ *Objectives and Principles of Securities Regulation*, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, (May 2003), https://www.iosco.org/about/?subsection=display_committee&cmtid=19&subSection1=principles.

¹⁶ Harvey Pitt & David Hardison, *Games without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW AND CONTEMPORARY PROBLEMS 199–229 (1992).

¹⁷ *Id.*

¹⁸ James Thompson, *A Global Comparison of Insider Trading Regulations*, 3(1) INTERNATIONAL JOURNAL OF ACCOUNTING AND FINANCIAL REPORTING 1 (2013).

investments and corporates and businesses are in search for new sources of finance across and beyond their national borders.¹⁹

Foreign Portfolio Investments (or) Foreign Institutional Investments have been one of the biggest driving forces in the Indian securities markets where, India attracted an investment of USD 171.81 trillion between FY 12-18.²⁰ Though India has been one of the most attractive destinations for foreign investors, 2018 appeared to be the darkest year for India as foreign investors pulled out a record Rs. 81,912 crores from the Indian equity and debt market.²¹ While the same has been due to global trends and policies like a hike in the US Federal Reserve rates, rising crude oil prices, etc., it nevertheless increases the pressure on India to make its markets more secure and profitable by bringing in transparency and stricter regulation.

Though these pressures may not be fundamentally different in character from that of domestic pressures that have led India to prohibit insider trading,²² in the International patois, insider trading is more often condemned to be inconsistent with the move towards transparent markets,

¹⁹ David Michaels, *Subject Matter Jurisdiction over Transnational Securities Fraud: A Suggested Roadmap to the New Standard of Reasonableness*, 71(4) CORNELL LAW REVIEW 919 (1986), <https://scholarship.law.cornell.edu/clr/vol71/iss4/6>.

²⁰ Brand India, *Foreign Institutional Investors*, IBEF (Jul 21, 2019) <https://www.ibef.org/economy/foreign-institutional-investors.aspx>.

²¹ *2018 in review: Why foreign investors gave India a miss this year*, BUSINESS TODAY, (Jul. 21, 2019), <https://www.businesstoday.in/markets/stocks/foreign-investors-india-a-miss-sensex-nifty-rupee-ltcg-tax/story/303823.html>

²² Joseph Blum, *The Regulation of Insider Trading in Germany: Who's Afraid of Self-Restraint*, 7 NORTH-WESTERN JOURNAL OF INTERNATIONAL LAW & BUSINESS 507–531 (1986).

and markets with well laid down standards and procedures, that are easily comprehensible to foreign investors.²³ Also, countries that appear lackadaisical in taking steps to prohibit insider trading are often criticised harshly by international bodies as well as other countries with competing securities market

For instance, within the European Economic Community itself, it is highly predicted that a handful of financial centres with established regulations and enforcement will soon be dominating the European markets.²⁴ The criticism and backlash extend to major economies as well, where, the British Press pounced upon the report finding insider trading in Germany.²⁵ This, as a result, led to German bankers voicing their support for additional insider trading regulations and a much stricter enforcement of the same.²⁶

In such a frenzy international scenario, it becomes imperative for India to improve and strengthen its insider trading regulations and make the implementation stricter as well. Therefore, in anticipation of a positive response, India made changes by setting up two committees for the same purpose- N.K. Sodhi committee which recommended the Prohibition of

²³ *Europeans Are Steering for Market Reform: Push Is toward Stiffer, Uniform Disclosure Laws*, LOS ANGELES TIMES, August 17, 1988, <https://www.latimes.com/archives/la-xpm-1988-08-17-fi-629-story.html>.

²⁴ Stephen Greenhouse, *An Old Club Transformed*, THE NEW YORK TIMES, July 23, 1991, at 6.

²⁵ Katherine Campbell, *Spotlight Falls on German Trading Practices*, FINLAND TIMES, July 3, 1991.

²⁶ Harvey Pitt & David Hardison, *Games without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW AND CONTEMPORARY PROBLEMS 202 (1992).

Insider Trading Regulations, 2015 and the T.K. Vishwanathan committee that recommended the amendments to the regulations in 2018.

2. International Regulation and Enforcement

Globalisation not only facilitates foreign investments, but also provides unintended opportunities for insider trading, market manipulations, etc. Insider trading more often than not crosses boundaries of a nation where a foreign national engages in insider trading in the national market. The successful investigations and prosecutions of these trans-national cases thus require international cooperation among countries and their regulatory bodies.

In view of the same, mandating members to cooperate with each other for the purposes of carrying out their duties according to EC Directive has been one of the most laudatory aspects of the EC Directive.²⁷ In fact, India is also a signatory of the IOSCO Memorandum of Understanding, the first worldwide multilateral enforcement cooperation arrangement among securities and derivatives regulators.²⁸ This requires SEBI to cooperate with other signatories and aid their national cases. India, being a major financial market in the world, thus

²⁷ Directive 2003/6/EC, of the European Parliament and OF THE COUNCIL of 28 January 2003 on insider dealing and market manipulation (market abuse), (2003), <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF>.

²⁸ The Board of the International Organization of Securities Commissions, *IOSCO Standards Implementation Monitoring (ISIM) on Secondary and Other Market Principles*, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (Jul 26, 2019), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD623.pdf>.

requires the aid of other countries for successful prosecution and investigation of its own insider trading cases that may be trans-national and is also required to return the favour.

3. Development of Technology

Across the globe, technological progress has brought various developments-one of them being a paradigm shift in stock market operations.²⁹ The stock exchanges across the globe have realised the potential of information technology and have upgraded to electronic trading systems, which have a much wider reach as well as better mechanism for pre-trade, trade and post-trade transactions.

At the same time, conventional wisdom holds that with advancement in technology, along with multiple listing of securities, scope for twenty-four-hour trading, it not only brings the desired advantages, but also other undesired effects such as vast increase in the opportunities for insider trading, market manipulation etc. Unfortunately, today, this holds true since the surveillance mechanisms lag far behind the technological developments in the stock exchanges.³⁰

India is far behind other countries in the use of advanced technology in its surveillance mechanisms. SEBI lacks the much-needed powers like the power to wiretap phone calls, which has been denied time and again despite several recommendations by high level committees and

²⁹ *Our Trading Technology*, NATIONAL STOCK EXCHANGE OF INDIA LTD. (Jul 21, 2019), https://www.nseindia.com/global/content/about_us/trading_technology.htm.

³⁰ Craig Forman, *Old World Traditions Include Insider Trading*, THE WALL STREET JOURNAL, February 8, 1989.

panels.³¹ Even the power to call for phone records was given to SEBI only in 2013 after the Rs.10 billion Sharada scam.³² In such a scenario of towering technological advancement in stock markets and exchanges, without substantial increase in that of surveillance, it becomes imperative for India to bring in stricter regulations through other means, thus bringing in the need for the 2015 regulations and the 2018 amendment.

III. EMERGING TRENDS AND RECENT LEGAL DEVELOPMENTS: AN ANALYSIS

While the Securities and Exchange Board of India (Prohibition of Insider Trading) Act came in 2015 with various new concepts such as trading plans, unlisted companies etc., this paper focuses on the most recent legal development- The Securities and Exchange Board of India (Prohibition on Insider Trading) (Amendment) Regulations, 2018.

Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018 came after a 116-page report was submitted by the fair market committee headed by T.K.

³¹ SEBI, *Report of committee on fair market conduct under the chairmanship of Dr. T. K. Viswanathan* (2018), GOVERNMENT OF INDIA, https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html.

³² ET Bureau, *Amendment to SEBI Act will give more power to watchdog related to Ponzi schemes*, THE ECONOMIC TIMES (Jul 21, 2019), <https://economictimes.indiatimes.com/news/economy/policy/amendment-to-sebi-act-will-give-more-power-to-watchdog-related-to-ponzi-schemes/articleshow/39785617.cms?from=mdr> (2014).

Viswanathan.³³ This amendment is a much needed one for various stakeholders in the stock market.³⁴

To start with, the new amendment has given clear and well laid down definitions that were missing in its previous regulations. The term “legitimate purposes” was not defined under any previous acts, and was open to various interpretations. The issue came to light when Cyrus Mistry alleged Ratan Tata to have sought confidential information including UPSI from the company.³⁵ SEBI, taking cognizance of the same, established that sharing UPSI with the Chairman of the company fell under the ambit of legitimate purposes.³⁶ This incident led to the need for defining the term legitimate purposes, which was addressed by the Committee and later included in the Amendment Act, 2018.³⁷

The Amendment act requires the Board of Directors of the company to determine what constitutes “legitimate purpose” as a part of its “Code of Fair Disclosure and Conduct”.³⁸ The act also moves a step

³³ *Id.*

³⁴ Sara Jain & Swapnil Singh, *The 2018 Insider Trading Amendment: A Step in The Right Direction?*, INDIA LAW JOURNAL <https://www.indialawjournal.org/the-2018-insider-trading-amendment.php> (last visited Jul 25, 2019).

³⁵ Mobis Philipose, *Did Tata Sons violate insider trading norms?*, LIVEMINT, (Jul 21, 2019), <https://www.livemint.com/Opinion/KHA3k8guR1GIAjAXCJYFhI/Did-Tata-Sons-violate-insider-trading-norms.html>.

³⁶ Moneycontrol.com, *SEBI observation on insider trading puts Ratan Tata in the clear*, MONEYCONTROL (Jul 21, 2019), <https://www.moneycontrol.com/news/business/companies/sebi-observationinsider-trading-puts-ratan-tatathe-clear-943636.html>.

³⁷ Regulation 3(2A), SEBI (Prohibition of Insider Trading), Regulations, Gazette of India, pt. III sec. 4, 2015.

³⁸ “Codes of Fair Disclosure and Conduct” formulated under regulation 8, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

forward and provides an illustrative list of all that could constitute as legitimate purposes in the explanation.³⁹ Despite the above definition being laid down, there still exist an ambiguity in the legal implementation and enforceability of the same since it is unclear whether the illustrative list acts merely as an example or mandates a bare minimum circumstance which ought to be included in the ambit of the definition.

Unlisted companies came under the purview of insider trading regulations only after the 2015 Regulations. Until then, the regulations laid down were applicable only for the listed companies in India. Even after the introduction of the concept of “proposed to be listed companies” in the 2015 Regulations, there was widespread ambiguity and confusion as to the stage at which a company would be recognised as one. Absence of clarity led to the term being open to various interpretations such as Board’s approval of an IPO or red herring prospectus with SEBI or any other event. Thus, the insertion of the definition of the same in the 2018 Amendment is seen as a laudatory recommendation by the Committee. The Amendment clearly lays down that a company would be “proposed to be listed” if the company has filed the relevant documents for listing to the relevant authorities⁴⁰ or due to an amalgamation or a merger and has filed a scheme for the same under the Companies Act, 2013.⁴¹

³⁹ Philipose, *supra* note 35.

⁴⁰ Regulation 3, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

⁴¹ Regulation 2(ha), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

While the above two definitions have come as the much needed ones, the 2018 Regulation has also inserted certain other definitions such as “financially literate”⁴² and has also amended the definition of the term UPSI to remove the clause “material events in accordance to the listing agreement” since it may or may not include price sensitive information as per Regulation 30⁴³ of the SEBI listing regulations.

Secondly, the Amendment also brings in the concept of institutional framework for the first time in India, in which front India has been lagging behind the other countries for quite some time now. The new regulation, for the first time has taken into consideration the recommendation of a decade and a half old World Bank report (2004) on Indian capital markets where it strongly recommended an institutional framework in India.⁴⁴ The responsibility for establishing and maintaining internal controls has been laid on the CEO, MD or such other analogous person of a company to ensure that the basic requirements to prevent insider trading are complied with.⁴⁵ To add to this, the Audit Committee of the company is now required to review and assess if the internal controls are effective and adequate and monitor the compliance of the company

⁴² Regulation 2(1)(c), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

⁴³ Regulation 30, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

⁴⁴ Report on the observance of standards and codes (ROSC), Corporate Governance Country Assessment, INDIA, April 2004, <http://documents1.worldbank.org/curated/en/790421468033284999/pdf/350840IN0REV0Corporate0rosc1cg.pdf>.

⁴⁵ Regulation 9A(1), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

with the regulations.⁴⁶ Along the same lines, the Amendment also requires the Board of Directors to maintain a digital database of all those in possession of the UPSI and subsequent flow of the same within the organisation.⁴⁷ The inclusion of the Amendment is seen as a move that propels India towards achieving an at par status with the regulations of other countries.

In the recent times, the Indian stock market has witnessed a series of cases involving leaks of UPSI.⁴⁸ Leaking of UPSI has become quite a common phenomenon due to the loose reins of SEBI on the same. With a view to eliminate such incidents in the future, individuals and entities circulating unpublished price sensitive information (UPSI) of listed firms over social media platforms have come under the regulator's glare.⁴⁹ The Amendment mandates every listed company to formulate written policies and procedures for inquiry in case of leak or even suspected leak of UPSI.⁵⁰ It is high time that such provisions came into place since cases of leaking UPSI have lately emerged even in top companies like HDFC and leaking UPSI seems to have missed scrutiny by SEBI's sight to such a great extent that they are being circulated on WhatsApp chats and groups.

⁴⁶ Regulation 9A(2) & (3), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

⁴⁷ *Id.*

⁴⁸ Shrimi Choudhary, *SEBI moves to curb sensitive information leak, seeks trading details* *Business Standard* (2019), BUSINESS STANDARD (Jul 21, 2019), https://www.business-standard.com/article/markets/sebi-moves-to-curb-sensitive-information-leak-seeks-trading-details-119061801398_1.html.

⁴⁹ *Id.*

⁵⁰ SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015, Regulation 9A(5).

Investigations by SEBI into the National Stock Exchange (NSE), Sun Pharmaceutical Industries Ltd, ICICI Bank Ltd and Infosys have one thing in common- all of them have been based on whistle-blower complaints.⁵¹ This led to SEBI's introduction of the concept of the whistle blower policy into regulations. All entities are now required to create whistle blower policies for any employee who comes forth to share information of a leak in UPSI.⁵²

Along the same lines of the whistle blower policy, the SEBI recently floated a discussion paper describing the informant mechanism that has been devised. SEBI has laid down that in case information by the informant lead to a disgorgement of at least Rs.5 Crore, a reward of 10% shall be given.⁵³

India is known to have one of the strictest laws in the world since it follows the classical theory where the onus to prove that an insider in possession of the UPSI did not trade based on that UPSI lies on the insider. Due to the presumption of guilt of the insider, the Amendment thus sought to dilute the scope of applicability of insider trading in order to prevent the chance of prosecution of an innocent person by inserting

⁵¹ Jayshree Upadhayay, *SEBI seeks to address frivolous insider trading complaints*, LIVE MINT (Jul 25, 2019), <https://www.livemint.com/market/stock-market-news/sebi-seeks-to-address-frivolous-insider-trading-complaints-1560224586571.html>.

⁵² Regulation 9A(6), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

⁵³ Jash Kriplani, *SEBI suggests Rs 1 crore for whistle-blowers who expose insider trading*, BUSINESS STANDARD (2019), https://www.business-standard.com/article/markets/sebi-suggests-rs-1-crore-for-whistle-blowers-who-expose-insider-trading-119061001325_1.html. (last visited Jul. 21, 2019).

certain necessary defences⁵⁴ including Off-market inter-se transactions between insiders, transactions through the block deal window mechanism, statutory or regulatory obligation to carry out a bona fide transaction like achieving Minimum Public Shareholding Requirements as per the exercise of stock options in respect of which the exercise price was predetermined in compliance with SEBI (Share Based Employee Benefits) Regulations, 2014.

Despite the plethora of Amendments brought in by the regulation, the Committee recommendations as well as the provisions cannot be called perfect and flawless.⁵⁵

Various recommendations of the committee have also gone under the logs since they find no place in the Amendment. The committee had recommended several powers such as powers to conduct searches and seizures, obtain call records, wiretap suspects, etc. to be granted to SEBI.⁵⁶ Nevertheless, these powers were not to be found in the Amendment. The denial of the power to wiretap phone calls to SEBI is not a recent phenomenon. SEBI has been continuously requesting the Government to allow it to wiretap with a view of improving the conviction rates, but time

⁵⁴ SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015, Regulation 4(1).

⁵⁵ Sara Jain, *The 2018 Insider Trading Amendment: A Step in The Right Direction?*, INDIA LAW JOURNAL, <https://www.indialawjournal.org/the-2018-insider-trading-amendment.php> (last visited Jul 25, 2019).

⁵⁶ SEBI, *Report of committee on fair market conduct under the chairmanship of Dr. T. K. Viswanathan* (2018), GOVERNMENT OF INDIA, https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html

and again has been denied so. The Government has always rejected such powers owing to the protection of privacy of its citizens. While the committee recognises and acknowledges the possibility of misuse of such powers⁵⁷, it has asserted that call interception would be a substantial improvement and a huge leap forward in the present scenario, for instance, the U.S. Securities and Exchange Commission unearthed crucial information and evidence by wiretapping the conversations between Raj Rajaratnam and Rajat Gupta, that ultimately resulted in their conviction. This tool is a long shot for SEBI, especially considering the fact that it took a USD 6 million scam – the Sharada scam⁵⁸ for the SEBI to be granted the basic power to call for phone records.

Also, SEBI has been granted the power to petition before a criminal court and institute criminal proceedings against the insider; for which the punishment includes imprisonment up to 10 years.⁵⁹ In spite of this, until today, no man has ever been sent to the prison for insider trading. The reason for this can be traced to the lack of powers in the hands of SEBI. White collar crimes usually require a solid strong string of evidence in order to be proven. Also, for criminal prosecution, it is required to be proved beyond reasonable doubt. And SEBI is in no position to submit such proofs since it has no access to the bare evidences

⁵⁷ Keshav Malpani, *Amendments to SEBI's Regulations on Insider Trading Are they Sufficient?* INDIA CORPLAW (2019), <https://indiacorplaw.in/2019/03/amendments-sebis-regulations-insider-trading-sufficient.html>. (last visited Jul 21, 2019).

⁵⁸ Umakanth Varottil, *Power of SEBI to Seek Call Data Records*, INDIA CORPLAW (2017), <https://indiacorplaw.in/2014/05/power-of-sebi-to-seek-call-data-records.html>. (last visited Jul. 21, 2019).

⁵⁹ The Securities and Exchange Board of India Act, 1992 No.15, Acts of Parliament, 1992 (India), § 24.

and lacks the much-needed powers like that of intercepting phone calls. With no substantial evidence with SEBI, moving to a criminal prosecution is nothing but a wild goose chase.

In some ways, SEBI has been granted at par powers with the SEC and other enforcement agencies around the world; what is lacking is enforcement and implementation by SEBI authorities. While, it is obviously fair of SEBI to demand additional powers from the Government, it has failed to look into the existing powers that have been granted to it.⁶⁰ For instance, SEBI has been granted the power to impose a penalty of up to Rs. 25,00,00,000 or 3 times of profit made, whichever is higher.⁶¹ But the maximum penalty that has till date been imposed by SEBI is a mere Rs.60,00,000. For instance, in the case of insider trading in the Sun Pharmaceuticals Ltd that affecting thousands of small retail investors, a settlement with SEBI was reached at a meagre Rs.70,00,000.⁶² The leniency of SEBI, the sole regulatory authority increases and gives way to further insider trading. The failure of SEBI to impose higher penalties increases the lackadaisical behaviour of the company in maintaining strict confidentiality of UPSI.

⁶⁰ Malpani, *supra* note 57.

⁶¹ Securities and Exchange Board of India Act, 1992 No.15, Acts of Parliament, 1992 (India), § 15(H)A.

⁶² ET Bureau, *Sun Pharma lab's senior exec, wife settle insider trading case with SEBI*, THE ECONOMIC TIMES (2019), <https://economictimes.indiatimes.com/markets/stocks/news/sun-pharma-labs-senior-exec-wife-settle-insider-trading-case-with-sebi/articleshow/68842504.cms> (last visited Jul 21, 2019).

While on one hand, SEBI lacks various powers that the regulatory bodies around the world possess, on the other hand, SEBI fails to use the powers already granted despite the autonomy and discretion it possesses. It appears to be an irony where SEBI has been constantly seeking for various powers that it does not possess, while fails to fully use the powers it has already been granted.

IV. LAW AND ECONOMICS: THE PRACTICAL CONUNDRUMS

The law and economics analysis of insider trading seeks to identify the behavioural tendencies of an insider in relation to the laws in place and their enforcement. While the legal analysis sought to reflect the need and the prospective effect it has on the society, the eco-legal analysis seeks to reflect the behaviour of an insider with respect to that of the regulations and enforcement.

The white-collar crime of insider trading can be ranked in accordance to its seriousness where x denotes the seriousness of the crime. Let y denote the insider's payoff from the trading. The seriousness of insider trading in this case depends on the value of trading that is done, where when y increases, then $f(x)$ will also increase proportionately.

The punishment for insider trading can also be ranked by the severity of punishment where 's' denotes the severity of punishment. The severe the crime, the severe the punishment i.e. f increases with the increases in $f(x)$. To punish the crime of insider trading, the fine or penalty

collected must exceed the payoff of the criminal- $f(x) > y$. Accordingly, in India the severity of punishment does increase with the increase in the seriousness where the penalty for insider trading is three times the amount of profit earned by the insider. Thus, if every insider trading was punished with a fine that exceeded the payoff, then committing insider trading would not be efficient or result in a payoff to the criminal, deterring him/her from committing the crime i . Thus, the criminal would choose $x=0$.

But, in reality, punishment is probabilistic and not certain. Thus, the expected punishment not only depends on the severity of punishment but also on the probability of punishment (p) where the expected punishment is pf . For instance, an insider gets a profit of Rs.30,00,000 from trading in shares based on UPSI and the penalty is Rs.90,00,000(three times of the profit made) and the probability of punishment is 0.30. The expected punishment is only Rs. 27,00,000 because there is a 70% chance that the insider goes unpunished or even undetected where the punishment is Rs.0 and only a 30% chance where a punishment of Rs. 90,00,000 is imposed. This makes the expected punishment a mere Rs. 27,00,000 thus making the expected punishment lesser than the expected payoff for the criminal. Since the payoff is higher than the punishment of the insider trading, the insider will not be deterred and will still go ahead with insider trading. As stated above, the insider in most cases in India escapes detection, apprehension or conviction.

In India, the probability of punishment depends on the seriousness of the crime committed. The deterrence is almost nil or very minimal for insider trading where the payoff is very less since the probability of punishment in such cases is 0. In cases where the payoff to the insider is considerable, then the increase in probability is too gradual or too slow with the increase in the seriousness of the insider trading committed. In India, in the financial year 2016-17, only 34 cases were taken for investigation and the number fell in financial year 2017-2018 when only 15 cases were taken up. In India, the focus is only on the big fish, thus deterrence is visible only in substantially large cases since the probability of punishment increases proportionately with that of the seriousness of the crime in this category.

The difference between the insider's payoff $y(x)$ and the expected punishment $p(x)f(x)$ amounts to the insider's net gain from the insider trading committed. While, in countries like the US, insiders are mostly in situations where the crime doesn't pay due to the increased severity and probability of punishment, in India an insider mostly finds himself in a situation where the crime pays off. This is because the probability of punishment in India is abysmally low. In India, where 5461 companies have been listed on BSE and NSE as in May 2019, in the financial year of 2017-18, only 15 cases of insider trading were even taken up for investigation. Out of the 15 cases, a mere number of 6 cases were completed and the reports were submitted only for those 6 and the rest still lie incomplete. The investigation rate was thus less than 50% in the year 2017-18. The probability of punishment is very less when compared to its

US counterpart SEC. The SEC handles more than 50 cases of insider trading cases in a year. Also, in the US, individual stock exchanges also have certain mechanisms other than the SEC where NASDAQ, which has more than 3300 listed companies investigates around 400 cases per annum and sends 125-130 in a year to SEC for adjudication and prosecution. In comparison, the probability of punishment in India is very low, and thus is unable to deter the insider from indulging in insider trading. Also, the severity of punishment is less in India where it is noted that the maximum penalty of 3 times of the profit has never been imposed. Also, in India though insider trading has been criminalised, no man has ever gone to jail for insider trading. This makes the commission of insider trading in India all the more lucrative since the probability of getting caught and the severity of the punishment, in case an insider gets caught also is less thus making the expected punishment less than the expected payoff for the criminal, i.e. $y(x) > p(x)f(x)$.

In India, the number of insider trading cases is huge and rampant since the expected punishment is very less when compared to the payoff from insider trading. The above analysis of law and economics thus establishes the relation between the severity, probability of punishment and the seriousness of the insider trading cases. It has also reflected the reason for proliferation of insider trading cases in India despite the measures taken to improve the laws and regulations. It has established that since the probability of punishment is low due to lack of proper enforcement mechanisms, insider trading still exists rampantly in India.

Thus, it becomes imperative to analyse the reasons for the low rate of probability of punishment in India.

V. THE CHALLENGE TO OVERCOME: INEFFICIENT ENFORCEMENT

A number of reasons contribute to the abysmally low rate of enforcement of insider trading regulations. Although some of these may be changed most of them are sui generis. There are dual fundamental reasons for this problem:

- A. Scarcity of resources
- B. Problem of detection

A. Scarcity of Resources

The poor enforcement rates in India need to be viewed from the cost-benefit aspect of enforcement. Even though the prohibition of insider trading looks extremely desirable, the sound implementation of the same is extremely expensive. In India, since anyone who in possession of UPSI is considered as an “insider”, the enforcement becomes all the more difficult and runs the high risk being a wild goose chase.⁶³

The budgetary constraints of SEBI inhibit prohibition of insider trading and keep a close check on the market at all times. While the total income for the FY 2018-19 was estimated to be at Rs.631.92 crore, the

⁶³ Ajay Shah, *Why Forbid Insider Trading* Ajay Shah writing for the mass media (1998), MAYIN, <http://www.mayin.org/ajayshah/MEDIA/1998/index.html> (last visited Jul 24, 2019).

total revenue expenditure during the FY 2018-19 was estimated to be Rs.469.59 crore.⁶⁴ Additionally, the 2019 Union Budget has proposed that 75% of the surplus of SEBI would be contributed to Government funds.⁶⁵

And a majority of the resources of SEBI are exhausted in routine regulations such as reviewing audits and reports, overseeing general market well-being and rule-making. Given the low resources available in relation to the high costs, insider trading falls outside the radar of SEBI's highest priorities. Also, the personnel available with SEBI are lesser than what it ought to have. According to present statistics, one SEBI employee will have to be as efficient as 10 of USA's Securities Exchange Commission [SEC] employees in order to attain the same level of efficiency as the USA.⁶⁶ In 2017, SEBI had just 1 employee for every 6 listed companies in the market⁶⁷ and at the end of FY 2017 SEBI had 1,800 pending enforcement cases.⁶⁸

The adverse resource scarcity thus mandates SEBI to adopt a selection policy that gives priority to cases that are highly sensitive, involve a large amount of money or are comparatively less costly and

⁶⁴ Securities and Exchanges Board of India, *Memorandum to the Board Budget Estimates for the Financial Year (FY) 2018-19*, GOVERNMENT OF INDIA https://www.sebi.gov.in/sebi_data/meetingfiles/may-2018/1525328189491_1.pdf.

⁶⁵ Palak Shah, *SEBI's 75 per cent cash surplus to go to government*, THE HINDU (July 5, 2019), <https://www.thehindubusinessline.com/markets/stock-markets/sebis-75-per-cent-cash-surplus-to-go-to-government/article28298168.ece>

⁶⁶ Krishnamurthy Subramanian, *Opinion: Bridge the human resources gap at SEBI*, LIVEMINT (2018), <https://www.livemint.com/Opinion/P5feaU36POSSV97V9t0Y7J/Opinion--Bridge-the-human-resources-gap-at-Sebi.html> (last visited Jul 21, 2019).

⁶⁷ Malpani, *supra* note 57.

⁶⁸ *Id.*

requires lesser enforcement and investigation costs. These criteria thus result in a very narrow range of choices that phases out most of the insider trading cases. It thus follows that most violations are not usually subjected to enforcement actions.

B. Problem of Detection

One major problem is that these trades are hardly ever detected by the regulatory agency.⁶⁹ In order for SEBI to suspect an unusual activity, it needs to connect various dots acting as clues simultaneously. First and foremost, a notable material event needs to happen, for instance a merger or a takeover. In the absence of this event, then considerable increase in the volume of the shares traded and fluctuations in the market, unless extremely haphazard, are disregarded to be random market fluctuations in the usual course of operations.

Even in case of happening of a substantial event, SEBI will be unable to connect the events if the insider is successfully able to defer public announcement until few months from the date of trading in shares. Despite this, if SEBI establishes a connection, the work is only half done. SEBI has a series of job after this where it should scrutinize trading accounts to learn about the identities of the traders, formulate a criterion to winnow the trades, search long lists of trades in order to establish and detect a pattern or any other indication that establishes insider trading. It is necessary for SEBI to get through this exhaustive process before it can

⁶⁹ Peter Demarzo, Michael J Fishman & Kathleen M Hagerty, *The Optimal Enforcement of Insider Trading Regulations*, 106 JOURNAL OF POLITICAL ECONOMY 602–632 (1998).

even decide if it has to take up the case for investigation and enforcement. Thus, the long and tedious process in addition to the lack of technology for better methodology makes the enforcement ineffective.

VI. CONCLUSIONS AND RECOMMENDATIONS

There is absolutely no doubt that India has come a long way and has now joined the League of Nations with strict laws against insider trading. The recent laws enacted in India appear to be more hopeful and pragmatic in meeting the needs of India's growing capital market. But it is equally important to understand that India has still got a long way to go. India now stands still at crossroads- Strict regulations and laws in place; but lack of surveillance mechanism to enforce the same.

“For years, traders in the financial markets stood more risk of getting struck by lightning on the golf course than they did of being arrested for swapping a few share tips on the same fairways”.⁷⁰

The above statement was made in light of the Great Recession in the USA at a time when the enforcement of insider trading regulations became rigorous. It is high time that the statement becomes felicitous to India.

The efficient enforcement of regulations in India will remain a distant goal until SEBI is granted the much-needed powers required for

⁷⁰ Christopher Montagano, *The Global Crackdown on Insider Trading: A Silver Lining to the "Great Recession"*, 19(2) INDIANA JOURNAL OF GLOBAL LEGAL STUDIES 575–598 (2012).

investigation like wiretapping and is allocated more resources in order for it to carry out its regulatory activities in a better manner. The paradox between the toothless enforcement and the right to privacy of citizen's is here to stay. So, instead of being cynical of the consequences of the wiretapping power of SEBI, it is time that the power is granted to the regulatory body. Though the misuse of such a power by powerful players in control such as the ruling party etc. acts as a cause of concern, the mere apprehension of the same cannot be a barrier in the implementation or the granting of such powers to SEBI. It is perhaps the duty of SEBI to decipher and draw an effective line in order to prevent its misuse. Since the power has proved to be very effective in various jurisdictions like the US, France etc., it is the right time to grant SEBI such powers amidst the proliferation of insider trading cases.

The Government needs to decipher that the menace of insider trading cannot be curbed merely by creating more and more laws; the proper enforcement of the same is equally important. Overregulation and excessive authority can never act as an adequate alternate for the proper enforcement of the regulations. Effective enforcement of the insider trading regulations is the need of the hour in India in order for India to maintain and develop as a global financial centre. At a time when India's rankings in the ease of doing business and safety of capital markets are gaining stability, effective enforcement is the key to maintain and improve the global stance of the Indian market.