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Prevention of insider trading influence good governance in capital market

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Abstract

Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to nonpublic information about the company. In various countries, some kinds of trading based on insider information is illegal. This is because it is seen as unfair to other investors who do not have access to the information, as the investor with insider information could potentially make far larger profits that a typical investor could not make. Illegal insider trading raises the cost of capital for securities issuers, thus decreasing overall economic growth. However, some economists have argued that insider trading should be allowed and could, in fact, benefit markets.

Keywords: insider trading, prophylactics, bounty

Introduction

With the discovery of massive frauds in the Indian and International capital markets, regulators and legislatures have increasingly turned towards making corporate governance standards and have attached penalties to violation of these 'corporate governance' 'guidelines'. The concept of insider trading is based on the availability of unpublished price sensitive information about a company listed in the stock market. Use of such information by the persons having access to it for trading in the stocks for purpose of making personal gains is called 'Insider Trading'. Insider Trading has been explained by the high powered Committee on Stock Exchange Reforms in its report as "trading in shares of a company by the persons 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 not available to others [1]. Such trading involves misuse of confidential information and is unethical tan amounting to betrayal of fiduciary position of trust and confidence. The persons who have access to such information may be those closely associated with the company either as (1) top management as promoters or directors (2) executives and employees (3) persons associated with the company in their professional capacities as lawyers, auditors, financial consultants, etc. (4) persons working in banks and financial institutions dealing with the company (5) persons manning the firms having business relationship with the company and (7) persons not falling in above categories but have come in possession of price sensitive information. If insider trading is allowed unchecked in the capital markets, persons with insider information will have a consistent edge in trades executed with such information and those without the information will be consistent losers on the market.

Experience of Advanced Nations

To curb the menace of insider trading many developed nations have framed laws. U.K. and U.S.A. have comprehensive legislations and monitoring agencies to ensure enforcement of the law. In some nations, there is voluntary code of conduct to check insider trading like in Germany. In U.S.A., Securities and Exchange Board has been vested with powers to check insider trading and take preventive measures. Insider Trading Sanctions Act, 1984 was enacted to strengthen the hands of SEC further to prevent insider trading.

In U.K. there is a self-regulatory code known as City Code to curb this corporate malaise. A person connected with the company in any capacity is prohibited to deal with Securities at the Stock Exchange. Such person may be a director, employee or other person standing in professional or business relationship with the company or related company whose relationship gives him price sensitive information. Securities and Investment Board (SIB) also endeavors in preventing insider trading. In Hong Kong and Singapore, there are statutes which prohibit insider trading alike.

Time and again, insider trading has been drawing attention of the Government and its agencies, for example, Sachar Committee in the year 1978while examining the reforms in the Companies Act and other Corporate laws recognized the need for curbing the abuse of insider trading in the country by suggesting modifications in section 307 (Register of Directors shareholdings) [2] and 308 (Duty of Directors to make Disclosures of Shareholdings) [3]. Again Patel Committee in the year 1986 in its report dwelt with the need of immediate legislation to curb insider trading and suggested amendments in Securities Contracts (Regulation) Act, 1956.

SEBI has brought out a detailed draft on insider trading Regulation for a comprehensive and self-contained legislation on the issue. The Securities and Exchange Board of India (Insider Trading) Regulations, 1992 have been promulgated w.e.f. 19 November 1992. The power to issue orders has been enhanced.

Means of Controlling Insider Trading Prohibitions in India

Civil Sanctions
There is a need to add heavy civil consequences on the insider trader. According to SEBI, it does not have the power to impose civil penalties on the violator but SEBI could seek civil powers over violators with assistance from civil courts. S. 11 of the SEBI Act gives the Board broad discretionary powers to issue appropriate remedies [4]. To quote "Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit". It also has the powers to issue to any person connected to the securities market such directions "as may be appropriate in the interests of the investors in securities". SEBI has, like Harry Potter, powers it does not know of !!!

Criminal Sanctions
Of course there is the usual threat of a jail sentence for the offender under S.24 of the SEBI Act [5]. The section is more of a paper tiger. Though the jail sentence may look good on the statute, history bears out the difficulty in enforcing criminal prosecution against an economic offender. The burden of proof of proving a criminal charge is so onerous that a matter lies in the courts to unravel the complicated issues of facts of illegal transactions consummated over a period of time.

Other Sanctions
The Securities and Exchange Board of India may without prejudice to its right to initiate criminal prosecution under section 24 or any action under Chapter VIA of the SEBI Act, to protect the interests of investors and in the interests of the securities market and for due compliance with the provisions of the Act, Regulations made there under issue any or all of the following order, namely: -

a. Directing the insider or such person as mentioned in clause (i) of sub-section (2) of section 11 of the Act not to deal in securities in any particular manner;
b. Prohibiting the insider or such person as mentioned in clause (i) of sub-section (2) of section 11 of the Act from disposing of any of the securities acquired in violation of these Regulations;
c. Restraining the insider to communicate or counsel any person to deal in securities;
d. Declaring the transaction(s) in securities as null and void;
e. Directing the person who acquired the securities in violation of these regulations to deliver the securities back to the seller;
f. Directing the person who has dealt in securities in violation of these regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher to the investor protection fund of a Recognized Stock Exchange.

Prophylactics and Corporate Good Governance
The 2002 amendments to the Regulations provide extensive suggestions and also extensive regulations couched in the language of corporate good governance. Corporate good governance has been married to the penal provisions of the regulations provided by SEBI to create a smothering framework of regulations. Of course there is no denying that the regulations create a fair market and create a framework which more and more western countries are moving towards.

Sarbanes-Oaxley Act
The US legislature, witness to an unending line of scandals, recently passed amendments to the securities/disclosure laws of the country – in effect codifying into law several corporate governance suggestions made on previous occasions. The Sarbanes-Oaxley Act of 2002 requires:

- Directors, executive officers and large shareholders of public issuers to report transactions in the issuer’s equity securities within two business days of a transaction.
- Pre-clearance procedures for transactions in the issuer’s equity securities;
- The responsibilities the company will take for completing filings;
- The requirement (or encouragement) to use a specified broker for transactions in the issuer’s securities, or the certifications required from brokers if no specific broker is required;
- The applicability of the rules to persons with business or family relations to the insider; and
- Sanctions for failure to make timely filings.

Some possible additions to the already existeing regulations

Short swing profits
There should be a regulation introduced in the Insider Trading regulations which compel an insider to disgorge or turn in profits made by insiders to the company for any transaction in equity based securities in the company’s securities (including it’s parent’s or subsidiary’s shares) if both the buy and sell side of the transaction is entered into within six months of the other.

Designated or qualified brokers
Issuers should either designate a single broker through whom all transactions in issuer stock by insiders must be completed or require insiders to use only brokers who will agree to the procedures set out by the company. A designated broker can help ensure compliance with the company’s pre-clearance procedures and reporting obligations by monitoring all transactions and reporting them promptly to the issuer.

Derivatives Amendments
Parts of the regulations refer to ‘shares’ for the purpose of proscription while they should prohibit "securities" trading. For instance, one could, using derivatives, economically sell the shares without physically trading in those shares. Similarly, one can easily create synthetic securities with the same economic impact as an equity share of a company. By reclassifying shares into securities, one can eliminate the problem because securities are defined to include equity, quasi-equity,

derivatives and any combination of the three. Pure debt instruments can be excluded specifically from the regulations.

Civil Penalties

SEBI should be specifically provided with powers to charge several times the profit made (or loss avoided) and provide an economic blow to an economic offence. People trading in the market (not just counter parties to the insider) should also have specific powers to rescind trades and charge damages to the insiders during the period when they traded.

Proactive Stock Exchanges

The stock exchanges should take up at least a substantial burden of filing action against persons violating the regulations. Since the Rules and regulations of the stock exchanges are tabled in parliament, and court judgments have found the regulations having the force of law – they could easily enforce the requirements of the listing terms or the rules and regulations by seeking civil action in courts against persons or companies who violate such regulations.

Recession

One author has suggested that a contract of sale or purchase by an insider be declared void by the counterparty to a trade under the Indian Contract Act (this is besides the powers SEBI has to annul the trade under Regulation 11). Though legally feasible, it raises impossible burdens in today's virtually anonymous capital markets.

Tippee Liability

The regulations prohibit persons from tipping people about inside information by insiders i.e. the tipper. However, there seems to be no liability for a person who improperly receives a tip i.e. a tippee from trading. There is a vague prohibition against 'procurement' of information. However, it does not clearly prohibit a tippee from trading.

Bounty System

Section 21A (e) of the American Securities Exchange Act of 1934 authorizes the Securities and Exchange Commission to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, or from a person who directly or indirectly controlled an insider trader. This could be a useful addition to cracking into new cases of insider activity.

Disgorgement

Disgorgement orders could be obtained by SEBI from courts so that the ill gotten gains or the losses avoided can be taken away from the offender. A five times penalty or a ten times the gains made or loss avoided penalty besides disgorgement obtained from a civil court would be a more effective remedy than imprisonment under S. 24 of the SEBI Act (the courts are lenient in giving prison terms to economic offenders in any case). The SEBI should also seek asset freeze of bank accounts to catch insider trading funds from flying away and other ancillary reliefs like restitution, forfeiture of ill gotten gains when they cannot be returned to the rightful owner.

Conclusion

The core of securities regulations is the implementation of the purpose that all investors should have equal access to the rewards of participation in securities transactions. Inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life. What is sought to be caught is crime and treating all insiders as inherently tending towards a presumption of unfair dealing should be avoided. The regulator should specify in the Schedule to the regulations a list of optional procedure for limiting the possibilities of insider trading. What should be mandated instead should be a statement in the annual report of the degree of compliance with the standards set forth in the Schedule. Thus companies which do not follow corporate governance guidelines in substance would be penalized by its shareholders. Introduction of corporate governance ratings, similar to debt ratings would pressurize the management to comply with such measures.

References

1. (Patel Committee), 1986
2. (1) Every company shall keep a register showing, as respects each director of the company, the number, description and amount of any shares in, or debentures of, the company or any other body corporate, being the company's subsidiary or holding company, or a subsidiary of the company's holding company, which are held by him or in trust for him, or of which he has any right to become the holder whether on payment or not.
3. (1) Every director of a company, and every person deemed to be a director of the company by virtue of sub-section (10) of section 307, shall give notice to the company of such matters relating to himself as may be necessary for the purpose of enabling the company to comply with the provisions of that section.
   (2) Any such notice shall be given in writing, and if it is not given at a meeting of the Board, the person giving the notice shall take all reasonable steps to secure that it is brought up and read at the meeting of the Board next after it is given.
   (3) Any person who fails to comply with sub-section (1) or (2) shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both.
4. Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit.
5. (1) Without prejudice to any award of penalty by the adjudicating officer under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any

rules or regulations made there under, he shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.
(2) If any person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any of his directions or orders, he shall be punishable with imprisonment for a term which shall not be less that one month but which may extend to three years or with fine which shall not be less than two thousand rupees but which may extend to ten thousand rupees or with both.