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Regulation of Insider Trading in India: A Theoretical View

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Abstract

All insider trading are not illegal Insider trading is a familiar term for all investors and it is generally associated with an illegal conduct. But the term actually includes both legal and illegal conduct. Simply stated, insider trading means trading in a company's stocks or other securities by a corporate insider. This can also be stated as legal insider trading. A corporate insider, also referred to as classical insider, is typically a director or an official of a company. The liability for insider trading arises when an insider trades based on an inside information about a company that has emanated from a source other than from the company where the insider has passed on the information without the breach of fiduciary duty.

Key words – regulation and insider trading.

Introduction

Majority of the countries have framed laws prohibiting or regulating insider trading. As per available statistics, about 87 countries had adopted the insider trading laws by the end of 20th century. The pioneer country to recognize the need to regulate insider trading and, introduced the insider trading laws is the U.S. Although the U.S. had formulated its first insider trading law in 1942, it had commenced enforcing the restrictions on insider trading only since the 1960s. Following the U.S. example, many countries had enacted laws to regulate insider trading. Canada had laws relating to insider trading as early as 1966, closely followed by the French government which regulates the insider trading offence by the ordinance instituting a Commission des Operations de Bourse since September 1967.

Australia enacted the laws governing the insider trading in 1991 under the Securities Act. Singapore was probably one among the first countries in Asia to have framed laws regulating insider trading in 1973. The United Kingdom enacted the Criminal Justice Act, 1985 prohibiting insider dealings. India had enacted its insider trading regulations in 1992. The primary concern for all the countries which have enacted legislations on insider trading was to ensure fair transaction in the securities market by mandating disclosure of the material information affecting the trading in the market.

MEANING OF INSIDER TRADING

All insider trading are not illegal Insider trading is a familiar term for all investors and it is generally associated with an illegal conduct. But the term actually includes both legal and illegal conduct. Simply stated, insider trading means trading in a company's stocks or other securities by a corporate insider. This can also be stated as legal insider trading. A corporate insider, also referred to as classical insider, is typically a director or an official of a company. The category of insiders in a company also includes the "constructive insiders" who become privy to the corporate information legitimately by virtue of their relationship with the company. For instance, an underwriter, accountant, lawyer or consultant working for a company and exposed to the company's inside information are regarded as the constructive insiders. This implies that if any corporate or constructive insider of a company trades in the company's securities, such insider will be regarded as carrying on insider trading.

Illegal Insider Trading

Only if the corporate or constructive insider of a company trades in the company's securities, knowing that he is in possession of the unpublished price sensitive inside information, it becomes a legal wrong. Therefore, insider trading may not always be a prohibited activity.

THEORIES OF INSIDER TRADING

There are various theories of liability which the U.S. courts have applied to determine the liability of an insider in the insider trading cases. The U.S. courts have applied these theories to interpret the "anti-fraud rule", under Rule 10b-5 of the Securities Exchange Act, 1934, which is the primary provision dealing with the enforcement of insider trading cases. These theories have also been relied upon by many other countries while laying the foundation for the respective laws relating to insider trading. A brief overview of the theories is given below.

Currently, there are three important theories on which the liability of an insider in the insider trading cases is based. These theories are the "theory of abstain or disclose", "theory of fiduciary duty" and the "misappropriation theory."

Abstain or Disclose Theory

Until 1980, the U.S. courts used only the theory of abstain or disclose to base an insider's liability in the insider trading cases. According to this theory, when an insider is in possession of certain material corporate information and the insider intends to deal in the company's securities using such information which may affect the price of the securities, the insider should either disclose such price sensitive information to the market, or abstain from trading in the company's securities. This classical theory was set forth by the second circuit court in the US in the case of SEC v. Texas Gulf Sulphur and in the case of SEC v. Cady Roberts. In these cases, the court has observed that an insider in possession of material inside information must either disclose the information to the investing public or, if the insider is disabled from disclosing it in order to protect a corporate confidence, or, if the insider chooses not to disclose the information, the insider must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. However, it is crucial to assess the timing of the disclosure of information. For example, if the insider of a company makes disclosure regarding any new business venture it may be planning, such disclosure if too early may result in an opponent competing against the company. Moreover, until the information is disclosed by an insider, the insider bears the corporate as well as the market specific risks. The deal as well as the stock market or both may fall any time. On the other hand, the early disclosures will minimize the risks of an insider, if the insider has indulged in insider trading.

Fiduciary Duty Theory

The U.S. recognized the concept of fiduciary duty vis-à-vis the directors of a company in 1903, in the case of Oliver v. Oliver. A U.S. Supreme Court has ruled that "where the director obtains information giving added value to the stock by virtue of the director's official position, the director holds such information in trust for the benefit of the shareholders" . Until this case, the U.S. courts had rejected the fiduciary duty on the part of the corporate officers and the directors in their private dealings with the shareholders. Thereafter, in 1909, the U.S. Supreme Court, in the case of Strong v. Repide , had ruled that the concealment of relevant information regarding the company by a director at the time of purchase of shares from the shareholder was in violation of his duty as a director to disclose such information, and amounted to deceit. Further, in 1933, in the case of Goodwin v. Aggassiz, the Supreme Judicial Court of Massachusetts while analyzing the concept of directors' fiduciary duty, had considered the applicability of affirmative disclosure obligation. In this case, the defendants were the directors and the senior officers of a mining corporation. A geologist working for the company had suggested that there might be substantial copper deposits in Northern Michigan. The company considered this prospect and began securing mineral rights on the relevant tracts of land. The plaintiff was a former stockholder who had sold his shares of the company in the stock market to the defendants without knowledge of the geologist's prediction. Finally, while the plaintiff knew that the defendant had bought the shares based on the geologist's information about the mining project, the plaintiff sued the directors, on the ground that he would not have sold the shares if the geologist's propositions had been disclosed to him. The Massachusetts Court rejected the plaintiff's claim and held that the defendants had no duty to disclose the geologist's propositions before trading. The court ruled that "Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might find later and that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equal basis as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud."

The judicial interpretations of the U.S. courts over the years had concluded that the fiduciary duty of insiders means a duty owed by persons who are in a fiduciary relationship with the company, to the investors or to the source of material price sensitive information. The courts held that insider trading is not the breach of a general fiduciary duty, but the breach of a specific fiduciary duty to refrain from self dealing based on material price sensitive information which is confidential in nature. Therefore, based on the reasoning given by the U.S. courts, a better approach to regulate insider trading on the basis of fiduciary duty theory would be to treat it as a breach of insider's fiduciary duty to the company. This is so because; the insider owes no fiduciary duty to the shareholders, or to an unknown buyer in the securities market.

Misappropriation Theory The third theory of 'misappropriation' was formulated by the federal courts in the U.S. during the early 1980s. Under this theory, a person commits a fraud in connection with the purchase or sale of a security, if the person misuses the information given to him for legitimate reasons, for such trading and trades for personal gain. The liability for insider trading arises when an insider trades based on an inside information about a company that has emanated from a source other than from the company where the insider has passed on the information without the breach of fiduciary duty. For example, if an employee of an investment banking firm comes to know that his company's customer is planning on a tender offer for another company X, and the employee trades on the basis of that knowledge, there is no violation of 'abstain or disclose' rule, because the employee does not have any fiduciary duty to the company X, but he owes a fiduciary obligation to his employer and he ought to have refrained from profiting on the confidential information entrusted to him in the course of his employment. This is the basis of the theory of misappropriation.

The U.S. Supreme Court recognized the theory of misappropriation in the case of Carpenter v. United States. In this case, a Wall Street Journal Reporter and his confederates had misappropriated certain information belonging to the Wall Street Journal. The Supreme Court ruled against the plaintiff, Winans, an author for the Journal and Carpenter, who aided and abetted Winans, and held that the plaintiff had misappropriated the employer's insider information for personal gain and has therefore, violated the Rule10b5.

Thereafter, in 1997, the U.S. Supreme Court had reiterated the theory of misappropriation in the case of U.S. v O'Hagan. In this case, the court had recognized that "deception through non-disclosure is central to the theory of liability for which the government seeks recognition." Further, the court had held that if a misappropriate has disclosed his trading plans to the source of the information prior to trading, there will not be any violation of the Rule 10b-5.

Subsequently, the U.S.' securities market regulator, the Securities Exchange Commission launched an investigation. The trial court held Keith and Chestman liable for aiding and abetting misappropriation under Rule 10b-5. However, the Second Circuit court set aside the convictions on the following grounds.

a. It is a settled position of law that to be liable as an aider and abetter under the misappropriation theory, the tipper must owe a fiduciary duty of confidentiality to the corporation and the aider and abetter must know of the tipper's breach of fiduciary duty;

b. (ii) To find liability under Rule 10b-5 for aiding and abetting, there must be evidence to show that

    (a) Keith breached a duty owed to the Waldbaum family or his wife, based on a fiduciary or similar relationship of trust and confidence; and

    (b) Chestman knew that Keith had breached this duty; and (iii) Fiduciary relationship does not arise simply by entrusting a person with confidential information, nor does marriage or family automatically create a fiduciary relationship.

Therefore, the court held that Keith could not be held liable because he did not breach any fiduciary duty in order to commit fraud under Rule 10b-5. The Court held that Keith owed neither Susan nor the Waldbaum family a fiduciary duty or its functional equivalent, and therefore, he did not defraud them by disclosing news of the pending tender offer to Chestman. Absent a predicate act of fraud by Keith Loeb, the alleged misappropriator, Chestman could not be derivatively liable as Loeb's tipper or as an aide and abettor. Therefore, Chestman's Rule 10b-5 conviction also was reversed.

NEED TO REGULATE INSIDER TRADING

The fundamental purpose of the insider trading laws is to protect the investor interest and integrity of the securities market. An ideal securities market is one which accurately reflects the risks involved in trading and the returns for the investors. The proponents of law prohibiting insider trading did not regard all instances of insider trading as illegal, but sought to prohibit certain instances of insider trading carried out using non-public material information. This is to ensure parity of the information available in the market to all the traders in the securities market. Additionally, most of the legislators all over the world had intended to enact a law which would enable an honest director of a company to trade in the company's securities, and simultaneously, conduct the management of the company in good faith.

However, the legislators could not foresee that it is not possible for a company's director (the insider), to verify the identity of those with whom he is trading and make all disclosures relating to the company. Therefore, the expectation from the insider director trading in the company's securities was to publicly disclose the material facts affecting the price of the securities in their possession, before trading. Else, the directors should refrain from trading.

Apart from 'parity of information' theory, the above reasoning also seems to be a premise on which the insider trading laws has been developed in all the countries. In the U.S., the first legislation relating to insider trading, the Exchange Act incorporated a transactional disclosure regime mandating the insiders to make periodic disclosures of information affecting the price of the securities to the U.S.' securities market regulator, the SEC. This is because the main purpose of the federal law on insider trading was to advance mandatory disclosure of information by an insider to bring about parity in the securities market. However, the Exchange Act did not mandate comprehensive disclosure of information. This is probably because the legislators had realized the need for balancing between the protection of the investors' interest by mandating disclosure and the company's need for secrecy of material information by not providing for comprehensive disclosure.

Non-Economic Reasons

In addition to the foregoing reasons, there are both economic and non-economic reasons for regulating insider trading19. The major economic reasons include economic injury to investors and the firms, and claims relating to the property rights in information. The noneconomic reasons broadly include protection of mandatory disclosure system and the element of fairness in insider trading.

Mandatory Disclosure

Insider trading prohibition becomes absolutely necessary for the effective working of the mandatory disclosure system, as it ensures that insider's confidentiality obligations to the company is not abused for personal benefit of the insider. This is the primary non-economic reason to prohibit insider trading and the investors' interests. In this regard, major jurisdictions such as the U.S. and the U.K., and countries such as India, have heavily stressed upon the need for protecting the disclosure system and this is reflected in these countries' respective securities related legislations. For instance, India's major legislations relating to regulation of the companies and securities market mandate public disclosure of all material information by the companies. Some of this legislation includes the Companies Act, 1956, the Listing Agreement under the Securities Contract Regulation Act, 1956, the statute specific to insider trading, the SEBI (Prohibition on Insider Trading) Regulations, 199220, and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1996, which mandate various kinds of disclosures to be made by the companies to the regulators.

Economic Reasons

Injury to investors

The primary economic reason for prohibiting insider trading is to protect the investors from any kind of injury including monetary injury. This is because, in insider trading, the insider who possesses the corporate inside information about the company, through his trades misusing such information, can generate incorrect or unreal expectation about 32 investing in the company. Therefore, the investors may be induced to trade at the wrong price when dealing with an insider or in an insider induced transaction, as the insider is in possession of inside information, which the investors do not possess. The insider may abuse the corporate insider information for personal gain in multiple ways. For instance, an insider may choose not to disclose the price-sensitive information at all to the buyer or the seller of the securities. Further, the insider may decide to delay the disclosure of the information or make early disclosures, which in both cases will result in the price variation of the securities. Therefore, to minimise the harm caused by the information asymmetry between the insiders and investors, it is a must to regulate the insider trading.

Delay

Insider trading may adversely affect the company as it may delay the decision making process by the management and also the effective implementation of the company's policies. This is because the insider may retain any material information of the company for trading for personal gain and may deliberately delay the transmission of the information within the company. Further, there are chances of the information getting distorted. This can be harmful for the company as well as for the investors.

Interference with corporate plans

If insiders or persons in-charge of a merger or acquisition or other similar corporate plans indulge in insider trading using such information, the trading may have financial implications on the deal, such as the stocks of the entities involved may vary thereby affecting the overall price and profits involved in the deal. Further, the insiders may manipulate the revenues by delaying the payables, such as the dividends, or by expediting the receipts. Also, the insiders may structure the corporate deal to advance their personal benefits. Sometimes, an acquirer company itself may be interested in publicly disclosing the information, such as the name of the target company in an acquisition transaction.

Injury to Reputation of the Company

The instances of insider trading in a company may damage the company's reputation, thereby adversely affecting the shareholders' relations with the company and undermining the investors' confidence in the company's stock. This will also result in loss of the company's goodwill among the public as well as the regulators. Further, such injury to the company's reputation may consequently translate into a financial injury to the company.

Property Rights

A company has proprietary rights in all the information relating to the company. The existence of property rights in intangible property is well established. For example, the property rights in trademarks, copyrights, patents, and trade secrets are a few of them. If an insider misuses the company's inside information for trading in the company's securities for personal gain, the insider is actually infringing the company's proprietary rights in such information.

In India, private enforcement of insider trading cases are rare26 and the enforcement of the insider trading cases are only initiated by the SEBI suo moto or on receipt of a complaint from an interested party. In a way, the regulator has substituted the private rights with its regulatory powers.

Therefore, the discussion about the property rights involved in insider trading prohibition becomes significant. Similar to the case of patent infringement or theft of trade secrets, in insider trading cases also, the aim is to protect the economic incentive of the developer of the information to produce socially valuable information. Considering that an insider can easily appropriate such information for personal gain, the property right should be created in the information to prevent such misappropriation of information and enable the person who developed the information to profit out of the information or at least recover the costs involved in developing the information.

Conclusion

Under Indian law, the price manipulation cases are booked by the regulator under the SEBI (Prohibition of Fraudulent and Unfair Practices in the Securities Market) Regulations, 1996, whereas, insider trading cases are dealt under the Insider Regulations. Insider trading in India is definitely a class of fraud in itself. Also, the Indian securities market regulator, SEBI, has maintained the stand that the liability for the violation of the Insider Regulations is one of strict liability48. The Patel Committee in its report has said that insider trading involves misuse of confidential information and therefore, is unethical as it involves betrayal of the fiduciary position of trust and confidence. Therefore, on an analysis of the various judgements of the tribunals, 'parity of information' seems to be the only rationale behind the prohibition of insider trading in India.

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