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The Need to Legalize and Regulate Insider Trading - An Analysis

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Abstract

Insider trading is perceived as a problem across capital markets. The Securities Exchange Board of India (SEBI) created the SEBI (Prohibition of Insider Trading) Regulations, 2015, which criminalizes insider trading. However, insider trading laws have faced several problems at the implementation and enforcement stage. This article considers these problems from the viewpoint of the economic rationale that insider trading should be permitted in capital markets and thus legalized. These economic arguments have largely been ignored by regulators who have continued to come down hard upon insider trading, despite limited success. Moreover, due to concerns related to privacy, insider trading investigations may face greater hurdles in the future. This article takes these factors and economic arguments into consideration and balances them against the regulators' concerns to suggest that insider trading be not only prima facie legalized, but also regulated when there is a breach of fiduciary duties or when there is a dissemination of positive information.

Keywords: Privacy Laws, Kotak Committee, Fiduciary Duty, Capital Markets, SEBI (Prohibition of Insider Trading) Regulations 2015

1. Introduction

Insider trading is based on the idea of asymmetric information. At every stage, some people will have more information about a company than others- more often than not these people will be insiders

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of the company or connected to them. Insider trading has been regulated stringently by capital market regulators worldwide. However, there has always been a small, but vocal group of economists who have vehemently proposed that insider trading should be permitted, so that efficient capital markets can flourish. Although this argument has not been taken seriously by regulators, failures to detect insider trading, difficulties in enforcement and privacy issues make this a worthwhile argument to consider, in the context of India. In that sense, this article encapsulates the age-old debate between supporters of the market as an in-built mechanism, as opposed to those who reinforce the necessity for Regulation. The Article also discusses the theoretical basis of the argument that insider trading should be legalized as well as the many advantages to decriminalizing insider trading. Arguments from the other perspectives are also highlighted as to why insider trading must be regulated and why capital markets continue to do so. The Article contextualizes the debate to India by highlighting the basics of insider trading Regulation in India and pointing out various concerns about detection, enforcement, and privacy. Finally, the Article revisits the economic argument, considers its application in India and provides recommendations for the same.

2. The Economist's Stance

The battle for securities and information is carried out on capital markets. For an economist, the capital markets are efficient, because it is a market in which prices always 'fully reflect' all available information.[2] This means that since all known information is already available in the market, any information that is revealed to investors would not affect the share price. The efficient capital market hypothesis states that financial markets are efficient, in the sense that at a given point of time, all available information is reported accurately. This means that the only way that the price of a share will change is if there is new information that is introduced in the market – this new information is unknown and it could be

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[2] Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 (2) JOURNAL OF FINANCE 383, 383 (1970).

beneficial or detrimental to share value. The belief that insider trading should be legalized stems from the acceptance of the strong-form theory of the efficient capital market hypothesis, that believes that even insiders within a company would not be able to benefit disproportionately from their activities, because the capital market would already have assimilated the information that the insider would trade on.

In 1966, Henry Manne published the highly controversial book, 'Insider Trading and the Stock Market' which suggested that insider trading should be permitted because it did no significant harm to long-term investors. It could be used as a component of executive compensation,[3]which has been the most controversial of claims, although many commentators have backed it, citing that there are benefits in allowing private negotiations between companies and their insiders to determine whether insiders can profit from trading on insider information as part of their compensation package. It can also contribute to the efficiency of stock market pricing.[4] Manne stressed that empirical literature supports that insider trading can affect share prices (often along with other mechanisms), as "even if only on a few occasions and either by itself, or in tandem with other forces, insider trading may be sufficient to move the price of a company's stock."[5] The basic reason for supporting insider trading would be that since the capital market would be more efficient as more information is made public, allowing managers to trade on inside information gives them a powerful incentive to communicate their information rapidly to the market, through a buy or sell order.[6] The buy or sell order itself provides information to the market about the company because it indicates that there is some information that exists that motivates the insider investor to buy or

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[3] See Daniel R. Fischel& Dennis W. Carlton, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1982).

[4] See HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (The Free Press, 1966).

[5]Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. CORP. L. 167, 170 (2005).

[6]STEPHEN J. SPURR, ECONOMIC FOUNDATIONS OF LAW, 234 (Routledge, 2010).

sell. This does not, however, necessitate disclosure of the actual information per se, because such a disclosure could potentially be harmful to the company. However, this is only an extreme situation as insiders will limit the size of their positions because of risk aversion, and will camouflage their trading to some degree; they convey less information by trading than that conveyed by (credible) full disclosure.[7]

Moreover, in a system where insider trading is permitted, the prices at which consecutive transactions take place do not fluctuate; Manne asserts that if insider trading were barred, there would have been a sudden, sharp price jump upon public disclosure of the discovery as 'buy' orders flooded in.[8] Insider trading would also allow a company to convey information that it could not feasibly announce publicly because an announcement would destroy the value of the information, would be too expensive, not believable, or- owing to the uncertainty of the information-would subject the firm to massive damage liability if it turned out ex-post to be incorrect.[9] It could have the impact of controlling information because the announcement of information need not be continuous, while trading on inside information can be.[10] Moreover, there is no guarantee as to how markets would react to information; if we adopt the weaker form arguments of the efficient capital market hypothesis that share prices follow a random walk, it highlights that markets may not respond logically or predictably to all information. This means that insider traders may have more information than other traders, but their information is lacking the critical element on how other market participants react.[11] This is linked to the fact that markets usually operate on asymmetric information anyway

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[7] Fischel& Carlton, *supra* note 3, at 857-868

[8] Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market,* 53 (7) VA.L.R. 1425,1433 (1967).

[9] Fischel& Carlton, *supra* note 3, at 868.

[10] *Id* at 868.

[11] Carol Roth, *It's time to legalize insider trading*, CNBC, (Jun. 17, 2014), https://www.cnbc.com/2014/06/17/its-time-to-legalize-insider-tradingwall-streetcommentary.html.

since some players in the market have more information than others.[12]

One of the problems with using the efficient capital market hypothesis as the basis of the claim that insider trading should be legalized, is that very few people believe in strong form efficiency.[13] However other commentators have looked at other means to justify the economic argument about legalizing insider trading.

Many scholars view the insider trading debate as one that 'is a debate about how to allocate a property right within a firm.[14]The first formal conceptualization of this was done by Fischer and Carlton, who applied the work of Ronald Coase on social costs, and argued that whether insider trading benefits the market depends on whether the managers or the investors value the property right to the information more. In either case, the parties can engage in a value-maximizing exchange by allocating the property right in information to its highest-valuing user.[15] Thus, if the information is more valuable to the insiders then they should be able to negotiate its use as part of their compensation package. If, however, the critics of insider trading are correct, then both investors and insiders would benefit if the property right in the information lies with the investors. The property right in insider information as a negotiable commodity has important consequences for the efficiency argument. Negotiations between owners and controllers of pay packages comes with a cost, but insider information eliminates this transaction cost because the manager can 'renegotiate' his compen-

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[12] Doug Bandow, *Its Time to Legalize Insider Trading*, FORBES, (Jan 20, 2011), https://www.cato.org/publications/commentary/its-time-legalize-insider-trading.

[13] ANDREW M. CHISHOLM, AN INTRODUCTION TO INTERNATIONAL CAPITAL MARKETS: PRODUCTS, STRATEGIES, PARTICIPANTS, 134 (John Wiley&Sons, 2009).

[14] JONATHAN R. MACEY. INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY, 4 (Aei Press, 1991)

[15] Fischel& Carlton, *supra* note 6, at 863; See Ronald Coase, *The Problem of Social Cost*, 3 J. L. and ECON 1 (1960).

sation in light of new knowledge every time he trades – there need not be a separate negotiation each time.[16]

This also means that from a corporate governance perspective, managers will be inclined to act upon value increasing opportunities, since they can reward themselves by the insider information such opportunities create. Permitting insider trading then gives managers an incentive to find ways to increase the value of the firm and to create valuable information, since they would know that once the information is created, they would be able to exploit it through insider trading.[17] Insider trading could thus, actually be beneficial for firms, since managers would be incentivized to increase profitability and reduce agency costs with a significant positive impact on corporate governance. Insider trading also helps to identify potentially good managers from bad managers since it rewards those managers who create valuable information and are willing to take risks. Managers who most prefer such compensation schemes may be those who are the least risk-averse and the most capable.[18] Permitting insider trading may especially make sense where there are controlling shareholders because although insiders may benefit from special information they also bear special costs insofar as they are controlling shareholders,[19] such as the risk that they undertake. The promoter's ability to trade on information would then be considered as one of the benefits of bearing such a risk. However, as Manne points out, this view overlooks the fact that – "a control block of shares presents agency cost problems of its own since there are other devices besides inside information by which a controlling shareholder may transfer wealth from minority shareholders."[20]

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[16] *Id.* at 870-871.

[17] Spurr, s*upra* note 6, at 234.

[18] Fischel& Carlton, *supra* note 6, at 871-872.

[19] Harold Demsetz, *Corporate Control, Insider Trading and Rates of Return*, 76 (2) THE AMERICAN ECONOMIC REVIEW: Papers and Proceedings of the Ninety-Eighth Annual Meeting of the American Economic Association 313, 315 (1986).

[20] Manne, *supra* note 4, at 169.

Many supporters of legalising insider trading also point to the fact that it is largely a 'victimless crime' because the insider trades on information that is available to him/her as opposed to taking the information from someone else. The insiders' trading does not result in defrauding any party per se, or putting any party in a worse off position than before. Although insider trading sounds ter[21],it rarely involves fraud and operates in large and impersonal[22] securities markets where insiders purchase/sell shares anonymously from members of the general public who are agreeable to transacting at that price, in such a context it may be more sensible to legalize such transactions.

However, despite these arguments, insider trading has generally been perceived as bad for companies, corporate governance, economics and investors as represented by the spate of insider trading Regulations that persist in most jurisdictions.

Insider trading is regulated in almost all capital markets- both developed and emerging. This is due to several reasons which include the perceived failure of efficient capital markets to prevent large scale corporate governance scams such as Enron. Critics of the efficient capital market hypothesis point out that there is significant empirical research that suggests that insider trading does not have any substantial impact on share prices.[23] Others in favor of criminalizing insider trading point out that insider trading can create a significant moral hazard because it permits insiders to benefit on bad news and also encourages short-selling, which distances controllers' motivations from the owners. Insider trading can also incentivize insiders to make risky decisions because it creates a range of higher profit outcomes based on insider information.[24]

There may also be economic inefficiencies from insider trading. Macey writes that information being used by insiders can be ineffi-

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[21] Bandow, *supra* note 12.
[22] *Id.*
[23] See Schotland, *supra* note 8, at 1443.
[24] See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981).

cient; for instance in a takeover bid, the harm caused by the insider's buying in advance of their client's bid is two-fold. Firstly, this is because such purchases drive up the target's share prices, increasing the costs of acquisition to the detriment of the acquirer. Secondly, the purchase by the insider sends signals to the market that other interested parties take as a sign, once more driving up the purchase price. In such a situation, "the price of the target company's stock could rise to such a high price that the arbitrage gains anticipated by the bidder would evaporate and the takeover would no longer be economically viable for the bidder."[25] This is a loss of efficiency for corporate control markets as well. However, the biggest criticism of insider trading seems to stem from the view that it is inherently unfair due to the lack of parity of information. Insiders can take advantage and make gains that others cannot. This seems to be the basis underlying insider trading laws in several jurisdictions, including India.[26]

Moreover, even if we can economically justify insider trading as promoting efficient capital markets, when we engage in economic analysis, we do not banish permanently the legal and moral aspects of the problem analyzed.[27] Society is founded not only on economic goals, but also non-economic goals. The argument that economic analysis and markets do not always lead to solutions that respond to society's non-economic goals also exists. Scholars also feel that contrary to promoting efficient capital markets, insider trading on undisclosed material information is contrary to a free, open and healthy stock market, and thus contrary to our laws aimed at ensuring such a market.[28] Many also take the view that once insider trading is legalized, insiders would be able to seek external financing to finance insider trading transactions, attracting all financiers because of the lower risk and higher returns they promise and ef-

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[25] Jonathan R. Macey, *Beyond the Personal Benefit Test*, YALE LAW & ECONOMICS RESEARCH PAPER NO. 565, 10 (2017).

[26] Sandeep Parekh, Overhauling Insider Trading Laws, FINANCIAL EXPRESS (Dec. 19, 2013), www.financialexpress.com/archive/column-overhauling-insider-trading-laws/1209226/.

[27] Schotland, *supra* note 7, at 1438.

[28] *Id*. at 1477.

fectively remove outsiders from the trading process, leading to no public ownership in companies and eventually no capital markets themselves.[29]

The supporters of the legalising insider trading camp however remain unconvinced, highlighting that if insider information is seen as part of a compensation scheme. There are no questions of fairness, because nobody would argue seriously that salaries, options, bonuses, and other compensation devices allow insiders to profit at the expense of outsiders, because these sums otherwise would have gone to shareholders.[30] Moreover, it is argued by some that unfairness cannot be the basis of imposing harsh penalties – "One can draw an analogy between theft from someone's pocket which is illegal and a situation where a person finds a hundred rupee note on an empty road and picks it up, which is not illegal but can be called unfair."[31] In that context, criminalizing something unfair may seem like an overreaction. However, regulators seem less convinced by these arguments and insider trading is banned in most capital markets.

3. Indian Law on Insider Trading

Despite the economic arguments, insider trading continues to be treated as an offence and thus regulated in almost all jurisdictions and capital markets. Insider trading in India, until very recently, was subject to a double-scrutiny, one for all companies (included unlisted ones) as applied by the Companies Act 2013 and another specifically for listed companies as mandated by the Securities Exchange Board of India (SEBI), through the SEBI (Prohibition of Insider Trading) Regulations 2015.

Section 195 of the Companies Act, 2013 stated that no person, including a director or key managerial personnel (KMP), should enter into insider trading and also penalized those found guilty of the

[29] George W. Dent, *Why Legalised Insider Trading would be a Disaster*, 38 DEL J CORP LAW 247 (2013).
[30] Fischel& Carlton, *supra* note 6, at 881.
[31] Parekh, *supra* note 26.

offence of insider trading. Since insider trading is largely a concern of capital markets where it is possible to trade securities publicly on insider information, criminalizing insider trading in private or unlisted public companies was heavily criticized as a misnomer, as both the existing and potential shareholders of the company are effectively already insiders. Taking this into account, the Companies (Amendment) Act, 2017 removed section 195 of the 2013 Act,[32] with the consequence that now, insider trading provisions only apply to listed companies and are only within the ambit of SEBI.

The relevant Regulation is SEBI's 2015 Insider Trading Regulation, which replaced the 1992 Regulations, after the recommendations of a 2013 report published by a SEBI constituted Committee headed by the former Chief Justice of the Karnataka and Kerala High Courts, N. K. Sodhi. Interestingly, the Regulations are known as the SEBI (Prohibition of Insider Trading) Regulations 2015, which at the outset make it clear that the aim of the Regulation is not to regulate insider trading per se, but to prohibit it, thus making it illegal. The Regulations do not specifically define insider trading, although they define the terms themselves and create two separate insider trading offences. The definition of an insider is extremely broad in the Regulations, as it includes within this both connected-persons as well as any person possessing or having access to unpublished price sensitive information.[33] This means that anyone in possession of or having access to unpublished price sensitive information should be considered an 'insider' regardless of how one came in possession of or had access to such information.[34] The onus of showing that a person was in possession of, or had access to unpublished price sensitive information at the time of trading, would be on the person levelling the charge. It would be up to the person against whom such a charge was levelled to demonstrate that she was not in possession of such information or had not traded or was

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[32] The Companies (Amendment) Act, 2017, No. 1 of 2018, s. 65.

[33] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 2(1)(g); SEBI (Prohibition of Insider Trading) Regulations 2015, r. 2(1)(n)

[34] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 2(1)(g).

covered by one of the defenses embedded in the Regulations.[35] The definition of connected persons has created an interesting chicken-egg scenario, where certain known insiders cannot use unpublished price sensitive information and others may automatically become insiders (in the eyes of the law) due to possession of or access (possible possession) to unpublished price sensitive information.

The Insider Trading Regulations create two offences: firstly, the communication offence where the insider is liable for disclosing unpublished price sensitive information to another person[36] and secondly, the trading offence, where the insider is liable for trading when in possession of unpublished price sensitive information.[37] The communication offence not only creates an insider trading offence for the person who communicates the information, but also places a burdens the person who procures or causes the insider to communicate the information, thus penalizing anyone who tries to induce or extract information from an insider.[38] The offence, however, does contain some exceptions to take into account. The conflicts that may arise include situations where transacting parties convey information as part of the due diligence process,where such passing of information triggers the communication offence.[39] The trading offence has a high threshold that imposes a strict standard since it requires no proof of mala fide intention. It presumes that a person who has the information has traded on the information rather than requiring proof that the knowledge of unpublished price sensitive information was used to make a trade. This is somewhat mitigated by the Regulations, which permit the insider to prove their innocence by proving that the transaction was an off-market inter-se transfer between promoters and is part of a trading plan, or the action of an unknowing and unconnected individual

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[35] *Id.*

[36] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 3(1)

[37] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 4(1)

[38] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 3(2).

[39] UmakanthVarottil, *Due Diligence in Share Acquisitions: Navigating the Insider Trading Regime*, JOURNAL OF BUSINESS LAW (2017).

within a non-individual insider.[40]The 2015 Regulations are significantly more rigorous than the preceding Regulations because of the strict nature of the offence. The offence carries significantly large criminal penalties under the SEBI Regulations which applies section 15G of the SEBI Act of 1992.[41] It is interesting to note though, that unlike section 195 of the Companies Act, 2013 that had provided a specific jail term, section 15G of the SEBI Act which is related to the offence of insider trading, only provides a monetary penalty.[42]

However, the enforcement of insider trading in India has not matched up to the rigour of the substantive provisions. Figure 1 outlines the number of investigations taken up and completed in the last 7 financial years.

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Investigations Taken Up	28	24	11	13	10	12	26
Investigations Completed	15	21	14	13	15	20	4

Fig 1: Insider Trading Investigations by SEBI[43]

The data shows that the number of investigations taken up has not increased since 2010. Considering the burgeoning growth of Indian capital markets, where for example the market capitalization of the Bombay Stock Exchange has increased by 42.1 percent between

[40] SEBI (Prohibition of Insider Trading) Regulations 2015, r. 4(2).

[41] *Id.* at r. 10.

[42] See Ankit Handa and Arunima Vijay, *Harmonization of Insider Trading Norms and the Companies Act*, INDIACORPLAW BLOG, (Jan. 31, 2018),https://indiacorplaw.in/2018/01/harmonization-insider-trading-norms-companies-act.html.

[43] Handbook of Statistics on the Securities Market 2017, SEBI, https://www.sebi.gov.in/sebiweb/home/HomeAction.do?doListing=yes&sid=4&ssid=32&smid=0.

November 2016 and November 2017[44], the growth of the number of insider trading investigations seems insufficient. There seems to have been an increase in the number of investigations after the introduction of the 2015 Regulations on Insider Trading, but this does not seem to be reflected in the number of investigations that have been completed. The financial year 2016-17 showed by far the lowest number of investigations completed since 2010-11.

However, it must be kept in mind that the data is ambiguous as insider trading investigations often take numerous years (especially in the case of SEBI) and it is difficult to assess how old the investigations that are being completed are. Moreover, many investigations conducted by SEBI are often overruled by the Securities Appellate Tribunal or SEBI after passing a prima facie conviction for insider trading, because of lack of proof by the final order stage. A recent example of this is SEBI's August 2017 directions against former officials of Multi Commodity Exchange Ltd (MSEL), promoted by the same parent company that promoted the National Spot Exchange Ltd (NSEL), whom it suspected of violating insider trading norms by the trading of shares based on prior information about the National Spot Exchange Scam. However, in January 2018, SEBI revoked the directions against 7 of the officers, since they could not establish the alleged violation of insider trading laws.[45] It is also worth noting the large interval of time it took for the NSEL scam to come to light in July 2013.

This is not a problem that is specific to India. In the United States, despite the desire to curtail insider trading, the Securities and Exchange Commission (SEC) has been unable to aggressively enforce

[44]Data collected from World Federation of Exchanges, https: //www.world-exchanges.org/focus/index.php/in-every-issue/statistics/market-statistics?limitstart=0.

[45] *SEBI revokes insider trading orders against ex-MCX officials*, LIVE MINT, (Jan. 2018) https:// www.livemint.com/ Money/ 1h3S7CyUKp3v Vw4IWNGn8L/Sebi-revokes-insider-trading-orders-against-exMCX-officials.html.

the law by bringing actions and imposing penalties.[46] There also seems to be failure to start investigations in the first place. A highly publicized study in 2014 by academics from the Stern School of Business and McGill University found that out of all the merger and acquisitions deals announced from 1996 to 2012, 25% of these showed informed trading activity in options, also known as insider trading. In only 7% of the deals was there any litigation by the SEC.[47] In the course of the study, it was revealed that the trading on apparently secret deals was timed so well, that the probability of such deals happening merely by chance was three in a trillion,[48] thus pointing to a very high level of certainty that there was insider trading. This highlights that the investigation and enforcement lag that has dogged SEBI persists, in the United States as well.

The same trend seems to be followed in the United Kingdom, where a report in early 2018 stated that the Financial Conduct Authority (FCA) has prosecuted just eight cases of insider trading in the past five years, and securing 12 convictions, despite its research suggesting that the crime remains commonplace.[49] The lower rate of convictions must be seen alongside the comparatively much higher number of investigations that take place in the UK as compared to in India, the FCA had started investigating eighty four insider trading cases in 2017 and seventy in 2016.

The data and the anecdotal evidence seem to suggest two problems – firstly, that not enough investigations are taken up and secondly, that once taken up, the accusations of insider trading fail because of

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[46] John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 (2) U. PA. L. REV. 229, 266 (2007).

[47] See Patrick Augustin, Menachem Brenner, and Marti G. Subrahmanyam, *Informed Options Trading prior to M&A Announcements: Insider Trading?* Working Paper, Stern School of Business NYU and McGill University (2014).

[48] *Id.*

[49] Ben Chapman, *FCA: City watchdog secures just 12 insider trading convictions in five years,* INDEPENDENT (Jan. 19 2018) https:// www. independent.co.uk/news/business/news/fca-city-london-insider-trading-convictions-five-years-financial-conduct-authority-a8167486.html.

a lack of evidence. Some of these problems are due to systemic problems in SEBI's enforcement of insider trading. Firstly, SEBI is seriously understaffed – it has one employee for six listed companies, while the SEC in the United States has about one employee for every listed company.[50] Secondly, as compared to the SEC, SEBI's investigative powers are significantly lower. For instance, the SEC is permitted to tap phones to investigate allegations of insider trading but SEBI is only permitted to ask for phone records and SEBI was only granted this power as late as 2013 to combat the Sahara and Saradha scams.[51]

Fetters on investigative power are largely exacerbated by the fact that technology often moves faster than regulators can keep up. In late 2017, allegations were made in a Reuter's report that three days before Dr. Reddy's Laboratories Ltd announced quarterly results this summer, a message circulated on a private WhatsApp group saying the Indian drugmaker would not post good numbers.[52] The message was proved to be correct when on July 27th,Dr. Reddy's reported a loss of 587 million rupees, leading to a fall in share prices of 4.4%. Reuters obtained information of a total of twelve companies about which insider information was being circulated on WhatsApp. These included companies with stellar reputations such as Cipla Ltd, Axis Bank, HDFC Bank, Tata Steel, Wipro, Bajaj Finance, Mahindra Holidays and Resorts, Crompton Greaves Consumer Electricals Ltd, Mindtree Ltd, Mastek Ltd, and India Gly-

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50 SEBI, *Report of the Committee on Corporate Governance* (2011) https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html.

51 *SEBI got new powers in 2013 to fight Sahara, Saradha and other scams*, FIRST POST (Dec. 21, 2014) http://www.firstpost.com/economy/sebi-got-new-powers-in-2013-to-fight-sahara-saradha-and-other-scams-1315993.html.

52 Rafael Nam, *Exclusive: Prescient messages about Indian companies circulate in WhatsApp groups*, REUTERS (Nov. 16, 2017) https://in.reuters.com/article/india-whatsapp/exclusive-prescient-messages-about-indian-companies-circulate-in-whatsapp-groups-idINKBN1DG0IQ.

cols.[53] SEBI responded to this report by investigating the matter and issuing directions to some of the companies to conduct an internal probe. The response of Whatsapp was understandable in the circumstances. They pointed towards their privacy policy and stated that providing such information to SEBI would constitute a breach of privacy,[54] especially after 2017's judgment that has established a right to privacy in India.[55]

Interestingly, in April 2018 it was reported that in investigating the trading of shares in Deep Industries Limited, based on unpublished price sensitive information, SEBI had started looking at Facebook accounts of the suspected persons and had analysed the data in their accounts.[56] The purpose of this was to identify people who could be deemed as 'connected persons' for the Insider Trading Regulations. This highlights another potential privacy issue that SEBI may have to face in the future; the use of social media by SEBI in insider trading investigations, though helpful for carrying out investigations, has other socio-legal implications that need to be considered.

4. Legalize, but Regulate

What seems apparent is that enforcing insider trading has proved to be difficult and with the new laws of privacy, they could face greater difficulty in the future. The problem is that despite the cries of fairness that persist from those who support the criminalization of insider trading, there is a fundamental economic argument

53 *Id.*

54 Pavan Burugula, *WhatsApp refuses to share user-specific data with SEBI*, BUSINESS STANDARD (Mar. 1 2018), http://www.business-standard.com/article/technology/whatsapp-refuses-to-share-user-specific-data-with-sebi-118030100069_1.html.

55 Justice K S Puttaswamy (Retd.) and anr. v Union of India and ors (2017) 10 SCC 1.

56 *Sebi scans Facebook 'likes'; finds evidence in insider trading case*, ECONOMIC TIMES (Apr. 19 2018) http://economictimes.indiatimes.com/ articleshow/ 63830095.cms?utm_source= contentofinterest&utm_medium = text&utm_campaign=cppst.

against the insider trading laws that currently exist. Unfortunately, the objective of insider trading laws in most regimes is 'counter-intuitive' because it effectively:

> prevent(s) people from using and markets from adjusting to the most accurate and timely information. The rules target 'non-public' information, a legal, not economic concept. As a result, we are supposed to make today's trades based on yesterday's information.[57]

This shows a clash between the motivation of many insider trading laws and the core economic foundations of efficient capital markets. Another issue concerning insider trading laws is that they can only realistically regulate half the trading equation. This is because every piece of information that comes to the insider can have four consequences – they can buy, sell, hold or opt out of buying shares. While regulators can investigate transactions where there is an easily identifiable sale or purchase, it is virtually impossible to track those decisions to not buy or sell shares or those decisions taken to hold onto currently owned shares. Thus, economists point to an enforcement bias in insider trading laws which can only target those trades that are identifiable because they involve some buying or selling, stating that this disrupts the market because it entitles traders to rely on the best and most timely information so long as you do nothing. Such a rule is not likely to improve private investment decision-making or promote more efficient markets.[58]

The economic arguments are attractive, and the conclusion to legalize insider trading is succinct and does away with the enforcement and evidentiary issues of India's insider trading regime. However, unlike the economist, a regulator or a jurist cannot claim that just because a law is difficult to enforce and investigate, it is a sufficient basis for doing away with it. Such an argument would almost immediately fall foul of any normative beliefs that exist about why society has rules and why these rules are required to be enforced.

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[57] Bandow, *supra* note 12.
[58] *Id.*

Instead what this article recommends is a change in the perception of insider trading law, recognizing its economic benefits and regulating it rather than rendering it illegal. There is a marked difference between making insider trading illegal and regulating insider trading. The former strictly enforces that any insider trading is prima facie illegal by automatically deeming it a criminal offence, whereas the latter does not always see it as an offence, but recognizes that in certain instances insider trading could be damaging and identifies such situations and regulates them accordingly. Thus, the author recommends that insider trading be legalized.

The statement that insider trading should be legalized is provocative and would almost immediately raise the hackles of all capital market regulators. Taking into account the understandable policy concerns of regulators, the recommendation here is that though insider trading ought to be considered prima facie legal, it would not go unregulated and left to the whims of the capital markets. Instead, the recommendation is that insider trading should continue to be regulated despite being legalized. A parallel here can be drawn to related party transactions. Although related-party transactions can have significant consequences for corporate governance and is a great concern of SEBI, such transactions are not forbidden outright or made illegal. There is legal recognition of the fact that it not possible to make all related party transactions illegal, and in fact, such a move may be undesirable as well for a company and its profitability. Instead, it is regulated in such a way so that if such transactions are carried on in a way that is detrimental to shareholders or other stakeholders only then will they fall foul of the law. Similarly, insider trading too should be legal but regulated in situations where they could be considered damaging and against core principles of corporate law.

One way to do this would be to have contractual rules against insider trading, rather than government-mandated ones. This would have an advantage because it would take into account that since the circumstances facing companies differ, insider trading might be advantageous for some companies and not for others.[59] Thus, some firms could opt out of insider trading enforcement. As Haddock notes, the law fails to make provision for opting out, highlighting that it automatically assumes that insider trading is per se bad for all companies. It would be more efficient if policymakers took into account who is harmed, who is helped (other than the insiders), and by how much.[60]

In line with this, the Kotak Report on Corporate Governance in 2017 made an interesting recommendation that highlighted the flexibility in regulating, rather than criminalizing insider trading. The recommendation provided a framework for the regulation of information rights of controlling promoters or shareholders. Promoters and controlling shareholders are 'insiders' of a company which allows them to have unpublished price sensitive information about the company which minority shareholders do not have. This information asymmetry is a key corporate governance concern[61] and the Kotak report addressed this by its recognition of this asymmetry as the reality of Indian companies and attempting to bring it out of the shadows.[62] It proposed to do this by enabling promoters or controlling shareholders to have certain information rights in companies, if the listed entity enters into such an agreement. Such information rights would have meant that these shareholders would have de jure access to unpublished price sensitive information, something they already de facto had. The agreement would put forward checks and balances to ensure that such information is not abused or unlawfully exchanged, thus still regulating insider trading on such information. However, this recommendation was rejected by SEBI on the basis that giving any shareholder preferential treatment compared to other shareholders for getting access to information (will) have far-reaching implications and

[59] David D. Haddock, Insider Trading, *The Concise Encyclopedia of Economics,*https://www.econlib.org/library/Enc1/InsiderTrading.html.

[60] *Id.*

[61] See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 (4) JFE 305 (1976).

[62] SEBI, *Report of the Committee on Corporate Governance*, 50 (2017).

therefore may not be desirable.[63] The Kotak Committee's recommendation highlights that the reality of insider trading in India is not accurately reflected in the legal provisions. Recognition of this reality may lead to regulation rather than the criminalization of insider trading.

However, the question that arises is on what basis should such Regulation be created? One way could be through the use of fiduciary duties. This has been recommended by scholars because an insider, such as a director or key managerial personnel, has a fiduciary duty to the company/shareholder. In such a scenario, if insiders trade with special information available to them as fiduciary, trading against such shareholders in the absence of disclosure would amount to a breach of fiduciary duty and fraudulent conduct.[64] Thus, where an insider trades on information on breach of his/her fiduciary duties then there could potentially be an offence. If insider trading is enforced only as a fiduciary duty then the advantage is that individuals and companies can punish those that violate their trust but the offence is civil rather than criminal. Making insider trading a civil rather than criminal offence has the benefit of the punishment fitting the offence, since insider trading is not a situation where the government is "justified in using intrusive enforcement measures developed to combat violent crime."[65] However, care must be taken not to overextend the fiduciary relationship as has been done in the United States, with the misappropriation doctrine that holds liable those who trade based on information they gain from insiders.[66]

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[63] SEBI, View on *the Recommendations of Kotak Committee on Corporate Governance, 10 (2017)* https://www.sebi.gov.in/ sebi_data/ meetingfiles/ apr-2018/1524031522572_1.pdf.

[64] Parekh, *supra* note 25.

[65] Bandow, *supra* note 11.

[66] See Stephen M. Bainbridge, *The Law, and Economics of Insider Trading: A Comprehensive Primer,* (2001) http://papers.ssrn.com/ paper.taf? abstract_id=261277.

One way to ensure that the fiduciary doctrine is not extended is to highlight that the enforcement of the fiduciary duty must be initiated by the principal in the agency relationship, that creates the fiduciary duty, and whose duty has been breached. Thus, only the principal to whom a fiduciary duty was owed can claim a fiduciary breach of duty for insider trading and gain at his/her expense. This narrows the ambit of insider trading by highlighting that it is the breach of duty that matters, rather than the strict enforcement of the criminal offence of insider trading. Thus, the securities regulator would not have to enforce insider trading on behalf of the public at large or capital markets. This has two advantages to the economist – firstly, it is no longer a victimless crime because the trade would only have legal ramifications where there would be a victim. Secondly, the capital market which ordinarily operates on asymmetric information, will continue to do so and trades by insiders that do not breach fiduciary obligations will be assimilated into the market price of shares. However, those trades that breach the core fiduciary obligation that underlies corporate governance systems would result in negative consequences. But, like all breaches of fiduciary duties, this would be a provable offence, a civil offence rather than a criminal one and have an identifiable party who could enforce such a claim against a fiduciary. This would automatically reduce the evidentiary issues that SEBI faces as a regulator, because the principal to whom the duty is enforced would now have the burden of providing evidence of a breach and would probably initiate proceedings only after some evidence was accumulated in the first place. Thus, enforcing fiduciary duties may be one way that although insider trading is legalized, it is also regulated such that a balance is achieved in the economists' and regulators' perceptions of insider trading.

Another way to regulate insider trading which may be more balanced than the two extreme debates analysed may be to look into the nature of the information itself. Scholars distinguish between negative and positive information. Information is negative when disclosure leads to a decrease in the stock price and positive when it leads to an increase.[67] It makes economic sense to distinguish between these because the dissemination of both has different consequences. While insiders may be keen to trade on positive information because it may have positive consequences for them, since negative information may tie into their inefficiencies, they will be more hesitant to trade on these. Thus, in such a situation it may make sense to penalize insider trading on positive information, but not negative information. The dissemination of negative information could be seen as a form of whistleblowing, which may be incentivized and lead to greater efficiency in capital markets. This would lead to an overall social benefit because it would result in the dissemination of information that would have been concealed otherwise.[68] A counter-argument that may be raised is that permitting trading on negative information may lead to insiders producing negative information deliberately. To avoid this, Grechenig suggests that insider trading on negative information should only be allowed for insiders that have not produced the information in the first place. Thus, this may operate as another way where insider trading is regulated only half the way, to increase efficiency, rather than criminalizing it at the outset.

5. Conclusion

The criminalization of insider trading continues to be a bone of contention between those economists who believe that insider trading should be legalized and regulators who point to the inherent unfairness of insiders exploiting the basic information asymmetries in firms and capital markets. This article discusses in some detail the economic arguments that support the legalization of insider trading and the contrary view taken by regulators. It discusses the law of insider trading in India and highlights that the detection and enforcement of insider trading in India leave much to be desired, a leitmotif that also runs in more developed capital markets like the

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[67] Kristoffel Grechenig, *Positive and Negative Information - Insider Trading Rethought*, University of St. Gallen Law School Law and Economics Research Paper Series Working Paper No. 2007-28, 4.

[68] *Id*at 11.

U.S. and the U.K. The article also highlights some of the other problems that insider trading Regulations face and how these problems have exacerbated due to rapidly developing technology and concerns about privacy.

In the light of these issues, the article suggests a solution that may provide a neutral opinionto the debate – legalizing insider trading and only regulating it in specific identifiable situations, such as when there is a breach of duty in a fiduciary relationship. Such a solution may be easier to enforce, friendlier to capital markets and less likely to fall foul of privacy concerns in the future. The article also considers the possibility of recognizing between trading positive and negative information. A distinction in the regulation of these would also capture some of the potential efficiencies that insider trading can lead to in capital markets. Declaring insider trading prima facie illegal has failed from both an economists' and an enforcers' perspective. A new solution may be required to tackle those specified cases of insider trading that are so damaging that they cannot be resolved by the capital market and require tailored regulatory intervention.