Insider Trading in Company Securities : An Overview

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Abstract

Insider trading refers to the illegal trading of securities based on confidential information from internal company sources, which would not be generally available to the public, so that the trader has an unfair advantage. Scholars, academicians, market players and market regulators have classified insider trading into two categories: legal and illegal. Undoubtedly, insider trading is a white-collar financial crime. Securities market players like Harshad Mehta, Hiten Dalal or Ketan Parekh were involved in insider trading activities in the Indian stock market, whereas Michael Milken, Ivan F Boesky, Martin Siegel and Dennis Levin were their counterparts in the international stock market. The Securities Exchange Commission (SEC) in the USA has implemented insider-trading regulations and has penalized insiders in many cases. In India, the Securities Exchange Board of India (SEBI) framed regulations in the year 1992 for the first time, and later, thoroughly revised its regulations in the year 2002. These regulations have been criticized from different points of view.

Key-Words : Insider trading; Insider; Price-sensitive information; Securities Exchange Commission; Securities Exchange Board of India.

Introduction

History reminds us of some sad examples of Indian stock market. Big scamsters played an important role behind of 1992 securities scam and price rigging. A number of new companies were involved in fraudulent practices during 1997-2000. Few companies started functioning during this time and thereafter vanished during the period 1996-1999. A list of phoney IT(Information Technology) companies were formed during the IT boom of 1998-1999. In each and every case there were massive malpractices, price manipulations, price rigging and insider trading involved. These facts exposed the impotency of the market regulators and the effectiveness of the securities laws in India to tackle the scam and prevent fraud of the common investors. This paper is a humble attempt to discuss illegal and legal insider trading, and the magnitude of the insider trading.

Insider Trading

Insider trading refers to the illegal trading of securities based on confidential information from internal company sources, which would not be generally available to the public, so that the trader has an unfair advantage. Insider traders use specific unpublicized information either for their own financial benefit or for avoiding losses. The concept, implicit in the term 'insider trading', includes any person having access to unpublicized price-sensitive information about the company. Once such unpublicized information becomes available to the public, it affects the share-prices of the company in such a manner that its benefit becomes available only to the insiders, only at the first instance. Insider trading undoubtedly is a white-collar financial crime, the volume of which is estimated to be around US$ 750 billion (UK £ 500 billion) all over the world.

According to Phil Erlanger, a former Senior Technical Analyst with Fidelity, and founder of a Florida firm that tracks short selling and options trading, insiders made off with billions (not mere millions) in profits by betting on the fall of stocks during the tumble in the aftermath of the World Trade Center and Pentagon attacks (http//www.erlangersqueezeplay.com).

Legal Insider Trading

There is a debate among the scholars, academicians, market players and market regulators whether the insider trading is legal or illegal. Further, the issue arises how it could be proved? A number of financial economists and law professors take the position that insider trading ought to be legal. They base their case on the proposition that insider trading makes the stock market efficient. Presumably, the inside information will come out at some point. Otherwise, the insider would have no incentives to trade on the information. If insider trading was legal, this group argues that insiders would bid the prices of stock up or down in advance of the information being released. The result is that they would more fully reflect all information both public and confidential about a company at a given time.

Insider trading might be advantageous for some companies and not for others and if so would not be sensible to permit firms to opt out of insider trading enforcement? An interesting example in this respect is that Charles F. Fogarty purchase of Texas Gulf Sulfur shares during 1963 and 1964. Fogarty, an executive Vice-president of Texas Gulf Sulfur, knew that the company had discovered a rich mineral lode in Ontario that it could not publicize before concluding leases for mineral rights. In the meantime Fogarty purchased 3,100 Texas Gulf shares and earned $125,000 to $150,000. For this reason Fogarty was elevated to chief executive officer of his company. Moreover, following Fogarty's death, another insider who was also known to have traded on the same information was elevated to replace him. Clearly Texas Gulf's Board of Directors and shareholders must not have found the trading completely reprehensible. Yet the law makes no provision for opting out, implicitly assuming that inside trading ignores all companies policymakers never seriously ask who is harmed and who is helped and by how much.

The legal version of insider trading occurs when corporate insiders i.e. directors, officers and greater than 10% beneficial owners buy and sell stock in their own companies. In this case insiders must report to the market regulators in USA (Securities Exchange Commission) by filling the required forms as per section 16 of Securities & Exchange Act of 1934. After appointing an officer, director or beneficial owner they must fill up the Form 3 within 10 days. Changes in ownership within 10 days of the end of the month in which the change took place should be reported in Form 4 and an annual statement an annual statement of ownership of securities in Form 5.

Who are Insiders ?

An insider is one who has access to valuable information concerning the company before it is available to the general investing public. Directors and other key company officials, bankers, substantial shareholders, professional advisors, auditors, stock exchange officials, share transfer agents and any other party or persons having any kind of fiduciary relationship with the company may be considered as insiders. Insider trading may be conducted not only the insiders mentioned above but also by relatives, friends, and associates of such insiders. It is also mentioned that past officers and agents of company are also sometimes included as insiders.

Price-sensitive Information

Some of the important company related, insiders use events and phenomena that have the potential of changing prices as follows:

- Decisions concerning payment of dividends, bonus shares or right shares
- New investment decisions
- Changing financial policies
- Entry or exit of key managerial personnel
- Impending mergers and acquisitions etc.
- Launching of new products and introduction of new production technologies.
- Exploration of new markets
- Entry or exit of key managerial personnel
- Initiation of new sales and pricing policies

Effects of Insider Trading

An efficient and effective stock market should have excellent information processing ability. But the fact is that the most active stock markets in the world sometimes lack these attributes. The ill effects of insider trading are as follows :

i) Insider trading undermines investor confidence in the fairness and integrity of the capital market.

ii) The privileged few benefit and the common investors are left to suffer.

iii) Rampant insider trading defers foreign investors from the capital markets.

iv) Insider trading is often coupled with rigging of share prices to attract investors or lure genuine investors into deals of mergers and acquisitions etc. The ultimate gain accrues to an unscrupulous investor and ultimate loss to a genuine investor.

Important Insider Trading Cases in USA

USA is one of the most regulated stock market so far in the world market. Great securities scam were found not only in the US stock market but throughout the world. The companies such as Marcus Scholoss & Co., Drexel Burnham Lambert and the names of Michael Milken, Ivan F Boesky, Martin Siegel or Dennis Levin have cropped up and hurt the market sentiment which indicates and tends to suggest that there is large scale involvement of corporate insiders in the USA and also in the international arena.

The landmark market players in USA accused for insider trading by the courts are as follows :

Trader	Occupation	Fines &Repayments of Illicit Profit	Jail sentence
Michel. R. Milken	Banker, Drexel Burnham Lambart	$600 million	Pending
Ivan F Boeskey	Arbitrage	$100 million	3 years
Dennis Levine	Banker , Drexel Co.	$11.6 million	2 years
Paul Bilzerian	Investor, Chairman, Siger Co	$1.5 million	4 years
Martin Siegel	Banker, Kidder Peabody, Drexel	$9 million	2 months
Charles Zarzecki	Partner, Princeton/Newport	$1.6 million	4 years
Boyd Jefferies	CEO, Jefferies& Co.	$250,000	Probation

Important Insider Trading Cases in India

Although there is no statistical evidence of the incidence of insider trading in India, Indian companies such as Hindustan Lever limited, Colgate Palmolive etc. and the activities of the market operators Harshad Mehta, Hiten Dalal or Ketan Parekh prompt us to believe the existence of this crime in the country. The landmark case of insider trading in India can be discussed as an example (Hindustan Lever Limited).

- ***Hindustan Lever Limited vs. SEBI***

A core team consisting common directors of Hindustan Lever limited (HLL) & Brook Bond India Ltd.(BBIL), had been formed to consider modalities of a merger between HLL&BBIL. Unilever Inc.of U.K. is the parent company HLL & BBIL.On January 17, 1996, the Regional Directors of Unilever had granted in principle for the merger.

HLL purchased a total of 19.74 lakhs shares of Brook Bond Lipton India Ltd. in the phases. First lot of 7 lakhs shares were purchased prior to January 1996, the second lot of 8 lakhs shares were purchased in March 1996 through public financial institutions, UTI for Rs. 350.35 per share by paying a premium of 10% over the market price of Rs.318. The purchase deal was finalised on March 25,1996. The public announcement of the merger was made on April19, 1996. The third lot of 4.7 lakhs shares, were purchased in December 1996.

Pursuant to a large number of complaints, SEBI investigated the matter and came to a conclusion that HLL as an 'insider' purchased 8 lakhs shares of BBIL on the basis of unpublished price-sensitive information and had therefore, violated SEBI (Insider Trading) Regulations, 1992. SEBI also held that since information about merger would have affected the price of securities and reasonable investor would have attached importance to such information, non-disclosure of this information to UTI put it to a distinct disadvantage and prevented it from taking an informed decision. So, HLL has been charged to be involved in insider trading practices. SEBI thus passed an order directing HLL to compensate UTI to the extent of Rs. 3.04 crores and also didected prosecution against HLL and its five directors.

Thereafter HLL appealed to the Appellate Authority. The Appellate Authority raised the following questions :

i) Whether HLL was an insider?

ii) Whether the information available to HLL constituted unpublished price-sensitive information ?

iii) Whether it was necessary for SEBI to establish that the purchase of shares was motivated by the price-sensitive unpublished information and whether it was also necessary to establish the motive for profit or gain for proving insider trading ?

iv) Whether SEBI was empowered to award compensation of RS. 3.04 crores to UTI ?

v) Whether SEBI was justified in ordering prosecution of the Directors of HLL under Section of SEBI Act ?

After thorough investigation by the appellate authority the following conclusions were arrived—

i) HLL and BBIL were closely interconnected under the same management of Unilever. Thus HLL was to treat as an insider in respect of the information about the merger before it was made public.

ii) The information relating to merge was in price-sensitive and contention of HLL that only information relating to swap ratio was sensitive was not tenable.

iii) The circumstantial evidence available established strongly that the purchase of 8 lakhs shares of BBIL by HLL was motivated by the impending merger proposal. But the Section 3(1) of SEBI Regulations of insider trading reveals that there is no necessity to prove the motive of profit or avoiding loss to provide insider trading.

iv) SEBI did not have the power to award of compensation as a direction under section 113 of SEBI Act, 1992. Even SEBI was not given opportunity of being heard to HLL.

v) Lastly, the prosecution ordered by SEBI was not justified since the charge of IT was not established . This is due to the fact that the information about the merger was publicly known as several newspapers reported.

The whole episode from 1996 to 1998 is detailed below :

1	Pre- January ,1996	UTI sells 7.0 lakh shares of BBIL To HLL
2	March 19, 1996	UTI sells another 8 lakh shares to HLL @ 350/ per share
3	April 19, 1996	HLL, BBLIL inform the stock exchanges about their proposal of merger.
4	April, 22,1996	Boards approve merger in the ratio of 9 equity shares of Hll for 20 equity shares of BBLIL; market being Rs. 390/-
5	April, 30 1996	SEBI commences investigation into insider trading.
6	December,1996	Third lot of 4.7 lakh shares of BBLIL was sold to HLL< taking Unilevers's direct and indirect holding in BBLIL
7	August 4, 1997	SEBI issues communication of findings to HLL
8	March 11, 1998	SEBI issues order for presentation, for HLL and its five directors and Rs. 3.08 Crore compensation to UTI.
9	April, 21998	HLL appeals to appellate authority against SEBIs order
10	July 14, 1998	Appellate authority sets aside SEBI order

Need for Change of Regulations in India

Insider trading has been practiced in India for the last 50-60 years. Two expert committees namely the Patel Committee in 1985 and the Sachar Committee in 1987 had made recommendations to curb such type of trading. However, no such concrete steps were ever been taken by the government in this direction prior to the formation of SEBI. Securities and Exchange Board of India was set-up as the apex investor protection body in the year 1992. It framed regulations on insider trading named SEBI, Securities and Exchange Board of India (Insider Trading) Regulations, 1992. But these regulations suffer major drawbacks in respect of curbing insider trading and protecting investors. In the year 2002 they have thoroughly revised these Regulations. An important example of this revision is, prior to amendment, Regulation 2, clause (k) defined 'unpublished price sensitive information' under 8 parameters. After amendment, clause (ha) has been inserted to define 'Price Sensitive information' and clause (k) has been amended to define the word 'unpublished'.The amendment seeks to take away the defence which was provided by the definition earlier i.e. any information which is generally in the media or otherwise, cannot qualify as 'unpublished price sensitive information'. This defence was relied upon by the Directors of M/S Hindustan Lever Ltd. (HLL) when they were charged with the offence of insider trading in connection with the merger of M/S Brook Bond Lipton India Ltd. (BBLIL) with HLL.

Conclusion

If insider trading is a notorious practices in the stock market then how can it be determined whether there is insider trading or not? It is mostly admitted that behind almost all big scams and scandals in the stock market all over the world, for all the time, insider trading played a villainous role. The problems for which the stock market of a country fails to attain the critera of an efficient stock market. Though there are valid reasons behind legal insider trading, ultimately it does hurt the market sentiment, which needs to be curbed.

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