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Insider Trading: World View

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The recent enhanced scrutiny resulting in enforcement actions against insiders have again brought the topic of insider trading to the fore, as one of the unresolved challenges to good corporate governance. Regulatory action across the world, particularly in the United States (US), as was observed in the prominent case of Raj Rajratnam, highlights that insider trading is on their priority list. This is further reflected in the active and rigorous enforcement proceedings brought about by the Securities & Exchange Commission (SEC), the securities market regulator in the US, as well as by the US Department of Justice (DOJ).

Despite existence of stringent laws to curb insider trading, there have been only a few cases universally where enforcement has taken place. Further, growing use of technology and social-media networks offers both obstacles and opportunities for law enforcement. All this has led to an enhanced policing against insider trading to boost investor confidence and to attract the international investors.

What Is Insider Trading And What Is Illegal About It?

Insider trading refers to the practice of trading in the shares of a publicly listed company by a person having access to material information which is not publicly available, and which may have a bearing on the stock price of that company.

The standards and the actual conduct which attract penal action vary across jurisdictions (see table below), but the above mentioned core elements remain the same. US has been at the forefront of securities regulation, which introduced the Securities Act of 1933 and Securities Exchange Act of 1934 after stock market crash of 1929 to control the abuses believed to have contributed to the crash. The US securities regulatory framework exerts a strong influence on other jurisdictions' regulatory framework and enforcement actions. Indian securities regulatory framework is no exception and it is to an extent influenced by the US securities regulatory regime.

Insider Trading Debate

The core philosophy guiding the need to regulate insider trading is the one based on market efficiency. The story goes like this – in order to allocate capital in an efficient manner in an economy requires the market to be efficient. For the markets to be efficient, market participants should have equal access to information so that they may make their guess on the price in a narrow range resulting in an equilibrium price which is reflective of or nearer to the fair value and hence efficient. This is possible only in a market where there is information symmetry i.e. all market participants have equal access to information.

The fundamental characteristic of insider trading is that market participants have access to differential information resulting in information asymmetry. Once the market participants discover that there is information asymmetry in the market and that they might not know some information which their counterparty might know, they start factoring this knowledge of the existence of information asymmetry into the prices they quote, resulting in higher spreads. Gradually, market participants who don't have access to inside information leave the markets after suffering losses. All this results in the markets either becoming inefficient or in some limited cases completely collapsing. In order to prevent this outcome and to protect the interests of market participants who do not have access to inside information, the prohibitions against insider trading are in place. The prohibition against insider trading helps in ensuring fairness, achieving information symmetry and ultimately market efficiency.

The Contrarian View

Regulation of insider trading has always attracted diverse viewpoints and one of such viewpoints is the argument against regulating insider trading. The argument goes like this – insider trading based on non-public information in public markets help in the process of price discovery, as the actions of market participants in possession of inside information have a signaling effect to other market participants, bringing the prices closer to their fair value and enhancing market efficiency. It is further argued that the primary purpose of the regulations against insider trading is to prevent manipulation which necessarily involves moving the market prices away from fair value. Trading actions by insiders based upon inside information help the market participants to deduce information from actions of insiders and act accordingly, in the process moving the prices closer to their fair value and improving market efficiency.

Although there may be strong theoretical foundation for this contrarian viewpoint, it may not get accepted as a mainstream view in the foreseeable future because of the general perception of insider trading being inherently unfair and harmful for small investors, and therefore the need to regulate insider trading to protect innocent market participants.

Insider Trading Laws In Various Jurisdictions And Regulatory Reforms By Regulators

As discussed above, US was the first to enact the law on insider trading directly through Section 16(b) and indirectly through Section 10(b) of the Securities Exchange Act, 1934.Rule 10b-5, codified by the SEC pursuant to the authority granted to it by Section 10b of the Securities Exchange Act, 1934, is a broad and general anti-fraud provision in law giving the SEC authority to tackle fraud in the securities markets. After this in November 1989, the European Community Directive Coordinating Regulations on Insider Trading was adopted by the European Union requiring all members to enact legislation by June 1992.

Keeping pace with its counterparts, India also enacted the Securities Exchange Board of India Act, 1991 and issued various regulations including the Securities Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 to govern trading of shares of the company by the insiders and related disclosures. Under Indian law, an insider is prohibited from dealing in securities of the company based on unpublished price sensitive information (UPSI) (a concept similar to that of Material Non Public Information in the US). UPSI means price sensitive information likely to materially affect the price of the securities of a company which is not published by the company. In the Indian context, there have been only a handful of notable cases such as Rakesh Agarwal, Hindustan Lever Limited which have contributed in advancing the jurisprudence on the subject.

Overview - Insider Trading Laws Around The World

Country	Law	Laws first enacted*	Law first enforced*	Sanctions (civil / criminal)
Australia	Australian Act	1991	1996	Different penalty for individuals and corporations. Currently the maximum penalty for individuals for insider trading is a prison term of 10 years and/or a fine of up to A$495,000 or three times the value of the benefits obtained. For corporations the maximum penalty is the greater of a fine of A$4,950,000 or three times the benefit obtained, or 10% of the annual turnover if the benefit obtained cannot be determined.
Britain	Financial Services and Markets Act 2000	1980	1981	Maximum allowable prison sentence of 7 years or unlimited fine.
India	SEBI Act, 1991 and SEBI (Prohibition of Insider Trading) Regulations, 1992	1992	1998	INR 250 million or three times the amount of profits made out of insider trading, whichever is higher.
Japan	Financial Products	1988	1990	Maximum allowable prison

	Transaction Act (Translated name)			sentence of 3 years. For individuals fine upto Yen 5 million plus disgorgement of total trade value. For non-natural persons fine upto Yen 500 million.
Singapore	Securities and Futures Act, 2001	1973	1978	Maximum allowable prison sentence of 7 years. Fine upto three times of profit gained or loss avoided with a minimum of SGD 50,000 for persons other than corporations and SGD 100,000 for corporations. In case no profit gained or loss avoided the court may impose a penalty in the range of SGD 50,000 – SGD 100,000 on the person.
United States	Exchange Act, 1934	1934	1961	Maximum allowable prison sentence of 20 years. Fine upto three times of the profit made or loss avoided. Liability for person directly or indirectly controlling the violator may extend to USD 1 million or upto three times of the profit made or loss avoided. For willful violations penalty may extend upto USD 5 million for natural persons and USD 25 million for others.

***Source**: Bris, Arturo, Do Insider Trading Laws Work?, European Financial Management (2005)/ The Economist (October 15, 2011) and other research.*

Recent Regulatory Actions

After the global financial crisis, financial reforms have been on a fast track across the world. In the US, the Dodd-Frank Act was enacted as a direct response to the perceived failures of the regulatory mechanism during the financial crisis. New avenues for detecting securities regulatory violations were introduced, such as, for e.g. the 'whistleblower' provisions in the Dodd-Frank Act. The provisions enables detection of corporate fraud by incentivising whistleblowers in form of a percentage share of the fines/penalties imposed if the information they provide leads to successful prosecution resulting in fines/penalties beyond a certain threshold.

Even in India, some major regulatory developments have taken place in the recent past with respect to insider trading. By virtue of recent amendment to the consent order scheme in May, 2012, insider trading is now outside the ambit of the consent order mechanism. A consent order mechanism is a process where violations can been settled by paying fine as against full-fledged enforcement proceeding.

Inspite of stringent laws as can be seen above, insider trading being an extraordinarily difficult crime to prove virtually goes unprosecuted as direct evidence against insider trading are very rare and prosecution can only be carried out based on circumstantial evidence.

Lessons For Corporates

Insider trading brings disrepute and dis-fame apart from adversely affecting the commercial interests of an enterprise. Recent regulatory actions in different jurisdictions indicate that regulators are now far more vigilante than ever before, especially in light of the financial crisis. This heightened regulatory sensitivity coupled up with the risks posed by insider trading to the long term commercial interests of an enterprise places the corporate leaders in a position of increased responsibility, which requires them to take proactive measures to address the risks and neutralize them.

Insider trading may result in a variety of risks which may adversely affect the commercial interests of an enterprise. Some of the possible risks which may result from securities laws violations related to insider trading are:

Reputational Risk

One of the biggest risks which an enterprise may face following an insider trading violation is the damage such a violation may cause to the reputation of an enterprise. An insider trading scandal may bring negative publicity to the enterprise and may affect its commercial interests. This may pose challenges in retaining existing client(s)/business, acquisition of new client(s)/business and retaining/hiring talent.

Access to Capital
Although not always, there is a possibility of a fallout in case a company gets embroiled in an insider trading case in the form of reduced access to capital as investors become cautious about investing in a so-called 'tainted' company. Further, there might be a possibility that the cost of capital for the company may increase as a result of it being involved in an insider trading scandal. Additionally, some significant market participants such as pension funds may avoid investing in the company altogether owing to their investment criteria based upon principles such as for e.g. good corporate governance practice being followed in their portfolio companies.

Distractions Due to Regulatory Proceedings
One of the most damaging fallouts of a company being involved in an insider trading scandal is the distraction it causes both to the management and the company as a whole while the investigation is ongoing. It also hampers employee morale. The management becomes preoccupied with tackling and defending the company in the investigations, in the process losing sight of the strategic goals of the company.

Civil/Criminal Liability
A possibility of a heavy civil or even a criminal liability also poses a significant risk to the operations of the company. Another possible action which the regulators resort to is to restrict the company from accessing the capital markets for a defined time period, thus foreclosing one of the important avenues for raising capital for the company.

In light of the above mentioned risks, it becomes very important for companies to address the risks emanating from an insider trading scandal in a systematic and organized manner. It is often observed that having a formal system and process in place capable of reasonably detecting violations; taking of corrective measures; being forthcoming with the regulatory authorities and cooperating with them during investigations is invariably always helpful in setting the tone for future interactions and is generally seen in positive light.

In summary, the enhanced insider trading scrutiny in the recent past has forced corporations across the globe to reassess and rethink their internal processes and approach towards insider trading. The need to address insider trading goes beyond policy objectives of governments, and into the core of corporate existence, having a bearing on the commercial interests of an enterprise in todays connected world. Enforcement approaches adopted by a regulator in one part of the world may be replicated by other regulators, the same holds true for corporate best practices to be adopted to prevent such violations. In a globalized world lessons may be learned and applied across borders, in the process addressing issues which may crop up in future. It's about time that corporate leaders explore this path.