Insider Trading Should Be Legal or Illegal

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Abstract : Insider trading plays a very vital role to make market inefficient. Insider trading directly reflects the weak form of market in which material information is known to some people; through this they generate profits. This material non-public information is known to mainly upper class like directors, chief officers or even employees. This illegal insider trading ensures that there will be no fair play in the market. It affects both the small investors and big investors because the market is inefficient and there is no fair play of supply and demand of stocks and then the investors will lose its interest in stock market.

In this research paper, all we get to know is about Insider Trading. Insider trading means gathering material non-public information by the insider and trading on that information to gain more. Insider may be the director, employees, employers or any person who are attach to the company. In this research paper we will discuss about whether the insider trading should be legal or banned. Some of the authors are in favour of legalising the insider trading because they stated that information in the market is to gain whether it is material non-public information. Then we will conclude that it would be legal or illegal and if it is legal then we will discuss different standards and guidelines of insider trading especially in India.

INTRODUCTION

Insider trading is that type of trading by individuals of a public company’s stock with access to non-public information the company. Insider trading is illegal because of its efficient use by the insiders that will lose confidence in other investors. By legalising insider trading the market will be inefficient and thus leads to fewer players in the market.

Insider trading is contradictory as some authors’ claim that this types of illegal trading increases the cost of securities issuers and automatically decreases the overall growth of the economy.

In many countries insider trading is legal. Whenever insider trading done by either director or employees of the company, it is automatically reported to SEC.

Insider trading is somehow beneficial for the people who are in stock market because if insider trader purchases any of the stock, then it gives positive impact on the market and then people start purchasing that stock because insider trader had some extra information about the company.

Live example like Warren Buffet, he is not an insider trader but acts like that. He is named as the god of stock market. Whenever he purchases any stock it prices automatically start increasing because people think that he had some information about that company.

OBJECTIVE :-

1. Its impact on the market and the investors.
2. About insider trading whether it is legal or illegal.
3. How insider trading works.
4. Its guidelines and standards

LITERATURE REVIEW:-

Bhattacharya and Daouk (2002): They had investigated that how many countries enforce the law of banning insider trading. They took a survey and came to a conclusion that out of 103 countries, only 34 had law out of which only nine enforce the law. After that figures are increasing rapidly like from 34 to 87. The first nation to enforce the law of insider trading is United States because of increasing trend of insider trading. They also discussed about the popular case of “the wolf of the wall street”.

Veenman, D. (2010). Insider trading: the interrelation between accounting information, stock prices, and reported insider trades Amsterdam: Insider trading is interconnected with all the factors whether it is stock prices, accounting information and all the investors who are in the market. The change in one should directly influence other to change and all these factors have important role in making the market efficient and inefficient.
INSIDER TRADING MAY BE LEGAL OR ILLEGAL?

There is a code of conduct in the market in which trading by insiders are prohibited. In US sec16b, 10b of SEC1934 directly and indirectly signifies insider trading. As compare to US, Europe is stricter then US when it comes to illegal insider trading. This type of trading directly abuses the market.

MEANING OF ‘INSIDER’

Generally insiders are the persons who are within the organisation and had some part of contribution or share in the company. They may be directors, company’s officer and any beneficial owner having 10% stake in the company. Trade made by these persons by having material non-public information directly address fraud. There is an indirect link between the insider(directors, employees) and shareholders or the person who have real interest in the company. If the insider trade they will automatically lose interest of their shareholders because of inefficiency in the market.

VIOLATION THEORY

It states that anyone who violate the rule of insider trading will directly prohibited the SEC laws and will have bear the consequences.

PROOF OF RESPONSIBILITY

Someone who is responsible for insider trading is very hard to prove. The person who is responsible for insider trading may try to hide or may get proxies. At this time SEC came into an action. They have special eye on the activity of company’s directors or any other person. The SEC can refer these cases to regulatory board but they didn’t have the authority to handle it on their own.

INSIDER TRADING CAN BE LEGAL?

Legal trade is common everywhere by the insiders; it depends on the information that converts legal to illegal trade. If any insider caught trading with material non-public information then there is no need of any evidence, possession of such information is alone to violate the law.

It depends on the situation for example, if insider retires and wants to sell his shares every month in a specific amount for two years. The company came into the eye of SEC of having insider trading in the company. So this man does not come under the prohibition of insider trading.

Nishith Desai Associates (NDA) 2013: This research paper is based on the regulations in insider trading in the perspective of Indian economy like prohibition on insider trading and penalties if use insider trading and some methods to prevent insider trading and also explain about the rights of the party who is affected by the insider trading.

Laura Nyantung Beny(2008): In this paper, it presents the political analysis of the insider trading in the economy. It tells us about all the factors like political, legal and many more affect the insider trading decision. This research paper is given by the professor of the Harvard University. They conclude that information may be influenced by political, legal and other factors to be out in public.

The Know-All of Insider Trading – Decades of Corruptive Prevention (2015): This report talks about how to prevent from insider trading. The report defines some section which will help the company to prevent from insider trading. Some of the sections explain to maintain all the records of their members who are insiders like their holdings in the company of the securities and shares. It also tells about the preventing from outsiders who have direct link to the company. If the insider trading is being conducted in the company by the board then it also tells about how to find those insiders who are in insider trading.

Prof Kamlesh M. Pandya.: He talks about the standards and guidelines set by SEBI (Security Exchange Board of India) for trading in the market and penalties for insider trading. This report conveys all the standards to the rational investors who are not aware of insider trading.

Arjun Nihal Singh: Analysing insider trading in the Indian economy and talks about some of the cases in India of insider trading e.g. Rajat Gupta scam and many more. This report gives main focus on the penalties for using insider trading.
Under SEC regulation if company disclose the information intentionally to some people then it has to disclose in the public to not get into the insider trading.

PROTECTION MADE BY SECURITY ANALYST

Security analysts gather information regarding all wrong doing activities and then send to the company’s insiders or higher authorities. In this type of job, there should be no carelessness, the analyst should have proper eye on each and every activities which may go wrong. Like in CFA code of ethics, analyst should give report on timely basis to their clients or employers.

While sending some information whether it is material non-public information to their employers, they should give the information in proper way without violating any code of ethics or should not fall under the scam of illegal insider trading.

DEBATE FOR LEGALISATION

Some economists like Thomas Sowell, Henry Manne and others claimed that insider trading should be repelled. In addition they said that material non-public benefits investors by introducing new more information in the market. Someone said that the trader should require showing his trade in public because selling and buying pressure itself is material information to the market like warren buffet, his trades in the market can make prices up and down because everyone follows him.

Other members said that insiders should focus on their company’s goal not their personal goal. If the insiders trade upon the material non-public information then it will directly harm its own company. Some authors have argued that trading on negative information should be legalized because it will not affect the company. Positive information is more beneficial than negative information to the investors and on the behalf of company’s prospectus also.

Additional information- There are very limited law against insider trading in commodities market.

EFFECTS OF INSIDER TRADING

- Insider trading curbs the quantum of demand and supply of the stocks and then artificially increases the prices of the particular stock. And then these stocks will purchased by innocent investors.
- After the purchase of these shares by the innocent investors and will bear huge loss by the public investors, which will turn into large dip in the SENSEX.
- This has great impact on capital market because of global connection. The mechanism of insider trading start with the insider who had some material non-public information and form the group of people and then spread this information to regulate the price of the stock by purchasing and buying the stocks in the market. This effects the global market.

INSIDER TRADING IN INDIA AND ITS STANDARDS AND GUIDELINES

Insider trading in India is an offense under sec 195 of the company’s act 2013 and 15g of SEBI act (Security and Exchange Board of India). Insider trading means the person can gain more profits with just information which is not known to the public as compare to any investor. These are generally the directors, officers and employees of the company.

This type of trading is generally done to gain huge amount of profits with material non-public information. Penalty for insider trading is imprisonment which may extend to five years and minimum cash penalty is five lakh which may go to 25 crores or three times the profits which one is higher.

LEGAL INSIDER TRADING STANDARDS

Legal insider trading can be done if the information is disclosed. If non-public information cannot be disclosed then it may convert into illegal insider trading.

SEBI GUIDELINES FOR DISCLOSURE OF INSIDER TRADING-

- Every insider whether he is director, promoter or CEO should disclose his holdings within 30 days and the person who is selected for director of the company should disclose his holdings within 7 days.
- Upper class member should disclose its securities which were acquired or disposed in a recent time within 2 days.
- Any connections should be disclose by the members which can help him in insider trading.
CONCLUSION:

Insider trading should be banned in the economy because it creates inefficiency in the market that include no fair play, using material non-public information to gain extra profits in the market which can directly affect other investors and the investors whether they are small or big will directly lose interest. However some of the economists were against this banning of insider trading but they don’t have hard point to proof. They only said that it will benefits the investors to have material non-public information and it also helps the stock market to grow. One thing I have noticed is that positive material non-public information has more impact on both economy and company but negative information has less impact as compare to positive information. So in the end banning insider trading is much more beneficial for the company, investors and this will maintain the efficiency in the market.

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