Illegal insider trading undermines the market

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In 2001, Sam Waksal, CEO, ImClone Systems, USA, was given seven years and three months for insider trading. His crime: he had learnt from his brother, the COO of the same company, that the FDA would reject an application for ImClone's leading drug, and had acted upon it in the stock market.

In April this year, two Goldman Sachs employees made more than $6.7 million by engaging an analyst to provide information on Wall Street deals and a forklift driver to leak copies of a market-moving magazine. The US Securities & Exchange Commission (SEC) charged 13 people with insider trading.

SEC has filed more than 200 cases of insider trading in the past five years. In India, according to the latest available data, only 14 cases were taken up in 2003-04 and seven in 2004-05. So, is the crime less prevalent here or do our laws/ systems lack teeth to detect it?

Before we examine that question, let's first understand that insider trading includes both illegal and legal conduct.

Illegal Insider trading

This generally involves buying or selling a security in breach of a fiduciary duty or other relationship of trust and confidence, while possessing material non-public information about the security. The biggest perpetrators in India are the promoters and close associates, who trade through benami/front names. Investigating or even detecting such trades is difficult, as the holdings aren't shown as belonging to the insiders, but are disguised as public shareholding.

Some violators also use information that they've misappropriated or have received as a 'tip' to trade in the market. The practice is rampant. For instance, takeover announcements are often preceded by a massive run up in the stock prices of the companies.

If one draws a list of recipients of price-sensitive information, one will find the promoters and their cohorts at the top, followed by their relatives and friends, the directors, private equity investors, analysts, employees, suppliers/customers, institutional investors and brokers, may be in that order. By the time the information reaches the common investor, all cream has already been eaten up.

Companies rarely comply with Sebi's regulation on the disclosure of price-sensitive information to analysts/institutional investors. Under the guidelines, only public information should be revealed. But if it is non-public, it should be made public at the earliest. Besides, at least two company representatives should be present at meetings with analysts, and the discussions should preferably be recorded.

A company also has to be careful when dealing with analysts' questions on issues outside the intended scope of discussion. Unanticipated questions should be taken on notice and a considered response given later. If the answer contains price-sensitive information, a public announcement should be made before responding. Moreover, a company should issue a press release or post relevant information on its website after every meeting it organises with analysts. Very few companies follow these guidelines.

Another loophole is in Sebi's definition of the term 'relatives', which, for example, excludes in-laws. So an insider can trade in his father-in-law's name and escape detection. Interestingly, unlike the US, Sebi's definition of an insider excludes government employees, although many learn of price-sensitive information due to the positions they enjoy.

Going forward, the shareholding format needs drastic changes. Disclosures about public shareholders should also include fathers' names and addresses and, in the case of private corporate bodies, their addresses and the names and addresses of all the directors and signatories to the articles. The promoter's confirmation regarding links/relationships should be made compulsory. For non-promoter insiders, a surveillance system that can detect unusual trades is essential.

Legal Insider trading

The legal version is when 'declared' corporate insiders buy and sell their own companies' stocks and report the trades to the stock exchanges. Many among the investing public track such trades, as there is a school of investing that follows the lead of insiders.

In the US, these trades are instantly made public and are easy to find. But in India, the system of dissemination is very weak. Under the guidelines, the insider must first disclose to the company all his trades in a defined format within four days, after which the company is given five days' time to file this information with the stock exchange. Thereafter the exchange is expected to disclose the information to the market in a "quick and efficient manner" through its network and website.

But there are problems. No formats are prescribed for disclosures from exchanges to the market. Even the forms that insiders/companies file are not available on the websites of the exchanges. Some diligent companies that file information on insider trades, do so in sentences that often get lost in a maze of corporate information and hence are of little use – even the media cannot pick them up.

The entire process should be completed the same day, on an as-happens basis, and in an investor-friendly and accessible format.

It is also not clear why the clause "such other information as may affect the earnings of the company" was dropped from Sebi's definition of price-sensitive information in an amendment in 2002. The need is actually to keep enlarging the definition of price-sensitive information, as the range of situations in which one comes to possess valuable information is extensive.

Proving illegal insider trading will always be difficult, as traders often hide behind nominees, offshore companies and other proxies. However, since insider trading has hugely undermined investor confidence, the detection and prosecution of violations should assume top priority. That is the only way we can stem this fraud.