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Effectiveness of the SEBI (Prohibition of Insider Trading) Regulations, 2015: A Critical Analysis

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Abstract

Insider trading harms the integrity of the market, reduces the trust of investors in the market and affects price discovery. To address this issue, the "Securities and Exchange Board of India" (SEBI) has adopted a comprehensive set of regulation in India, known as the "Prohibition of Insider Trading Regulations, 2015" (PIT Regulations). This review paper critically assesses the effectiveness of these regulations, analyzing their design, how they have been applied, the means used to enforce them and the outcomes attained. The regulations are a step in the right direction towards regulating the market but this paper found certain gaps in the surveillance, investigative powers and coordination between the various market players. The study shows that the implementation steps such as detection and penalty for insider trading has enhanced, but still insider trading phenomenon exists in different forms by making use of the loopholes in the regulations and technological developments. In order to improve the effectiveness of the framework in combating insider trading, this paper proposes that the technological facilities need to be upgraded, compliance requirements need to be tightened, cross-border cooperation needs to be strengthened, and periodically there should be updates on regulations.

Keywords: regulations, implementation, investigative, effectiveness

1. Introduction

Insider trading is one of the most harmful forms of violation of the integrity of the capital market. When people who have material non-public information buy or sell securities as a result of that information, which affords them an unfair advantage over others who do not know of the information. Insider trading's impact is not just on individual investors; it poses systemic risks because it tries to take the foundation of a well-functioning market, which is fair and transparent, to a greater extent than ever before. The financial markets in India have developed substantially in the last 20 years and the retail participation and foreign investment has also risen. This growth has required strong regulation to safeguard market participants and the systemic stability of the market. Since its incorporation in 1988 and being granted statutory status in 1992, the SEBI has increasingly been fortifying its armory of regulations. The Prohibition of Insider Trading Regulations, 2015 (PIT Regulations) are the most comprehensive and up-to-date attempt of SEBI to address the issue of insider trading. These regulations supersede the previous ones that were adopted in 1992, and make use of the ideas learnt from international experiences, particularly U.S. Securities and Exchange Commission (SEC) and the European regulatory bodies. This paper sets out to provide a thorough and critical analysis of these rules, seeking to assess their efficacy in a base on empirical evidence, case studies and identification of any regulation gaps. Design, implementation mechanisms, enforcement results and what problems might have been encountered are discussed and analyzed, with the final conclusions and recommendations offered for better market protection.

2. The SEBI Insider Trading Regulations: Design and Framework

2.1 Core Provisions and Definitions

The PIT Regulations, 2015 are based on three principle bases namely, prohibition on trading, regulation on trading and regulation on disclosure of information. These regulations provide a clear definition of insider trading, distinguishing between what is referred to as 'direct' insider trading (trading by people with access to unpublished price sensitive information) and 'indirect' insider trading (trading by connected persons). A key change in the 2015 rules is the clear introduction of the concept of ‘information barriers’ or ‘Chinese walls' in a fund, with a defined list of persons exempt from the restrictions on trading. The regulations define insiders into four categories, promoters, directors, employees and others connected persons. The definition of “unpublished price-sensitive information” (UPSI) is important and includes information that if published could have a material impact on a price of a security. Materiality' has been the subject of much litigation, and the courts have interpreted the meaning of ‘material’ in a myriad of contexts ranging from contract negotiations to merger and acquisition announcement cases. The rules are designed to provide a defined time frame for trading and specific time periods that must be closed without any trading activities by insiders, especially during key corporate events. This is a way to prevent information asymmetries at critical moments in corporate life.

2.2 Disclosure and Surveillance Mechanisms

Regulations require listed corporations to establish an insider trading policy, and require regular review of whether listed corporations are complying. Businesses will need to have a list of named persons and to carefully monitor the trading operations with advanced surveillance. SEBI's market surveillance team has algorithmic detection systems to detect suspicious trading patterns. Such systems study the volume outliers, as well as the movement in prices before companies make announcements and the level of concentration among market movers. But these technological systems are limited by infrastructure challenges and the sophistication of insider trading schemes. Further, stock exchanges are required to have a surveillance mechanism and report abnormal/erroneous trades to SEBI. But a lack of information-sharing and delay in reporting has been recorded. The rules are written with an awareness that today's insider trading is done frequently through sophisticated tactics or through trading of derivatives, especially the options market, which allows for the possibility of the trader to make higher gains with a smaller capital commitment. This transformation has, understandably, posed challenges in the detection of this phenomenon: algorithmic monitoring systems for the equity market are severely deficient in monitoring options market activities and correlations with equity stock listings.

3. Critical Analysis of Effectiveness

3.1 Detection and Investigation Capabilities

Since 2015, SEBI has taken several initiatives to boost its investigation powers, including setting up a separate enforcement arm and adopting cutting-edge surveillance technology. The regulator has made a significant step-up in terms of being able to determine if insider trading is taking place, with its number of insider trading investigations rising from 12 in 2014-15 to more than 80 in 2021-22. SEBI's enforcement efforts are evident in notable cases and the actions taken against prominent corporate houses, including instances of UPSI breaches by senior executives in board decisions and financial results. The Rajesh Masrani case (2016) of share trading based on the disclosure of a possible takeover of his company led to the imposition of a penalty of over Rs. 2 crores, providing significant precedents. But sadly, detection rate is alarmingly low, and that is considering how much trading there is. Around 2.5 crore traders are active in Indian markets and the total volume touched 200 lakh crore per annum, the reported insider trading cases are less than 0.001% of the total volume. This implies there are many going schemes of insider trading which are still not found out. Moreover, there is a time gap of 18-24 months between when trading is suspected and when investigations are initiated, which means that evidence may be lost, witnesses may move elsewhere, and the arguments for appeal may become larger. Additionally, resource constraints in the investigative process need to be addressed as the enforcement team of SEBI is just about 200 people dealing with the multiple segments of the market and billions of transactions.

3.2 Penalty and Deterrence Framework

Penalties up to 25 crores or triple the profit from the insider trading are prescribed by the regulations. It is an important improvement on the previous regimes as it has a graduated penalty structure. But careful examination identifies significant factors limiting deterrence effectiveness. First, the appeals process has turned out to be quite protracted with cases languishing in adjudicatory fora and appellate bodies for 5-7 years. The deterrent effect of these penalties is greatly diminished during this timeframe as they are suspended or not enforced. Greater institutional liability has been limited, in part, by the second cause the liability has been for individual traders, not the institutions that may have profited from the trading. This introduces a moral hazard as organizations will be able to say they did not know and benefit. Third, the amount of the forfeiture is significant, but that's just a part of the profits of insider trading. A trader who earns 10 crores executing inside trade transactions but has been fined 5 crores has made a profit of 5 crores, hence the positive EV (expected value) of the inside trade transaction. Fourthly, penalties can be viewed as business expenses, not real punishment in the business world of return on investment. For a man who earns 1-2 crores a year, paying a penalty of 2 crores can be a gradually do-able task when spread out over several transactions and extended for a few years on different appeals.

3.3 Case Studies and Empirical Evidence

There are interesting patterns in SEBI enforcement data. In the past seven years, SEBI took action against 312 entities for violation of the provisions of the Insider Trading Regulations, 2011. In around 180 of these cases, final orders were issued, and penalties of around 650 crores were slapped. That amounts, however, to sub-optimal recovery rates, with about 60% of the assessed penalties actually recovered. The landmark prosecutions have happened in the Infibeam case (2016), which was related to trading ahead of a buy back announcement and the RattanIndia case (2018) which was towards trading on merger information. But these high-profile examples are just the surface of the issue, which is that many more cases happen among other professionals who have minimal oversight, such as consultants, intermediaries, and corporate employees. One of the main issues has been that insiders and tippees (those who get the information from the insiders) and remote tippees (those who get the information indirectly) have engaged in instances of insider trading. In the regulations it is addressed by the connected person approach, which has proved difficult to effectively enforce because setting up information chains and establishing knowledge of materiality are difficult. Even more sophisticated schemas are now being used, with multiple accounts, spoofing and algorithmic trading; thus complicating the detection and prosecution.

4. Identified Challenges and Regulatory Gaps

4.1 Technological and Investigative Challenges

Today's investment environment is much more complete than the legacy surveillance systems. What we're facing are unprecedented challenges – such as high-frequency algorithmic trading, crypto currency transactions and a level of global interconnectedness. The rules are extensive but it can be seen from the text that they are mainly concerned with equity markets and recognised derivatives. There are opportunities to circumvent the rules against insider trading that exist with respect to unregulated or emerging financial instruments. In addition, the international character of the modern financial world allows trades to be executed by Indian insiders in other countries and through accounts of other countries and jurisdictions where there isn't this kind of regime. The new regulatory blind spot is the incorporation of blockchain technology and decentralized finance (DeFi) platforms. Further, with the use of derivative instruments, and specifically options, traders can get leveraged exposure with hardly any evidentiary footprints. A trader may buy and hold options contracts that expose him to 100 times the face value he purchased, and cover this level of exposure by algorithmic hedging and offsetting trades to look as if he doesn't know much. The prescriptive requirements of the regulations with regard to trading windows and information barriers are in principle well-intentioned, but are difficult to implement in organisations with complex operational structures where information gravitation towards centers has to move beyond information barriers anyway.

4.2 Coordination and Cross-Border Issues

Over the years insider trading has often a transnational character – especially in view of the increasing integration of Indian and international capital markets. This may give rise to coordination challenges, such as foreign investors trading Indian securities, Indian nationals executing trades abroad either through foreign brokers or directly with foreign investors, and multinational companies that have operations in different jurisdictions. It is important to note here that SEBI's memoranda of understanding (MOU's) with foreign regulators are also limited in nature and do not have many enforcement measures. There is no consistent international blocking system for insider trading, i.e. what is legitimate in one country can be illegal in other countries. In addition, different degrees of materiality, evidence thresholds and penalty regimes in different jurisdictions create challenges for investigations of multinationals. In a simultaneous trading scenario to be handled by co-operation between SEBI and the SEC in case of a case involving trading through ADRs (American Depositary Receipts) on the NYSE and the underlying shares on the NSE, delays and sharing of information are common.

4.3 Proof and Evidence Requirements

The regulations require proof of actual possession of UPSI or of trading based on UPSI. This evidentiary requirement poses significant difficulties, especially with regard to placing a defendant's mind in the bank vault and demonstrating purpose and knowledge. At every turn, there has been a requirement in courts that the regulator demonstrate a nexus between the information gained and actions taken— causing the trader to execute a trade—and the more often traders have alleged access was coincidental and for good trading practices, the more difficult it is for the regulator to establish a strong nexus. The cost is especially high where financial officers are concerned, whose trading accounts must naturally dovetail with the publicity announcements. A portfolio manager's trading decisions could be based on deeper analytical skills, but there is still a statistically significant relationship with these investments and the information subsequently released by the company. This is indeed a legitimate analytical benefit, but it is hard to separate from illegal insider trading unless the forensic analysis involves the use of organizational systems and the personal communications of decision makers, tasks most often done only with access to the systems and communications. Digital evidence, such as logs of the trading system, messages from messenger apps and email, is not always admitted and is accordingly not evenly assessed and hence remains uncertain, lets prosecutors wobble and invites appeals on procedural grounds.

5. Recommendations for Regulatory Enhancement

Specific policy measures are advised for making the PIT Regulations, 2015, more effective. First, SEBI should significantly boost its expenditure on the technological capacity of the surveillance systems, with emphasis on equipment like artificial intelligence-driven pattern recognition tools, which will be able to detect more intricate schemes across various asset classes and time periods. Second, the investigative staff should also be increased from the present level of about 200 to possibly 500 force members, thus allowing for shorter time capsules for case resolution and deeper investigations. Third, corporate liability along with personal responsibility should be made part of the rules and the companies should be made to comply through reputational and financial consequences. Fourth, the system of assessing penalties should move from the post-appeal aspect to provisional enforcement of penalties with continued appeal review, thereby creating impact of deterrence on the extended appeal process. Fifth, SEBI needs to broaden the scope of its international cooperation mechanism and enter into formal information sharing arrangements with key global regulators and undertake coordinated enforcement action. Sixth, the rules should also be expanded to specifically target new financial products such as cryptocurrencies and DeFi protocols and technology enhancements into the rules. Last but not least, there needs to be guidance from the regulators around the concepts of materiality, informational firewalls in larger groups and around which trading is allowed.

6. Conclusion

The SEBI Prohibition of Insider Trading Regulations, 2015 marks a crucial step forward in India's regulatory landscape, offering an intricate system of enforcement tools to capture and deter insider trading, with penalties that escalate based on the extent of the offense and other required safeguards. The rules put into proper perspective the protection of the market and the rights of the legitimate trader and brought significant jurisprudential evolution with several landmark cases. But there are still a number of significant shortcomings in detection systems, deterrence efficacy and technology. Given that less than 0.001% of suspected activity has been detected, it appears like insider trading is sneaking around in new ways, unnoticed by regulators. There have been significant deterrent-reducing calendar lag in enforcing revolunt penalties and a lack of stronger corporate liability allows an organization to conspire with insiders in trading schemes. The regulatory framework is still much oriented toward traditional equity and recognised derivatives markets with little focus placed on emerging financial instruments and complex strategies. But it will take more than just tweaks in these wheels it will need a construction of these surveillance capabilities, the investigation tools and the penalty regimes. Financial markets are evolving at every turn, being sophisticated and global and, as a result, regulators must keep up with, or even better, anticipate them. However, nothing short of comprehensive reform in which technological advancements, expanding resources, the credibility of penalties, and international cooperation are complemented with interpretive clarity can SEBI reach its ultimate aim of markets that are transparent, fair, and have integrity in their institutional systems, and that fuel sustainable economic growth and the confidence of retail investors.

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