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ISSN: 2582-6433

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AN ANALYSIS OF INSIDER TRADING IN COMPANIES IN INDIA AND ITS EFFECTS

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ABSTRACT

Insider trading is malpractice of those who are directly related to a company or body corporate or has any relation with the company. These persons use their position to get price sensitive information related to value of shares etc. which is unpublished. In simple words the term Insider trading is about trading with the use of inside information i.e., information that has not yet been disclosed to the public. However, insider trading is divided into two limbs as legal and illegal. Legal Insider trading is done mainly by corporate insiders, who can be classified as officers, directors, and employees buy and sell stocks in their own companies. But we are more concerned with the illegal aspect of insider trading like secretive information is disclosed or leaked out without concerning for the needs of the investor.

KEYWORDS: Inside trading, unpublished, legal insider trading

INTRODUCTION

Insider trading generally involves the act of subscribing or buying or selling of the company's securities, when in the possession of any unpublished price sensitive information ('UPSI') about the company[1]. It also involves UPSI about the company to others who could subscribe or buy or sell the company's securities. Regulation on insider trading clearly says that it will be considered illegal if the insiders of public limited company trade on basis of price sensitive undisclosed information to make profit or avoid loss. Trades made by these insiders in the company own stock, based on material non- public information, are considered to be fraudulent since the insiders are violating the trust or the fiduciary duty that they owe to the shareholders. The corporate insider, simply by accepting employment, has made a contract with the shareholders to put the shareholders' interests before their own, in matters related to the corporation. When the insider

[1] Baiman, S. and Verrecchia, R.E. (1996). "The relation among capital markets, financial disclosure, production efficiency, and insider trading." Journal of accounting research"

ISSN: 2582-6433

buys or sells based upon company owned information, he is violating his contract with the shareholder.

EFFECTS OF INSIDER TRADING

Insider trading is an unfair practice, wherein the other stockholders are at a great disadvantage due to lack of important insider non-public information[2]. Various other disadvantages of insider trading are as follows-

- It is fraudulent for the investors at the time of buying the shares- Insider Trading is a dominant evil in stock markets. It is fraudulent and illegal because it is unfair to those who do not have access to price sensitive information and when a person uses such information to make money, he puts others at the risk of buying at a higher price or suffering a higher loss.

- Insider trading shakes the public/investor's confidence- Insider trading can shake the confidence of ordinary investors or public. Too many insider trading scandals in a condensed period could leave investors frustrated and wondering how they can make any money in stocks if they are consistently being put at a disadvantage by unscrupulous insiders.

- The corporate reputation is at stake and the overall industry gets affected Corporates often experience substantial negative publicity when insider trading is detected and revealed. Such negative publicity and the resulting reputational losses likely have a deterring effect on informed trading Further, the executives of firms with more reputational capital; thereby have more to lose from negative publicity, to profit less from insider trading. It is pertinent to note that even an individual behaviour can also damage a firm's reputation.

- Harms the efficiency, fairness, and integrity of the capital market- Trading on inside information, especially illegal insider trading, can cause significant harm to the fairness and efficiency of capital markets.

[2] Chauhan, Y., Chaturvedula, C. and Iyer.V. (2014). "Insider trading, market efficiency, and regulation A literature review."

ISSN: 2582-6433

UNPUBLISHED PRICE SENSITIVE INFORMATION:

Unpublished Price Sensitive Information is data relating to a company that has not been made public but could have an impact on its share price[3]. It is against the law for holders of non-public material information to use the information to their advantage in trading stocks. It is also illegal to share this information with others who use for profits in the market.

- Unpublished Price Sensitive Information refers to corporate news or information that has not yet been made public and which could also have an impact on its share price.
- It is illegal to use this kind of information for one and advantage in trading stocks or other securities.
- Legally, it does not matter how Unpublished Price Sensitive Information is obtained, or whether the person who acts on it is employed by the company or not.
- Insider trading is illegal when it involves the use of non-public material information.

The study seeks to decode the pattern of insider buying and selling across various styles. Is there a possibility of insiders making abnormal profit and viability of following insider trades as an investment idea to be followed by the outsiders? Whether the information advantage in insider transactions reflects for outside investors to follow insiders, and earn abnormal returns from insider trading disclosures? The focus is on gaining a better understanding of the effects of insider trading on the broad-based market in the immediate short run and the long run. Insider trading regulations evolve over a period shedding light on the impact of regulations on insider trading.

OBJECTIVES

1. To understand the term insider trading.
2. To know about several regulations and the laws that bound Insider trading
3. To identify the disclosure requirements.
4. To assess the information content of insider trading.

[3] J Sarkar & Subrata Sarkar, ‘Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India, International Review of Finance’ (2000) 161-194.

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HYPOTHESIS

There is lack of Efficient laws to curtail Insider trading and to protect the Investors.

The reason for the present study reduces from the fact that there are very few studies on this subject with regard to the emerging markets. Since India is an important emerging market, the findings of the study will be of significance. The study is based on the existing laws that is prevalent, as a result, the findings of the study shall be beneficial to the ordinary investors who do not have access to inside information and depend only on the publicly available information for investing. The study aims to find out the importance to the regulators to understand the strategies pursued by the insiders and that may help them to devise the regulations accordingly. It also gives an opportunity to assess the effectiveness of insider trading laws in creating a level playing field between insiders and outsiders.

Understanding Unpublished Price Sensitive Information:

It does not matter how the Unpublished Price Sensitive Information was received or if the person is employed by the company. For example, suppose someone learns about non-public material information from a family member and shares it with a friend. If the friend uses this insider information to profit in the stock market, then all three of the people involved could be prosecuted. The best way to stay out of legal trouble is to avoid sharing Unpublished Price Sensitive Information. Contrary to popular misconceptions, not all insider trading is illegal. Insiders are legally permitted to buy and sell shares of their company& stock, provided the transactions are registered and filed with Securities Exchange Board of India (SEBI). The illegal type of insider trading takes place when Unpublished Price Sensitive. Information is used to obtain an unfair advantage.

Types of Unpublished Price Sensitive Information:

There are many types of corporate information that can be considered non-public material information. Sometimes, this information comes from within the company affected. Alternatively, it can come from regulatory agencies, lawmakers, credit agencies, or financial institutions. Other examples of Unpublished Price Sensitive Information include critical financial filings such as earnings reports. Upcoming corporate actions that can move the price of a stock are often considered as Unpublished Price Sensitive Information, too. Examples include prior knowledge of initial public offerings (IPOs), acquisitions, stock buybacks, or splits. The outcomes of pending legal proceedings can also be considered Unpublished Price Sensitive Information. Such outcomes

ISSN: 2582-6433

include decisions in lawsuits and rulings by agencies like the Food and Drug Administration (FDA) and the National Highway Traffic Safety Administration.

Insider trading is illegal when it is done by using Unpublished Price Sensitive Information. Having information that is not public and making investing decisions of that, particularly if those decisions can impact the financial well-being of an entity, is considered illegal and is a civil and criminal offense that is punishable with prison time and fines.

Unpublished Price Sensitive Information can be disclosed at the discretion of a company in compliance with the law. When a company discloses material public information on a large scale, it is widely disseminated and can be used by all individuals, creating a fair playing field for investors.

The Insider Trading Regulation states that the unpublished price sensitive information(“UPSI“) means any information, directly or indirectly related to the company or its securities that is not generally available to the public, and which upon becoming generally available to the public, is likely to materially affect the price of the securities. Such information shall include the information relating to the following:

- Financial results of the company
- Dividends of the company
- Change in capital structure of the company
- Any mergers, demergers, acquisitions, delisting, disposals and expansion of the business
- Any change in key managerial personnel
- Any material events under the listing agreement.

The code of conduct is that the Compliance Officer Senior level employee appointed by the listed company shall report to the Managing Director \ Chief Executive Officer. · He shall be responsible for setting forth policies, procedures, monitoring adherence to the rules for the preservation of Price Sensitive Information. He shall maintain a record of the designated employees. He shall also assist all the employees in addressing any clarifications regarding the regulations and the company’s code of conduct. · Officers comprising the top three tiers of the company management and the employees designated by the company to whom these trading restrictions shall be applicable shall include DESIGNATED EMPLOYEE who shall follow the code of conduct. · All the directors and employees shall maintain the confidentiality of all Price Sensitive Information. They shall not pass on such information to any person directly or indirectly by way of making recommendation for the purchase or sale of securities. · Files containing confidential information shall be kept secure and Computer Files must have adequate security of login and password etc.

The company shall specify a trading period, to be called TRADING WINDOW for trading in the company's securities. The trading window shall be closed during the time of declaration of financial results, declaration of dividends, issue of securities by way of public\rights\bonus, any major expansion plans or executive of new projects, amalgamation, mergers, takeovers and buy-back, disposal of whole or substantially whole of the undertaking or any changes in polices, plans or operations of the company. The TRADING WINDOW shall be opened 24 hours after the information made to the public. · The directors are bound to pre clearance transactions. · An undertaking for not breaching the code is necessary. · All directors or officers or designated employees who buy or sell any number of shares of the company shall not enter into an opposite transaction.

Any employee or officer or designated officer, in violation of the code of conduct, shall be subjected to penalties and other appropriate action to be taken by the company, such as, disciplinary action like suspension, wage freeze or other actions. And the same decision shall not preclude SEBI from taking any action in case of violation of SEBI Regulations. · The SEBI shall be intimated about the violation by the company or the Compliance Officer[4].

SEBI has incorporated some significant changes to improve the then-existing Insider Trading Regulations, 1992. The regulation was amended to overcome certain loopholes that were highlighted in the cases of Hindustan Lever Ltd. v. SEBI[5] and Rakesh Agarwal v. SEBI[6]. The new legislation was named "SEBI [Prohibition of Insider Trading] Regulations 2002." The definition of 'deemed to be connected person' (Insider) was amended to include "a person who is an 'intermediary', 'investment company', 'trustee company', 'Asset Management Company' or an 'employee' or 'director' thereof or an 'official of stock exchange' or 'of clearing house' or 'corporation'." The definition of 'insider' was amended again in 2008. In 2015, SEBI (Prohibition

[4] Hemant Singh, 'How Securities and Exchange Board of India (SEBI) Controls Capital Market of India?' (Jagran Josh, 22 Sept 2019)
[5] (1998) 18 SCL 311 MOF
[6] https://indiankanoon.org/doc/863433/

of Insider Trading) Regulations, 2015 were notified by SEBI which were further amended in 2018 as SEBI (Prohibition of Insider Trading) (Amendments) Regulations, 2018.

In India, SEBI is the regulating authority for insider trading. SEBI derives its power to form the regulations for insider trading under the SEBI Act, 1992. It is the responsibility of SEBI to regulate and safeguard the securities market in India. Also, SEBI keeps a check on the insider trading of securities.

The Indian market has no depth because of which it is highly volatile. However, there has been significant growth in the capital market due to the increasing number of investors, more participation of different companies, capitalisation, stock exchanges, foreign direct investment, turnover, mutual funds, brokers, etc. The growing economic reforms in the country are a big reason behind the development of the capital market. The market has also improved its volume, transparent operations, and investment holding methods by way of a depository.

The Harshad Mehta scam of 1992[7] and other fraudulent practices in the Indian capital market have negatively impacted the image of the market that many investors fear the credibility of investment in the security market, nowadays. Some of the common reasons for these apprehensions are:

- Activity of insider trading;
- Less transparency in transactions;
- Unwarranted transactions;
- Lack of knowledge to general investors.

Indian authorities have tried hard to regulate and encourage investment in the market through its various agencies namely, the Company Law Board (CLB), Reserve Bank of India, SEBI, and various stock exchanges. There have been various regulations issued by SEBI to control insider trading and other malpractices of market manipulations. However, for the first time with respect to insider trading, SEBI issued the SEBI (Insider Trading) Regulation, 1992 which was last amended in 2018.

[7] 1992) 94 BOMLR 789, 1992 CriLJ 4032

ISSN: 2582-6433

SEBI Regulations:

Insider trading in India is prohibited by the Companies Act, 2013 and the SEBI Act, 1992. SEBI has formed the SEBI (Prohibition of Insider Trading) Regulations, 2015 which prescribe the rules of prohibition and restriction of Insider Trading in India. The Regulations passed by the Securities Exchange Board of India i.e., SEBI (Prohibition of Insider Trading) (Amendments) Regulations, 2018, are applicable mainly to "dealing in securities" which involves "buying, selling or agreeing to buy, sell or deal in any securities by any person either as principal or agent, by insiders on the basis of any private confidential information." The Regulations are only applicable to the exchange of listed securities.

The Regulations provide that the communication or dissemination of any confidential information, by an insider, is prohibited. The information communicated or disseminated must be unauthorized. The information can be used by the person himself or any other person on his behalf. If any person contravenes with any provision of the SEBI Regulations, it amounts to an offence under the Act and is punishable with imprisonment up to 10 years or a fine up to 25 crores, whichever is higher. Under the SEBI Regulations, the adjudicating officer may impose a penalty on any person who contravenes with the provisions of the regulations except for the offence committed under section 24 of the Act. SEBI also has the power to investigate the case of Insider Trading and related matters. The powers of Investigation may be exercised by SEBI for two main reasons:

1. to investigate into the complaints received from investors, intermediaries or any other person on any matter having a bearing on the allegations of insider trading; and,
2. to investigate upon its own knowledge or information in its possession to protect the interest of investors in securities against breach of these regulations. Under the Regulations, promoters of the company will be held liable irrespective of their shareholding status if they are found violating insider trading norms using unpublished price sensitive information of the company in absence of any legitimate purpose.

There are certain exceptions to these prohibitions by SEBI such as,

1. Disclosure is allowed for legitimate purposes, performance of duties or discharge of legal obligations. In the case of Dirks v. SEC, it was held that "persons like lawyers, accountants, etc. who are actually outsiders will be construed as insiders from the point at which the UPSI was shared with them under ordinary course of business."

ISSN: 2582-6433

2. Disclosure is allowed when there is an obligation to make an open offer; and where disclosure is required in the best interest of the company. In the case of Samir Arora v. SEBI, it was held that to attract a provision of Insider Trading, the unpublished private information needs to be true.

Companies Act, 2013, passed by the Indian parliament also devised the code of conduct for the administration of insider trading regulations. The listed companies in India are guided by Clause-36 of the Listing Agreement of the stock exchanges, which states that, the issuer will have to inform the stock exchange where the company is listed immediately about events such as closure on account of power cuts, lockouts, strikes, etc. All events which may have a posture on the operations or performance of the firm, as well as price sensitive information have to be reported at the beginning of the event as well as after the end of the event. This is intended to facilitate the shareholders and the public to assess the information and act accordingly. Over the years, to improve the fairness and transparency of the capital markets, SEBI has made several amendments to its SEBI (Prohibition of Insider Trading) Regulations, 1992.

Prohibition on insider trading consists of the following key components:

(i) prohibition on communicating UPSI by an insider
(ii) prohibition on other persons on procurement of UPSI and
(iii) prohibition on trading by an insider while in possession of UPSI.

As stated above, at stark variation with the 1992 Regulations, the Regulations restricts communication by insiders and by outsiders of UPSI of a company or its securities listed or proposed to be listed. This provision intends to cast an obligation on all insiders who are in possession of UPSI to handle such information with care and to deal with information with them when transacting their business strictly on ‘need-to-know’ basis. SEBI’s intention is that to organisations develop practices based on ‘need-to-know’ principles for treatment of information in their possession. However, the charge of insider trading will not get attracted in case such communication or procurement is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

In India, the other related provisions other than the Insider Trading Regulations which govern insider trading are Section 195 of the Companies Act, 2013, read with Section 12A and 15G of

ISSN: 2582-6433

the SEBI Act, 1992 ("Act").

Section 195 of the Companies Act, 2013 provides that no person, which includes any director or key managerial personnel of a company, shall enter into insider trading. This section also defines the terms 'insider trading' and 'price-sensitive information'.

According to Section 12A(d) of the Act, no person shall engage in insider trading, either directly or indirectly. On the other hand, Section, 15G of the Act imposes a penalty for insider trading which is not less than ten lakh rupees (Rs 10,00,000) but which may extend to twenty-five crore rupees (Rs 25,00,00,000) or 3 times the amount of profits which are made out of insider trading, whichever is higher.

The Insider Trading Regulations provides the following restrictions on any communication or procurement of UPSI and trading:

1. The Regulations restricts/prohibits an insider to communicate, provide or allow access to any UPSI which is related to a company or securities listed, to any person including other insiders.
2. The Regulations restricts/prohibits a person to procure any UPSI from an insider, which is related to a company or securities listed, to any person including other insiders.
3. The Regulations restricts/prohibits an insider, when in possession of UPSI, to trade in securities that are listed or proposed to be listed on a recognized stock exchange.

The exceptions to the above are;
The UPSI communicated or procured under Regulation 3(1) and 3(2) respectively, shall be communicated or procured only for the lawful purposes or for performance of duties or for discharge of legal obligations.

A UPSI may only be communicated or procured under the following circumstances:

1. If such UPSI requires an obligation to make an open offer under the Takeover Code, where the board of directors believes that the proposed transaction is or will be in the best interest of the company.
2. If such UPSI does not require or attract the obligation to make an open offer under the Takeover Code but where the board of directors believes that the proposed transaction is

ISSN: 2582-6433

or will be in the best interest of the company and the information constituting UPSI is made generally available to the public at least two trading days before the proposed transaction is being effected as per the board of directors.

Exceptions related to Rule 4(1) of the Insider Trading Regulations:

The transaction is an off-market transfer between or among the promoters who were in the possession of the same UPSI and both the parties had made an informed trade decision. Since the parties have the same UPSI, there would be no unlawful gains. In the cases involving non-individual insiders, the individuals who are in possession of such UPSI, were different from the individuals taking trading decision or decisions who did not own such UPSI when they decided to trade; and

Appropriate arrangement or arrangements were taken place to ensure that there is no violation of these regulations and no UPSI was communicated to the individuals taking trading decision or decisions by the individuals owning the information and there is no evidence showing breach of such arrangements. Most financial regulations require constant modifications to keep pace with the ever-evolving market dynamics. Insider trading is no different. With a view to do away with the lacunae and inadequacies of the 1992 Regulations, SEBI has revamped the entire framework governing insider trading in India. Hence, under the 2015 regulations, imperative changes including widening the scope of ‘connected persons’, strengthening the definition of an ‘insider’, rationalising disclosure events, removing redundant provisions, among others, have been introduced. A unique feature of the Regulations i.e., legislative notes interspersed within provisions will be an effective tool for interpretation of these Regulations going forward. It may be further stated that SEBI has overhauled the entire framework for regulation of insider trading, which is seen to be a deep-rooted problem in India, with a view to ensure a level playing field in the securities market and to safeguard the interest of the investors. This move by SEBI will provide a much-needed boost to the Indian capital market and facilitate further economic buoyancy. However, on digging deep, one finds that some of the changes proposed and new concepts introduced by the 2015 Regulations lack clarity. Therefore, it is anticipated that the new regulations are interpreted by courts and authorities in a progressive manner and timely clarifications are issued by the capital market regulator.

www.ijlra.com
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CONCLUSION:

This study could help the individual investors to understand the dynamics of the insider trading since the data used in this study is in the public domain. Further, the results also can be helpful to the securities market regulator, SEBI, and policymakers to understand the insider trading pattern across various stock categories and devise the regulations accordingly. If corporate insiders trade illegally, it is beyond the scope of the study. It would be thought-provoking to see if similar studies are conducted and inferences are drawn from the stock markets of the other developing economies as well. Thus, the problems in establishing charges of insider trading are largely related to the unavailability of sufficient proof to establish mental intent and whether or not access to unpublished price sensitive material was possible in the facts and circumstances of a particular case. On an analysis of the regulatory mechanism in India, the only conclusion that can be reached is that the laws prevalent in India are ill-equipped to combat insider trading and are not conducive to the needs of a rapidly changing economy and corporate structure. There are better equipped laws prevalent in other countries when compared to India to prevent and penalize the practice of insider trading.