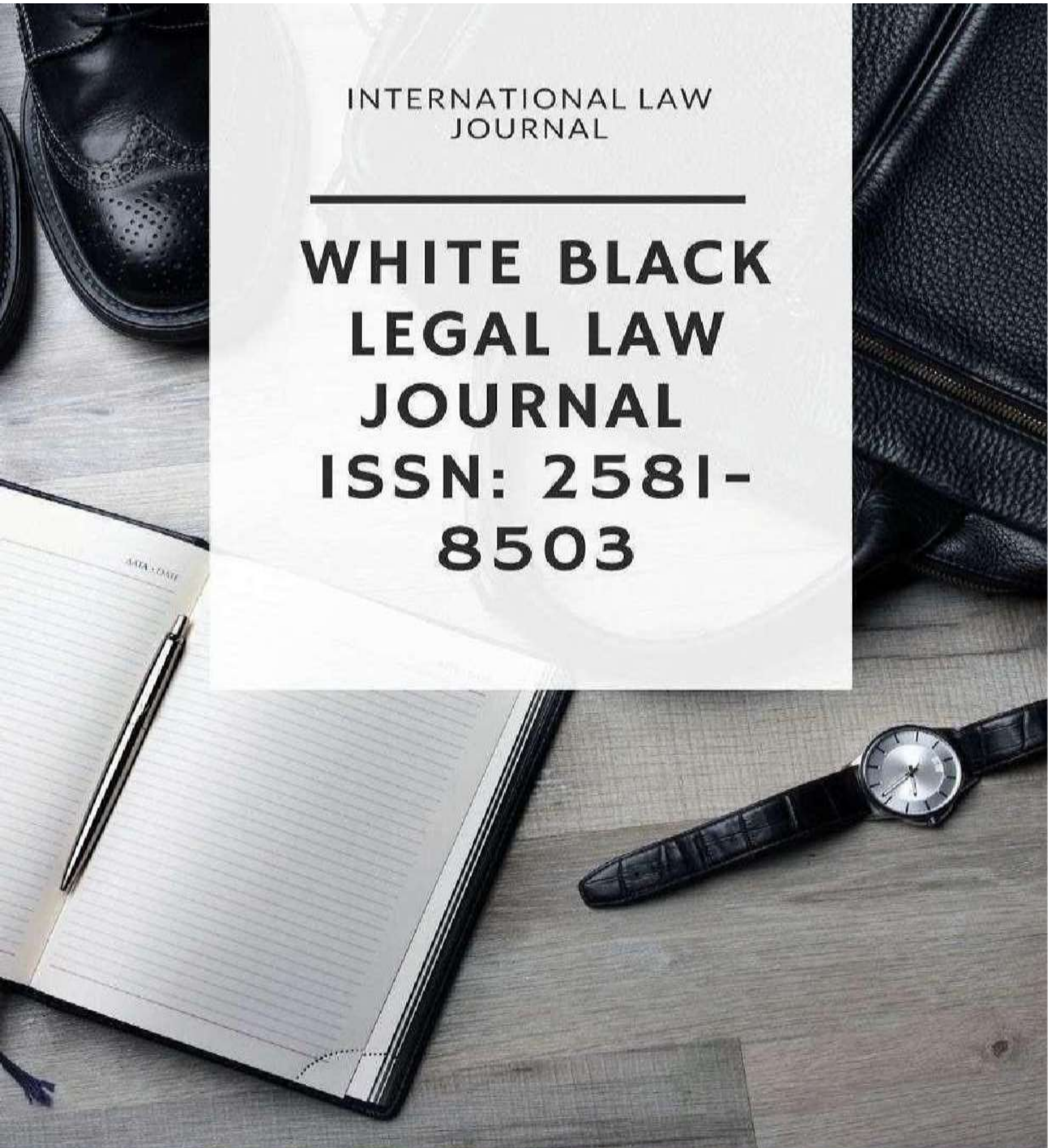

INTERNATIONAL LAW JOURNAL

WHITE BLACK LEGAL LAW JOURNAL

ISSN: 2581-8503

Peer - Reviewed & Refereed Journal

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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

<u>AN EXAMINATION OF THE LEGAL FRAMEWORK FOR INSIDER TRADING AND MARKET MANIPULATION</u>

AUTHORED BY - DHRITI BHUTANI,
Student at Guru Gobind Singh Indraprastha University

ABSTRACT

The notion of insider trading is thoroughly examined in this research study, complemented by the rules for sanctions for violations and the actions taken by regulatory bodies. Additionally, it explores the background of insider trading and compares the regulatory requirements established in effect in various countries, including India, the United States, and the United Kingdom, as well as their strengths and weaknesses. Along with the landmark rulings and earlier occasions when the regulatory agency, that is, SEBI, levied penalties under the charge of insider trading, "Market Manipulation" and "Market Efficiency" are among the themes that are thoroughly explored in this research paper. A person who has access to unpublished price sensitive information (UPSI) that has the potential to affect the share price is said to be engaging in insider trading when they buy or sell securities of a company. Given that it offers insiders an unfair advantage and undermines confidence among investors, it is prohibited and unethical. Under the Securities and Exchange Board of India's (SEBI) (Prohibition of Insider Trading) Regulations, 1992 and the SEBI Act of 1992, insider trading is governed. Insider trading cases may be looked into, punished, and prosecuted by SEBI.

1. Introduction

"Insider trading tells everybody at precisely the wrong time that everything is rigged, and only people who have a billion dollars and have access to and are best friends with people who are on boards of directors of major companies - they're the only ones who can make a true buck."

- *Preet Bharara*

The terminology 'Insider Trading' is subject to many definitions and connotations and it encompasses both legal and prohibited activity. Insider Trading, at a legal level, takes place regularly, when the officers, directors, or employees, that are also referred to as 'Corporate Insiders', perform the function of trading by buying or selling securities in their corporation, within the confines of policy of the company and the regulations governing the trading process.

The fiduciary duty that the management and promoters of the firm shoulder towards the public shareholder serve as the foundation for public participation and the infusion of public capital into a company.

1.1 Insider Trading: Definition

Insider trading, in simpler terms, can be defined as, the trading of securities, using the means of price-sensitive unpublished information, by an 'insider'. It can be considered as an act of trading securities of a listed public company, either directly or indirectly, based on unpublished information, that if published can influence the market price of those securities. This is considered illegal, in the eyes of the law, as the use of insider information for gain is partial to those who do not have access to such type of information or are connected with people who are familiar with this type of information.

According to the provisions of the Securities Exchange Board of India ‘SEBI’ Act 1992 and SEBI (Prohibition of Insider Trading) Regulation 1992, Insider trading in the market is strictly prohibited, and the watchdogs of the Capital Market, that is, Securities Exchange Board of India are always onlook for violation of market regulations.

About sub-clause (g) of section 2 of SEBI (Prohibition of Insider Trading), an ‘Insider’ is a person, a natural or an artificial judicial person, who is connected to the corporation, or is someone who has access or has sensitive information that can influence the market scenario related to that corporation and is yet to be published to the public. An insider may tend to take economic advantage, through the access of sensitive information, which, as a consequence can impair the interests of a public shareholder, who is not privy to such price-sensitive information.[1]

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[1] “*Insider Trading Regulations - A Primer*”, Nishith Desai Associates (2013, July).

1.2 Study of History of Insider Trading

The concept of insider trading was not taken seriously in the earlier times. In 1973, a prominent newspaper 'Sunday Times of UK' revealed that the restrictions imposed on insider trading was mocked under the pre-tenses of 'The crime of being something in the City'. [2]

Across the world, many jurisdictions have recognized the restrictions necessary to prevent the abuse of insider information to gain profits by way of trading in securities. This change was made over many years, after carefully analyzing many situations.

India, also was not too late, in officially recognizing the risks of insider trading and laid down the required legal restrictions soon enough. The first step they took towards this cause was to set up a legal committee in 1948, soon after its independence from colonial rule, under the chairmanship of Mr. P.J. Thomas. The core objective of this committee was the detailed evaluation of the restrictions that can be imposed on short-swing profits. This step was taken when the authorities in India realized the impact trading using price-sensitive information can make on the rights imposed on public shareholders, corporate governance, and the Capital Market.

1.3 Chinese Wall Policy

A set of guidelines known as the "Chinese Wall policy" is intended to stop information from being shared across divisions in a financial institution that might lead to insider trading. The goal of the policy is to avoid conflicts of interest and ensure that private information is not misused. The Sarbanes-Oxley Act (SOX), which required that businesses have more stringent measures against insider trading, was passed in 2002, strengthening the necessity for a Chinese wall policy.[3]

The Chinese Wall policy is a set of rules and regulations created to stop the improper use of insider information in the trading of securities by restricting access to sensitive,

[2] http://expressindia.indianexpress.com/fe/daily/20000821/fc021044.html

[3] Seyhun, H. Nejat, '*Insider Trading and Effectiveness of Chinese Walls in Securities Firms*', Journal of Law, Economics and Policy, Forthcoming (September 2007)

confidential information to company divisions that might abuse it. It is a mechanism for information barriers within an organisation intended to stop information transmission or communication that might result in conflicts of interest. The goal of the policy is to avoid conflicts of interest and ensure that private information is not misused

In actuality, the Chinese Wall policy functions by erecting an electronic and physical wall between various divisions inside a financial institution.[4] Employees from one department are unable to access private data held by another department due to this barrier. Additionally, the policy stipulates that employees who have access to confidential information cannot use that knowledge for commercial gain.

1.4 Measures Adopted

It is not tenable to impose absolute restraint on insider trading, though it is possible to monitor the capital market through various key measures, such as

Disclosure

Disclosure of insider trading is commissioned at two levels – Immediate disclosure of the Unpublished Price Sensitive Information "UPSI", and Disclosure of the transaction undertaken through the means of insider's information. The former tenets prevention of insider trading while the latter focuses on revealing of insider trading in the capital market. Insiders and the corporation are recommended to publish the sensitive information to even out the field for all sorts of investors – be it an insider or a public shareholder. This will ensure that no one is in any position that can put that person in a biased advantageous position.

Trading Restrictions

Restriction on trading by insiders entails that any person who has access to Unpublished Price Sensitive Information is prohibited to trade in securities until that piece of information is made publicly accessible. The trading working for them is closed since they

[4] Dr. David F.C. Brewer and Dr. Michael J. Nash, '*The Chinese wall security policy',* IEEE Symposium on research of security and privacy, pp 206-214 (May 1989)

come in possession of the UPSI and the window reopens a few days after the information is made public. This particular step ensures that the insider is not provided with an opportunity to reach the finish line before public shareholders, that is, they do not get a chance to trade in the short time window of information getting published and the public getting a fair chance to trade. Their trading windows a regulated by the company itself or the recognized stock exchange.

Pre-clearance of trades

The compliance officer of the company is empowered to approve a trading plan that is pre-drafted before the insider gets in possession of information that may hinder his/her right to trade. A trading plan is a pre-approved plan that includes all the trades a person will make in a prescribed period. It should be of a minimum 12 months in length. It ensures fairness in the capital market and also removes the undue advantage an insider might have during the trading window with access to UPSI.

1.5 Penal Provisions

Under the SEBI (Prohibition of Insider Trading) Regulations, 2015, the Securities and Exchange Board of India (SEBI) governs insider trading in India. Penalties can be imposed by the SEBI on people who violate the regulations. Fines of up to Rs. 25 crores or three times the profits generated through insider trading, whichever is greater may be imposed as penalty. In addition to imposing fines, SEBI may also impose other penalties, including the forfeiture of profits, an exclusion on access to the securities market, and a ban on holding any type of position inside the firm.

2. **Manipulation of Market**

Market Manipulation happens when a person, with mala-fide intentions, purposely attempts to make changes in the supply-demand of a particular asset.[5] As a consequence, this can lead to substantial increase and decrease in stock prices. Deception of other investors in order to get at an advantageous position, using the fluctuations in the stock prices is the prime motive of market manipulators.

[5] https://www.wallstreetmojo.com/market-manipulation/#:~:text=potential%20new%20risks.-,Market%20Manipulation%20And%20Insider%20Trading,available%20to%20the%20general%20public

Market abuse is the use of strategies like disseminating false information about a company, engaging in a financial transaction to make a security appear actively traded, and manipulating quotes, price levels, or trades to give the impression that there is more or less demand for a security than there precisely is. It is crucial to remain mindful that micro-cap stocks have a higher potential for market manipulation.

In 17th century, when the Amsterdam Stock Market was established, the first instance of market manipulation has been recorded. It was related to Dojima Rice Futures Market. The diversity of tactics and resources available for price manipulation has increased as a result of the development of financial markets. In addition, more people now fear market manipulation, particularly with regard to short-selling strategies, as a result of the growing influence of influential traders.

2.1 Strategies in Market Manipulation

There are two types of strategies that are prominent in the concept of market manipulation –

- Pump and Dump

  It is a method of market manipulation that is used to artificially increase the price of the security. It entails artificially inflating the price of a microcap stock before dumping it afterwards. The manipulator then exits the scene, leaving followers with an asset whose worth has been unjustly inflated. This is relevant to stocks with a micro-market capitalisation.

- Poop and Scoop

  In this kind of strategy, slanderous statements against a stock are produced in an effort to lower the price at which the shares are being purchased. A simple poop-and-scoop method used by short-sellers to earn money is short-and-distort variant. Order spoofing, which is another common technique, entails placing numerous buy or sell orders with the intention of moving the stock price, then cancelling those orders once other traders have altered their bids or requests in response to the price movement.

2.2 Linkage between Market Manipulation and Insider Trading

Market manipulation encompasses the deliberate dissemination of erroneous data in an attempt to manipulate prices. Furthermore, insider trading implies the trade of securities is based on confidential information, or information that is not publicly accessible.

Market manipulation is frequently carried out by company executives, speculators, or purported "stock market experts." By manipulating the market, these individuals seek a rise in their prices or buy shares. Contrarily, a person who engages in insider trading is either an employee at the company, a consultant, or has a strong connection to the business.

Insider riches expropriation by insiders, market manipulation, and disclosing inaccurate or misleading information to the market are very distinct from insider trading. It should be highlighted that, among other markets, notably for labour, commodities, and real estate, trades based on unequally disseminated information are frequent and frequently legal. Nevertheless, a lot of individuals still find trading in corporate shares on the inside unappealing the fiduciary obligations that corporate employees, functioning as their agents, have to their principals, the shareholders, are one argument against it (Wilgus 1910). An analogous criticism is that managers can transfer wealth from outsiders to themselves in an arbitrary and covert manner given that they control the production, disclosure, and access to inside information (Brudney 1979; Clark 1986).[6]

3. Comparative Study of Insider Trading

'Market manipulation' is phrased in a somewhat more ambiguous way. Shortly put, market manipulation takes place when someone unfairly disadvantages investors, either directly or through indirect means, by trading in financial instruments to their advantage through information that is not publicly available (insider dealing), by distorting the way prices are set for financial instruments, or by disseminating false or misleading information. Market manipulation, in essence, can be defined as behaviour that may mislead or deceive others into making hasty, erroneous financial decisions.

[6] Stanislav Dolgopolov, '*Insider Trading*', Econlib.org.

'Market manipulation' is a phrase that has been used more broadly to encompass 'practises deemed damaging to the financial markets'.[7]

3.1 Indian Aspect

The Thomas Committee was established in 1948 and assessed several methods used globally to prohibit insider trading, including the Securities Exchange Act of 1934. This was the first significant attempt to regulate insider trading. Sections 307 and 308 of the Companies Act of 1956 were included as a result of the Thomas Committee's recommendation. However ineffective this reform was in preventing insider trading, it did open the door for some mandated disclosures by management and directors.

The Sachar Committee in 1978 and the Patel Committee in 1986, were constituted with the intentions to regulate insider trading. They had recommended a separate statute for curbing insider trading. In 1989, another committee, that is the Abid Hussain Committee recommended penal provisions for violations of insider trading regulations. Their recommendations resulted in enforcement of a comprehensive legislation, SEBI (Insider Trading) Regulation 1992. It was further amended in 2002 to plug the loopholes discovered through different cases like, *Hindustan Lever Ltd V. SEBI* and *Rakesh Agarwal V. SEBI*. The act was renamed as SEBI (Prohibition of Insider Trading) Regulations 1992. It was amended 5 more times, with the last amendment in 2011.

Insiders are barred from trading in listed company shares whilst they are in possession of any UPSI, and they additionally refrain from providing any UPSI to a third party who trades in listed company securities while they are in possession of that UPSI. However, Regulation 3 is not pertinent to transmissions of UPSI required in the normal conduct of business, profession, employment, or pursuant to any law.

3.2 American Aspect

The legislation related to Insider Trading is ambiguous and complex, as per the laws of

[7] Ester Herlin-Karnell, Nicholas Ryder, '*Market Manipulation and Insider Trading: Regulatory Challenges in the United States of America, the European Union and the United Kingdom'* (2019)

the United States. In order to determine the feasibility of application of laws of different jurisdiction to the US System, the Congress and the Securities Exchange Board has been advised to assess regulatory framework of other countries. Although the US Securities regime have their shortcomings, it still maintains a critical component that the other countries have failed to incorporate in their regulations, that is, an enforcement framework, with private and governmental grounds. This framework works on enhancement of legal compliances and facilitates levying of punishments, in the form of penal provisions, in case a violation occurs.[8]

Consequently, despite the fact that the intricacies of U.S. securities law may need to be addressed in the area of insider trading, efficient enforcement elevates the U.S. framework to the top of securities markets. Simply put, effective implementation of defective (but appealing) securities regulations is substantially more advantageous for establishing market integrity and investor trust than having admirable laws that are seldom or intermittently enforced.

Federal law serves as the fundamental regulatory framework for insider trading. State law is frequently unavailable in this instance, notwithstanding the fact that some states, ranging from New York, authorise derivative lawsuits against inside traders based on unjust enrichment and perceived impairment to the corporate enterprise. There is no statute that codifies the specifics of the insider trading ban under US law. The SEC and the federal courts are in fact the primary players. Prior to rulings by the U.S. Supreme Court in the 1980s, lower courts interpreted the "disclose or abstain" criterion of Securities Exchange Act Section 10(b) (and SEC Rule 10b-5) in the backdrop of insider trading utilising the parity of information and equal access approaches

3.3 United Kingdom Aspect

Insider trading is outlined as trading in organised securities markets by individuals who have exposure to material non-public information. Insider trading is a pervasive issue that is challenging to address. Corporate information, or specifics about a company's finances

[8] Marc I. Steinberg, '*Insider Trading – A Comparative Perspective'*, The Securities Regulation Law Journal.

or operations, is foundational for some insider trading. nevertheless, in the last few decades, the majority of significant dealing instances have involved mergers and acquisitions. This is partly because takeover activity has increased dramatically over the past ten years. There is a strong temptation to capitalise on inside information to make a quick profit for the community of bankers, lawyers, public relations consultants, and others who are privy to firsthand knowledge of proposed takeovers, which invariably occur at a significant premium over the prevailing market value of the acquired company's shares. [9]

The United Kingdom had minimal regulations on insider trading up to 1980. The act was neither expressly forbidden by law nor was it punishable per common law. The Court of Chancery determined in the landmark case of Percival v. Wright that a corporate director experienced a fiduciary duty only to the company and not to the company's individual shareholders, and that as an outcome, the director was typically not required to disclose information about the company to the shareholders before collaborating in business with them.

4. Past Instances and Benchmark judgements

The regulatory structure "SEBI" has looked into up to 70 alleged allegations of insider trading, albeit only 19 investigations have been concluded. The Securities and Exchange Board (SEBI) took on more than 140 of these cases between FY15 and FY19. Some of these instances, that are prominently related to insider trading are[10]

4.1 General Insurance Company

General Insurance Company, or GIC, received a notification from SEBI in October 2019 alerting it to upcoming insider trading investigations. The insurance provider acquired a settlement offer from SEBI along with the notification. GIC resolved the allegations in December of that same year by forking up a fine of estimated Rs. 1.23 crore.

[9] Kern Alexander, '*Insider dealing and market abuse: The financial services and markets act 2000'*, ESRC Centre for Business Research, University of Cambridge, Working Paper No. 222 (December 2001)
[10] https://groww.in/p/insider-trading

4.2 Infosys

When the IT company neglected to disclose a claim of a company insider regarding illicit trading, it came to light that it had violated SEBI insider trading restrictions. Whilst the initial complaint was submitted on September 20, 2019, it wasn't until the whistleblower mailed a copy of the same to the media in October that the issue came to light.

4.3 Rakesh Jhunjhunwala

Rakesh Jhunjhunwala, a self-made billionaire investor, was summoned before SEBI for alleged insider trading at Aptech Limited. Reputable sources, the regulatory agency has its sights into the months of February and September 2016. SEBI investigated the involvement of Jhunjhunwala's family members in the case in furtherance of him.

4.4 Reliance Industries

The Securities and Exchange Board of India fined RIL and banned it from the derivatives market for a year. The exchange regulator charged the company of seeking to make money by evading restrictions on its legally permitted trading limits and suppressing the stock's cash market price.

4.5 Rakesh Agrawal vs. SEBI[11]

In 1996, Bayer AG, a German company, along ABS Industries Ltd.'s managing director Rakesh Agrawal agreed that Bayer AG would acquire 51% of ABS Industries Ltd.'s shares. Agrawal granted Kedia, who was deemed guilty of insider trading, a portion of his stake. Agrawal was ordered by SEBI to deposit 34 lakhs rupees in Investor Protection Funds.

Despite trading shares while in possession of UPSI, the Securities Appellate Tribunal (SAT) concluded that Mr. Agrawal was not guilty of insider trading. The jury decided that in order to impose penalties on an insider for violating the regulations, it had to be shown that they had unfairly profited from the transaction. The jury also disagreed

[11] https://blog.ipleaders.in/five-landmark-cases-insider-trading/#Rakesh_Agrawal_vs_SEBI

with SEBI's assertion that insiders who have UPSI are prohibited from trading in a company's stock until they disclose their UPSI. As a means to recognise the intention and motivation of insiders, the SAT emphasised the significance of mens rea in Indian law.

5. Market Efficiency

Market efficiency asserts that at any one time, prices precisely reflect all information that can currently be obtained regarding a specific stock and/or market. This idea is supported by the Efficient Market Hypothesis (EMH), which was first proposed by Eugene Fama in the late 1960s and further elaborated upon in 1970. 2013 saw Fama acquire the Nobel Memorial Prize in Economic Sciences along with Lars Peter Hansen, Robert Shiller, and other recipients. No investor has a competitive edge in projecting a return on a stock price, according to the EMH, because no one has access to information that is not already known to everyone else. Market efficiency asserts that prices consistently reflect all information that is currently available on a specific stock or market. No individual can out-profit the competition because prices only reflect information that is accessible on the market.[12]

Investors ought to think a market is unprofitable and inefficient prior it can become efficient. Ironically, it is investing techniques devised to profit on market imperfections that retain a market functioning effective. A market requires to be substantial and active. Information concerning accessibility and associated expenses must be broadly disseminated and supplied to investors precisely at the same time. Transaction costs must be less expensive than the anticipated earnings of an investing plan. The EMH suggests that investors must also have sufficient capital to profit from inefficiency until it returns.

5.1 Impact of Efficiency

Information concerning political, economic, and social events, in addition to how investors interpret them, whether genuine or rumoured, will be reflected in the stock price. Information is not required to be confined to financial news and research alone. According

[12] https://www.investopedia.com/insights/what-is-market-efficiency/

to the EMH, no one will be able to out-profit another person because prices respond solely to information that is readily available in the market and because all market players have accessibility to the same information. Prices in efficient marketplaces become unpredictable and erratic, making it impossible to identify an investment trend. Therefore, a planned approach to investing cannot be profitable.

5.2 Anomalies of Efficiency

However, there are unambiguous arguments of the EMH in the real world of investing. There are investors who have outperformed the market. Warren Buffett, for instance, made billions of dollars using an investment strategy that focused on inexpensive stocks and inspired a large number of imitators. It is true that certain portfolio managers have a more successful track record than others, and that some investment firms are devoted to more credible research analysis than others. Hence, how can performance be random when people are obviously making money and outperforming the market?

6. Affinity between Market efficiency and Insider Trading

Insider trading can be broken down into two basic categories: illegal insider trading and legal insider trading. Not every type of insider trading is prohibited. However, the notion of "insider trading" tends to be employed to denote illicit transactions involving significant, confidential business information. The SEC perceives the investigation and prosecution of insider trading offences as one of its enforcement priorities as they have a tendency to erode investor confidence in the fairness and integrity of the securities markets. Contrarily, legal insider trading refers to the buying and selling of stock in one's own company by corporate insiders, including officers, directors, and employees.[13] If insiders adhere to the SEC's regulations, it is entirely legal for them to purchase and sell shares of their firm. In other words, no law is breached as long as insiders are trading using information that is generally available to the public.

If a stock price precisely reflects a company's intrinsic worth, it is deemed to be accurate. Considering stock price accuracy has a direct impact on investment decisions and, in furthermore, the volatility of

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[13] Trang Hoang, Emma Neuhauser, Hossein Varamini, *'The Linkage between Insider Trading Activities, Market Efficiency, and Stock Information Content',* Journal of Business & Economic Policy, Vol. 4(3) (September 2017)

the security market, it attracts considerable attention. Public investors ought to consider all available information on the companies they intend to invest in or already own, and they should use that information as an outline until they arrive at their final investment decision. Since insiders are frequently seen as the most knowledgeable participants in the stock markets, public investors frequently consult them as one source of information in an effort to obtain extra information to more accurately estimate the stock performance (Chauhan, Chaturvedula, and Iyer, 7).

The stock market turns more informative as a consequence of insider trading, argues proponents of the approach (Chauhan, Chaturvedula, and Iyer, 7). It encourages the most effective application of resources. Insider trading and the veracity of stock prices were subjects that Beny addressed head-on in her article. She claims that two factors determine how accurate a share price is: first, the amount of information available on a company's potential future dividends, and second, how much of this information is reflected in the stock price (Beny, 247). Both factors of share price accuracy may be impacted by insiders who possess the aforementioned information.

7. Conclusion

Insider trading may influence the efficiency of the market in ways that are both beneficial and detrimental. One source claim that insider trading can increase market efficiency by disseminating market information. Even if the insider is unknown, the market will nevertheless observe an increase (or reduction) in demand for a particular stock, and the price will fluctuate correspondingly. Insider trading, however, might occasionally result in less efficient stock prices. This is because insider trading inhibits other traders from gathering information and trading and skews the distribution of information possessed by traders towards one trader, resulting in both which reduce the market's ability to compete.[14]

Insider trading is illegal under securities regulations because it conflicts with the autonomous functioning of supply and demand in the market. It undermines the fundamental principles of justice and integrity, which instil investors' confidence. In accordance with federal law, an "insider" is a company's officers, directors, or a person with at least 10% of the company's stock securities under

[14] Sultan Mehmood, Muhammad Shaoor Ul Hassan, Muhammad Irfan, '*Effect of Insider Trading on Market Efficiency*', Research Journal of Finance and Accounting, Vol.11, No.24 (2020)

their control.[15] A firm is required to notify the Securities and Exchange Commission (SEC) of any transaction by corporate executives, directors, or other company members with significant access to privileged information. Under the SEBI (Prohibition of Insider Trading) Regulations, 2015, the Securities and Exchange Board of India (SEBI) governs insider trading in India.

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