Meger announcement and insider trading in india

Economics, Trade

Abstract

This study examines the stock price effects and volume pattern of the selected companies for the existence of illegal insider trading before a merger. The study is based on Merger/acquisition announcement during 2001 to 2005. The analysis has been done for 20 target companies which are listed in BSE and NSE, this study analyses the stock prices and the trading volume 30 days before an acquisition announcement. In order to study the pattern of stocks the Abnormal returns (AR), Cumulative abnormal returns (CAR) and the abnormal volume has been calculated for the selected target companies in the Indian context. Besides, very little theoretical work has been done by researchers in India. However, with improved availability of databases and computing resources, and with increasing global interest in Indian markets, we expect an explosion of work in the near future.

In this analysis I found that a considerable sample of firms have abnormal return before the actual announcement has taken place and also there are evidence of huge abnormal volume before a public announcement in the given sample.

Introduction

It is widely accepted that insiders trading activities generate interest, sometimes create panic and also increase the trading volume of other market participants. Most financial analysts keep track of insider trading, and some advisory services specialize in gauging insiders’ transactions. Business dailies and Financial Journals are preoccupied with trends in insider trading.

It is generally supposed that corporate insiders have access to information superior to that of outsiders.

An inference sometimes drawn from these articles is that insider trading is based on inside information or nonpublic information and is therefore a violation of law. Of all white-collar crimes, insider trading probably is the most pervasive and acquiesced with. Lax regulations and the ease with which a manager can access sensitive information to profitably manipulate stock prices are, of course, what drives this nefarious practice. The most radical line of reasoning objects to any form of trading that is on the basis of differentials in information. It is argued that unrestricted insider trading will lead to a breakdown of capital markets which are unable to perform their role efficiently. The least restrictive view of insider trading sees insider trading as illegitimate only if it involves a breach of fiduciary duty or at least a breach of trust and confidence. Thus, the profits that managers make at the expense of their shareholders would be an abuse of the relation of trust, which links managers to their shareholders, as the gains accrue on the basis of information, which the managers have obtained by virtue of their position. The primary argument against insider trading is that it works to the disadvantage of outside investors who would then exit the market place, taking their capital with them. The argument in favor of allowing insider trading is that such trading leads to more informative security prices.

The announcement of a corporate merger is a major news event that has a significant impact on the share price of the target firm, it is generally accepted that insiders' trading activities generate a lot of interest and also increase the trading volume of other market participants. It is generally supposed that corporate insiders have access to information superior to that of outsiders. An inference sometimes drawn from these articles is that insider trading is based on inside information or non public information and is therefore a violation of law. One of the most important restrictions on trading involves insider trading. It is illegal for anyone to transact in securities to profit from inside information i. e. private information held by officers, directors or major shareholders of the firm.

It is not only illegal to trade your own stock in a company based on this inside information but it is also illegal to pass on that information to someone, so that they can trade their stock. Anybody who has material and non-public information can commit such an act. This means that nearly anybody—including Directors, CEO'S, brokers, family, friends, and employees can be considered as an insider.

Insider trading actions by the Securities and Exchange Commission (SEC) against Dennis Levine, Ivan Boesky, Martin Siegel, and others have influenced the public perception of mergers and acquisitions activity. These well-publicized cases generally involve illegal insider trading based on non-public information about impending bids for take-over targets. Many regulators have interpreted public concern about illegal insider trading as political support for legislative proposals to restrict mergers. These regulators argue that increased trading in the shares of target companies before merger announcements indicates the pervasive nature of insider trading.

Associating share price run-ups with insider trading has intuitive appeal. The success of several regulatory authorities at identifying and prosecuting insider traders has reinforced the perception that such conduct is pervasive and that legitimate speculation is overwhelmed by illegitimate trading on non-public information. An active mergers and acquisitions market enhances opportunities for profitable legal and illegal trading in anticipation of take-over bids. If illegal conduct is sufficiently widespread, then that conduct could be an important cause of pre-bid price run-ups.

Some analysts, on the other hand, generally view increases in share prices before merger announcements as supportive of the efficient market hypothesis, which states that share prices at any time fully reflect all public information (Fama, 1970). Researchers have documented share price reactions to many types of corporate announcements including dividend changes, earnings reports, share splits, unexpected management changes, and macroeconomic events such as inflation, oil price shocks and interest rate changes. In cases where it is possible for traders to discover information in advance of news announcements, there is generally a significant share price run-up preceding the event.

Legitimate research and analysis of corporate information gives some traders informational advantages and their superior earnings serve as compensation for their efforts (Larcker and Lys, 1987). Their trading is beneficial to the extent it aligns share prices with their theoretically correct values, promoting efficient allocation of capital. The prospect of large take-over premiums and the many kinds of clues legally available assure the existence of an active market for information on prospective merger targets (Comment, 1986). Therefore, much share trading that precedes important news can be attributed to a well-functioning market and not necessarily insider trading.

In line with trends in many developing countries, South Africa has in recent years witnessed a sharp rise in merger/take-over activity. However, there have been no investigations on the relative importance of public versus private information related to the price run-ups associated with take-over announcements. The purpose of this study is to examine the role of pre-announcement news reports as an explanation for the excess returns associated with merger announcements of target companies listed on the Johannesburg Stock Exchange (JSE).

Purpose of the study

Those who possess privileged information have an incentive to gain illegal profits over the less privileged outsiders; this study is aimed at examining the effectiveness of the regulations by the SEBI and also the efficiency of the market.

The purpose of the study is to give a fair chance for the outside investors who would lose their trust on the capital markets and exit the market with them.

This research study is aimed at protecting the trust and confidence of the individual investors who do not have access to inside information and who depend upon only the publicly available information for investing

This study examines the existence of illegal insider trading before an acquisition announcement. The purpose of this study is to apply the mechanisms for detecting insider trading and to find how efficient the market is?

Problem Statement

Insider trading before announcement date of merger is characterized by wide share price and volume fluctuations and heavy trading within a short p of time. Insider Trading is a traditional worry of investors, and is associated with fast-growing stocks, high P/Es, smaller companies, InformationTechnology(IT) firms. Insider trading of stock market is usually caused by leakage of company news to insiders. Share prices fluctuations affect the investor’s wealth creation. In this context, the study of the impact of Insider trading before announcement date of merger in stock market is undertaken.

Does insider trading take place prior to an Acquisition announcement in India?

Background of the Study

Merger & Acquisition in India

The restructuring of companies through merger is governed by the SEBI (Substantial Acquisition of shares and Takeovers) Regulations, 1997. The regulations were formulated so that the process of mergers are carried out in a well defined and orderly manner following the principles of fairness and transparency. The applications for merger are scrutinized by the Merger panel constituted by the SEBI.

The terms Merger, Acquisition and Take-over are all part of the M&A parlance. In a merger, the companies come together to combine and share their resources to achieve common objectives. The shareholders of the combining firms often remain as joint owners of the combined entity. An acquisition resembles more of an arm's-length deal, with one firm purchasing the assets or shares of another, and with the acquired firm's shareholders ceasing to be owners of that firm. In a merger, a new entity may be formed subsuming the merging firms, whereas in an acquisition the acquired firm becomes the subsidiary of the acquirer firm.

Acquisitions may be undertaken to access the market through an established brand, to get a market share, to eliminate competition, to reduce tax liabilities or to acquire competence or to set off accumulated losses of one entity against the profits of other entity. The process of mergers and acquisitions in India is court driven, long drawn and hence problematic. The process may be initiated through common agreements between the two parties, but that is not sufficient to provide a legal cover to it. The sanction of the High Court is required for bringing it into effect. The Companies Act, 1956 consolidates provisions relating to mergers and acquisitions and other related issues of compromises, arrangements and reconstructions, however other provisions of the Companies Act get attracted at different times and in each case of merger and acquisition and the procedure remains far from simple. The Central Government has a role to play in this process and it acts through an Official Liquidator (OL) or the Regional Director of the Ministry of Company Affairs. The entire process has to be to the satisfaction of the Court. This sometimes results in delays.

Mergers and acquisitions in India has touched US$5. 4 billion in the first five months (till May end) 2005, which works out to 3% of Asia-Pacific deal value. Significantly Asia-Pacific contributed to 23% of global volumes which was at $680bn for the first quarter and 18% of global volumes ($971bn) from January to May.

The M&A activity in Asia-Pacific has gone up with total deals for the first quarter at $130bn more than double that of the first quarter of ’04 when it was at $56bn. The total M&A volumes in the region for the last calendar year was at $234bn while till May end it was $179bn. The UB – Shaw Wallace deal has been listed among the top 10 deals in the consumer/healthcare sector in Asia Pacific. UB Group’s McDowell & Co and its affiliates entered into an agreement with the promoters of Shaw Wallace, to acquire its 54. 54% stake in the company for Rs 325 per share. The other major deal which had been announced early this year was the Holcim- ACC deal.

According to the ET CMIE survey on mergers and acquisitions in calendar year ’02 there were 121 open offers, amounting to Rs 7, 696 crore a whooping 165% from last year’s figure of Rs 2, 895 crore from a total of 92 open offers. At the same time, the number of mergers has risen from 308 in ’01 to 348 in ’02. The value of acquisitions in ‘ 04 increased three-fold to Rs 55, 534 crore in ‘ 04 compared to Rs 19, 117 crore in the previous year, according to CMIE Mergers & Acquisitions (M&A) database. 574 deals were reported in 2003 and 353 deals were reported in 2004 around 35% less compared to the last year. Indian corporate mergers and acquisitions doubled in the first six months of 2002 from the same period last year, bucking a worldwide trend, off the long-awaited sale of big-ticket state-run assets, analysts said Wednesday.

India Advisory Partners, a consultancy firm tracking mergers, estimated that the value of transactions had jumped to 362 billion rupees (7. 41 billion dollars) for the six months to June 30 from 168 billion rupees a year earlier. The number of transactions in the period soared to 433 from 57 in the first half of 2001, as companies merged units to benefit from regulatory changes.

The consultancy firm said government policies drove consolidations by private-sector companies, which sought in bulk to face increased competition from foreign rivals such as the Royal-Dutch Shell Group with the deregulation of the 65 billion-dollar Indian oil market.

India’s biggest private sector firm Reliance Industries in March announced the acquisition of its petroleum unit in a 110 billion-rupee all-stock deal to become India’s biggest non-state company by profit. And ICICI Bank Ltd. absorbed its parent ICICI Ltd. in a 23. 27 billion rupees deal after the central bank eased rules segmenting the type of services banks could offer.

Analysts say that takeovers, which rose in India as they slumped 35 percent worldwide, could accelerate in the next six months as the economy expands, and the government sells assets and opens its industries to further competition. The boom means surging fees for advisers such as Merrill Lynch and Company and Morgan Stanley. The Indian government has set itself a target of raising 120 billion rupees through privatization of state enterprises in the financial year ending March 2003.

New Delhi set the same goal last year, but managed to raise no more than 60 billion rupees. However, hopes have risen for a smoother process after the successful privatisation of sizeable firms such as Bharat Aluminium Company Ltd. despite dogged resistance by labour unions.

The government has announced that it will consider investments by foreign individuals in domestic airlines, although foreign airlines cannot. This opens the door to Richard Branson, who owns Virgin Atlantic Airways Ltd, to buy a stake in an Indian airline. The entrepreneur has announced that he is looking to buy a 25? 49% stake in an Indian airline in his individual capacity, and that he is in talks with Air Deccan, the fast growing Indian “ no frills” airline.

Singapore state investment agency Temasek Holdings Pte. Ltd has announced its acquisition of a 10% holding in Indian-Singapore logistics group Gateway Distriparks Ltd for Rs204m. Gateway Distriparks is one of India’s largest private logistics companies, operating container freight stations at the Jawaharlal Nehru Port in the western state of Maharashtra and other locations. It is also setting up a large facility in Visakhapatnam and buying a facility in Madras.

General Electric Co announced on 8 November that it has sold a 60% stake in its Indian business process outsourcing unit, GE Capital International Services, for about US$500m, making it one of the largest deals in the country’s booming back-office industry. The stake has been sold to two private equity firms, General Atlantic partners and Oak Hill Capital Partners. The sale is expected to be completed within six months.

Indian Technology Company, iFlex Solutions is to diversify by buying stakes in two overseas companies. The company, which designs and services the world's most popular banking software, will acquire 100% of US based Equinox, which provides business process outsourcing services to US companies from is call centre in Delhi, and a 33% stake in Login, a French treasury software developer.

DHL is to buy a majority stake in Indian delivery firm Blue Dart Express Ltd. The global logistics company will pay US$125m for a 68. 2% stake in South Asia's leading integrated air express carrier and make an open offer to holders for a further 20%.

There has been a flurry of M&A activity in the recent past; several of the larger acquisitions have involved MNC's in consumer industries targeting Indian companies to capture market share and distribution facilities. Prominent among these are Coke's strategic alliance with Parle, India's largest soft drink manufacturer; Colgate's buyout of Ciba Geigy'shealthcare business; and Hindustan Lever's (Unilever's Indian venture) merger with a competitor — TOMCO and the acquisition of three large domestic ice cream businesses — Kwality, Milkfood and Cabdury's. Recently, Whirlpool acquired a controlling stake in Kelvinator, India's leading refrigerator company in which Electrolux has a minority stake. The increase in market activity has resulted in a number of financial intermediaries and investment banks offering M&A related services. Several firms, such as Arthur Andersen, Lazard Credit Capital, Kotak Mahindra, and Peregrine offer services in identification, valuation and negotiation for M&A transactions.

Announced Mergers and acquisitions deals in India (2001-2004)

Distinction between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms “ merger” and “ acquisition” mean slightly different things. When a company takes over another one and clearly becomes the new owner, the purchase is called an acquisition.

A merger happens when two firms, often about the same size, agree to go forward as a new single company rather than remain separately owned and operated. This kind of action is more precisely referred to as a “ merger of equals.” Both companies’ stocks are surrendered, and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created. In practice, however, actual mergers of equals don’t happen very often. Often, one company will buy another and, as part of the deal’s terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it’s technically an acquisition. Being bought out often carries negative connotations. By using the term “ merger,” dealmakers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEO’s agree that joining together in business is in the best interests of both their companies.

But when the deal is unfriendly–that is, when the target company does not want to be purchased–it is always regarded as an acquisition.

So, whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of director employees and shareholders.

The model depicted in the adjacent diagram captures the critical elements of an effective integration strategy. This approach is a major advancement over the traditional approach to M&A management in which market, supplier, and people issues are addressed far too late to ensure success. The approach seeks to ensure that the five ingredients above are addressed by creating riveting focus, realigning the organizations, generating high selfaccountabilityfor results, creating leading indicators of success, and using a process that maximizes learning.

Insider Trading and Insider

" Insider trading" is a term subject to many definitions and connotations and it encompasses both legal and prohibited activity. Insider trading can occur when a person who possesses material non-public information trades in securities on the basis of such information or communicates such information to others who trade. The person who trades or " tips" information violates the law if he has a fiduciary duty or other relationship of trust and confidence not to use the information. The most common examples of insider trading involve corporate officers and directors; they owe a duty either not to trade the securities of their own company or not to disclose any material non-public information they possess. Trading is also prohibited when a person who receives information through a confidential relationship uses (“ misappropriates”) the information for his or her own trading or tips to others. People who receive information in confidence can include a broad range of persons involved in the securities markets. In USA, from time to time, the Security Exchange Commission has charged investment bankers, arbitrageurs, attorneys, law firm employees, accountants, bank officers, brokers, financial reporters and even a psychiatrist with misappropriating information and violating insider-trading prohibitions.

The American notion that insider trading is wrong was well established long before the passage of the federal securities laws. In 1909, the United States Supreme Court held that a director of a corporation who knew that the value of the stock of his company was about to skyrocket committed fraud when he bought company stock from an outsider without disclosing what he knew. 2 But this condemnation is not universal, even in the United States.

By Securities and Exchange Board of India (Insider Trading) Regulations, 1992: “ insider” means “ any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information inrespectof securities of the company, or who has received or has had access to such unpublished price sensitive information.” To most people it appears rather unjust that some speculators are able to earn profits at the expense of others who just happen to know less about the asset in question. Securities and Exchange Board of India (SEBI) has also put in place the disclosure norms for the office bearers of the stock exchange and directors of Asset Management Companies (AMCs) to prevent insider trading.

The directors of AMCs are required to file the details of the purchases and sales of transactions on quarterly basis. Indeed, the European Economic Community has formally recognized the importance of insider trading prohibitions by passing a directive requiring its members to adopt insider trading legislation. The preamble to the directive stresses the economic importance of a healthy securities market, recognizes that maintaining healthy markets requires investor confidence and acknowledges that investor confidence depends on the " assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information." 3 These precepts echo around the world, as reports of increased insider-trading regulation and enforcement efforts are daily news.

Insider Trading and Cost to Investors

Illegal insider trading costs investors millions of dollars a year by inflating the cost of mergers and acquisitions, according to aHarvardBusiness School study. Between 1974 and 1990, bidding companies paid extra $4 billions as a result of trading on information unavailable to the public. Meulbrock in, " Insider trading is tremendously costly for the bidding companies," has found that when insiders ran up the stock price of the company being acquired before the announcement, buyers ended up paying a 30 per cent higher premium for the company, on average, than they otherwise would have. Insider trading could even drive up the stock price so much that the takeover would no longer be practical.

Public Announcement & Announcement Date

A public announcement is an agreement made in the newsstudys by the acquirer primarily disclosing his intention to acquire shares of the target firm from existing shareholders by means of an open offer.

The announcement date is one when the target firm first publicly disclosed as a possible acquiring target. These announcements are made in the national dailies.

Regulations over Insider Trading

Investing, the insider takes his place alongside embezzlers, frauds, and all other varieties of scam artists. He uses privileged knowledge gained from executive friends told over a cup of tea or a game of golf to earn enormous profits in the stock market.

Surely, this kind of activity should be universally condemned as unfair and unethical. After all, one person, solely by virtue of personal connections or occupation, gains an advantage that the average investor does not have. Should not everyone have an equal opportunity to earnmoneyin the stock market?

For India, along with most of the industrialised countries, the answer is yes. Insider trading was outlawed in 1992 when the stock market was liberalised and the Securities and Exchange Board of India (SEBI) was given the mandate to investigate instances of alleged insider trading.

It is a well-known fact that insider trading, and many other forms of corrupt dealing, are very common in the securities markets in India. According to one author, “ Price-rigging and insider trading have become a way of life in the Indian stock market (Sivakumar).” And the former president of the Bombay Stock Exchange is quoted as saying, “ that there is no other kind of trading in India, but the insider variety (Dalal).” Important steps have been taken towards reform and the purpose of this study is not to downplay many of the problems that exist in the markets in India. However, I believethe facts will show that insider trading does not belong in the same category as outright fraud or theft and that the negative effects of insider trading have been exaggerated. Furthermore, many of the fundamental problems plaguing the Indian markets are unrelated to insider trading and require reforms unrelated to insider trading laws.

Insider trading laws exist for reasons of both equity and efficiency. In regards to equity, the government wants to ensure that everyone involved in the stock market has equal information and that any information available to one active participant in the market is available to all participants. In other words, no one has an unfair advantage in the market. There is also a justification for insider trading laws based on efficiency considerations. Basic microeconomic theory holds that a commodity (i. e. a stock or an options contract) is priced efficiently if all information known or knowable is incorporated in the price. In other words, in an efficient market, if Intel invents a new, revolutionary microchip that will cause profits to triple next year, the price of the stock should immediately rise by three times as all market participants learn of this fact simultaneously. If there is unequal access to information (imperfect information in economics terms) then the market is said to be inefficient.

A quantitative study on the effects of insider trading on market efficiency has been completed by Utpal Bhattacharya and Hazem Daouk. They argue that, based on data collected in all 103 countries that have stock exchanges, the enforcement of insider trading laws increases market liquidity and decrease the cost of equity. The study attempts to control for factors such as the quality of legal institutions, level of international integration, foreign exchange risk, and others.

In all tests, they find a positive relationship between enforcement and liquidity and a negative relationship between enforcement and cost of equity (Bhattacharya).

Are these results to be believedSince countries that have insider trading laws have more advanced economies and more transparent markets, the correlation that does exist is not surprising. The only issue, and one that requires further research, is whether other factors such as these are adequately taken into consideration. Market transparency and investor I confidence, irrespective of insider trading laws or enforcement, are extremely difficult to quantify.

One objection to the two justifications for insider trading laws is that the government, by enforcing insider-trading laws, is expected to enforce an unattainable ideal on the stock market. Perfect information is an abstraction that exists only in elementary microeconomics textbooks and not in the real world markets. In fact, as information technology has progressed so rapidly, information can travel much faster and be available to more people than ever before. It could be argued that technology has done more to ensure an efficiently operating securities market than government regulations have. According to Ajay Shah and Susan Thomas, the introduction of computerisation into the Bombay Stock Exchange has increased both liquidity and efficiency in that stock exchange (A Shah–-Automation). Insider trading laws can hardly be credited with a similar improvement in efficiency. Insofar as insider-trading laws encourage the free distribution of stock-related information, they help to ensure more efficient pricing of stocks. However, when insider-trading laws discourage investors from buying or selling based on inside information, they only result in stocks being priced in a manner inconsistent with all available information. If insiders are allowed to act on the information they possess, it will also lead to more efficient pricing, as the buying and selling resulting from the information will be reflected in the overall price of the stock.

The argument in favour of insider trading laws also ignores the issue of use of information. Even if everyone has equal access to information, there is no guarantee that they will all use this information in the same way. Information must be analysed and different people have different opinions on what the best analysis of stock-related information is. For instance, although it is generally true that when two companies merge, the stock of the resulting company is worth more than the combined value of the individual stocks, it is not always the case. So an insider who knows in advance of a proposed merger cannot mindlessly purchase shares of the two companies hoping to earn an easy profit. He must examine whether the merger is sound and what the market's perception of the merger is and act accordingly. So the possession of inside information by itself is not as valuable as it appears to be at first.

Another argument is that it is not the government's job to ensure everyone is equal and has equal access to information. In fact, even with the entire insider trading laws that so many countries have, inequality of information still exists. Investors who are too busy to read the financial section of the newsstudy or to follow the latest information about the companies they invest in voluntarily allow information inequality to exist. Since so much inequality of information exists even when the government attempts to narrow the knowledge gap, equal access to information is a utopian goal.

India's current insider trading regulations prohibit any " insider" from either acting on non-public information or from disclosing this information to any other person. The original law was passed in 1992 and SEBI passed a series of regulations to broaden the scope of the law in 2002.

A quick survey of enforcement of insider trading laws around the world will reveal that these laws are very rarely used. In Australia, there have been only six successful insider-trading prosecutions since 1992 (P Shah). The Netherlands, similarly, has also had only one successful prosecution in the past ten years and Japan has yet to even use its insider trading laws (Newkirk). Additionally, Germany did not even have a law against insider trading until it was required to pass one by the European Union in 1994 (P Shah). Of the 87 countries that prohibit insider trading, only 38 have prosecuted any insider trading case (Bhattacharya). India appears to follow in the footsteps of these countries as from 1996 to 2000; SEBI brought only Centre for Civil Society fourteen new insider trading cases (www. sebi. com). Furthermore, India, at the time of this writing, has yet to punish anyone for insider trading violations.

According to Arturo Bris, if a country has insider-trading laws that are weak or rarely enforced, the situation is worse than having no insider trading rules at all. Insider trading laws increase the potential profits of those who choose to break the law. The reason for the higher profitability of insider trading among countries where there are laws against the practice is that the market reacts more strongly to public announcements when insider trading is illegal since there are less people willing to act on inside information prior to public disclosure. This means that the few people who are willing to take the risk to trade based on inside information can earn larger profits and the net result is that the profitability of insider trading is increased rather than decreased (Bris). Therefore, when a nation fails to enforce its insider trading laws, insider trading becomes more profitable and there is no appreciable decline in insider trading activity. The facts stated above clearly establish that India is one of many countries that rarely enforces the insider trading laws that exist on the law books. Therefore, according to Bris’s analysis, insider trading is a very profitable venture in India with little chance of facing punishment. The two choices that India faces are to strengthen the existing laws against insider trading or to do away with the laws altogether.

The United States is an oft-cited example of a country that has been very successful in countering insider trading with its combination of tough laws and vigorous enforcement. Again referring to Bris's study, the level of profitability of insider trading in the United States is comparatively low. Some of this can be attributed to liberal, transparent markets and the rapid dissemination of financial information in that country, but its insider trading laws is also relevant. Nevertheless, insider trading is still a profitable venture and therefore its existence, even in the United States, is guaranteed. Another important issue that is outside the scope of this study is the cost-effectiveness of enforcing insider-trading laws. The normative benefits of insider trading laws must be weighed against their costs. So even if one supports insider trading laws in theory, it is important to ask whether the money that would go to SEBI to make it as powerful as the SEC (Securities and Exchange Commission, USA) could not be spent more wisely elsewhere. Equally important is the fact that insider-trading laws have costs in regard to the efficiency of the stock market.

A corporate officer buys shares of his company's stock in advance of a business deal announcement that is sure to send the stock price up. This officer could be disciplined by the stockholders as well as the company itself for bringing the company into disrepute. An outside investor trades based on information he gained from a company insider. In this case, every company and every stockholder has an interest in confidentiality so whoever revealed the information in question could be in violation of company rules.

An options trader with advance knowledge of a company’s losses buys an option to sell the company’s stock in the near future. The broker he deals with is directly hurt by this action since he must buy the stock after the company’s losses become public and the stock price goes down at a higher than normal price. In this case, the options market could have its own rules against insider trading and brokers and buyers could also sign a contract stipulating that they have no inside information prior to a transaction.

World Scenario

Insider-trading laws came into being after the crash of 1929. Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 to curb common abuses of the era. The 1934 act specifically addressed insider trading, although “ insiders” were defined narrowly as corporate officers, directors and owners of at least 10% of a company’s stock. Later court cases and Securities and Exchange Commission regulations broadened the definition to include corporate “ outsiders” and people who receive illicit tips.

Nonpublic information that gets you into hot water. You are guilty of insider trading if you are a corporate insider who trades on such information or that rightly belongs to someone else, such as an issuer of securities. “ Misappropriation” applies to an investment banker who trades in advance of a merger deal, for example, or to a printing-press worker who sells information about an article he sees ahead of its publication.

In fact, the insider-trading laws were changed three years ago to make prosecutions easier. Under the new rules, it’s now assumed that an insider has a “ relationship of confidentiality” with close family members. If you show off knowledge of confidential information to your 18-year-old daughter, and she trades on it, you’re both in trouble — if, that is, she had reason to believe it was truly inside information.

The legal concept in question here is “ scienter,” doing something with fraudulent intent. If you didn’t know the information was tainted, you’re okay. “ The empty-head defense can work,” says Bebel. “ But willful blindness is not a defense.” Translation: If you sell after learning that the CEO and his relatives were bailing out of a stock the day before a pivotalFoodand Drug Administration meeting, yourfailureto see a connection might not be perceived as credible.

Don’t assume you can fool authorities by flying under the radar. The SEC periodically targets small fry precisely to discourage such thinking. Recently, the SEC brought a case against a man whose gains totaled all of $500. The SEC and the exchanges have the power to detect virtually every move you make.

Several kinds of activities are sure to arouse the SEC’s suspicion. “ Buying on margin, buying options for the first time, buying stock for the first time or making a much larger trade than usual are red flags,” says Paul Berger, associate director of the SEC's division of enforcement. Acting too close to the date of a major announcement and " doing anything that is out of the ordinary for you as an investor are also warning signs," adds Nancy Grunberg, a former SEC enforcement official.

Guilty or not, lawyers advise against talking to SEC officials if they contact you about insider trading instead, have your lawyer answer their questions. You may not have all the relevant information at your fingertips, and if the SEC catches you in a mistake, you could face charges of making a false statement. In addition, people have a tendency to tell stupid lies to government investigators.

Indian Scenario

The Securities and Exchange Board of India (SEBI) prohibits fraudulent and unfair trading practices, including insider trading and self dealing, Insider trading is defined as " taking place when insiders or other persons who, by virtue of their position in office or otherwise, have access to unpublished price sensitive information relating to the affairs of a company and deal in the securities of such company and deal in the securities of such company or cause the trading of securities while in possession of such information to others who use it in connection with purchase or sale of securities".

Penalty for insider trading

Either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or Communicates any unpublished price sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or Counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price sensitive information, shall be liable to a penalty not exceeding five lakh rupees (emphasis added). However, implementation of the Act is problematic. Despite full fledged electronic trading facilities at the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), it is difficult to flag a trade as a possible case of insider trading. Given the number of brokers and intermediaries who operate in the market, a person with insider information can create fire-walls between himself and the regulators. An additional factor making surveillance more difficult, are multiple listings, which are common. The main surveillanceresponsibilityrests with the principal stock exchange. If the regional exchange does not have a sophisticated surveillance mechanism, monitoring compliance becomes almost impossible. Despite this handicap, SEBI has initiated probes in several cases of insider trading.

L. K. Singhvi, Senior Executive Director, in charge of enforcement, investigations and surveillance, said: “ We welcome the market movements as they are good from the investor’s point of view. But we have to check for movements which are detrimental to investors, especially if such movements are witnessed prior to certain announcements and are of abnormal nature or are at the cost of the other investors.” To cite, the share price of Pentafour Software moved from Rs. 144. 75 on December 1, 1997 to Rs. 359. 50 on March 6, 1998, on rumors of an impending takeover of the company. Following news reports of India Cements making a bid for Rassi Cement and the subsequent announcement by India Cements, the latter's share price moved up from Rs. 56. 50 on December 1, 1997 to Rs. 239. 10 on March 6, 1998.

In 1998, Indian financial markets were rocked by massive share price rigging fraud involving reputed industrial groups such as BPL, Sterlite and Videocon. No punitive action has been taken so far by SEBI against the main offenders. The latest controversy is related to the rigging of share prices of a private bank, Global Trust Bank (GTB). It has been alleged that Ketan Parekh and his associates rigged the share prices of the GTB prior to its merger with the UTI Bank, in order to improve the swap ratio in favor of GTB. With Parekh and his associates being the major traders, the share price of GTB rose from Rs. 70 in October 2000 to Rs. 117 within three weeks. It is only now when the bank merger had already been announced that investigations have been launched to look into Ketan Parekh's role in alleged insider trading. The interim investigations carried out by India's regulatory authority, Securities and Exchange Board of India (SEBI) found " evidence of a nexus" between Ketan Parekh and Ramesh Gelli, promoter of GTB.

Unfortunately, in most of the instances, the response of the regulatory agencies has been reactive rather than proactive. Like popular Indian movies, the regulatory agencies came into the picture when the damage had already been done. This is despite the fact that regulatory authorities have an armory of instruments at their disposal to prevent such frauds. According to L C Gupta, former member of SEBI Board, even when actions are taken, they are generally ad hoc in nature. Because of these reasons, there is a growing feeling that the regulatory authorities, particularly the SEBI, tend to protect the interests of big players rather than small investors.

The application of insider trading regulations in India have been flawed from the very beginning, and the long delayed order in the Larsen & Toubro (L&T) case has further eroded their credibility. This case was treated differently. A high-powered, board-appointed committee of the Securities and Exchange Board of India decided it, probably because it dealt with Reliance — India's most powerful industry group. After dragging its feet over the investigation since November 2001, SEBI exonerated Reliance and the Ambani brothers of all wrongdoing in the strange transaction.

A reading of the order indicates that Reliance's aggressive arguments were all accepted by SEBI without contest. And the brazen display of financial muscle and premeditated buying was condoned without reprimand or criticism. Let's do a recap. Reliance Industries, which held 4. 38 per cent of L&T's capital on November 5, 2001, steadily hiked its stake to 10. 05 per cent over the next 10 days until November 16. Consequently, the scrip rose sharply from Rs 167 to Rs 209. Coincidentally, on November 6, Reliance was approached for a possible sale of a block of shares to Grasim. SEBI's order does not worry about the size of the stake that Grasim had sought, although it is important information.

In fact, the Grasim board recorded the deal as being an offer from Reliance rather than the other way around. Also, it went about arranging funds for a 10 per cent of the L&T shares at a substantial premium, suggesting premeditated buying by Reliance based on specific information. On

November 16, Grasim allegedly made a firm offer of a 47 percent premium (Rs 306 per share) to the ruling market price for a block of 10. 05 per cent of Reliance's holding; and the deal was finalised on November 18. The investment banker is close to both parties, but Reliance claims that it had no idea that a deal would materialise.

The L&T management, which fought hard to keep the Birla's out, also didn't bother about the soaring price. And SEBI quickly accepted Reliance's contention that since L&T was completely out of the picture there was no inside dealing. Several questions, asked by ordinary investors about the deal, apparently did not occur to SEBI's powerful committee.

For instance, Reliance says that there was increase in the stock price after the deal became public. Since the Birla's had made it clear that there would be no open offer to retail investors, only foolish investors would buy more shares above Rs 208. 5. The order says nothing about the price manipulation angle.

Similarly, SEBI is unconcerned that Reliance wasn't an outsider in L&T. It had two board positions, a ' substantial holding' (by SEBI's own definition) and at one time even controlled the management. So much so, that Grasim was willing to buy L&T only if Reliance signed a deal specifically promising to keep away from L&T for a long time. SEBI does not discuss the sanctity or purpose of its " Substantial" shareholding rules, which require investors to report any holding of over five per cent in a publicly listed company. Isn't this because this threshold is considered a significant indicator of a possible change in managementYet, Reliance's 10-day circus on the bourses was not discussed by SEBI in this context, even though the sale of its holding triggered a nasty two-year battle for control.

SEBI's exoneration of Reliance proves that there is no uniformity in the application of insider trading rules. For instance, contrast the L&T case with the SEBI's allegations against Hindustan Lever (HLL). In 1997, two Unilever group companies (HLL and Brooke Bond, both with a 51 per cent stake by the parent) had merged. Just prior to the merger, HLL bought additional shares from Unit Trust of India (UTI) at a premium to market and extinguished them during the merger. This was done to keep Unilever's stake in the merged company also at 51 per cent. It was a transparent deal, openly reported to shareholders. There was no monetary benefit to Unilever; if anything, the value of all shareholders increased when HLL extinguished the shares.

SEBI accused two HLL chairmen and several top directors of insider trading and ordered HLL to compensate UTI for a notional loss that UTI had not even claimed. SEBI turned livid when the Securities Appellate Tribunal (SAT), then comprising two top secretaries of thefinanceministry, overturned its order. It filed an appeal in the civil court, which is still pending. Just a year ago, it revived the case by filing a criminal writ petition against HLL for ostensibly delaying the hearings a charge that is hotly contested by the company. The case is languishing again.

If SEBI's munificence towards Reliance and harshness towards HLL are two extreme examples of the application of Insider Trading Rules, then take a look at SEBI's attitude to public sector banks, which dumped units of UTI before its dramatic collapse in May-June 2001.

Although the banks dumped units at a high Rs 14. 75 on the specific knowledge of UTI's financial problems (UTI had borrowed from those very banks to fund its redemption), it wasn't even considered insider trading or investigated. When JE Talaulicar, a Tata Finance director, was indicted for insider trading, SEBI even punished a senior executive of the group for Talaulicar's actions. Yet, it holds Reliance blameless in L&T.

SEBI's only clear indictment for insider trading was that of Rakesh Agrawal, Managing director of Bayer ABS Ltd in 2001. But that order too was set aside by SAT on the strange premise that although he (in fact a close relative) traded on unpublished, price sensitive information about the merger between Bayer and ABS Industries, SEBI had not proved that he derived an unfair advantage. Then there is the case of Samir Arora, the best-known fund manager in India. SEBI barred Arora from the capital market without even a hearing. And although many of us supported its quick action, the L&T-Reliance matter has us wondering if the regulator is even-handed especially since it continues to go soft on Alliance Capital Mutual Fund, which employed Arora and benefited from his actions.

Meanwhile, the flare up in stock prices of companies, preceding every major announcement by them, indicates that insider traders in India are seldom caught and are selectively persecuted.

The RBI has laid down guidelines for the process of merger proposal, determination of swap ratios, disclosures, the stages at which boards will get involved in the merger process and norms of buying and selling of shares by the promoters before and during the process of merger.

The guidelines cover two situations of mergers and amalgamations; an amalgamation of two banking companies and amalgamation of a non-banking finance company (NBFC) with a banking company.

For NBFC-Bank mergers, the RBI has said that its nod is needed ahead of the High Court approval. " Where an NBFC is proposed to be amalgamated into a banking company, the banking company should obtain the approval of the RBI after the scheme of amalgamation is approved by its board but before it is submitted to the High Court for approval."

The RBI has decided that the Insider Trading norms stipulated by the Securities and Exchange Board of India, (SEBI) will be applicable for bank mergers and acquisitions. " SEBI regulations on Prohibition of Insider Trading should be strictly complied with information relating to takeovers and mergers and transfer of shares of listed banks and NBFCs is price sensitive. Even unlisted banks and companies should follow the SEBI guidelines in spirit and to the extent applicable." The central bank has decided the price to be paid to dissenting shareholders in bank mergers.

To enable the RBI to determine the value, the amalgamated banking company should submit a report on the valuation of the share of the amalgamated company made for this purpose by the valuers appointed for the determination of the swap ratio and detailed computation of such valuation.

Where the shares of the amalgamated company are quoted on the stock exchange, the RBI needs the details of the monthly high and low of the quotation on the exchange where the shares are most widely traded together with number of shares traded during the six months immediately preceding the date on which the scheme of amalgamation is approved by the boards.

It is undeniable that there are serious problems in India's stock market and there is a real need to enact reforms that will lead to a more transparent and more efficient capital market. The question is whether insider-trading laws are a part of the reform package that must be put in place to strengthen India's capital market or whether they are a needless hindrance to the operation of the stock market.

At first, insider trading appears to be counter to the notion of a transparent market. If market participants are trading based on information the general trading public does not possess, then this appears to be a step away from a transparent market. However, as is always the case in economics, we must compare the scenario in which insider trading takes place to the scenario where insider trading is forbidden and much rarer. In the second case, there is not perfect information but rather equal access to information. This distinction is important because it means then that the price of a stock does not reflect all that is known or knowable about it. The stock price is not sensitive to inside information so there is a consequent loss of efficiency in the pricing of stocks.

Additionally, a point that must be stressed is that most varieties of insider trading do not, as is often claimed, result in loss of confidence in the market. If it is well known to investors that there is a group of insiders who trade on information prior to its general release e, why exactly would investors wish to not invest in that stockOn the other hand, when market manipulation is allowed to occur, there is a serious loss of confidence in the market as investors feel that they can never be sure that the market price of a stock is fair. According to Ajay Shah, " Manipulation is intrinsically about making market prices move away from their fair values; manipulators reduce market efficiency. Insider trading brings prices closer to their fair values; insiders enhance market efficiency (A Shah, Why forbid?)." So there is a non-trivial distinction between market manipulation and insider trading and it is inaccurate to equate the two.

Given the fact that the Indian stock market has many problems related to efficiency, such as the lack of transparency and the existence of market manipulation, what can be done to reform the stock marketOne viable area of reform is the elimination of restrictions on short selling. Short selling is an important moderator of price fluctuations and since India restricts its practice to such an extent, it is clear that government regulations are at least part of the problem. Another action that can be taken against market manipulation is the creation of anonymous stock trading systems, so that a group of manipulators cannot be sure whether the rest of the participants are fulfilling their part of the agreement. Like a member country of OPEC (Organisation of Petroleum Exporting Countries) that sells more oil than it should, there is a strong incentive for a member of a market manipulation cartel to short-sell a stock that the others are buying since he knows it is overvalued.

Reserve Bank of India had constituted, on the recommendations of the Joint Parliamentary Committee (2002), a Working Group to evolve guidelines for voluntary mergers involving banking companies. Based on the recommendations of the Group, the guidelines laying down the process of merger proposal, determination of swap ratios, disclosures, the stages at which Boards will get involved in the merger process and norms of buying / selling of shares by the promoters before and during the process of merger have since been finalised. The detailed guidelines are enclosed.

While dealing with the merger proposals between two banking companies or between a banking company and a non-banking financial company, banks may act in accordance with the enclosed guidelines. Boards of the banks have to play a crucial role in the process. It may be ensured that the decision of merger should be approved by two third majority of the total Board members and not those present alone.

The Reserve Bank has discretionary powers to approve the voluntary amalgamation of two banking companies under the provisions of Section 44A of the Banking Regulation Act, 1949.

These powers do not extend to the voluntary amalgamation of a banking company with a non-banking company where amalgamations are governed by sections 391 to 394 of the Companies Act, 1956 in terms of which, the scheme of amalgamation has to be approved by the High Court.

However, in both situations, the Reserve Bank is concerned that while amalgamations are normally decided on business considerations such as the need for increasing the market shares, synergies in the operations of businesses, acquisition of a business unit or segment etc., it is essential that considerations like sound rationale for the amalgamation, the systemic benefits and the advantage accruing to the residual entity are evaluated in detail.

These guidelines cover two situations namely: – (a) An amalgamation of two banking companies (b) An amalgamation of a non-banking finance company (NBFC) with a banking company.

Section 44A of the Banking Regulation Act, 1949 requires that the draft scheme of amalgamation has to be approved by the shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of the shareholders, present in person or by proxy at a meeting called for the purpose.

Before convening the meeting for the purposes of obtaining the shareholders' approval, the draft scheme of amalgamation needs to be approved individually by the Boards of Directors of the two banking companies. When according this approval, the Boards need to give particular consideration to the following matters:-

The values at which the assets, liabilities and the reserves of the amalgamated company are proposed to be incorporated into the books of the amalgamating banking company and whether such incorporation will result in a revaluation of assets upwards or credit being taken for unrealized gains.

Whether due diligence exercise has been undertaken in respect of the amalgamated company. The nature of the consideration, which, the amalgamating banking company will pay to the shareholders of the amalgamated company.

Whether the swap ratio has been determined by independent valuers having required competence and experience and whether in the opinion of the Board such swap ratio is fair and proper.

The shareholding pattern in the two banking companies and whether as a result of the amalgamation and the swap ratio the shareholding of any individual, entity or group in the amalgamating banking company will be violative of the Reserve Bank guidelines or require its specific approval. The impact of the amalgamation on the profitability and the capital adequacy ratio of the amalgamating banking company.

The changes which are proposed to be made in the composition of the board of directors of the amalgamating banking company, consequent upon the amalgamation and whether the resultant composition of the Board will be in conformity with the Reserve Bank guidelines in that behalf.

Section 44A of the Banking Regulation Act, 1949 also requires that after his scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of the Section, it shall be submitted to the Reserve Bank for sanction.

The NBFC has availed of credit facilities from banks/FIs and if so, whether the loan agreements mandate the NBFC to seek consent of the bank/FI concerned for the proposed merger/amalgamation.

Regulation 2(ha) of the SEBI (Prohibition of Insider Trading) Regulations, 1992, which is applicable to the securities of listed companies, defines price sensitive information, as “ any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of the securities of the company”.

SEBI regulations on Prohibition of Insider Trading should be strictlycomplied with, as the various information relating to takeover/merger and transfer of shares of listed banks / NBFCs are price sensitive. Even the unlisted banks / companies should follow the SEBI guidelines in spirit and to the extent applicable. Insider trading laws cannot be justified on economic grounds. One of the most common claims made about insider trading laws is that they improve market efficiency, but as argued above, insider trading laws can only help to improve informationequality, not information availability. If we compare a country that has insider trading laws with a country that has no such laws, the country with insider trading laws has a more equitable market, but a less efficient one. The existence of insider trading laws cannot move a market closer to perfect information because it does not improve information availability. A country with no insider trading law s, however, will only punish insider trading when there is a specific aggrieved party who is the victim of fraud or a breach of contract. The rest of the insider transactions that take place improve e market efficiency by bringing prices closer to the price that would prevail under perfect information. If India were to abolish its insider trading laws, it would improve the efficiency of its financial markets.

So why not prohibit insider trading on the basis of fairnessIf someone believes in fairness strongly enough, then any cost of insider trading laws can be justified. However, the situation in financial markets around the world governed by insider trading laws is very far from fair. Even in richer countries with more transparent markets, insider trading is quote common and even accepted in some situations. A law that prohibits an activity as common and accepted as insider trading can hardly be described as fair. Furthermore, when so few insider tradingcases are investigated by SEBI, this result in a situation of selective enforcement and makes those willing to violate the law even more wealthy. Laws, in a free society, should not seek to force people to change the way they conduct their everyday affairs but, instead, should " seek to enable [the people] to continue doing what they do within the framework of a set of rules that promote the common good without altering the basic rhythms of society (Chakra verti, 08)." The case for insider trading laws therefore falls even on fairness grounds.

It is often claimed that insider trading reduces investor confidence in the market. Supporters of this claim argue that one of the reasons there is so much foreign investment in the United States is that country's strict enforcement of insider trading laws. If confidence in the market really does decrease when insider trading exists, than deregulation of financial markets is the most effective way to increase investor confidence. Stock exchanges that have private rules forbidding insider trading will attract more investors and corporations will wish to havetheir stocks listed on these exchanges. The free-market can provide for sensible insider trading rules without government intervention.

A cynic might argue that insider-trading laws exist to cater to rich investors who trade on inside information frequently and do not want anyone else to join them and lessen their profits. A more benign and more realistic proposal is that insider-trading laws exist because its premis