

CH-5 QUIRKY GOVERNANCE: INSIDER TRADING AND WHISTLE BLOWING

Corporate stakeholders often have unequal access to information leading to:

Insider Trading – when a person trades securities using confidential, price-sensitive information.

Whistle Blowing – when a person discloses information about wrongdoing or poor corporate conduct to the public.

According to Macey (2008), insider trading, and whistle-blowing, are examples of **quirky governance**. Quirky Governance refers to **unconventional information-based governance mechanisms** such as **insider trading**, and **whistle-blowing** that, although not part of the formal corporate governance framework, can discipline managers and improve corporate governance. These mechanisms are called "quirky" because they operate outside the formal governance structure of -BODs, shareholder meetings, Audit Committees, regulatory oversight and still reveal information and improve accountability.

- Insider trading can function as a quirky governance mechanism because insiders' buying and selling can act as signals- (eg. insiders buy imply some good news coming soon and insiders sell imply bad new coming soon)- causing share prices to reflect that information more quickly.
- Whistle-blowing is regarded as another a quirky governance mechanism because here insiders disclose wrongdoing, reduce information asymmetry, enhance transparency, and strengthen managerial accountability.

Aspect	Insider Trading	Whistle-Blowing
Possesses private information?	Yes	Yes
Information asymmetry exists?	Yes	Yes
Use of information	Personal benefit	Public/organizational interest
Impact on asymmetry	Information asymmetry gets exploited	Information asymmetry gets reduced
Impact on governance	Weakens governance	Strengthens governance
Legal position	Generally considered illegal and unethical in most jurisdictions.	Generally encouraged and protected by law.

--	--	--

INSIDER TRADING

Insider Trading refers to transacting in securities of a company by an **insider** based on Unpublished Price Sensitive Information (**UPSI**).

Insider means a **connected person** or a **person possessing UPSI**. A **connected person** is any person who is associated with the company in any capacity such as director/officer/employee or in a professional relationship (banker) or contractual relationship (consultant) or any person having a fiduciary or business relationship with the company (solicitor, auditor). **UPSI** refers to information that is not publicly available, and can materially affect the price of securities when disclosed eg. financial results, dividends, changes in capital structure, mergers, acquisitions, and major corporate transactions etc.

Legal Position in India.

Insider trading based on UPSI is a prohibited offence in India as per SEBI (Prohibition of Insider Trading) Regulations, 2015.

Evils of Insider Trading

(i) Distorts Market Efficiency-Markets are called efficient when all investors have equal access to information. Insider trading creates information asymmetry giving insiders an unfair advantage over others.

(ii) Undermines Investor Confidence-Insider trading can cause sudden and unexplained price movements. Such volatility reduces investors' trust in the market.

(iii) Weakens corporate governance- Insider trading benefits a few individuals at the expense of other stakeholders. It violates principles of transparency, accountability, fairness, and ethical conduct.

(iv) Increases Regulatory and Legal Risks -Allegations of insider trading can reduce stakeholder trust and tarnish the company's image. Companies and individuals may face investigations, penalties, and other sanctions from regulators.

SEBI (Prohibition of Insider Trading) Regulations, 2015

Introduced by SEBI to promote transparency, prevent insider trading, protect investors, and ensure fairness in the securities market. Important provisions-

1. **Compliance Officer** -The Compliance Officer is responsible for monitoring and implementing company's Code of Conduct on insider trading.
2. **Restriction on Exercise of ESOPs** -Designated persons are prohibited from exercising ESOPs within six months after selling shares.
3. **Threshold for Disclosures** -Specified persons like promoters, directors etc. must disclose their securities transactions to the Compliance Officer when the value of trades exceeds the prescribed threshold.
4. **Trading Plan by an Insider** – A trading plan is a pre-decided schedule of future trades made by an insider and he cannot later deviate from the plan. Certain insiders (e.g., CEO, CFO, directors) may possess UPSI most of the time and so if insider-trading rules are applied strictly, they will never be able to trade in the company's shares. However, a trading plan provides a safe mechanism for them to trade without attracting allegations of insider trading because the decision to trade was made in advance and was not based on UPSI.
5. Insiders may formulate a trading plan and submit it to the Compliance Officer for approval and public disclosure. The Compliance Officer must approve or reject the trading plan within 2 days of its submission. Once approved and publicly disclosed, trades can be executed according to the plan. A cooling-off period (i.e. 120 days gap from the date of public disclosure) is required before trading under the plan begins. **The 120-day cooling-off period ensures that a trading plan is not used as a mechanism to trade on existing UPSI. It creates sufficient time for the UPSI available at the time of formulation of the plan to become public, thereby promoting fairness, transparency, and investor confidence in the securities market.**
6. **Maintenance of Disclosures** -Companies must maintain records of disclosures and information relating to persons possessing UPSI (eg. trading plan disclosures, disclosure of change in shareholding etc.). These records must be stored in a structured digital database (and not on softwares such as MS word or MS power point as these are editable) and preserved for minimum 8 years.

7. **Whistle-Blower Policy** -Listed companies are required to establish a Whistle-Blower Policy. SEBI introduced a mechanism allowing informants to directly report insider trading violations to it. The reward available to whistle-blowers in insider trading cases was increased significantly in 2021 from 1 crore to 10 crores.

WHISTLE BLOWING

Whistle-blowing is the disclosure of illegal, unethical, fraudulent, or improper activities within an organization by a person to authorities so that they can take corrective action.

Types of Whistle-Blowing Based on Whom the misconduct is reported to-

Internal Whistle-Blowing	External Whistle-Blowing
Misconduct is reported within the organization.	Misconduct is reported to outsiders such as regulators, government agencies, or media.
Usually follows internal channels.	Used when internal mechanisms fail or are ineffective.
Less damaging to organizational reputation.	May attract public attention and regulatory action.
Eg. Cynthia Cooper , internal audit head at WorldCom. discovered accounting fraud and reported it to audit committee and the BODs Sherron Watkins , vice president at Enron ,wrote a letter to CEO Kenneth Lay warning him about accounting irregularities within Enron.	Eg. Erin Brockovich exposed groundwater contamination caused by Pacific Gas and Electric co. in Hinkley, California.

Types of Whistle-Blowing based on Identity Disclosure

Open Whistle-Blowing	Anonymous Whistle-Blowing
Whistle-blower discloses his identity.	Whistle blower conceals his identity
Can be contacted for further information.	Cannot be contacted for further information
Greater credibility	Credibility may be questioned.

Security can be provided to whistle blower as his details are there with the authority. Also, rewards can be given to them.	Security cannot be provided to whistle blower as his details are not there with the authority. Also, rewards cannot be given.
---	---

Pros and Cons of Whistle-Blowing

Advantages of Whistle blowing	Disadvantages of whistle blowing
(a) Financial Compensation- Some laws provide monetary rewards to whistle-blowers. Eg: Dinesh Thakur received a reward after exposing data manipulation at Ranbaxy.	(a) Retaliation - Risk of job loss, demotion, harassment, isolation, physical harm or career damage.
(b) Reduces Risk- Acts as an early warning system and helps prevent harm to colleagues, employees, stakeholders, and society.	(b) Ethical Dilemma-Conflict between loyalty to the organization and duty to the public. Whistle-blowers may suffer emotional stress.
(c) Ethical Responsibility- Employees/insiders may disclose wrongdoing because of their moral duty and sense of right and wrong.	(c) Credibility Issues- Motives of whistle-blowers may be questioned. Anonymous complaints may be viewed with suspicion.
(d) Legal Protection- To encourage whistle blowing, authorities make and enforce laws and organizational policies to protect whistle-blowers from retaliation.	(d) Loss of reputation of the organisation and stakeholder trust. Possible legal penalties and financial losses to the organisation.

COMPONENTS OF A WHISTLEBLOWER POLICY

- **Scope & Coverage** -Defines who all can report (employees, directors, vendors, customers, stakeholders) and reportable matters (fraud, violation of code of conduct, financial misstatement, insider trading, corruption, safety issues, harassment)
- **Reporting Channels**- Provide multiple reporting channels- dedicated email, toll free-helpline, web portal, direct access to Audit Committee
- **Confidentiality and Anonymity**- Maintain confidentiality of the whistle-blowers. Enable complaints to be logged with code number, not name. Anonymous complaints should be accepted & investigated if details are sufficient.

- **Protection Against Retaliation/Victimization**- Protect whistle-blowers from retaliation, victimization, discrimination, injury or harassment. No termination, demotion, transfer, or threat to whistleblower. Disciplinary action against the culprit in case retaliation happens. Audit Committee must review victimization cases.
- **Independent Oversight** - Audit Committee to monitor and regularly review the Whistle Blower mechanism. Direct access for whistle blower to Chairman of AC in exceptional cases.
- **Proper Investigation Process** -Define who will investigate and in how much time. Establish a fair, impartial, and time-bound investigation procedure. Define responsibilities, timelines, and corrective actions. Provide for action against persons found guilty of misconduct.
- **Closure and Communication**-Tell whistle blower the outcome without breaching confidentiality. Even if anonymous, post outcome on portal. If people never hear back, they assume complaints go to dustbin.
- **Reward/Incentive Clause** - Provide incentives/rewards to encourage reporting of wrong doing. Prescribe penalty for frivolous complaints.

Advantages of a Good Whistle-Blower Policy to the organisation.

- Early detection of frauds and misconducts.
- Reduction in legal and compliance risks.
- Protection to employees who report wrongdoing.
- Builds confidence and trust among stakeholders.
- Encourages ethical behavior.

WHISTLE BLOWING LAWS IN INDIA

In India, whistle-blowing is regulated through a combination of the Companies Act, 2013, SEBI Regulations, and the Whistle Blowers Protection Act, 2014.

Law	Coverage	Main Feature
Companies Act, 2013 (Sec. 177)	Listed & prescribed companies	Mandatory Vigil Mechanism
SEBI Regulations, 2015	Insider trading cases	Informant mechanism and reward up to ₹10 crore
Whistle Blowers Protection Act, 2014	Public servants	Protection against corruption disclosures

Companies Act, 2013 (Section 177(9) & 177(10))

- It is mandatory for all listed companies and prescribed companies (i.e. companies which accept public deposits or companies having borrowings from banks/public financial institutions exceeding ₹50 crore) to establish a vigil mechanism.
- This mechanism should enable the directors, employees and other stakeholders of the companies to report their genuine concerns or grievances.
- Audit Committee has been given the responsibility to oversee the vigil mechanism. Companies which are not required to have an Audit Committee, a director nominated by the Board performs this role. As per Schedule IV- Code for Independent Directors, it is the duty of IDs to ensure that the company has adequate and functional vigil mechanism.
- The vigil mechanism should safeguard the whistle blowers from victimisation and retaliation. In exceptional cases, they should be allowed direct access to the Chairperson of the Audit Committee or the director

nominated. Suitable action may be taken against employees/directors making repeated false or frivolous complaints.

- Details of the vigil mechanism must be disclosed on the company's website and in the Board's Report.

SEBI and Whistle-Blowing

- SEBI introduced whistle-blower provisions under the SEBI (Prohibition of Insider Trading) Regulations, 2015 by adding Chapter IIIA.
- Allows reporting of insider trading violations directly to SEBI bypassing the company's internal whistle-blowing channels.
- This will enhance confidentiality and anonymity of informants leading to increase in reporting of violations.
- SEBI may grant financial rewards to informants to encourage whistleblowing. To claim reward from SEBI, the eligible informant will have to file an application in a prescribed format.
- Reward can be up to **10% of the monetary sanctions recovered**, subject to a cap of **₹10 crore**. It means the whistle-blower's reward is linked to the penalty/fine/disgorgement money actually recovered by SEBI from the wrongdoer.

Whistle-Blowers Protection Act, 2014

- The Act seeks to protect persons making **public interest disclosures** related to corruption, misuse of power or criminal offences by public servants. Public interest disclosure means revealing information for the benefit of society at large and not for personal gain or revenge.
- The **Central Vigilance Commission (CVC)** is empowered to receive complaints and assess public disclosure requests. Every complaint must contain the identity of the complainant. CVC will examine whether or not the complaint qualifies as a genuine public interest concern warranting an inquiry.
- CVC shall ensure whistleblower protection and safeguard the complainants.
- It shall ensure confidentiality of the complainant and penalize officials who reveal the complainant's identity without authorization.
- The Act prescribes penalties for knowingly making false complaints.

-----X-----