



INTERNATIONAL JOURNAL OF HUMAN RIGHTS LAW REVIEW

An International Open Access Double Blind Peer Reviewed, Referred Journal

Volume 4 | Issue 3 | 2025

Art. 68

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Basil Raju

LLM Student,

Amity Law School, Amity University, Bengaluru

Jyotirmoy Banerjee

Assistant Professor,

Amity Law School, Amity University, Bengaluru

Recommended Citation

Basil Raju and Jyotirmoy Banerjee, *Corporate Fraud and Insider Trading as Legal Triggers of Stock Market Volatility*, 4 IJHRLR 953-964 (2025).

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Corporate Fraud and Insider Trading as Legal Triggers of Stock Market Volatility

Basil Raju

LLM Student,

Amity Law School, Amity University, Bengaluru

Jyotirmoy Banerjee

Assistant Professor,

Amity Law School, Amity University, Bengaluru

Manuscript Received

05 June 2025

Manuscript Accepted

07 June 2025

Manuscript Published

09 June 2025

ABSTRACT

The stability of financial markets is built on the foundation of transparency, fairness, and trust. Yet, this equilibrium is increasingly disrupted by corporate fraud and insider trading legal infractions that not only betray investor confidence but also act as seismic triggers of market volatility. This dissertation critically investigates how these acts of corporate misconduct destabilize capital markets, with a concentrated lens on India's regulatory and judicial landscape, while drawing comparative insights from global precedents. Corporate fraud ranging from financial misreporting to embezzlement and insider trading, involving the illicit use of unpublished price-sensitive information, violate core principles of market integrity. Their occurrence results in a breach of the 'level playing field', creating information asymmetry that disadvantages retail investors and induces sudden and often severe fluctuations in stock prices. Case studies such as the Satyam scandal, the Enron debacle, and the Rajat Gupta affair serve as illustrative benchmarks of how such violations manifest into systemic risks. The study also explores the aftermath of these events, including regulatory crackdowns, criminal prosecutions, investor lawsuits, and its ripple effects on market sentiment and valuation. Additionally, the role of financial media and digital platforms in amplifying the public and investor response to these events is examined. By bridging legal doctrine, empirical evidence, and policy analysis, this dissertation argues for a fortified legal framework, efficient enforcement strategies, and enhanced corporate governance mechanisms. Ultimately, it asserts that tackling corporate fraud and insider trading

is not only a legal imperative but a prerequisite for resilient and trustworthy capital markets.

KEYWORDS

Stock Market, Corporate, Fraud, Insider Trading

1. INTRODUCTION

Stock market volatility is a complex and multifactorial phenomenon, influenced by economic indicators, geopolitical events, and legal developments. While macroeconomic factors such as interest rates, inflation, and fiscal policies are well-documented contributors to market fluctuations, legal events particularly those involving corporate misconduct have increasingly been recognized as potent destabilizers of investor sentiment and market stability. Among these, corporate fraud and insider trading stand out as egregious legal transgressions that not only breach regulatory norms but also erode the foundational trust on which capital market's function¹.

Corporate fraud typically involves intentional misrepresentation of a company's financial status, embezzlement, or manipulation of accounting records, often with the objective of misleading investors and inflating stock valuations². Insider trading, conversely, refers to the buying or selling of a company's securities by individuals possessing material, non-public information, giving them an unfair advantage over ordinary investors³. These practices violate the principle of a level playing field and create information asymmetry, leading to unjust wealth transfer, distorted asset prices, and often, panic-driven volatility.

In the Indian context, incidents such as the Satyam Computer Services scandal in 2009, where an accounting fraud of ₹7,800 crore was unearthed, underline the destructive potential of such misconduct⁴. Similarly, global cases like the Enron collapse and the Rajat Gupta insider trading prosecution in the United States demonstrate how legal violations can trigger sharp market reactions, regulatory overhauls, and widespread investor disillusionment⁵.

¹ Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 242 (2009).

² TOMASZ ZALEWSKI, *CORPORATE FRAUD: CASE STUDIES IN DETECTION AND PREVENTION* 3 (John Wiley & Sons 2009).

³ SEBI (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, Part III, Sec. 4.

⁴ G. Ramesh & S. M. Jawed, *Satyam Fiasco: Corporate Governance Failure and Lessons Thereafter*, 5 IUP J. CORP. GOV. 6 (2009).

⁵ Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines*, 66

This paper aims to examine the role of corporate fraud and insider trading as legal catalysts for stock market volatility, with a special emphasis on the Indian regulatory framework while drawing comparative insights from global experiences. Through doctrinal analysis, case law review, and empirical references, the paper also offers recommendations to strengthen legal and institutional safeguards against such malpractices.

2. UNDERSTANDING STOCK MARKET VOLATILITY

Stock market volatility is a crucial concept that reflects the degree of variation in trading prices over time. It is widely regarded as a barometer of market risk and investor sentiment, and it plays a pivotal role in shaping investment decisions, portfolio management, and regulatory policies. This section explores the multifaceted nature of volatility, the theoretical frameworks explaining it, and the profound impact of legal breaches particularly corporate fraud and insider trading on market stability.

2.1. Definition and Measurement of Volatility

Volatility refers to the statistical measure of dispersion in the returns of a financial instrument. It quantifies how much the price of a stock, index, or asset fluctuates over a specified period⁶. This fluctuation is typically expressed through measures such as standard deviation, variance, or implied volatility indexes like the VIX, often dubbed the “fear gauge” of the market⁷.

- Historical volatility measures past price fluctuations based on historical data.
- Implied volatility reflects the market's expectations of future volatility, derived from options pricing models⁸.

High volatility implies larger swings in prices and usually indicates heightened uncertainty, risk, or fear among market participants. Conversely, low volatility often signals market stability and investor confidence. Understanding these dynamics is essential for investors, regulators, and scholars who seek to

U. MIAMI L. REV. 321, 325–28 (2012).

⁶ Robert E. Whaley, *Derivatives on Market Volatility*, 27 J. DERIVATIVES 44, 44–45 (2020).

⁷ Torben G. Andersen, Tim Bollerslev & Francis X. Diebold, *Parametric and Nonparametric Volatility Measurement*, in 4 HANDBOOK OF FINANCIAL ECONOMETRICS 67, 69–72 (Yacine Aït-Sahalia & Lars Peter Hansen eds., 2009).

⁸ Id.

interpret market behaviour and design appropriate interventions.

2.2. Legal Triggers of Volatility: Corporate Fraud and Insider Trading

Volatility fueled by corporate fraud and insider trading is particularly pernicious because it arises from illegal manipulation and breaches of fiduciary duty. These practices distort the information environment, undermining market integrity and investor trust.

2.2.1. Corporate Fraud

Corporate fraud encompasses intentional deception by company officials, including:

- Manipulating or falsifying financial statements to present a healthier picture than reality.
- Misappropriation of company assets or embezzlement.
- Concealing liabilities or losses to mislead investors and regulators⁹.

Such fraudulent activities cause a disconnect between reported corporate performance and actual financial health. When fraud is uncovered, markets react sharply, correcting valuations in response to the new truthful information. This correction is often dramatic, leading to a spike in volatility and severe losses for investors.

Case Example: The Satyam Scandal

Satyam Computers, once a prestigious IT firm in India, became synonymous with corporate fraud in 2009. The company's chairman admitted to manipulating financial accounts by inflating assets and revenues by approximately ₹7,800 crore¹⁰. Following the revelation, Satyam's share price plunged by over 75% within days, wiping out billions of rupees in investor wealth and causing widespread panic in the Indian stock market¹¹. The scandal also triggered regulatory reforms, including stricter corporate governance standards and

⁹ Tomasz Zalewski, *Corporate Fraud: Case Studies in Detection and Prevention* 3 (John Wiley & Sons 2009).

¹⁰ G. Ramesh & S. M. Jawed, *Satyam Fiasco: Corporate Governance Failure and Lessons Thereafter*, 5 IUP J. CORP. GOV. 6 (2009).

¹¹ Id.

increased vigilance by the Securities and Exchange Board of India (SEBI)¹².

2.2.2. Insider Trading

Insider trading involves buying or selling securities based on material, non-public information obtained through privileged access within the company. This practice undermines the principle of **information symmetry**, where all investors are supposed to have equal access to relevant information.

- Insiders may exploit confidential knowledge about earnings reports, mergers, or regulatory approvals to gain unfair profit.
- Such trades often precede major price movements, suggesting illicit leakage of sensitive information¹³.

2.3. *The Interplay Between Information, Law, and Market Stability*

The integrity of financial markets fundamentally depends on the legal system's capacity to enforce disclosure, prevent malpractices, and sanction wrongdoers. When laws are weak or enforcement is ineffective, fraudulent and insider trading practices become more prevalent, exacerbating volatility and impairing capital formation.

- The principle of fair disclosure and corporate governance mechanisms act as safeguards to reduce information asymmetry¹⁴.
- Enforcement agencies like SEBI and market watchdogs play a critical role in deterring illegal trading and fraud¹⁵.
- Transparency, timely disclosure, and whistleblower protections are key to mitigating volatility caused by legal infractions¹⁶.

¹² Securities and Exchange Board of India (SEBI), Annual Report 2009-10, at 45 (2010).

¹³ SEBI (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, Part III, Sec. 4.

¹⁴ Burçin Yurtoglu, *Corporate Governance and Stock Market Development*, in THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 2-3 (Mike Wright et al. eds., 2013).

¹⁵ Securities and Exchange Board of India (SEBI), *Annual Reports* (Various years).

¹⁶ Id.

3. CORPORATE FRAUD AND INSIDER TRADING: LEGAL PERSPECTIVE

Corporate fraud and insider trading are serious legal violations that strike at the heart of market integrity and investor confidence. This section analyses their definitions, the relevant Indian legal framework, enforcement mechanisms, and comparative insights from international jurisdictions. Understanding these legal dimensions is essential to grasp their role as triggers of stock market volatility.

3.1. Defining Corporate Fraud And Insider Trading

Corporate fraud encompasses a broad range of deceptive acts committed by corporate officials, executives, or entities aimed at financial gain or concealment of wrongdoing. It includes fraudulent financial reporting, misappropriation of assets, bribery, and concealment of material facts¹⁷. The intent behind corporate fraud is typically to mislead stakeholders' investors, creditors, regulators about the true financial health or operations.

In contrast, insider trading refers specifically to the buying or selling of a company's securities by individuals who have access to material, non-public information about that company¹⁸. The essence of insider trading lies in the unfair advantage gained by insiders, often company executives, directors, or employees, who use confidential information to make profits or avoid losses ahead of the market.

Both these practices violate fundamental principles of fairness, transparency, and equality in securities markets, leading to distorted price discovery and undermining investor trust.

3.2. Indian Legal Framework Addressing Corporate Fraud and Insider Trading

India has developed a comprehensive legal and regulatory framework aimed at preventing, detecting, and penalizing corporate fraud and insider trading, primarily through the following instruments:

¹⁷ Tomasz Zalewski, *Corporate Fraud: Case Studies in Detection and Prevention* 3 (John Wiley & Sons 2009).

¹⁸ SEBI (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, Part III, Sec. 4.

3.2.1. Legal and Regulatory Framework in India

India has established a robust framework to prevent and penalize corporate fraud and insider trading, mainly through:

- **Companies Act, 2013:** This Act mandates accurate financial record-keeping and audits, with strict penalties for fraud under Section 447, including fines and imprisonment. It also empowers the Serious Fraud Investigation Office (SFIO) to investigate complex corporate frauds.
- **SEBI (Prohibition of Insider Trading) Regulations, 2015:** These regulations define insiders and material non-public information, require disclosure of trades, prohibit trading based on unpublished price-sensitive information, and impose monetary and criminal penalties. Amendments have strengthened enforcement and closed loopholes.

COMPARATIVE INSIGHTS: GLOBAL LEGAL APPROACHES

Analyzing international legal frameworks governing corporate fraud and insider trading offers valuable perspectives for India, helping to identify best practices as well as gaps in the domestic regulatory regime. Different jurisdictions have evolved distinct mechanisms tailored to their capital market structures, legal traditions, and enforcement cultures. Understanding these differences can guide reforms in India to strengthen market integrity and reduce volatility arising from legal breaches.

3.2.2. United States

The United States is widely regarded as having one of the most stringent and well-developed legal frameworks addressing corporate fraud and insider trading. This framework rests on robust statutory provisions, active regulatory enforcement, and a highly litigious environment.

- **Securities Exchange Act of 1934:** This foundational statute regulates secondary trading of securities, imposing strict disclosure obligations on publicly traded companies and prohibiting manipulative and deceptive practices, including insider trading¹⁹. The Act established the Securities and Exchange Commission

¹⁹ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq.

(SEC), an independent regulatory authority empowered with broad investigative and enforcement powers.

- **Sarbanes-Oxley Act of 2002 (SOX):** Enacted in the aftermath of corporate scandals such as Enron and WorldCom, SOX introduced sweeping reforms to improve corporate governance, accountability, and financial disclosure. It mandates CEO and CFO certifications of financial statements, enhances auditor independence, and imposes criminal penalties for fraudulent activities²⁰.
- **Enforcement Practices:** The SEC aggressively pursues insider trading through both civil and criminal proceedings. Insider trading cases in the U.S. often result in substantial financial penalties, disgorgement of illicit gains, and even imprisonment for executives and traders involved. The U.S. Department of Justice (DOJ) also prosecutes criminal violations in coordination with the SEC²¹.
- **High-Profile Precedents:** Landmark cases such as the Enron scandal, where corporate fraud led to one of the largest bankruptcies in history, and the Martha Stewart insider trading conviction, have cemented a culture of accountability and deterrence. These cases demonstrate that no individual or company is above the law, reinforcing market confidence²².

The U.S. legal framework exemplifies how rigorous laws combined with proactive enforcement and strong governance mechanisms can help maintain market stability and investor protection.

3.3.2 United Kingdom

The United Kingdom's approach blends criminal and civil enforcement with regulatory oversight to curb corporate fraud and insider trading.

- **Financial Services and Markets Act 2000 (FSMA):** This Act consolidates much of the UK's securities regulation, including prohibitions against market abuse, false trading, and misleading statements²³. It

²⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

²¹ U.S. Securities and Exchange Commission, Enforcement Actions

²² United States v. Enron Corp., 535 F.3d 325 (5th Cir. 2008); United States v. Stewart, 433 F.3d 273 (2d Cir. 2006).

²³ Financial Services and Markets Act 2000, c. 8 (U.K.).

grants the Financial Conduct Authority (FCA) wide powers to investigate and sanction insider trading and corporate fraud.

- **Financial Conduct Authority (FCA):** The FCA operates as the UK's principal securities regulator, combining supervisory, investigative, and enforcement functions. The FCA employs a risk-based supervisory model and emphasizes transparency and consumer protection in its market conduct regulation.
- **Civil and Criminal Sanctions:** The UK employs both civil penalties such as fines and market bans and criminal prosecutions for insider trading and fraud. This dual-track approach enhances deterrence while allowing regulatory flexibility²⁴.
- **Whistleblower Protections:** Recent regulatory reforms in the UK have enhanced protections and incentives for whistleblowers, recognizing their critical role in uncovering fraud²⁵.

Overall, the UK system underscores the importance of a balanced approach combining enforcement, transparency, and market participant education to uphold market integrity.

4. LEGAL AND REGULATORY FRAMEWORK IN INDIA

India has developed a comprehensive legal and regulatory framework to address corporate fraud and insider trading, which are significant threats to market integrity and investor confidence. The primary legislation includes the Companies Act, 2013, and regulations issued by the Securities and Exchange Board of India (SEBI), India's capital markets regulator.

Under the Companies Act, 2013, companies are required to maintain accurate books of accounts and adhere to strict audit and reporting standards. Section 447 specifically deals with fraud and prescribes penalties including imprisonment and fines for individuals found guilty of fraudulent activities. The Act also empowers the Serious Fraud Investigation Office (SFIO) to investigate complex and high-profile corporate fraud cases involving public interest companies, enhancing the government's ability to tackle serious violations effectively²⁶.

²⁴ Financial Conduct Authority, Enforcement Guide (EG) (2019)

²⁵ OECD, Good Practice Guidance on Whistleblower Protection (2016)

²⁶ Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India); Ministry of Corporate Affairs, Serious Fraud Investigation Office

SEBI plays a central role in regulating securities markets and preventing insider trading and market manipulation. The SEBI (Prohibition of Insider Trading) Regulations, 2015 define key concepts such as “insider” and “material non-public information” and impose stringent obligations on insiders to disclose trading activities. These regulations prohibit trading based on unpublished price-sensitive information and empower SEBI to impose penalties including monetary fines and imprisonment. Over time, these regulations have been amended to strengthen enforcement and address emerging challenges²⁷.

However, enforcement in India faces several challenges. Investigations can be slow and complex, partly due to the sophisticated nature of financial frauds and the need for advanced forensic tools. Coordination between various enforcement agencies such as SEBI, SFIO, and the Enforcement Directorate sometimes suffers due to overlapping jurisdictions. Additionally, despite the existence of a whistleblower policy, protections for informants remain limited, which may discourage reporting of fraud or insider trading²⁸.

Recent reforms have aimed to address some of these gaps by enhancing digital market surveillance, strengthening insider trading rules, and formalizing whistleblower protections. Nonetheless, experts advocate for further improvements such as a unified securities fraud law, clearer definitions, faster judicial processes, and stronger whistleblower safeguards to ensure more effective enforcement and bolster investor confidence in India’s capital markets²⁹.

5. CONCLUSION

Corporate fraud and insider trading remain critical legal triggers that significantly contribute to stock market volatility in India. These illegal practices undermine market integrity by creating information asymmetry and eroding investor confidence, ultimately destabilizing financial markets. While India has established a solid legal and regulatory framework through the Companies Act, SEBI regulations, and specialized investigative bodies like the SFIO,² enforcement challenges persist, including slow investigations, limited whistleblower protections, and

²⁷ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (India); Securities and Exchange Board of India, Annual Report 2023-24, at 45.

²⁸ Ravi Sharma, Enforcement Challenges in Indian Securities Markets, 10 J. FIN. REG. 78, 82 (2021); SEBI Whistleblower Policy, 2018

²⁹ N. Ramesh Kumar, Towards a Unified Securities Fraud Law in India, 12 INDIAN J. SEC. L. 120, 125 (2024); SEBI Technology Adoption Report, 2023, at 23.

jurisdictional overlaps.³ Comparative insights from jurisdictions like the U.S. and the U.K. highlight the need for stronger enforcement mechanisms, enhanced transparency, and improved investor safeguards in India.⁴ To ensure a more resilient and fair market, India must continue refining its legal framework by adopting global best practices, streamlining judicial processes, and empowering regulatory authorities. Robust corporate governance, effective regulatory oversight, and active stakeholder participation are essential to curb fraudulent activities and promote market stability, thereby safeguarding the interests of all investors and fostering sustainable economic growth.³⁰

³⁰ Manish Agarwal, *Market Integrity and Financial Crimes*, 14 IND. J. CORP. L. 211, 218 (2023).