INSIDER TRADING:
A COMPARATIVE LAW ANALYSIS

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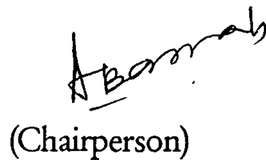
CERTIFICATE

This is to certify that the dissertation entitled **INSIDER TRADING: A COMPARATIVE LAW ANALYSIS** submitted by **VINAI KUMAR SINGH** is in partial fulfillment of the requirement for the degree of ***Master of Philosophy*** (M.Phil.) of this university. It is his original work and may be placed before the examiners for evaluation. This dissertation has not been submitted for the award of any other degree of this university or of any other university.



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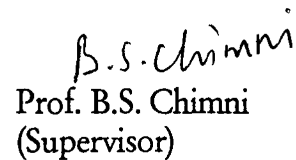

Prof. B.S. Chimni
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Dedicated

To

My Mother

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CHAPTER -I

INTRODUCTION

Insider trading has a tendency to make the equity and debt market unsafe for normal investors. The effect of this is that investors loose confidence in the market and tend to stay away from them. This affects the economy adversely. Insider trading can not only cause wide fluctuations in the price of the securities, but also undermine the trust of the investors in the capital market.

Insider trading generally means trading in the shares of a company by persons who are in the management of the company, or are close to it, on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but is not available to others. Such trading, at it involves misuse of confidential information is unethical, tantamounting to the betrayal of fiduciary position of trust and confidence.

Since 1997, stock exchange regulators in India stated that the system was safe and constantly monitored. But this illusion was broken by one man Ketan Parekh in March 2001 and then by BSE President Anand Rathi. The subsequent turmoil in the stock markets has exposed the weakness in the system. Whether it is rewind to 1992

(the Harshad Mehta orchestrated securities scam), or fast forward to 2001.

The insider trading scandal triggered by the Big Bull Ketan Parekh to be well over Rs. 3,000 crore. Besides admitting his unholy nexus with Madhavpura Co-operative Bank officials in the pay order and scam,[1] he has also apparently confessed to taking loans from his favourite companies like HFCL and Zee Telefilms.[2] This brokers and promoters nexus gave an opportunity to manipulate a few select stocks. The market collapsed. Not surprisingly, the stock market crash is claimed its victims. Virender Kumar Agarwal and his wife Ramkali poisoned themselves in a hotel at Delhi. Abhishek Banka drowned himself in Calcutta and his wife Sona threw herself from ninth floor. Sanjay Aggarwal and his wife Sapna first killed their children and then hanged themselves.[3] It is undeniable that what led these unfortunate people to end their lives was their own greed-the

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[1] The market melt down also took toll of the banking sector when Ahmedabad –based co-operative bank, Madhavpura Mercantile Co-operative Bank (MMCB), faced a run on its deposits because of heavy exposure to stock markets. The bank in collusion with Ketan Parekh issued pay orders (an order, backed by cash or deposits, issued by a bank to pay any third party on behalf of a client), without the backing of sufficient funds. Ketan Parekh, in turn, used this money to rig up the prices of shares. This nexus went unnoticed for almost a year but was broken when MMCB failed to honour the pay orders that it had issued. It has been estimated that Parekh and his front companies siphoned off nearly Rs 8000 million from Bank. The immediate fallout of this fraud was on the leading commercial banks such as Bank of India, State Bank of India and Punjab National Bank which have suffered huge losses on account of pay order fraud. Besides, over 300 co-operative banks in the state of Gujarat have also burnt their fingers in overnight exposure to the MMCB. According to RBI estimates, the total loss in the entire fraud was around Rs.12000million.

[2] Shantanu Guha Ray and Arijit Barman, "The Story and Bull Story", *Outlook*, April 23, 2001, p.49; As per SEBI's finding, Zee group companies funded Ketan Parekh's firm – Panther Fincap and Panther Investrade – in January 2001 to the extent of at least Rs.90 crore. This transfer was apparently done through three investment companies – Ganjum Investments, Churu Investment and Prajatma Investments. These three companies were also the channel used by Zee to transfer another Rs 50 crore to the same two Parekh companies early March.

[3] Nikhil Mookerji, "Casino Kolkata's Big Black Hole", *Outlook*, April 2, 2001, p. 48.

prospect of high returns on the bourses, leading them even to borrow or embezzle huge amounts. But it is equally undeniable that the Indian stock market could overnight turn into a very dangerous place for the small investor.

Further, during the merger mania of 2001, the SEBI became frustrated over its inability to prosecute outsiders who relied on confidential takeover information that they were inevitably exposed to during the merger process. The reversal of Securities Exchange Board of India (SEBI) decision by finance ministry in Hindustan Lever Ltd.(HLL) and Brook Bond Lipton India Ltd.(BBLIL) merger case left it disarry and frustrated. When Global Trust Bank (GTB) was in the process of merging with UTI Bank, there were strong accusations that the GTB management colluded with Parekh to take a strong position in GTB shares which they could sell at a profit at once the merger news became public and the prices went up.[4]

Thus for example, Parekh had close business dealings with GTB. The merchant banker for the GTB-UTI merger was SBI Capital Markets, which was a consultant for the VSNL disinvestments along with Credit Suisse First Boston (CSFB); and CSFB is one of the foreign institutional investors (FII) being accused by SEBI of being in

[4] Sachdev Ray, "Barman, Bear-Hug and After, *Outlook* ", March 19, 2001, p. 51; and Rajat Rajgarahia, "UTI Bank Limited", available at <http://www.indianinfoline.com/comp/utik/cont.html>

collusion with Parekh.[5] So, the merchant banker, investment advisor, consultant and FII all were indulged in the merger process.

Indeed, takeovers are a great example of insider trading. The majority of cases involve leaks. Takeovers are regarded as the special events that are likely to move prices and create the climate for insider trading. The basis for this widely held suspicion is the movement in prices prior to the announcement. According to Vinod Gupta, a legal advisor of FICCI, it is possible that share prices move upward in the pre-takeover period because takeover targets are often identified in the course of market analysis but it is also true that part of the movement comes from insider trading.[6] In other words, there is a link between takeover and insiders.

The opportunities for insider trading in India have been, and continue to be, extensive. This is not simply a matter of greed but the result of a complex web of values, market conditions and professional or peer group tolerance of insider trading. It is no surprise to find that institutional factors in the market such as technological and mineral discoveries and company takeovers provide major opportunities for insider trading. A bull market, especially where share prices are highly volatile and there is a great deal of activity, provides many easy opportunities for insider trading. Finally, the apparent tolerance of insider trading and peer group supports for insider traders who have

[5] ibid.

not been convicted are important factors in enlarging the opportunities for insider trading.

In this backdrop, SEBI initiated moves to make a stronger insider trading law. It constituted a committee under the chairmanship of Kumara Mangalam Birla to strengthen the existing insider trading regulation and create a framework for prevention of insider trading. The recommendation of the Committee was considered by the SEBI. The amended regulation was notified in the Gazette on 20/2/2002. The new insider trading regulation needs to be examined with a view to determine whether it would be able to prohibit and deter insider trading in the future.

The present study aims at discussing the adequacy of India's security laws dealing with insider trading in the backdrop of developments in other national jurisdictions. It will make an effort towards this end to present an overview of all the legal issues relating to insider trading cases. More specifically it will:

(i) compare securities laws of India with the US national laws dealing with insider trading;

(ii) analyse the securities enforcement laws and their impact on the search for investor's confidence;

[6] Personal meeting held with author, dated March 23, 2002.

(iii) enquire into the nature of the liability regime for the violation of securities laws dealing with insider trading in India and else where;

(iv) discuss briefly the various laws governing securities market and the possibility of harmonizing them with a view to protecting the interest of investors in securities and to regulate the securities market.

The study will also seek to highlight the most important factors that India should consider when regulating insider trading and to make some suggestions in this regard. The study has been divided into four chapters. The first chapter will provide an introduction to the study. The second chapter will examine India's insider trading laws. The third chapter will compare India and US national securities laws dealing with insider trading. The final chapter contains the conclusion and recommendation of the study.

1. Rationale of Regulating Insider Trading

There are competing views as to whether insider trading needs to be controlled and restricted.[7] There are many who argue against insider trading. Henry Manne was of the opinion that insider trading is not an activity that is to be denounced as unlawful. Rather he

[7] Kamath and Majumdar, "Insider Trading – Regulate or Not to Regulate", *Corporate Law Advisor*, vol 30, 1998, p. 173.

believes it to promote efficiency in the market and therefore should not be controlled or punished, as it falls within the ambit of 'victimless crime'.[8] Later on, it has come to be settled that insider trading is an objectionable practice and requires to be prohibited.[9]

1.1 Argument Against Regulation

(1) Some argue that, traditionally there was an emphasis upon fiduciary obligation to shareholders. This is unrealistic today and reflects a paternalistic attitude. The rationalization of fiduciary duty policy is artificiality. Now, caveat emptor principal is gaining ground in security transaction.[10]

(2) The rhetoric of the level playing field was often also applied to this ethos of fairness, although this metaphor was not very appropriate to insider trading.

(3) Insider trading profits are viewed by some as appropriate compensation and rewards for corporate insiders or 'entrepreneurs'.[11]

(4) Insiders do not gain from insider trading because they pay for insider trading in the form of capital at the Initial Public Offering (IPO) or SEO stage.[12]

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[8] Henry G. Manne, "In Defence of Insider Trading", *Harvard Business Review*, vol.44, 1966, p.113. Manne, "Insider Trading and Stock Markets", *Stanley Law Review*, 1966.

[9] Roy A Schotland, "Unsafe At Any Price: A Reply to Manne Insider Trading Stood Market", *Virginia Law Review*, vol. 53, 1967, p. 1425.

[10] J. E. Reece, "Buyer Beware: The US No Longer Wants Foreign Capital to Fund Corporate Acquisition", *Denver Journal of International Law and Policy*, vol.21, winter 1993, p.401.

[11] Carbon and Fischel, 'The Regulation of Insider Trading", *Stanley Law Review*, vol.35, 1983, p.857.

(5) It is unclear that insider trading will have a significant or long lasting impact on stock prices.

(6) It is unfair to impose such restrictions on large companies as it destroy the whole working structure where decision making is to be made at the top level and information flow is supposed to come from the lower levels.

(7) If insider trading is so bad, why don't corporations themselves prohibit it.

(8) Can new information be inferred or decoded from insider traders? This is doubtful, but if it were true, insiders likely would behave strategically and trade longer periods of time and/or through more intermediaries. This would frustrate the allocative efficiency goal.[13]

1.2 Arguments in Favour of Regulation

The policy justification for regulation of insider trading mainly revolves around market efficiency, fiduciary duty and fairness:

(1) The purpose of insider trading legislation is to provide fairer markets by promoting equal treatment and to stop illegal gains. In

[12] Laura Nyantung Beny, "The Political Economy of Insider Trading Legislation and Enforcement: International Evidence", available at <earch?q=cache:Z5br0HTLMC:www.law.harvard.edu/programmes/olin_center/papers/pdf/348.pdf+Insider+Trading+law+%2B+India&hl=en&ie=UTF-8> visited dated November 23, 2001>

[13] Gilson and Krakmin, "The Mechanisms of Market Efficiency", *Vanderbuilt Law Review*, vol.87, 1984, p 549; and available at <earch?q=cache:Z5br0HTLMC:www.law.harvard.edu/programmes /olin_center/papers/pdf/348.pdf+Insider+Trading+law+%2B+India&hl=en&ie=UTF-8> visited dated November 23, 2001>

short, insider trading is to be regulated in order to provide a level playing field. The laws are seen to have the goal of seeking to protect small investors. An efficient market requires equal access to information. And in a system of limited liability companies it is unjust that some should have access to information which others do not. Finally, there must be a pairty in the bargaining power of all the players. The very basis of the operation of the stock exchange being that it functions on the tacit understanding that all participants are to have equal access to material information regarding publicly traded securities.

Many argue against the principle of 'fairness in the securities markets' on the grounds that there can and will never be an equality of information. Some parties always being better informed as a result of their superior foresight and analysis of market trends. However, such an argument seems to miss the point because what is desired is an equality of access to price sensitive information and not an equality of information per se. Insider trading gives rise to the situation where some people, who are being treated as equal competitors in the market, are in positions whereby they have a greater access to the price sensitive information. Therefore, the inequality in insider trading results from the position of the person and not his personal abilities.

It can not therefore be denied that there is a need to set right the injustice of the free market and thereby protect the investors.[14]

(2) Insider trading violates the fiduciary duties imposed by law. Certain insiders of a company have the fiduciary duties to act in good faith, not to misuse corporate opportunities, and to protect the interests of all the investors. The director is not an agent but rather a trustee. It is an expectation from him not to breach the trust.

(3) Confidential business information has long been recognized as property.[15] So, the misappropriation of information is a theft.

(4) Insider trading is fundamentally about the allocation of the property right in corporate information and hence about the distribution of rents derived from the use of such information.[16] The state creates and protects property rights. This makes a political economy framework an appropriate way to understand a country's decision to enact and/or enforce insider trading legislation.[17]

(5) Since the basis of commercial activity in the corporate sector is the mobilisation of public funds, the non regulation of insider trading is a

[14] Saul Levmore, "Securities and Secrets: Insider Trading and the Law of Contracts", *Virginia Law Review*, vol.68, 1982, pp.117, 124, 127.

[15] *Carpenter v US*, 484 US 19 (1987).

[16] Goshen and Parchomovsk, 2000, Kraqiece,2001 cited in Laura Nyantung Beny, "The Political Economy of Insider Trading Legislation and Enforcement: International Evidence", available at <earch?q=cache:Z5br0HTLMC:www.law.harvard.edu/programmes/olin_center/papers/pdf/348.pdf+Insider+Trading+law+%2B+India&hl=en&ie=UTF-8> visited dated November 23, 2001>

[17] Laura Nyantung Beny, "The Political Economy of Insider Trading Legislation and Enforcement: International Evidence", available at

risk that securities market any where in the world can ill afford to take.

(6) Insider trading distorts the pricing of listed securities. It is the basic principle of stock market that price should be accurately listed.

(7) An insider will attempt to accentuate stock price volatility by misleading or embellished statements.

(8) Managers might adopt riskier business venture on the logic that regardless of whether a project succeeds or fails is less significant since they can trade before news of the outcome of the venture is made public.[18]

(9) Insider trading encourages the management of a company to indulge in manipulative practices. These manipulative practices may take diverse forms.[19] Often the companies whose insiders indulge in the practice will not make timely disclosures in a deliberate attempt to misuse their positions. As a result of this practice, the flow of information is adversely affected. In such situations the company suffers losses and the investors are defrauded.

On the whole, there is a uniform expression of hostility to insider trading and the shared belief that such conduct should be

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<earch?q=cache:Z5br0HTLMC:www.law.harvard.edu/programmes/olin_center/papers/pdf/348.pdf+Insider+Trading+law +%2B+India&hl=en&ie=UTF-8> visited dated November 23, 2001>

[18] Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation", *Michigan Law Review*, vol.8, 1982, p.1051.

[19] A. A. Berk, "Legal Problem of Economic Power", *Columbia Law Review*, vol.60, 1960, p.4.

prevented.[20] It can, therefore, be reasonably argued that, on the strength of the above arguments, insider trading is an unjustifiable practice that may not be in consonance with the values of any civilized society.[21] The investor, who is the focus of commercial activity, should not be allowed to loose faith as a result of non-protection.[22] It is on this basis that there has been international denouncement of the practice. The spurt of legislation on the point in recent years shows that societies are no longer willing to tolerate insider trading.

2. SEBI'S Overall Role in the Securities

SEBI is the national regulatory body for the securities market, set up under the SEBI Act, 1992, to "protect the interests of investors in securities and to promote the development of and to regulate, the securities market and for matters connected there with or incidental thereto". The board of SEBI comprises a chairman, two members from the central government representing the ministries of finance and law, and one other member appointed by the central government.

As per the SEBI Act, 1992, the powers and functions of the board encompass the regulation of stock exchanges and other

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[20] Eighty-seven countries have insider trading laws. "The World Price of Insider Trading", available at <http://www.icfshanghai.org/aub_files/working_paper/jdwp%202000-5%20Text.pdf>

[21] Kamath, Majmudar, "Insider Trading – Regulate or Not to Regulate", *Corporate Law Advisor*, vol. 30, 1998, p.176.

[22] ibid.

securities markets: registration and regulation of the working of stock brokers sub brokers, bankers to an issue, trustees of trust deeds registrars to an issue, merchant bankers, under-writers, portfolio managers, investment advisors and such other intermediaries who may be associated with the stock market in any way; registration and regulation of mutual funds; promotion and regulation of self regulatory organization; prohibiting fraudulent and unfair and certain trade practices and insider trading in securities markets :regulating, substantial acquisition of shares and takeover of companies; calling for information from, undertaking inspection, conducting inquiries and audits of stock exchanges intermediaries and self regulatory organizations of the securities market, and performing such functions and exercising such power as contained in the provisions of the Capital Issues (Control) Act, 1947 and Securities Contracts (Regulation) Act, 1956, levying various fees and other charges, conducting such other functions as may be prescribed from time to time.

The SEBI has suffered a blow in its first and a high profile test case of insider trading regulations. On July 14, 1998, the Appellate Authority in the Finance Ministry set aside *SEBI's March 1998 ruling*[23] that Hindustan Lever Ltd. (HLL), the biggest Indian company in terms of market capitalization, had indulged in insider trading on the eve of

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[23] *HLL v SEBI* and *UTI v SEBI*, *Company Law Journal*, vol.3, 1998, p.973.

the merger of Brooke Bond Lipton India Ltd.(BBLIL) with it in 1996. Both HLL & BBLIL were subsidiaries of Unilever. The Appellate Authority reversed SEBI's order that the company and five of its directors be prosecuted and also struck down the ruling that HLL pay Rs 3.04 crores to the publicly owned Unit Trust of India (UTI), the alleged victim of the instance of insider trading. It also said that SEBI's ruling suffered from "procedural lapses" and that it used powers beyond its jurisdictions. However, the grounds on which the Authority based its ruling and the manner in which it interpreted the SEBI (Insider Trading) Regulation, 1992 and the SEBI Act 1992, have raised a controversy.

The facts of the case were as follows: [24] ,

UTI, the second biggest shareholder in both HLL and BBLIL after Unilever (which now has a 51 % stake in HLL), had complained that the information on the proposed merger of BBLIL with HLL was not known to it when it bought the shares. SEBI ruled that the companies were well in the way towards a merger and that the directors of Unilever, HLL and BBLIL were actively involved in the exercise. As a result, SEBI reasoned that while HLL, a party to the transaction, had access to privileged 'price sensitive' information and UTI, the other party had no knowledge of the proposed merger. HLL

[24] http://www.expressindia.com/fe/daily/19980715/19655024.html – 19k visited dated November 20 2001; http://www.expressindia.com/fe/daily/19981024/29755424.html - 18k visited dated November 20, 2001.

also claimed that the market was generally aware of the merger talks and that UTI would have discounted for this in the price at which the share was traded. However, SEBI noted that there was a fundamental difference between the general information that was available to UTI and the material specific information available to HLL.

Resorting to the legal position that 'no person can be an insider to himself ', HLL argued that it was not an insider as defined in the SEBI(Insider Trading)Regulation, 1992. It noted that SEBI was a separate entity and that its information on the merger with BBLIL arose out of it being a party to the merger and not because it was an "insider". SEBI overruled this maintaining that the "competence" to decide about BBLIL's merger with HLL did not vest with HLL alone but also with BBLIL and Unilever. Therefore, it said that the information about the merger did not "constitute HLL's own knowledge about its own affair or even its knowledge as a principal party". SEBI pointed out that a core team comprising the directors of BBLIL and HLL, had been formed in January 1995 and that Unilever had granted "inprinciple" approval to the merger proposal in January 1996. The core team, it held, met between March 6 and 10 and decided to make the announcement about the merger on April 29. SEBI alleged that the company kept back from UTI concrete information on the merger when the transaction was made on March 25, 1996. SEBI also charged that HLL failed in its "fiduciary duty" to UTI, the second

largest shareholders of the company. HLL laid great emphasis on the fact that it did not have the details of the swap ratio – the ratio at which BBLIL shares were exchanged for shares of HLL at the time of transaction. It argued that the mere information about the proposed merger did not constitute price sensitive information and that only information on the swap ratio would have materially affected share prices. SEBI dismissed this plea, saying that although the swap ratio may be a price sensitive factor, it was by no means the only factor. It pointed out that HLL had circulated a note prohibiting company officials from investing in the shares of group companies in situations in which mergers or acquisitions were imminent because they would impact on the share price. The Appellate Authority agreed with SEBI's ruling that HLL was an "insider". It observed that Unilever was the dominant shareholder in both HLL and BBLIL and that they were "connected" and that the merger was not driven by decision processes entirely internal to HLL. Moreover, the Authority accepted the SEBI's ruling that the information on the merger constituted price sensitive information available to the company. The Authority also agreed with the SEBI ruling that the share purchase was intended to maintain Unilever's holding in the merged company at 51 per-cent. In effect, the Appellate Authority held with SEBI that HLL was an "insider" in the transaction; that HLL had privileged price- sensitive information; and that HLL had a motive in pushing through the transaction. However, its ruling has been based on the reasoning that the proposal on the

merger was generally known. In support of its ruling, the Appellate Authority cited press reports that indicated prior market knowledge of the merger. But by its own admission, there were only few reports "prior to the actual purchase (of shares from UTI),". The Authority came down heavily on UTI suggesting that it was not market- savvy, and that it did not know what was generally known in the market. In fact, the burden of the Authority's ruling rests on the premise that the information was freely available and that trading in that information would not have offered either party any advantage or special privilege. Lawyers specialising in corporate law have argued that the weightage given to media reports of merger and other such information can not be equated to hard market information or concrete information available especially within companies.

The case assumes importance because it also raises issues of corporate governance. HLL is one of the biggest companies in India with a turnover of nearly Rs 8000 crores. Unilever, the parent company is in the process of restructuring HLL's operation through a series of amalgamations, which commenced in 1993 with the merger of TOMCO with HLL. Since then Lakme and Ponds have also been merged with the company.[25] If its intention was only to keep its holding in BBLIL at 51 per-cent it need to have purchased only three

[25] Shankar Chakarvorty, "Set Back to the Market Regulation", *Corporate Law Advisor*, vol 15, no. 16, August 1–14, 1998; and available at <http:// wwwlaw.indiainfo.com/tax-fin/sebi.html-3k> visited November 22, 2001.

lakh shares and not eight lakh shares as it did from UTI.[26] If Unilever had adopted another route to hike its stake in the merged company, for example, issuing preference share it would have had to obtain various clearance from the Reserve bank of India and the government apart from the bringing in foreign exchange to buy the shares.[27]

This case leaves following issues of wide ranging to be discussed.

Is it proper to treat HLL as an in insider?

Can there be a criminal offence without mens rea?

Is SEBI competent to award a compensation for UTI's alleged 'loss of profit'?

Does possession of price sensitive information require suspension of a company's business?

Why did not the SEBI ascertain the government's policy on the issues raised in the application?

Thus, this case earmarked the inefficiency of present legislation SEBI (Insider Trading) Regulation, 1992, the lacks of powers and the shortcoming of present regulatory bodies in curtailing mal-practices in the capital market. The proposed study will also make an endeavour to consider and analyse the above-said issues.

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[26] ibid.

[27] ibid.

3. Regulatory Responses to Insider Trading in International Markets

These days insider trading has become a global phenomenon. The unprecedented pace of internationalization of the world's securities markets; the technological advances in communication and operations; the removal of restrictions on foreign participation by many of the world's securities markets, and the financial innovations in securities products and services has both globalised the market and rendered it more vulnerable to insider trading.

While globalisation has been heralded as a boon to the investment community, it has created a fundamental problem for the national regulators of securities markets on how to apply purely national securities laws and regulations to international securities transactions. Such transaction may involve foreign national investors, foreign national issuers, and foreign national markets. This problem involves both issues of substance (e.g. the applicable body of law, the conduct of the investigation and the gathering of evidence) as well issues of procedure (e.g. the existence of jurisdiction, the exercise of jurisdiction and the service of process).[28]

Insider trading has been recognized as both a civil and criminal offence by most of the world. The emerging global consensus favours

[28] Baltic, III, "The Next Step in Insider Trading Regulation: International Co-operative Efforts in the Global Securities Market", *Law and Policy in International Business*, vol.23, no.1, winter 1991-1992.

punishing such activity as it undermines the integrity of the market place. This view was expressed at the 1989 summit of the Arch in Paris, France. The economic declaration signed at the summit stated that, insider trading ... could hamper the credibility of financial markets. International co-operation should be pursued and enhanced to curb insider trading practices.[29]

The regulatory approaches of various nations, though evolving, remain discordant. Because of these differences, traders, issuers and regulatory enforcement bodies face a complicated web of rules governing insider trading. Trading involving multiple national markets may be subject to different degrees of accountability and to conflicting regulatory standards.

Meanwhile, the problem of multi-jurisdictional insider trading has become much more pronounced in today's internationalized markets.

Regulators have developed a variety of regulatory responses, both individually and collectively, to deal with this phenomenon. Attempts by regulators to gain access to information and to conduct insider trading prosecution can generate conflicts with other nations. Therefore, securities regulators have undertaken a number of co-

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[29] Joint Communiqué Following Conclusion of Economic Summit in Paris, Issued in July, 1989 (Text), BNA, para 16 cited in Baltic, III, 'The Next Step in Insider Trading Regulation: International Co-operative Efforts in the Global Securities Market", *Law and Policy in International Business*, vol.23, no.1, winter 1991-1992.

operative initiatives to obtain information and ensure access to illicit profits held outside a particular country.

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4. Reciprocity and Harmonisation

Harmonisation is the regulatory effort to develop shared regulatory policies while acknowledging structural discretion. This process began in 1970 through the establishment of the International Organization of Securities Commissions (IOSCO). In 1986 IOSCO adopted a resolution on co-operation mandating that members should agree to provide assistance on a reciprocal basis for gathering information related to market oversight and protection of each nation's markets against fraudulent securities transactions.[30] Its 27th Annual Conference is to be held in Istanbul, Turkey from May 18 to May 24, 2002 to draft a law relating to transfrontier insider trading.[31]

There was another effort to harmonise the law relating to insider trading by European Economic Community (EEC). On November 13, 1989 the European Council of Ministers passed a directive co-ordinating regulations on insider dealing in member states of the

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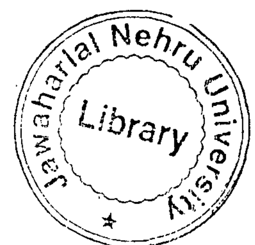
[30] Schultz, Amy E., "Insider Trading and Internationalization of Securities Market", *Columbia Journal of Transnational Law*, vol.27, 1989, pp. 409-15.

[31] http://www.iosco.org visited dated November 22, 2001.



EEC.[32] It is one of the most advanced co-operative efforts among national securities regulations.

The EEC directive forces its member states to harmonise their laws.[33] Although the directives legally bind EEC member states, they are sufficiently general to allow the member states to decide how to implement them.[34] Member states are permitted great flexibility in incorporating the provisions of directive. The Directive states that its rules are only a minimum requirement. The member states are therefore left free to enact more stringent rules than those provided by the Directive.[35] The Directive also leaves the determination of penalties to the member states.[36] These penalties must however be "sufficient to promote compliance with those measures".[37]

To ensure that prohibitions against insider trading are enforced, the Directive requires member states to designate authorities responsible for ensuring that the state applies the adopted provisions of the Directive.[38] The Directive provides that these authorities shall have "all supervisory and investigatory powers that are necessary for the exercise of their functions.[39]

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[32] Council Directive 89/592 of November 13, 1989.

[33] Amy E. Schultz, "EEC Insider Trading Directive", *Vanderbuilt Journal of International Law*, vol 23, no.1, 1990, p.197.

[34] ibid.

[35] Art 6 of EEC Directive

[36] Art 13 of EEC Directive.

[37] ibid.

[38] Art 8 of EEC Directive.

[39] Art 1 of EEC Directive.

The Directive also contains provision for co-operation between member states[40] and rules governing professional secrecy.[41] The Directive instructs the regulatory authorities in member states to exchange information and cooperate whenever necessary to carry out their duties.[42] The authorities, however, may refuse to act on a request for information when communication of the information might harm the security or public policy of the member state or when judicial proceedings are already initiated, or when a final judgment has been rendered in the same action.[43] The Directive allows the EEC to enter into agreements with non-member states on matters governed by the Directive.[44]

As a result of this Directive, EEC states with existing laws on insider trading were required to amend their laws to meet its provisions. Its weaknesses are its lack of definite penalties and its lack of institutional level surveillance system. Thus, by adopting the present Directive, the EEC takes a strong step towards harmonizing the insider trading laws of EEC states.

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[40] Art 10 of EEC Directive.
[41] Art 9 of EEC Directive.
[42] Art 10 (1) of EEC Directive.
[43] Art !0 (2) of EEC Directive.
[44] Art 11 of EEC Directive.

5. Extra-territorial Jurisdiction of SEBI

In India, SEBI with the help of Enforcement Directorates, Central Bureau of Investigation (CBI), and Department of Company Affairs normally investigate the foreign participant who indulged in insider trading. For this, Indian regulators have some bilateral agreements, including mutual legal assistance treaties and memorandum of understanding (MOUs). But these bilateral agreements are not established with many states. The SEBI recently drew a blank from the Mauritius Offshore Business Activities Authority (MOBAA) when it tried to seek details of actual beneficiaries and the source and utilization of funds of certain Overseas Corporate Bodies (OCBs) in connection with the recent stock market scam. The foreign authorities refused to cooperate with the Indian regulators since they have no jurisdiction in their territory, nor any arrangement to share information in the events of any financial mismanagement.[45]

According to an interim report of SEBI on the securities scam, five OCBs in connivance with foreign institutional investors (FIIs) and Ketan Parekh have repatriated close to Rs. 3,000 crore in last two years from the Indian stock market.[46] Thus, this OCB route was being abused by broker's to siphon off funds from the country.[47]

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[45] *Hindustan Times*, November30, 2001, p.13.
[46] *Hindustan Times*, August17, 2001, p.13.
[47] ibid.

Further, situation became aggravated, when a controversy had broken out on IT investigations into FIIs registered in Mauritius. The Finance Ministry scuttled the probe.[48] The result was that the RBI has banned OCBs from investing in Indian Capital Markets.[49]

6. Comparative Law: how is this methodology useful?

'Comparative Law' is the comparison of different legal systems of the world. To compare the spirit and style of different legal system, the methods of thought and procedure used is called macro comparison. Here, instead of concentrating on individual concrete problems and their solutions, research is done into methods of handling legal materials, procedures for resolving and deciding disputes or the roles of those engaged in law. One could, for instance, study the different ways of resolving conflicts adopted by different legal systems and ask how effective they actually are.

Micro comparison has to do with specific legal institutions or problems. That is, it is concerned with the rules used to solve actual problem or particular conflicts of interest.

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48 <http://www.indiainfoline.com/publ/28mar0.1html>, visited March 28, 2001
49 Ibid.

The dividing line between macro comparison and micro comparison is admittedly fixed[50]. Indeed, one must often do both at the same time, for it is only by discovering how the relevant rules have been created and developed by the legislature or the courts and ascertaining the practical context in which they are applied that one can understand why a foreign legal system resolves a given problem the way it does and not otherwise.[51]

6.1 Comparative Law and Public International Law

At first sight there is little common between comparative law & public international law. The latter is essentially a supranational and global system of law. Yet comparative law is essential to the understanding of 'the general principles of law recognized by civilized nations' which is laid down as being one of the sources of international law by Art 38(1) of the Statute of International Court of Justice.

Legislators all over the world have found that on many matters good laws can not be produced without the assistance of comparative law studies. The final function of comparative law and its significance is in the preparation of the project for the international unification of law.[52] The political aim behind such unification is to reduce or eliminate so

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[50] Konrad Zeveigert and Hein Kotz, *Introduction to Comparative Law: The Framework* (Oxford, 1987) 2nd revised edn, vol-I, p.5.
[51] ibid.
[52] ibid, p.23.

far as desirable & possible, the discrepancies between the national legal systems by inducing them to adopt common principles of law.[53]

[53] ibid, p.19.

CHAPTER -II

INDIA'S INSIDER TRADING LAW

This chapter will examine India's security laws relating to insider trading. It will present a discussion on Possession v. Use test with regard to non-public sensitive information. Next, it reviews the enforcement programme of SEBI. Finally, it proceeds with examination of extra territorial operation of SEBI's authority. In this chapter will seek to analyse critically various relevant issues relating to India's insider trading law.

The capital market in India is large and continues to grow. While the capital market has a long history, the integrated regulation of the securities market is a recent phenomenon. The establishment of SEBI as a statutory body by the SEBI Act, 1992, was the first step towards centralized regulation of the capital markets. Until then the following three principal acts characterized the regulatory framework for the capital and securities markets:

(i) The Capital Issues (Control) Act, 1947 that restricted "Issuers" access to capital market, controlling pricing of IPOs & other issues

generally constricted the Capital Market. This Act was abolished by the 1992 SEBI Act.

(ii) The Companies Act, 1956, which set out the code of behaviour and conduct for the corporate sector in general; and

(iii) The Securities Contracts (Regulations) Act, 1956, which gave the Central Government control of secondary markets and stock exchanges.

The SEBI Act came into force on 30 January, 1992. It established SEBI as a statutory body with the following objectives: to protect the interest of investors in securities; to promote the development of the securities market; and to regulate the securities market.

The SEBI Act, 1992 authorises the Central Government and SEBI to make rules and regulation respectively, for carrying out the purposes of the Act.[54] Further, the SEBI shall, in exercise of its power or the performance of its function under this Act, be bound by such direction on question of policy as the Central Government may give in writing to it from time to time.[55] The obvious hierarchy created by the Act, curbs the autonomy and independence of SEBI giving a power to the central government to interfere in the regulation of capital market.

[54] S.29 and S.30 of SEBI Act, 1992.

[55] S.16 of SEBI Act, 1992.

The Cumulative effect of these provisions has given a tool in the hands of finance minister to pepup the SEBI to meet his expectation.

SEBI is also entrusted with the statutory responsibility to regulate the business of stock exchange, register and regulate the work of stock brokers and other securities market, prevent fraudulent and unfair trade practices relating to securities, and prohibit insider trading in securities the subject of this dissertation.

With the growing awareness of corporate governance, the urgency to curb insider trading practices is gaining ground. In India, insider trading regulation was made by SEBI in 1992. This Regulation has inter alia taken guidance from relevant provisions of the U.K Securities (Insider Dealing) Act of 1985 and 1993 and U.S Securities Exchange Act, 1934 and US court's decisions.

The turmoil in the Indian's stock market in the nineties has exposed the weakness of the system. For over five years, the stock exchange regulator stated that the system was safe and constantly monitored. But this illusion was broken by Ketan Parekh in March 2001 and once by Bombay Stock Exchange (BSE) president Anand Rathi. Furthermore, during the merger mania of 1998, 1999, 2001, the SEBI became frustrated over its inability to prosecute outsiders who relied on confidential takeover information that they were

inevitably exposed during the merger process.[56] The reversal of SEBI decision by Finance Ministry in Hindustan Lever Limited left SEBI frustrated. Meanwhile US-64 crisis has shown the hollowness of SEBI's authority.[57]

In this backdrop, SEBI initiated moves to frame a stronger insider trading law. It constituted a Committee under the chairmanship of Shri Kumarmanglam Birla to identify ways to strengthen the existing insider trading regulation and create a better framework for prevention of insider trading. The recommendation of the committee was considered by the SEBI in 2002. An amended Regulation was notified in the Gazette on 20.02.2002.

Through the SEBI (Prohibition of Insider Trading) Regulation, 1992, an attempt is being made to establish healthy trade practices in the stock exchanges so as to sustain the confidence of investors.

1. What is Insider Trading?

The expression "insider trading" is not defined by the SEBI (Prohibition of Insider Trading) Regulation, 1992. So, there is a need

[56] Ray, n.4, p.51.

[57] UTI, since beginning, claimed that it was not a mutual fund. In 2000, UTI agreed to allow SEBI to regulate schemes launched after 1992, SEBI's birth year. The new Economy Stocks (as per recommendation of Deepak Parekh Committee) are not under SEBI scrutiny. SEBI, Chairman, as he then was, said, I agree many of the investments were controversial. But how can we intervene? It is outside our jurisdiction.

to refer definition clauses of the Regulation to ascertain as to what "insider trading" precisely means for the purposes of the Regulation. The basic definition in this connection are "dealing in securities " [Regulation 2 (d)] and "insider " [Regulation 2 (e)].

"Dealing in securities" means an act of subscribing, buying or agreeing to subscribe[58], buy, sell or deal in any securities by any person either as principal or agent[59].

The term "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 to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information.[60]

By integrating these two definitions we can describe 'insider trading' as the purchase or/and sale of securities of a corporation by a person with access to confidential information about the corporation that can materially affect the value of its securities and is not known by other shareholders or the general public.

Thus, there are two categories of insider, namely "any person connected with the company" and "any person deemed to have been

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[58] This word "subscribing" and "subscribe" is added by the Amendment Regulation of Feb. 2002

[59] Regulation 2(d) of SEBI (Prohibition of Insider Trading) Regulation, 1992.

[60] Regulation 2(e) of SEBI (Prohibition of Insider Trading) Regulation, 1992.

connected with the company". The former is called a 'primary insider' and the latter a 'secondary insiders'. The definition of the two expressions is given in Regulation 2 (c) and Regulation 2 (h) respectively.

The primary insiders are – (a) a director; (b) a shadow director, i.e, a person who is deemed to be a director by virtue of Section 307(10)(c) of the Companies Act, 1956; (c) an officer or employee of the company; and (d) a person who holds a position involving a professional or business relationship. However, merely by reason of some professional and business relationship a person can not be treated as a "connected person" unless there is some evidence to establish a nexus between himself and the company. Thus, what is necessary to establish is that, first, the person is placed in a position involving a professional or business relationship with the company and second, by virtue of that position, he is to be reasonably expected to have access to such information. This will depend upon facts and circumstances of each case with due regard to the nature of relationship and the degree of probability.

One explanation has been added by Amendment Regulation February 2002. The words "connected person" shall include any person who is a connected person six months prior to an act of insider trading.

Secondary insiders are identical in eight broad categories by Regulation 2 (h): a company under the same management or group or subsidiary; or person is an intermediary investment company, trusted company, An Asset Management Company or an employee or director thereof or official of a stock exchange or cleaning house or corporation; or the person is a merchant banker, share transfer agent, investment adviser, portfolio manager or is a member of the board of trustee of a mutual fund; or, the person is a member of the board of director or an employee of a public finance institution; or the person is an official or an employee of a half regulatory organization or the person is a related of any of the aforementioned person; or the person is a banker of the company; or person is a relative of the connected person a concern firm, institution, Hindu Undivided Family, and association of person having more than 10 per-cent of the holding or interest[61].

However, the above definition excludes the directors of a stock exchange or of a cleaning house or corporation from the scope of deemed connected persons. This is a serious lapse. If employees of stock exchange or cleaning house or corporation can be included as deemed connected persons; then, there is no reason why directors of such outfits who are privy of price sensitive unpublished information

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[61] Added by the Amendment Regulation February 2002.

while discharging their role as a part of the Board of Directors, should be excluded.

There are some serious problems in this definition. This definition includes relatives of relatives of deemed connected person. The term relative means relatives as defined under the Companies Act 1956. Section 6 of the Companies Act 1956 lists 24 relatives. This list besides being archaic is also cumbersome. How can the SEBI determine as to who are the relatives of such relatives? A person may not even fully know the names of his own relatives. If this is the case then a person will need to put his business on hold for some time and find out as to who are his relatives. SEBI will also need to set up a special body for monitoring and keeping a record of the relatives of such relatives.[62]

Further, the sub-clause defining the deemed connected persons also erroneously excludes an officer and director of a listed company holding 10 per-cent interest or holding in such concern, HUF, company or association of persons. This is a serious omission.

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[62] Amit K. Vyas, "Insider Trading Regulations: A Silver Linings Amid Dark Clouds", available at http://www.financialexpress.com/fe_full_story.php?content_id=6741; visited Monday, April 15, 2002.

2. Unpublished

The expression "unpublished" is defined in Regulation 2(k).[63] Unpublished means information which is not published by the company or its agents and is not specific in nature. Speculative reports in print or electronics media shall not be considered as published information[64].

3. Price Sensitive Information

This expression is defined by Regulation 2 (ha). It means any information, which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of a company. The following are deemed to be price sensitive information:

-periodical financial results of the company;

-intended declaration of dividends (both interim and final);

-issue of securities or buy- back of securities;

-any major expansion plans or execution of new projects;

-amalgamation, mergers or takeovers;

[63] Added by the Amendment Regulation February 2002

-disposal of the whole or substantial part of the undertaking; and

-any significant changes in policies, plans or operations of the company.

4. Prohibition Against Insider Trading

Regulation 3 and 3A are the key provisions that contain prohibitory provisions with regard to insider trading. There are, in fact, three prohibitions enumerated in Regulation 3 viz. (a) dealing, (b) communication, and (c) counseling. In addition to this, Regulation 3A provides that no company shall deal in securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

In US, from various case laws, two broad theories of insider trading liability has emerged.

(1) Abstain or Disclose Theory[65]: The thrust of this theory is that an insider when dealing on inside information should disclose the information or abstain from dealing. The theory rests on two propositions. First, that their exists a relationship giving access to confidential information to be used for corporate purposes. Second, it

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[64] Explanation of Regulation 2 (k), Added by Amendment Regulation February 2002

[65] See in detail in Chapter –III, p.[illegible]-62.

is inherently unfair for a person to take advantage of that information knowing that it is not available to those with whom he is dealing.[66]

(2) The Misappropriation Theory[67]: Under this theory, a person is liable for insider trading if he converts information for personal use which has been entrusted to him. Two elements appear necessary for liability under misappropriation theory – (i) there must be a fiduciary type relationship between the person who trades and the sources of information; and (ii) trading must be in breach of duty not to misuse that information.[68]

In the light of Regulation 3[69] and 3A, India would appear to follow the Misappropriation Theory.

5. Possession v Use Test

Before the Amendment Regulation 2002, it was required from the SEBI to prove the use of unpublished price sensitive information in dealing of securities of a company. The SEBI (Prohibition of Insider Trading) Regulation, 2002, has added the words 'when in possession of' in the clause (i) of Regulation 3. The introduction of these worlds

[66] *Dirks v SEC* 463 US 646; *Chiarella v US* 445 US 222

[67] See in Detail in Chapter –III, p.65.

[68] *US v Newman* 464 US 683 (1983); *SEC v Materia* 471 US 1053 (1985); and *US v Carpenter* 741 F. 2d 1024 (2d cir. 1986).

[69] no insider shall communicate, counsel or procure, directly or indirectly any unpublished price sensitive information to any person who while in possession of such information shall not deal in securities.

infer that there is no need to prove the use of unpublished price sensitive information in dealing of securities of a company. Only the possession of unpublished price sensitive information and dealing of securities is sufficient to substantiate the insider trading. The proof of possession of price sensitive information and dealing of securities would make a prima facie opinion that the accused is involved in insider trading.

The burden lies on the accused to prove that the price sensitive information was not a factor in the trading decision.[70]

The addition of these words would make easier for SEBI to substantiate the charge of criminal offence of insider trading. As being a criminal offence, there is a need to prove the case beyond reasonable doubt by an insider to an outside person.

However, there is a serious ambiguities in Regulation 3 sub-clause (ii).[71] This regulation has been amended in such a manner that a clear cut doubt arises with respect to the aspect of communication of unpublished price sensitive information by an insider to an outside person. Previously, sub-clause (ii) had clearly prohibited communication of such information to any person by an insider and such an act was to be treated as an act of insider trading. However, the amended sub-clause (ii) stipulates that "no insider shall

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[70] See in detail in Chapter III, p.68-71.

[71] Amit K. Vyas, "Insider Trading Regulations: A silver Lining And Dark Clouds", available at http://www.financialexpress.com/fs-full_story.php?, visited dated Monday, April 15, 2002.

communicate, counsel or procure, directly or indirectly any unpublished price sensitive information to any person who while in possession of such information shall not deal in securities". A plain reading of the above indicates that there are two prohibitions - the first being on the communication of unpublished price sensitive information and the second being on the person who is recipient of such information from an insider to deal in securities. However, SEBI has wide its press release[72] dated the February 22, 2002 clarified that the "communication of unpublished price sensitive information is per se not an offence". It appears that there is a clear-cut ambiguity in this regard which needs rectification.[73]

6. Contravention and Punishment

The Regulation does not contain any provision prescribing penalty for contravention of the provisions thereof. Regulation 4 merely declares that any insider who deals in securities in contravention of the provision of Regulation 3 and 3A shall be guilty of insider trading. Any contravention would give a power to SEBI to issue

any or all of the following order, namely: directing the insider or such person not to deal in securities in any particular manner; prohibiting the insider or such person from disposing of any of the securities

[72] Reference no-PR 43/2002 dated February 22, 2002.
[73] ibid.

acquired in violation of this Regulation; restraining the insider to communicate or counsel any person to deal in securities; declaring the transactions in securities as null and void; directing the person who acquired the securities in violation of this Regulation to deliver the securities back to the seller, provided that in case the buyer is not in a position to deliver such securities, the market price prevailing at the time of issuing of such direction or at the time of transactions whichever is higher, shall be paid to the seller; and directing the person who has dealt in securities in violation of this Regulation to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher, to the investor protection fund of a recognized stock exchange.[74]

The aforesaid power of SEBI is without prejudice to its right to initiate criminal prosecution under Section 24 or any action under Chapter VI A of the Act. Section 24 provides that whoever contravenes or attempts to contravene or abets the contravention of the provisions of the Act or rules or regulation, shall be punishable with imprisonment for a term which may extend to one year or with fine or with both. So far as the punishment by fine is concerned, the section does not prescribe any maximum amount of fine. Before 1999 Amendment Act, a complaint would be filed by SEBI only with the previous approval of the central government (S. 26(1)). But by the

[74] Regulation 11 of SEBI (Prohibition of Insider Trading) Regulation, 1992.

Amendment Act of 1999, this requirement of approval of central government is dispensed with. But still one lacuna is left, that is, only SEBI is competent to file a complaint and not the aggrieved private parties.

So far as chapter VI A is concerned, Section 15G provides penalty not exceeding five lakh rupees for insider trading. For the purpose of adjudging under S.15G, the SEBI will appoint any of its persons not below the rank of a Division Chief to be an adjudicating officer.[75]

7. Anomalies in the Scheme of Punishment

Provision and Act	**Authority**	**Nature of Punishment**
Regulation 11 of SEBI (Prohibition of Insider Trading) Regulation, 1992	SEBI	(a) Directing the insider not to deal; and/or (b) Prohibiting the insider from disposing; and /or (c) Restraining the insider not to communicate or counsel any person to deal; and/or

[75] S.15-I of SEBI Act, 1992.

		(d) Directing the transaction as null and void; and/or (e) Directing such person who acquired the securities in violation to deliver it to back; and/or (f) Directing violators to transfer alleged amount to the Investor Protection Fund
S.15G of Chapter VI–A of SEBI Act, 1992	Adjudicatin g officer	a highest penalty of Rs. 5 Lakh.
S.24 of SEBI Act, 1992	SEBI	Punishment not exceeding one year or with fine or both

In sum, the punishment for the violation of provisions of insider trading is provided in S.24 of SEBI Act, 1992 or under chapter VI-A of SEBI Act, 1992 or under Regulation 11 of SEBI (Prohibition of Insider Trading) Regulation, 1992. (a) Section 24 provides punishment not exceeding one year or with fine or both; (b) While chapter VI-A provides for a highest penalty of Rs.5 lakh. This amount of penalty is determined by the adjudicating officer to be appointed by SEBI; and

(c) Regulation 11 may issue any or all of the following order, namely (i) directing the insider not to deal; (ii) prohibiting the insider from disposing; (iii) restraining the insider to communicate or counsel any person to deal; (iv) directing the transactions as null and void; (v) directing such person who acquired the securities in violation to deliver it back; (vi) directing the violators to transfer alleged amount to the Investor Protection Fund.

There are certain anomalies in the scheme of punishment.[76] These two types of punishments are mutually exclusive. If a violation is assigned to an adjudicating officer for adjudication of monetary penalties, the penalty of direction, prohibition, restrain and transaction as null and void given under Regulation 11 can not be imposed as it is within the purview of SEBI. It is possible that a violation attracts both the types of punishment, but it is the SEBI which would predetermine the type of punishment to be imposed for the violation. As per the scheme of the Act, SEBI shall appoint an officer to adjudge if some body has contravened any of the provisions of S.15 A to 15 F of the Act. Once such an adjudicating officer is appointed, the SEBI loses control over the case and the adjudicating officer decides the case on merit. The adjudicating officer can at best impose monetary penalty even if he finds that the violation really warrants prohibition, direction and transaction as null and void.

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[76] M. S. Sahoo, "Securities Watchdog Sets More Teeth", *Chartered Secretary*, August 1996, pp. 841-42.

A corollary of the above is that mind is made up about the type of punishments to be imposed on the erring party when the alleged violation is referred to adjudicating officer for adjudication or taken up by SEBI for imposition of prohibition, direction or restrain the transaction. It meant that at a stage when the nature and gravity of the violation has not been ascertained.[77]

8. Power to Make Inquiry and Inspection

Chapter III of the Regulation comprising Regulation 4-A to11 contain provisions regarding SEBI's powers of investigation. Regulation 4-A (1) provides that if the SEBI suspects that any person has violated any provision of these regulations, it may make inquiries with such persons or any other person as mentioned in S.11 (2) (i) as deemed fit, to form of prima facie opinion as to whether there is any violation of these Regulations.

Regulations 4-A (2) provides that the SEBI may appoint one or more persons to inspect the books and records of the insider and also to investigate into the complaints received from an investor or suo moto upon its own knowledge. Regulation 6 lays down the procedure to be followed by SEBI in regard to investigation into insider trading. Sub-Section (1), which incorporates the principle of natural justice,

[77] ibid, p.842

requires SEBI to give a reasonable notice to the insider. But such a notice can be dispensed with in public interest.

Regulation 7 imposes certain obligations on the insider with regard to investigation viz. to produce books, accounts and other documents, to give reasonable access to the premises in order to examine or record statements, to give assistance to authority.

Regulation 8 requires the authority to submit to SEBI a report within one month.

Regulation 9 enjoins upon SEBI to communicate to the insider the finding of investigation. The insider is required to reply to the same within 21 days. On receipt of such a reply, the SEBI can take such measure as it deems fit to protect the interests of the investor.

Regulation 10 empowers SEBI to appoint a "qualified auditor" to investigate into the books of account.

9. Policy of Disclosure and Internal Procedure for Prevention of Insider Trading

Internationally, a growing school of influential thinkers advocated that insider trading measures should be more by self-regulation of organization rather than by legislation and regulation. This is one of the measures that can act as a deterrent and discourage people from indulging in insider trading. It is pertinent to note in this

connection the comprehensive recommendations of the Sachar Committee (appointed by the Government of India in 1978) in para 8.23 to 8.28 of its report.[78]

The SEBI (Prohibition of Insider Trading) Regulation 2002, contains the provision of policy of disclosure and provision of internal procedure for prevention of insider trading for listed and other entities. These provisions have been added by the Amendment Regulation 2002. The objective is to preserve the confidentiality of information, prevent its misuse and ensure commitment to transparency.

Chapter IV comprises Regulation 12 to 15 deals with the code of internal procedures, disclosure of interests and provisions relating to the violation of disclosure requirement. Chapter IV was added by the Amendment Regulation February 2002 [SEBI (Prohibition of Insider Trading) Regulation, 1992]. As we have already discussed[79], that possession of unpublished price sensitive information and dealing in those securities is enough to constitute the offence of insider trading. There is no need to prove the use of material unpublished price sensitive information. It has been further reinforced by several other measure viz. Chinese Wall, prompt disclosure, internal procedure, model code of conducts. All these measures have been added by the February 2002 Amendment of insider trading regulation.

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[78] <http:/www.sebi.gov.in/report.htm>

[79] See Chapter II, p.38, (heading 5. Possession v Use).

Regulation 12 deals with code of internal procedures and conduct for listed companies and other entities. Regulation12 (1) requires that all listed companies and organizations associated with securities market including the intermediaries as mentioned in S.12 of the Act, asset management companies and trustees of the mutual funds; the self regulatory organizations recognized or authorized by the board; the recognized stock exchanges and clearing house or corporations; the public financial institution, and the professional firm should frame a code of internal procedure and conduct as near to the model code specified in schedule I of the Regulations.

The entities mentioned in sub-regulation (1), are required to abide by the code of corporate disclosure practices as specified in schedule II of the Regulations. Moreover, it is also required that all aforementioned entities shall adopt appropriate mechanisms and procedures to enforce the codes specified under sub-regulation (1) and (2).

Furthermore, the SEBI is not precluded from initiating proceedings for violation of the regulation irrespective of the fact whether the entities have taken action against any person.

Regulation 13(1) deals with the requirement of disclosure of interest or holding (Initial Disclosure). It is required that any person who holds more than 5% shares or voting rights in any listed company

shall disclose to the company, the number of shares or voting rights held by such person, on becoming such holder, within 4 working days. Moreover, directors or officers of the company are required to disclose to the company the number of shares or voting rights held by each of them within 4 working days of becoming a director or officer of the company.[80]

Regulation 13 (3) and (4) require from any person who holds more than 5% share or a director or officer of the company to disclose change in shareholding or voting rights as the case may be. This disclosure should be made within 4 working days of. And within five days of receipt, every listed company shall disclose to all stock exchanges the information received under Regulation 13(1), (2), (3) and (4).

Regulation 14(1) says that a person who violates the provision of Regulation 12 shall be liable for action under Section 11 or 11 B and/or Section 24 of the Act. Regulation 14(2) says that a person who violates the provision of Regulation 13 of SEBI(Prohibition of Insider Trading)Regulation, 1992 shall be liable for action as specified in Regulation 11 or Section 11, 11 B or action under Chapter VI A or Section 24 of the SEBI Act, 1992.

[80] Regulation 13(2) of SEBI (Prohibition of Insider Trading) regulation, 1992.

10. Model code of conduct for prevention of insider trading for listed companies and other entities

As discussed Regulation 12 requires listed entities to frame a code of internal procedure and conduct according to the model provided in Schedule I.[81] Schedule I consist of two parts. Part A deals with the model code of conduct for prevention of insider trading for listed companies and Part B deals with the model code of conduct for prevention of insider trading for other entities.

Listed Entities

For listed companies, the Amendment Regulation (Schedule) requires that it should appoint a compliance officer who will monitor the preservation of "price sensitive information". The compliance officer is to assist all the employees in addressing any clarification regarding the SEBI (Prohibition of Insider Trading) Regulation,1992 and the company's code of conduct. The compliance officer shall report to the Managing Director/Chief Executive Officer.

Further, it is required from the employees/director to maintain the confidentiality of all price sensitive information. This unpublished price sensitive information is to be handled on a "Need to Know" basis, i.e., should be disclosed only to those within the company who need the information to discharge their duty and whose possession will not give rise to a conflict of interest or appearance of misuse of the

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[81] See Chapter II, p.48.

information. All non-public information directly received by any employee should immediately be reported to the head of the department. There should be trading restriction viz. Trading window. The company shall specify a trading period, to be called "Trading windows" for trading in the company securities. The trading window should be closed during the time the information relating to price sensitive is unpublished viz. declaration of financial results, declaration of dividends etc. The trading window shall be opened 24 hours except under the conditions mentioned above. All directors/officers/designated employees of the company shall deal in the securities only in a valid trading window. In case of ESOPs, the exercise of option may be allowed in the period when the trading window is closed. All directors/officers/designated employees of the company should pre-clear the transactions as per the pre-dealing procedure described here under. There should be an undertaking to be executed by such designated employee/director that he or she does not have any access or has not received "price sensitive information" up to the time of signing the undertaking. And if they have access to information after the signing and before the execution of the transaction they should inform the compliance officer. There are other restrictions mainly related to transaction of their interest or holding. If an aforementioned person of the company violates the code of conduct, he or she shall be subject to disciplinary action by the company and also by SEBI irrespective of whether the company has

taken action or not. It is also required from the company to inform SEBI about insider trading.

So far as other entities are concerned, more or less the same measures are required by Schedule I of SEBI (Prohibition of Insider Trading) Regulation, 1992. To prevent the misuse of confidential information the organization should adopt a "Chinese Wall" policy, which separates the 'inside areas' from 'public areas'. There is also a restricted and grey list which will restrict trading in such list in order to monitor the Chinese Wall procedure.

11. Code of Corporate Disclosure Practices for Prevention Insider Trading

Schedule II deals with the Code of Corporate Disclosure Practices for the Prevention of Insider Trading. To ensure disclosure of price sensitive information the following norms are to followed by listed companies: (i) prompt disclosure; (ii) price sensitive information should be given by listed companies to stock exchanges and disseminated on a continuous and immediate basis; (iii) listed companies should designate a compliance officer to oversee corporate disclosure; (iv) if information is accidentally disclosed without prior approval, it should be informed to the compliance officer; (v) responding to market rumours, (vi) timely reporting of share holding by major shareholders, (vii) only public information to be provided to

analyst and institutional investor, (viii) in order to avoid misquoting or misrepresentation, it is desirable that at least two company representatives be present at meeting with analysts, brokers or institutional investors and such discussion should preferably be recorded. Unanticipated questions may be taken on notice and a considered response given later; (ix) disclosure may be done through various media, etc.[82]

12. Observation of Code

Implementation of these codes will be mandatory as these codes have been made a part of the Regulation as a new chapter. It is an effort to level the playing field among large and small investors. The Amended Regulation relating to insider trading establishes requirements for full and fair disclosure of national information by public companies. The Regulation will have a significant impact on the way issuers interact with analysts and other securities market professionals. Issuers should define who are their senior officials and other employees who regularly communicate with securities market professionals or shareholders. These personnel should be briefed by the issuer's counsel on the regulation. Issuers should also take measures to ensure that person outside of this group of employees do

[82] Schedule II of SEBI (Prohibition of Insider Trading) Regulation, 1992.

not communicate with securities market professionals or shareholders.[83]

Issuers will be forced to carefully consider what types of interaction they wish to have with analysts. Giving guidance (including indirect guidance) to analyst will likely trigger a disclosure requirement under SEBI (Prohibition of Insider trading) Regulation,1992. And it would force on issuer to permanently divulge information which it did not yet wish to disclose to the public.

The code of corporate disclosure practices [Schedule II of SEBI(Prohibition of Insider Trading) Regulation 1992] seeks to take away the defence which was provided by the definition earlier i.e, that any information which is known generally in the media or otherwise, can not qualify as unpublished price sensitive information. This defence was relied upon by HLL when they charged with the offence of insider trading in connection with the merger of BBLIL with HLL.[84] Since this defence was provided by the definition under Regulation 2(k)[85] itself, HLL was able to take advantage of the same and the Appellate Authority upheld its contentions and acquitted HLL of the insider trading charges. As per the code, it can be inferred from the above that information can be said to have been published, when the

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[83] <http/www.cybersecuritylaw.com/GDC/insider.htm-14k> visited dated 28/03/2002.
[84] express-india, n.24.
[85] n.64.

same is formally or officially made known to public by the company or by its authorised agents.

Yet there are some shortcomings in the disclosure requirement of SEBI (Prohibition of Insider Trading) Regulation, 1992;

(i) It does not apply to any foreign government or foreign private issuer; and

(ii) It does not create any private cause of action. Though violation of self regulation may be used as evidence against the insider.[86]

13. SEBI's Enforcement Efforts

As on March 31, 2000 SEBI had 196 officers and 161 staff members in various other categories.[87] SEBI took necessary steps to augment staff requirements at various levels including recruitment of 34 candidates from various management institutes as a part of campus recruitment. There is a SEBI Division of Investigations, Enforcement and Market Intelligence (IEMI) on strengthening the surveillance and enforcement process.[88]

86 <http://www.cato.org/pubs/pas/pa.101es.html-5k> visited dated March 28, 2002.

87 <http://www.securities.com/public/public98/sebt/SEBI/report/pt974.html> visited dated November 5, 2002.

88 "The Enforcement Programme Assistance", available at <http://www.securities.com/Public / Public98/price/7.html> visited dated March 23. 2002.

Since 1996, SEBI has been pushing for a 'Stock-Watch' system to be implemented at the major exchanges. Some success in this regard seems to have come only in 1999, but even today most of the exchanges (with the exception of the NSE, BSE & DSE) do not make much use of the 'stock-watch' system.[89]

Market Surveillance plays a key role in ensuring safety and integrity of markets. SEBI's market surveillance essentially focuses on introduction of surveillance system and risk containment measures, overseeing the surveillance activities of the stock exchanges. However, the primary responsibility of market surveillance has been entrusted to stock exchanges.

14. Extra Territorial Operation of SEBI's Authority

Given the technological advances in communication and operations, the removal of restrictions on foreign participation [Foreign institutional Investor (FII), overseas corporate body (OCB) etc.], and globalisation and integration of securities markets some fundamental problems have arises in the regulation of securities transaction, particularly insider trading. There are some barriers to global investigation. There are three basic steps to a SEBI Investigation: (i) identification of a violation, (ii) compilation of relevant evidence of that

[89] See in details in Chapter III, p.86-87; and S. Shivkumar, "Insider Trading- Following the SEC Lead",

violation, and (iii) prosecution of the violators. Self regulatory organizations usually identify potential violations and then refer these violations to the SEBI. Once a possible violation is referred to it or detected by it, the SEBI begins an investigation if it determines that such action is warranted. When the transaction is transnational, the search for evidence may be fruitless, if a witness or potential defendant is outside India. In personam jurisdiction may not exist and therefore no further discovery would be possible. The most serious constraints preventing the SEBI's effective enforcement of securities laws are the blocking and secrecy laws enacted in other countries. So, in order to deal with these problems there should be either an international multilateral co-operation or ad hoc bilateral co-operation agreements. India is having a bilateral co-operation with many counties. SEBI also takes advantage of the bilateral agreement. But these agreements are not altogether effective. One principal limitation is that the agreements are criminal in nature. The use of memorandums of understanding (MOU) provides the most effective technique of international securities enforcement. MOUs are vitally important to the development of fair and honest markets.[90] The main reason for using MOUs is preference for a treaty is confidentiality.[91] Since MOUs is not a treaty, there is generally no national or

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available at <http://www.flonet.com> visited dated March 28, 2002.

[90] Cooney, "SEC Holding Enforcement Talks with Four More countries", (Lexis-Nexis Website) May 19, 1998.

[91] Anthony Aust, *Modern Treaty Law and Practice* (UK, 2000), p.24.

international requirement or need to publish it. MOUs is not required by Art 102 of the UN charter to be registered with the UN.[92]

Powers of the SEBI regulator to assist foreign regulators or to enter into MOUs or other co-operation arrangements are not explicitly provided in the legislation.[93] However, SEBI has arrangement for sharing of information with regulators overseas.[94]

The MOUs is currently the centerpiece of the SEBI's international enforcement methods. SEBI does not have MOUs with many countries. Recently the role of OCB in India came under sharp criticism following the recent Ketan Parekh stock market scam.[95] SEBI drew a blank from Mauritius Offshore Business Activities Authority (MOBAA) when it tried to seek details.[96] The foreign authority refused to co-operate with the indian regulators since they have no jurisdiction in their territory, nor any arrangement to share information in the event of any financial management.[97]

This chapter made an evaluation of India's insider trading law. However, notwithstanding the above novel features the insider trading regulation of 1992 suffers from many serious infirmities, which if not

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[92] ibid.

[93] *Indian Securities Market, A Review* (Mumbai: NSEIL, 2000).

[94] SEBI is having MOUs with US and Malaysia field with IOSCO dated March 6, 1998 and March 14, 2000 respectively regarding co-operation, consultation and provision of technical assistance.

[95] Hindustan Times, Friday November 30, 2001.

[96] ibid.

[97] ibid.

rectified on time are likely to lead to unnecessary litigation and ever possible defeat of the Regulation.

It may be worthwhile to consider an international (Insider Trading) regulation model such as the Securities Exchange Commission (SEC) rules, operating in the American well developed capital market, with a view to understand the American perspective on curbing insider trading and setting forth the powers granted to SEC under such regulation. In this context, next chapter will discuss the development of insider trading law in U.S. and compare it with India's insider trading law.

CHAPTER - III

INSIDER TRADING LAW: COMPARATIVE ANALYSIS OF INDIA AND US

This chapter will focus on a comparison of India's and US national securities laws dealing with insider trading. Insider Trading essentially involves the deliberate exploitation of unpublished price sensitive information obtained through or from a privileged relationship to make profit or avoid loss. Various attempts have been made by India to regulate insider trading. Recently, SEBI introduced an amendment in SEBI (Insider Trading) Regulation, 1992. However a number of measures are still required to effectively deter insider trading in India. From this perspective, the insider trading laws of the US is examined.

This chapter is divided into two parts. Part I of this chapter will explore the US supreme court's treatment of insider trading liability and subsequent development of insider trading regulation. During this period, the Supreme Court of US entertained disclose or abstain theory and misappropriation theory. Finally, it presents lower courts debate on the applicability of the misappropriation theory to Section 10 (b) and promulgation of certain disclosure rules. Part II of this

chapter compares securities laws of India and U.S. national laws dealing with insider trading.

Part I

1. US Law of Insider Trading

Before the adoption of New Rule 10b5-1 and 10b5-2, insider trading was regulated by Section 10b and Rule 10b-5 of the Securities Exchange Act of 1934. Rule 10b-5 states that:

> *"It shall be unlawful for any person directly or indirectly by use of any means or instrumentality of inter state trade, commerce or of the mails or of any facility of any national securities exchange (1) to employ any device, scheme or artifice to defraud, (2) to make any untrue statements written or oral of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of circumstances under which they are made not mis- leading, or (3) to engage in any act practice, or course of business which operates or would operate as fraud or deceit upon any person in connection with the purchase or sale of any securities."*

The insider trading law in the US has largely evolved through judicial opinions construing the Securities Exchange Act of 1934 (Section 10b + Rule 10b-5). New Rule 10b5-1 and 10b5-2 are an ironic departure for the Securities Exchange Commission (SEC). In the past, SEC has generally not supported efforts to codify the law of insider trading, (including the Insider Trading and Securities Fraud Enforcement Act, 1988), preferring instead to let the law develop by

judicial decisions.[98] In US from various case laws, two broad theories of insider trading liability have emerged viz., abstain or disclose theory and the misappropriation theory. Both these theories became a basis for a new insider trading rule. We will discuss each step of the development of the US insider trading law in below.

1.1 Disclose or Abstain Rule

As under the common law, a failure to disclose is actionable under Rule 10b-5 only when there is a duty to disclose. However, the SEC adopted the bipartite test for insider trading liability in *In re cady, Roberts & Co.*[99] The test rests on two principal elements: first the existence of relationship giving access, directly or indirectly, to information intended to be available only for corporate purpose and not for the personal benefit of any one. And second, the inherent unfairness involved where a party take advantage of such information knowing that it is unavailable to those with whom he is dealing.[100]

By imposing liability on the basis of these two elements *Cady, Roberts* departed somewhat from the common law action of fraud. The common law requires disclosure of material facts where the relationship of trust or confidence exists between the parties. However, *Cady Roberts*, requires disclosure where there is access to

[98] Stuart J. Kaswell, "An Insider's view of the Insider Trading and Securities Fraud Enforcement Act of 1988", *The Business Lawyer*, vol. 45, November 1989, p.145.
[99] 40 SEC 907 (1961).
[100] ibid, p.912.

non-public corporate information. Thus, the duty to disclose under *Cady, Roberts* is not based specifically on fiduciary duty. The second element is also a departure from the common law in that unfairness is not an element of a common law fraud.

Seven years after *Cady, Roberts*, the United States Court of Appeals for their Second Circuit Court decided in *SEC v Texas Gulf Sulphur Co.*[101], that any one in possession of material inside information must either disclose it to the investing public or abstain from trading. The effect of this decision is that the mere possession of material inside information may result in a duty to disclose. However, since the 'tippees'[102] were not defendants in the case, the court did not decide their liability.

In *In re Investor Management Co.*[103], the SEC decided that, in certain circumstances, a tippee is subject to the same degree of liability under Rule 10b-5 as an insider. Furthermore, the SEC removed the *Cady, Roberts* requirement of a special relationship giving access to non-public information as a pre-requisite to tippee liability. However, the concurring opinion of Commissioner Smith stated that the special relationship test should not be eliminated.

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[101] 401 F. 2d 833 (2d cir. 1968), cert: denied; 394 US 976 (1969). The SEC is having a power to investigate and passed a decree against the violators. The District Court will frame a charge and permit the jury to convict them. Any person aggrieved by an order of the District Court may prefer an appeal to circuit courts of Appeals. Circuit Courts of Appeals are the level of the court-immediately below the Supreme Court. Available at <http://www.cec.org/pubs_infor_resources /law_treat_agree/ summary_enviro_law/publication/US 01. cfm?Varlam=english>.

[102] A 'tippee' is a person who has received material non-public information from an insider.

[103] 44 SEC 633 (1971).

Chiarella v US[104] was the first insider trading case relating to rule 10b-5 to reach the US Supreme Court. The Court held therein that the one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so i.e., fiduciary or other similar relation of trust and confidence. Thus, the Court held that mere possession of material non-public information does not give rise to a duty to disclose under S. 10(b). There must be a fiduciary relationship. Although the tippees' generally is not in a fiduciary relationship with anyone, the tippee may incur liability under Rule 10b-5 when the tippee's duty to disclose or abstain derives from that of the insider. The leading case involving the liability of a tippee is *Dirks v SEC.*[105] The US Supreme Court held that a duty to disclose arises from the relationship between the parties and not merely from one's ability to acquire information because of a person's position in the market. The court stated that the 'the tippees' duty to disclose or abstain is derivative from the insider's duty.

In sum, the *Chiarella* and *Dirks* opinion base the fiduciary duty upon a relationship of trust and confidence. However, this theory invited some criticism. This theory may not properly address the insider trading problem. The nebulous definition of "fiduciary" creates several potential problems for insider trading law. First, federal law regulates securities transaction, but state law defines fiduciary relationship, and thus, the classical theory may not apply

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[104] 445 US 222 (1980).
[105] 463 US 646 (1983).

uniformly.[106] For example, the majority view in early common law stated that corporate officers were not fiduciaries of their shareholders.[107] Second, if what constitutes a "fiduciary" is unclear, what constitutes a "similar relation of trust and confidence"[108] is even less clear. Third, enforcement of criminal liability with an imprecise rule raises constitutional concerns.[109] These problems are not so serious in the classical context because *chiarella* reaches only company insiders. These problems indeed emerge, however, when the courts attempt to extend liability to outsiders.[110]

1.2 Misappropriation Theory

Under this theory a person is liable for insider trading if he converts for personal use information entrusted to him. This theory, which is being used as an alternative to the fiduciary duty theory, does not require a breach of a fiduciary relationship.[111] The first case in which the misappropriation theory was applied was *US v Newman*,[112] decided by the US Court of Appeals for the Second Circuit.

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[106] Micah A. Acoba, "Insider Trading Jurisprudence After US v O'Hagan: A Restatement (Second) of Torts 551 (2) Perspective", *Cornell Law Review*, vol. 84, no.5-6, 1999, p. 1376.

[107] Richard W. Painter et. al., "Don't Ask, Just Tell: Insider Trading After US v O;'Hagan, *Vanderbuilt Law Review*, vol. 84, 1998, p.15.

[108] *Chiarella v US* 445 U.S. 222, 228 (1980).

[109] See *Grayned v Rockford*, 408 US 104, 108 (1972) (It is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined).

[110] ibid.

[111] Willis W. Hagen II, "Insider Trading under Rule 10b-5: The Theoretical Bases for Liability", *The Business Lawyer*, vol. 44, November 1988, p.23.

[112] 664-F.2d (2d cir. 1981), cert. denied. 464 US 863 (1983).

The misappropriation theory, as a basis of liability has been left unresolved by the Supreme Court in the *Chiarella* and *Dirks* decisions. Under the classical theory of insider trading, insiders of the corporation, such as its officers and directors, violate 10(b) and rule 10b-5. These individuals owe a fiduciary duty to the corporation in whose stock they trade, and to its shareholders. The insider breaches this duty when he trades on the corporation's confidential information for his own benefit.[113] Classical insider trading amounts to a 'deceptive device" under 10(b) because the insider's relationship of trust to the shareholders triggers a duty to disclose or refrain from trading.[114] Under certain limited circumstances, the classical insider trading theory also applies to some non-insiders. For example, people who are tipped off by insiders about information who known or should have know that the information was given to them improperly violate the securities laws under the classical theory if they trade on that information.[115]

In addition, lawyers, accountants, and other professionals who temporarily owe a fiduciary duty to the corporation in whose stock they trade may be prosecuted under the classical theory.[116] During the "merger mania" of the 1980s, the SEC became frustrated over its inability to prosecute outsiders who relied on confidential takeover

[113] *Chiarella*, 445 US at 228-29.
[114] ibid.
[115] *Dirks v US* 463 US 646 659 (1983).
[116] ibid, p.654.

information that they were inevitably exposed to during merger process. It was out of this frustration that the misappropriation theory was born. The Supreme Court first confronted the misappropriation theory in *Chiarella v US.*[117]

Chiarella could not be prosecuted under the classical theory of insider trading. The government invoked the misappropriation theory. They argued that Chiarella had committed fraud on his employer's clients when he misappropriated confidential information.[118] Although the Supreme Court ultimately reversed Chiarella's convictions, it did not reject the government's new theory. Rather, it declined to rule on the validity of the misappropriation theory. However, Chief Justice Burger strongly dissented in support of the misappropriation theory.[119] The Chief Justice believed that Chiarella had clearly violated 10(b) when he 'stole' the printer's information and used it for his own benefit.[120] Since *Chiarella,* the SEC has relied heavily on the misappropriation theory and used it to support numerous prosecutions, such as in *Drexel Burnham Lambert Inc.*[121], *Ivan Boesky*[122] and *Martin Siegal*[123]. Several Circuit Courts have also embraced the misappropriation theory.

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[117] 445 US at 222.
[118] ibid, at 235-36.
[119] ibid, at 240.
[120] ibid. at – 240 (Burger, J. dissenting).
[121] *SEC v Drexel Burnham Lambert Inc.*, No. 88 Civ 7209 (SDNY, June 20, 1989)
[122] *SEC v Ivan Boesky*, No.86 Civ. 8767 (SDNY Nov. 14, 1986)
[123] *SEC v Martin Siegal*, No. 87, Civ. 0963 (SDNY Feb. 13, 1987).

Based on facts virtually identical to those in *Chiarella,* the Second Circuit Court in *SEC v Materia*[124] reaffirmed and further explained the misappropriation theory. The *Materia* courts did not need to address the issue of whether the defendant had breached a duty to a particular plaintiff. In an enforcement action, the primary concern was whether a fraud had occurred in connection with the purchase or sale of securities.

In 1987, a case involving the misappropriation theory finally reached the US Supreme Court. That case was *Carpenter v US*[125]. The S.C. split four-to-four affirming the conviction but expressing no opinion on the misappropriation theory. However, in *Carpenter,* the District Court and the Court of Appeals further developed the misappropriation theory by explaining the holding of *Newman* and *Materia* and by distinguishing the fiduciary duty theory used in *Dirks.* These courts rejected the argument of defendant Carpenter that they had not breached a duty of confidentiality as Materia and Newman had done.[126]

Thus, the misappropriation theory turns the concept of insider trading inside out: "outsiders" now stand on equal chance of prosecution. The Supreme Court in *US v O'Hagan*[127] approved the

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[124] 471US 1853 (1985).
[125] 108 S. Ct. 316 (1987).
[126] Wills W. Hagan II., "Insider Trading under Rule 10b-5; The Theoretical Bases for Liability", *The Business Law*, vol. 44, November 1988, p.27.
[127] 92 F. 8d. 612, 622 (8th cir, 1996).

misappropriation theory in criminal and civil insider trading cases. A jury convicted O'Hagan on all 57 counts, but the Eight Circuit Court reversed it. It found that the misappropriation theory was inconsistent with the plain language of 10b and Rule 10b-5 of the Securities Act of 1934.[128] The Supreme Court's decision in *O'Hagen* was hardly unanimous – three justices took exception to stretching the language 10(b) to accommodate the misappropriation theory.[129] O'Hagan enables the government to prosecute any person who receives confidential information and subsequently trades on that information, regardless of whether the source of that information had any connection to, or even a remote interest in the securities transaction.

For almost two decades, the US Supreme Court was silent as to the validity of the so-called "fraud on the source" misappropriation theory of insider trading liability. This changed in June 1997 when the theory received a resounding endorsement from the courts in *US v O'Hagan*. Critics of *O'Hagan* have argued that the court's decision reaches too far.[130]

Apart from its inconsistency with statutory requirements, policy and prior case law, the misappropriation theory also presents practical problems of application. The misappropriation theory strives

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[128] ibid, p.617.

[129] <http:/www.fool.com/Rogue/1997/Rouge970703.htm-29k visited dated dec. 20 2001>.

[130] Dona M. Nagy, "Reframing the Misappropriation Theory of Insider Trading Liability: A Post O' Hagan Suggestion", *Ohio State Law Journal*, vol.59, no.4, 1999 available at www.sec.gov./division/enforce/insider.htm.

to protect the fiduciary relationship. Although the law certainly aims to protect corporate confidence, the federal securities law is not the proper means of achieving this goal.[131] State corporate law already governs internal corporate affairs, and thus, each state may define fiduciary relationships differently.

When the misappropriation theory premises criminal conduct on the existence of a fiduciary relationship, it creates "troubling consequences" because state laws contain different definitions of fiduciary relationships and duties.[132] To achieve uniform results across state lines absent congressional action, the courts would have to develop a federal common law of fiduciary relationships.[133] The court discouraged this practice in *Santa Fe,* however, noting that federal regulation of fiduciary duties through the securities laws "would overlap and quite possibly interfere with state corporate law". [134] Thus, the misappropriation theory presents the theoretical problem of indirect protection and the practical problem of difficult application.

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[131] The misappropriation theory came before the court in Chiarella, but the government had not argued the protection of third parties before the jury. See Brief of Amicus Curiae Laws Professors and counsel in support of Respondent, at 6, O'Hagan (No. 96-842). For the securities laws to govern an outsider's fiduciary relationships would be illogical. "Whether or not the 1934 Act imposed a general duty on all person to disclose material non-public information before trading, the statute was not designed to condition duty to disclose on a corporate outsider's and relationship either with his employer or derivatively with his employer's customers." ibid.

[132] Micah A. Acoba, "Insider Trading Jurisprudence After US v O'Hagan: A Restatement (Second) Torts 551(2) Perspective" *Cornell Law Review*, vol. 84, no.5-6, 1999, p.1406; (Significant differences exist among state jurisdictions in terms of the duties that fiduciaries owe, thereby possibly (relating significant disparities in the coverage of federal criminal law depending on the applicable state civil law.)

[133] ibid, p.1406.

[134] *Santa Fe Indus v Green*, 430 U.S. 462, 479 (1977). The Court noted, "absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the Law of corporations

1.3 Possession v Use Test

Section 10b and rule 10b-5 both contain the words "in connection with the purchase or sale of any security".[135] The judicial dichotomy between broad and narrow interpretations of 10b-5's "in connection with" language is seen in the controversy. A broad interpretation of "in connection with" embraces the view that a defendant need only have "knowing possession" of inside information to satisfy a required element of an insider trading violation. A narrow interpretation of "in connection with" holds to the view that in addition to "knowing possession" of insider information, the defendant must 'use' the inside information in the trade. And in this narrow view the crucial issue becomes satisfying 10b-5's scienter requirement rather than 10b-5's 'in connection with' requirement. In *US v Teicher*[136], the second circuits held that the government need not prove a causal relationship between the misappropriated material non-public information and the defendant's trading. That is, the government need not prove that the defendants purchased or sold securities (i.e., not actually participated in securities transaction) because of the material non-public information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold

that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." ibid.

[135] See Chapter III, p.61.

[136] 987 F. 2d 112 (2d cir 1993).

securities while knowingly in possession of material non-public information.

Five year after the *Tiecher* decision the eleventh circuit rejected the second circuit reasoning. In *SEC v Adler* (11th Cir. 1998) the Eleventh Circuit Court held in a civil enforcement action, that "use" is the ultimate issue, but that proof of possession provides a "strong inference" of use that suffices to make out a prima-facie case, subject to rebuttal, if the defendant can prove evidence that the information was not part of the trading decision (e.g., evidence that orders for the trade in question were placed before the information came into defendant's possession).[137]

The SEC reacted swiftly to the decision in *Adler* and also growing acceptance of use test that posed problem to its enforcement problem. On December 15, 1999 the SEC published this new proposed rules: Rule 10b5-1 & Rule 10b5-2.[138]

The SEC adopted this New Insider Trading Rules to address two issues in insider trading law that have been the subject of disagreements among various courts.[139] Rule 10b5-1 deals with trading "On the Basis of Material Non-public Information", while Rule

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[137] *SEC v Adler*, 137 F. 3d 1325 (11th cir., March 1998).

[138] Exchange Act 1934, Release No. 43, 154; available at http:/www.library.findlaw.com/securitieslaw _1_289_html-33k> visited dated November.27, 2001.

[139] <http:/www.gcwf.com/articles/sec/sec_sum00_2html-59k> dated September20, 2001.

10b5-2 deals with the Duties of Trust or Confidence in Misappropriation insider trading cases.

1.4.1. Rule 10b5–1: Trading "On the Basis of" Material Non-Public Information

Rule 10b5-1 addresses the unsettled issue in insider trading law of whether it must be shown that the defendant "used" the insider information he or she possessed in trading or is it enough to show that the defendant was in "knowing possession" of the information. Under the Rule, if a trader "was aware of" material non-public information when he or she made the trade, he or she has violated Rule 10 b-5. Thus SEC adopted the "knowing possession" test instead of "use" test for insider trading violations. The Rule provides specific affirmative defenses against liability designed to cover situation in which a person can demonstrate that the material non-public information was not a factor in the trading decision. The primary affirmative defence set forth in Rule 10b5-1 requires that a person demonstrate that a trade was executed under a pre-existing written plan, contract or instruction entered into in good faith. First, the trader must demonstrate that prior to becoming aware of the material non-public information, he or she had entered into a binding contract to purchase or sell the security and provided instructions to another to execute the trade for the instructing person's account or adopted a written plan for trading securities. Second, the trader must show that the contract, instruction or plan either expressly specified the

amount, price and date or provided a written formula or algorithm or computer programme, for determining amounts, prices and dates. Third, the trader must demonstrate that purchase or sale was executed pursuant to the contract, instruction or plan.

1.4.2. Rule 10b5-2: Duties of Trust or Confidence in Misappropriation Insider Trading Cases

Under the misappropriation theory of insider trading, a person that misappropriates material non public information for trading purposes in breach of a duty of loyalty or confidence has violated Section10(b) of the Exchange Act and Rule 10b-5. It has been established under case law that certain business or agency relationship such as attorney- client or employer-employee provide the duty of trust of confidence required under the misappropriation theory. However, it has not been established under what circumstances certain non business relationship such as family and personal relationship provide the duty of trust necessary under the misappropriation theory. Rule 10b5-2, adopted substantially three non-exclusive bases for determining when a person receiving insider information was subject to duty of trust under the misappropriation theory.

-When the person agreed not to disclose the information

-When the person disclosing the information and the person receiving the information "have a history, pattern or practice of sharing

confidence, such that the recipient of the information knows or reasonably should know that the person communicating the material non-public information expects that the recipients will maintain its confidentiality.

-or when a person receives information from a spouse, parent, child or sibling, unless it can be shown that no duty of trust or confidence existed by establishing there was no expectation the person would keep the information confidential.

1.5 New SEC Rules on Selective Disclosure and Insider Trading

The SEC adopted new rules in a release dated August 10, 2000. The rules are based on the Rules proposed in the SEC release dated Dec. 20, 1999 (the "Proposing Release"[140]) and have been modified as a result of comments received by the SEC. The new rule became effective on Oct. 23, 2000.[141]

The SEC has adopted a new regulation, Regulation FD (Fair Disclosure), to address its concerns over selective disclosure.[142] Selective disclosure occurs when an issuer releases material non-public information on a limited basis, such as to a group of analysts or institutional investors, prior to releasing the information to the

[140] <http:/www.ici.org/issues/select_prop.html-11k> visited dated December 10,2001.
[141] <http:/www.cybersecuritieslaw.com/GDC/insider.html-14k> visited dated December 10, 2001.
[142] <http:/www.ici.org/issues/select_find.html-13k> visited dated December 10, 2001.

public as a whole. In the proposing Release and its Release[143], the SEC discusses several unfavorable consequences of selective disclosure, including loss of investor confidence, in the integrity of the capital markets which results when persons with access to selective disclosures make a quick profit or minimize losses by trading on the information before it is public, delayed disclosure of information to the public so they can use the information to bolster credibility with particular analyst or institutional investors. Accordingly, in an effort to level the playing field among the large and small investors, the new regulation establishes requirements for full and fair disclosure of material information by public companies.

The new Rules FD require that whenever an issuer or a person acting on an issuer's behalf, intentionally discloses material non-public information to securities market professionals and holders of the issuer's securities, the issuer must make simultaneous public disclosure. If the issuer unintentionally discloses material information, it must promptly make public disclosure of such information. Provided that insider trading liability arises when a person trades while aware of material non public information.

[143] SEC Release Nos. 33-7881, 34-4 3154 (August – 10, 2000); <http://www.sec/sec-sum00_02html> visited dated 22December 2001.

The drawback of the Regulation is that it does not apply to: (a) any foreign government or foreign private issuer, or (b) any investment company other than a closed end investment company.[144]

The final regulation expressly provides that it is not an antifraud rule[145] and that it does not create any private cause of action. But it is possible that a failure to comply with the Regulation could be used as evidence in a Rule 10 b-5 action.

1.6 SEC's Enforcement Efforts

Section 15(b) (4) (E) of the US Security Exchange Act provides that the SEC may suspend for up to one year or revoke the registration of broker- dealer that has willfully aided, abetted, counseled, induced or procured the violation of federal securities laws. At the urging of the SEC, Congress passed the Insider Trading Sanctions Act of 1984 (ITSA)[146] to bolster the SEC's enforcement efforts.

ITSA added Section 21 (d) (2) A to the Exchange Act, 1934. It provides a civil penalty not exceeding three times the profit gained or loss avoided as a result of the unlawful purchase or sale. Section 21 (d)(2)(B) of the Exchange Act, as amended by ITSA, provided that "no person shall be subject to civil penalty for insider trading solely

[144] <http:/www.cato.org/pubs/pas/pa.101es.html-5k> visited dated November 5, 2001.
[145] *Carpenter v US* 108 S. ct. 316(1987).
[146] P. l. no. 98-376, 98 state. 1264 (1984).

because that person aided and abetted an insider trader". In other words, a broker dealer could not be subject to an ITSA civil penalty for the insider trading of its employee unless the broker dealer tipped the information to others.

1.7 Self Regulation

Internationally, a growing school of influential thinkers advocated that insider trading measures should be more by self regulation of organization rather than by legislation and regulation. This ofcourse is unexceptionable and deserve full support.

Several of SROs have implemented National Association of Security Dealer (NASD's) Rules of Fair Practice[147] requiring broker-dealers to improve their supervisory systems. The Rule requires that the system must be reasonably designed to achieve compliance with applicable securities laws and regulations. Even though, the insider trading occurred at retail firms without involvement of broker dealer. Yet, the existing law did not impose civil penalty liability on controlling person for insider trading of controlled persons.

On Saturday, November 19, 1988, President Reagan signed into law the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).[148] The legislation imposes by statute certain specific new

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[147] NASD Rules of Fair Practice, Art III, Sec. 27, NASD Manual (CCH), available at <http://onlinestore.cchn/com/productpages/bfg/>

[148] Pub. L. No. 100 – 704, 102 stat. 4677 (1988) [hereinafter] [ITSFEA].

responsibilities on broker-dealers and investment advisors to prevent insider trading. It also imposes substantial penalties on all controlling persons for failure to detect and deter insider trading. It deletes Section 21(d)(2) of the Exchange Act and adds a new Section 21A.[149] Under Section 21(A)(a)(2), the penalty is still same that is, it shall not exceed three times the profit gained or the loss avoided as a result of insider trading. Section 21(A)(a)(1)(B) permits the SEC to bring an action to impose a civil penalty against controlling person. The penalty shall not exceed the greater of $1 million or three times the profit gained or loss avoided. Thus, Section 21(A) (b)(1)(B) of the exchange Act can impose liability on broker- dealers and investment advisors.

Another important provision in the legislation is that the SEC now has the authority to award bounties. Section 21 (A) (e) of the Exchange Act grants to the SEC the sole discretion to pay bounties to persons who provide information to the SEC regarding insider trading. The bounty may not however exceed ten per-cent of the civil penalty recovered.

ITSFEA expands the rights of private parties to sue insider traders for damages. Section 20 A of the Exchange Act created a new private right of action in favour of contemporaneous traders against insider traders. There are however several important limitations on this new private right. First, the insider trader may be liable for an

[149] 15 U.S.C.A 78U-1 (1989)

amount not exceeding the profit gained or loss avoided.[150] Second, the amount of the damages will be reduced by any court ordered in disgorgement of profits that the SEC obtains under section 21(d) of the Exchange Act.[151] Third, in case involving tipping, the liability of the person, to whom the communication was made, is limited, that is, the amount of civil penalty must not exceed the penalty imposed on controlling persons.

ITSFEA also amended Section 32 (a) of the Exchange Act to increase criminal penailties for willful violation of that Act. ITSFEA imposed criminal fines of upto $ 1 million.

The next issue in front of SEC was which investors are eligible to submit claims and how some may still be excluded from a distribution plan. During the late 1970's and early 1980's, two competing theories developed over who has standing to submit a claim in insider trading cases - the privity standards and the contemporaneous trader rule. Under the privity standards, only those investors who actually traded with the securities law violator could make a claim of disgorged funds.[152] While some circuit courts adopted the contemporaneous trader rule.[153] The rule is that had plaintiff been contemporaneously trading in the same market, that is, buying and

[150] S. 20 A (b) (1) of the Exchange Act, 15 U.S.C.A 78 t-1(b) (1).

[151] S. 20 A (b) (2) of the Exchange Act, 15 U.S.C.A 78 t-1(b) (2).

[152] *Fridrich v Bradford*, 542 F. 2d. 307, 318-23 (6th cir. 1976), cert denied, 492 US 1053 (1977);

[153] *Backman v Poloroid Corp.*,540 F supp 667 (Dmass 1982) [first circuit court]; *Leventhall v General Dynamics corp*, 740 F. 2d 407(8th circuit court).

selling common stock at the same time defendant was trading.[154] ITSFEA, 1988 also adopted the contemporaneous trader rule.[155]

In insider trading cases, some times the amount of claims often exceeds the fund available for distribution. Then, the question arose who is first in line.

Just because an investor is a contemporaneous trader does not necessarily mean he or she will be able to participate in a distribution plan proposed by the Commission. The Commission and Court have recognized that the enforcement action are designed to deter unlawful trading and are not simply collection efforts on behalf of injured investors. Providing restitution to injured investors is merely a secondary aim of disgorgement.[156] Among the equities the SEC and the Court usually considered (1) the limited size of distribution plan, (2) the extensive damage suffered by those who had out of pocket losses, and (3) the fact that one of the potential claimants, who had not suffered any out- of pocket losses because of hedging strategies.

ITSFEA also includes a provision that will allow the SEC to assist foreign securities authorities with their investigation. Section 8 of the ITSFEA allowed the SEC's authorization to fund activities of the International Organization of Securities Commissions (IOSCO). The

[154] ibid.
[155] Codified in scattered section of 15 USCA 57.
[156] Rory C. Flynn, "SEC Distribution Plans in Insider Trading Case", *The Business Lawyer*, vol 48, November 1992, p. 121.

SEC agreement with IOSCO is to further international co-operation on enforcement activities and other securities regulation issues.[157] Thus, through the enactment of ITSA and ITSFEA, US sought to increase the economic consequences associated with this activities and thereby to increase the deterrence against insider trading.

In sum, so far as the settlements with the SEC are concerned, there is no definite formula or set of factors in settling insider trading cases. When the staff negotiates a settlement agreement, it takes into account any facts or circumstances that either mitigate or aggravate a violation. The Commission rarely accepts any settlement less than an obey –the – law injunction in an insider trading cases. The remaining issues in the settlement[158] negotiation revolve around the appropriateness of additional sanctions, such as disgorgement, pre-judgment interest, or a suspension from the industry. Clearly, the more aggravated the conduct of a particular defendant, the greater the likelihood of rigorous settlement. Recurring violations, combination of trading and tipping deception or attempts to avoid detection, occupation of defendant, co-operation with the investigation, all these factors would be in consideration at the time of settlement.

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[157] Stuart J. Kaswell, "An Insider's View of Insider Trading and Securities Fraud Enforcement Act of 1988", *The Business Lawyer*, vol 45, November 1989 p.179.

[158] Mclucas, Wolsh, Fountain, "Settlement of Insider Trading Cases with the SEC", *The Business Lawyer*, vol 48, November 1992, pp-79-105.

Part II

2. Comparative Study of India and US Insider Trading Law

As the proposed study aims at discussing the adequacy of India's security laws relating to insider trading in the backdrop of US national securities laws dealing insider trading. From this perspective, Part II of this Chapter compares the securities laws of India and US national laws dealing with insider trading.

Like Securities Exchange Commission in US, SEBI is the regulatory body to protect the interest of investors in securities and to promote the development of and to regulate securities market SEBI's independence was strengthened by allowing it to issue regulation and file suits without prior approval of the Central Government. SEBI has also been empowered to impose monetary penalties for a wide range of violations and accordingly the SEBI Act, 1992 provides for adjudication and empowers SEBI to appoint adjudicating officers.

Section 10b and Rule l0b5-1 and 10b5-2 of Securities Exchange Act, 1934 deals with the insider trading. While SEBI came into operation in 1992 and through a notification brought the SEBI (Insider Trading) Regulation,1992 which was amended in Feb 2002 and named SEBI (Prohibition of Insider Trading) Regulation, 1992. One major difference is that the insider trading laws in US has got the sanction from the Congress while in India SEBI (a regulator) has

notified regulation to prohibit the insider trading. Essentiality, violations defined in an Act have greater legal force than the ones which is enforced through Regulations. For a regulation can be superseded by other legislations. In case of litigation too, a law enforced on the basis of an Act would have greater legal standing in a court than one enforced via Regulations.[159] In this backdrop, the Government of India has proposed to strengthen SEBI by defining insider trading in the SEBI Act.[160] By moving the definition from the Regulation to underlying SEBI Act, 1992, the government would strengthen the insider trading laws in the India.

The Regulation do contain detailed provisions on insider trading.[161] But SEBI has not done enough to implement these provisions. For example, between April 1996 and March 2000, SEBI took up only 14 cases for investigation and completed investigation in only six.[162] Even in the few cases of insider trading SEBI has taken years to complete investigations. SEBI took more than 14 months to

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[159] Finance Ministry set a side SEBI's March 1998 ruling *HLL v SEBI* (see in detail in Chap I). The SEBI has moved the Bombay H.C. to have the order of the Central Government in the HLL insider trading case set aside. What are the issues that may need the High Court's consideration in this connection?

S. 16 SEBI Act, 1992 declares that SEBI shall, in the exercise of its powers or the performance of its function under the Act, be bound by such directions on question of policy as the center may give in writing to it from time to time, after considering SEBI's view in the matter. Sub-section (2) of S.16 is unequivocal. The decision of the Central Government on whether a question is one of policy or not shall be final. Can a regulatory organ seek court ruling against government ruling? "We also must not miss S.30 of SEBI Act, 1992, which provides that the Board may make regulation consistent with the Act and rules made there under. Thus this case has shown the regulator's absence of teeth because nature of SEBI as a delegate and not an instrumentality of the Center and also because of S.16 and 30 of SEBI Act, 1992. (See also Chapter II, p.28)

[160] Economics Times, April 6, 2002.

[161] See Chapter II.

[162] Investigation, Enforcement and Surveillance, available at <http://www.sebi.gov.in/report/9900/ar

investigate the alleged insider trading in HLL, perhaps the only case it pursued with some zeal. In the cases of alleged insider trading in the scrip's of Sterlite, BPL and Videocon in June 1998, SEBI issued notice to the companies management only in March 2000. Though, prima-facie, the stock exchanges concerned are expected to handle issues related to stock movements including insider trading. Given the pathetic conditions prevailing in India with most broker office bearers of the large exchanges, notably BSE, indulging in price- rigging and insider trading, one would expect SEBI to play a more active role in investigation of such cases. Compare SEBI's lackluster performance with that of SEC, the SEBI's US counterpart. The SEC handles about 50 insider trading cases every year.[163]

Unlike in India, individual stock exchanges in the US such as the New York Stock Exchange (NYSE) and the NASDAQ have their own highly effective surveillance mechanism to trace insider trading and pursue investigations. These exchanges refer only exceptional cases to the SEC. For instance, NASDAQ, which oversees more than 5,000 listed companies, initiates up to 400 insider trading investigation a year. It hands only 100-125 of those cases to the SEC or the US Department of Justice for further investigation and prosecution.[164]

99002f.html> visited dated November 16, 2001.

[163] <http://www.nse.com.>

[164] ibid.

NASDAQ employs more than 180 fraud investigators with a full team of 12 dedicated to tracking insider trading, supplementing the over 350 investigators employed by the SEC to detect fraud cases related to securities transaction, including insider trading. The SEC also employs around 940 people, including lawyers and support staff involved in the prevention and detection of frauds.[165] With over 8,000 companies listed at the BSE alone, SEBI with a total strength of 357, (as of March 31, 2000), including 196 officers, could hardly be expected to do justice to its surveillance and investigation responsibilities.

Another issue relates to technology. Stock exchanges in the US and UK have installed sophisticated computer surveillance software systems to track insider trading. In the US, the exchanges and the SEC use a software that continually flags unusual price and volume swings in the 10 days before and after major news events such as takeover, based on the historical patterns of the individual stocks.

Information generated by the programme, dubbed SWAT (Stock Watch Automated Tracking), is then used to build a chronology of events and case.[166] Most of the SEC's investigations are computerized.

Since 1996, SEBI has been pushing for a 'stock watch' system to be implemented at the major exchanges. Some success in this

[165] <http:/www.sec.gov/division/enforce/insider.htm-16k> (more result from www.sec.gov.in).
[166]<http:/www.nse.gov.in>

regard seems to have come only in 1999. But even today, most of the exchanges (with the exception of the NSE, BSE and DSE) do not make much use of the stock-watch system.

The SEC's success in tracking cases of fraud, including insider trading, has been greatly complemented by Edgar, the electronic data gathering analysis and retrieval system that performs automated collection, validation, indexing, acceptance and forwarding of the various submissions which the companies listed in the US are required to file with the SEC.[167]

In India, the leakage of price sensitive information by company management to select investors, including FIIs and major broking firms, is rampant. With the FIIs becoming the dominant forces in the stock market, company management has found new ways of meeting the objective of selective disclosure of information by providing information to the research outfits of FIIs. As discussed in Chapter II[168] a Model Code of Conduct and Code of Internal Procedure in India would not apply effectively on foreign companies.

While SEBI's responsibility to prevent insider trading is understood, it would be of interest to discuss its authority. Under the existing rules, the maximum penalty SEBI can levy in insider trading

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[167]<http:/www.sec.gov/insidertrading-17k> visited dated November 23, 2001.

[168] See chapter II, p.46-53 and see <http://www.cato.org, n.86.

cases is ridiculously low viz., Rs. 5 lakh[169] or one year imprisonment.[170] Far from being a deterrent, this has often acted as an incentive for many to indulge in insider trading. Compare this with the US, where the SEC is empowered to impose a penalty of upto three times the profit gained or losses avoided.[171] This can go up to $1 million per person per case.

For several years now, SEBI has been pleading with the government (especially the Department of Company Affairs) for an enhancement in the penalty. The Dhanuka Committee appointed by SEBI in 1998, recommended the penalty for insider trading to be raised to Rs. 25 lakh.[172] Interestingly, the world over, insider trading, is a criminal offence, punishable with imprisonment of up to ten years.[173] Since criminal cases are difficult to prove and drag for years, the SEC has consciously followed civil proceedings that offer a much wider range of sanctions, including trading bans and forcing repayment of illegally obtained profits. Being a civil agency, the SEC has sweeping powers to gather evidence prior to a trial and it does not need to prove each element of its case beyond a reasonable doubt. It only has to show 'a preponderance of evidence', which works very effectively in cases. This also explains why the SEC handles a much

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169 S. 15 G of SEBI Act, 1992.

170 S. 24 of SEBI Act, 1992.

171 S.21A of Securities Exchange Act, 1934

172<http:/www.sebi.gov.in/report/Dhanuka 19,html> visited at dated February 9, 2002.

173 South Korea, HongKong, Indonesia, Malaysia, etc. (<http:/www.indoexchange.com/regulation-11htm>).

larger number of cases more effectively.[174] In most cases involving insider trading the offenders accept the crime and opt for an "out of court" settlement. Of-course, in more serious cases on insider trading, the Ministry of Justice works closely with the SEC in a parallel manner, simultaneously pursuing criminal options against the offenders.[175] In sharp contrast to SEBI, the SEC enjoys a high level of credibility in the US and is highly regarded and respected both by the government and the courts there. Thus, for instance (as discussed earlier[176]) when some US courts had taken the view that use of

information and not mere possession, would have to be proved. The SEC has gone ahead and used its law making powers to introduce major additions to the existing Rules 10b 5-1 and 10b 5-2 with effect from October 23, 2000. These new rules provide that mere possession of information would suffice to charge a person and that its use in share market deals need not be proved.[177]

SEBI, on the other hand, lacks even basic powers in dealing with the offenders. Under Section 4-A of SEBI (Prohibition of Insider Trading), 1992, the SEBI may form a prima-facie opinion as to violation of these Regulations. Furthermore, Art 4 states that any

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[174] S. Shivakumar, "Insider Trading-Following the SEC's Lead", Financial Daily, from the Hindu Group of publisher, Thursday, April 26, 2001 (Hindu Business Line).

[175] ibid.

[176] See Chapter III, p.72.

[177] ibid, p.71.

insider deals in securities in contravention of the provision of Regulation 3 shall be guilty of insider trading.

Clause (i) of Section 3 prevents the insider form dealing in securities and clause (ii) Section 3 prevents the insider from communicating, conselling the information. However, SEBI has vide its press release Reference no. PR 43/2002 dated the February 22, 2002 clarified that the "communication of Unpublished price sensitive information is per-se not an offence". It appears that there is a clear cut ambiguity in this regard.[178] Thus, tipping of the information in India as such is not an offence. In determining the liability of tippee, the release would create a hardship in establishing the commission of insider trading.

Moreover, Section 16 and 17 of SEBI Act, 1992 provides a power to central government to give direction and supersede the SEBI.[179] Furthermore, SEBI has no jurisdiction to punish the promoters. Only the Department of company Affairs is empowered to do that. Though more powers have been delegated to SEBI under the recently amended Companies Act but still it is not sufficient to deter the insider trading.

In US, ITSFEA, 1988 imposes substantial new responsibilities and liabilities on firms and others for insider trading. ITEFEA expanded the scope of civil penalties to "controlling persons" who

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[178] See in detail in Chapter II, p.40; and see also Ref, n.72.
[179] See Chapter II, p.29-30.

failed to take appropriate measures to prevent insider trading by their employees, gave the commission the authority to award payments to person who provided information regarding insider trading violations, required broker dealer and investment advisors to establish, maintain and enforce written policies designed to prevent misuse of material non public information, codified a private right of action for contemporaneous traders, and enhanced the commission's authority to co-operate with foreign governmental authorities in the investigation of international securities laws violation.[180] Thus, through the enactment of ITSFEA, the US Congress sought to increase the economic consequences associated with this activity and thereby, to replace the traditional remedy an obey-the-law injunction with the increased form of deterrence against insider trading.[181]

In India, SEBI recently amended the SEBI (Insider Trading) Regulation 1992. It introduced the concept of self regulation of companies/organization firms etc. It imposes liability on the controlling person not to involve an insider trading by putting a policy of disclosure and internal procedure. However, this model does not prescribe the penalty for the violation of the provisions of the model. Neither does it create a private right of action to punish the insider or gives discretion to pay bounties. Furthermore, the SEC has adopted a plan in insider trading cases to pay compensation to potential

[180] See Chapter III, p.78-82.
[181] ibid, p.75-79.

contemporaneous traders for loss.[182] SEBI do not have such a comprehensive idea in settling the insider trading cases.

Finally, the SEC has been allowed to assist foreign securities authorities with their investigation. This provision is intended to encourage foreign government to co-operate with SEC in pursuing its investigation. Besides this, Section 8 of the ITSFEA, 1988 authorised the SEC to fund activities of the International Organisation of Securities Commission (IOSCO). The SEC indicated that it had been working with IOSCO to further international co–operation on enforcement activities and other securities regulation issues.[183]

US Insider Trading Laws	**India's Insider Trading Laws**
1. Insider trading Laws in US (Section 10b of Securities Exchange Act 1934, Insider Trading Sanction Act (ITSA) 1984, Insider Trading Securities Fraud Enforcement Act, 1988 has got the sanction from the congress.	SEBI has notified SEBI (Prohibition of Insider Trading) Regulation, 1992 to prohibit the insider trading. Essentially, violation defined in an Act has greater legal force than the ones which in enforced through regulations.
2. SEC has adopted the	2. The Amendment regulation

[182] ibid, p.78-79.
[183] ibid, p.79.

possession test (instead of use test) in Rule 10b5-1. If a trader was aware of material non-public information and he or she made the trade, he or she has violated Rule 10b5-1. But the rule also provides specific defences against liability. The trader must show that the material non-public information was not a factor in the trading decision.	2002, has added the words 'when in possession of' in the clause (i) of Regulation 3. The introduction of these words infer that it is required to prove the possession of unpublished price sensitive information with trader at the time of dealing of securities. There is, however, no need to prove the use of unpublished price sensitive information in the trading. But, there is no clear cut provision of specific defences outlined in SEBI (Prohibition of Insider Trading) Regulation, 1992.
3. Being a civil agency, the SEC has sweeping powers to gather evidence prior to a trial and it does not need to prove each element of its case beyond a reasonable doubt. It only has to show a preponderance of	3. Still SEBI has to prove each element of its criminal case beyond a reasonable doubt.

evidence.	
4. SEC is empowered to impose a penalty of upto three times the profit gained or losses avoided. This can go up to $ 1 million per person per case.	4. The SEBI (Prohibition of Insider Trading) Regulation, 1992 and the SEBI Act, 1992 provides penalty of upto Rs. 5 lakh or one year imprisonment.
5. ITSFEA expanded the scope of civil penalties to "controlling persons" who failed to take appropriate measures to prevent insider trading by their employees. ITSFEA permitted the SEC to bring an action to impose a civil penalty against controlling person. The penalty shall not exceed the greater of $ 1 million or three times the profit gained or loss avoided.	5. The SEBI (Prohibition of Insider Trading) Regulation, 1992 contains the model code of conduct for prevention of insider trading for listed companies and other entities. The Code requires from listed companies and other entities to prevent insider trading by making self regulation. Thus, first liability is on the companies to prevent insider trading. However, Code would not preclude the SEBI to take any action in case of violations of SEBI (Prohibition of Insider Trading) Regulation,

	1992. But Code does not prescribe a penalty for the violation of provisions of Code.
6. ITEFEA grants the SEC the sole discretion to pay bounties to person who provides information to the SEC regarding insider trading.	6. The SEBI (Prohibition of Insider Trading) Regulation, 1992 does not have such provision.
7. ITSFEA codified a private right of action for contemporaneous trader.	7. The SEBI (Prohibition of Insider Trading) Regulation, 1992, does not have such provision.
8. ITSFEA allowed the SEC to assist foreign securities authorities with their investigation. Section 8 of the ITSFEA allowed the SEC's authorisation to fund activities of the IOSCO.	8. Power of the SEBI's to assist foreign regulators or to enter into MOUs or other cooperation arrangements are explicitly provided in the securities legislation.
9. SEC is having 34 MOUs with different countries regulator filed	9. SEBI is having MOUs with US and Malaysia filed with IOSCO

with IOSCO regarding co-operation, consultation and provision of technical assistance.	dated March 6, 1998 and March 14, 2000 respectively regarding co-operation, consultation and provision of technical assistance.

CHAPTER -IV

CONCLUSION

This study addressed several issues related to full and fair disclosure of information and insider trading law. Since the liberalization of the indian economy from the early nineties, the country has witnessed at least a dozen major white collar crimes and frauds in the financial sector. Despite the establishment of regulatory authorities such as SEBI, financial frauds are recurring at regular intervals. In response to insider trading scandals in recent years and other stock market abuses, SEBI has taken a positive step to restore public confidence in the integrity of Indian security market by overwhelmingly making an amendment in insider trading regulation in February 20, 2002. But a lot more measures are required to banish insider trading from the Indian securities markets.

U.S. is having comprehensive legislations regulating every aspect of insider trading. These legislations not only regulates insider trading on non-public information but also establishes enforcement of sanction, settlement of insider trading cases with SEC, distribution plan of SEC in insider trading cases. The SEC has wide jurisdiction over companies, their officers, directors brokerage houses in the purchase and sale of securities.

On an average, India has witnessed major financial frauds throughout the nineties.[184] Likewise, the financial markets were in a serious panic on April 3, 2000, when the Sensex lost 361 points following the income tax notices served on several FIIs operating in Indian financial markets. As a result, nearly Rs. 6,00,000 million (approximately US $ 13 million) were lost in this blood bath. This was the second biggest single day market crash. These FIIs were routing their investments through Mauritius in order to benefit form the Indo-Mauritius Double Taxation treaty. After accusing the fly-by-night operators for this crash and declaring that India is not a "Banana Republic" the IT Department issued notices to these FIIs. The Finance Minister buckled down the very next day and cancelled the income tax notices issued to the FIIs. It is also an open secret that several Mauritius based corporate entities with huge amount of money operate sub-accounts of FIIs working in India. These corporate entities use FIIs to re-route illegal Indian money back to the country. Many of these sub-accounts are actively involved in price rigging by bulls and bears. All the above mentioned instances of frauds and manipulations reveal the weak regulatory and supervisory framework in India. It also points out the lax attitude of the regulatory authorities to prevent such frauds. The surveillance system of regulatory authorities is in such a bad state that they had absolutely no clue while the frauds were being committed. Unfortunately, in most of the instances, the

[184] Discussed in Chapter I.

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 has 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, (a former member of SEBI Board) even when actions are taken, they are generally adhoc in nature.[185] Because of these reasons, there is growing feeling that the regulatory authorities, particularly the SEBI, tend to protect the interests of big players rather than small investors.

It is common knowledge that there are not only bear cartels but also bull cartels playing their games in the Indian financial markets. Why has SEBI not taken any action against such cartels in the past? What about insider trading, which is so rampant in the Indian markets? What about circular trading (a group of brokers buy and sell shares to generate volumes in specific stocks basically to cure other investors) so prevalent in the Indian markets? Why has SEBI not taken any action regarding the Indian money routed through the FIIs? Why the SEBI turned a blind eye to the illegal business transactions in Calcutta Stock Exchange? These are some of the questions SEBI has so far not answered satisfactorily. These questions not only expose the incompetence of SEBI but also the lack of political will among the policy makers. Although our policy makers are keen to

[185] Statement came out in a meeting with author at FICCI, New Delhi.

adopt the Anglo Saxon system of running the domestic financial sector, they have ignored that fact that such financial frauds would have attracted punitive measures even in the so called "free market" economies such as the US. In these countries, insider trading[186] and short selling are serious offences. Further, there is a speedy investigation mechanism in place and culprits are quickly booked.

On the contrary, the situation in India is completely different. Scamsters and fraudsters are well-respected public figures in India, whose advice is frequently sought by financial markets and the media. Instead of spending their lifetime in jail, scamsters lead a lavish lifestyle and write newspaper columns. The cases against the late Harshad Mehta and his associates in the securities scam of 1992 are still pending in the Court. Almost ten years have passed, still no one has any clue when these culprits will finally be punished.

Despite the growing integration of Indian financial markets with the global markets along with the introduction of sophisticated investment instruments and electronic trading, the financial markets in India are highly inefficient and frequently manipulated by a handful of rogue traders. A nexus consisting of big institutional-investors-businessman–banker-official-politician is powerful enough to manipulate the financial markets to its advantage. While the small retail investor is a certain loser in market manipulation.

[186] Discussed in Chapter III.

Various attempts by the government to encourage small investors to return to financial markets are not going to yield positive results until and unless the Indian authorities ensure that savings of small investor will not be held to random by a handful of unscrupulous big operators and manipulators. In its bid to tighten insider trading norms, the SEBI introduced an amendment in SEBI (Indian Trading) Regulation, 1992, and has prescribed a code of internal procedures and conduct for listed companies and for other entities associated with the capital market.[187] This Code is being prescribed to create an internal framework of compliance at every level in order to prevent or minimize insider trading. The code stipulates mandatory disclosure on two counts. One, with respect of disclosure of interest /holdings by directors and other officers who are insiders in the company and thereafter accumulating continuously for every 5,000 shares or shares worth Rs. 5 lakhs, which ever is higher. Two, shareholders or those holding at least five percent stake in a company and therefore accumulating every additional two per-cent. It also stipulates every company must have a compliance department, which would serve as a nodal agency to collate information, specify policy requirement etc. It suggests following the principle of 'need to know' with regard to unpublished information. Access should be limited to those who need it. To prevent misuse of information, it provides a

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[187] See Chapter II, 50-53.

trading window. The code also prescribes pre-clearance of trades and reporting to compliance officers.[188]

To prevent the misuse of confidential information the organization/firm is required to adopt a 'Chinese Wall' policy which separates those areas of the organization which routinely have access to confidential information considered 'inside areas' from 'public area'.[189]

This self regulation measure for the listed and other entities has invited some criticism. It is appropriate to ask whether self regulation would be a more effective response. This option should be considered in a climate of deregulation. The stock exchanges in India are expected to handle issues related to stock movements, including insider trading. Given the pathetic conditions prevailing in India (with most broker office-bearers of the large exchanges, notably BSE, indulging in insider trading) one would expect that government and SEBI have to play a major active role in investigating such cases as it would increase the confidence of small investors. It is doubtful whether brokers are effective self regulators.

So far as the 'Chinese Wall' measure as a part of self-regulation is concerned, its success depends on the ethics of the firm. It is not the structure but the commitment. The Chinese Wall works in the

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[188] ibid.
[189] ibid.

office but outside the office social contact can break down. It can not work in practice and is easy to overcome. Thus, Chinese Wall ultimately depends on the integrity of the people behind them. Further, their effectiveness depends upon the standard of probity of the organization. The porosity, thinness and superficiality of Chinese Walls is their lack of effectiveness in small firms and the commonly held view is that they are cosmetic.

In this background, more measures are required to banish insider trading from the Indian securities market.

(1) There is a need to pass an insider trading law from the parliament as opposed to having a regulation issued by SEBI a regulator through notification.[190] Essentially, violation defined in an Act has greater legal force than that which is enforced through regulations. This is because regulations can be superceded by other legislations. In case of litigation too, a law enforced on the basis of an Act would have greater legal standing in a court than one enforced via regulations.

(2) The role and jurisdiction of various agencies (SEBI, Department of Company Affairs[191], RBI[192], and Finance Ministry) that have supervisory and regulatory authority over various aspects of securities

[190] See Chapter II, p.83-84.

[191] Department of Company Affairs under Ministry of Law and Justice and Company Affairs govern the incorporation, management, merger, and winding up of companies. Recently, DCA has been transferred under jurisdiction of Ministry of Finance [notified dated July 2, 2002], Economic Times, July 4, 2002.

[192] RBI has regulatory involvement in the capital market, but this has been limited to debt management through primary dealers, foreign exchange control, and liquidity support to market participants. It is RBI and not SEBI that regulates primary dealers in Government securities market.

market need to be clearly defined. Still better, if only one agency is given exclusive authority over the Indian securities market. There are four basic pieces of legislation that all provides regulatory framework for the securities market. There are (a) the Companies Act, 1956, which deals with issue, allotment and transfer of securities and disclosure to be made for public issues; (b) the Securities Contracts (Regulation) Act, 1956 which provides for regulation of transaction in securities through control over stock exchange; (c) the Securities Exchange Board of India Act, 1992, which provides for the establishment of a regulatory authority to protect the interest of investors; and (d) the Depositories Ordinance, 1995, which provides a legal basis for establishment of depositories to maintain the ownership record of securities in a book entry form and effect the transfer of securities. All these have caused a lot of confusion not only in the mind of investors, but also among the various agencies who administer these legislations. Several amendments have been made in order to enlarge the jurisdiction of SEBI. Still, there is a need to harmonise and consolidate all the laws relating to securities market into a single piece of legislation to be administered by one agency.

(3) There is a need to enhance SEBI's powers to call for information on the lines of the RBI, where the regulator could ask for additional information, backed by a court order. This would provide for a check to the extent that the capital market regulator can not go on a fishing trip to prove a violation.

(4) There is also need to strengthen the SEBI by appointing four full time members and enhancing the powers of the Securities Appellate Tribunal (SAT).

(5) SEBI also needs persons who would carry a high degree of credibility and inspire the institution down the line. SEBI should be given a free hand in getting quality manpower. The restriction on compensation should go. The market offers a pay structure that is now, and will always be ahead of, what the regulators can pay. This is true even of the US SEC.[193] But the way to get around this problem is to make working for SEBI a prestigious job. That is certainly the case with the US SEC. The SEC's pay, in some categories, are a third of what is offered elsewhere.[194] But the SEC job carries much weight from a long-term point of view. This is what has enabled it to put together a good set of skills that are used very well. There have been attempts to sort out the pay differentials. SEBI should also offer its manpower the kind of merit offered by SEC.[195] SEBI should also be allowed to move away from the traditional government/bank-type of recruitment. That is the only way it will attract quality professionals. It should also have a specialized team of lawyers, accountants market observers and mutual fund specialists who can provide an edge in implementing the regulation most effectively.

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[193] http://www.securities.com/Public/Public98/sebi/SEBI/report/pt974.html-10k dated November 20, 2001.

[194] http://www.indian-express.com/ie20020204/bus2.html-19k dated November 20, 2001.

[195] ibid.

(6) It is also necessary to provide higher penalties on insider trading – Rs. 25 crore or three times the illegal gains from insider trading which ever is higher.

(7) All principal regional exchanges should have a sophisticated surveillance mechanism, monitoring compliance because of multiple listing.

(8) SEBI must adopt the compromise formula (awareness equals use presumption) provided by new insider trading rule 10b5-1 and 10b5-2 of U.S. This rule says that a defendant found to be 'aware' of material non-public information at the time of a trade must prove that before becoming aware of the information, he or she had (a) entered into a binding contract to make such trade; (b) instructed another person to make a trade for his account; (c) adopted a written plan for trading pursuant to which such trade was made.[196]

(9) There should be a private right of action. Any aggrieved person who is a contemporaneous trader, as defined by the courts, to sue the insider trader for damages. But this should be some limitation: first, the insider trader may be liable for an amount not exceeding the profit gained or loss avoided. Second, the amount of the damages may be reduced by any court ordering disgorgement of profits that the SEBI

[196] See in detail in Chapter III, p.73-74.

obtains under Regulation.[197] Thirdly, in cases involving tipping, liability of communication was directed.

(10) SEBI should be given a discretion to pay bounties to person who provide information to SEBI or the Attorney General regarding insider trading that leads to the imposition of a penalty under S.15G or Chapter VI-A of SEBI Act, 1992 and Regulation 11 of SEBI (Prohibition of Insider Trading) Regulation, 1992. The bounty may not exceed 10 pre-cent of the civil penalty recovered.

(11) There has been perceptible change in the corporate ownership on account of exponential growth of capital market activities. It necessitates urgent review of the system of corporate governance with particular emphasis on reporting and accountability, the role of financial institutions, non-executive directors, managing directors, chairman and audit committee, and the relationship between stock exchange and companies and also companies and investors.

The amendment in insider trading regulation is a promising development, both in terms of bringing the confidence of small investor and deterring the insider trading. The amendment in insider trading regulation will do much towards reaching the objectives set out by the SEBI in regulation of capital market. The purpose of this study has been to point out the adequacy of India's security law dealing with insider trading in the backdrop of developments in US

[197] ibid.

national laws dealing with insider trading. However, notwithstanding the above novel features the insider trading regulation 1992 suffers from many serious infirmities. Despite the fact that stringent penalties against insider trading are imperative, the SEBI (Prohibition of Insider Trading) Regulation, 1992 do not constitute an adequate regulatory framework is accepted. By overruling SEBI's authority, the ministry has preempted itself from enforcing accountability in SEBI's actions. Thus SEBI has been defanged in the strict enforcement of the rules and regulations framed for the intermediaries. SEBI seems to be in piquant situation of having autonomous powers but still not enjoying real autonomy.

Moreover, this analysis can possibly serve as a guide to both legislators and practitioners as they endeavour to mould our regulatory legislation to meet the changing demands of the international economy.

ANNEXURE

SEBI (Prohibition of Insider Trading) Regulation. 1992

Some Important Provision

CHAPTER I

PRELIMINARAY

Short Title and Commencement

1. (1) These regulations may be called the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992. (2) These regulations shall come into force on the date of the publication in the Official Gazette.

Definitions

2. In these regulations, unless the context otherwise requires;- (a) "**Act**" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(b) "**body corporate**" means a body corporate as defined under section 2 of the Companies Act, 1956 (1 of 1956);

(c) "**connected person**" means any person who-

(i) is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 (1 of 1956) of a company, or is deemed to be a director of that company by virtue of sub-clause (10) of section 307 of that Act or

(ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company, whether temporary or permanent, and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;

Explanation: For the purpose of clause (c), the words "connected person" shall include any person who is a connected person six months prior to an act of insider trading

(d) "**dealing in securities**" means an act of subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in any securities by any person either as principal or agent;

(e) "**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 to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information;

(f) "**investigating authority**" means any officer of the Board or any other person, not being a firm, body corporate or an association of persons, having experience in dealing with the problems relating to the securities market and who is authorised by the Board under Chapter III;

(g)"**officer of a company**" means any person as defined in clause (30) of section 2 of the Companies Act, 1956 (1 of 1956) including an auditor of the company;

(h)"**person is deemed to be a connected person**" if such person-

(i) is a company under the same management or group or any subsidiary company thereof within the meaning of section (1B) of section 370, or sub-section (11) of section 372, of the Companies Act, 1956 (1 of 1956) or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969) as the case may be; or

(ii) is an intermediary as specified in section 12 of the Act, Investment Company, Trustee Company, Asset Management Company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation.

(iii) is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, investment advisor, sub- broker, investment company or an employee thereof, or, is a member of the Board of Trustees of a mutual fund or a member of the Board of Directors of the Asset Management Company of a mutual fund or is an employee thereof who have a fiduciary relationship with the company;

(iv) is a member of the Board of Directors, or an employee, of a public financial institution as defined in Section 4A of the Companies Act, 1956; or

(v) is an official or an employee of a self Regulatory Organisation recognised or authorised by the Board of a regulatory body; or

(vi) is a relative of any of the aforementioned persons;

(vii) is a banker of the company;

(viii) relatives of the connected person; i. a concern, firm, trust, Hindu Undivided Family, Company, Association of Persons wherein the relatives of persons mentioned in sub-clauses (vi), (vii) and (viii) has more than 10% of the holding or interest

ha) `**price sensitive information**' means any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company;

Explanation:

The following shall be deemed to be price sensitive information:-

i. periodical financial results of the company;

ii. intended declaration of dividends (both interim and final);

iii. issue of securities or buy-back of securities;

iv. any major expansion plans or execution of new projects;

v. amalgamation, mergers or takeovers;

vi. disposal of the whole or substantial part of the undertaking;

vii. any significant changes in policies, plans or operations of the company

(i) "**relative**" means a person, as defined in section 6 of the Companies Act, 1956 (1 of 1956)

(j)"**stock exchange**" means a stock exchange which is recognised by the Central Government or Securities and Exchange Board Of India under section 4 of Securities Contracts (Regulation) Act, 1956 (42 of 1956);
(k) "**Unpublished means information**" which is not published by the company or its agents and is not specific in nature.

Explanation: Speculative reports in print or electronic media shall not be considered as published information

CHAPTER II

Prohibition on Dealing, Communicating or Counseling

Prohibition on dealing communication or counseling on matters relating to inside trading

3. No insider shall - (i) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange when he is in possession of any unpublished price sensitive information; or (ii) communicate, counsel or procure, directly or indirectly, any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information shall not deal in securities. Provided that nothing contained above shall be applicable to any communication required in the ordinary course of business or under any law
3A. No company shall deal in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

Violation of provisions relating to insider trading

4. Any insider, who deals in securities in contravention of the provisions of regulation 3 or 3A shall be guilty of insider trading.

CHAPTER III

INVESTIGATION

Power to make inquiries and inspection

4A. (1) If the Board suspects that any person has violated any provision of these regulations, it may make inquiries with such persons or any other person as mentioned in clause (i) of sub-section (2) of section 11 as deemed fit, to form a prima facie opinion as to whether there is any violation of these regulations.
(2) The Board may appoint one or more officers to inspect the books and records of insider(s) or any other persons as mentioned in clause (i) of sub-section (2) of Section 11 for the purpose of sub-regulation (1).

Board's right to investigate

5. (1) Where the Board is of prima facie opinion that it is necessary to investigate and inspect the books of account, other records and documents of an insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act for any of the purposes specified in sub-regulation (2), it may appoint an investigating authority for the said purpose.

(2) The purposes referred to in sub-regulation (1) may be as follows:
(a) to investigate into the complaints received from investors, intermediaries or any other person on any matter having a bearing on the allegations of insider trading; and

(b) to investigate suo-moto upon its own knowledge or information in its possession to protect the interest of investors in securities against breach of these regulations.

Procedure for investigation

6. (1) Before undertaking an investigation under regulation 5 the Board shall give a reasonable notice to insider for that purpose.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of investors or in public interest no such notice should be given, it may by an order in writing direct that the investigation be taken up without such notice.
(3) On being empowered by the Board, the investigating authority shall undertake the investigation and inspection of books of accounts and an insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act shall be bound to discharge his obligations as provided in regulation 7.

Obligations of insider on investigation by the Board
7. (1) It shall be the duty of every insider, who is being investigated, or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act to produce to the investigating authority such books, accounts and other documents in his custody or control and furnish the authority with the statements and information relating to the transactions in securities market within such time as the said authority may require.

(2) The insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act shall allow the investigating authority to have reasonable access to the premises occupied by such insider and also extend reasonable facility for examining any books, records, documents and computer data in his possession of the stock-broker or any other person and also provide copies of documents or other materials which, in the opinion of the investigating authority are relevant.

(3) The investigating authority, in the course of investigation, shall be entitled to examine or record statements of any member, director, partner proprietor and employee of the insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act.

(4) It shall be the duty of every director, proprietor, partner, officer and employee of the insider to give to the investigating authority all assistance in connection with the investigation, which the insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act may be reasonably expected to give.

Submission of report to the board

8. The investigating authority shall, within reasonable time of the conclusion of the investigation submit an investigation report to the Board.

Communication of findings, etc.

9(1) The Board shall, after consideration of the investigation report communicate the findings to the person suspected to be involved in insider trading or violation of these regulations.

(2) The person to whom such findings has been communicated shall reply to the same within 21 days; and

(3) On receipt of such a reply or explanation, if any, from such person, the Board may take such measures as it deems fit to protect the interests of the investors and in the interests of the securities market and for the due compliance of the provisions of the Act, the Regulations made there under including the issue of directions under regulation 11.

Appointment of auditor

10. Notwithstanding anything contained in regulation 4A and regulation 5, the Board may appoint a qualified auditor to investigate into the books of account or the affairs of the insider or any other person mentioned in clause (I) of sub-section (1) of section 11 of the Act; Provided that, the auditor so appointed shall have the same powers of the inspecting authority as stated in regulation 5 and the insider shall have the obligations specified in regulation 7.

Directions by the board

11 - The Board may without prejudice to its right to initiate criminal prosecution under section 24 or any action under Chapter VIA of the Act, to protect the interests of investors and in the interests of the securities market and for due compliance with the provisions of the Act, Regulations made thereunder issue any or all of the following order, namely: -

a. directing the insider or such person as mentioned in clause (i) of sub-section (2) of section 11 of the Act not to deal in securities in any particular manner;

b. prohibiting the insider or such person as mentioned in clause (i) of sub-section (2) of section 11 of the Act from disposing of any of the securities acquired in violation of these Regulations;

c. restraining the insider to communicate or counsel any person to deal in securities;

d. declaring the transaction(s) in securities as null and void;

e. directing the person who acquired the securities in violation of these regulations to deliver the securities back to the seller; Provided that in case the buyer is not in a position to deliver such securities, the market price prevailing at the time of issuing of such directions or at the time of transactions whichever is higher, shall be paid to the seller.

f. directing the person who has dealt in securities in violation of these regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher to the investor protection fund of a Recognised Stock Exchange.

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