REGULATION OF INSIDER TRADING IN INDIA: DISSECTING THE DIFFICULTIES AND SOLUTIONS AHEAD

Roopanshi Sachar¹ & Dr. M. Afzal Wani²

INTRODUCTION

Insider trading, the use of privileged information for trading in shares and securities for the purposes of gain (or to avoid a loss) at the expense of the uninformed general public, is morally and legally reprehensible. The term is so commonplace that it is almost self-explanatory³. In common parlance, insider trading refers to trading in securities on the basis of information that has not been made public⁴. The central feature of conduct which could be characterised as insider trading, beyond the obvious requirement of purchase or sale of security, is the possession by the trader of the information that is in some sense material to the value of the securities traded, and is not, information already publicly known, or more specifically known to other people in the market⁵. Insider trading can also be described as purchase and sale of securities of corporation by person with access to confidential information about corporation that can materially affect the value of securities and which is not known by the shareholders or the general public⁶.

Henry G. Manne, the proponent of law and economics discipline defined it as:

“Insider trading generally refers to the practice of corporate agents buying or selling their corporation securities without disclosing to the public significant information which is known to them but which has not affected the price of the security⁷.”

New Oxford Companion to Law states:

“Insider dealing occurs when a person with access to information that is precise and not generally available improperly discloses that information or uses it to deal to his advantage in financial securities in public market⁸.”

Thus, the chief characteristics of insider trading are: (1) insider possess the inside information which is not available to the general public; (2) insider uses confidential information for his own benefit either by making gain or avoiding loss; (3) information is used to the detriment of

¹ LL.B. (H) (Gold Medalist), LL.M. (Gold Medalist), NET - JRF (UGC), Ph.D. Scholar, University School of Law and Legal Studies, Guru Gobind Singh Indraprastha University, Delhi.
² Ex - Dean and Professor, University School of Law and Legal Studies, Guru Gobind Singh Indraprastha University, Delhi.
persons who do not have that information; (4) insider put shareholder to disadvantage; (5) information should be material\(^9\).

**INSIDER TRADING AND ITS REGULATION IN INDIA**

India is among the fastest growing economies of the world. Along with the growth of its financial market, there has been a rapid increase in the financial crimes associated with the Indian market\(^10\) the most rampant of which has been that of insider trading. India being one of the fastest growing economies of Asia needs to have an effective check on its occurrence in financial markets so as to provide a fair and equal play field for domestic and international investor, if it wants to be in the ranks of major economies of the world. In the year 1992, a Former President of Bombay Stock Exchange began his speech in a seminar on capital markets by making an observation:

"There is no other kind of trading in India, but the insider variety. It is another matter that by the time the retail guys get the hot tip the real operator are already dumping their holdings"\(^11\).

The above said observation was made at the time when the stock market although thriving after introduction of liberalization measures, was under an unvarying curse of cunning participants, who were very well skilled in the art of insider trading. With the new economic policies aimed at integrating the Indian economy with world economy having been announced, and the investment channels for foreign institutions and funds having been opened out, there was legitimately a need to provide for a suitable regulation over insider trading, if not for anything else, to satisfy such foreign investors that we in India too, have insider trading laws\(^12\).

Based on the suggestions of various Committees\(^13\), the Government of India vide notification issued on 12\(^{th}\) April, 1988 set up the Securities and Exchange Board of India as the first regulatory body to regulate the securities markets post the reforms of 1991. SEBI was constituted as an interim administrative body to function under the overall supervision of Ministry of Finance, Government of India. However soon a call for a special enabling and empowering legislation that provided statutory backing to SEBI arose which led to enactment of Securities and Exchange Board of India Act, 1992. Under Section 11 of the Act, it is the duty of SEBI to protect the interest of the investors in securities and to promote the development of, and to regulate the securities market by such measures as it thinks fit. Under Section 11 (2) (g), prevention of insider trading has been specifically mentioned as one of its duties. Section 12-A of the Act explicitly prohibits insider trading in securities of companies listed in stock exchanges\(^14\) by stating that “no person shall directly or indirectly: (a) engage in insider trading:

\(^13\) Sachar Committee (1977), Patel Committee (1986) and Abid Hussain Committee (1989).
\(^14\) Chapter VA inserted by SEBI (Amendment) Act, 2002 w.e.f. 29\(^{th}\) October, 2002.
or (b) deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the Rules or the Regulations made there under”. Violation of Section 12-A attracts civil penalty under Section 15-G of the Act upto twenty-five crore or three times the amount of profits made out of insider trading, whichever is higher. Insider trading is also a punishable criminal offence under Section 24 of the Act with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.

The increased instances of insider trading in a rapidly advancing securities market in India required a more comprehensive legislation to regulate insider trading. Section 30 of the SEBI Act, 1992 empowers SEBI to make Regulations consistent with the Act and rules made there under to carry out the purposes of the Act, by notification to be published in the Official Gazette of India. In exercise of this power, SEBI framed the SEBI (Prohibition of Insider Trading) Regulations, 1992 comprising of 4 Chapters and 3 Schedules encompassing the 15 Regulations. Chapter I dealt with definitions of terminologies used in the Regulations like connected persons, deemed person, insider, price sensitive information, etc. Chapter II provided for prohibition on dealing, communicating or counseling by insider as defined in the Regulation. Chapter III narrated the investigative power of SEBI under the Regulation and enumerated the prohibitory orders or directions that it can issue against the guilty and in the interest of capital market regulation. Chapter IV dealt with the code of internal procedures and conduct to be followed by listed companies and other entities, disclosure requirements to be followed by company directors, officers and substantial shareholders and the appeal provision which an aggrieved may like to follow against the order of SEBI.

In November, 2014, India’s market capitalization crossed USD 1.6 trillion, making it world’s ninth largest economy by market capitalization. The need of revamping the law on insider trading could be attributed to the fact that more than twenty three years had passed since SEBI issued the Regulation which was turning inadequate in the light that since the year 1992, the listed companies, the stock market and the economy as a whole had endured changes. These changes highlighted the lacunae in the Regulation of 1992 which had a harmful effect on the rights of shareholders, corporate governance norms and thus injured the overall confidence in Indian financial markets. Thus SEBI thought it was needful that a new legal regime be introduced to plug the loopholes in the legal framework and to ensure this, a systematic review of the existing law was called for. SEBI, therefore, constituted the 18 member High Level Sodhi Committee under the Chairmanship of Justice N. K. Sodhi, former Chief Justice of the High Courts of Kerala and Karnataka and Former Presiding Officer of Securities Appellate Tribunal to

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15 Published in the Gazette of India, Extraordinary in Part III, Section 4 on 19th November, 1992.
16 SEBI (Prohibition of Insider Trading) Regulations, 1992, Regs. 1 to 2.
17 Id., Reg. 3 to 4.
18 Id., Reg. 4A to 11A.
19 Id., Reg. 12 to 15.
20 Samie Modak, “India’s market capitalisation cross 100 trillion” Business Standard, Nov. 28, 2014.
undertake a comprehensive review of the existing Regulations and modify the law on insider trading. The Report of the Sodhi Committee was discussed and approved by the SEBI in its meeting held on 19th November, 2014 and formed the basis for introduction of the SEBI (Prohibition of Insider Trading) Regulations, 2015\textsuperscript{22} which replaced the earlier Regulations. The Press Release that accompanied the 2015 Regulations stated that the primary objective for the introduction of the Regulations has been to strengthen the legal and enforcement framework, align Indian regime with international practices, provide clarity with respect to the definitions and concepts, and facilitate legitimate business transactions\textsuperscript{23}. The Regulation of 2015 comprises of 5 Chapters, 2 Schedules and 12 Regulations. Chapter I deals with the definitions. Chapter II deals with the Restriction on Communications and Trading by Insiders. Chapter III talks about the disclosures to be made by the companies while trading its securities by insiders. Chapter IV prescribes a Code of Fair Disclosure and Conduct. Chapter V contains miscellaneous provisions.

DISSECTING THE LACUNAS OF INDIAN INSIDER TRADING LAWS

Out of all the issues that the regulator of the securities market in India has to tackle with, the regulation of insider dealing has proved to be the most difficult. Experience of such regulation, which has attracted the unflattering label of ‘the unwinnable war’, prompts reconsideration of the issue\textsuperscript{24}. India is one of many countries that rarely enforce the insider trading laws that exist on the law books\textsuperscript{25}. It is a matter of serious concern that the SEBI has done very little apart from initiating probes, that too, very often, only after the issues are raised by the media\textsuperscript{26}. Instances of insider trading in majority of cases fail to be detected and even when detected, the prosecution fails to establish the case against the accused. While numerous cases may have been investigated by SEBI since 1992, the rate of successful prosecution has been very low. Investigations have been carried out for years without resulting into any convictions. In the cases of final conviction, there were some suspensions, prohibitions or mere warnings issued. In some cases, SEBI issued consent orders. But nobody went to jail as all of the convicted cases ended up with penalties. Thus insider trading is a very profitable venture in India with little chance of facing punishment.

On the other hand, certain western countries are way ahead of India in this regard. The most obvious instance of such a success has been the conviction of Raj Rajaratnam and Rajat K. Gupta in United States. This is not the sole example of success of regulatory authorities in other countries but there are many more to the list. Such a situation clearly leads to a conjecture that there must be certain deficiencies or defects in the existing legal regime in India, whether in terms of prosecution or in its enforcement. A thought process over such a situation leads us to certain issues that need to be addressed to ensure better and effective implementation and prosecution in insider trading cases. The issues that need to be addressed are:

\textsuperscript{24} A.M. Louis, “The Unwinnable War on Insider Trading” Fortune 72 (1981)
\textsuperscript{25} Mark Miller, “The Insider: Parasite or Legitimate Profit-Maker?”, online available at ccs.in/internship_papers/2002/29.pdf.
\textsuperscript{26} Naresh Kumar, “How Effective Are the Insider Trading Regulations” 75 Corporate Law Adviser 35 (2006).
1. The problem in Indian insider trading prosecutions has been lack of contemporary, modern and technologically advanced monitoring and surveillance mechanism without which it is impossible to catch the offender. SEBI lacks technological expertise in this aspect and handicap in this field impedes the effectiveness of the inquiry in a significant manner. In contrast, SEC and the stock exchanges in USA possess highly effective surveillance mechanism to catch insider trading and pursue its investigation. Though both SEC and SEBI both have attained a fully automated oversight system over their respective capital markets, however as compared to India, United States enjoys an excellent market oversight and surveillance system giving it an edge over in detecting insider trading cases.

2. Proving cases of insider trading is a challenge as the charges are based almost entirely on circumstantial evidence. In most cases, telephone records and transcripts are the only evidence available to prove a nexus between those indulging in such illegal activity. SEBI does not have in its hand a crucial power of investigation i.e. tapping of phone calls. Soon after the Raj Rajaratnam-Rajat Gupta insider trading case became public, SEBI had approached the government for powers to tap phone calls for suspected insider trading and other securities frauds. However SEBI does not have the power to tap phones as that was denied by the government on grounds of it being liable to misuse. UK Sinha, SEBI Chairman said, “The SEBI does not have the power to tap phones. It can only request for call data records in suspicious cases. In India only a few economic agencies like the Central Board of Direct Taxes have the power to tap phones.” Such a power can prove to be the most decisive piece of evidence in investigation to prove a case against the guilty. An example of such power being used successfully is in USA, where insider trading by Rajat Gupta was proved by relying exclusively on 18,000 wiretapped recorded telephone conversations and e-mails on which he had leaked out price sensitive information of the company to Mr. Raj Rajratanam.

3. Due to globalization of world economies, the world has emerged as a global village and the offence of insider trading has also started crossing the national borders. The Indian law in this regard is backward as it lacks application outside the territory of India i.e. extra territorial application. The main objectives of extraterritorial applications of national laws have been protection of domestic markets and rights of resident investors from conduct of foreign participants. Under the Indian law, there is no provision to impose penalty or even ensue investigation on the foreign national who has committed the offence of insider trading. There is no mention in the Regulation about the enforcement of criminal sanction against director of foreign company listed in domestic

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28 “Insider trading is Rampant on Dalal Street” The Economic Times, June 18, 2012.
30 “Stricter Disclosure Norms soon for Research Analysts” The Indian Express, July 18, 2015.
exchange which has indulged in insider trading as SEBI Act shall not be applicable to territory outside India and it shall be an extra territorial application of this Act. Many developed countries like USA have laws that have extra territorial operation i.e. applicable on transactions that have foreign element involved.

Moreover, as a result of globalization of the securities trade, there may be cases where an investigation initiated in India may have some piece of evidences outside it territory. The Indian law does not suffice in seeking transnational support and assistance in such regard. For investigatory assistance Indian regulators have some bilateral agreements, including Mutual Legal Assistance Treaty (with 39 countries out of 196 countries) and Memorandum of Understanding (with 22 countries out of 196 countries). But these bilateral agreements are not established with many states as majority states remain uncovered. Thus many foreign authorities decline to cooperate with the Indian Regulator SEBI as it does not have jurisdiction in their territory, nor share any arrangement to share information in the events of any financial offence.

4. In India, insider trading blooms during merger and acquisitions between companies. Takeovers are regarded as the special events that are likely to move prices and create the climate for insider trading. In USA, Rule 14e-3 of Securities Exchange Rules, 1942 specifically caters to the problem of insider trading in scenario of merger and acquisitions by prohibiting any person who is in possession of material non-public information relating to commencement of tender offer, directly or indirectly from either the bidder or the target company, from trading in target companies securities. Such a provision is lacking in India.

5. There is no private right of action or class action available to protect the investors’ interest under the Indian insider trading laws as it does not also give the investor victimized by insider trading the right to institute civil action privately before a regular court. Section 26 of the SEBI Act, 1992 states that no court shall take cognizance of any offence punishable under SEBI Act or the Rules or Regulations made there under, except on complaint filed by SEBI. The absence of private right of action leaves enforcement solely in the hands of SEBI and prevents investors from taking active role in regulation of securities market. However the US law provides a number of civil remedies in which civil actions can be maintained by private individuals under Rules 10b-5 and Rule 14e-3 of Securities Exchange Rules, 1942 and Section 16-b and Section 20-a of the Securities Exchange Act which have proved to be crucial to the deterrence of insider trading in USA.

6. Under the SEBI Act, SEBI has a right to launch an investigation only when any intermediary or any person associated with the securities market has violated any of the provisions of this Act or the Rules or the Regulations made or directions issued by the Board. But there might arise a situation where SEBI gets to know about some anticipated occurrence of insider trading through an informer and may seek to prevent it. However under India law, anticipatory action with a view to prevent insider trading is not provided for and only an enquiry into the aftermath of a leakage of unpublished price-sensitive information is permissible.

7. SEBI has never been heard of carrying out a self-appraisal of its own processes / investigation undertaken in various insider trading cases that failed to be proved. SEC of USA has been doing self-appraisals to find out what went wrong in their investigation by time and again undertaking investigation of their processes. For example report titled “Investigation of failure of SEC to uncover Bernard Madoff’s Ponzi scheme” takes an in depth look to find out the faults that SEC suffered from due to which Madoff was able to escape prosecution for a long time. The lack of conception of performance appraisal for SEBI leads to the same deficiencies finding way in the investigation again and again.

8. In India, under Section 11B (3) of the SEBI Act, 1992, empowering SEBI to carry out investigation, the investigating authority may require only an ‘intermediary or any person associated with securities market in any manner’ to furnish information to, or produce books, or registers, or other documents, or record before him or any person authorised by it in this behalf. This is quite the opposite to the position in UK where under Section 177 (1) of the Financial Services Act, 1986, the Secretary of State is empowered to appoint one or more competent inspectors to carry out investigations and the inspector so appointed is entitled to require ‘any person’ whom they consider to be able to give information concerning any such contravention, to produce document, to attend before them and otherwise give all assistance in connection with the investigation. This implies that the investigatory power of SEBI is limited in its ambit to only persons as mentioned in the Section 11B (3) of the Act and thus SEBI might be handicapped in situations where the person whose assistance is required does not fall within the ambit of the persons mentioned in the sub section.

9. SEBI had prescribed consent mechanism for settlement of cases relating to insider trading for the first time in circular no. EFD/ED/Cir-1/2007 dated 20th April, 2007 to cut down on cost, enforcement and efforts to take up enforcement action. The amount to be paid in settlement through consent orders is merely a fine which is very small as

36 Securities and Exchange Board of India Act, 1992, s. 11 C.
38 Online available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1291879532674.pdf, stating: “All appropriate administrative or civil actions e.g. proceedings under Sections 11, 11B, 11D, 12(3) and 15I of SEBI Act and other civil matters pending before SAT / courts may be settled between SEBI and a person (party) who may prima facie be found to have violated the securities laws or against whom administrative or civil action has been commenced for such violation.”
compared to the amount under dispute\textsuperscript{39}. Settlement of insider trading cases through consent order leads an impression that insider trading does not involve much high risks of financial loss and imprisonment is a rare probability. This may end up lowering the fear in mind of the potential insider traders and thus turn futile and infact disastrous in it effect. It is also that such resolution restricts the development of law on the subject and does not shed light on the process by which the initial inquiry order was instituted\textsuperscript{40}.

10. SEBI regulates the stock market by performing three kinds of function: legislative (formulation of Regulation and circulars); executive (detection and investigation of alleged malpractices and misconduct) and judicial (passing of orders imposing fines, restraint, etc.) A single body has been overstrained with multitude of tasks making it difficult for it to concentrate absolutely on any of its acts. This in contrast to position in US where the SEC duty is to detect and investigate the insider trading and to move the appropriate court thereafter for seeking civil penalties and criminal prosecution of offenders. Thus SEC is determined only to act on the task of detection of insider trading and is not saddled with the task of acting in other capacities.

11. Another problem in Indian insider trading prosecutions has been lack of resources and manpower equipped. As compared to SEBI, SEC of United States is a much powerful body which has fully equipped itself with human resources as well as a strong infrastructure to detect and curb insider trading. The SEC employees staff of 3958 persons\textsuperscript{41} while SEBI employs a mere 643 persons in toto as its employees all over the country at its various offices\textsuperscript{42}.

The present law on regulation of insider trading is suffering from certain defects in its structure, approach and draft. They are:

1. A notable omission in the Regulation of 2015 is the absence of express mention of ‘public servants’ and ‘servants of SEBI’ itself in the definition of ‘connected person’ although many of them learn of price-sensitive information due to the positions they enjoy.

2. The Regulation does not set out some reasonable time frame to close the investigation of insider trading cases. Any unusual delay in the conclusion of investigation may result in loss of key evidentiary material and gives the white collar committers chance to influence the investigation.

3. The Regulation of 2015 also does not mention any special procedure for carrying out investigation in cases of insider trading.

4. SEBI Regulation or any other law has not introduced any method to encourage private people to share information that leads to the exposure of insider trading act being


\textsuperscript{40} Satvik Varma, “Insider Trading is a criminal offence” The Economic Times, Dec. 11, 2011.

\textsuperscript{41} U.S. Congressional Budget Justification for Financial Year 2013 – 2014.

\textsuperscript{42} Online available at: http://www.sebi.gov.in/acts/EmployeeDetails.html.
undertaken. India lacks a special provision in its law that provides bounty for those privies to information relating to insider trading awarding them for communication of such information.

5. Under the Regulation of 2015\textsuperscript{41}, any person who is or has during the six months prior to the concerned act been associated with a company, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or business relationship between himself and the company that allows such person access to unpublished price sensitive information or is reasonably expected to allow such access is deemed to be a connected person. Thus, it means that an officer, employee or directors of a company who had resigned from it and a period of six months has passed since the resignation are no longer deemed to be connected to the company and free to use the UPSI for trading in the securities after the expiry of six months from his / her resignation. This idea of fixing the time limit to six month seems to be unfounded as certain UPSI may be significant for a longer time and thus affect the price of the securities even after expiry of 6 months period. As an instance, such an ex-insider may conspire with his / her former colleague to delay the disclosure of the information for more than six months so that later the transaction causing gain to them may be executed.

6. Regulation 3 and 4 Regulation of 2015 uses the term ‘proposed to be listed’ as an adjective for securities about which no UPSI can be communicated, provided or allowed access to and securities which cannot be traded on the basis of UPSI. However in absence of definition of the term ‘proposed to be listed’ in the Regulation, it is unclear as to what is meant by the phrase. Whether such a loose term may be intended to envelop companies that are on the stage of preliminary discussion for listing, or whose Article of Association are to be approved, or who have filed draft red herring prospectus with SEBI, or has already proposed Initial Public Offering, etc. is unclear. This is a major loophole in the Regulation as its puts the applicability of the heart of the Regulation under ambiguity.

7. One of the most striking features of the Regulation of 2015 has been the extension of the role and responsibility of the compliance officer in an incredibly extensive manner. They are required to report trades executed by all classes of connected persons, in addition to their own employees. The term ‘employee’ brings in all the employees of a company under the ambit of the disclosure provisions. This enlarges the scope of duties of the compliance officer to immeasurable limits as number of employees in any large company may be many times more than the number of high ranking officials. The responsibility for monitoring and reporting conduct of ‘connected persons’ seems to extensive as such ‘connected persons’ may include company's bankers, financial and legal advisers, immediate relatives and many others. Because of the broad scope of the

\textsuperscript{41} SEBI (Prohibition of Insider Trading) Regulation, 2015, Reg. 2 (1) (d).
definition of connected person in the Regulation, it is a tedious task for the compliance officer to do so. A large third-party community has been included as ‘connected person’ and it is a challenge for listed companies to get disclosure compliance from them. A single entity carrying such burdensome responsibility increases chances of default in their duty.

8. The Regulation prohibit dealing in securities when in possession of insider information, as well as the communicating or procuring insider information, except where this is in furtherance of ‘legitimate purposes’, ‘performance of duty’ and ‘discharge of legal obligation’. These phrases have not been defined in the Regulation making it very unclear as to what purposes, performances and discharges are legitimate enough to allow insider information to be communicated or procured.

9. Regulation 2 (1) (n) of the Regulation of 2015 define ‘unpublished price sensitive information’ as meaning any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities. ‘Generally available information’ is defined in Regulation 2 (1) (e) with the aid of use of words ‘non discriminatory’ but the term ‘non discriminatory’ has not been defined anywhere in the Regulations. The extent to which the law requires the information to be disseminated in the public domain, for it to be considered as ‘available on a non-discriminatory basis’, remains unanswered.

10. The Regulation has introduced a system of submitting investment trading plan by those insiders that are ‘perpetually in possession of UPSI’ setting out the value, number of shares and the date of the dealing in them in advance. This concept of trading plan also has its share of limitations. As the Regulation has omitted defining the meaning of the phrase ‘perpetually in possession of’, it is difficult to understand as to what category of

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45 SEBI (Prohibition of Insider Trading) Regulation, 2015, Reg. 4.
46 Id., Reg. 3.
48 SEBI (Prohibition of Insider Trading) Regulation, 2015, Note to Reg. 5.
traders can avail this entitlement to formulate a trading plan. Moreover, a thought can also be given about the impractical nature of the trading plan. The situation may create problem for company officials or insider in even genuinely trading shares of their own companies. As the trading plan requires mandatory publication before its commencement, it may give rise to speculation in the market and investors are likely to get influenced by the trading plan of such officials which have already been disclosed in public. For example if a promoter makes a plan to buy 500,000 shares six months on, since the plan is irrevocable, persons aware of this information can buy shares ahead of the promoter’s purchase. Lastly, the trading plan once approved and published is irrevocable and cannot be deviated from but no exemptions has been provided for in case of personal exigencies i.e. medical emergencies.

11. Regulation of 2015 incorporates specific legislative notes in most of its Regulation to reflect upon the legislative intent and rationale behind the formulation of the particular legal requirement. Though the High Level Sodhi Committee Report specified that the notes are an integral and operative part of the Regulations, such mention / clarification does not find place in Regulations. This may impact the enforceability and reliability of these appendices to the Regulation.

12. As the interpretive notes appended to Regulation 2 (1) (l) of the Regulation of 2015 define the term ‘trading’ in a broader manner than mere ‘dealing’ (as used in SEBI Act, 1992), it goes beyond the scope of the scope of the Parent Act. Such an extension being outside the purview of the parent legislation, expands the scope of the legislated definition beyond the interpretative limits and may be called in question before a court of law.

13. The Regulation of 2015 define ‘trading’ in a very wide manner intending to curb the activities based on unpublished price sensitive information which are strictly not buying, selling or subscribing, such as pledging etc. when in possession of unpublished price sensitive information. Such a wide definition of trading is bound to give rise to uncertainty and ambiguity as to what all transactions can amount to trading.

14. The way ‘trading’ has been expanded in the note to Regulation 2 (1) (l) including pledge of shares has a huge profound impact on financing transactions and market as in case of taking financial assistance promoters are usually expected to pledge their shares to lenders of companies. The experts opine that the entire sector is going to be profoundly impacted if one is to put all the UPSI which it has in public domain before pledging the shares. Moreover, such a restriction is baseless as in a financing transaction, the financial companies, while lending money against pledged shares, is only concerned with its value.

51 SEBI (Prohibition of Insider Trading) Regulation, 2015, Reg; 5 (4).
based on the price discovery in the market and is not dealing on a proprietary basis but only taking security.

15. Regulation 3 (3) of Regulation of 2015 permits due diligence exercise (involving communication and sharing of UPSI regarding the merger and acquisition transaction), before acquiring a listed company to decide if the target company is a good buy for the acquirer, the potential difficulties, liabilities and danger involved in the acquisition, and the price at which acquisition should be culminated. However it is usual in such transactions for the acquirer not to proceed further with the acquisition or aborting the deal, if considered unfavorable even after carrying out of due diligence about which Regulation 3(3) is silent. So, the question arises as to fate of UPSI already shared with the acquirer for such aborted transactions. The acquirer will continue to be an insider and therefore should not trade in the securities of the target listed company while in possession of the UPSI, until the UPSI is generally made available to the public. But how company’s management and promoters are placed in the eyes of the law by virtue of sharing information as insiders with the acquirer is a question. The Insider Regulations are silent on this issue and a line of clarification from SEBI will set the issue at rest.

16. Permission to carry out due diligence under the Regulation in case of open offer requires first the Board of Directors to form an informed opinion about the deal being in best interests of the company. However, in a corporate structure, the real deal drivers is the management and if it approaches the board at a very early stage, the board, which is used to cooked deals and not unplanned ones, will not be in a position to establish, and particularly independent directors will be able to conclude that the transaction is in the best interest of the company at this stage. Moreover if the transaction in question is completely secondary transaction, the board may hesitate to form a view on whether selling by the promoter or a majority shareholder to somebody is in the best interest of the company when a competitive offer is still possible. Thus the directors will therefore have to do a tough balancing act between commercial considerations and their duties to the company and shareholders, leaving open the possibility of shareholders challenging the board’s decision to disclose UPSI. Due diligence requirement in other cases not involving an open offer requires that the UPSI be announced two days before the effectuation of the proposed transaction. Very often a deal has to be done on the basis of an average market price for the previous few weeks. When the UPSI is disclosed two days in advance, it changes the market dynamics and it changes the entire deal structure.

SEBI (Prohibition of Insider Trading), 2015, Reg. 3 (3) (i).
17. A very striking change that has been bought under the Regulation of 2015 has been communication of UPSI itself being made an offence. In the Regulation of 2015, it has been made abundantly clear that mere communication, even if not followed by trading, is an offence. This fundamental shift has made it tough for the companies and large corporate houses to monitor compliance of the Regulation who have been dealing with thousands of employees and large number of officials to ensure that there is no violation of the Regulation.

18. Another unintended consequence that the Regulation language may lead to is with regards the use of word ‘frequent communication’ in defining ‘connected person’. One can be in frequent communication with another person which is completely unconnected with company’s functioning but the Regulation virtually makes that person a connected person and if by chance that person were to trade during a period when some merger and acquisition transaction was impending, he has to prove his innocence now. It would be difficult situation for the person just because he is constant communication with some official of the company.

19. The Regulation of 2015 has even accentuated the pre existing ambiguity as to the requirement of establishment of mens rea in insider trading offence rather than resolving it. Proviso to Regulation 4(1) of Regulation of 2015 states that ‘provided that the insider may prove his innocence by demonstrating the circumstances including the following….’, followed by a set of inclusive or illustrated defenses which are available. Thus other than the specific carve outs as mentioned in the proviso which are illustrative in nature, the Regulation also permits the proving of innocence. The use of term ‘innocence’ implies absence of mens rea/intention to commit the offence. However, the note appended to the Regulation states; ‘reasons for which he trades or the purpose for which he applies the proceeds are not intended to be relevant for determining whether the person has violated the regulation’. So, they exclude that mens rea defense by saying that the reasons are not relevant. This is apparently a peculiar example where the Note and the Regulation contradict and complicate the ambiguity regarding requirement of mens rea even more.

SOLUTIONS AHEAD

The identification of problem though the major and most significant step of dealing with an issue; may all go in vain unless supplemented with an understanding of suggestions for way ahead. In order to check the difficulties posed by insider trading in India, SEBI needs to consider these suggestions:

58 The Regulation of 1992 did not create communication as an offence per se without any dealing on its basis. Dealing was a very critical part as reflected in the SEBI Press Release No. 43/2002 dated 22nd February, 2002 which categorically said that unless you deal with it, communicating is not an offense.

59 SEBI (Prohibition of Insider Trading) Act, 2015, Reg. 2 (1) (d).

60 In case of connected person, burden of proof lies on the connected person himself.
1. **Education / Training / Awareness** – Spreading awareness against the practice of insider trading and its ill effects among the general people can go a long way in curbing this abuse. In order to facilitate this, SEBI may publish an insider trading manual (booklet) and distribute it to the relevant section of the public either itself or through aid of various NGOs, stock exchange, companies or intermediaries, etc. and also regularly conduct programs / discussions / seminars to create awareness in the investors who get caught in such abuses about its harmful effect and how to protect themselves against such harmful activities. The ignorance is not only on the level of individuals but many organizations for which not only SEBI, but also the Central Government, directors and employees of every organization and company are to think of ways of educating people about this issue and its impacts. Moreover the company managements including professionals associated with companies must create awareness amongst the insiders of the company about the relevant laws and requirements so as to ensure due compliance with it.

2. **Corporate Governance / Prophylactics** - In order to ensure effective implementation of insider trading laws, at the grass root level, cooperation from companies is also needed. The companies must practice self-regulation and take prophylactic action because corporate governance is one of the pillars on which effective enforcement against insider trading stands. Constant vigilance and strict reporting and monitoring by companies over their directors and officers are the need of the day. Each company should adopt watertight insider trading code in its governance framework and ensure its strictest adherence as their first line of defence to address insider trading and the compliance officer should monitor the personal trading of employees in accordance with best practices and industry regulations.

3. **Multi Jurisdictional Insider Trading** – There has been need to extend the reach of Indian insider trading regulation beyond the national territories by amending the law in order to effectively guard the domestic market and investors from the impact of insider trading. In USA, this need has been satisfied by Section 27 (b) of the Securities Exchange Act, 1934 which confers extra territorial jurisdiction on the regulator. Such an extra territorial jurisdiction to SEBI will aid in dealing with insiders who try to evade the law by committing the act from beyond the territory of India.

Another aspect of this problem is ensuring successful investigation and prosecutions of such cases with transnational features by ensuring international cooperation between India and various other jurisdictions. The solution leers in the approach exercised by USA wherein SEC has entered into agreements with its foreign counterparts for mutual legal assistance in the cases of violation of securities law. Though India has entered into MoU and MLATs with other countries, but it requires more attention from India on this area by entering into more arrangements with other countries.

4. **Bounty** - SEBI must welcome any kind of tip that directs it to the discovery of insider trading being indulged in and it should also encourage people to share information with it.
relating to insider trading activities in progress. In USA, under Section 21A(e) of the Securities Exchange Act, SEC gives away rewards for what it terms as bounty to the individuals who provide them with any kind of information leading to the discovery of an insider trading scam.

5. **Private Right of Action** – Need of the time is to formulate the law as in US which provides a number of civil remedies in which civil actions can be maintained by private individuals under Rules 10b-5 and Rule 14e-3 of Securities Exchange Rules, 1942 and Section 16-b and Section 20-a of the Securities Exchange Act. If any person is injured / has suffered losses because of insider trading, the Indian law should provide him / her private right to obtain redress against the insider which shall essentially involve compensation to injured parties for losses caused to them. With the enforcement solely in hands of SEBI, the insider is in most cases acquitted scot-free or even when convicted, required to pay a paltry sum of money as penalty which is much less than the amount of profits that they might have actually made. As the end result, the insider walks away satisfactorily with the profits he has finally been left with.

6. **Consent Order** - It is suggested to do away with the use of consent mechanism in cases of insider trading so as to ensure that adequate deterrent effect of punishment sustains. Such an approach other than restricting the development of judicial jurisprudence on insider trading also is no disincentive for the insider as it makes them assume that insider trading involves low risks.

7. **Judicial** – The law in US has been able to tackle insider trading incidences by a strong interplay between two institutions, legislature and judiciary, both exhibiting extra ordinary dynamism in addressing the various problematic aspects in regulating insider trading. It is this dynamism and enthusiastic approach that we need to imbibe and replicate within our regulatory framework. The Indian judiciary should contribute to the field of evolving jurisprudence with regards insider trading by being committed to the purpose of punishing the violators of the pernicious activity. Till yet, the trend has been that the courts and the appellate body has been interpreting the law in a way that affords generous benefit of doubt to the alleged violators. This is evident from the manner in which SEBI’s rare findings on guilt have been overturned by SAT in insider trading cases starting from the case of Hindustan Lever till yet. The approach of Indian judiciary towards insider trading should be matched with USA where the judges contribute by sustaining insider trading convictions based on circumstantial evidence and pursuant to the federal sentencing guidelines, impose lengthy periods of incarceration.

8. **Preemptive / Anticipatory action** - The Indian legislature needs to bring a change in its approach of only punishing insider trading after it has occurred but should concentrate on

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61 See SEC v. Sargent, 229 F. 3d 68, 75 (1st Cir. 2000) (Circumstantial evidence, if it meets all the other criteria of admissibility, is just as appropriate as direct evidence.), quoting United States v. Gamache, 156 F. 3d 1, 8 (1st Cir. 1998).

its prevention by nipping it in the bud itself while it is being shaped up. The stock exchanges and SEBI should undertake pre-emptive action on creation of circumstances pointing at insider trading rather than taking action after the event has already occurred. For this, a surveillance system that will work to caution the public of likely insider trading needs be established. For example if there is a change of more than 10 per cent in the stock price for 3 consecutive days, there may be chances of some unfair dealing in that stock. The exchanges may then warn the public at large about possible insider trading on basis of such set up filter brackets depending upon unusual price movements. Such guidance can prevent the uninformed investors from incurring losses by dealing in such shares.

9. **Structural Issues** - The first solution to lack of effective enforcement of insider trading law is the call for further funds and manpower. Such a suggestion finds support in the fact that while SEBI staffs mere 643 persons in toto as its employees all over the country at its various offices, SEC employees 3958 persons. Moreover, SEBI has to look after the investigation of insider trading seriously by formulating its own team of professionals who shall investigate the crime efficiently. Guidance can be taken from US example where the SEC established the Market Abuse Unit which aims to be proactive by identifying patterns, connections and relationships among traders and institutions at the outset of investigations.

10. **Merger and Acquisition** - Considering the fact that the period just before the announcement of merger or acquisition or any other corporate restructuring is most favorable for the commission of insider trading, India also needs a prohibition similar to Rule 14e-3 of the Securities and Exchange Rules, 1942 in US so that there can be special attention on the trades conducted during such periods.

11. **Media hype** - Hyping up and advertising cases relating to insider trading are suggested as one of the key methods to influence the insiders and others to avoid committing insider trading. It should be in SEBI’s portfolio to hype up successful insider trading prosecutions in India in the media.

12. **Mens Rea** - The need of the time is to state with clarity the requirement of mens rea in insider trading prosecution which has been left unaddressed since a long time. There is no clear interpretation for the criminal intent or mens rea required for an insider trading violation in Indian law. Both in UK and USA mens rea is considered as essential ingredient for the offence of insider trading although the burden of proof is shifted to the defendant to prove that he had a different intention to undertake the trade.

13. **Clarity as to nature of offence** - There is absence of any decisive outlook of SEBI or Indian courts on the question if violation of SEBI Regulation is civil or criminal offence.

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In *Rakesh Agarwal v. SEBI*65, the SAT acted on the basis that insider trading is a criminal offence. However, in the case of *Cabot International v. SEBI*66, the Bombay High Court gave the finding that all violations of SEBI Act and the Regulations made there under are civil in nature which was upheld by the Supreme Court while deciding that the imposition of penalties under Chapter VIA of SEBI Act does not require *mens rea* in *SEBI v. Shriram Mutual Fund and Another*67. Therefore, there needs to be clarity and consistency in the opinions as to whether the offence of insider trading is civil or criminal offence. The necessary fundamentals required to establish a case of insider trading needs to be clearly differentiated for a civil or criminal action under the Indian law. Guidance can be taken from US law where insider dealing qualifies for a criminal penalty when the defendant’s action expressly constitutes a willful violation of the securities crime under Section 32 (a) of the Securities Exchange Act, 1934.

14. Performance Audit – SEBI, in order to be sensitized of where more efforts are required, need a timely thorough performance audit of its processes, structure and practices.

15. Limit on Investigatory Powers – The limit on investigatory power of SEBI (power to call information, produce books, or registers, or other documents, or record before him or any person authorised by it in this behalf ambit) covering only persons as mentioned in the Section 11B (3) of the Act68 should be removed as it handicaps SEBI in situations where the person whose assistance is required does not fall within the ambit of the persons mentioned in the sub section.

16. Checking the ambiguities - Checking the ambiguities in the Regulation of 2015 as below is required:

i. Clarity as to as to what category of traders can avail the entitlement to formulate a trading plan by defining the term ‘perpetually in possession of UPSI’ is required.

ii. The term ‘non-discriminatory’ as used in Regulation 2 (1) (e) of the Regulation of 2015 in defining unpublished price sensitive information needs to be clarified.

iii. The phrases ‘legitimate purpose’, ‘performance of duty’ and ‘discharge of legal obligation’ need to be clarified especially when the same is part of the defence from the main charging provision of the Regulations.

iv. The term ‘proposed to be listed’ used as an adjective to securities as used in Regulation 3 and 4 needs to be clarified especially when the same is part of the main charging part of the Regulations.

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67 AIR 2006 SC 2287.
68 Intermediary or persons associated with the securities market.
v. Precincts of Regulation 2 (1) (l) defining what all transactions can amount to 'trading' must be defined to a sufficient degree.

vi. The use of word ‘frequent communication’ in defining ‘connected person’ in Regulation 2 (1) (d) may be guarded against catching a person who is in frequent communication with another person which is completely unconnected with company’s functioning.

vii. The Regulation of 2015 effect of accentuating the pre existing ambiguity as to the requirement of establishment of *mens rea* in insider trading offence (through the contradiction between the Note and the Regulation) needs to be clarified.

viii. The ambiguity regarding the enforceability of the Notes may be remedied.

ix. Ambiguity in Regulation 3(3), regarding the fate of UPSI shared while carrying out due diligence in a transaction that has been aborted, needs to be remedied. How company’s management and promoters are placed in the eyes of the law by virtue of sharing information as insiders with the acquirer is a question and a line of clarification from SEBI will set the issue at rest.

17. **Other proposed changes in the Regulation**: Certain amendments that may be made in the law relating to insider trading are:

i. Inclusion of ‘public servants, persons holding statutory positions, servants of SEBI’ itself in the definition of connected person under the Regulation of 2015.

ii. The Regulation of 2015 should provide guidelines on how long SEBI can take with its investigations, before passing its orders.

iii. Considering the seriousness of the offence of insider trading and the complexities that go into establishing its charge, the legislature must specify a specific procedure that guards the investigation in cases of insider trading.

iv. 6 month law in India with regard to ‘connected person’ definition in Regulation of 2015 is required to be altered as it has no reasonable basis for this fixation of time period. Instead it may provide that a former insider is not allowed to use the UPSI for trading of securities except when they can prove that such trading was not based upon any information they had attained as an insider.

v. The Regulation may suggest that the contract of sale or purchase by an insider be declared void by the counterparty of the trade.

vi. To endure an impartial and proper performance of duty, the compliance officer may be appointed by the SEBI or the Government and should necessarily be under the employment of the Government.
vii. A single entity shouldering the onerous responsibility as on Compliance Officer increases chances of default in their duty. The Regulation should provide for separate posts dividing the arena of responsibility between them.

viii. The impracticability of requirement of trading plan under Regulation 5 of Regulation of 2015 like no leverage for emergent situations, speculation in case of pre disclosure of trading plan, envisioning it in advance as long as 18 months, needs to be addressed to so as to ensure its success.

ix. With the ill effect that the inclusion of ‘pledge’ in definition of trading will cast over financial transaction between companies and the financial institutions, it may be suggested that such an inclusion may be done away with as it does not solve any purpose.

x. SEBI should issue guidance with respect to ‘due diligence’ to guarantee that the Regulations promote legitimate transactions while reducing the prospects for abuse. Some areas that SEBI would need to clarify are: (1) Procedure for providing UPSI: The procedure adopted for selective communication of UPSI in connection with a due diligence exercise needs to be cautiously carved out so as to make certain that both parties have clear and same understanding as to what information is UPSI and the implications of receiving it. There also needs to have great clarity on precisely which information constitutes UPSI and the expected time period during which they cannot trade. It must be ensured that the potential investors are not provided with UPSI on the potential transaction unless they agree to the confidentiality obligations and trading restrictions to minimize the risk of inadvertently providing UPSI; (2) Manner of disclosure: The Regulations do not lay down the form in which a company would communicate the UPSI to the market prior to the transaction taking place and thus has left it to the discretion of the company’s directors. In such disclosure, only non-public price sensitive information is to be disclosed to the market and not all the non-public information that has been shared with investors during the course of due diligence. Going through the information disclosed for due diligence to the potential investors to establish the extent of the information that constitutes UPSI may prove to be a challenging task for directors and leaves much scope for interpretation by a company’s directors. SEBI, in a need to check the companies’ interpretation, may provide additional guidance.

18. Technology and Surveillance Technique - A stronger, thorough and proficient investigative and prosecutorial techniques that help SEBI in its investigations and ensures effective action against insider trading is needed. SEBI should overhaul the infrastructure and machinery used by it and envisage beyond the traditional investigative mechanism by employing modern and sophisticated mechanisms to detect, investigate and establish the violation. Any insufficiency of human resources or technological advancement can hurt
accomplishment of this end and thus not only must proficient staff be employed by SEBI but they must be supplied sufficient resources to conduct successful surveillance and prosecution. Finally all this shall require accentuated investments in field of surveillance related information technology and manpower which in SEBI’s case may be higher because of the fact that it would be dealing with far more data compared with the other markets.

SEBI should be endowed with more investigative powers to access electronic records like USA especially wiretapping. As on the worldwide scale, electronic evidence in form of telephonic conversations, emails, etc. has been admitted by the courts as evidence, change has to be bought in India also for improvement of state of market affairs.

In India, as no such cases have been witnessed where SEBI and other government investigation agencies (Central Bureau of Investigation) has acted together in investigation of cases involving insider trading. Assistance, if any, has been limited only to sharing of primary information. The need of the hour is to ensure such assistance not only at the information level but at all levels, even for active investigative activity. USA has been availing assistance from the other official government investigative agencies in carrying out investigation into insider trading matters like Federal Bureau of Investigation which aids SEC in inspecting the instances of insider trading in a more comprehensive and expeditious manner.

19. Finally, preventing insider trading is not about a set of rules or filling alleged loopholes. It is about a determination to go after illicit trades. Until SEBI shows it is serious about checking insider trading, the activity will continue to thrive unchecked.

Despite the fact that SEBI as a regulator and the Government has been dealing with this menace seriously with time and again introduction of updated laws and efforts to firm up the investigative efforts, the desired effect of the law has not been achieved with insider trading still being practiced rampant in the capital market. What is required in such a situation is that the law as it stands today should be evolved and improved keeping in mind the interests of the investors and the loss suffered by them to make it more deterrent in a way that insiders are prevented from misusing the confidential information in any manner possible. To achieve this end and on way forward for increased efficiency of the Indian financial system, the need of the hour is to adopt certain statutory and other changes as reflected in the suggestions above made. It is hoped that if the above suggestions are given due weight age, the problem of insider trading in India can be tackled in a better way and it could help the economy in providing the basic economic services to the investing public, so as to maintain their confidence and faith in the securities market. However, if the above suggestions are not addressed promptly and the issue is left to time, the menace of insider trading, threaten to injure the efficiency and integrity of the securities markets. The above efforts may appear to be daunting initially but it may be said, in the words of John F. Kennedy “All this will not be finished in the first hundred days, nor in the first thousand days, nor perhaps in our lifetime on this planet earth, but let us begin!”