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Insider Trading Regulations - A Primer

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Lawyer of the Year" by Legal Era (2013). He was listed in the Lex Witness 'Hall of fame: Top 50' individuals who have helped shape the legal landscape of modern India (August 2011). Nishith Desai has been the recipient of Prof. Yunus 'Social Business Pioneer of India' – 2010 award. He has been voted 'External Counsel of the Year 2009' by Asian Counsel and Pacific Business Press and the 'Most in Demand Practitioners' by Chambers Asia 2009. He has also been ranked No. 28 in a global Top 50 "Gold List" by Tax Business, a UK-based journal for the international tax community.

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1. Introduction

"There is no other kind of trading in India, but the insider variety" remarked a former president of the Bombay Stock Exchange in 1992. Insider trading has utterly no place in any fair-minded law-abiding economy – stated the then Securities Exchange Commission ("**SEC**") Chairman Mr. Arthur Levitt in 1998. Between these two extreme quotes lies the entire debate on insider trading.

In simple terms, insider trading is the act of trading, directly or indirectly, in the securities of a publicly listed company by any person, who may or may not be managing the affairs of such company, based on certain information, not available to the public at large, that can influence the market price of the securities of such company. An insider, who has access to critical price sensitive information with respect to a given company, may tend to use such information to his economic advantage, severely impairing the interests of a public shareholder who is not privy to such information.

The United States of America was the first country to formally enact a legislation to regulate insider trading.[1] This decision of the US Congress had surprised many around the world especially because in certain other parts of the world, access to inside information and its use for personal benefits were regarded as perks of office and the benefits of having reached a high stage in life. Imbibing this sentiment, the restriction on insider trading was mocked as 'the crime of being something in the city' by the Sunday Times of UK in 1973.[2] However, over the years, most of the jurisdictions around the world have recognized the requirement to restrict insider trading in one form or the other and have accordingly put in place legal restrictions to this effect.

The discussion on insider trading invariably boils down to a conflict between 'fairness' and 'efficiency'. It certainly is unfair to permit trading of listed securities when individuals are differently informed on the affairs of a company. When insiders use price sensitive privileged information to reap profits or to avert losses, the other investors or shareholders may suffer severe economic disadvantage. Like the US, most of the countries have put in place regulatory measures in one form or the other to restrict insider trading.

India was not late in recognizing the detrimental impact that insider trading can inflict upon the rights of the public shareholders, corporate governance in India and the financial markets overall. The first step towards regulation of insider trading in India was taken in 1948 by constituting a committee under the chairmanship of Mr. P.J. Thomas to evaluate restrictions that can be imposed on short swing profits. As on date, Securities and Exchange Board of India ("**SEBI**"), the market watchdog regulates insider trading through the SEBI Act, 1992 ("**SEBI Act**") and the SEBI (Prohibition of Insider Trading) Regulations, 1992 ("**Insider Trading Regulations**") issued under the SEBI Act.

While the legal regime including the enforcement mechanism relating to prevention of insider trading is still evolving, cases like the recent conviction of corporate bigwigs like Mr. Rajat Gupta and Mr. Raj Rajaratnam in the US prove that the prohibition on insider trading is not merely a paper tiger. This paper analyses the Insider Trading Regulations and its enforcement in India. Chapter I is a brief introduction to the paper and Chapter II explains the concept of insider trading and the necessity to regulate the same. While Chapter III is an examination of the provisions of the Insider Trading Regulations, Chapter IV delves into the options available to the parties who are affected by insider trading. Chapter V is a comparative analysis between laws on insider trading in India with US and UK and Chapter VI covers certain important judicial pronouncements and precedents that will help the reader in better understanding the practical implications of the law in India.

1. Securities and Exchange Act, 1934
2. http://expressindia.indianexpress.com/fe/daily/20000821/fc021044.html

2. Exploring the Concept and the Necessity to Regulate

"Insider trading" is a term subject to many definitions and connotations and it encompasses both legal and prohibited activity. Insider trading takes place legally every day, when corporate insiders – officers, directors or employees – buy or sell stock in their own companies within the confines of company policy and the regulations governing this trading.[3]

The distinction between legally permitted share trading by insiders and what is illegal needs to be carefully understood. The presumption that an insider who is involved in the management or affairs of a public company would have access to privileged information is but natural. However, that cannot absolutely preclude insiders from acquiring or alienating any securities. Such a blanket prohibition would not be reasonable and would be in violation of the legal rights of insiders and would defy the logic of freely tradable securities. More importantly, such a prohibition may not even be practically viable as it would be irrational to stop promoters of a company from dealing in their securities. This is exactly where a distinction is required to be drawn between what is permitted and what is not.

The restriction is on corporate insiders directly or indirectly using the price sensitive information that they hold to the exclusion of the other shareholders in arriving at trading decisions. There is absolutely no restriction on insiders in trading in securities of the company if they do not hold any price sensitive information that the public is not already aware of. Upon the price sensitive information being disclosed to the market, the share prices would surge if the price sensitive information is perceived to be positive and the share prices would plummet if the price sensitive information is perceived to be negative. During that short while, between insiders receiving the price sensitive information and the public disclosure of that information, insiders attempt to deal in securities such that they can take advantage of the market reaction that is about to follow.

Any such transaction backed by non-public private information is misuse of the information that they have and also the position that the insider holds in the company. The basis of public participation and infusion of public funds in a company is the fiduciary duty that the management and the promoters of the company owe to the public shareholders. US courts have categorically mentioned that *the insiders who receive UPSI by virtue of their connection with the company and for corporate purposes only, such insiders owe a fiduciary duty (or a duty akin to a fiduciary duty) to the company not to misuse or misappropriate such information for an unlawful purpose i.e. to make secret profits or personal gains for themselves.*[4] The public shareholders rely on the management and the promoters to adhere to highest standards of corporate governance in managing the company and its affairs. Any abuse of position or power by the insiders for personal benefits, monetary or otherwise, is a fraud on the public shareholders who legitimately expect the management to run the company in the best interests of the public shareholders.

As discussed above, permitting few people to take advantage of Unpublished Price Sensitive Information ("**UPSI**") before it is disclosed to the others is a grave compromise on fairness and equity. This will not only affect the performance of the company but also the integrity of the financial market. Any market that is not fair in its dealings or cannot effectively control unfair dealings in companies will not be an attractive investment

3. Mr. Thomas C. Newkirk, Associate Director, Division of Enforcement, SEC on September 19, 1998 http://www.sec.gov/news/speech/speecharchive/1998/spch221.html
4. Chiarella v. US 455 US 222

destination for investors. Rampant market manipulation and fluctuations will be frowned upon by the investors and will dry up the inflow of investment into such markets.

Making systematic gains from trading on the basis of material inside information, thereby turning an informational advantage into a pecuniary gain, is also a violation of the proprietary rights of the person owning such information. Information has value and can also generate value.

Since, absolute prohibition of share trading by the insiders is not tenable; insider trading is restricted and monitored through a series of measures in different jurisdictions. Some of the key measures that have been adopted around the world are:

I. Disclosure

Typically, disclosure is mandated at two levels; one is the immediate disclosure of any material information and the other is the disclosure of transactions undertaken. While the former is meant to prevent insider trading, the latter is for revealing insider trading, if any. Insiders and the company are obligated to disclose all the price sensitive/ material information to the public at the earliest so that a level playing field is achieved amongst all the shareholders and proposed investors. When the information is equally available to all, there is no distinct advantage that insiders can capitalize on.

II. Trading restrictions

Insiders may be restricted from dealing in the securities, directly or indirectly, during certain specific time periods to stop them from taking advantage of having the material information before the public or the other shareholders. It goes without saying that, the insiders are prohibited from dealing in securities when they are in possession of or have access to material non-public information. Additionally, insiders may also be prohibited from dealing in securities for a certain period after the information is disclosed to the public. The insiders can place the buy/ sell orders simultaneously with the disclosure of information or immediately thereafter. In that event, insider trading would have happened in that very short spell between the disclosure of information and the public reaction to it. Though, technically this may constitute insider trading, the insiders are still exploiting their access to information to touch the finish line before others. Therefore, the trading window should remain shut for the insiders for a certain period immediately after the disclosure of the material information. This will ensure effective dissemination of the disclosed material information before the insiders jump into action.

A stricter measure would be permitting insiders to deal in the securities only through a specifically designated trading window that is controlled and monitored by the company or the stock exchange.

III. Pre-clearance of Trades

A condition may be imposed on the insiders that they can deal in the securities of the company only after obtaining a prior approval in accordance with the procedure and policy prescribed by the company in that regard. In addition, it may also be prescribed that a pre-approved trade will have to be undertaken within the stipulated time period, failing which the approval would lapse.

3. Regulating Insider Trading – An Indian Perspective

I. Insider Trading in India

India was not late in recognizing the harm that insider trading can inflict upon the rights of the public shareholders, corporate governance in India and the financial markets. The first concrete attempt to regulate insider trading was the constitution of the Thomas Committee in the year 1948, which committee evaluated the global practices in restricting insider trading *inter alia,* the Securities Exchange Act, 1934. Pursuant to the recommendation of the Thomas Committee,[5] sections 307 and 308 were introduced in the Companies Act 1956. This change paved way for certain mandatory disclosures by directors and managers, but was not very effective in achieving the objective of preventing insider trading.

Subsequently, the Sachar Committee and the Patel Committee were constituted in the years 1978 and 1986, respectively, to recommend measures for controlling insider trading in India. The Patel Committee had defined insider trading as *"the trading in the shares of a company by the person who are in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others".* Along with other recommendations, both the Sachar Committee and the Patel Committee had recommended the enactment of a separate statute for curbing insider trading.

The Abid Hussain Committee constituted in 1989 had recommended that a person guilty of insider trading should be penalized, both in the form of civil and criminal proceeding. A separate statute for prevention of insider trading was one of the recommendations of the Abid Hussain Committee too. On the basis of the recommendations made by these committees, a comprehensive legislation, 'SEBI (Insider Trading) Regulations, 1992' was promulgated and brought in to force. This regulation was substantially amended in the year 2002 to plug certain loopholes revealed in the cases of *Hindustan Lever Ltd. v. SEBI*[6] and Rakesh *Agarwal v. SEBI*[7] and was renamed as the SEBI (Prohibition of Insider Trading) Regulations, 1992. Ever since then, the Insider Trading Regulations have been amended 5 (five) times and the last amendment was in the year 2011.As on date, SEBI, the market watchdog regulates insider trading through the SEBI Act and the Insider Trading Regulations.

II. Prohibition on Insider Trading

Regulation 4 of the Insider Trading Regulations stipulates *that any insider who deals in securities in contravention of the provisions of regulation 3 or 3A shall be guilty of insider trading.* Therefore, in India, the test of whether a person is guilty of insider trading is determined on whether that person has breached Regulations 3 or 3A of the Insider Trading Regulations.

Regulation 3 of the Insider Trading Regulations prohibits insider trading in the following manner:

"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 in possession of any unpublished price sensitive information; or*

ii. *communicate or 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:*

5. Report on the Regulation of the Stock Exchanges in India – 1948 (P J Thomas), available at, http://www.sebi.gov.in/History/HistoryReport1948.pdf
6. (1998) 18 S.C.L. 311AA
7. (2004) 1 CompLJ 193 SAT, 2004 49 SCL 351 SAT

> ***Provided*** *that nothing contained above shall be applicable to any communication required in the ordinary course of business or profession or employment or under any law."*

Regulation 3A of the Insider Trading Regulations provides that:

"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."

While Regulation 3 of the Insider Trading Regulations prohibits insider trading by all insiders in general, Regulation 3A is a specific prohibition on insider trading by companies.

The prohibition is twofold: (i) insiders cannot deal in the securities of a listed company when in possession of any UPSI; and (ii) insiders cannot pass on the UPSI, in any manner, to any other person, who deals in securities of a listed company when in possession of such UPSI. However, communication of UPSI required in the ordinary course of business or profession or employment or under any law is exempt from the scope of Regulation 3.

Though Regulation 3A is a specific prohibition applicable only to companies, the prohibition under Regulation 3 is applicable on all "persons" and is applicable to companies that may also be insiders.

SEBI has clarified in the Adjudication Order dated February 28, 2011 in the matter of Mr. Naval Choudhary[8] that the word 'person' is a generic term and it may take in its ambit, when construed in common parlance, not only individuals but also firms, associations or bodies corporate. Section 3(42) of the General Clauses Act, 1987 gives an inclusive definition of the term, according to which "person" shall include any company or association or body of individuals, whether incorporated or not.

i. Who is an Insider?

Regulation 2(e) of the Insider Trading Regulations define an 'insider' as any person who,

i. 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 UPSI in respect of securities of a company, or

ii. has received or has had access to such UPSI."

SEBI has clarified in the matter of *KLG Capital Services Limited,*[9] that a person would qualify as an "insider" under the Insider Trading Regulations, if such person fulfills all or any of the following conditions:

a. the person should, have or have had connection or deemed connection with the company and by virtue of such connection should reasonably be expected to have access to UPSI; or

b. the person has received or has had access to UPSI.

The definition of insider envisages two kinds of insiders and prescribes different standards for each of them. The first kind consists of persons who are connected[10] or deemed to be connected with the company and who are reasonably expected to have access to UPSI on account of their connection with the company. The other kind consists of persons who are **not** connected or deemed to be connected with the company but have actually received or had access to UPSI. Thus, a person is an insider, even though he may not be connected or deemed to be connected with the company, if it is proved that such person has received or has had access to any UPSI.

SEBI had amended the definition of 'insider' under Regulation 2(e) in 2008 vide the SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2008.[11] Prior to this amendment, the definition of 'insider' implied an interpretation

8. Adjudication Order No. PB/ AO- 15/ 2011
9. WTM/MSS/ISD/18/2009
10. The term 'connected person' is also defined under the Insider Trading Regulations. Please refer to the next question for detailed analysis of the terms, 'connected person' and 'deemed connected person'.
11. Notification No. LAD-NRO/GN/2008/29/44801 dated November 19, 2008

that connection with the company (actual or deemed) was a mandatory pre-requisite for any person to be an 'insider'. Such an interpretation could severely restrict the scope of the term 'insider' and could enable persons not connected or not deemed to be connected with the company, but in possession of the UPSI, to deal in shares of the company with impunity. Securities Appellate Tribunal ("**SAT**") tried to plug this loophole in matters, *Rajiv B. Gandhi, Sandhya R. Gandhi, Amishi B. Gandhi v. SEBI*[12] and *Dr. Anjali Beke v. SEBI*[13] by clarifying that, *"a person who has received UPSI or who has had access to such information, becomes an insider". He need not be a person connected with the company.* Subsequently, SEBI amended Regulation 2(e) to the present position to avoid any ambiguity in the definition.

It is interesting to note that Regulation 2(e)(i) of the Insider Trading Regulations refers to *UPSI in respect of securities of a company.* Would this mean that access to UPSI pertaining to any matter other than the securities of the listed company, like information on a proposed business transfer, not make a connected person an insider?

This could not be the case and specific reference to "in respect of the securities of a company" appears to be a drafting oversight or it could be because all UPSI will, directly or indirectly have a bearing on the securities of the company. In the matter of *S. Ramesh, S. Padmalata v. SEBI*[14], SAT has treated it as reference to access to any UPSI.

ii .Who is a 'Connected Person'?

Regulation 2(c) of the Insider Trading Regulations defines 'connected person' as any person who,

i. is a director[15] of a company, or is deemed to be a director of that company by virtue of section 307(10) of the Companies Act, 1956, 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 UPSI in relation to that company.[16]

Regulation 2(h) of the Insider Trading Regulations enlists the persons who are deemed to be a connected person. This *inter alia* includes:

1. Other companies under the same management or group, or any subsidiary[i];
2. Intermediary as specified in section 12 of the SEBI 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;
3. 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 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 has a fiduciary relationship with the company;
4. Member of the board of directors, or an employee, of a public financial institution as defined in section 4A of the Companies Act, 1956;
5. An official or an employee of a self-regulatory organization recognised or authorised by the board of a regulatory body;
6. Relatives of any of the aforementioned persons or of the connected person;
7. Banker of the company; or
8. Concern, firm, trust, hindu undivided family, company or association of persons wherein any of the directors or deemed directors of the company, or any of the persons mentioned in 6 or 7 above having more than 10% of the holding

12. Appeal Number 50 of 2007
13. Appeal No.148 of 2005
14. Appeal No. 163 & 165/03
15. As defined in section 2(13) of the Companies Act, 1956
16. Explanation to the Regulation 2(c) of the Insider Trading Regulations states that the words 'connected person' shall mean any person who is a connected person six months prior to an act of insider trading.
i. Group for this classification would be as defined under section 370 (1B) or section 372 (11) of the Companies Act, 1956 or section 2 (g) of the Monopolies and Restrictive Trade Practices Act, 1969, as the case may be.

or interest.

Determination of connected person is one of the criteria for determination of who an insider is under the Insider Trading Regulations. The separate definitions used in Regulations 2(e) and 2(c) of the Insider Trading Regulations give the impression that there can be connected persons who are not insiders. However, a closer look at these definitions highlight that there exists certain overlap between these two definitions in certain respects.

To elaborate, Regulation 2(c)(ii) of the Insider Trading Regulations classifies *persons who are officers or an employees of the company or persons having a professional or business relationship with the company (temporary or permanent),* ***and*** *who may reasonably be expected to have an access to UPSI in relation to that company as* 'connected persons'. Regulation 2(e) states that any connected person who is reasonably expected to have access to UPSI in respect of securities of a company shall be an insider. To that extent, the moment a person becomes a connected person under Regulation 2(c)(ii) such person shall also automatically become an insider without having to fulfill any other conditions. Please note that this overlap between "connected person" and "insider" would arise only if the "connected person" is a "connected person on account of Regulation 2(c)(ii) and not on account of Regulation 2(c)(i).

A combined reading of Regulations 2(e), 2(c) and 2(h) of the Insider Trading Regulations reveal that any connected person or deemed connected person shall become an insider when there is a reasonable expectation of that person having access to UPSI in respect of securities of a company. It is important to note that here the test is not whether the connected person or deemed connected person has UPSI in fact, but the establishment of a reasonable expectation of them having access to UPSI shall be enough.

In the event a person is not a connected person or a deemed connected person under the Insider Trading Regulations, then the test is the factual determination of whether such person has received or has had access to UPSI relating to the company. In the matter of *SEBI v. Shri A.L. Shilotri*[17]*,* the SAT has clarified that a person who is not a connected person will be an insider if he had access to UPSI. It is to be noted that the access of a person to UPSI is relevant but in case of a connected or deemed connected person, the test is stricter. Mere reasonable expectation of access to UPSI can make connected person or deemed connected person an insider.

iii. Connection with one Company and UPSI of Another Company

Per Regulation 2(e)(i) of the Insider Trading Regulations, a person is an 'insider', if he is connected with **the company** and is reasonably expected to have access to UPSI in respect of securities of **a company.** The use of words **the company** in one place and **a company** at the other place, implies that the UPSI need not be of the same company with which the person is connected or is deemed to be connected. Vide the amendment dated February 20, 2002, the word *"the"* was substituted by the letter "a" in the second part of Regulation 2(e)(i) where reference is made to UPSI. To illustrate, a person would be an "insider" if he / she is the director of a company X and by virtue of his office in company X, he / she can reasonably be expected to have access to UPSI in respect of securities of another company Y.[18]

SEBI has explained in the matter of *Mr. V.K. Kaul,*[19] that a person who is connected or deemed to be connected with the company can be an insider if he / she, on account of such connection, can reasonably be expected to have access to UPSI of that particular company or any other company. It is important to note that this proposition presumes a nexus between the connection that the person has with the first company and the reasonable expectation of him

17. Group for this classification would be as defined under section 370 (1B) or section 372 (11) of the Companies Act, 1956 or section 2 (g) of the Monopolies and Restrictive Trade Practices Act, 1969, as the case may be.
18. Appeal No. 31/2004 dated May 21, 2004
19. SEBI in the Adjudication Order No.ID-6/OCPL/VK/AO/DRK/AKS/EAD-3/301/67-11 against Shri V.K. Kaul

having access to UPSI of any other company. As mentioned above, the critical determination here is whether the reasonable expectation of access to UPSI is **by virtue of** the connection that the person has with the company.

iv. What is Price Sensitive Information?

Regulation 2(ha) of the Insider Trading Regulations defines 'price sensitive information' ("**PSI**") as,

> *"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; and
vii. significant changes in policies, plans or operations of the company."

For any information to be price sensitive, the information (i) has to relate to the company, directly or indirectly; and (ii) should have the capability to materially affect the price of the securities of the company when disclosed to the public. Possession of any and every information that relates to the company cannot stop an insider from trading in securities of that company; and therefore, what is of importance is the possession of information that can materially impact the market price of the securities. If the information pertaining to the company can influence the price of the securities then such information is PSI. The ability of certain information to be price sensitive would depend upon a combination of factors like the nature of information, the extent of information, timing, etc.

SAT has clarified on multiple occasions that an evaluation of the nature of the information is critical to determine whether it is price sensitive or not. Information pertaining to the normal course of business operations of a company cannot be price sensitive as the company is expected to undertake such activities as part of its business. Information of sale of the shares held by a manufacturing company in another company is price sensitive but similar information may not be price sensitive in case of an investment holding company that buys and sells shares on a regular basis. In the case of Gujarat NRE Mineral Resources Ltd. vs. SEBI[20], SAT held that for an investment company whose business was only to make investments in the securities of other companies, earning income by buying and selling securities is the normal activity of the investment company and every decision to buy or to sell its investments would have no effect on the price of the securities of the company. By way of an illustration, SAT observed that if a manufacturing company were to sell its product or buy raw material, it would be a part of its normal business activity and would not be PSI.

Similarly, in the recent case of Anil Harish v. SEBI[21], SAT held *that when a company which is in the business of infrastructure projects, bags an order in the normal course of its business, although it may be required to give intimation to the stock exchanges under Regulation 36(7) of the Listing agreement, the information need not necessarily be price sensitive. It was further held in the matter that when a company, having contracts worth Rupees Ten Billion pending with it for execution, bags a few new projects through the tendering process such information need not necessarily be price sensitive.*

On the contrary, price of the shares for the purpose of acquisition of substantial shareholding of a

20. Appeal no. 207 of 2010 decided on 18.11.2011
21. Appeal No. 217 of 2011 Date of decision: 22.06.2012

company has been held to be 'PSI'.[22] Similarly, information regarding the failure of a proposed deal has also been rendered as 'PSI'.[23]

With respect to the extent of information required to make it price sensitive, it is to be noted tion price sensitive. For instance, information on the probability of a merger between the company and another company has the ability to influence the price of the securities even when the exact share swap ratio or valuation remains unknown. Similarly, the mere information of the proposed rights issue by the company is price sensitive even without the exact price of issue being known.

Particular information may not be price sensitive in perpetuity and the timing of the information and the time of trade are very important in ascertaining whether the information was price sensitive at the time of trading. For instance, PSI will cease to be so after it is in the public domain.

v. When is Price Sensitive Information Unpublished?

PSI will remain "unpublished" for the purposes of the Insider Trading Regulations if such information is not published by the company or its agents and is not specific in nature.[24] Speculative reports in print or electronic media shall not be considered as published information.

SEBI has *clarified that unpublished means information which is not published by the company or its agents or which is not made public in print or electronic media and is not specific in nature. The information published by a company or its agents in any newspaper or any print or electronic media as specified which is specific in nature with an objective to make it known to the investing public, would be a published information or otherwise unpublished.*[25]

vi. Should the Insider Deal in Securities?

The offence of insider trading can occur only and only if the insider has dealt in the securities of a listed company, directly or indirectly, when in possession of UPSI. Regulation 2(d) defines "dealing in securities" *as 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.* There is no prohibition on an insider holding or having possession of UPSI; but an insider is prohibited from dealing in securities of a company 'in reliance of' or 'on the basis of' such UPSI. To that extent, it is critical to determine in an insider trading investigation whether the insider has dealt in securities of the listed company or not.

The term *dealing in securities* is widely worded to bring under its ambit all forms of transactions in connection with the securities including subscription, purchase, sale, agreement to undertake the purchase or sale or any other dealing as principal or agent. Purchase or sale can be direct or through any intermediaries like stock brokers.

Regulation 3 states that:
"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 in possession of any unpublished price sensitive information; or
ii. communicate or 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."

SEBI has clarified that *an insider being in possession of UPSI is prohibited with respect to (i) dealing; (ii) communicating; (iii) counseling; and (iv) procuring in or about securities of a*

22. S. Ramesh and S. Padmalata Asis Bhaumik v. SEBI [2005] 59 SCL 521 (SAT)
23. Kemefs Specialities Pvt. Ltd. v. SEBI – Appeal No. 54/2011, SAT order dated 21.07.2011
24. Regulation 2(k) of the Insider Trading Regulations
25. Adjudication Order dated February 28, 2011 in the matter of Mr. Naval Choudhary; and Adjudication Order dated February 28, 2011 in the matter of Mr. Neeraj Jain

company, directly or indirectly. Similarly, under clause (ii) of Regulation 3 a person to whom UPSI is communicated is prohibited to deal in securities. Communication may be written or verbal and the communication of information by an insider to any other person even without the latter asking for it would be sufficient to bring the insider within this prohibition. The words 'directly or indirectly' denote that communication, counseling or procuring of such information may be done directly by the insider himself or through any other person or mode. 'Counsel' means advise or consultation and 'procure' means obtain, acquire or bring about. An insider who counsels or procures someone else to deal in securities will be guilty of contravention of this provision if the latter deals in securities. In nut shell, insider trading is indulged in by an insider by passing onto any other person UPSI in his possession enabling such person to deal in securities.[26]

Regulation 3 places dual restrictions on an insider; one is a prohibition on dealing in securities of a listed company in the event that he is in possession of UPSI and the other is prohibition on communicating, counseling or procuring the UPSI to another person which person shall then not deal in securities. While the first restriction is a fairly straight forward prohibition on insider trading, the second restriction has two limbs to it. The insider is prohibited from communicating the UPSI to another person and such recipient is further prohibited from dealing in securities of a listed company when in possession of such passed on UPSI. The language of Regulation 3 imposes a strict prohibition on an insider in sharing UPSI with another person but that prohibition is further qualified by the condition that the recipient should not deal in securities while in possession of the UPSI received. Therefore, mere disclosure of UPSI by an insider to another person will not tantamount to insider trading so long as the recipient does not deal in securities while in possession of the UPSI. However, the disclosure of UPSI by an insider to another person could in itself be a violation of insider's confidentiality obligations.

vii. Should the Dealing in Securities be on the basis of UPSI?

There has been a lot of debate on whether the insider should deal in securities on the basis of UPSI to commit insider trading. One school of thought suggests that an insider is guilty of insider trading only if the insider has dealt in securities, directly or indirectly, on the basis of or in reliance of the UPSI that the insider held. In other words, the UPSI should actually motivate the insider to deal in securities and mere possession of some UPSI at the time of trading will not result in insider trading. A literal interpretation of Regulation 3 does not favour this understanding. Regulation 3 prohibits insiders from dealing in securities, directly or indirectly, when the insider is in possession of the UPSI. Therefore, per Regulation 3, the mere possession of any UPSI at the time of dealing in securities will trigger insider trading. The regulations are strictly worded because determination of whether the insider has acted on the basis of UPSI is a factual determination that may be difficult to establish. On the flip side, genuine transactions consummated by the insiders that may be unrelated with the UPSI may also constitute insider trading if the insider held some UPSI.

Under the Insider Trading Regulations, an insider, on his behalf or on behalf of any other person, is prohibited from dealing in securities of a listed company when he is in possession of any UPSI, irrespective of whether or not such a trade was made for the purpose of making a gain or reducing a loss. As such, the existence of profit motive is not required while interpreting the violation of Insider Trading Regulations. However, in the case of *Rakesh Agarwal v. SEBI*[27], it was held that if an insider deals in securities based on the UPSI for no advantage to him, over others, it is not against the interest of investors. Further, SAT held that it is

26. Adjudication Order dated February 28, 2011 in the matter of Mr. Naval Choudhary
27. [2004] 49 SCL 351

true that the regulation does not specifically bring in *mens rea* as an ingredient of insider trading. But that does not mean that the motive need to be ignored.

SAT has devised a method to balance the interests of all the stakeholders and has clarified that insider trading under Regulation 3 will be committed only if the insider has dealt in securities (directly or indirectly) on the basis of UPSI. However, if the insider was in possession of UPSI at the time of dealing in securities then it will be presumed that such insider has acted on the basis of the UPSI unless the insider proves otherwise. Therefore, the real test is whether the insider has acted on the basis of UPSI but the same shall be presumed unless established otherwise by the insider. The onus is on the insider to demonstrate that the UPSI has not motivated him / her to deal in securities and the UPSI was unrelated to the decision to deal in securities.

In the recent matter of *Mrs. Chandrakala v. SEBI*[28], SAT has laid this down in very clear terms. SAT has clarified that the prohibition contained in Regulation 3 of the Insider Trading Regulations apply only when an insider trades or deals in securities on the basis of any UPSI and not otherwise. It means that the trades executed should be motivated by the information in the possession of the insider. If an insider trades or deals in securities of a listed company, it may be presumed that he / she traded on the basis of UPSI in his / her possession unless the contrary is established. The burden of proving a situation contrary to the presumption mentioned above lies on the insider. If an insider shows that he / she did not trade on the basis of UPSI and that he / she traded on some other basis, he / she cannot be said to have violated the provisions of Regulation 3 of the Insider Trading Regulations.

In the above matter, the alleged was successful in establishing that she did not deal in securities on the basis of UPSI though she was privy to UPSI. The appellant was informed of the declaration of financial results, dividend and bonus which were all positive information about the company. SAT opined that an entity that is privy to positive UPSI, will only tend to purchase shares and not sell the shares prior to the UPSI becoming public but the appellant was only trading in normal course of business and had not only bought shares but also sold shares. SAT, interestingly, observed that, unlike in the present case, in case any insider is motivated by the UPSI, such person will usually tend to purchase shares and not sell shares prior to the UPSI becoming public. SAT reviewed the trading pattern of the appellant to conclude that the appellant's trades were not induced by the UPSI.

SAT had categorically laid down this rule in the matter of *Rajiv B. Gandhi, Sandhya R. Gandhi and Amishi B. Gandhi v. SEBI*[29]*.* SAT had clarified the following,

On a plain reading of Regulation 3 it appears that the prohibition contained therein shall apply only when an insider trades or deals in securities on the basis of any UPSI and not otherwise. The words "on the basis of" are significant and mean that the trades executed should be motivated by the information in possession of the insider. To put it differently, the information in possession of the "insider" should be the factor or circumstance that should have induced him / her to trade in the scrip of the company. It is then that he / she will be said to have dealt with or traded "on the basis of" that information. We are of the considered opinion that if an insider trades or deals in securities of a listed company, it would be presumed that he traded on the basis of the UPSI in his possession unless he establishes to the contrary. Facts necessary to establish the contrary being especially within the knowledge of the insider, the burden of proving those facts is upon him. The presumption that arises is rebuttable and the onus would be on the insider to show that he did not trade on the basis of the UPSI and that he traded on some other basis.

28. Decision dated January 31, 2012 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1327988739076.pdf
29. [2008]84SCL192(SAT)

He shall have to furnish some reasonable or plausible explanation of the basis on which he traded. If he can do that, the onus shall stand discharged or else the charge shall stand established.

III. Mechanisms to Prevent Insider Trading

SEBI has put in place a twofold mechanism for preventing and controlling insider trading in India. The primary responsibility to monitor and regulate insider trading is vested on the company itself. The second level of check is maintained by SEBI through the Insider Trading Regulations.

I. Model Code

Regulation 12 of the Insider Trading Regulations obligates all listed companies and organisations associated with the securities market to frame and adopt a code of internal procedures and conduct ("**Code of Conduct**"). The Code of Conduct should be framed on the lines of the Model Code ("**Model Code**") which is specified in the 'Schedule I' of the Insider Trading Regulations, but should not be diluting the requirements under the Model Code, in any manner. It is possible to either adopt the Model Code as the Code of Conduct or frame a separate Code of Conduct without diluting the requirements under the Model Code. The responsibility to ensure compliance with the requirements of the Code of Conduct is also with such listed companies and organisations associated with the securities market. Appropriate mechanisms and procedures can be adopted to enforce the Code of Conduct.

'Part A' of the Model Code applies to all the listed companies and 'Part B' of the Model Code is applicable to all other organisations associated with the securities market including the following:

a. the intermediaries as mentioned in section 12 of the SEBI Act, asset management company and trustees of mutual funds;
b. the self-regulatory organisations recognised or authorised by the Board;
c. the recognised stock exchanges and clearing house or corporations;
d. the public financial institutions as defined in section 4A of the Companies Act, 1956; and
e. the professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies.

Part A of the Model Code

The key provisions under Part A of the Model Code include the following:

i. Appointment of a Compliance Officer

Every listed company has to mandatorily appoint a senior level employee as the compliance officer, who shall report to the managing director / chief executive officer of the company. The compliance officer shall *inter alia* be responsible for (i) prescribing and implementing the internal policies and rules for the preservation of PSI (ii) pre-clearing relevant trades; (iii) maintenance of relevant records; (iv) periodic reporting to the board / officers of the company; and (v) reporting to SEBI, regarding violation, if any, of the Insider Trading Regulations.

ii. Preservation of PSI

Employees / directors shall maintain the confidentiality of all PSI and shall not pass on such PSI to any person directly or indirectly by way of making a recommendation for the purchase or sale of securities. PSI is to be handled on a "need to know" basis, and should be disclosed only to those within the company who need the information to discharge their duty. Files containing confidential information shall be kept secure. Computer files must have adequate security of login and password, etc.

iii. Restrictions on the Directors, Officers and the Designated Employees

To prevent insider trading, the following restrictions are placed on the directors, officers and the designated employees of the company:

A. Specific Trading Window

The company has to specify a trading period (called the "**trading window**") for trading in the company's securities. The company is empowered to keep the trading window open or closed as directed in the Part A of Schedule I. The directors, officers and the designated employees can trade in the securities of the company only when the trading window is open.

When the trading window is closed, the employees / directors shall not trade in the company's securities or deal in any transaction involving the purchase or sale of the company's securities. The company has the freedom to determine when the trading window should be open and when it should be closed but the trading window has to be, *inter alia*, closed at the time of:

a. Declaration of financial results (quarterly, half-yearly and annually).
b. Declaration of dividends (interim and final).
c. Issue of securities by way of public / rights / bonus etc.
d. Any major expansion plans or execution of new projects.
e. Amalgamation, mergers, takeovers and buy-back.
f. Disposal of whole or substantially whole of the undertaking.
g. Any changes in policies, plans or operations of the company.

In case of the specific situations mentioned above, the trading window shall be opened only 24 hours after the information referred to in above is made public. The objective being that the insiders should be allowed to trade only when the PSI has effectively reached the public at large. In case of ESOPs, exercise of option may be allowed in the period when the trading window is closed. However, sale of shares allotted on exercise of ESOPs shall not be allowed when trading window is closed.

B. Prior Approval for Trading

All the directors / officers / designated employees of the company and their dependents as defined by the company who intend to deal in the securities of the company (above a minimum threshold limit to be decided by the company) should obtain prior approval for the transaction in accordance with the procedures prescribed.

Once the approval has been granted by the company, the transaction for which approval has been granted has to be completed within one week from the date of the approval, failing which fresh approval will be required for the transaction. All directors / officers / designated employees who buy or sell any number of shares of the company shall not enter into an opposite transaction i.e. sell or buy any number of shares during the six months following the prior transaction. All directors / officers / designated employees shall also not take positions in derivative transactions in the shares of the company at any time.

In the case of subscription in the primary market (initial public offers), the above mentioned entities shall hold their investments for a minimum period of 30 days. The holding period would commence when the securities are actually allotted. In case the sale of securities is necessitated by personal emergency, the holding period may be waived by the compliance officer after recording the reasons in writing.

C. Reporting Requirements

All directors / officers / designated employees of the listed company have to mandatorily disclose certain specified details of their securities transactions including the statement of dependent family members (as defined by the company) to the compliance officer.

vi. Penalty for Breach of the Model Code

Any employee / officer / director who trades in securities or communicates any information for trading in securities in contravention of the Code of Conduct may be penalised and appropriate action may be taken by the company and shall also be subject to disciplinary action by the company, which may include wage freeze, suspension, ineligible for future participation in employee stock option plans, etc. Action by the company does not prohibit SEBI from taking any further action in case of any violation of the Insider Trading Regulations.

Part B of the Model Code

Similar obligations have been provided under Part B of the Model Code on the intermediaries of listed companies and the organisations associated with securities market including the ones specifically mentioned in Regulation 12 of the Insider Trading Regulations. Regulation 12 is widely worded to include all persons who have any association with the securities market and this includes even professionals like law firms and accountants rendering services to listed companies. If such intermediary or person associated with the securities market is also a listed company then such intermediary / person has to comply with both Part A and Part B of the Model Code. Part B prescribes certain obligations on the employees / directors / partners / designated employees of the persons associated with the securities market in addition to those prescribed under Part A, and that include:

i. Chinese Wall

To prevent the misuse of confidential information the organization / firm shall adopt a "Chinese Wall" policy which separates those areas of the organization / firm which routinely have access to confidential information, from those areas which deal with sale / marketing / investment advice or other departments providing support services. The employees in the respective areas shall not communicate any PSI to the other areas.

ii. Restricted / Grey List

In order to monitor Chinese Wall procedures and trading in client securities based on PSI, the organization / firm shall restrict trading in certain securities and designate such list as restricted / grey list. Securities of a listed company shall be put on the restricted / grey list if the organization / firm is handling any assignment for the listed company and is privy to PSI.

II. Disclosure

The Insider Trading Regulations stipulates that all directors, officers and substantial shareholders in a listed company to make certain periodic disclosures of their shareholding in the company. Certain key disclosures required are:

i. By any Person who Holds More Than 5% Shares or Voting Rights

Regulation 13(1) of the Insider Trading Regulations obligates any such person to disclose to the company, in the prescribed format, the number of shares or voting rights held by such person. This disclosure has to be made within 2 (two) working days of (a) the receipt of intimation of allotment of shares; or (b) the acquisition of shares or voting rights, as the case may be.

Further, if there is a change in shareholding or voting rights of any person who holds more than 5% shares or voting rights in any listed company, in excess of 2% of total shareholding or voting rights in the company after the last disclosure is made, then such person has to disclose such change and the shares / voting rights held after such change to the company in the format and time prescribed.[30]

ii. By any Person who is a Director or Officer

Regulation 13(2) of the Insider Trading Regulations

30. Regulation 13(3) of the Insider Trading Regulations

obligates any director or officer of a listed company to disclose to the company in the prescribed format, the number of shares or voting rights held and positions taken in derivatives by such person and his dependents (as defined by the company), within 2 (two) working days of becoming a director or officer of the company.

Further, if there is a change in the shareholding or voting rights, of any person who is a director or officer of a listed company or their dependents, in excess of INR 500,000 (Rupees Five Hundred Thousand Only) in value or 25,000 shares in number or 1% of total shareholding or voting rights, whichever is lower, then such person has to disclose the total number of shares or voting rights held by such person and change in shareholding or voting rights, to the company and the stock exchange in the format and time prescribed.[31]

iii. By any Person who is a Promoter or Part of Promoter Group

Regulation 13(2A) obligates any such person who is a promoter or part of promoter group of a listed company to disclose to the company, in the prescribed format, the number of shares or voting rights held by such person, within 2 (two) working days of such person becoming a promoter or part of promoter group.

Further, if there is a change in the shareholding or voting rights, of any person who is a promoter or part of promoter group of a listed company, in excess of INR 500,000 (Rupees Five Hundred Thousand Only) in value or 25,000 shares in number or 1% of total shareholding or voting rights, whichever is lower, then such person has to disclose the total number of shares or voting rights held by such person and change in shareholding or voting rights, to the company and the stock exchange in the format and time prescribed.[32]

31. Regulation 13(4) of the Insider Trading Regulations
32. Regulation 13(4A) of the Insider Trading Regulations

iv. By the Company

Every listed company shall disclose to all the respective stock exchanges on which the company is listed, the information received from the disclosures mentioned in 1, 2 and 3 above, within 2 (two) working days of receipt of the relevant disclosure.

v. Code of Corporate Disclosure Practices

In addition to the specific disclosure obligations mentioned above, all listed companies and other organizations associated with the securities market have to compulsorily abide by the Code of Corporate Disclosure Practices included in Schedule II to the Insider Trading Regulations (“**Disclosure Code**”). The Disclosure Code prescribes mandatory standards and compliances to be adhered to / undertaken by listed companies and organizations associated with the securities market while dealing with PSI. If the misuse of PSI can be avoided or controlled, then the possibility of insider trading will be substantially reduced and that is precisely what the Disclosure Code aims to achieve. The Disclosure Code forms part of the Insider Trading Regulations and all the listed companies and the other organizations are bound by the requirements under the same. Unlike the Code of Conduct, which is to be specifically adopted by the parties, no specific action is required to adopt the Disclosure Code. The key requirements under the Disclosure Code are:

a. PSI shall be given by listed companies to stock exchanges and disseminated on a continuous and immediate basis.
b. Listed companies may also consider ways of supplementing information released to stock exchanges by improving Investor access to their public announcements.
c. Listed companies shall designate a senior official (such as compliance officer) to oversee corporate disclosure. This official shall be responsible for ensuring that the company complies with continuous

disclosure requirements and shall oversee the disclosure of PSI to stock exchanges, analysts, shareholders and media and educating staff on disclosure policies and procedure.

d. Information disclosure / dissemination may normally be approved in advance by the official designated for the purpose.
e. If information is accidentally disclosed without prior approval, the person responsible may inform the designated officer immediately, even if the information is not considered price sensitive.
f. Listed companies shall have clearly laid down procedures for responding to any queries or requests for verification of market rumours by exchanges.
g. The official designated for corporate disclosure shall be responsible for deciding whether a public announcement is necessary for verifying or denying rumours and then making the disclosure.
h. Disclosure of shareholdings / ownership by major shareholders and disclosure of changes in ownership as provided under any regulations made under the SEBI Act and the listing agreement shall be made in a timely and adequate manner.
i. Listed companies should follow the guidelines given hereunder while dealing with analysts and institutional investors:
   i. Only public information to be provided – Listed companies shall provide only public information to the analyst / research persons / large investors like institutions. Alternatively, the information given to the analyst should be simultaneously made public at the earliest.
   ii. Recording of discussion – In order to avoid misquoting or misrepresentation, it is desirable that at least two company representatives be present at meetings with analysts, brokers or institutional investors and discussion should preferably be recorded.
   iii. Handling of unanticipated questions – A listed company should be careful when dealing with analysts' questions that raise issues outside the intended scope of discussion. Unanticipated questions may be taken on notice and a considered response given later. If the answer includes PSI, a public announcement should be made before responding.
   iv. Simultaneous release of information – When a company organizes meetings with analysts, the company shall make a press release or post relevant information on its website after every such meet. The company may also consider live webcasting of analyst meets.
j. Disclosure / dissemination of information may be done through various media so as to achieve maximum reach and quick dissemination. Corporates shall ensure that disclosure to stock exchanges is made promptly. Corporates may also facilitate disclosure through the use of their dedicated website. Company websites may provide a means of giving investors a direct access to analyst briefing material, significant background information and questions and answers. The information filed by corporates with exchanges under continuous disclosure requirement & may be made available on the company website.
k. The disclosures made to stock exchanges may be disseminated by the exchanges to investors in a quick and efficient manner through the stock exchange network as well as through stock exchange websites. Information furnished by the companies under continuous disclosure requirements, should be published on the website of the exchange instantly. Stock exchanges should make immediate arrangement for the display of the information furnished by the companies instantly on the stock exchange website.

IV. Powers of the Regulator and Penalties

SEBI is the market watchdog that is entrusted with the responsibility of monitoring and regulating the securities market in India. It is often said that SEBI is a toothless tiger and the lack of power vested in SEBI defeats the objectives for which SEBI has been established. This negative sentiment is extended to the regulation of insider trading also and the general perception in India is that the Indian legal system is sorely lacking and backward in insider trading law in comparison to the laws in other jurisdictions. Some of the legal experts discount this perception as unfounded and opine that the Indian approach to insider trading is far more ferocious than any other country.

The process of investigation of insider trading is structured under the Indian laws as follows:

i. Inquiries & inspection

If SEBI suspects any violation, it may conduct an enquiry into the books and records of the suspected parties. It may also examine the books and records of the stock exchanges, mutual funds, intermediaries, self-regulatory organizations and other associated persons.[33] Based on this enquiry, it will form a *prima facie* opinion as to whether investigation is necessary and whether there is any violation of the Insider Trading Regulations.

ii. Investigation

If further investigation is necessary, SEBI shall dispatch a notice to the insider for the said purpose.[34] It may appoint an investigating authority for the purpose of investigation.[35] This investigating authority has the power to call for any documents, records, accounts and information, relating to the transaction in the securities market, from the insider. The subject is to allow the investigating authority reasonable access to the premises and facilitate the examination of documents, records, accounts and information in possession. The investigation authority is also entitled to record and examine the statements of any member, director, proprietor or employee of the insider.[36] After due consideration of the investigation report of the investigation authority, SEBI shall communicate its findings to the insider who shall reply within 21 (twenty one) days. On receipt of the reply, SEBI shall make its decision.[37]

iii. Appointment of Auditor

In addition to the investigation, an auditor may also be appointed by SEBI to investigate the books of accounts or other affairs of the insider.[38]

iv. Directions and Penalties

Depending on the outcome of the investigation, SEBI may *inter alia* prohibit the insider from investing in or dealing in securities, declare violative transactions as void, order return of securities so purchased or sold. SEBI may also transfer the proceeds equivalent to the cost price or market price of shares whichever is higher to the investor protection fund of a recognized stock exchange. SEBI may also impose a penalty of INR 250,000,000 (Rupees Two Hundred Fifty Million Only) or 3 times the profit made out of insider trading, whichever is higher.[39] Further, under section 24 of the SEBI Act, SEBI has additional powers to punish any person contravening or attempting to contravene or abetting the contravention of the SEBI Act with imprisonment for a term which may extend to ten years or with fine which may extend to INR 250,000,000 (Rupees Two Hundred Fifty Million Only) or with both.

v. Powers Under the SEBI Act

For the purposes of regulation of the market and

33. Regulation 4A of the Insider Trading Regulations read with Section 11 (2) (i) of the SEBI Act
34. Regulation 6; However, SEBI is not required to send thenotice if it determines that the notice is against publicinterest and records its reasons for such determination inwriting.
35. Regulation 5 of the Insider Trading Regulations
36. Regulation 7 of the Insider Trading Regulations
37. Regulation 9 of the Insider Trading Regulations
38. Regulation 10 of the Insider Trading Regulations
39. Section 15G of the SEBI Act

matters incidental, SEBI has the same powers as a civil court. It can ask companies, intermediaries, brokers, trustees and any other person associated with the securities market to furnish any documents, accounts, information that it requires. It can conduct enquiry and investigation, on a complaint or *suo moto.* It can issue directions, cease and desist orders and impose fines.

V. Risk on Conducting Due Diligence in PIPE and M&A Transactions

Unlike many other jurisdictions, there are no specific carve outs for private investments in, or acquisitions of, publicly listed companies (“**Pipe Transactions**”) under the Insider Trading Regulations. Thus, PIPE transactions carry inherent risk of insider trading if the investor / acquirer is in possession of UPSI, directly or indirectly at the time of Pipe Transactions. Also, no specific formal or informal guidance has been given by SEBI on the issue of how they would view such PIPE transactions from an insider trading perspective. In absence of any such guidance, certain market practices have been employed by the concerned persons to mitigate the risk of insider trading in PIPE transactions.

Mitigation of Insider Trading Risks Under PIPE Transactions

Following are certain propositions to avoid the triggering of provisions of Insider Trading Regulations:

- Both the target company and the investor must take due care that the investor is not privy to any material UPSI or any other confidential information which is generally not made public.
- The target company should not disclose any UPSI to the investor unless the investor agrees to treat that information as confidential and not to deal in securities when in possession of such UPSI unless such information is made public.
- In case of any due diligence to be conducted on the target company on behalf of the investor, it is pertinent that the legal advisors of the investor do not divulge or provide any UPSI, which they may receive or may get access to in the course of preparing the due diligence reports, to the investor or any of its advisors & agents & affiliates & representatives.
- From the investor’s perspective, providing a sufficient cooling off period between the due diligence exercise and actual dealing in securities is advisable, assuming that if any UPSI is disclosed, the same is made public by the investee company.

4. Rights of Affected Parties

I. Availability of Right of Appeal – Judicial Forums

Any party aggrieved by an order of SEBI may prefer an appeal to SAT within 45 (forty five) days of receiving the order from SEBI.[40] Further, an appeal from SAT lies to the Supreme Court of India, being the apex court of India, which should be filed within 60 (sixty) days of receiving the order from SAT.[41] The following flowchart shows the appeal process that is required to be followed:

Appeal Process

SEBI Order / Order of the adjudication officer

Appeal to the SAT
(Section 15T of SEBI Act)

Appeal decided in favour of SEBI / Appellant

Appeal by aggrieved party to the Supreme Court of India
(specifically on question of law)[42]
(Section 15Z of SEBI Act)[43]

An appeal can lie before the Central Government against an order / rule / regulation of the SEBI under Section 20 of SEBI Act and SEBI (Appeal to Central Government) Rules, 1993.

II. Standard of Proof Required to Establish Insider Trading

Although the Insider Trading Regulations do not explicitly mention the standards of proof, the past SEBI and SAT orders give an insight into what might be the implied standards. In *Samir Arora v SEBI*[44], SAT opined as follows:

> *It was argued before us on behalf of the respondent* ***(SEBI)*** *that it is very difficult to gather adequate evidence in respect of charges relating to conflict of interest, market manipulation and insider trading. While we appreciate the difficulty it is not possible for us to let mere suspicions, conjectures and hypothesis take the place of evidence as described in the Indian Evidence Act.*

SAT further held in the matter that *evidence satisfying reasonable standard of proof* would be required for establishing insider trading.

In the matter of *Mr. V.K. Kaul v. The Adjudicating Officer,* SEBI[45] SAT has confirmed that reliance on circumstantial evidence for establishing the offence of insider trading is not in conflict with the regulatory framework prescribed by SEBI and SEBI / SAT can look into circumstantial evidence while deciding case of insider trading.

In the matter of *Dilip S Pendse vs. SEBI*[46]*,* SAT held that the charge of insider trading is one of the most serious charges in relation to the securities market and having regard to the gravity of this wrong doing, higher must be the preponderance of probabilities in establishing the same.

40. Section 15T of the SEBI Act
41. Section 15Z of the SEBI Act
42. Refer SEBI v. Sterlite Industries (India), 2005 125 CompCas 14
43. After SEBI (Amendment) Act, 2002.
44. Appeal No: 83/2004
45. Appeal No. 55/ 2012
46. Appeal No. 90 of 2007

In many cases[47], SEBI has been unable to establish price manipulation and insider trading for want of evidence in the nature discussed above.

III. Applicability of Principles of Natural Justice

SEBI is required to send a notice to the subject before it initiates an investigation for insider trading. This step may be skipped only when SEBI deems it in public interest or in the interest of investors to not send the notice. In such case, SEBI shall by an order in writing, direct that the investigation shall be taken up without such notice.[48] SEBI also forwards to the subject the investigation report and allows him a period of 21 (twenty one) days to reply to the report before passing an order.[49]

SAT is to conduct its proceedings in accordance with the principles on natural justice.[50] Further, certain regulations also follow the procedures of natural justice:

- **Regulation 5 of the Insider Trading Regulations,** SEBI, on *prima facie* opinion, has the right to investigate and inspect the books of account, records or documents of an insider. However, such an investigation can be done only when the Board has given a **reasonable notice** to the insider (**Regulation 6**).
- In pursuance of every appeal made to the SAT under **Section 15T of the SEBI Act,** SAT **shall** give the **opportunity of being heard** to the SEBI / appellant before passing an order.
- In pursuance of every appeal made to the Central Government under Section 20 of the SEBI Act, the Central Government **shall** give a **reasonable opportunity of being heard** before disposing of an appeal.

IV. Benefit of Doubt

Yes, SAT and courts do provide benefit of doubt in certain cases. For example, in the SAT order of *Rakesh Agarwal v SEBI*[51]*,* the part of the order of SEBI directing Rakesh Agarwal to pay Rs. 34,00,000 couldn't be sustained, on the grounds that Rakesh Agarwal did that in the interests of the company (ABS) to help Bayer A. G acquire his company. Further, in the matter of *Dilip S Pendse vs. SEBI*[52]*,* SAT clarified that in the absence of direct corroborated evidence, not action for insider trading can be taken against any person and benefit of doubt will always be in his / her favour.

47. Balaji Telefilms, Mastek, United Phosphorous and Hinduja TMT.
48. Regulation 6(2) of the Insider Trading Regulations
49. Regulation 9 of the Insider Trading Regulations
50. Section 15 U of the SEBI Act
51. [2004] 49 SCL 351
52. Appeal No. 90 of 2007

5. Comparative Between India with USA and India with UK

US has been one of the prime enforcer of Insider Trading regulations across the world. Recently, US has been in the limelight with certain high profile and landmark insider trading cases coming to the forefront. One case being the conviction of Mr. Rajat K. Gupta[53], director on the board of Goldman Sachs group, where he was found guilty of conspiracy and securities fraud for leaking boardroom secrets to a billionaire hedge fund manager. And the other case where Mr. Raj Rajaratnam[54] was held guilty of insider trading. This Galleon Group insider trading case is quite unusual, perhaps more strikingly in the use of wiretaps to record telephone conversations while apparently inside information was being exchanged.

The Securities Exchange Act of 1934 ("**Exchange Act**") was the first legislation to officially tackle insider trading on the Wall Street, in wake of the great depression of 1929. The Exchange Act deals with insider trading in:

- A general anti-fraud rule which makes it unlawful to employ any manipulative or deceptive method in a securities transaction or conduct a transaction in contravention of securities law.[55] This provision extends to unlisted securities as well.
- Rule against Short Swing Profit Making which disallows directors, officers or stockholders that own more than 10% shares in a company from making short swing profits.[56]

The general text of these provisions has enabled the Securities Exchange Commission ("**SEC**") to stringently prevent Insider Trading in the USA. The courts have assisted the SEC in development of jurisprudence relating to insider trading. Two theories exemplify this:

I. The Disclose or Abstain Theory

Also known as the classical theory, under this, the insider must either disclose UPSI to the public before making the trade or abstain from making a trade at all.[57] This classical theory applies to insider trading by directors, officials, employees and other associated persons or connected persons (as referred in India).

II. The Misappropriation Theory

Under this theory, a person breaches a fiduciary duty owed to the source of UPSI by communicating it to a third party who uses it to trade.[58] This misappropriation theory applies to those who are not by themselves insiders but acquire UPSI from an insider who places trust in them to keep it confidential.

The United States Sanction Act, 1984 imposes fines up to three times the profit gained or loss avoided by use of such material non-public information. It is not out of place to mention here that Section 16 of the Exchange Act requires all officers and directors of a company and beneficial owners of more than 10 per cent of its registered equity securities to mandatorily file an initial report with the SEC as well as with the exchanges on which the stock may be listed. They should disclose their holdings of each of the company's equity securities. The US law is much more stringent in comparison to the Indian regulations which are often being castigated as paper tiger for its lack of efficacy in curbing insider trading. It is pertinent to mention here that the US law provides that the profits obtained from the purchases and sales from such securities within any six month period may be

53. US v. Rajat K. Gupta ,11 Cr. 907 (JSR)
54. US v. Rajaratnam, No. 622 F.3d 159 (2d Cir. 2010
55. Section 10 (b) of the Exchange Act
56. Section 16 (b) of the Exchange Act
57. Cady Roberts & Co, 40 SEC 907 (1961)
58. United States v. Vincent F Chiarella, 445 U.S 222 (1980)

recovered by the company or by any security holder on its behalf.

The US Supreme Court in **US v. O'Hagan**[59] has expanded the concept of insider trading by approving the misappropriation theory and stating that a person commits insider trading when he obtains material confidential information and uses it in securities transactions in breach of fiduciary duty or similar relationship of confidence to the source of information but not necessarily to the shareholders of the company whose stock are traded. It is noteworthy to mention here that in the US, the finance market is well developed and the regulatory regime is also stringent which is able to cope up with different difficulties concerning adherence to strict corporate governance norms.

In **SEC v. Texas Gulf Sulphur Coa**[60]**,** federal circuit court held that anyone in possession of inside information must either disclose the information or refrain from trading. In 1984, the Supreme Court of the US ruled in the case of **Dirks v. SEC**[61] that the (tippees) receivers of the second hand information are liable if they have reason to believe that there is a breached fiduciary duty in disclosing confidential information and the tipper had received personal benefits for the same. Since Dirks disclosed the information in order to expose a fraud, rather than for personal gain, nobody was liable for insider trading violations in this case. This case holds significance owing to the fact that the courts are dynamic in judging the culpability of the insider. In the instant case, since the insider has acted with good faith and without any vested and parochial interest for personal gains, the court did not find him guilty.

The **Dirks case**[62] also defined the concept of constructive insiders. Constructive insiders are like whistle blowers who bring to the public forefront any corrupt practice which is prevalent in their organization. The lawyers and investment bankers who bring such corrupt practice into light are not considered to be guilty due to the very fact that they disclose the internal fact to prevent the leakage and punish the culprit. Constructive insiders are also liable for insider trading violations if the corporation expects the information to remain confidential, since they acquire the fiduciary duties of the true insider.

In **US v. Carpenter**[63] case, the US Supreme Court unanimously upheld mail and wire fraud convictions for a defendant who received information from a journalist rather than from the company itself. The journalist was also convicted on the grounds that he had misappropriated information belonging to his employer. The employer in this case happened to be the Wall Street Journal. In this widely publicized case, the journalist traded in advance of 'Heard on the Street' column appearing in the Journal.

The court held in the Carpenter case[64] that *"It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principle for any profits derived there from."*

Indian Insider Trading Regulations have been widely criticized although the plain text of the regulations may be strong. In fact, the SEBI Act envisages a 10 year imprisonment and penalty of 25 crore for any violation under the SEBI Act, rules or regulations.[65] The penalty for insider trading is 25 crore or 3 times the profit accrued by insider trading, whichever is higher[66]. However, in practice,

59. US Vs O'Hagan, 521 U.S. 642 (1997)
60. SEC v. Texas Gulf Sulphur Coa, 1968 U.S. App.Fed. Sec. L. Rep. (CCH) P92,251
61. Dirks v. SEC, 463 U.S. 646 (1983)
62. Ibid.
63. US v. Carpenter, 484 U.S. 19 (1987)
64. Ibid.
65. Section 24 of the SEBI Act.
66. Section 15G of the SEBI Act.

the highest ever penalty imposed by SEBI is INR 60,00,000 only.[67]

SEBI rulings have a number of times been overruled by SAT due to lack of evidence. SAT dictates that insider trading can be established by "clinching evidence" only.[68]

The lacuna is therefore not in the law but in its execution. SEBI has wide powers to call for inspection of all transactional documents and other relevant information. It can summon witnesses and make any directions it thinks fit for the general well-being of the securities market. However, SEBI is yet to fully stretch its wings and crackdown on mishaps in the market.

III. Comparative Between India and the UK

The Financial Services and Markets Act, 2000 (**"FSMA"**) and the Criminal Justice Act, 1993 (**"CJA"**) provide the statutory framework for insider trading regime in the UK. However, none of the two Acts define insider trading. Part V of the CJA provides for the offence of insider dealing and treats it as a criminal offence. The FSMA provides for market abuse regime and provides powers to the UK Financial Services Authority (**"FSA"**) to sanction anyone who engages in 'market abuse', that is misuse of information, misleading practices, and market manipulation, relating to investments traded on prescribed UK markets. It also applies to those who require or encourage others to engage in conduct that would amount to market abuse. The FSMA treats market abuse as a civil offence.

IV. Criminal Justice Act, 1993

CJA prohibits dealing in price-affected securities on the basis of inside information, encouragement of another person to deal in price-affected securities on the basis of inside information and knowing disclosure of inside information to another.[69] To prove an offence under section 52 of the CJA, i.e. market abuse, it is necessary to demonstrate two elements:

a. the status of the person charged as an insider, and
b. the type of information in its possession to be inside information.

CJA applies to only individuals because the term 'individual' is defined to exclude corporations and other entities.[70] Thus, corporations and other entities will escape criminal liability if they indulge in insider dealing.

Under CJA, insider dealing will be committed where an insider, whilst in possession of inside information, deals in securities which are price-affected in relation to that information, or where he either acquires or relies on a professional intermediary or is himself acting as a professional intermediary and disposes of such securities on a regulated market, or where an insider in possession of inside information encourages another person, including a company, to deal in price-affected securities, even if that other person does not know that the securities are price-affected and where an insider discloses inside information to another person, including a company, otherwise that in the proper performance of the functions of his employment, office or profession.[71]

Under section 53 of the CJA, an individual is not guilty of insider dealing by virtue of dealing in securities if he shows:

a. that he did not at the time expect the dealing to result in a profit attributable to the fact that the information in question was price-sensitive information in relation to the securities, or

67. In the matter of Jayaprakash Associates, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1325832569186.pdf
68. Samir C Arora v. SEBI, 2004 http://www.sebi
69. Section 52, Criminal Justice Axt, 1993
70. Kern Alexander, Insider Dealing And Market Abuse: TheFinancial Services And Markets Act 2000, Working PaperNo. 222 ESRC Centre for Business Research, University ofCambridge, available at http://www.cbr.cam.ac.uk/pdf/WP222.pdf.
71. Section 52, Criminal Justice Act

b. that at the time he believed on reasonable grounds that the information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information, or
c. that he would have done what he did even if he had not had the information.

Section 55 of the CJA makes the insider dealing applicable to an act done as an agent. Under section 55, dealing in securities is defined to include acquisition or disposal of the securities (whether as principal or agent) or procuring, directly or indirectly, an acquisition or disposal of the securities by any other person.

Under section 56 of the CJA, an important requirement of inside information is that it should be such that if disclosed, it would have an effect on price of such securities.

Under section 57 of the CJA, which defines 'insider', a person has information as an insider, if and only if:
a. it is, and he knows that it is, inside information, and
b. he has it, and knows that he has it, from an inside source.

Further, a person is said to have information from an inside source, if and only if:
a. he has it through:
   i. being a director, employee or shareholder of an issuer of securities; or
   ii. having access to the information by virtue of his employment, office or profession; or
b. the direct or indirect source of his information is a person within paragraph (a).

The FSMA was passed to fill the gaps in the CJA. The FSMA made the offence of market abuse applicable to legal entities and natural persons. The FSMA introduced the wider offence of market abuse: this covers insider dealing, disclosing inside information, dissemination of false and misleading information, employing fictitious devices, and market distortion.[72]

V. Financial Services and Markets Act, 2000

Section 118 (2) of the FSMA defines 'market abuse' as including a behavior where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information relating to the investment in question.

Under Section 118B of the FSMA, an insider is a person who has inside information: (a) as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments, (b) as a result of his holding in the capital of an issuer of qualifying investments, (c) as a result of having access to the information through the exercise of his employment, profession or duties, (d) as a result of his criminal activities, or (e) which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information.

Section 118C of the FSMA divides inside information into two parts. One deals with commodity derivatives and the other deals with non-commodity derivatives. Section 118C (2) of the FSMA defines inside information in relation to qualifying investments, or related investments, which are not commodity derivatives, as one which (a) is not generally available, (b) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and (c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.

Section 118C (3) of the FSMA defines inside information in relation to qualifying investments or related investments which are commodity derivatives as one which (a) is not generally available, (b) relates, directly or indirectly, to one or more such derivatives, and (c) users of markets

72. Kern Alexander, Supra note 2.

on which the derivatives are traded would expect to receive in accordance with any accepted market practices on those markets.

Section 118C (4) of the FSMA defines inside information in relation to a person charged with the execution of orders concerning any qualifying investments or related investments, as one which (a) is of a precise nature, (b) is not generally available, (c) relates, directly or indirectly, to one or more issuers of qualifying investments or to one or more qualifying investments, and (d) would, if generally available, be likely to have a significant effect on the price of those qualifying investments or the price of related investments.

Under Section 118(5) of the FSMA, information would be likely to have a significant effect on price if and only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.

Market abuse enforcement actions under FSMA attract civil penalties and, unlike criminal insider dealing, do not require that a person must have acted deliberately or recklessly.[73] Unintentional violations of market abuse rules and acting in good faith will not prevent imposition of liability. For example, in a recent case, the FSA fined Ian Hannam, a J.P. Morgan Cazenove Ltd. banker, GBP 450,000 for market abuse violations under Section 118(3) of FSMA (improper disclosure) even though he (i) did not intend to engage in market abuse or make disclosures with the intent that the information would be abused; and (ii) no trading resulted from the disclosures.[74]

VI. Comparison of the UK and Indian Law

An insider under Indian law is the one, among other people, who has received or has had access to UPSI. Thus, definition of insider under the CJA is limited as compared to the Indian law, as the latter has extended it to any person who receives or has access to UPSI from any source whatsoever. However, UK's FSMA defines insider widely and includes information which is obtained by *other means and which he knows, or could reasonably be expected to know, is inside information.* Thus, as far as civil liability is concerned the applicable insider definition is similar.

Both the Indian and the UK laws have similar definition of price sensitive information. The information should be such that it would have substantial effect on the price of the security.

In India, the same statute applies for criminal and civil liability. However, in UK both the liabilities are dealt under different statutes; thus, requirements for criminal and civil liability are different.

Under the Indian statute, a person is liable as a connected person only if he has been a connected person for six months prior to the act of insider trading. No such time threshold is present under the UK regulations.

Section 53 of the CJA gives certain defenses which may be used to escape the liability of insider dealings. Such defenses are not available under the Indian regulations. Only defense available is to a company dealing with securities of another company if it can be proven that proper due diligence was done by it.[75]

The Indian law is limited to dealings with the listed companies. No such restriction is placed under the UK law.

Section 58 of the CJA gives a wide scope to information which can be considered public. Among other things, it includes information which can be acquired only by persons exercising

73. Noam Noked, *Differences Between US and UK Market Abuse Regimes,* 7 April 2012, available at http://blogs.law.harvard.edu/corpgov/2012/04/07/differences-between-us-and-uk-market-abuse-regimes/
74. Jeffery Roberts et al., *U.S. insider trading vs. U.K. market abuse rules,* 9 may 2012, available at http://www.thedeal.com/content/regulatory/us-insider-trading-vs-uk-market-abuse-rules.php
75. Regulation 3B, SEBI (Prohibition of Insider Trading) Regulations, 1992

diligence or expertise, is communicated to a section of the public and not to the public at large, can be acquired only by observation, is communicated only on payment of a fee or is published only outside the UK. Under the Indian regulation, only unpublished information is defined. Section 2(k) defines an information to be unpublished which is not published by the company or its agents and is not specific in nature. Thus, UK law is less stringent on this point. FSMA doesn't define public information.

Under section 62 of the CJA, territorial connection to the UK is required for commission of insider dealing. No such requirement has been spelt out under the Indian regulation.

Under CJA, there is a requirement of motive as a person is liable only if he knows that the information is inside information. However, under the Indian regulation, there is no requirement of motive. In Hindustan Lever Ltd. v. SEBI[76], the Appellate Authority supported the stand taken by the SEBI and clearly ruled out the requirement for a motive.[77] Neither do the Insider Trading Regulations provide for any requirement of motive in order to secure a conviction for insider trading.[78]

Section 15G of the SEBI Act specifies a penalty of twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, for insider trading. Further under section 24 of the SEBI Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of the SEBI Act or of any rules or regulations made there under, he can be punishable 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. This section read with Regulation 3 of the Insider Trading Regulation makes insider trading a criminal offence. The maximum sentence for insider trading in UK is 7 (seven) years.[79] Under section 123, FSA has the authority to impose a fine of such amount as it thinks appropriate.

76. (1998) 18 S.C.L. 311 AA.
77. Anonymous, How to tackle Insider Trading in INDIA: An Analysis of current laws and Regulations through judicial decisions, 28 March 2012, available at http://corporatelawreporter.com/tackle-insider-trading-india-analysis-current-laws-regulations-judicial-decissions-8603.html
78. Id.
79. Section 61, Criminal Justice Act, 1993

6. Judicial Interpretation and Application

I. Mr. Manoj Gaur v. SEBI[80]

i. Facts

Mr. Manoj Gaur was the executive chairman of the Jaiprakash Associates Ltd. ("**JAL**"), Mrs. Urvashi Gaur is his wife and Mr. Sameer Gaur is his brother. JAL received the trial balances for the quarter ending September 30, 2008 from various units in the first week of October 2008. Thereafter, JAL made announcement on October 11, 2008 through the stock exchange that in the board meeting scheduled to be held on October 21, 2008, the matter with regard to unaudited financial results for the quarter ending September 30, 2008, interim dividend for the year 2008-09 and rights issue will be considered. Accordingly, as required under the code of conduct of JAL, the trading window was closed from October 11, 2008. The quarterly results were finalized on October 17, 2008 and the consolidated and finalized results were placed before the audit committee on that day.

Mrs. Urvashi Gaur bought 1,000 shares of JAL on October 14, 2008 and Mr. Sameer Gaur bought a total of 7,400 shares of JAL on October 13, 14 and 16, 2008 when the trading window was closed. SEBI has adjudicated that Mr. Manoj Gaur was in possession of UPSI regarding the financials JAL from the first week of October 1, 2008 and Mrs. Urvashi Gaur and Mr. Sameer Gaur have dealt in the securities of JAL on the basis of such UPSI.

ii. Questions of Law

i. Whether Mr. Manoj Gaur was in possession of UPSI at the time when Mrs. Urvashi Gaur and Mr. Sameer Gaur had purchased the securities of JAL?
ii. Whether Mr. Manoj Gaur has indulged in insider trading through Mrs. Urvashi Gaur and Mr. Sameer Gaur?
iii. Whether Urvashi Gaur and Mr. Sameer Gaur have violated the provisions of the code of conduct by trading in securities when the trading window was closed?
iv. Whether principles of natural justice were violated as SEBI refused to share the investigation report with Mr. Manoj Gaur?

ii. Judgment

i. Mr. Manoj had argued that he was not in possession of any UPSI prior to October 17, 2008 as the financials were finalized only on that date. He also argued that merely because the trading window was closed on October 11, 2008 it cannot be assumed that there was UPSI in existence. Trading window need not only be closed when there is UPSI and it can be closed even otherwise subject to other conditions he argued. SAT agreed that closure of trading window ipso facto does not mean that there was some UPSI. However, based on the facts SAT was of the opinion that the trial balances were available from first week of October and that clearly means Mr. Manoj had access to the financial results of JAL from such period though in a rough shape. SAT clarified that the financial results may have crystallised into a final form only on October 17, 2008 but the numbers were available from first week of October. Therefore, SAT agreed with SEBI to hold that Mr. Manoj had access to UPSI from first week of October, 2008.

ii. SAT relied on two precedents to arrive at a decision on this point. The first being, *Chandrakala vs. SEBI*[81] wherein it was held that the prohibition contained in Regulation 3 of the Insider Regulations apply only when an insider trades or deals in securities on the basis of / motivated by, any UPSI and not otherwise. However, if an insider trades or

80. Appeal No. 64 of 2012 dated October 3, 2012
81. Appeal No. 209 of 2011 decided on January 31, 2012

deals in securities of a listed company, it may be presumed that he has traded on the basis of / motivated by, UPSI unless the contrary is established by the insider.

The second was the order in the matter of Dilip S. Pendse vs. SEBI which holds that the charge of insider trading is one of the most serious charges in relation to the securities market and having regard to the gravity of this wrong doing higher must be the preponderance of probabilities in establishing the same. It is a settled principle of criminal jurisprudence that the more serious the offence, the stricter the degree of proof, since a higher degree of assurance is required to convict the accused. This principle applies to civil cases as well where the charge is to be established not beyond reasonable doubt but on the preponderance of probabilities.

In light of these rulings, SAT held that there is no concrete or sufficient evidence to establish that Mrs. Urvashi Gaur and Mr. Sameer Gaur have acquired the shares of JAL, on the basis of / motivated by the UPSI in the possession of Mr. Manoj. SAT examined the trading pattern to determine that Mrs. Urvashi Gaur and Mr. Sameer Gaur frequently trade in the shares of JAL and other companies and if their intention was to misuse the UPSI then they would have not acquired just nominal number of shares and put their reputation at risk.

iii. Paragraph 3.2.2 of the Model Code prescribes that the employees / directors shall not trade in the company's securities when the trading window is closed. Since, Mrs. Urvashi Gaur and Mr. Sameer Gaur are not employees or directors of JAL, this restriction under the Model Code does not apply to them. However, the code of conduct, specifically prescribed by JAL prescribes that the code is applicable to all the connected persons and persons deemed to be connected under the Insider Trading Regulations. To that extent, Mrs. Urvashi Gaur and Mr. Sameer Gaur are guilty of breaching the code of conduct of JAL by trading in the securities of JAL when the trading window was closed. SAT did not rule on this point as SEBI had not pressed this charge.

iv. Mr. Manoj had alleged violation of principles of natural justice by SEBI on the ground that the investigation report of SEBI was not shared with him. SAT refused to accept this argument relying on Regulation 9(i) of the Insider Trading Regulations. Regulation 9(1) specifically provides that only the findings of the investigation report are to be communicated to a person suspected of insider trading. Such findings were furnished to Mr. Manoj. Since the adjudicating officer has complied with the statutory requirements, there is no legal obligation on SEBI to furnish the entire investigation report to the appellants.

II. Rakesh Agarwal v. SEBI

i. Facts

Mr. Rakesh Agarwal was the managing director of ABS Industries Ltd. ("**ABS**"), a listed Indian company. Bayer AG ("**Bayer**") is a German company that acquired the control of ABS in October, 1996. Prior to such acquisition there were a series of negotiations between the management of ABS and Bayer. Mr. Rakesh had visited the officials of Bayer in Germany between September 6, 1996 and September 8, 1996. During that meeting, the decision to proceed with the transaction was arrived at but Bayer management had stipulated a condition that the acquisition would be subject to Bayer being able to acquire a minimum of 51% in ABS. During the period between September 9, 1996 and October 8, 1996, Mr.I.P.Kedia, Rakesh's brother-in-law had acquired 1,82,500 shares of ABS using the funds provided by Mr. Rakesh.

On September 29, 1996 Rakesh and his legal / financial advisors went to Germany again to finalise the modalities of the transaction. On October 1, 1996, a communication was shared with BSE/

NSE disclosing the details of the transaction. Thereafter, the definitive agreements were entered into and the transaction between ABS and Bayer was consummated. SEBI ruled that Mr. Rakesh had indulged in insider trading through Mr. I.P.Kedia during the period between September 9, 1996 and October 1, 1996, when the information about the deal with Bayer was a UPSI. SEBI also directed Mr. Rakesh to deposit INR 34,00,000 in the investor protection funds of the various stock exchanges involved to compensate for the losses that may be suffered by the shareholders of ABS at a later point of time. SEBI also ordered the initiation of adjudication proceedings against Mr. Rakesh under Section 15I read with Section 15G of SEBI Act. Mr. Rakesh challenged the SEBI order on the following grounds:

- Media carried reports on the deal with Bayer even before October 1, 1996 and therefore, the information was not UPSI when Mr. I.P. Kedia had acquired the shares of ABS.
- Rakesh had caused Mr.I.P.Kedia to acquire the shares only to ensure that Bayer gets a minimum of 51% in ABS and the deal goes through. He was acting only in the best interest of ABS there was no personal gain or benefit for him.

ii. Questions of Law

a. Whether the information about the deal with Bayer was UPSI prior to October 1, 1996?
b. Whether personal gain and mens rea are critical constituents of the offence of insider trading under the Insider Trading Regulations?
c. Whether SEBI is empowered to direct Mr. Rakesh to deposit INR 34,00,000 in the investor protection funds under Regulation 11 of the Insider Trading Regulations?

iii. Judgment

A. Information About the Deal with Bayer was UPSI till October 1, 1996

SAT noted that since 1995, there were media reports suggesting that ABS is seeking strategic alliance with other market players. Some of the media reports even had references to a possible deal with Bayer. However, SAT ruled that such media reports were speculative and incomplete. The specific details of association and transaction are important for the shareholders to know.
The nature of Bayer association, the extent of its involvement, its financial stake in ABS etc. are of considerable importance from the point of view of other investors. None of the media reports gave any specific indication of Bayer's entry as a 51% stake holder in ABS which was a specific UPSI in relation to the deal with Bayer. SAT agreed with SEBI to hold that there was nothing on record to show that the relevant information was "generally known" till October 1, 1996 (till the time disclosure was made to the BSE and the NSE).

B. Profit Motive / Mens rea Cannot be Disregarded

SEBI had ruled against Mr. Rakesh on the premise that profit motive and / or *mens rea* are not essential ingredients of the offence of insider trading under the Insider Trading Regulations. This was based on a literal interpretation of Regulation 3 which clearly prohibits dealing in securities when in possession of UPSI, irrespective of whether there is any intention to make profits or gains. SAT held that such an interpretation completely disregards the objective, purpose and spirit of the Insider Trading Regulations.

SAT held that if SEBI's view is accepted the very purpose of imposing prohibition on insider dealing in the securities on the basis of UPSI would become meaningless. If an insider, based on the unpublished price sensitive information deals in securities for no advantage to him, over others, how it can be said to be against the interest of investors. Taking into consideration the very objective of the Insider Trading Regulations, the intention / motive of the insider has to be taken cognizance of. It is true that the regulation does not specifically bring in *mens rea* as an ingredient of insider trading. But that does not mean that the motive need be ignored. Regulation 3 merely aims to prohibit the insider from breaching this duty to the company. The breach of this duty necessarily involves an element of "manipulation" or "deceit", and the making of some secret profits or personal gain / benefit by the insider. Mr. Rakesh had caused acquisition of shares of ABS not for any personal gain or advantage but for ensuring that the deal with Bayer goes through. The deal with Bayer was critical for ABS, failure of which would have been fatal for ABS. To that extent, Mr. Rakesh was acting only in the best interest of ABS and was not misusing the UPSI for his gain or benefit.

As an alternate argument, SEBI also argued that Mr. Rakesh had made profits out of the shares acquired by his brother in law. By ensuring that the deal with Bayer went through, Mr. Rakesh was ensuring that ABS, earns a better value. Also, he had continued to hold managerial position in ABS even after the acquisition by Bayer. SAT rejected this argument and concluded that the purpose of I.P.Kedia's acquisition was corporate purpose for saving ABS and its business. Mr. Rakesh, as the director ABS was only exercising his fiduciary duty towards ABS and other stakeholders by ensuring that an ideal business ideal was consummated. I.P.Kedia had acquired shares even after October 1, 1996 when the deal was in the public domain and it clearly means that he was acquiring shares to facilitate the entry of Bayer for the betterment of the company and its other shareholders, employees etc. Even if Mr. Rakesh had gained some economic advantage of the acquisition, was only incidental, and certainly not by cheating others. If Mr. Rakesh's intention was to make money in the process, he would have cornered much more shares for making more profits.

C. *SEBI is not Authorized to Direct* Mr. Rakesh Deposit Monies into the Investor Protection Fund Under Regulation 11

SAT held that SEBI was not empowered under the then existing Regulation 11 to direct Mr. Rakesh to deposit monies into the investor protection fund and relieve Mr. Rakesh from that obligation. The then existing Regulation 11 permitted SEBI to issue only the following three directions:

a. *directing the insider not to deal in securities in any particular manner;*
b. *prohibiting the insider 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;*

The then existing Regulation 11 did not empower SEBI to pass any other wider directions and the power under Regulation 11 was only to pass necessary interim directions for the purpose of preserving the status quo during or immediately after the investigation.

However, with effect from February 20, 2002, SEBI specifically amended Regulation 11 to read as follows:

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 investor and in the interests of the securities market and for due compliance with the provisions of the Act, regulation madethereunder 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 :
f. 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;

g. 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.

After this amendment, SEBI is empowered to direct defaulter to deposit monies in the investor protection fund of a recognised stock exchange.

III. Chandrakala v. SEBI[82]

i. Facts

The board meeting of M/s Rasi Electrodes Ltd. ("**REL**") was scheduled to be held on June 30, 2007, in which meeting the financials of REL and the rate of dividend for the financial year were to be finalized. The agenda for the board meeting was finalized between June 19 to 21, 2007 and the agenda was discussed internally between Mr. B. Popatlal Kothari, chairman and managing director and Mr. G Mahavirchand Kochar, whole time director of the company. Hence, during this period, information about the financial results and dividends constituted UPSI.

Similarly, the agenda for the board meeting to be held on July 25, 2007, *inter alia,* including issuance of shares was discussed internally during the period between July 15, 2007 to July 17, 2007 and the agenda paper was circulated on July 17, 2007. Therefore, the period from July 15, 2007 to July 17, 2007 was a period when the information about the issue of bonus shares was UPSI. Mrs. Chandrakala, who is the accused in the matter, happens to be the wife of the promoter of REL, Mr. Uttam Kumar Kothari, who is the brother of Mr. B. Popatlal Kothari, the chairman and managing director of REL. She had traded in the scrip of the company when the information on the bonus issue and the financial results were UPSI. Her transactions were noted by the SEBI Board, as the Board conducted investigations into the rise in price and volume in the scrip of the company during the period 8th June, 2007 to 20th July, 2007.

It was clear that at the time of the trading, Mrs. Chandrakala was an 'insider' and the information on bonus issuance and the financial results were UPSI. However, a defense was taken in favour of the accused that offense of insider trading will only be committed if the trading is undertaken **on the basis of** UPSI and mere possession of any UPSI at the time of trading will not result in insider trading.

ii. Question of Law

Regulation 3 prohibits from trading in securities when they are in possession of any UPSI. *No insider shall either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange* ***when in possession*** *of any unpublished price sensitive information,* prescribes Regulation 3(1) of the Insider Trading Regulations. Hence, it had to be determined whether mere possession of any UPSI by the insider at the time of transaction would result in insider trading or is it necessary that the trading was undertaken on the basis of or in reliance of the UPSI that is in the possession.

iii. Judgment

The prohibition contained in Regulation 3 of the Insider Trading Regulations apply only when an insider trades or deals in securities on the basis of any UPSI and not otherwise. It means that the trades executed should be motivated by the information in the possession of the insider. If an insider trades or deals in securities of a listed company, it may be presumed that he / she traded on the basis of UPSI in his / her possession unless contrary to the same is established. The burden of proving a situation contrary to the presumption mentioned above lies on the insider. If an insider shows that he / she did not trade on the basis of UPSI and that he / she traded on some other

82. Order of SAT dated January 31, 2012.

basis, he / she cannot be said to have violated the provisions of Regulation 3 of the Insider Trading Regulations.

SAT has in a way diluted the strict prohibition under Regulation 3 by holding that insider trading will occur only when the insider is trading on the basis of insider information and on account of mere possession of UPSI when trading in securities. However SAT has laid down a presumption that the insider would have traded on the basis of the UPSI that it holds unless proved otherwise by the insider. In light of this legal principle, Mrs. Chandrakala had to factually establish before SAT that its trading in securities was not motivated by or on the basis of the UPSI that it held. SAT examined the following facts to conclude that Mrs. Chandrakala had not violated Regulation 3 of the Insider Trading Regulations as she had not traded in securities on the basis of UPSI:

i. Mrs. Chandrakala used to trade regularly in the shares of REL in the normal course of business. Mrs. Chandrakala had not only traded in securities when she had access to UPSI but also prior to and after such period.
ii. Declaration of financial results, dividend and bonus are positive UPSI which, on becoming public is likely to cause a positive impact on the price of the scrip of REL. Any person who is privy to such positive UPSI will only tend to purchase shares and not sell the shares prior to the UPSI becoming public. This was not so in the case under consideration. The trading pattern of Mrs. Chandrakala shows that she not only bought but also sold the shares when she had access to UPSI.

IV. Gujarat NRE Mineral Resources Ltd. v. SEBI[83]

i. Facts

FCGL Industries Ltd. ("**FCGL**") is a listed core investment company that held 17.7% of the total paid up equity capital of the Gujarat NRE Coke Ltd. ("**Coke Company**").

In the board meeting of FCGL dated July 4, 2005, the following decisions were taken:

- FCGL would acquire certain coal mining leases in Australia though a special purpose vehicle incorporated in Australia under the name Gujarat NRE FCGL Pty Ltd. (joint venture between the Coke Company and FCGL).
- To meet the funding requirements for the acquisition of the mining leases, FCGL decided to dispose of part of its investments in the Coke Company.

The said meeting was attended by Shri G.L.Jagatramka and Shri A.K.Jagatramka who were the chairman and director, respectively of FCGL. Soon after the meeting, the BSE was informed of FCGL's decision to acquire mining leases in Australia and of the high costs involved, however, the decision to dispose of its investments in the Coke Company was not disclosed.

Pursuant to the board's decision, FCGL's shares in the Coke Company were sold between July 18, 2005 and September 29, 2005. It was observed that Matangi Traders and Investors Ltd. ("**Matangi**") and Marley Foods Pvt. Ltd. ("**Marley**"), two companies had bought the shares of FCGL during the period between September 5, 2005 and September 24, 2005 and during such period, G.L.Jagatramka and A.L.Jagatramka who were the chairman and director respectively of FCGL, were also the directors of Matangi and Marley.

It was alleged that the decision by FCGL to dispose of its investments in the Coke Company was UPSI when Matangi and Marley had acquired the shares of FCGL and such acquisition was on the basis of the UPSI. The share price of the shares of FCGPL had risen during the period when Matangi and Marley had acquired the shares of FCGL. It was also alleged that the failure by FCGPL to disclose its decision to sell part of the shareholding in the Coke Company violated paragraph 2.1 of the Disclosure Code which obligates listed companies to disclose PSI to the stock exchanges on a continuous and immediate basis.

83. SAT decision dated November 18, 2011

ii. Question of law

Whether the decision by an investment company to sell its shareholding / investment in a company and subsequent sale would amount to PSI that needs to be disclosed to the public? If yes, whether trading in securities of FCGPL by Matangi and Marley was based on such UPSI.

iii. Judgment

SAT clarified that for any information to be PSI, it should relate to the company and when disclosed it should be likely to affect the price of the securities of a company. The definition of PSI under the Insider Trading Regulations clarify that the information on *disposal of the whole or substantial part of the undertaking* is PSI. It had to be determined if part sale of investment would amount to *disposal of the whole or substantial part of the undertaking.*

FCGL is an investment company whose business is only to make investments in the securities of other companies. It earns income by buying and selling securities held by it as investments. This being the normal activity of an investment company, every decision by it to buy or sell its investments would have no effect, much less material, on the price of its own securities. If that were so then no investment company would be able to function because every time it would buy or sell securities held as investments, it would have to make disclosures to the stock exchange(s) where its securities are listed.

Also, disposal of all or part of an undertaking would mean a company deciding to dispose of the whole or substantial part of its business activity or project in which it is engaged. The word 'undertaking' cannot possibly mean investments held by an investment company which are its stock-in-trade. To illustrate, if a manufacturing company were to dispose of the whole or a substantial part of its manufacturing unit, it would be an event which would materially affect the price of its securities and according to the explanation it would be price sensitive requiring the company to make the necessary disclosures at the earliest. On the other hand, if a manufacturing company were to sell its products or buy raw materials, it would be a part of its normal business activity which would not be price sensitive and not required to be disclosed.

Therefore, the decision by an investment company to sell its shareholding in another company is only a decision in the ordinary course of its business and not a UPSI. SAT clarified that the price rise in the shares of FCGPL and trading by Matangi and Marley in the securities of FCGPL was based on the acquisition of mining leases in Australia which was already disclosed and not on the basis of the decision to sell shareholding in the Coke Company. The Appeal was allowed and the impugned order of SEBI was set aside.

7. Conclusion

The Insider Trading Regulations in entirety had not undergone any systematic review ever since it was enacted in the year 1992. Independent and separate amendments by SEBI to various provisions of the Insider Trading Regulations had resulted in lacunae in the Insider Trading Regulations. Further, the regulator was not able to garner requisite support from the language of the Insider Trading Regulations, especially from the perspective of presenting evidence, for establishing the offence of insider trading. Also, it was felt in the industry circles that it was high time the Insider Trading Regulations were modified in light of global best practices. Against this backdrop, SEBI has recently constituted a High Level Committee to review the Insider Trading Regulations and suggest suitable recommendations for amendments as it considers necessary. Justice N.K. Sodhi is the chairman of the High Level Committee which includes 18 other members.

It is expected that the High Level Committee would review and revamp the Insider Trading Regulations in the same manner in which the Takeover Regulations Advisory Committee had overhauled the takeover laws in India. Since, the High Level Committee has already initiated the process of review of the Insider Trading Regulations, it is only a matter of time for the Insider Trading Regulations to undergo a crucial revision.

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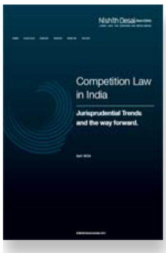

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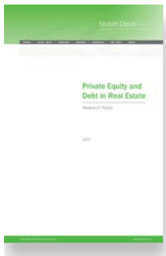

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