CHAPTER- VI

INSIDER TRADING AND CORPORATE GOVERNANCE

Insider trading becomes a serious crime in the capital market because it trenches upon the faith of fair dealing. Trading by an insider of a company in the shares of a company is not a violation of law per se but what is prohibited is the trading by an insider in the breach of trust or confidence in the stock of a company on the basis of non public information to the exclusion of others. The degree of the violation and penalties differ widely from country to country. is one of the most serious crimes on the faith of fair dealing in a capital market. The degree of the violation and penalties differ widely from country to country. Trading by an insider of a company in the shares of a company is not per se a violation of law. In fact trading by insiders, including directors, officers and employees of the company in the shares of their own company is a positive feature which companies should encourage because it aligns its interests with those of the insiders. What is prohibited is the trading by an insider in breach of a duty of trust or confidence in the stock of a company on the basis of non public information to the exclusion of others.

Insider trading refers to transaction in securities of a public listed company, by any insider or any person connected with the company, based on any material yet non-published information, which have the ability to impact on said company's securities market price, for their personal advantage. Corporate insiders such as employees, directors, managers, and other connected persons get access to the critical price sensitive information easily. When these persons use this price sensitive and non-public information for their own economic advantage, they not only breach the fiduciary duty they have been imposed with, but also impair the interests of shareholders. The act of insider trading is a result of asymmetric information. Insiders enjoy the privilege of being in the company and close to the primary source of information while general shareholders at large are dependent upon the secondary sources of information. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take
advantage of non-public information. However, this theory does not hold much relevance today. The United States of America took a big step and became the very first country to formally enact a legislation to regulate insider trading. Taking inspirations from America, most of the jurisdictions around the world also put legal restrictions to this effect. India was also 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 market watchdog, Securities Exchange Board of India (SEBI) has laid down the SEBI (Prohibition of Insider Trading) Regulations, 1992 to curb and prevent this malpractice.

Insider trading is a term subject to various interpretation, connotations and definitions. “Insider” means any person who is a connected person or in possession of or having access to unpublished price sensitive information. "Trading" means and includes subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, deal in any securities, and "trade" shall be construed accordingly. In simple terms, it can be defined as dealing in the securities of a company on the basis of certain confidential information relating to the company which is not published or not in the public domain, i.e. unpublished price sensitive information. Such unpublished price sensitive information, if had been published, would have affected the securities price of the company in a significant manner, and includes information relating to the major mergers and acquisitions, takeovers, any major project plan, contract, buy back of securities, bonus issues and so on and so forth. This is the fundamental reason behind the disclosure norms set up by the regulators. The disclosure requirements can reduce the investor's uncertainty and search expenses. Moreover, making such price sensitive information public may enable the company's current investors to sell their shares at a higher price in the market. The insider trading involves three basic elements. Firstly, there must be material non-public information. Secondly, this information must emanate from an inside source and must be in possession of some persons.

1 Section 2 (g) of the SEBI (Prohibition of Insider Trading) Regulations, 2015.
2 Section 2 (l) of the SEBI (Prohibition of Insider Trading) Regulations, 2015.
And lastly, these persons shall deal in the securities based on the possessed material non-public information. These persons who make the profits or avoid losses are known as Insiders. To put it differently, an insider is a person who has received or had access to such information or is so connected with the company that it is reasonable to expect that he would have had access to such information. The person who trades or tips any information violates the law if he has a fiduciary duty or other relationship of trust and confidence not to use the information. Trading is also prohibited when a person who receives information through a confidential relationship uses the information for his or her own trading or tips to others. People who receive information in confidence can include a broad range of persons involved in the securities markets. In USA, from time to time, the Security Exchange Commission (USA market regulator) has charged investment bankers, arbitrageurs, attorneys, law firm employees, accountants, bank officers, brokers, financial reporters and even a psychiatrist with misappropriating information and violating insider-trading prohibitions.

The rationale behind the prohibition of Insider Trading is the obvious need and understandable concern about the damage to public confidence which insider dealing is likely to cause and the clear intention to prevent, so far as possible, what amounts to cheating when those with inside knowledge use that knowledge to make a profit in their dealings with others. Permitting few people to take advantage of Unpublished Price Sensitive Information before it not only affects the performance of the company but also 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 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. Since, absolute prohibition of share trading by the insiders is not feasible; insider trading is restricted and monitored through a series of measures in different jurisdictions.

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6.1 Development of the Insider Trading Law

India’s Company Law was enacted in 1956. However, it did not include any provisions to charge the directors and the managing agents of companies for making the unfair use of inside information. Although the Thomas Committee had pointed out the lack of a special legislation to deal with the ‘unfair use of inside information’ in 1948 itself, it took a few decades to actually formulate a legislation to curb insider trading.6 The provisions relating to Insider Trading were incorporated in the Companies Act, 1956 under Sections 307 and 308, which required shareholding disclosures by the directors and managers of a company. Due to inadequate provisions of enforcement in the Companies Act, 1956, the Sachar Committee in 1979, the Patel Committee in 1986 and the Abid Hussain Committee in 1989 proposed recommendations for a separate statute regulating Insider Trading. The concept of Insider Trading in India started fermenting in the 80's and 90's and came to be known and observed extensively in the Indian Securities market. The rapidly advancing Indian Securities market needed a more comprehensive legislation to regulate the practice of Insider Trading, thus resulting in the formulation of the SEBI (Insider Trading) Regulations in the year 1992, which were amended in the year 2002 after the discrepancies, observed in the 1992 regulations. The amendment in 2002 came to be known as the SEBI (Prohibition of Insider Trading) Regulations, 1992. The regulations of 1992 seemed to be more punitive in nature while the 2002 amendment regulations on the other hand are preventive in nature. The amendment required all the listed companies, market intermediaries and advisers to follow the regulations and also take steps in advance to prevent the practice of insider trading. These preventive measures ensured the reduction of the cases involving the practice of Insider Trading and also informing the persons who indulge in such practices, of the laws relating to Insider Trading. These regulations particularly emphasize on the delegation of powers on the entities themselves to conduct internal investigations before they present their case before the Stock Exchange Board of India in

relation to insider trading. The guidelines provide for a definite set of procedures and code of conduct for the entities whose employees, directors and owners are most expected to be in a position to take an undue advantage of confidential inside information for their personal profits.

Various committees were constituted in India from time to time to assess the corporate regulation frame work in India. These committees had also examined the then existing framework in the U.S.\(^7\), as the U.S. had elaborate laws on the subject. The provisions in the U.S. law, under the Exchange Act were considered effective.\(^8\) For instance, the regulations framed by the SEC under Section 14(d) of the Exchange Act, facilitated active participation by security-holders and the investors in the affairs of the companies. The following committees were constituted in this regard:

6.1.1 Thomas Committee\(^9\)

This committee considered the issue of introducing regulation of short swing profit in the line with section 16 (b) of Securities Exchange Act, 1934 of U.S.A. the Committee gave recommendation for strengthening of disclosure mechanism under the company law in the line with similar recommendation of Cohen Committee on company law reform in U.K. Cohen approach reflected the old tradition that insider trading is wholly a matter of company law.\(^10\)

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\(^7\) In the year 1948, U.S.A already had the provision at section 16 of the Securities Exchange Act of 1934 which says that directors and officers of companies (whose shares are registered for trade) and stockholders who own a more than 10% of any registered issue or stock have to file with the SEC and with the Exchange a statement of each such security, together with such changes of ownership as have occurred during each month. Such persons are also prohibited from either selling short or selling against stock, permanently held, of the issuing corporation. Any profit realized by corporate insiders from certain short-term transactions is recoverable from them by the issuer and under certain conditions by a security holder also.

\(^8\) The provisions discussed by the Thomas Committee as effective in curbing the insider trading in the U.S. in addition to section 16 were:
   a) Section 12 of SEC Act, 1934 forbids trading in a security unless it is registered with the SEC (or exempted from registration), the commission insists on detailed returns being submitted to them, not only annual reports but current reports in the event of certain material changes occurring in the affairs of the company (e.g.: declaration of dividends etc.) to be promptly telegraphed to it.
   b) SEC’s power under the then section 10 (a) (2) of the Act to suspend or withdraw the registration of a security if the issuer fails to comply with the above provision.
   c) SEC is authorised to prescribe rules under section 14(d) of SEC Act, 1934 concerning the solicitation of proxies, etc. in connection with listed securities. SEC has made regulations under this in the public interest or for the protection of investors.

\(^9\) [http://reports.mca.gov.in/Reports/40Thomas%20report%20of%20the%20regulation%20of%20the%20stock%20market%20in%20India,%201948.pdf](http://reports.mca.gov.in/Reports/40Thomas%20report%20of%20the%20regulation%20of%20the%20stock%20market%20in%20India,%201948.pdf) (Visited on November 1, 2015).

rationale was disclosure of holding in public domain would reduce the opportunity for engaging in insider trading. Based upon this and other recommendations of disclosure regime were introduced under section 307 and 308 of Companies Act, 1956 by its 1965 amendment. Insider trading continued to be legal it was only in early 1980s it began to be recognised as undesirable practice.

6.1.2 The Bhaba Committee

The Bhaba Committee was constituted in 1952 in order to revamp the then existing Companies Act, 1913. In its report, the committee observed the trend of fraudulent dealings in the shares by the directors of the companies. The report observed that there existed evil of the directors dealing in the shares of their own companies, exists although on a limited scale. However, it is interesting to note that the term ‘insider trading’ does not find place in the report prepared by the committee, especially when Thomas Committee has elaborately discussed this issue way back in 1948.

Further to these provisions, in order to enforce these sections, the committee also felt it necessary to impose a duty on the director of a company and on every person who is deemed to be a director to give notice to the company of all matters relating to the shares and debentures held by the director, as required under this section. It was viewed that unless a director or a person who is deemed to be a director is required by law to intimate the relevant facts to a company, it will not be possible for the companies to maintain the register of directors’ holdings in the company.

Thus, Sections 307 and 308 were incorporated in the Companies Act of 1956. Section 307 provided for maintenance of a register by the companies to record the directors' shareholdings in the company. Section 308 prescribed to the duty of the directors and persons deemed to be the directors to make disclosure of their shareholdings in the company. Thereafter, by the Companies Amendment Act, 1960, had extended this requirement to the shareholdings of a company’s managers as well.

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12 Para 100 of the Bhabha committee report on Company law committee, 1952.
Section 307 of the Companies Act, 1956 covers all directors, including deemed directors, i.e., every person in accordance with whose directions or instructions, the Board of Directors is accustomed to act. The register of shareholdings to be maintained by the companies, must carry details regarding names, description and the amount of the shareholding of each of the directors and the deemed directors, and also the nature and the extent of the interest or right in or over any shares or debentures of such person. If a right or interest exists, irrespective of its nature or whether it is direct, indirect or remote it must be disclosed. This recordal requirement applies even in respect of such persons the holdings, interest or right in or over the shares or debentures of the company, or any body corporate in which the Board of directors is accustomed or bound to act according such persons’ directions or instructions. Further, even if the body corporate or its Board of Directors are not accustomed or bound to act according to such persons’ directions or instructions, if the person hold or control one third of the total voting rights in that body corporate the recordal is mandatory.

Section 308 casts a statutory responsibility on the directors and managers to disclose to the company the prescribed particulars so that these can be entered by the company in the register. Thus, even before the formal laws directed towards prohibition of insider trading were framed in India, attempts were made to curb the malpractice, with the primary focus on disclosures by insiders. The inertia on the part of the committee members to define ‘speculative profits’ could be one of the reasons that prevented the legislators from framing clear-cut legislation for insider trading, although the recommendation was made as early as 1952.

6.1.3 Sachar Committee

In 1977, Sachar Committee, a high powered committee was set up to review the provisions of the Companies Act and the Monopolies and Restrictive Trade Practices Act, 1969 (the current Competition Act, 2002). This Committee


14This committee was headed by Justice Shri Rajindar Sachar, the then judge of the High Court of Delhi.
opined that Sections 307 and 308 of the Companies Act were insufficient to curb insider trading. The Committee’s view was that the statutory provisions which require disclosures to the shareholders regarding the transactions in the sale and purchase of shares by the directors and other key managerial persons are insufficient to solve the problem of certain class of people securing unfair profits by the use of non-public confidential information.

The Sachar Committee had also identified certain category of persons who may be included in the category of insiders, such as the company's directors, statutory auditors, cost auditors, financial accountants or financial controller, cost accountants, tax management consultants or advisers and the whole time legal advisers or solicitors who would generally have access to the price sensitive information not available to the outsiders. Although the Thomas Committee had also earlier suggested a broader category of insiders to be identified within the regulatory purview, no legislative actions were pursued in this regard.

Further, the Sachar Committee had identified that it is often difficult to prove whether or not the material non-public information has been actually put to use in a transaction. The committee was of the view that the law should provide that an insider including the categories mentioned above, should be prohibited from purchasing or selling the shares of the company, either directly or indirectly, for a period of two (2) months’ prior to and after the closing of the accounting year of the company. This period was specifically considered crucial as there was a presupposition that an insider would possess confidential information during such time. The proposal was that once it is proved that the deal by an insider has resulted in one party taking advantage over the other by misusing the information relating to the company, then the insider shall be liable at law to the other party: i.e., the person with whom the insider has then dealt, the company in whose shares he has dealt or whose information he has used in so doing.

Another recommendation made by the Sachar Committee had also opined that the law should confer a remedy on persons who can establish an identifiable loss by reason of the misuse of materially significant information; and in addition, an insider should be held to be accountable to the company for his unjustifiable profits. Despite the foregoing recommendations, until date, the Indian securities
laws do not provide for sufficient remedies to the persons suffering losses due to misuse of information. In this regard in India, the Stock Exchange Board of India has made efforts to disgorge the profits illegally made by market manipulators and insiders, by exercising its powers, to issue directions in the interest of the investors and to protect the integrity of the securities market. However, until 2009, the SAT had not upheld any such enforcement order for disgorgement, as the Stock Exchange Board of India did not have any specific statutory powers to order disgorgement. In *Dhaval Mehta v SEBI* the SAT, for the first time, recognized Stock Exchange Board of India’s power to direct disgorgement of illegal profits made by market manipulators. More specifically, the Sachar Committee had recommended additional requirements for the disclosures under the Companies Act and the disclosures by other persons, who are temporary insiders or who become insider by virtue of their possession of information.

15 Section 11B of the Stock Exchange Board of India Act, 1992.
17 The recommendations of Sachar committee are reproduced verbatim here. (i) Any Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time legal Adviser or Solicitor of the company and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest should, prior to actual purchase or sale, notify in writing the Board of Directors of the company his or their intention to buy or sell the shares of the company.

(ii) Full disclosure as to the number of shares, price at which they were bought or sold shall be made by persons mentioned at (i) above to the shareholders of the company by annexing a suitable statement to the published accounts.

(iii) The requirements of (i) and (ii) above should apply to the spouse and dependent children of persons mentioned at (i) above.

(iv) Any Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time Legal Adviser or Solicitor of the company and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest should be prohibited from either purchasing or selling the shares of the company, two months prior to the closing of the accounting year of the company and for a period of two months thereafter. Such prohibition should extend for a period of two months prior to any Rights issue orBonus issue.

(v) If for compelling reasons the Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time Legal Adviser or Solicitor and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest, desire to buy or sell the shares of the company within the prohibited period, he or they must give prior intimation in writing of the proposal to purchase or sell to the Board. If the Board does not, within the period of fifteen days from the date of receipt of such notice at the registered office of the company, refuse permission, the person concerned would be entitled to sell or purchase shares in the company within the prohibited period, as proposed.

(vi) The spouse and dependent children of the persons referred to at (i) above should also be subject to similar disability during the specified periods.
6.1.4 Patel Committee

The Government of India had constituted a high power committee in May 1984 headed by G. S. Patel (the “Patel Committee”) to make a comprehensive review of the functioning of the stock exchanges. The Patel Committee had highlighted that insider trading was unethical as it involves misuse of confidential information and betrayal of fiduciary position of trust and confidence. The Patel Committee had suggested that a malpractice such as ‘insider trading’ should be made a cognizable offence.\(^{18}\) The report submitted by the Patel Committee defined ‘insider trading’ as “trading in the shares of the company by the persons who are in the management of the company or are close to them, on the basis of unpublished price sensitive information, regarding the working of company, which others do not have.”\(^{19}\) This was the first time that the term “insider trading” was defined and proposed as an area that required legislation, to the Indian Government. Further, it was for the first time in India that a government committee had recommended a specific statutory prohibition of insider trading. Although the Sachar Committee had recommended that transactions by directors and key managerial persons of like nature should be prohibited, the activity by the name of ‘insider trading’ was sought to be prohibited for the first time by the Patel

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\(^{18}\) Para 2.49 of the Patel Committee Report.

\(^{19}\) Para 7.25 of the Patel Committee Report.
Committee. The Patel Committee had recommended that a codified legislation similar to the Australian law should be drafted in India also to counter the malpractice of ‘insider trading.’ The committee had also submitted draft legislation for prohibiting insider trading. As regards the legal mechanism, the Patel Committee had recommended the introduction of provisions relating to insider trading as an amendment to the SCRA, on the lines of the Australian legislation. Additionally, the committee also recommended incorporating some of the important provisions of the U.K. Company Securities (Insider Dealing) Act, 1985.

This committee dealt with the offence of insider trading in a thorough and comprehensive manner. For example, the committee had suggested that insider trading should be fined heavily for first offence,$^{20}$ and imprisonment up to five (5) years should be given for second and subsequent offences. The Patel Committee report also acknowledged that in the U.S., other than the specific legislation, the Supreme Court and the Court of Appeals of various states have issued guidelines on insider trading, to maintain proper ‘fiduciary standards’, ensure justice and equity in the securities market, and to protect the interests of the investing public. The committee’s report also suggested certain remedial measures for tackling the menace of insider trading. The Committee had identified that one of the reasons for excessive speculation in the stock exchanges during 1980s, was the lack of prompt disclosure of corporate news by the companies whose shares are listed with the stock exchanges.

Therefore, as remedial measure, the Patel Committee had recommended that all the listed companies should publish their un-audited working results at least on a half-yearly basis, and on a quarterly basis if the paid-up capital of the company is more than Rs.10 crores. The committee further recommended that the stock exchanges should be immediately informed about any significant financial or other news or developments affecting the price of the company’s securities, as soon as such matters are placed on the agenda of the board meetings and circulated to other directors.

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$^{20}$ Para 7.27 of the Patel Committee Report.
The committee also proposed that if any company fails to comply with the provisions of the listing agreement (entered between the companies and the stock exchanges) relating to material disclosures by the company, the person in-charge of the management of the company should also be penalized for non-compliance. The committee recommended that such statutory responsibility for non-compliance of disclosure obligations should be introduced under the Companies Act, 1956, and the Securities Contract (Regulation) Act. However, it was only after 20 years in 2002, that a provision imposing monetary penalty for non-compliance of listing agreement was inserted in Securities Contract (Regulation) Act, 1956.21

6.1.5 Abid Hussain Committee on Capital Markets

In 1989, the Abid Hussain Committee was set up to examine the adequacy of the existing institutions, instruments and the structures in the Indian capital market and the rules governing its functioning. One of the first and foremost problems identified by the committee was insufficiency of the basic rules of the capital market. The basic rules were adjudged to be insufficient because of the fast changing needs capital market especially in the area of investor protection and guidance. The committee also acknowledged that despite the continuing efforts on the part of various authorities, many aspects of trading practices still required improvement. Rules and standards emphasizing fairness in securities dealings were perceived to be insufficient and amenable to misuse by the traders. The committee also observed that the absence of effective checks and penalties was encouraging the speculators and not the genuine investors.

In April 1988, the Government of India constituted the SEBI, with the primary mandate of investor protection. During the deliberations of the Abid Hussain Committee, the SEBI had initiated the process of incorporating the legal framework to regulate the conduct of all the major players in the market, i.e., the issuers, intermediaries and the exchanges.

21 Section 23E of Securities Contract (Regulation) Act, 1956, imposes a penalty of upto Rs 25 crores on a company, collective investment schemes or mutual fund for failure to comply with listing conditions.
Although the Abid Hussain Committee had admitted its difficulty in prescribing remedies to each one of the trading malpractices in the Indian stock market, it is observed that problems of insider trading and secret takeover bids could be tackled to a large extent by appropriate regulatory measures. The committee proposed that insider trading should be regarded as a major offence, punishable with civil as well as criminal penalties. The committee recommended that the SEBI should be asked to formulate the necessary legislation, empowering itself with the authority to enforce the provisions.

6.1.6 Sodhi Committee

The High Level Committee was constituted to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992 under the Chairmanship of Justice N.K. Sodhi, former chief justice of Karnataka and Kerala High Courts and former presiding officer of the Securities Appellate Tribunal, submitted its report to SEBI Chairman, Shri U.K. Sinha, on December 7, 2013 at Chandigarh. The Committee has made a range of recommendations to the legal framework for prohibition of insider trading in India and has focused on making this area of regulation more predictable, precise and clear by suggesting a combination of principles-based regulations and rules that are backed by principles. Some of the salient features of the proposed regulations are set out below:

I. While enlarging the definition of "insider", the term “connected person” has been defined more clearly and immediate relatives are presumed to be connected persons, with a right to rebut the presumption. The term “immediate relative” would cover close relatives who are either financially dependent or consult an insider in connection with trading in securities.

II. Insiders would be prohibited from communicating, providing or allowing access to UPSI unless required for discharge of duties or for compliance with law.

III. The regulations would bring greater clarity on what constitutes “unpublished price sensitive information” (“UPSI”) by defining

what constitutes “generally available information” (essentially, information to which non-discriminatory public access would be available). A list of types of information that may ordinarily be regarded as price sensitive information has also been provided.

IV. Trading in listed securities when in possession of UPSI would be prohibited except in certain situations provided in the regulations.

V. Insiders who are liable to possess UPSI all round the year would have the option to formulate pre-scheduled trading plans. In such cases, the new UPSI that may come into their possession without having been with them when formulating the plan would not impede their ability to trade. Trading plans would, however, be required to be disclosed to the stock exchanges and have to be strictly adhered to.

VI. Conducting due diligence on listed companies would be permissible for purposes of transactions entailing an obligation to make an open offer under the Takeover Regulations. In all other cases, due diligence would be permissible subject to making the diligence findings that constitute UPSI generally available prior to the proposed trading. In all cases, the board of directors would need to opine that permitting the conduct of due diligence is in the best interests of the company, and would also have to ensure execution of non-disclosure and non-dealing agreements.

VII. Trades by promoters, employees, directors and their immediate relatives would need to be disclosed internally to the company. Trades within a calendar quarter of a value beyond Rs. 10 lakhs or such other amount as SEBI may specify, would be required to be disclosed to the stock exchanges.

VIII. Every entity that has issued securities which are listed on a stock exchange or which are intended to be so listed would be required to formulate and publish a Code of Fair Disclosure governing disclosure of events and circumstances that would impact price discovery of its securities.
IX. Every listed company and market intermediary is required to formulate a Code of Conduct to regulate, monitor and report trading in securities by its employees and other connected persons. All other persons such as auditors, law firms, accountancy firms, analysts and consultants etc. who handle UPSI in the course of business operations may formulate a code of conduct and the existence of such a code would evidence the seriousness with which the organization treats compliance requirements.

X. Companies would be entitled to require third-party connected persons who are not employees to disclose their trading and holdings in securities of the company.

6.2 Insider Trading and the Stock Exchange Board of India

The Controller of Capital Issue was the first authority to approve issue of securities, and the amount, type and the price of securities, as well. The Controller of Capital Issue was set up in 1947, under the Capital Issues Act. However, with the repeal of Capital Issues (Control) Act, 1947 the Controller of Capital Issue also was abolished and the SEBI was set up in April 1988, for healthy growth of capital market and investor protection as its primary objective.

The SEBI Act had established SEBI as a regulatory body to protect the interests of the investors in securities, promote the development of the securities market, and to regulate the securities market. SEBI assumed the statutory status on 21 February, 1992, by way of an ordinance promulgated on 30 January, 1992. This Ordinance was replaced by the SEBI Act on 4 April, 1992. The Preamble to the SEBI Act mandates SEBI to ensure investor protection and healthy and orderly development of the securities market. In July 1988, before the Ordinance, the SEBI had prepared an approach paper on a complete legislative framework for securities market which included measures to curb fraudulent and unfair practices. Relying on the ‘high standard of conduct’ stressed by the Cohen Committee\(^\text{23}\) with

\(^{23}\) The Cohen Committee on Company Law Reform in England had observed: "Even if legislation is not entirely successful in suppressing improper transactions, a high standard of conduct should be maintained, and it should be generally realised that a speculative profit made as a result of special knowledge not available to the general body of shareholders in a company is improperly made. Bharat, Compendium on SEBI, Capital Issues & Listing, 657.
respect to insider dealing, the SEBI had issued a press release dated 19 August 1992\(^\text{24}\) with a recommendation to formulate the ‘internal code of conduct’ for the companies to check the practice of insider trading.

### 6.2.1 SEBI (Prohibition of Insider Trading In The Securities Market), Regulations, 1992

Under the SEBI Act, Section 11(2) (g)\(^\text{25}\) empowered the SEBI to take such measures, inter alia, to prevent insider trading, to protect the interest of investors and to promote the development of and regulate the securities market. The SEBI has been further empowered to make regulations consistent with the SEBI Act under Section 30 of the SEBI Act. Pursuant to such powers, the SEBI had framed

\(^{24}\) The press release issued on August 19, 1992 reads as follows: “The smooth operation of the securities market, its healthy growth and development depends to a large extent on the quality and integrity of the market. Such a market can alone inspire the confidence of investors. Factors on which this confidence depends include, among others, the assurance the market can afford to all investors, that they are placed on an equal footing and will be protected against improper use of inside information. Inequitable and unfair trade practices such as insider trading, market manipulation, price rigging and other security frauds affect the integrity, fairness and efficiency of the securities market, and impairs the confidence of the investors. The Securities and Exchange Board of India Act, 1992 has empowered SEBI to prohibit insider trading in securities and SEBI is in the process of framing regulations for this purpose. The consultative paper on the subject issued by SEBI and widely circulated through the press in December 1991 outlines the broad framework for the Regulations. After the regulations are notified and brought into effect, violation of these regulations would be an offence punishable under the SEBI Act.

In this context, SEBI has recently written to the banks, financial institutions, stock exchanges, mutual funds, merchant bankers and other intermediaries and professional bodies such as the Institute of Chartered Accountants of India, Institute of Company Secretaries of India, Institute of Cost and Works Accountants in India and Chambers of Commerce about the desirability of evolving an internal code of conduct and setting up internal procedures and checks and balances in these institutions and among the members of the professional bodies, to ensure that their employees or members as the case may be, who may from time to time be privy to unpublished price sensitive information regarding company is listed on the stock exchange is in the normal course of business, do not use such information for the purpose of trading in the securities of such companies or companies belonging to the same group for the purpose of personal profit or avoidance of loss. SEBI is of the view that besides creating awareness within these organisations about the fact that using insider information is unethical and would be punishable under law once regulations have been notified, such a measure would serve to minimise the risks of the employees or members of such organisations becoming liable to action under Insider Trading Regulations. SEBI requests the companies to take appropriate act in this regard and institute similar checks and balances through periodic disclosure and reporting requirements for the securities transactions by their directors and employees. Such voluntary preventive action on the part of companies, banks, financial institutions, stock exchanges and professional bodies would help SEBI in implementing the provisions of the SEBI Act and insider trading regulations.”

\(^{25}\) Section 11 (1) Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. Section 11 (2)(g) Without prejudice to the generality of the foregoing provisions, the measures referred to therein may provide for prohibiting insider trading in securities.
the SEBI (Prohibition of Insider Trading in the Securities Market), Regulations, 1992 on 19 November, 1992 for prohibiting the offence of ‘insider trading.’ Thus, the Insider Regulations were framed by SEBI seven (7) months after the Indian Parliament enacted the SEBI Act.\textsuperscript{26}

Regulation 4 deals with the offence of insider trading, it provides that any insider who deals in securities\textsuperscript{27} in contravention of Regulation 3 (or 3A)\textsuperscript{28} is guilty of ‘insider trading’. Regulation 3 seeks to prohibit dealing, communication and counselling on the basis of unpublished price sensitive information (“UPSI”). Therefore, the ingredients for the offence of insider trading are identified in Regulation 3.

The Insider Regulation defines the term “insider” as any person who, is or was connected with the company or is deemed to be connected with the company and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information (Regulation 2(e) of the Insider Regulations). If a person is an ‘insider’ and if he is in possession of ‘unpublished price sensitive information’\textsuperscript{29}, then he will be covered within the prohibition contained in Regulation 3 of the Insider Regulations. However, prior to the amendment of 2002, the prohibition applied to situations where the insider had actually used the unpublished price sensitive information while dealing in securities. The reason attributed for this shift from liability for use of the unpublished price sensitive information to mere possession

\textsuperscript{26} SEBI Act came into effect from 4 April, 1992.
\textsuperscript{27} The amendment dated 20-2-2002 removed the clause “or communicates any information or counsels any person dealing in securities.”
\textsuperscript{28} Inserted by the SEBI (Insider Trading) (Amendment) Regulations, 2002 w.e.f. 20-02-2002.
\textsuperscript{29} Under regulation 2(k), ‘unpublished price sensitive information’ means any information which relates to the following matters or is of concern, directly or indirectly, to a company, and is not generally known or published by such company for general information, but which if published or known, is likely to materially affect the price of securities of that company in the market.

a) financial results (both half yearly and annual) of the company
b) intended declaration of dividends (both interim and final)
c) issue of shares by way of public rights, bonus, etc
d) any major expansion plans or execution of new projects,
e) amalgamation, merger and takeovers
f) disposal of the whole or substantially the whole of the undertaking
g) such other information may affect the earnings of the company
h) any changes in policies, plans or operations of the company
of the unpublished price sensitive information is because of the difficulty to prove that the insider had actually used the unpublished price sensitive information while dealing in the securities, whereas it is easier to prove that the insider dealt in securities while in possession of unpublished price sensitive information.

In 1993, the SEBI once again advised the companies to prescribe certain internal norms relating to the company’s information vis-à-vis the Insider Trading Regulations.\(^\text{30}\) The suggested parameters under the press release were:

(i) Identification of the types of information which could be considered as price sensitive information in relation to the business of the company and its subsidiaries and associate companies, for example:
   (a) Earnings forecast or material changes therein;
   (b) Proposals for mergers & acquisitions;
   (c) Significant changes in investment plans;
   (d) Acquisition or loss of a significant contract;
   (e) Significant disputes with major suppliers, consumers or sub-contractors; and
   (f) Significant decision affecting the product pricing, profitability, etc.

(ii) Identification of the employees or officers or sections of employees/officers of the company who are likely to have access to such information and considered as insiders.

(iii) Nomination of an officer or officers of a company who would give clarifications to the employees of the company on their ability to deal in the company’s shares without attracting the charges of insider trading.

(iv) Controls on handling the price-sensitive information identified above and the publication of such information, wherever possible, so as to eliminate the non-public character of the information.

(v) The norms to be followed by all officers and the employees of the companies, such as not dealing in the shares of the company for a particular period (before and after the declaration of periodical financial results), the time period for which the employees and officers

\(^{30}\) SEBI Press note dated September 13, 1993.
of the company have to wait before they deal in the shares of the company (after any price-sensitive information has been made public), etc.

(vi) Declaration of purchase and sale of the shares of the company to be obtained from employees and officers including transactions done by the relatives of employees and officers.

(vii) The procedure to be laid down for handling information which may affect the price of the securities of other companies in situation such as mergers, takeovers, etc.

In 2002, the above norms were further modified and the Model Code of Conduct framed under the Insider Regulations came into force. Further, it was only in 2002 that a specific provision regarding the prohibition on insider trading was inserted in the SEBI Act.31 The SEBI Act prohibits manipulative trades, insider trading activities and substantial acquisition of securities. It provides as below:-“No person shall directly or indirectly –

(i) use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made there under;

(ii) employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;

(iii) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made there under;

(iv) engage in insider trading;

31 Chapter V A was inserted in the SEBI Act in 2002 and Sections 12A (d) & (e) of Chapter VA specifically related to insider trading. This amendment, inter alia, incorporated the provisions of Insider Trading Regulations into the SEBI Act.
(v) deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules or the regulations made there under;

(vi) acquire control of any company or securities more than the percentage of equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange in contravention of the regulations made under this Act.”

As regards sub-clauses (d) and (e) above, although the SEBI had incorporated the provisions relating to insider trading in the SEBI Act, the SEBI Act did not define the term “insider trading.” Although the Section 12A did not have any material impact on the analyses and enforcement of the insider trading cases in India, the demand among the jurists for a specific provision under the SEBI Act prohibiting insider trading was recognized. Subsequently, the SEBI amended the Insider Regulations on several occasions. A close look at the timing of these amendments even makes it possible to think that the experiences gained through the process of testing various enforcement actions of the Indian regulator and the views of the courts and tribunals/appellate authority on the subject, was the background of these amendments.

In Hindustan Lever Limited v. SEBI. Hindustan Lever Limited (HLL) and Brooke Bond Lipton India Ltd (BBLIL) were subsidiaries of the common parent company, Unilever. A merger announcement between BBLIL and HLL was intimated to the stock exchanges on 19 April, 1996. SEBI was notified about the leakage of the merger information and insider trading by the market as well as the media. Therefore, the SEBI had initiated investigations into the matter. SEBI found that HLL as an insider had purchased the securities of BBLIL from the Unit Trust of India (“UTI”) on the basis of the UPSI about the impending merger, thereby violating the provisions of the Insider Trading Regulations and the SEBI Act. As a result, UTI incurred losses. SEBI, in exercise of its power under Section 11B of the SEBI Act read with Regulation 11 of the Insider Regulations had

directed the HLL to compensate the UTI to the extent the UTI had suffered losses. SEBI estimated the loss caused to the UTI on account of the insider trading at Rs.3.04 crores. The basis for this calculation was the difference between the market price of the shares of BBLIL at which the shares were sold by UTI to HLL after the announcement of the merger and the price of the shares prior to the announcement of the merger, excluding premiums. SEBI justified its action as corrective steps. UTI and HLL filed separate appeals against the SEBI’s order before the appellate authority, the central government.  

SEBI had concluded that if a connected person actually gains or receives such information independently, notwithstanding his position in the company, such person will fall within the definition of ‘insider’ and therefore, SEBI regarded HLL as an insider. This was upheld by the appellate authority. However, the appellate authority overruled the SEBI’s order, inter alia, on the following grounds: (i) the news about the merger was not a UPSI as it was generally known and acknowledged by the market; (ii) the information relating to merger could not have significant impact on the price at which the transaction was concluded; (iii) the SEBI’s decision to award compensation to UTI suffers from procedural deficiencies; (iv) SEBI’s direction to HLL to compensate UTI lacks jurisdiction; and (v) SEBI’s direction for prosecution under Section 24 of the SEBI Act was bad in law as the order did not state the reasons for prosecution and also SEBI did not invoke its specific powers for adjudication under Section 15G of the SEBI Act. Therefore, the SEBI’s decision to prosecute HLL was set aside by the appellate authority.

6.2.2 Kumar Mangalam Birla Committee

In early 1999, the SEBI had set up a committee headed by Kumar Mangalam Birla, a member of the SEBI Board, to promote and raise the standards of good corporate governance. The Kumar Mangalam Birla Report on Corporate Governance.

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34 Initially, the orders of SEBI were appealable before the central government by the aggrieved party. Section 20 of the SEBI Act, 1992 provides that any order of the Board passed before the Securities Law Amendment, 1999 shall be appealable to the Central Government. It was in the year 1995, with the insertion of chapter VI A of SEBI Act, 1992 that the Securities Appellate Tribunal (SAT) was set up. Initially only the orders of A.O. were appealed before the SAT. However, with the amendment of 1999, SAT was conferred with the powers to decide the appeals preferred against orders of SEBI as well as that passed by A.O.
Governance elaborately discussed about the importance of prohibition of insider trading for good corporate governance. Some of the relevant recommendations in the report are as follows:

(i) suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;

(ii) drafting a code of corporate best practices; and

(iii) safeguards to be instituted within the companies to deal with the inside information and insider trading.

The report also observed that the existence and enforceability of regulations relating to insider information and insider trading are crucial to good corporate governance. Further, the provisions regarding existence and enforceability of insider trading regulations were examined separately by a group appointed by SEBI under the Chairmanship of Kumar Mangalam Birla. However, no separate report is publicly available prescribing safeguards for companies to deal with insider trading or suggesting any changes in the Insider Regulations.

35 Para 1.4 is quoted below: - “1.4 Another important aspect of corporate governance relates to issues of insider trading. It is important that insiders do not use their position of knowledge and access to inside information about the company, and take unfair advantage of the resulting information asymmetry. To prevent this from happening, corporates are expected to disseminate the material price sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. The principle should be ‘disclose or desist’. This therefore calls for companies to devise an internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its directors and employees and other insiders. For example, in many countries, there are rules for reporting of transactions by directors and other senior executives of companies, as well as for a report on their holdings, activity in their own shares and net year to year changes to these in the annual report. The rules also cover the dealing in the securities of their companies by the insiders, especially directors and other senior executives, during sensitive reporting seasons. However, the need for such procedures, reporting requirements and rules also goes beyond corporates to other entities in the financial markets such as Stock Exchanges, Intermediaries, Financial institutions, Mutual Funds and concerned professionals who may have access to inside information. This is being dealt with in a comprehensive manner, by a separate group appointed by SEBI, under the Chairmanship of Shri Kumar Mangalam Birla.”

36 Para 2.9 of the Kumar Mangalam Birla Report.
Nevertheless, the 2002 amendment to the Insider Regulations is presumed to be an outcome of the deliberations of this committee.

6.2.3 Securities and Exchange Board of India (Insider Trading) (Amendment) Regulations, 2002

Insider Trading Amendment Regulations, 2002 brought about the much awaited amendments in the Insider Regulations, which included the conceptual alterations. The below mentioned significant amendments were introduced under different headings of the Insider Regulations:

6.2.3.1 Insider

(i) The definition of ‘connected person’ at Regulation 2 (c) that existed earlier was substituted with a new definition of ‘connected person’. The amendment included the persons having both temporary and permanent professional or business relationship with the company under in the definition of “connected person.” Therefore, the scope of the term “insider” was broadened by including temporary professionals as well. Further, connection was given a periodical existence, i.e., a person connected within six (6) months prior to the act of insider trading was regarded as connected person.

(ii) The definition of “insider” was modified and the words ‘by virtue of such connection’ were deleted from the definition. SEBI’s argument in the Hindustan Lever Case that the acquisition of UPSI by an insider could be independent of the insider’s connection with the company was upheld by the appellate authority. On similar lines, by the amendment in 2002, the SEBI had altered the law to avoid any contrary interpretations in future.

(iii) A clause was included in the definition of “insider” whereby the intermediaries such as the Investment Company, the Trustee Company, the Asset Management Company or an employee or director of stock exchange or clearing house or clearing corporation were also included in

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38 The detailed discussion on the amended definition of “insider” has been included in Chapter IV of this study.
the scope of ‘deemed connected person’.\textsuperscript{39} This description of “intermediary” was taken from Section 12 of the SEBI Act.\textsuperscript{40}

(iv) The relatives of connected person were also included in the category of deemed connected person.

(v) Further categories were included in the definition of ‘deemed connected person’, such as a person who is a concern, firm, trust, Hindu undivided family, company or association of persons wherein, either the director or deemed director\textsuperscript{41} or any of the persons mentioned at Regulation 2(h) (vi) to (viii), (i.e., relative of the persons mentioned in the initial clauses of definition of ‘deemed connected person’), who have more than 10% of the holding or interest.

6.2.3.2 Unpublished Price Sensitive Information

The definition of ‘unpublished price sensitive information’ was bifurcated into “unpublished information” and “price-sensitive information”. The new definition for ‘price-sensitive information’ was inserted at Regulation 2(ha) and the term ‘unpublished’ was defined at Regulation 2(k). The term ‘unpublished’ was defined separately as ‘information which is not published by the company or its agents and is not specific in nature.’ The explanation to the provision stated that “speculative reports in print or electronic media are not considered to be published.” The term “price-sensitive information” was defined 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.” The definition also provided an inclusive list of kinds of information which are deemed to be price-sensitive information. Thus, the new definition of ‘price sensitive information’ seems to have taken care of the ambiguity pointed out by the appellate authority in the Hindustan Lever Case relating to the ‘unpublished price sensitive information.’

\textsuperscript{39} The term ‘deemed connected person’ was subjected to a lot of criticism before the SAT in the case of Samir Arora.

\textsuperscript{40} This provision has certain elements contained in the following clause (iii) under the definition of ‘deemed connected person’. There is an overlapping of the provisions under clauses (ii) and (iii).

\textsuperscript{41} As defined to be connected persons at regulation 2 (c) (i) of SEBI (Prohibition of Insider Trading) Regulations, 1992.
6.2.3.3 Offence of insider trading

i. The definition of “dealing in securities” was amended to include the term ‘subscribe’, in addition to the existing actions of buying and selling. Therefore, the offence of insider trading was extended to the primary market by covering the cases of initial public offers.

ii. Earlier, the liability of insider trading could be imposed if the insider dealt in the securities on the basis of the UPSI. However, the amendment altered this requirement and provided that mere possession of the UPSI is sufficient to impose the liability for insider trading. The words ‘on the basis of’ in Regulation 3 was substituted with the words ‘while in possession of’. This amendment was similar to the Rule 10 b-5-1 of the U.S.’ Exchange Act relating to possession v. use of UPSI. This amendment in the Insider Regulation was very significant in the Indian scenario as well, as the amendment eased SEBI’s difficulties in proving the liability of an insider who had traded on the basis of UPSI. Consequently, this resulted in better enforcement of insider trading cases in India.

iii. Tipping per se was made an offence under the amendment. Earlier, if the tippee did not trade using the tipped UPSI, the tippee and the tipper could not be held liable. However, after the amendment, the tippers’ and the tippees’ liability was made absolute and they could be held liable even if the tippee himself did not trade on the tipped UPSI. Therefore, Regulation 3 (ii) was amended to prohibit tipping UPSI, irrespective of whether the tippee trades using the tipped UPSI.

iv. Prior to the amendment, a company could not be held liable for insider trading. This became an issue as many companies also involved in insider trading and made huge profits. Therefore, the Regulation 3A was inserted to prohibit companies from dealing in the securities of another company or associate of that other company while in possession of UPSI. This amended was warranted as companies and not just persons were stakeholders in other companies and during takeovers, the potential bidders (which were companies) were in possession of UPSI.
6.2.3.4 Provisions on Investigation

(i) The amendment conferred SEBI with additional powers to conduct inquiries and inspection against an insider to establish the liability for violation of Insider Regulations.

(ii) Prior to the amendment, SEBI could not proceed with an action for insider trading violation, if the SEBI did not have written information about the violation. However, now the requirement of ‘written information’ to be in the possession of SEBI has been dispensed with. Now, SEBI can initiate investigation by appointing an investigating authority if SEBI is of the prima facie opinion that it is necessary to investigate.

(iii) The scope of investigation has been extended to more categories such as stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisations in the securities market.

(iv) The timeframe of one (1) month to complete the investigation and submit the investigation report has been substituted by ‘reasonable time’. Although this amendment may cause delays in enforcement of insider trading cases, SEBI will get adequate time to carry out detailed investigations as required and collect evidence, before concluding the liability of insider trading on an insider.

(v) Time limit of twenty-one (21) days was prescribed to a person who had to file a reply upon receipt of the communication with the findings of the investigation.

6.2.3.5 Enforcement

The amendment gave additional powers to SEBI to issue appropriate directions to an insider for insider trading violations, focusing on the investors’ interests. Under the amended provisions, the SEBI had powers to declare a transaction underlying an insider trade null and void. SEBI also procured additional power to issue directions to the person who acquired the securities to deliver such securities back to the seller, and if he is not in a position to deliver, to pay the market price of such securities (prevailing at the time of issuing of directions or at the time of the transactions) to the seller. Post 2002 amendment,
SEBI could also direct a person who has dealt in securities in violation of the regulations to transfer a fixed 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.

6.2.3.6 Corporate Governance

The most important amendment introduced was the mandatory good governance provisions in Chapter IV of the Insider Regulations and the Model Code of Conduct for the listed companies and other entities, and relating to disclosures, for prevention of insider trading as Schedules I and II respectively.

Based on the foregoing, it can be concluded that the amendments of 2002 have significantly strengthened the regulatory regime of insider trading in India. Emphasis was given to the inclusion of corporate governance norms as a method for prevention of insider trading in companies and other entities associated with the capital market. The ‘possession’ requirement for deciding the liability in the cases of insider trading also resolved the problems faced by the regulator in proving the cases. Substantial changes were made to the provision of UPSI, all of which had enhanced the SEBI’s enforcement capability, specifically with respect to insider trading cases.

In *Rakesh Agarwal v. SEBI*42 it was held Mr. Rakesh Agarwal, the Managing Director of ABS Industries, guilty of insider trading. According to the facts of this case, a German pharmaceutical company, Bayer, had acquired ABS Industries during October 1996. The allegation of ‘insider trading’ in this case related to the period prior to the acquisition.

SEBI found that:

(i) Rakesh Agarwal is a “connected person” within the meaning of Regulation 2 (c) and he is also an “insider” as he negotiated on behalf of ABS Industries and knew about the impending merger.

(ii) The information about the takeover was ‘price-sensitive information’ within the meaning given under the Insider Regulations.43

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42 (2004 ) 49 SCL 351 SAT.
In view of the foregoing, SEBI held Rakesh Agarwal liable for insider trading. SEBI also ordered adjudication proceedings under Section 15 (G) of SEBI Act against Rakesh Agarwal, and found this to be a fit case to launch prosecution. The enforcement order of SEBI in Rakesh Agarwal Case was more or less similar to the order of SEBI in Hindustan Lever Case, in terms of compensation to investors and prosecution against insiders. The additional feature was that SEBI had invoked its specific adjudication powers provided under Section 15 (G) of the SEBI Act, unlike in the Hindustan Lever Case. Rakesh Agarwal appealed against the SEBI’s order before the SAT. Although the SAT found that Rakesh Agarwal was an insider and that the information about the merger was UPSI, the SAT set aside the SEBI’s finding that Rakesh Agarwal was guilty of insider trading. The reasoning given was that there was no unfair advantage gained by the insiders and the act of Rakesh Agarwal of making the shares of ABS Industries available for Bayer was only to ensure the successful acquisition, which was crucial for ABS Industries’ business.

Although the SEBI took the plea before the SAT that Regulations 3 and 4 are “plain vanilla” sections without the specific mention of motive or intention, the SAT was of the opinion that Insider Regulations in India, if read with the objective of prohibiting the insider trading, makes clear that motive is built in and the insider trading without establishing the motive factor is not punishable. SAT was of a firm view that Insider Regulations in India seek to prohibit gaining of unfair advantage by the insider by indulging in insider trading. Hence, the SAT ruled that Rakesh Agarwal was acting in the interest of the company and therefore, he was not guilty of violating Insider Regulations. Although the order of SEBI to compensate investors was set aside by the SAT, it held that it did not have the jurisdiction to interfere with the SEBI’s direction to launch prosecution and initiate adjudication against Rakesh Agarwal. SEBI filed an appeal against this decision of the SAT, in the Supreme Court of India. However, the case was settled through the SEBI’s consent scheme and thus, there was no occasion for the Supreme Court to analyze of the facts of the case and law involved. If the case had been disposed of on merits, the Indian law on insider trading would have had
more clarity as regards the significance of “motive” and “intention” in the insider trading cases.

6.2.4 Amendment of 2002 for Chinese wall Defences

It is interesting to note that another amendment was introduced in the same year 2002 in the Insider Regulations.\textsuperscript{44} The amendment was introduced as Regulation 3B, which provided for general defences available to a company for defending the charge of insider trading. These defences are popularly referred to as ‘Chinese Wall Defences’ for the companies and are similar to the provisions under the Australian Corporations Act. The defences available in India are that the UPSI was in the possession of an officer or employee, and:

(i) that the decision to enter into the transaction or the agreement was taken on the company’s behalf by person or persons other than that officer or employee;

(ii) the company has put in place the system of demarcating the activities of the company in such a way that the person who enters into a transaction on behalf of the company cannot have access to information which is in the possession of other officer/employee of the company;

(iii) arrangements were made to ensure that information was not communicated to the person or persons who made the decision and that no advice with respect to the transactions or agreement was given to that person or any of those persons by that officer or employee;

(iv) the information was not communicated or no such advice was given; and

(v) the acquisition of shares of a listed company were as per the SEBI’s Takeover Regulations.

In view of the foregoing, the defences for insider trading under the Insider Regulations are available only to the companies and not to the individuals. It is surprising that no defences have been made available to the entities other than the companies. An intermediary or other entities in the securities market who is alleged to have indulged in insider trading, while in possession of UPSI, and if it was the intermediary’/s/entities’ employee who actually committed the insider

\textsuperscript{44} The second amendment in the year 2002 was on 29-11-2002, known as the SEBI(Prohibition of Insider Trading)(Second Amendment)Regulations, 2002.
trading stealthily, cannot have a defence under Regulation 3B. But if it has the legal structure of the company, the defences are available. It is unfair that the norms prescribed for prevention of insider trading apply to all entities including the companies, whereas the defences are available only to the companies. The specific inclusion of Regulation 3A and 3B (relating to offence of insider trading by a company and the defences) was on the premise that a company is a juristic person and not a natural person, and therefore, a company cannot indulge in insider trading. However, this explanation is untenable from a legal and logical standpoint.

6.2.5 Amendments in Insider Regulations (2003)

Minor amendments were again introduced in the Insider Regulations in 2003 regarding the formats in which the disclosures were to be made under the Insider Regulations. For instance, the Form A under Regulation 13 (filing of disclosures) was part of this amendment.

In *Reliance Industries Limited v Securities and Exchange Board of India* this case, Based on the complaint received the SEBI conducted an investigation into the alleged transactions. SEBI was of the prima facie view that RIL and the Ambanis were insiders, the acquisition of RIL’s stake in L&T by GIL was price-sensitive information, and that the acquisition of L&T shares by RIL, prior to the sale to GIL was on the basis of UPSI. Based on the above, SEBI had issued a show-cause notice to RIL. The Ambanis denied that they were insiders and also said that they did not have access to the alleged price-sensitive information. Therefore, the primary issue before the SEBI was the interpretation of the term ‘insider’ whether Mukesh Ambani and Anil Ambani were ‘insiders’ within the meaning of Regulation 2(e) of the Insider Regulations and whether they can be termed as ‘connected persons’ or ‘deemed to be connected persons’ in terms of Regulation 2 (c) and (h) of the Insider Regulations. In its order dated 21 January 2004, the SEBI ruled that as the Ambanis were the directors on the board of L&T and were reasonably expected to have access to the L&T’s UPSI; the Ambanis were ‘connected persons’ within the meaning of Regulation 2 (c) of the Insider Regulations. SEBI also observed that RIL and L&T may be deemed to be bodies

45 2004 INDLAW SAT 234.
corporate under the same management as per Section 2 (g) of the MRTP Act, 1969, and therefore, RIL would be “deemed to be a connected person” with L&T. Thus, although the SEBI concluded that the Ambanis can be regarded as “insiders”, the finding regarding insider trading violation was that as the UPSI was not received by RIL or Ambanis as insiders of L&T, they cannot be held liable for violation of Regulation 3.

In *Samir C. Arora v. Stock Exchange Board of India*\(^{46}\) this case, the SEBI initiated suo moto investigation into the alleged violation of the Insider Regulations amongst other violations. SEBI’s case was that by trading on the UPSI, Samir Arora took an undue advantage and succeeded in avoiding losses to the tune of Rs.23.57 crores at the cost of buyers who had no such information. As the incentives of the fund managers are linked to the performance of the funds managed by them, he was alleged to have been motivated by the personal gain that could accrue to him. In view of the foregoing facts, SEBI held that Samir Arora had violated Insider Regulations. In appeal SAT, in its order dated 15 October 2009, although observed that the SEBI’s interpretation of the definition ‘deemed to be connected person’ was too wide and would make every market player vulnerable to the charge of insider trading, the SAT accepted the SEBI’s interpretation that Samir Arora was an insider on the basis of the term “deemed to be connected person”, and that there was a UPSI and the trading.

In *Dsq Holdings Ltd v. SEBI*\(^{47}\) this case SEBI and the SAT had interpreted the Insider Regulations. It was prima facie found that DSQH violated the Insider Regulations. SEBI passed an order dated 27 February 2003 holding DSQH liable for insider trading and debarring DSQH from dealing in the securities market for five (5) years. DSQH appealed against the SEBI’s order before the SAT. SAT ruled against DSQH and held that information about the rights issue was a UPSI, and was in the possession of DSQH by virtue of it being a group company of the other. Therefore, the purchase of the shares of DSQ made by DSQH violated Insider Regulations. The facts that appellant is an insider, and that he traded in the

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\(^{46}\) [2005] 59 SCL 96 (SAT).

\(^{47}\) Appeal No: 50/2003 decided by SAT on 15.10.2004 (www.sebi.gov.in).
shares of DSQH, subsequent to his possession of UPSI have been established by SEBI and therefore, the SEBI had conclusively proved that DSQH had committed insider trading violation.

In **Dr. Anjali Beke v. SEBI**\(^{48}\) the scope of the term “insider” was widened. SEBI held that it was not necessary to show that in all cases of insider trading, a person (insider) is connected with or deemed to be connected with the company. It was the first time, when the SEBI had interpreted the definition of ‘insider’ to include persons who has received or had access to UPSI. The logic explained by SEBI was that it was possible that sometimes an insider may not be connected with or deemed to be connected with the company, but, would nevertheless become an insider for a limited period when he is in possession of the UPSI which is not known to others, and if such person trades on the basis of the said UPSI, such trading would be in contravention of the Insider Regulations. Based on these facts, SEBI held that Anjali Beke and API were insiders and violated Insider Regulations.

In appeal, the SAT, upheld the SEBI’s reasoning that when a person has received UPSI or has had access to such UPSI, the person becomes an insider\(^{49}\). It is not necessary that the person should be a connected person to the company.

In **Rajiv B. Gandhi v. SEBI**\(^{50}\) SEBI found that the results for the quarter ending December 1998 showed a negative performance of the Company over the previous quarter and Gandhi, his wife and sister (jointly referred to as “Gandhis”) sold 3600 shares of the Company on 21 January 1999 and 22 January 1999 based on this UPSI, prior to the board meeting itself, when the negative financial results were not available to the general investors. Although the Gandhis denied the charges against them, they pleaded that Gandhi’s wife and sister were not insiders within the meaning of the Insider Regulations and, therefore, no action was maintainable against them. In appeal, the SAT held that if an insider trades or

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\(^{49}\) The definition of ‘insider’ was amended by SEBI in the year 2008, whereby it was the legislative provision clearly provided that any person in possession of UPSI was an insider.

\(^{50}\) Rajiv B Gandhi v. SEBI. In this case, SEBI’s order was passed on November 30, 2006 and the SAT passed its order in appeal No. 50 of 2007 decided by SAT on 9.5.2008 (www.sebi.gov.in).
deals in the securities of a listed company, it would be presumed that he traded on the basis of the UPSI in his possession unless he establishes the contrary. As the facts necessary to establish the contrary will be within the knowledge of the insider, the burden of proving those facts is upon him. The SAT observed that 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. He should 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. As Gandhis could not establish beyond doubt that they did not trade “on the basis of” the UPSI, the SAT upheld the findings of SEBI and held Gandhis guilty of insider trading.

6.2.6 SEBI Insider Regulations 2008

In 2008, the SEBI made an attempt to introduce the concept of short swing profits in the Insider Regulations. SEBI sought to prohibit certain category of insiders from making short swing profits, i.e., profits made from the sale of securities followed by their repurchase within six (6) months. However, the proposal as contemplated in SEBI’s concept paper did not materialize in its entirety. Prior to this, the Thomas Committee of 1948, inter alia, had evaluated the U.S. regulations on short swing profits under Section 16 of the Exchange Act. Section 16 of the Exchange Act provides for a three-fold attack against the possible abuses of inside information by corporate insiders, which, inter alia, include: (i) reporting by certain insiders of their stock holdings and transactions in the company’s securities; (ii) makes it unlawful for the same insiders to engage in short sales of their company’s equity securities; (iii) permits the company or a security holder to initiate an action on behalf of the corporation to recover the benefits of the short swing profits.

Besides the short swing profit regulations, the other key features of the 2008 amendment are as follows:-

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51 On January 1, 2008, a concept paper was posted on SEBI’s website titled ‘Short Swing Profit’ Regulations in India.
The term ‘insider’ was amended once again, finally resolving a lot of issues\(^{52}\) relating to the interpretation of the term ‘insider’. Thus, with the amendment in 2008\(^{53}\), the definition of “insider” has been simplified and is made applicable to any person who has or has had access to the UPSI of the company. Therefore, any person, irrespective of whether the person is within the company or outside, who chances upon UPSI can be held liable for insider trading.

Prior to the 2008 amendments, the Regulation 13 provided that certain category of persons had to make certain disclosures within four (4) working days. The amendment of 2008 has reduced this reporting time period from four (4) days to two (2) working days.

The provision at Regulation 13(4) has been substituted with the new clause that any person who is a director or officer of a listed company, shall disclose to the company and the stock exchange the total number of shares or voting rights held, and change in shareholding or voting rights, if there has been a change in such holdings of such person and his dependents (as defined by the company) from the last disclosure made under sub-regulation (2) or under this sub-regulation, and the change exceeds Rs.5 lakh in value or 25,000 shares or 1% of total shareholding or voting rights, whichever is lower. These disclosures were to be made within two (2) working days from the receipt of the intimation of allotment of shares, or the acquisition or sale of shares or voting rights, as the case may be. Prior to the amendment, there was no disclosure requirement to the stock exchanges. Further, the furnishing of information regarding the change in the shareholding of the dependants did not exist earlier.

The procedure of e-filing\(^{54}\) was introduced to simplify the disclosure procedure.

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\(^{52}\) In majority of the litigations involving violations of Insider Regulations, SEBI found it strenuous to establish whether one is an insider.


\(^{54}\) A new clause (7) has been introduced at Regulation 13.
The amendment made it mandatory for all the shareholders to provide their Permanent Account Number (PAN) in all the forms relating to the disclosures under the Insider Regulations.

In *Sadhana Nabera v. SEBI*, SEBI had initiated investigations against Naberas and Adhunik and found that the Naberas were insiders and violated the Insider Regulations. Nabera appealed against SEBI’s order before the SAT. The SAT set aside the SEBI’s order on the ground that Nabera was an auditor in the SIL and could not be expected to have access to the UPSI, which was a policy decision. Further, the SAT also found that there was no restriction on any person, including those who were earlier insiders, to trade on the basis of that information. SAT said that when Nabera and his wife did not trade between the period Dilip Nabera joined SIL and the public disclosure of the company, they cannot be said to have violated the Insider Regulations.

However, the SAT’s observation that an auditor cannot be expected to have access to the company’s UPSI is not tenable because, practically, persons such as auditors, chartered accountants, legal counsels, etc., though may not be involved in the process of policy decisions, they may be aware of the UPSI by virtue of their positions in the company. Further according to Regulation 2(g) of the Insider Regulations, an “officer of a company” is defined to mean any person as defined in clause (30) of Section 2 of the Companies Act, 1956 (1 of 1956) including an auditor of the company. This clearly brings an auditor within the purview of ‘insider’ within Insider Regulations. This lacuna was, however, identified by SEBI and the amendment of the definition of “insider” in 2008 extended the definition of “insider” to such categories of people who have or have had access to the UPSI, irrespective of their position in the company.

In this context, the 2008 amendment to Insider Regulations in India is in harmony with the U.S. insider trading laws where persons such as accountants, auditors, legal counsels are regarded as “temporary insiders” of a company as they

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55 SEBI’s order is dated November 06, 2006 and in Appeal no:26/2007 decided on 19.02.2008.

56 It was also one of the recommendations of the Sachar Committee to consider the auditors as “insiders”.
may have access to the company’s UPSI by virtue of their position in the
company.

In *Dilip Pendse v. SEBI*, SEBI conducted investigations into the
dealings and found Pendse and others guilty of insider trading. In support of this
plea, Pendse produced documentary evidence to show that the transaction of
shares was made prior to the TFL incurring losses. Therefore, the main issue
before the SAT was whether the alleged sale transactions of shares of TFL took
place in September 2000 (when there was no UPSI) or end of March 2001 to hold
Pendse and others guilty of insider trading. The SAT observed 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 offence, higher is the
preponderance of probability and the burden of proof in establishing the offence.
The SAT also relied on a Supreme Court judgment, where the Supreme Court
had observed that “it is also 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.” Thus, SAT had extended this
principle to the civil cases as well where the charge is to be established not
beyond reasonable doubt but on the preponderance of probability.

*KLG Industries Limited Case* In this case, SEBI had charged the
executives of a company, SKIL Infrastructure Limited (“SKIL”), for trading in the
scrip of KLG Capital Services Ltd. (“KLG”), on the ground that SKIL’s
executives had traded in KLG’s shares based on the information that a company,
Awaita Private Properties Limited (“APPL”) was acquiring KLG, prior to the
public disclosure of this information. The executives appealed against this order
before SAT and SAT has remanded the case to SEBI for a fresh action. In this
case, the SEBI did not rely on the legal provisions as available under the Insider
Regulations such as the definition of “connected persons” provided under
Regulation 2 (c) which clearly includes person having professional or business
relationship, whether temporary or permanent, with the company. SKIL being the

57 Appeal no:80/2009 decided on 19 November 2009.
59 Decided by SEBI on June 10, 2009 (www.sebi.gov.in).
60 Appeal decided on 21 October, 2010 (www.sebi.gov.in).
promoter group company of APPL and involved in the acquisition, could be brought within the purview of the “connected person” under Regulation 2 (c). SEBI, inadvertently, did not apply the direct statutory provision and relied upon the SAT’s decision in Anjali Beke Case.

In Gabelli v. SEC, U.S. Supreme Court,61 between 1999 and 2002, SEC found that Gabelli Funds LLC had secretly allowed ‘market timing’ – short-term traders exploit inefficiencies in the pricing of shares of mutual fund – but did not file a complaint till 2008. According to the law of limitation in the United States, a time period of five years is provided to the SEC to file a complaint and initiate action. The only question is, from what date will the clock start ticking? SEC stated that it discovered the conduct in 2003 and hence the clock would have started ticking from that time according to the ‘discovery rule’, however, Gabelli argued that the time period would have started running from the date when the cause of action accrued. Thus, according to SEC, the initiation of proceedings was well within the time, however, according to Gabelli, the proceedings were time-barred. Interestingly, in 2008, Gabelli had agreed to pay $ 50 million to settle with the SEC, but without admitting or denying the guilt. The lower court had given additional time to the SEC, however, the Supreme Court in a unanimous decision reversed the lower court’s ruling and held that the time period would start running from the time of the alleged offence, and not from the time it was discovered by SEC as the ‘discovery rule’ could not be extended to SEC, unlike private parties. It has been a big blow for the financial regulator.

With respect to the private parties, the US Supreme Court, inter alia, observed:

“There are good reasons why the fraud discovery rule has not been extended to Government enforcement actions for civil penalties. The discovery rule exists in part to preserve the claims of victims who do not know they are injured and who reasonably do not inquire as to any injury. Usually when a private party is injured, he is immediately aware of that injury and put on notice that his time to sue is running. But when the injury is self-concealing, private parties may be unaware that they have been harmed. Most of us do not live in a state of constant investigation; absent any reason to think we have been injured, we do not

typically spend our days looking for evidence that we were lied to or defrauded. And the law does not require that we do so. Instead, courts have developed the discovery rule, providing that the statute of limitations in fraud cases should typically begin to run only when the injury is or reasonably could have been discovered.”

But, for the SEC, the Supreme Court said:

“The same conclusion does not follow for the Government in the context of enforcement actions for civil penalties. The SEC, for example, is not like an individual victim who relies on apparent injury to learn of a wrong. Rather, a central “mission” of the Commission is to “investigate potential violations of the federal securities laws.”… Unlike the private party who has no reason to suspect fraud, the SEC’s very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit. It can demand that securities brokers and dealers submit detailed trading information. … It can require investment advisers to turn over their comprehensive books and records at any time. … And even without filing suit, it can subpoena any documents and witnesses it deems relevant or material to an investigation. … The SEC is also authorized to pay monetary awards to whistleblowers, who provide information relating to violations of the securities laws. … In addition, the SEC may offer “cooperation agreements” to violators to procure information about others in exchange for more lenient treatment. … Charged with this mission and armed with these weapons, the SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect.”

_In Alec Kruger & Others v. The Commonwealth of Australia_, commonly known as the "Stolen Generations case", the High Court of Australia discussed the relationship between discretionary power and reasonableness and observed:

“Moreover, when a discretionary power is statutorily conferred on a repository, the power must be exercised reasonably, for the legislature is taken to intend that the discretion be so exercised. Reasonableness can be determined only by reference to the community standards at the time of the exercise of the discretion and that must be taken to be the legislative intention. Therefore, it would be erroneous in point of law to hold that a step taken in purported exercise of a discretionary power was taken unreasonably and therefore without authority if the unreasonableness appears only from a change in community standards that has occurred since the step was taken….”

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The Supreme Court observed in *Clariant International Limited and Another v Securities and Exchange Board of India*\(^{63}\):

“The Board exercises its legislative power by making regulations, executive power by administering the Regulations framed by it and taking action against any entity violating these regulations and judicial power by adjudicating disputes in the implementation thereof. The only check upon exercise of such wide ranging power is that it must comply with the Constitution and the Act. In that view of the matter, where an expert Tribunal has been constituted, the scrutiny at its end must be held to be of wide import. The Tribunal, another expert body, must, thus, be allowed to exercise its own jurisdiction conferred on it by the statute without any limitation.”

The courts rely on the expertise of regulatory bodies and it is up to these bodies to work in a professional manner with due alertness, and exercise discretion in a proper manner. It is easier said than done.

*U.S Securities Exchange Commission v. Gupta* \(^{64}\)

On October 26, 2011, the SEC charged Rajat Gupta with insider trading. It was alleged that Gupta had illegally tipped Raj Rajaratnam, his friend, with insider information about the quarterly earnings of Goldman Sach and Procter & Gamble, while he was serving on the board of both the companies, and also about a possible huge investment of about $5 billion by Warren Buffett’s Berkshire Hathaway in Goldman Sachs. Allegedly, Rajaratnam used this information, and either made illicit gains or avoided losses to the tune of about $23 million. While charging Gupta, Robert S. Khuzami, Director of the SEC’s Division of Enforcement, said:

“Gupta was honored with the highest trust of leading public companies, and he betrayed that trust by disclosing their most sensitive and valuable secrets to the disadvantage of investors, shareholders, and fellow directors…. Directors who exploit board room confidences for private gain can be certain they will ultimately be held responsible for their illegal actions.”

In *Securities and Exchange Commission v. Raj Rajaratnam*, The court held that while an order to compel the disclosure of wiretap communications is lawful, the district court exceeded its discretion in the current case because it failed to

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\(^{63}\) AIR 2004 SC 4236.

\(^{64}\) MANU/FESC/0796/2014.
determine the legality of the wiretaps before issuing the order, and did not limit the disclosure to only relevant conversations.\(^\text{65}\)

In *Avadhoot L. Shilotri v. SEBI*,\(^\text{66}\) SAT found that Shilotri was guilty in counselling Talaulicar and Pendse about the sensitive information within his knowledge about the state of affairs of Nishkalp which was a wholly owned subsidiary of TFL. Talaulicar and Pendse subsequently indulged in insider trading. Hence, appellant was liable for misconduct of insider trading.

In *Chairman, SEBI v. Shriram Mutual Fund and Another*,\(^\text{67}\) Supreme Court interpreted section 15 of SEBI Act and held that:

“In our opinion, mens rea is not an essential ingredient for contravention of the provisions of a civil act. In our view penalty is attracted as soon as contravention of the statutory obligations as contemplated by the Act is established and, therefore, the intention of the parties committing such violation becomes immaterial. In other words, the breach of a civil obligation which attract the levy of penalty irrespective of the fact whether the contravention was made by the defaulter with any guilty intention or not.”

In the context of civil proceedings as opposed to criminal proceedings the Supreme Court in *J.K. Industries Ltd. v. Chief Inspector of Factories and Boilers*,\(^\text{68}\) has held:

The “blameworthy conduct” in the adjudicatory proceedings is established by proof only of the breach of a civil obligation under the Act, for which the defaulter is obliged to make amends by payment of the penalty imposed by the Act irrespective of the fact whether he committed the breach, with or without any guilty intention.

Similarly in *R.S Joshi Sales Tax Officer, Gujarat & Ors. v. Ajit Mills Ltd.*,\(^\text{69}\) Supreme Court held that: Even here we may reject the notion that a penalty or a punishment cannot be cast in the form of an absolute or no-fault liability but must be preceded by mens rea. The classical view that ‘no mens rea, no crime’ has long ago been eroded and several laws in India and abroad, especially regarding

\(^{65}\) 622 F.3d 159 (2d Cir. 2010) [1].
\(^{67}\) 2006 INDLAW SC 237.
\(^{68}\) 1996 INDLAW SC 2480.
\(^{69}\) 1977 INDLAW SC 98.
economic crimes and departmental penalties, have created severe punishments even where the offences have been defined to exclude mens rea.

Motive has not generally been recognized as an element in deciding liability of person in both criminal as well as civil proceeding. It will make the task of prosecution very difficult in enforcing the provision of the act. Once motive however, good or bad can hardly be justified for acting on inside information to make illegal and unfair profit at the expense of an innocent investor.

While analyzing the case law decided in India, it becomes evident that successful enforcement actions in insider trading cases was a hard task for the Regulator, be it the loopholes exiting in the legal framework, or the inconsistency on the part of appellate bodies in interpreting the existing legal provisions. However, India has a well-structured regulatory framework in respect of insider trading. The minor inconsistencies could easily be fine-tuned. The awareness of inherent difficulties of proving the cases of insider trading in view of the complex facts amongst the appellate bodies and a consistent approach in resolving the important issues is what is required.

6.3 Corporate governance and Insider Trading

Corporate Governance Corporate governance thus is a means of self governance by companies whereby a company increases its ‘firm value’ by higher and qualitatively superior disclosure as well as more responsible action. It must be distinguished from regulations which are imposed by the law and which mandate behaviour at the risk of penalty.

The 2002 amendments to the Regulations provide extensive suggestions and also extensive regulations couched in the language of corporate good governance. Most of the good governance provisions are provided for as mandatory provisions.

Briefly, the good governance regulations provide for:

a) Officer, director and substantial shareholder to disclose their holding on certain events or at certain intervals.

b) Appointment of a compliance officer.
c) Setting forth policies and procedure to restrict the possibility of abuse of insider trading.
d) Monitoring and pre-clearance of trades by the designated persons.
e) Restrict trading by such insiders within a certain period of time i.e. before corporate announcements, buybacks etc. are made.
f) The company has to convey all the significant insider activity and corporate disclosure in a uniform publicly accessible means to the public – and to the stock exchange.
g) Chinese walls within a firm to prevent one part of the firm which deals in sensitive information from going to other parts of the firm which have an inherent conflict of interest with such other parts.
h) Minimum holding period of securities by insiders.
i) No selective disclosure to analysts. Wide dissemination of information.

6.3.1 Pre clearance of trades

Certain provisions are made for clearing of trades if certain officers/employees engage in shares of their own company. To cite from Schedule I, Part A.

I. All directors/officers /designated employees of the company who intend to deal in the securities of the company (above a minimum threshold limit to be decided by the company) should pre-clear the transactions as per the pre-dealing procedure as described hereunder.

II. An application may be made in such form as the company may notify in this regard, to the Compliance officer indicating the estimated number of securities that the designated employee/ officer/ director intends to deal in, the details as to the depository with which he has a security account, the details as to the securities in such depository mode and such other details as may be required by any rule made by the company in this behalf.

III. All directors/officers /designated employees shall execute their order in respect of securities of the company within one week after the approval of pre-clearance is given. If the order is not executed
within one week after the approval is given, the employee/director must pre-clear the transaction again.

IV. All directors/officers/designated employees shall hold their investments in securities for a minimum period of 30 days in order to be considered as being held for investment purposes. The holding period shall also apply to subscription in the primary market (IPOs). In the case of IPOs, the holding period would commence when the securities are actually allotted.

6.3.2 Sarbanes-Oxley Act

The US legislature, witness to an unending line of scandals, recently passed amendments to the securities/disclosure laws of the country— in effect codifying into law several corporate governance suggestions previously made. The Sarbanes-Oxley Act of 2002 requires:

i) directors, executive officers and large shareholders of public issuers to report transactions in the issuer’s equity securities within two business days of a transaction.

ii) pre-clearance procedures for transactions in the issuer’s equity securities;

iii) the responsibilities the company will take for completing filings;

iv) the requirement (or encouragement) to use a specified broker for transactions in the issuer’s securities, or the certifications required from brokers if no specific broker is required;

v) the applicability of the rules to persons with business or family relations to the insider; and

vi) sanctions for failure to make timely filings.

We will see in the Indian context several of the good governance regulations for their relevance and their reason to exist on the statute and further whether they need to be divorced from the mandatory/penal consequences of the regulations.\(^70\)

6.3.3 Officer, director and substantial shareholder to disclose their holding on certain events or at certain intervals.

There should be some coordination between the requirements of reporting at the 5% level with the requirements of the takeover code. In fact the takeover reporting is broader in some respects since it mandates reporting by any person over certain thresholds and also requires reporting by a group – a concept not introduced in these regulations. However, the insider trading regulations provide for disclosure of smaller amounts and even provide for disclosure on selling shares (something which the takeover code does not mandate). It is suggested that a purchase disclosure made under either regulations (with the same or higher level of disclosure) should be deemed to be good disclosure under the other. Additionally, this author suggests the introduction of short swing profits.

6.3.4 Short Swing’ profits:

There should be a regulation introduced in the Insider Trading regulations which compels an insider to disgorge or turn in profits made by insiders to the company for any transaction in equity based securities in the company’s securities (including its parents or subsidiary’s shares) if both the buy and sell side of the transaction is entered into within six months of the other. Such a liability should be imposed without any necessity for guilt or wrongfulness. This would be a provision which would get automatically attracted as soon as two things are established. First, the fact of being a designated insider, and second, the fact that the same securities were bought and sold within six months of each other. Such a regulation would be relatively easy to administer, since intent of the person is immaterial. Merely the fact of the trade is sufficient to take action. Thus the appearance of impropriety is removed from the markets.

6.3.5 Restrict trading by insiders within a certain period of time i.e. before corporate announcements, buybacks etc. are made.

Unfortunately, the wordings of the regulations are so broad, that it would chill trading in sometimes rather large windows. The regulation should not asphyxiate trading by insiders. As we have seen before trading by insiders and employees aligns their interests with those of the company and should be encouraged if there is no improper behaviour.
6.3.6 Trading window

I. The company shall specify a trading period, to be called "Trading Window", for trading in the company’s securities. The trading window shall be closed during the time the information referred to in para 3.2.3 is un-published.

II. When the trading window is closed, the employees / directors shall not trade in the company's securities in such period.

III. The trading window shall be, inter alia, closed at the time of:-
   (a) Declaration of Financial results (quarterly, half-yearly and annual)
   (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

Issuance of bonus/rights shares has no real effect on the price of the security and therefore there is no need to have a restricted window for that purpose. Clauses (d) to (g) are too broad and could cause unnecessary problems. To give an example, a company makes a large gas find, in one grid. It does not want to disclose that fact so that it can buy the neighbouring grids at a bargain price. It therefore, for a valid business purpose keeps the find a secret for six months. Even though the directors who know about the find would be expressly prohibited from trading in the securities under the substantive provisions of the regulations, all employees (who do not know) too would be barred from trading for six months in the shares of the company. This is obviously not an unusual hypothetical. An auto company comes out with secretive plans for introducing ‘new age’ models almost every month. Such companies would never allow employees to trade in their shares because there is a closed window for any ‘execution of new projects’. Let me clarify, that this does not in any way effect the

substantive provisions which restrict insider trading – which of course is prohibited.

6.3.7 Reporting of ‘process’ to CEO/MD

There is clause which requires the CEO/MD to consider all insider trades and accompanying documents.

The Compliance officer shall place before the Managing Director / Chief Executive Officer or a committee specified by the company, on a monthly basis all the details of the dealing in the securities by employees / director / officer of the company and the accompanying documents that such persons had executed under the pre-dealing procedure as envisaged in this code.

This kind of time for such a routine process by an MD is wasteful and unworkable – it is a totally unworkable clause for large companies and such micromanagement should not be part of corporate governance, leave alone regulations. This provision ought to be scrapped.

6.3.8 Other entities having access to inside information

Intermediaries in the capital markets like underwriters, lawyers, auditors are also required to comply with Part B of the first Schedule. The regulation of these other entities is overworked and overregulated at times and operationally impossible at other times. For instance having a compliance officer who inspects insider trades and grants pre-clearance for trades of securities of employees is absolutely uncalled for. To give an example practically every law firm advices listed companies. To have a compliance officer in every firm and monitoring of trades by each employee is completely unworkable – and even partial compliance will never happen. The fact that it is coupled with penalties of 10 years in jail, suspension, fines etc. should create a powerful argument for removal of these ‘corporate governance’ penalties for non corporate and in particular because adequate remedies are in place for actual insider trading. Certain other provisions are made for the intermediaries that need to be relooked at.

6.3.9 Confidential Files

“Files containing confidential information shall be kept secure. Computer files must have adequate security of login and pass word etc.”

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To mandate passwords/logins for securing confidential files is nonsensical, to say the least. It would create workings of entire organizations which are built on sharing information of confidential files unworkable. To again use the law firm example, if confidential files are not shared effectively between colleagues, effectively assisting a client may not be possible. It should be the discretion of the company/firm to bar access to such information as it sees fit. Such micromanagement should be frowned upon.

6.3.10 Other Recommendations

There are a few further provisions the Indian legislature/regulator should consider adding to the existing framework of regulations to reduce the occurrence of insider trading.

I. Designated or qualified brokers

To facilitate compliance with the new reporting of transactions, issuers should either designate a single broker through whom all transactions in issuer stock by insiders must be completed or require insiders to use only brokers who will agree to the procedures set out by the company. A designated broker can help ensure compliance with the company’s pre-clearance procedures and reporting obligations by monitoring all transactions and reporting them promptly to the issuer. If designating a single broker is not feasible, issuers should require insiders to obtain a certification from their broker that the broker will:

a) Verify with the issuer that each transaction entered on behalf of the insider was precleared; and

b) Report immediately to the issuer the details of each of the insider’s transactions in the issuer’s securities.

II. Derivatives amendments

Parts of the regulations refer to ‘shares’ for the purpose of proscription while they should prohibit “securities” trading. For instance, one could, using derivatives, economically sell the shares without physically trading in those shares. Similarly, one can easily create synthetic securities with the same economic impact as an equity share of a company. By reclassifying shares into securities, one can eliminate the problem because securities are defined to include
equity, quasi-equity, derivatives and any combination of the three. Pure debt instruments can be excluded specifically from the regulations.

Similarly, under Regulation 13 the disclosure requirements should refer to not merely a 5% stake in the equity but also to a minimum stake in derivatives of the company’s securities. The minimum can be a rupee amount of the market value of the derivative (since calculating 5% of the derivatives market is not possible and if possible not meaningful).

III. Civil private cause of action by contemporaneous traders

People trading in the market contemporaneously - not just the regulator or the counterparties to the insider should also have specific powers to rescind trades and charge damages to the insiders during the period when they traded. This will provide a broader remedy and will have many people exerting an economic pressure on the violator to make his trades unviable.

IV. Proactive Stock Exchanges

The stock exchanges should take up at least a substantial burden of filing action against persons violating the regulations. Since the Rules and regulations of the stock exchanges are considered ‘enactment’, and court judgments have found exchange regulations to have the force of law – they could easily enforce the requirements of the listing terms or the rules regulations by seeking civil action in courts against persons or companies who violate such regulations. The exchanges should also better coordinate monitoring and surveillance of listed companies to track unusual activity in the stock of a company across markets for traces of insider dealings or manipulation.

V. Recission

One author has suggested that a contract of sale or purchase by an insider be declared void by the counterparty to a trade under the Indian Contract Act (this is besides the powers SEBI has to annul the trade under Regulation 11). Though legally feasible, it raises impossible burdens in today’s virtually anonymous capital markets. For instance if an investor had bought 100 shares of the company during the period when the insider trading took place, it would be difficult to determine the counterparty to the insider. And in any case even if the counterparty

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to the trade is identified, the insider has not only hurt his trade counterparty but also the market as a whole.\textsuperscript{73} By buying (or selling) shares the insider would have raised (or lowered) the price of the shares so bought (or sold) and thus would affect the rights of every person who bought or sold contemporaneously.

VI. \textbf{Tippee liability}

The regulations prohibit persons from tipping people about inside information by insiders i.e. the tipper. However, there seems to be no liability for a person who improperly receives a tip i.e. a tippee from trading. There is a vague prohibition against ‘procurement’ of information. However, it does not clearly prohibit a tippee from trading.

VII. \textbf{Bounty system}

Section 21A (e) of the American Securities Exchange Act of 1934 authorizes the Securities and Exchange Commission to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, or from a person who directly or indirectly controlled an insider trader. This could be a useful addition to cracking into new cases of insider activity.

\textbf{6.3.11 The mystery penal clause}

In the schedule, clause 7.1 penalises violation of the regulations and whistle blowing duties of senior officers. It is not clear whether the ‘corporate governance’ schedule is included in the duty to report a violation i.e. does it include a procedural violation as well. However, a look at Section 14 clears all doubts that one can go to jail for 10 years for violating simple or minor process oriented details.

\textbf{6.4 Insider Trading under the Companies Act, 2013}

The Companies Act, 1956 did not have any express provisions laid down for insider trading other than section 307 and section 308 but under the Companies Act, 2013 provisions regarding prohibition on insider trading of securities have been made. It has made insider trading restrictions applicable on shares of a private or public unlisted company. According to the Companies Act, 2013, no person including any director or key managerial personnel of a company

\textsuperscript{73} See Basic v. Levinson 485 US 224.
shall enter into insider trading. Provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or employment or under any law. For this purpose “insider trading” means an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer of the company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or an act of counselling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person. “price-sensitive information” means any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company. If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crores rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.

It mandates that no director or key managerial personnel of a company shall engage in insider trading; which is described to include, among other things, subscribing or selling to shares by such persons or providing any price sensitive information to any person. This restriction will impact deal structuring since almost every deal in the unlisted company space would involve sharing of information by directors or key managerial personnel or subscription or sale of shares by promoters who are normally in an executive capacity within the company. Further, the Companies Act, 2013 delegate powers to SEBI to prosecute insider trading in securities of listed companies and companies which intend to get their securities listed. Therefore, the definition of company has been extended to cover entities that intend to get their securities listed. Since the Securities And Exchange Board Of India (Issue Of Capital And Disclosure Requirements) Regulations, 2009, known as ICDR Regulations mandate disclosure of all material

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74 Section 195 of the Companies Act, 2013.
75 Section 458 of the Companies Act, 2013.
information necessary for making an informed decision about applying for securities in an Initial Public Offer (IPO), insider trading could occur in relation to the price discovery process in the book-building under the ICDR Regulations, and would therefore be punishable by SEBI.

The core of securities regulations is the implementation of the purpose that all investors should have equal access to the rewards of participation in securities transactions. In other words all members of the investing public should be subject to identical market risks. Inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life. It is therefore important for there to be markets free from all types of fraud and in particular insider trading which disenchant the common investor from the workings of the markets as if he is being invited to play a game of crap with loaded dice.

Unfortunately with the unearthing of large frauds, even though India is not unique in this, the concept of corporate good governance has been lost in the war cry for blood. And as a result, the government has gotten into overregulation and micromanagement by converting good governance into statutory provisions. We tend to forget that fraudulent action cannot be stamped out by micromanagement; it can only be reduced by effective enforcement of the laws which should prohibit obvious illegalities.

Caution needs to be taken while taking on the crime of insider trading. The presumption that all insiders are unfair should be avoided. Top brass may set the standards of corporate governance. The regulator should specify in the Schedule to the regulations a list of optional procedure for limiting the possibilities of insider trading. What should be mandated instead should be a statement in the annual report of the degree of compliance with the standards of set forth in the Schedule. Thus companies which do not follow corporate governance guidelines in substance would be penalized by its shareholders. An author has also suggested introduction of corporate governance ratings, similar to debt ratings which would pressure management to comply with such measures. This could be the missing link providing a simple number which can be appreciated and understood by the masses and would indicate the processes a company has put in place for the benefit of their non-insider shareholders.