CHAPTER 2

INSIDER TRADING LAWS - EVOLUTION IN GENERAL

The insider trading laws have evolved together with other regulatory measures implemented by the global markets from time to time. The U.S. and the United Kingdom are the two major countries that have a well developed insider trading regulatory mechanism. Many of the global economies have borrowed ideas from these countries' regulatory frameworks. Further, as the U.S. has implemented the measures to regulate insider trading much prior to other global economies, and the United Kingdom, having a proper legal framework on insider trading since early 1980s, a detailed analysis of the origin and development of insider trading regulations in these countries is inevitable to understand the global scenario on enforcement of insider trading regulations.

2.1 DEVELOPMENT OF LAWS TO CURB INSIDER TRADING IN THE U.S.

2.1.1 Initial Stage-Insider’s Tortious Liability for Misrepresentation

In the U.S., there have been a few common law cases of insider trading in the beginning of 20th century, even before the federal securities laws came into existence. The plaintiff-shareholder in those
cases relied on the extended version of the ‘tort of misrepresentation’ to hold the corporate insiders liable for the material non-disclosures of corporate information while indulging in trades.

In *Strong v. Repide*\(^5^3\), a U.S. shareholder of a Philippines based sugar company was induced to sell her shares to a person who was the company’s general manager (unknown to her) and director. The buyer who was an insider knew that the company was going to enter into a very profitable contract with the Philippine Government. The U.S. Supreme Court ordered the rescission of the sale of shares under the ‘special facts’ doctrine. Considering that the general manager did not have an affirmative duty to disclose all material information to the seller, it was difficult to impose a tort liability on the general manager. However, the court based its decision on the special facts doctrine because the general manager was an insider and the nature of the information compelled a disclosure.

**2.1.2 Section 10 b and Section 16 of the Securities Exchange Act of 1934**

The regulation of the securities markets in the U.S. was initiated through the Securities Act of 1933, and the Securities

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The Exchange Act of 1934. The Section 10(b) of the Exchange Act is the key provision on which the prohibition of insider trading is based. Section 10(b) of the Exchange Act mandates as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Although the legislative intent behind this provision was to curb any kind of market manipulation activity, it had certain limitations with respect to prohibition of insider trading activities because it did not provide for a specific prohibition of insider trading.

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54 The different legislations that regulate the securities market in the U.S are mentioned below: Securities Act of 1933 (regulating distribution of securities); Trust Indenture Act of 1939 (protecting public interest and investors with regard to debt securities); Securities and Exchange Act of 1934 (regulating trade of securities subsequent to their original distribution); Securities Investor Protection Act, 1970 (creating non-profit membership corporation that covers loss when securities firm cannot pay its customer accounts); Public Utility Holding Company Act of 1935; (correcting abuses in financing and operation of public utility holding companies); Investment Company Act of 1940 (governing activity of public owned companies that invest and trade securities); Investment Advisors Act of 1940 (providing for regulation and registration of those in business of advising others on securities investments) are.
activities. This provision only authorized the SEC to make rules for prevention of market fraud and manipulations, which indirectly would include the insider trading activities as well.

Further, Section 10(b), although enabled the SEC to frame rules to prevent fraud and market practices, in the absence of any rules framed by SEC under this section, the U.S., did not have a specific provision for prohibiting insider trading. The U.S. however relied upon Section 16 of the Exchange Act to address the insider trading activities. Section 16 of the Exchange Act provides for a threefold 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. However, the section had certain limitations because the short swing profits could be recovered under this section only with respect to transactions that were carried out within a period of six (6) months prior to the date of initiation of the legal action and also, provided the transactions were carried out by the category of ‘high-level insiders’ covered by Section 16 (b).
2.1.3 *Rule 10b-5-anti fraud provision*

Notwithstanding the existence of Sections 10 (b) and 16, the U.S. faced significant incapacities in effectively curbing the complicated insider trading activities. In this backdrop, the SEC identified the need for implementing more specific and stringent regulations. Accordingly, the Rule 10b-5\(^{55}\), the SEC’s sweeping antifraud provision, was promulgated only in the year 1942. Rule 10b-5 has emerged as the most effective enforcement tool against fraud in the U.S. securities market\(^{56}\). The scope of this rule was so wide and it could by interpretation, include any kind of fraudulent activities in securities carried out by a variety of corporate insiders and related parties. Therefore, it can be said that an effective insider-trading prohibition regime originated in the US with the implementation of Rule 10b-5.

\(^{55}\) Rule 10b-5 provides that
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud, or …
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

\(^{56}\) Bhavik R. Patel, Securities Fraud Regulation — Rule 10b-5 no longer scares the judiciary, but may scare corporate defendants: The United States Supreme Court switches directions. Wharf Holdings Ltd v. International Holdings Inc (6.25 U. Ark.Little Rock L. Rev.191)
In the absence of specific statutory provisions, the development of jurisprudence on insider trading in the U.S.\textsuperscript{57} was based on the various interpretations provided by different courts to the antifraud provisions under Rule 10b-5 of the Exchange Act.

\textit{2.1.4 Liability fixed on the basis of Fiduciary Duty}

The initial tortious liability approach eventually transformed into the liability for breach of fiduciary duty. The courts relied on the blanket rule of compulsory disclosure, derived from the fiduciary status that existed between the management and the shareholders. Continuing on this line of precedent, it became the established rule under Rule 10b-5, that the insiders owe a fiduciary duty of disclosure while engaging in direct transactions with the shareholders.

In cases involving insiders who owe a fiduciary duty, the courts had interpreted that it was fraudulent for a fiduciary to trade without disclosure of the information based on which the trades were entered into, and therefore, such insiders were covered by Rule 10b-5.

A fiduciary relationship is based on actual expectation of fair dealing, which arises from a pre-existing relationship of trust and

\textsuperscript{57} The relevant provisions regulating insider trading in the market are Section 204A of the Investments Advisers Act, Section 10(b), Rule 14(e) of the Securities Exchange Act and also Section 17a of the Securities Act.
confidence. In such cases, the principal and the beneficiary will rely on each other’s good faith. Silence in such cases will be termed as fraudulent or deceptive. However, in large corporations, shareholders and management rarely have this kind of relationship where the former trusts that in security transactions, the latter would not take advantage of their position. Therefore, with the development of the market, and the complex financial relationships, the fiduciary theory also became insufficient.

2.1.5 Doctrine of Unjust Enrichment

The need for a broader principle to address the insider trading issues resulted in the formulation of the doctrine of unjust enrichment. Under this doctrine, a person who was in a position of responsibility in respect of property or welfare of another, such as a corporate officer or director, was obliged to act in that capacity for the best interest of the beneficiaries. The idea was that the insider officer or director should not benefit beyond the compensation expressly given to them at the beneficiaries’ expense. This principle mandated that even where the insider does not solicit the transaction or bargain the price, he must still place the shareholders’ interests above his own by sharing the corporate information with the shareholders. Thus, the duty of affirmative disclosure has merged into the theory of constructive fraud.
2.1.6. *Fraud on the Market Place*

Although the U.S. courts had recognized the fiduciary duty element in the transactions where the buyer and seller were the insiders and the shareholders respectively, the courts had refused to accept the theory of general fraud\(^{58}\) on the market place in cases where the insider was a seller. According to the theory of general fraud, the insider, by trading in the market, while in possession of unpublished price-sensitive information, commits fraud on the market place. The courts refused to accept that mere possession of the price sensitive information while trading amounts to fraud on the buyers in the securities market. The court’s view was that when the insiders sold and an investor bought the securities in the market, such buyer would have bought the securities in any event, irrespective of who the seller was. The U.S. courts had then weighed the expectation of a shareholder for fair dealing where the shareholder does not know or bother about the identity of the other party to the trade as compared to the insiders’ interests. In view of the foregoing, the courts had rejected the theory of an insider’s affirmative duty of disclosure in a stock exchange transaction.

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\(^{58}\)According to the theory of general fraud, the fiduciary by trading in the market, while in possession of an unpublished price-sensitive information, commits fraud on the market place.
However, in 1961, with the decision in *Cady, Roberts & Co*\textsuperscript{59}, the SEC for the first time declared that insider trading in the impersonal market\textsuperscript{60} violates Rule 10b-5. Until this decision, the courts had applied the common law principles of, deceit or fraud as the basis for liability in insider trading cases. Until this decision, liability for fraud was imposed on the insiders who directly traded based on the material price sensitive information. In the case of *Cady, Roberts*,\textsuperscript{61} an important issue arose regarding the liability of a person who is not an insider, but is trading in the shares of a particular company, based on the information obtained from a source within the company whose shares are being traded. The SEC had observed that there is no fiduciary obligation on the part of such class of persons who are not insiders but trade for an insider based on the information received from the insider. Therefore, to fix the liability for such corporate outsider, the SEC looked for a better explanation to bring such class of persons within the ambit of Rule 10b-5. The modern federal insider trading prohibition can be said to have begun with the Securities Exchange Commission’s enforcement action in the *Cady, Roberts Case*\textsuperscript{62}.

According to the facts of this case, Curtiss-Wright Corporation’s board of directors decided to reduce the company’s

\textsuperscript{59} Cady, Roberts & Co., 40 S.E.C 907 (1961)
\textsuperscript{60} In general, the buyer/seller will not know the opposite party to the transaction.
\textsuperscript{61} Ibid.
\textsuperscript{62} Ibid.
quarterly dividend. One of its directors, J. Cheever Cowdin, was also a partner of the stock brokerage firm Cady, Roberts & Co. Before the news of reduced dividend was announced to the shareholders, Cowdin informed one of his partners at the brokerage firm, Robert M. Gintel, of the impending dividend cut. Robert Gintel then sold several thousand shares of Curtiss-Wright stock held in customer accounts over which he had discretionary trading authority. When the dividend cut was announced, Curtiss-Wright’s stock price fell several dollars per share. Gintel’s customers thus avoided substantial losses.

The reasoning given by the court in this case is as follows:

“Analytically, the obligation for not to engage in insider trading rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a company and privy to its internal affairs, and
thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.”

Based on the foregoing reasoning and applying the broad rules of interpretation, the SEC held that the broker traded while in possession of non-public information he had received from the director of the company and had violated Rule 10b-5.

*Cady, Roberts* also involved the issue relating to tipping. The SEC had observed that in this case an insider who possesses confidential information but, does not himself trade, and informs or tips someone else who does trade based on the information is also liable under Rule 10b-5.

Further, the SEC also formulated the theory of ‘abstain or disclose’ in this case. The rule provided that the temporary or the constructive insider, who possesses material non-public information, should disclose such information before trading or abstain from trading until the information is publicly disseminated.

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63 Donald C. Langevoort, Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation, 99 Colum. L. Rev. 1319
Despite the clear ruling of the SEC in the *Cady, Roberts*\textsuperscript{65} case, the academicians were still apprehensive whether *Cady, Roberts* would have significant precedential value, as the decision was an administrative ruling by the SEC and not a judicial opinion. Nevertheless, this case significantly impacted the brokerage firms as they came under the close supervision of the SEC.

2.1.7 *Rule of Disclose or Abstain*

In the U.S., the academic approach has been that the genesis of the insider trading laws was based on the principal theory of liability, i.e., a corporate insider's obligation ‘to abstain or disclose’\textsuperscript{66}. According to this theory, if a corporate insider who is in possession of material non-public information desires to trade the shares in his company then, he either has to disclose to the public this information or refrain from trading. Practically, majority of the corporate insiders who trade based on the material non-public information are unable to make the public disclosures due to the confidentiality clauses in their terms of employment, which contractually prevent them from publicising their employers' proposed commercial transactions or other business related information. Further, even if an employment agreement does not have such confidentiality obligations, the

\textsuperscript{65} Cady, Roberts & Co., 40 S.E.C 907 (1961)
\textsuperscript{66} Donald C Langover, Insider Trading: Regulation, Enforcement and Prevention (Vol 18 Clark Boardman Callaghan Securities Law Series 1994)
employee's implied obligation of trust under an employment agreement also acts as an impediment for such disclosures. Therefore, the rule is always of abstinence.

U.S. federal court in the case of SEC v. Texas Gulf Sulphur Company67 supported the ruling of the SEC in Cady, Roberts Case68. The court observed that the federal prohibition on insider trading was intended to ensure that all investors trading on impersonal stock exchanges had equal access to material information.

In the TGS Case, a mining corporation began aerial surveys of an area near Timmins, Ontario and found evidences of ore deposits. TGS began ground surveys of the area and found significant deposits of copper and zinc. TGS’ president instructed the exploration group to maintain strict confidentiality, even to the point of withholding the news from other TGS’ directors and employees. TGS finally announced its discovery in a press conference after a few months when the discovery of ore was confirmed.

During this period, a number of TGS insiders bought stock and/or options on the TGS’ stock. Others tipped off the outsiders and

67 SEC v. Texas Gulf Sulphur Company 401 F.2d at 848
68 Cady, Roberts & Co., 40 S.E.C 907 (1961)
some others accepted stock options from the company’s board of directors without informing the directors of the discovery. After TGS’ disclosure, the company’s stock price per share rose tremendously and the insiders and the tippees had made significant profits.

As the SEC sued the insiders for violating Rule 10b-5, the court while ruling in SEC’s favor, observed that no person should be allowed to trade using the non-public information as this will amount to fraud committed on all other buyers and sellers in the market. Further, the Second Circuit court held that if an insider has material non-public information, Rule 10b-5 requires the insider to either disclose such information before trading or abstain from trading until the information has been disclosed. Thus, the rule of “disclose or abstain” was recognized by a court for the first time. The court further stated that the prohibition under Rule 10b-5 applies to anyone who has direct or indirect access to the confidential information and knows that the information is unavailable to the investing public.

However, in this case, the court did not determine the applicability of the abstain or disclose rule, i.e., who were subject to the ‘abstain or disclose’ obligation.
In *Chiarella Case*\(^{69}\), one of the issues raised was relating to the applicability of disclose or abstain rule. The U.S. Supreme Court rejected the equal access policy that was laid down in TGS. The court made clear that liability could be imposed only if the defendant was subject to a duty of disclosure, arising out of a fiduciary relationship between the inside trader and the persons with whom he trades. According to the facts of this case, Vincent Chiarella was an employee of a printing press, Pandick Press. While preparing the tender offer disclosure materials for a customer, Pandick Press used codes to conceal the names of the companies involved. But Chiarella broke the codes and misappropriated the material information of Pandick’s customer. He purchased the target company’s shares before the bid was formally announced, and sold the shares for considerable profits after the announcement of the bid. Chiarella was booked and convicted of violating Rule 10b-5 by trading on the basis of material non-public information.

The Second Circuit affirmed the conviction, applying the *TGS Case*’s\(^{70}\) principle of equal access to information based on the ‘disclose or abstain’ rule. Applying this principle, Chiarella was held liable because he had superior access to information than those with whom

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\(^{69}\) U.S. v. Chiarella 558 F.2d 1368

\(^{70}\) SEC v. Texas Gulf Sulphur Company 401 F.2d at 848
he traded. The U.S. Supreme Court, however, reversed this decision and rejected the notion that Rule 10b-5 was intended to ensure to all investors equal access to information. The court did not affirm Chiarella’s conviction on the ground that Chiarella did not have any fiduciary duty towards the printing press’ customer or the sellers of the shares and in turn, did not have any obligation to disclose the material non-public information prior to trading. Thus, the Chiarella71 Case made clear that disclose or abstain rule is not triggered merely because the trader possesses material non-public information.

When an action for fraud under Rule 10b-5 is initiated and is based upon a duty to disclose, there should be at least a duty to disclose in the first place to establish the fraud. Mere possession of non-public information does not create a duty upon the trader to disclose the information to the person he is trading with. Therefore, the disclose or abstain theory of liability for insider trading was now premised on the inside trader being subject to a duty to disclose to the party on the other side of the transaction, that arose from a relationship of trust and confidence between the parties thereto. In this case, Chiarella was not an employee, officer, or director of any of the companies in whose stocks he traded. He worked for the Pandick Press, which itself was not an agent of any of those companies.

71 U.S. v. Chiarella 558 F.2d 1368
Pandick Press worked for acquiring companies and not the takeover targets in whose stock Chiarella traded. Therefore, Chiarella had no duty to disclose the information to those with whom he traded.

### 2.1.8 Liability of the Outsiders (Tippees)

Tippees are the category of persons who receives non-public information from an insider and thereby facilitates insider trading. In some cases, the tippees are also held liable for fraud under Rule 10b-5 where insiders disclose non-public information to a tippee to facilitate insider trading and benefit personally from such trading and where the tippee knows or has a reason to know about the insider’s breach of fiduciary duty to the company whose stocks have been traded.

In *Chiarella*[^72] *Case*, the court limited the scope of insider trading prohibition by not attributing the liability of duty to disclose on an outsider who used non-public material information and traded based on such information for personal gain.

The primary issue that arose regarding tippee’s liability was whether the liability for fraud under Rule 10b-5 should be restricted to the classical insiders, such as the directors or the managers, or should it also extend to the tippees who receive information from such classical

[^72]: U.S. v. Chiarella 558 F.2d 1368
insiders. The classical theory of disclose or abstain suggests that the
tippee’s liability will arise only when the tipper makes the relevant
disclosure to the tippee for personal benefit and the tippee is aware of
such breach of the tipper’s fiduciary duty to the company. However,
from a practical standpoint, it is difficult to establish whether the tippee
actually knew about the tipper’s fraudulent disclosure for personal
gain.

The issue of liability of outsiders (tippees) was first examined
by the SEC in an administrative proceeding in the case of SEC v.
*Investors Management Company*73. In this case, an action was taken by
the SEC against a number of institutional investors who sold the shares
of Douglas Aircraft Company, after learning about a downward
revision in the company’s earnings estimates. The source of this
negative information was Merryl Lynch Pierce Fenner and Smith’s
investment adviser, who in turn had obtained the information in the
capacity of Douglas’ underwriter for the sale of Douglas’ debentures.

In this case, the SEC came to the conclusion that the tippee
must be held liable only when the tippee knows or has reason to know
that the information in question is non-public and obtained
“improperly, by selective revelation or otherwise.” The SEC held all

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73 SEC v. Investors Management Company 44 SEC 633 (1971)
the investors liable and regarded them as tippees who knowingly traded in Douglas’ stocks based on the non-public information received from the tipper. Therefore, the SEC ruled that the tippees were liable for fraud under the Rule 10b-5, similar to an insider’s liability under the Rule 10b-5, and there was no need for the tippee to establish a special relationship with the company.

As regards Merryl Lynch’s liability for tipping the information to the investors, the investors initiated a separate class action against Merryl Lynch for damages.\(^74\) The court held Merryl Lynch and the tipper liable on the ground that the tipper, being an underwriter for the company and having access to the company’s corporate inside information, owed a fiduciary duty towards the company and were required to follow the principle of disclose or abstain.

The leading case involving the liability of a tippee was \textit{Dirks v. SEC}\(^75\). In this case, Raymond Dirks, an officer of a New York broker-dealer firm specializing in investment analysis of insurance company securities, received information from a former officer of Equity Funding of America that EFA’s assets were grossly overstated as a result of fraudulent corporate practices. Dirks investigated the matter by contacting various employees of EFA who corroborated the fraud

\(^{74}\) Shapiro v. Merryl Lynch Pierce Fenner and Smith, 495 F. 2d 228 (2d Cir. 1974) \\
\(^{75}\) Dirks v. SEC 463 U.S. 646 (1983)
charges. Although Dirks and his firm did not own or trade in EFA’s securities, Dirks discussed the information about EFA’s fraudulent overstating of assets with his clients and investors. Thereafter, some of these clients and investors sold their holdings in EFA. SEC initiated action against Dirks for aiding and abetting violations of the federal securities laws including Section 10 b of the 1934 Act and Rule 10b-5 and held Dirks liable for fraud.

However, the Supreme Court reversed the decision and ruled that Dirks had not violated Rule 10b-5. The Supreme Court held that a duty to disclose arises from the fiduciary relationship between the parties and not merely from one's ability to acquire information because of his position in the market. The court stressed that imposing a duty to disclose solely because one has received the inside information would inhibit market analysts from ferreting out important information about securities. Market efficiency is significantly enhanced by the efforts of market analysts in seeking out and analyzing information regarding securities and analysts’ work therefore benefits all investors. Similarly, the public accountants, legal counsels, underwriters, or consultants working for a company are also treated as insiders and are called “constructive” or “temporary” insiders as the corporate inside information is revealed legitimately to them by virtue of their relation with the company. Therefore, these
individuals are also treated as fiduciaries of the stockholders and have a duty to disclose.

To ascertain whether a tippee has a duty to disclose or abstain, it is necessary to determine if the insider’s tip involves a breach of the insider’s fiduciary duty. Breach of fiduciary duty depends on the purpose for which the insider is revealing the information. In the *Cady Roberts Case*, the court had applied the principle whether the insider will personally benefit from the disclosure, to decide the liability for violation of the Rule 10b-5. The courts followed the same principle in *Dirks* also. Even if the insider does not benefit directly, there must be some personal gain in order to constitute a breach of the fiduciary duty to the stockholders. Consequently, without a breach by the insider, there can be no derivative breach by the tippee.

Shortly after the *Dirks* decision, the concept of “temporary insider” was applied in the case of *SEC v. Lund*. In this case, Lund was the President and Chairman of the board of Verit Industries. Horowitz was another director of Verit, who was the Chairman and the

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76 Although the court in Chiarella and Dirks insisted a breach of fiduciary relationship to ascertain the liability under rule 10 b 5, neither opinions defined such a relationship nor specified to whom it applies. Nevertheless, both these based the fiduciary duty upon a relationship of trust and confidence. Willis W. Hagan, Insider trading under Rule 10 b 5: the theoretical basis of the liability, 44 Bus Law 13.

77 *Cady, Roberts & Co.,* 40 S.E.C 907 (1961)

78 *Dirks v. SEC* 463 U.S.646 (1983)

79 Ibid.

President of the P&F Industries. Horowitz asked Lund if he would be interested in participating in a joint venture with P&F Industries to acquire a Las Vegas gambling casino, to which Lund agreed. Thereafter, Lund purchased a significant number of shares of P&F Industries. The subsequent announcement of the joint-venture enhanced the price of the P&F Industries to double and Lund made substantial profit by selling the shares at a higher price.

When Horowitz was charged for fraud for disclosing the information to Lund, one of the contentions before the court was that Horowitz had not violated any fiduciary duty by disclosing the information regarding the joint-venture to Lund, as he had merely discussed about a prospective transaction while discharging his official duties. Further, as regards Lund’s liability, Lund could not be held liable as a tippee because the tipper was not held liable. However, the court stated that the scope of the insider concept is flexible and is not limited to officers, directors and controlling shareholders of a company. Insiders can include any person who is in a special relationship with the company and privy to its internal affairs. Based on this principle, the court regarded Lund to be a “temporary insider” of P&F Industries and held him liable for fraud for trading on the basis of the information concerning the joint-venture. The court based its decision on the following reasons:
(i) a special relationship existed between Lund and P&F Industries because Horowitz told Verit Industries about the joint venture, through Lund;

(ii) the information was made available to Lund solely for corporate purposes;

(iii) the relationship between Horowitz and Lund implies that the information would be kept confidential;

(iv) Horowitz expected Lund to keep the information confidential because he certainly did not believe that Lund would publicize the information or use it for personal gain.

It appears that for a long time, the U.S. courts were unclear as to the applicability of the various theories and principles relating to insider trading, when dealing with the cases of insider trading and deciding the liabilities in such cases. The lower courts in the U.S., while deciding the cases of insider trading, had followed a secondary theory of liability, i.e., the misappropriation theory which was suggested by Justice Stevens in the case of Chiarella\(^8\)

2.1.9. **Rule 14e-3 for Tender Offers**

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\(^8\) U.S. v. Chiarella 558 F.2d 1368
The *Dirks Case*\(^{82}\) did not conclusively answer on the significant issue raised by *Chiarella Case*\(^{83}\): which was, whether the insider trading prohibition would apply to investors who traded based on the information obtained from sources outside the company.

The SEC proposed the Rule 14e-3 specifically to cover the liabilities in the tender offer cases. This primarily emanated from the U.S. Supreme Court’s decision in the *Chiarella Case*\(^{84}\) where the court had absolved the printer on the ground that the printer did not owe any fiduciary duty to the company whose tender offer was handled by the printer. Rule 14e-3 was adopted in September 1980 under the SEC’s authority under the Section 14(e) of the Exchange Act. Rule 14e-3 provides that:

“If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is non-public and

\(^{82}\) Dirks v. SEC 463 U.S.646 (1983).
\(^{83}\) U.S. v. Chiarella 558 F.2d 1368.
\(^{84}\) Ibid.
which he knows or has reason to know has been acquired directly or indirectly from:

(i) The offering person,

(ii) The issuer of the securities sought or to be sought by such tender offer, or

(iii) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

This implies that the Rule 14e-3 makes it unlawful for anyone other than the bidder or the prospective bidder, once the bidder has taken substantial steps to commence a tender offer, to purchase or sell the security without publicly disclosing the information, if that bidder or the prospective bidder, (i) possesses material information, (ii) which he knows or has reason to know is non-public, and (iii) which he knows and has reason to know comes from the bidder or the target or
“any officer, director, partner, or employee or any other person acting on behalf of the bidder or of the target.”

Therefore, it was very evident that the promulgation of the Rule 14e-3, immediately after the *Chiarella Case*\(^\text{85}\), was the SEC’s manifestation of its dissatisfaction to the Supreme Court’s decision in dealing with the misuse of information in the tender offer cases.

The Rule 14e-3 was first applied by the Supreme Court in the *O’Hagan Case*\(^\text{86}\) in 1997. The decision focuses on the deceptive manner of obtaining the non-public information rather than any uniqueness of position. The facts of the case involved an attorney who traded securities of a target company although the attorney's law firm represented the bidder. According to the court, the breach of a duty of loyalty or the confidentiality by a fiduciary, which deprives a principal of the exclusive use of confidential information, coupled with the self-serving use of that information, constituted a violation of Rule 10b-5 and the Rule 14e-3. Although the defendant in O'Hagan was held to have violated both Rules 14(e)-3 and 10b-5, it is unclear whether this decision endorsed the SEC's view that neither *scienter* nor a breach of fiduciary duty is required for liability under Rule 14(e)-3.

\(^{85}\) ibid

2.1.10 Exceptions to the Rule 14e-3

Rule 14(e) contains two (2) specific exceptions to the ‘abstain or disclose’ requirement. Sub-section (1) excludes purchases by a broker or by another agent on behalf of an offering person. This is designed to allow the bidders to utilize outside brokers to make open market purchases prior to the filing requirement. It does not protect the persons who purchase the securities on the bidder’s behalf based on the information received from the bidder, even if the bidder gave the information to advance his interests in the takeover battle.

Sub-section (2) provides that the sales by any person to the bidder based on the information received from the bidder are excluded from the ‘abstain or disclose’ rule. Thus, a person (for example, a major shareholder of the target company) who receives material non-public information from the bidder and thereupon sells his shares to the bidder above the market price does not violate the rule. As the transaction takes place with the seller having no informational advantage over the purchaser, obviously, there is no reason to make such trading unlawful.

2.2 DEVELOPMENTS POST 1980s
2.2.1 The Insider Trading Sanctions Act, 1984

The SEC afforded increased importance to insider trading laws post 1980s as the then existed provisions proved inadequate for effective regulation of insider trading. Criminal prosecutions happened very rarely, and the reliefs granted primarily included the disgorgement of the insider’s profits and injunction against the future violations. Class actions also were not entertained. Therefore, it had become a general perception that insider trading was profitable and at the same time did not involve much risk.

In view of the foregoing, the SEC eventually made a proposal to the Congress for revision of the sanctions for insider trading. The SEC recommended civil penalty up to three (3) times the profits made as a result of unlawful trading, and also to enhance the criminal liability for wilful violations of the securities laws. Finally, in 1984, the Congress passed the ITSA granting the SEC’s demand for increased civil and criminal penalties.

Besides the foregoing amendment, some congressmen had suggested including a definition for “insider trading” to bring more clarity in determining the categories of insiders. However, this recommendation was not accepted on the ground that the current law
was flexible and broad enough to reach the thievery of information for the purposes of securities trading. The SEC in its draft Bill of ITSA had carefully avoided defining “insider trading” or recommending any other substantive changes to the law.\(^{87}\)

The legislative intent behind the ITSA was to restrict any trading that was inconsistent with the basic notions of honesty and fair play. The other important reason was to deter those who profit from the theft of information by indulging in insider trading. This, however, did not establish a neat scheme for explaining coherently why such theft violates the securities laws.

Under the ITSA, the persons guilty of insider trading could be imposed with a civil penalty of up to three times the profits made (or losses avoided) as a result of the trading.\(^{88}\) Further, the criminal penalty was increased from US$10,000 to US$100,000. However, the increased penalties also were of no consequence and the insider trading scandals continued to increase even after 1984, and therefore, required even more stringent remedies.

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\(^{87}\) In his discussions, Langoovert cites a letter from SEC where it is said that ‘the flexibility which is gained by basing the imposition of the penalty on existing case law avoids the problems of freezing into law a definition which is too broad or too narrow to deal with newly emerging issues’. Donald C Langevoort, Insider Trading: Regulation, Enforcement and Prevention (Vol 18 Clark Boardman Callaghan Securities Law Series 1994) at page 2-20.

\(^{88}\) Section 21A of the Securities Exchange Act permits a court, in an action brought by the SEC, to impose a civil penalty of up to three times the trading gains or losses avoided, upon a finding that the defendant violated Rule 10b-5, Rule 14e-3, or any other provision or rule under the Exchange Act that prohibits insider trading.
2.2.2 **Introduction of the Insider Trading and Securities Fraud Enforcement Act of 1988**

In the mid 1980s, the *Levine Boesky*\(^{89}\) case attracted a lot of public attention. Ivan Frederick Boesky, a stock trader in the US, was convicted for insider trading and making illegal profits in a Wall Street insider trading scandal.

Although the SEC had succeeded in enforcement of the insider trading regulations in the *Boesky Case*\(^{90}\), the pressure to respond to a series of discrete problems under the law still continued. As a result, on 19 November 1988, the U.S. President signed the legislation known as Insider Trading and Securities Fraud Enforcement Act of 1988. The ITSFEA was an attempt to provide strength to the judicial and administrative initiatives which sought to overcome the restrictiveness of *Chiarella*\(^{91}\) and *Dirks*\(^{92}\). Under the ITSFEA, the criminal penalties were further enhanced for insider trading, private rights of actions were provided, and new responsibilities were imposed on those who employ or control insider traders or tippers.

Some of the salient features of the ITSFEA include:

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89 Ivan F. Boesky v. Securities Litigation, United States Court of Appeals, Second Circuit 36 F.3d 255, SEC v. Levine 881 F.2d 1165 (2d Cir.1989)
90 Ibid.
91 U.S. v. Chiarella 558 F.2d 1368.
(i) SEC was authorized to pay a bounty to any person for furnishing information concerning insider trading violations, up to ten percent (10%) of the civil penalty imposed or the settlement amount reached.

(ii) SEC was empowered to investigate, at the request of a foreign securities authority, violations of foreign securities laws whether or not such activities constituted a violation of the U.S. laws.

(iii) Persons who control the primary violator could also be imposed with a civil penalty of up to three (3) times the profit gained or loss avoided as a result of the unlawful insider trading.

(iv) ITSFEA provides for civil penalty on any controlling person, including registered broker-dealers and investment advisers. Additionally, the ITSFEA requires registered broker-dealers and investment advisers to establish, maintain, and enforce written policies and procedures “reasonably designed to prevent the misuse of material non public information”. The failure to comply with these provisions can be the basis for imposition of civil penalty where such failure “has substantially contributed to or permitted” the occurrence of the violation.

(v) One of the important contributions of the ITSFEA was that it created a specific private remedy against unlawful trading by insiders for the benefit of persons who traded in the same class
of securities “contemporaneously.” This is because, given the
difficulty of uncovering insider trading instances, many actions
against insiders demanded SEC’s involvement in such actions.
For instance, unlike SEC, it is very difficult for the plaintiff’s
counsel to analyze the unusual market movements and
determine the violation of insider trading regulations.

(vi) The criminal penalties for securities violations were increased
from five (5) years up to ten (10) years, and the fine was
increased from US$10,000 to US$ 1 million for individuals and
from US$ 500,000 to US$ 2.5 million for non-natural persons.

2.2.3 Regulation Fair Disclosure, 2000

On 23 October 2000, the SEC formally adopted the Regulation
Fair Disclosure under the provisions of Sections 13(a) and 15(d)\(^\text{93}\) of
the Exchange Act, through newly inserted Rule 100 of the Exchange
Act to prohibit the selective disclosure of material non-public
information to the analysts and the major institutional stockholders,

\(^{93}\) Under Section 15(d) of the Exchange Act, the Commission may prescribe as necessary or
appropriate in the public interest or the protection of investors, such supplementary and
periodic information, documents, and reports as may be required pursuant to section 13. . . .
The SEC expressly states that the purpose of the new regulation is to protect investors and
ensure fair dealing in the market. Section 13(a) provides the SEC with broad discretion to
proscribe rules and regulations necessary or appropriate for the proper protection of investors
and to ensure fair dealing.
etc., prior to releasing it to the public. This rule prohibits the companies from revealing market-sensitive information to Wall Street

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94 The FD Regulation at Rule 100 provides as follows:

a. Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in Rule 101(e): (i) Simultaneously, in the case of an intentional disclosure; and (ii) Promptly, in the case of a non-intentional disclosure.

b. 1. Except as provided in paragraph (b)(2) of this section, paragraph (a) of this section shall apply to a disclosure made to any person outside the issuer:

(i) Who is a broker or dealer, or a person associated with a broker or dealer, as those terms are defined in Section 3(a) of the Securities Exchange Act of 1934;

(ii) Who is an investment adviser, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940; an institutional investment manager, as that term is defined in Section 13(f)(5) of the Securities Exchange Act of 1934, that filed a report on Form 13F with the Commission for the most recent quarter ended prior to the date of the disclosure; or a person associated with either of the foregoing. For purposes of this paragraph, a "person associated with an investment adviser or institutional investment manager" has the meaning set forth in Section 202(a)(17) of the Investment Advisers Act of 1940, assuming for these purposes that an institutional investment manager is an investment adviser;

(iii) Who is an investment company, as defined in Section 3 of the Investment Company Act of 1940, or who would be an investment company but for Section 3(c)(1) or Section 3(c)(7) thereof, or an affiliated person of either of the foregoing. For purposes of this paragraph, "affiliated person" means only those persons described in Section 2(a)(3)(C), (D), (E), and (F) of the Investment Company Act of 1940, assuming for these purposes that a person who would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 is an investment company; or

(iv) Who is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.

2. Paragraph (a) of this section shall not apply to a disclosure made:

i. To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant);

ii. To a person who expressly agrees to maintain the disclosed information in confidence;

iii. In connection with a securities offering registered under the Securities Act, other than an offering of the type described in any of Rule 415(a)(1)(i) through (vi) under the Securities Act (except an offering of the type described in Rule 415(a)(1)(i) under the Securities Act also involving a registered offering, whether or not underwritten, for capital formation purposes for the account of the issuer (unless the issuers offering is being registered for the purpose of evading the requirements of this section)), if the disclosure is by any of the following means:

1. A registration statement filed under the Securities Act, including a prospectus contained therein;

2. A free writing prospectus used after filing of the registration statement for the offering or a communication falling within the exception to the definition of prospectus contained in clause (a) of section 2(a)(10) of the Securities Act;

3. Any other Section 10(b) prospectus;

4. A notice permitted by Rule 135 under the Securities Act;

5. A communication permitted by Rule 134 under the Securities Act; or

6. An oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act.
analysts and large shareholders without a simultaneous release to the general public. Thus, this was another attempt by the SEC to provide a "level playing field" for the investors by promoting full and fair disclosure of the material non-public information.

Prior to the Regulation FD, the prohibition against insider trading was based on the rule of ‘fair disclosure’ and was enforced by the SEC through their decisions in *Cady Roberts & Co*[^55], and later in *Texas Gulf Sulphur Co*[^56] by extending the ‘parity of information’ theory[^57]. However, in the decisions of both *Chiarella*[^58] and *Dirks*[^59], the court narrowed the scope of Rule 10b-5 liability and relied on the fiduciary duty or relationship of trust between the parties. The courts while rejecting the liability in ‘selective disclosure’ cases, questioned the formulation by SEC of future regulations and warned against the adoption of ‘parity of information’ theory absent any specific congressional intent. The U.S. Supreme Court reasoned that the duty to disclose arises from the relationship between the parties and not merely

[^56]: SEC v. Texas Gulf Sulphur Company 401 F.2d at 848
[^58]: U.S. v. Chiarella 558 F.2d 1368
[^59]: The Dirks tipping regime was an inadequate constraint on the selective disclosure practice as it can be difficult to prove that the tipper received a personal benefit in connection with disclosure. Stephen M Bainbridge: The Law and Economics of Insider Trading: a Comprehensive Primer (http://papers.ssrn.com/paper.taf?abstract_id=261277)
from one’s ability to acquire information because of his position in market.

The Regulation FD is not an anti-fraud rule and does not create new duties either under the anti-fraud provisions of the federal securities laws, or in private rights’ action. In this regard, the Rule 102 expressly provides that a failure to make a public disclosure required solely by Regulation FD shall not be deemed a violation of the Rule 10b-5. Also, private plaintiffs cannot rely on Regulation FD violation as a basis for a private action alleging the Rule 10b-5 violations by an issuer. Regulation FD does not affect any existing grounds for liability under the Rule 10b-5. Further, the liability for "tipping" and “insider trading” under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the Dirks v. SEC100 "personal benefit" test. Also, if an issuer's report or public disclosure made under Regulation FD contains either false or misleading information, or omitted material information, Rule 102 will not provide protection from Rule 10b-5 liabilities.

Regulation FD draws a line separating material and immaterial information. The SEC release during the adoption of Regulation on FD

spelt out the following seven (7) items\textsuperscript{101} that have to be reviewed carefully to decide whether they were material: (i) earnings information, (ii) mergers and acquisitions, (iii) new products or developments regarding customers and suppliers, (iv) changes in control or management, (v) change in auditors, (vi) a default or calling of securities, and (vii) bankruptcies.

Further, the liability for insider trading may arise under the Regulation FD, if an analyst breaches an agreement to keep confidential information supplied by an issuer under embargo. Under Regulation FD, an issuer is free to make a selective disclosure of material nonpublic information to an analyst if the analyst expressly agrees to maintain the information in confidence. If the analyst breaches such an agreement by disclosing the information to a client, the analyst may be liable for illegal tipping if the client trades. Traditional insider trading liability will also be available where an official of an issuer intentionally or recklessly makes a selective disclosure of material nonpublic information to an analyst, who trades or tips, and the issuer official receives in return a benefit – either a pecuniary benefit or a benefit to his or her reputation.

\textsuperscript{101} http://www.sec.gov/speech/spch415.html (last visited 10 August 2009)
The Regulation FD was well-founded and had improved fairness in the market. The market analysts no longer had the informational advantage which they previously enjoyed. However, the investors in the market were exposed to a flurry of information which may be irrelevant or misleading.

2.2.4 The passage of Rule 10b-5 1

The Rule 10b-5 1 provides that, “a purchase or sale of a security of an issuer is on the basis of material non-public information about that security or issuer if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale.”

In 2000, the SEC felt it necessary to enact Rule 10b-5 1, in the wake of circuit split among federal courts as to whether the “possession” or “use” of the material non-public information is the proper standard to determine liability under Rule 10b-5 for insider trading cases. The Second Circuit court in *United States v. Teicher* 102 had ruled that the possession of material non-public information was sufficient to impose liability in the insider trading cases. However,

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102 *United States v. Teicher* 987 F.2d. 112 (2d Cir. 1993)
subsequently, in the decisions of SEC v. Adler\textsuperscript{103} and United States v. Smith\textsuperscript{104}, the Eleventh and Ninth Circuit courts, respectively, ruled that the actual use of non-public information was necessary to establish an insider trading violation.

In United States v. Teicher\textsuperscript{105}, Teicher and Frankel were arbitrageurs. Michael David, who was interested in arbitrage, worked in the corporate department of the law firm of Paul, Weiss, Rifkind, Wharton and Garrison. David provided Teicher and Robert Salsbury who worked under Frankel, with information regarding potential acquisitions by Paul Weiss’ clients from December 1985 through March 1986. David, Teicher, and Andrew Solomon, a trader at the brokerage firm of Marcus Schloss Inc. also traded the confidential information between themselves. Salsbury provided Teicher with a confidential list of companies that one of the Paul Weiss’ clients was contemplating either merging with or taking over. SEC brought actions against Teicher and Frankel for violation of Rule 10b-5. The District Court convicted Victor Teicher and Ross Frankel for the insider trading violations. On appeal, the second circuit court affirmed the convictions by the District Court. The SEC in this case supported the ‘knowing possession’ standard.

\textsuperscript{103} SEC v. Adler 137 F.3d 1325 (11th Cir.1998).
\textsuperscript{104} United States v. Smith 155 F.3d 1051 (9th Cir.1998).
\textsuperscript{105} United States v. Teicher 987 F.2d. 112 (2d Cir. 1993)
While ruling against the tippees, the court had listed out several factors it considered important for determining “knowing possession” as the proper standard. First, the court noted that both the Section 10(b) and Rule 10b-5 had specified that a deceptive practice is one that is conducted only “in connection with the purchase or sale of a security.” The “in connection with” requirement under the rule is wide and broadly implies that the knowing possession standard was the correct standard. Second, the court reasoned that the knowing possession standard complies with the "disclose or abstain" theory. As the responsibility is placed on the possessor of information to disclose or abstain from trading, the court noted that “consistency dictated mere possession be the standard.”

Further, the court also favoured the knowing-possession principle on the ground of ease of proving the insider trading liability. The court concluded that the knowing possession standard is less burdensome to prove. Further, the knowing possession standard "recognizes that one who trades while knowingly possessing material inside information has an informational advantage over other traders."
The Eleventh Circuit dealt directly with the "possession" versus "use" debate in SEC v. Adler. In the Adler case, the court had adopted the use test. In this case, the SEC instituted suit against:

(i) Harvey L. Pegram, the founder of Comptronix Corporation, the securities of which company was being traded, who was a member of the board of directors during the time of trade;

(ii) Richard F. Adler, who was an outside director and a close friend of Pegram; and

(iii) Philip L. Choy, a business associate and social friend of Pegram, and Domer L. Ishler, a business associate and friend of three others for insider trading in 1989 and 1992. The district court granted the defendant's motion for summary judgment on each count. The Court of Appeals for the Eleventh Circuit reversed the judgment and remanded to the district court because there were genuine issues of material facts that had to be determined by a jury.

The detailed facts of the case are as follows:

(i) The 1989 Transactions of Pegram

Comptronix began to receive fewer orders from a large customer in the beginning of 1989. In August of 1989, Comptronix

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106 SEC v. Adler 137 F.3d 1325 (11th Cir.1998)
issued a press release explaining the decrease in orders. On 14 September 1989, Pegram had attended a meeting that involved more detailed discussion of Comptronix's status. Although the content of the information revealed is disputed among the parties, the record is clear that the board mentioned the instability of future orders from at least one major company. Pegram sold 20,000 shares of Comptronix stock between 19 September and 26 September 1989. Comptronix issued another press release on 6 October 1989 similar to the August press release informing the public that it received fewer orders than expected from a major customer. The price of Comptronix stock dropped over the next two (2) trading days in response to the press release. Pegram saved a significant amount of money by selling his Comptronix stock before the 6 October press release.

The SEC argued that Pegram, as a corporate executive, violated Section 10(b) and Rule 10b-5 because he "traded in his company's stock while in possession of material non-public information." However, Pegram’s defense was that he did not sell the stock because of any material non-public information received at the 14 September meeting, but instead, because of a pre-existing plan to do so. He claimed that he was forced to wait until after 14 September 1989 to sell the stock because of a lock-up agreement. He also offered evidence that he gained the required permission to sell from Comptronix's
counsel. The district court expressed doubt that the information Pegram obtained at the September 14 meeting was material and concluded that Pegram did not act with scienter as required. Thus, the district court granted Pegram's motion for summary judgment.

Before the Court of Appeals, the SEC had contended that the district court relied on a causal connection standard for insider trading violations that allows a trader to avoid liability if the trader proves that he did not purchase or sell securities because of the material non-public information that the trader knowingly possessed.

However, the court of appeals first analyzed the language of Section 10(b) and Rule 10b-5 and observed that the language suggests a focus on fraud, deception, and manipulation. It recognized that the choice between possession and use was difficult, but chose to adopt the use standard. The court found that there can be an inference of use that arises from the fact that an insider traded while in possession of inside information. The court adopted the use test also because it "best comports" with the applicable statutes. The court was fearful that convictions based on mere possession of material non-public information would "prohibit actions that are not themselves fraudulent."
But, the court did not uphold the district court's grant of summary judgment for Pegram. The court of appeals instead concluded that the possession of material non-public information created a real possibility that this information was used in the trade. The court held that summary judgment was inappropriate because genuine issues of material fact whether or not the information was used in the decision to make the trades remained to be examined.

(ii) **The 1992 Transactions of Pegram, Choy, and Ishler**

Adler attended a Comptronix board meeting on 15 November 1992 during which the board informed him of potential fraud within the company. Adler was part of the Special Committee created at this meeting to oversee the inquiry into the fraud. After investigating, the board issued a public statement on 25 November 1992 that described the fraud and indicated that there would be "material adjustments to the Company's historically audited financial statements." On the day of the announcement, trading was suspended for a period of time. Comptronix's common stock dropped significantly in value when trading resumed. Adler and Pegram had been friends for a number of years.

The SEC made an inference that Pegram possessed non-public information, based on the following sequence of events. The day
following Adler's disclosure of the potential fraud, Pegram called Adler at 7:53 in the morning. Pegram called his wife, Margie, at home two minutes later. At 8:07 a.m., Margie called their stockbroker to sell 50,000 shares of Comptronix stock. A total of 150,000 shares of their Comptronix stock were sold between 16 November and 24 November 1992. The SEC alleged that the stock was sold because of information given to Pegram by Adler, and, as a result, Pegram saved US$2,315,375 in losses. Pegram alleged that the sale of the stock was part of a "pre-existing plan to sell 150,000 shares of Comptronix after the 3 November presidential election."

Pegram’s defense was that the phone call to his wife was a wake-up call during which no mention of Adler or the stock was made. According to Pegram, the calls to Adler were similar to those made for about a year regarding normal business operations. His contention, therefore, was that he did not possess material non-public information when the trades were made.

The SEC alleged that Pegram provided Choy and Ishler with the material nonpublic information he received from Adler. Pegram made a call to Choy the same day he called Adler. After the call, Choy sold Comptronix stock. The SEC alleged that Choy was able to avoid substantial losses because he traded while in the possession of material
non-public information. Both Pegram and Choy testified that they did not discuss Comptronix stock during their phone call. Ishler called Adler on 15 November 1992 while Adler was joining, via telephone, the meeting at Comptronix about the potential fraud. They were unable to speak at that moment and Ishler was not able to speak to Adler again until 23 November 1992. Adler and Ishler alleged that the conversation only centered on trying to arrange a meeting. On 24 November 1992 Ishler purchased 300 "put options" in Comptronix stock. The SEC maintained that Ishler purchased these put options because of the material non-public information he received. Ishler gained a substantial amount of money when he exercised his put options after Comptronix's 25 November public announcement.

The district court denied the motion for summary judgment pertaining to the 1992 transactions as the timing of the telephone calls between the appellees raised a 'reasonable inference of materiality and scienter on the part of Pegram.' The jury was not able to reach a verdict after trial, and the district court granted the renewed motions for summary judgment as a matter of law.

The court of appeals held that the SEC had raised a reasonable inference that Pegram possessed non-public information. The court followed the same rationale it had used when discussing Pegram's
1989 transaction, when the court required that use of the material non-public information must be proven in order to find a violation of Section 10(b) or Rule 10b-5. Nevertheless, as a jury could reasonably conclude that the parties possessed the material non-public information, the district court's granting of summary judgment was inappropriate.

Shortly after the Eleventh Circuit decided *SEC v. Adler*\(^{107}\), the Ninth Circuit court also relied on the “use” standard in *United States v. Smith*\(^{108}\).

The facts of this case are as follows: Richard Smith worked for PDA Engineering, Inc. (“PDA”), a publicly traded software design firm. In 1993, after working for PDA for about three (3) years, Smith owned 51,445 shares of PDA stock. He sold all of these shares between 10 June and 18 June 1993 as well as "selling short" an additional 35,000 shares. Smith's parents also sold a substantial number of shares during the same time period.

Smith left a message on a co-worker's answering machine on 19 June 1993 indicating that he sold the shares of stock because he was

\(^{107}\) *SEC v. Adler* 137 F.3d 1325 (11th Cir.1998)

\(^{108}\) *United States v. Smith* 155 F.3d 1051 (9th Cir.1998)
worried about a decline in value. As a result, the SEC decided to investigate Smith regarding his sale of stock. The SEC held an investigation and after nine (9) months, turned the matter over to the U.S. Attorney in Los Angeles for potential criminal prosecution.

The government indicted Smith on eleven (11) counts of insider trading for violation of the Section 10(b) of the Exchange Act and the Rule 10b-5. The jury found Smith guilty of insider trading and Smith appealed. Smith alleged in the appeal that the information leading to his prosecution was not illegally gained, that the information he possessed was not material, and that the jury instructions were incorrect as they allowed a conviction based on mere possession.

The court rejected Smith's contention that the information he possessed was not material. Smith contended that because the information he dealt with was forward-looking and could not be material as defined by Rule 10b-5. The court rejected the idea that forward-looking information could not be material.

The court dealt with the possession v. use debate during the discussion of the appropriateness of the jury instructions. The government had argued that it was proper for the District Court to instruct the jury that Smith could be convicted of insider trading if he
possessed material inside information. Smith contended that the jury instructions inaccurately defined the burden the government must meet.

The court confirmed that no court in the Ninth Circuit had dealt with the possession v. use debate earlier and, it began the analysis. The court then indicated that the case relied upon by the government and the SEC for their contention that the possession standard was the proper standard, only dealt with that determination in dictum.

After discussion of the analysis in the *Teicher Case*\(^\text{109}\), the court determined that the “use” standard was the proper standard to apply. The court highlighted the Supreme Court's past requirement that causation should be proved, as well as the *Adler Case*\(^\text{110}\), to reach that conclusion. The court thought it significant that the language of the rules supported the necessity of finding a knowing misuse of inside information. The court expressed concern that those who did not actually commit fraud would be punished if the court adopted the strict knowing possession standard. The court dismissed concerns that the burden of proof in criminal cases would be too severe if the court adopted the use standard.

\(^{109}\) United States v. Teicher 987 F.2d. 112 (2d Cir. 1993)
\(^{110}\) SEC v. Adler 137 F.3d 1325 (11th Cir.1998)
Although the judicial interpretations on Rule 10b-5 delineated what constitutes unlawful trading and the prohibition on trading on the basis of material non-public information, the position was still unclear. In particular, there was no definitive authority whether liability could be based on trading while in mere possession of material non-public information or whether the SEC in an enforcement action, for example, had to establish that the defendant actually made use of the material non-public information while deciding to trade.

With the Rule 10b5-1 in place, the corporate insiders and others would be able to devise plans to engage in certain prearranged securities transactions without the breach of the prohibition on trading on the basis of the material non-public information about the securities. The rule was valuable for the executives and other insiders who wished to trade in securities not for obtaining private gain by insider trading, but for other reasons, especially when there is an increase in stock prices, and when they may come into possession of material non-public information.

The Rule 10b5-1 provided for certain affirmative defenses. An affirmative defense applies when the provisions of the defense are satisfied so long as the action taken to establish the defense was “in good faith and not as part of a plan or a scheme to evade the
prohibitions” of Section 10(b), under the Rule 10b5-1(c) (1) (ii). The rule deems a purchase or sale to be not “on the basis of” material non-public information if before becoming “aware” of material non-public information, the person had:

(i) entered into a binding contract to purchase or sell the security; or

(ii) instructed another person to purchase or sell the security for the instructing person’s account; or

(iii) adopted a written plan for trading securities. (Rule 10b5-1 (c) (1)(i)(A).)

The affirmative defenses provided for by Rule 10b5-1 are as follows:

1(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not 'on the basis of' material non-public information if the person making the purchase or sale demonstrates that: (A) Before becoming aware of the information, the person had: (1) Entered into a binding contract to purchase or sell the security, (2) Instructed another person to purchase or sell the security for the instructing person's account, or (3) Adopted a written plan for trading securities; (B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section: (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; (2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or (3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material non-public information when doing so; and (C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not 'pursuant to a contract, instruction, or plan' if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities. (ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section. (iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section. (A) Amount. 'Amount' means either a specified number of shares or other securities or a specified dollar value of securities. (B) Price. 'Price' means the market price on a particular date or a limit price, or a particular dollar price. (C) Date. 'Date' means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). 'Date' means, in the case of a limit
2.2.5  Changes to Rule 10b 5-1 made in 2009

On 25 March 2009, the Division of Corporation Finance of the Securities and Exchange Commission's issued new and revised interpretations regarding the operation of pre-established trading plans and instructions designed to satisfy Rule 10b5-1(c) under the Exchange Act, which provides an affirmative defense from insider trading liability. In the updated interpretations, the Division modified its interpretation relating to Section 10(b) and Rule 10b-5 liability for plan and trade cancellations and provided new guidance regarding:

(i) the availability of the Rule 10b5-1(c) defense when cancelling a trading plan or establishing a replacement trading plan;

(ii) the standard for satisfying the material nonpublic information requirement of the defense;

(iii) the transferability of a trading plan when a broker responsible for the plan goes out of business; and

order, a day of the year on which the limit order is in force. (2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not 'on the basis of' material non-public information if the person demonstrates that: (i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and (ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material non-public information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material non-public information, or those that prevent such individuals from becoming aware of such information.
(iv) the effect on the availability of the defense of a provision for the automatic reduction in the number of shares repurchased based on other discretionary transactions by the insider.

The new and revised interpretations in general endorse some of what have emerged as the best practices in Rule 10b5-1 plan design, but reflect a somewhat restrictive view on the availability of the Rule’s affirmative defense.

In a recent decision, a federal district court has rejected the SEC’s charge in the insider trading case against *Dallas Mavericks CEO, Mark Cuban*[^112]. The District Court concluded that an agreement to keep information confidential does not encompass any agreement not to trade and therefore, the trading in securities even after agreeing to keep the information confidential does not deceive the source of information. The SEC appealed against the district court’s dismissal of insider trading charges against MC, relating to MC’s sale of shares of Mamma.com Inc. On 21 September 2010, the United States Court of Appeals for the Fifth Circuit (the “Court”) had vacated the district court’s dismissal.

[^112]: SEC v. Mark Cuban, 2010 WL 3633059, No. 09-10996 (5th Cir.)
The allegations against the defendant was that in the spring of 2004, the Company’s CEO told MC about a proposed Private Investment in Private Equity (PIPEs) offering to gauge MC’s interest in participating. He prefaced the conversation with disclosure regarding the confidential nature of the information he intended to share with MC. MC agreed to keep the information he received confidential. At the end of the conversation, MC expressed his displeasure regarding PIPEs generally and expressed the view that he was now precluded from selling by stating, “[w]ell, now I’m screwed. I can’t sell.” MC then asked to see the terms and conditions of the offering. The Company’s CEO sent MC a follow-up e-mail giving MC the contact information for the placement agent, and MC called the agent and obtained additional information about the offering, including the fact that the offering was being sold at a discount to the market price. Following the call, MC sold all of his shares and avoided losses in excess of US$ 750,000 by selling, prior to the announcement of the PIPEs offering. MC did not inform the Company of his intention to trade on the information that he had been given in confidence and that he had agreed to keep confidential.

The SEC’s claims against MC were based on the misappropriation theory of insider trading liability recognized by the
Supreme Court in the *United States v. O’Hagan*\(^{113}\). Put simply, the theory holds that when a person other than a corporate insider misappropriates the confidential information for securities trading purposes, in breach of a duty owed to the source of the information, that person violates the anti-fraud provisions of the federal securities laws. The key substantive question before the court was whether the district court had erred in finding that a duty of confidentiality (in this case MC’s agreement to maintain as confidential the fact of the PIPEs offering), without more, is insufficient to provide the requisite duty to support misappropriation theory liability. The Court by-passed the legal issue at the heart of that question and, instead, concluded that as the SEC’s complaint had alleged that MC obtained access to the PIPE’s pricing information only after expressing his view that he was precluded from selling, a plausible basis existed to conclude that the CEO and MC did, in fact, share an understanding that he was not to trade on the basis of his knowledge of the pending PIPE’s offering. As such, the Court found that the SEC had sufficiently pled that MC owed a duty to the CEO to use the information solely for the purposes of evaluating whether he would participate in the PIPEs offering and not for his personal gain (in this case, avoidance of loss). The Court also declined to consider the lower court’s conclusion that the SEC could

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not rely on the Rule 10b5-2 (b) (1) to provide the requisite duty for misappropriation theory liability. Rule 10b5-2 provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading, and the Rule 10b5-2 (b)(1) provides that a duty of trust or confidence exists whenever a person agrees to maintain information in confidence. The lower court had determined that, as nothing in the Rule 10b5-2 (b)(1) requires that the confidentiality agreement encompasses an obligation not to trade on or otherwise use the information, the SEC could not rely on it to establish MC’s liability under the misappropriation theory.

However, the key substantive issues presented by the district court’s decision remain unresolved. The Court’s decision is noteworthy due to the fact that it vacated the trial court’s opinion on relatively narrow procedural grounds and declined to address the key substantive legal issue on appeal, i.e., whether a duty of confidentiality, without more, is sufficient to support the “misappropriation theory” of insider trading liability. Reading the complaint in the light most favorable to the SEC, the Court concluded that the allegations, taken in their entirety and assumed to be true for the purposes of a motion to dismiss, provide at least a plausible basis to
find that the Company’s CEO and MC had reached a no-trade agreement with respect to MC’s shares of the Company.

2.3 U.S. - WHETHER THE RIGHT EXAMPLE FOR FRAMING LAWS ON INSIDER TRADING

A survey of the securities laws of some of the developed markets reveals that several countries have rejected the U.S. approach on the insider trading laws and do not want to rely on the U.S. insider trading laws for framing their own laws. The U.S. approach has been rejected mainly due to the lack of consistency displayed in the decisions of the SEC and the courts in the U.S. while deciding the insider trading cases. Certain loopholes that still exist in the U.S. insider trading laws and the U.S. courts’ and the SEC’s decisions are as follows:

At the outset, the scope of the term “insider” is unclear, i.e., who are the persons who can be regarded as insiders, and to whom the liability for fraud and insider trading can be extended. Although in some of the cases, the categories of the classical insiders and the temporary insiders have been specified, due to the lack of clarity in the laws, there are interpretational difficulties in determining whether the trader is an insider and can be held liable under the Rule 10b-5. For instance, whether a close friend can trade

legally on the basis of the material non-public information that he inadvertently learns when visiting the insider at his home or office, is a question which can be only be decided on the specific fact situation, and not under any legal provision.

Further, the liability for insider trading under the U.S. law under the anti-fraud rule evolved on the basis of fiduciary duty and relationship of trust and confidence. The legal framework does not clarify the instances or the relationships which may be regarded as the fiduciary relationship or that of trust or confidence. As a result, each case has to be decided based on its specific facts and circumstances. Thus, there is no consistency in the decisions of the different U.S. courts and as such no precedential assistance for interpretation in the prospective and ongoing cases.

Moreover, many decisions even in some of the landmark cases pronounced by different U.S. courts and the SEC reveal different views on the same theories and same legal principles. For instance, in the cases of Chiarella\textsuperscript{115} and Dirks\textsuperscript{116}, the U.S. Supreme Court has reversed the rulings of the SEC. This is important considering that SEC is the regulator of the securities market as well as the law maker. Further, the interpretations of the significant terms relating to the insider trading liability such as “for improper

\textsuperscript{115} U.S. v. Chiarella 558 F.2d 1368
\textsuperscript{116} Dirks v. SEC 463 U.S.646 (1983)
personal benefit”, “misappropriation of information”, “tippers’ and tippees’
duty of disclosure”, etc., is still vague and unclear.

These are just some of the instances which can be attributed to the
absence of a robust statutory framework for insider trading.

Although the U.S., the veteran regulator for insider trading and popular
for rigorous enforcement of insider trading laws, has a regulatory framework
on insider trading with emphasis on ‘knowing possession’ of material non-
public information, most countries have opted for framing insider trading laws
based on the ‘access’ doctrine. A definition based on ‘access’ doctrine, other
countries expect that it would cover both categories of insiders, the traditional
insiders and others those who have access to information by virtue of their
profession, i.e., accountants, lawyers, etc.

Notwithstanding, many countries have adopted the law which reflects
the U.S. law in pre-Chiarella era. Effective enforcement is the most significant
feature of the US securities law framework that distinguishes if it from other
jurisdictions. Rightly said by Marc I. Steinberg¹¹⁷, that it is better to
effectively enforce less perfect laws to enhance investor protection and market
integrity than to have admirable statutes which are not being put into use.

¹¹⁷ Professor of Law and Senior Associate Dean for Research at Southern Methodist
University (SMU) Dedman School of Law
A concrete example of the treatment of insider trading law in the U.S. can be seen in *SEC v. Switzer*. Barry Switzer, a former football coach of the Dallas Cowboys and the University of Oklahoma, inadvertently received material non-public information from a key corporate executive relating to a forthcoming merger. Knowing the information to be reliable because of his relationship with the insider, Switzer and his cronies traded on the basis of this information and made a good profit. The insider, the corporate executive was unaware of Switzer being privy to the communication and the court therefore held that there was no unlawful tipping. The tippee liability under Section 10 b is derivative in nature. The court found that the insider tipper did not breach his fiduciary duty and hence Switzer as the tippee traded lawfully and therefore was entitled to keep his profits. However, the result in this matter would have been entirely different had the transactions been structured in a merger scenario. In such an event, Rule 14 e-3 would have been applicable and strict liability would apply as opposed to Section 10 b, which is derivative in nature. This is quite contrary to the later decision of the Supreme Court in the matter of *U.S. v. Chestman*.

Irrespective of its shortcomings, laws on curbing insider trading in the U.S. are viewed as very efficient. One reason could be the effective enforcement and the other could be the available remedies in the U.S.

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119 U.S. v. Chestman 947 F.2d 551. This is also the first case where Rule 14e-3 was used in a criminal conviction. Chestman was found guilty of trading Waldbaum Inc. in advance of a tender offer by Great Atlantic and Pacific Tea Co by using material non-public information given to him by a member of the Waldbaum family, who was not a fiduciary to the company.
framework which have received a lot of support from the market participants and the public. Even if countries have strict norms, they become meaningful only when they are enforced with some regularity. Lack of effective government personnel, resources\textsuperscript{120} and surveillance hardly deters prospective violators.

In the U.S., enhanced criminal prosecution under ITSFEA for insider trading has become an accepted component of the enforcement landscape. Further, the aggrieved traders may also institute civil action seeking damages against those who illegally traded on the basis of tipped material non-public information. The cultural attitudes prevalent in the U.S. favour relatively rigorous enforcement and the prosecution of the offence of insider trading. Judges are also supportive in this environment. An effective enforcement mechanism against the offence of insider trading has and will further culminate in the country’s securities markets becoming more attractive and secure as a forum for both capital raising and investment purposes.

2.4 INSIDER TRADING IN OTHER JURISDICTIONS

Unlike the U.S., other foreign countries have specific and detailed legislation on insider trading. Most of the jurisdictions have defined the key

\textsuperscript{120} SEC’s budget is nearly fifty times larger than Germany’s federal regulator., Steinberg quotes 34 Sec. Reg & L.Rep.432,433 (2002), supra n.33
terms relating to insider trading in the statutes. For example, in the United Kingdom, the term “inside information” has been defined.

Relatively, very few jurisdictions prefer the wider approach adopted by the U.S. based on ‘parity of information’ principle. For example, Australia’s prohibition against insider trading extends to any person or entity that possesses confidential price sensitive information. Under the Australian regulatory framework, one is deemed to be an insider and subject to the insider trading and tipping proscriptions, by:

(i) possessing information that is not generally available and if the information was generally available, it would have a material effect on the price or value of securities of a corporate body;

(ii) knowing, or ought to reasonably know that;

(iii) the information is not generally available; and

(iv) if it were generally available, it might have a material effect on the prize value of those securities.

On the tipping liability, Australia has a wider approach. Under the Australian law, a tippee, however remote he is, who knowingly possesses material non-public information, cannot trade or tip the said information. Similarly, the U.K. also has a broad prohibition against trading and tipping for those who knowingly received material non-public information, directly or indirectly, from an insider.
Many countries have more straightforward laws\textsuperscript{121} as compared to the U.S. Under the German law, the primary insiders can neither trade nor tip. However, the recipient of material non-public information communicated by a primary insider are not themselves precluded from tipping the subject information to others, although such recipients are themselves proscribed from trading based on the information received from the primary insiders. France, Italy and Japan have similar provisions.

2.5 DEVELOPMENT OF INSIDER TRADING AS AN OFFENCE IN U.K.

The principles of insider trading were recognized by the U.K. as early as in 1945. Until the enactment of the specific insider trading legislation of the Companies Act, 1980, the trading activities by insiders in the U.K. securities market was not prohibited, provided the insiders did not breach the fiduciary or other duties of care which they owe in the circumstances. An important decision of the chancery court illustrates how the British courts treated the fiduciary duty of the directors of companies.

In \textit{Percival v. Wright},\textsuperscript{122} the Court of Chancery held that a director of a company does not hold fiduciary duty to the shareholders of the company and

\textsuperscript{121} These countries include Switzerland, France, Italy, Germany, U.K., Australia, Japan, among others.

\textsuperscript{122} \textit{Percival v. Wright} [1902] 2Ch 421
is not liable to disclose information about the company to the shareholders, while trading with its shareholders and his duty is only towards the company. The court also observed that, when the Director is acting as an agent of certain shareholders, then the fiduciary duty arising from the agency relationship prevents him from making acquisitions of securities in his favour. In this case, the directors of a company bought shares from Z. However, they did not disclose to Z that negotiations were being conducted for the sale of all the shares in the company at a higher price than that being asked by Z. Those negotiations proved to be abortive but Z sued to have his sale of shares set aside on the ground that the directors ought to have disclosed the negotiations to him. The court, however, held that the sale was binding as the directors were under no obligation to disclose the negotiations to Z.

This decision may not hold good based on the present day principles of insider trading considering that the directors were not held liable although they were in possession of the non-public material information and traded based on such information.

A brief discussion on the evolution of insider trading principles in the UK is as follows:

2.5.1 Cohen Committee
The Companies Act, 1948 was based on the Cohen Committee Report which reviewed the state of the company law in 1945\textsuperscript{123}. The Cohen Committee recommended imposing disclosure requirements for a company’s directors dealing in the shares of the company. A highlight of this report was its reference to the issue of insiders using nominee companies and nominee shareholdings to avoid personal liabilities for insider dealing. The directors usually traded through the nominee companies registered outside the country. Although these problems were identified by the Cohen Committee, the regulation on insider trading in U.K. still took a long time.

2.5.2 Jenkins Committee

Jenkins committee in 1962 had put forth proposals for the reform of company law. The recommendation relating to the insider dealing by this committee was that if a director of a company traded in securities by making improper use of the price sensitive confidential information, then that director should compensate the person who suffered loss as a result of the director’s non-disclosure of confidential information, unless the information in question was known to that person. The Jenkins Committee also recommended that dealings by directors in options relating to the listed securities of their employing companies should be prohibited. Further, the committee had

\textsuperscript{123} The Companies Act, 1948 was largely based on the Cohen Committee Report
recommended civil remedies for the person who has suffered loss from insider trading. However, these recommendations regarding insider dealing did not crystallize into law.

2.5.3 Criminal Sanctions for Insider Dealing: White Paper on Company Law Reform

In 1972, Justice, a law reform organization, had suggested in its report that insider dealing should be made a criminal offence. Thereafter, in 1973, the stock exchange and the takeover panel, in its joint statement had also recommended criminal sanctions. Further, the Conservative government presented the White Paper in the Parliament; including the proposal that insider dealing should be made a criminal offence.

The White Paper on Company Law Reform presented by the Conservative government recognized that unfair benefits were obtained by the insiders on the basis of confidential price sensitive information, which was not available to the general investing public. Any legislation to regulate insider trading, it said, should ensure that an insider in possession of price sensitive information should be restrained from trading, until the information is made public. The recommendations of Jenkins committee, which suggested that the
legislation for curbing insider dealing should provide for a civil remedy to persons who could establish that they had suffered identifiable loss through the misuse of materially significant information, was also reiterated in the White Paper. The White Paper also provided that the law should ensure that any insider who abused his position should be held accountable to the company for any profit accruing out of his actions.

The Companies Bill, 1973, incorporated most of the recommendations on ‘insider dealing’ set out in the White Paper. However, as the Parliament was dissolved on 07 February 1974, the Companies Bill of 1973 did not get enacted.

2.5.4 Green paper on the Reform of Company Law, 1974

In May 1975, the Labour Party in the U.K., came forth with a Green Paper on the reform of company law. This paper expressed dissatisfaction on the existing supervisory role of government which stressed mainly on self-regulation.

As the various committees were constituted by the industry professionals from the securities market, investors had strong fear that the
stock exchange was run by the industry more in their own interest rather than that of the investors. The Stock Exchanges were thus considered inefficient to police the securities markets, lest insider dealing.

The Green paper also proposed that insider dealing should be made a criminal offence. The maximum penalty recommended by the Green paper for insider trading was imprisonment up to ten (10) years. According to the Green Paper, the basic provision of insider trading should be primarily applicable to the directors and such other persons who are likely to have access to the inside information in the course of their dealings with the company’s securities. It should be an offence for such persons to communicate price-sensitive non-public information to third parties knowing that such third parties are likely to deal in securities. It also proposed that there should be a civil remedy of revoking the transaction and making the insider accountable to the company for the profits earned by him in the dealing.

2.5.5 **The Companies Act, 1980**

The London Stock Exchange issued its Model Code in 1970s for securities transactions by the directors of listed companies. In 1977, the Takeover Panel and the Stock Exchange issued a joint statement which required the companies involved in takeovers to
ensure that insider dealing does not happen during the process. However, as insider dealing could not be controlled by self regulatory tactics, the Model Code and the takeover panel recommendations remained ineffective. Therefore, the Companies Act, 1980 which declared the ‘Insider Dealing’ as a criminal offence was widely accepted in London. However, the practitioners who knew about the practical difficulties in making a successful prosecution expressed their apprehensions about the efficacy of the new legislation of 1980\textsuperscript{124}.

Part V of the Companies Act, 1980, thus prescribed the specific offences involving insider trading. The insider trading was categorized into three (3) kinds of criminal offences;

(i) where an insider is in possession of information or who received information from an insider (who becomes a ‘tippee’) dealt in securities;

(ii) where an insider or a tippee counseled or procured another person to deal in securities; and

(iii) where an insider or a tippee communicated insider information to a third party, if the recipient was likely to use that information for dealing or counseling or procuring another person to deal.

\textsuperscript{124} Brazier, Gil, Insider Dealing (1996), by Cavendish Publishing Limited at 4.16
Primarily, two (2) factors were to be determined in order to establish the offence of insider trading:

(i) whether the person dealing in securities is an insider, depending on whether he was in possession of UPSI; and

(ii) whether the insider was actually involved in dealing in securities.

Therefore, although the Companies Act 1980 introduced insider trading as a criminal offence, the law on insider trading was consolidated in 1985 when the Companies Act was revised.

2.5.6. Company Securities (Insider Dealing) Act, 1985

Finally, U.K.’s law relating to insider dealing in company securities was consolidated in the Company Securities (Insider Dealing) Act, 1985. The object of the legislation remained the same, i.e., to prohibit insider dealing. A breach of the provision remained a criminal offence. This Act was amended by the Financial Services Act, 1986 and subsequently repealed by the Criminal Justice Act, 1993.

Under the CJA 1993, the insider dealing as a criminal offence required a stricter burden of proof to secure a conviction. The prosecution had the burden to prove the guilt of the accused beyond reasonable doubt and the accused did not have to prove anything. Therefore, although the insider dealing remained as an offence under
the statute since 1980, no convictions were made under the provisions due to onerous burden of proof on the prosecution. The CJA 1993 proved to be ineffective to deter people from manipulating the markets and trading dishonestly.

Additionally, the perpetrators of insider dealing offences usually formed a chain of people to disguise the identity of both the intermediaries and the beneficiaries and there were cases, where some offenders may operate from abroad. These offences involved complex derivative transactions which were not easily visible to the market or to the regulator. Further, as the standards required to establish a *prima facie* case of insider dealing were very high and in most cases, no direct evidence was available, proving the offence of insider dealing on the basis of circumstantial evidence became difficult. Evidentiary requirements regarding the profit or loss made in the transaction to prove the criminal offences beyond reasonable doubt weakened the prosecution.

Although the CJA 1993 imposed criminal liability for insider dealing, lack of civil remedy remained a difficulty for a company or a suffering investor. The civil regime for dealing with situations where

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investors suffered diminution in the value of their securities due to trades based on inside information was incorporated under the Financial Services and Markets Act, 2000, which is discussed below in detail.

2.5.7 The European Community Directive on Insider Dealing

The regulation of insider trading in Europe could trace its roots to the U.S. Federal securities regulation. Quite close to the decision of the U.S. court in 1968 in Texas Gulf Sulphur Case\textsuperscript{126}, prohibition against insider dealing leapt across to Europe. France was the first country in Europe, to introduce legislation on insider trading, in the year 1970. Subsequently, in 1980, the United Kingdom enacted the criminal legislation against insider dealing, followed by Norway in 1985, Sweden in 1985 and Denmark in 1986. The harmonization of the very fragmented European capital markets was attempted by enacting a string of directives in 1980s, ending with the 1989 insider trading directive of the European Community. The efforts by different countries prompted the European Community to propose a directive, which became the 1989 directive on insider dealing. The Council of the European Community adopted this directive on 13 November

\textsuperscript{126} SEC v. Texas Gulf Sulphur Company 401 F.2d at 848
1989, primarily to coordinate the prohibition of insider dealing amongst members of the European Community.\(^{127}\)

As certain members of the European Economic Community did not have any law for regulating insider dealing, the Council felt it advisable to have a common regulatory framework at the community level to deal with insider trading. Further, this approach could assist in combating trans-country insider dealing more effectively through cooperation between the various competent authorities. The 1989 directives also included certain activities which did not amount to insider dealing. For example, as the acquisition or disposal of transferable securities necessarily involve temporary decision to acquire or dispose, taken by the person who undertakes one or other of those operations, the carrying out of the acquisition or disposal does not in itself constitute the use of inside information. Also, the mere fact that the market-makers having inside information carry on the business of buying and selling of securities and stockbrokers with such information carry out an order and should not be held liable for misuse of such inside information.

\(^{127}\) The directive is cited as the Council of the European Communities Directive of 13th of November 1989.
Further, the process of carrying out transactions with the aim of stabilizing the price of new issue of the securities, or secondary offers of transferable securities should not in itself be deemed to constitute the use of inside information. The regulation directed against insider dealing was an attempt to protect the market players and ensure their trust in the fairness of the market.\footnote{The flock ought to be protected from the lurking insiders is the small, extremely rich and in every way privileged class of professional investors and their band of securities analysts. It is only they who with their substantial and expansive knowledge of the individual securities, can perceive it a threat if material information is not publicly available and thus outside their reach is used to trade against them. The lay investor on the other hand, is never on top of the available information and is at disadvantage when compared to the professionals. The risk of trading with an opponent using the inside information is hardly discernible to lay investors compared with their general informational disadvantage. To put it bluntly, the support for the action against insider dealing usually voiced by professional investors is provoked by a fear of being placed on the same dismal footing as that of lay investor. However, considering the importance of the pricing mechanism of the professional investors, which includes moving large sums of each day, it is justifiable to cater to their interests. Thus, the absence of insider dealing will make the pricing of securities more sound, which also benefits the lay investor. Jesper Lau Hansen, The new proposal for European Union directive on market abuse, University of Pennsylvania Journal of International Economic Law, Summer 2000, page 241.}

The 1989 directive of the European Community distinguished the dichotomy between primary and secondary insiders. Under the new directive, a lesser degree of \textit{mens rea}, i.e., negligence would suffice with respect to primary insiders, although it was up to the member states to decide whether they would apply the same low standard to secondary insiders. One of the stated objectives of the EEC legislation has been the establishment and subsequent functioning of the internal
market. Also, the ‘secondary market in transferable securities’, play an important role in the financing of ‘economic agents’, as per the directive. Therefore, for the secondary market to play its role effectively, it is necessary to ensure that all the steps are taken to inspire the confidence of the investors in the market. The investors should have the confidence that they are placed on an equal footing and that they will be protected against the improper use of inside information. When certain groups of investors are benefited as opposed to others, insider dealing is likely to undermine the confidence of investors and impede the smooth operation of the market.

In the United Kingdom, the implementation of the above 1989 directive led to the amendment and restatement of the law on insider dealing contained in part V of the CJA 1993, which are discussed in detail in Chapter 4 of this study.

2.5.8 **Financial Services and Markets Act, 2000**

Financial Services and Markets Act, 2000, which imposes both civil and criminal liability for market abuse, came into effect on 30 November 2001. The FSMA most importantly introduced the market

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129 Article 100 a(1) of the treaty which established the European Economic Community (EEC) states that the Council shall adopt measures for the approximation of the provisions laid down by law, regulation or administrative action in member states which have as their object the establishment and functioning of the internal market.
abuse regime and also constituted the Financial Services Authority as a super-regulator, with powers to regulate insurance, investment business and banking. The FSMA abolished the Self-Regulating Organizations and replaced the existing two-tier regulatory regime for investment business established under the Financial Services Act 1986, with an integrated regime and a single regulator being the FSA. The primary advantage of the FSMA was that the market abuse regime which included both the members of the public as well as the regulated individuals who deal in investments traded on certain prescribed markets\textsuperscript{130}.

The new market abuse regime did not replace the existing offences of insider dealing and the creation of a false market and rather, supplemented them. The provisions in relation to insider dealing as set out in Part V of the CJA 1993 continues in force as before. Part V has not been amended by the FSMA. However, there is one important change in relation to enforcement. Under Section 402 of the FSMA, the FSA is now authorised to institute proceedings for an offence under Part V of the CJA 1993. The regimes for market abuse and insider dealing are quite different in terms of their territorial extent, the investments and activities covered and the tests to be applied. Therefore, there must be a separate analysis in each case of

\textsuperscript{130} Prescribed markets are expected to be those operated by the seven UK recognised investment exchanges (RIEs).
whether or not the activity constitutes either insider dealing or market abuse or both.

Market abuse is a behaviour which relates to, or has an impact on, investments traded on a market and which does not meet the standard of behaviour reasonably expected of a person in that market because it involves a misuse of information, the creation of a false or misleading impression, or the distortion of the market in the investments. Market abuse is not a criminal offence. It is a conduct which gives rise to a liability to pay a penalty to the FSA, or to be censured by the FSA, or which can be prohibited by the FSA by way of an injunction or be the subject of a restitution order. Many commentators refer to the concept as that of a "civil offence". The fact that market abuse is a civil offence means that there is a lower standard of proof as compared to a criminal offence. Whether or not a person is guilty of market abuse is determined by the FSA (subject to an appeal to the appellate tribunal) rather than by a Court or a jury. It also means that it can be committed by any person, including a body corporate and any other legal person, rather than just by an individual.

Therefore, it can be said that FSMA has introduced more clarity and transparency in the market conduct and the focus of the market abuse regime remains on the effects of the investors’ behaviour.
in the market, and not on the intentions behind such behaviour. To impose civil liability under FSMA for market abuse, it is not necessary for any intention or purpose to be demonstrated in order for the regular user to conclude that certain behaviour amounted to market abuse.

The offence of market abuse in respect of insider dealing under FSMA may include activity which falls within the purview of the CJA, 1993. The policy objective behind this step of adopting both civil and criminal regime under the FSMA is stated to ensure that the participants in regulated markets use and disseminate information relating to qualifying investments in such a way so as not to undermine market confidence or the integrity and good governance of those markets, following the international standards discussed by International Organization of Securities Commissions\textsuperscript{131}. The FSMA market regime was amended by the European Union Directive on Insider Dealing and Market Manipulation (Market Abuse Directive of 2003)\textsuperscript{132}.

\textsuperscript{131} IOSCO is an inter-American regional association created in 1974 and formed into a global cooperative body in 1983. In 1998, IOSCO adopted a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), which is recognized as the international regulatory benchmarks for all securities markets. According to the IOSCO ‘Objectives and Principles of Securities Regulation’, the three (3) core objectives of ‘securities regulation’ are as follows: (a) the protection of investors; (b) Insuring that markets are fair, efficient and transparent; and (c) the reduction of systemic risk.

\textsuperscript{132} India is an active member of International Organisation of Securities Commission.

The relevant provisions of the FSMA subsequent to its amendment following the Market Abuse Directive 2003 are discussed in the subsequent chapters.
2.5.9 Market Abuse Regime, 2003

EEC Directive 155\textsuperscript{133} on insider trading prohibited market manipulation. The EU Insider Dealing and Market Manipulation Directive, 2003\textsuperscript{134} has defined insider dealing as a form of market abuse which can constitute both a civil and a criminal offence. Further, market manipulation is defined as trading or disseminating information in order to give false or misleading signals as to the price movements. This Directive is said to be more specific against market manipulation as compared to the U.S.’ Exchange Act, which prohibits ‘any manipulative or deceptive device or contrivance’\textsuperscript{135}. On an overall comparison, the basic premises of the 1989 Directive are retained in the MAD, 2003.

The MAD, 2003 defines ‘inside information’ as “information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial

\textsuperscript{133} 2003 Directive covers shares, unit trusts, money market instruments, futures, swaps, options, derivatives and any other instrument trading on a regulated market for which a request to trade has been made.

\textsuperscript{134} Barry Rider, Kern Alexander, Lisa Linklater and Stuart Bazley, Market Abuse and Insider Dealing 78 (2\textsuperscript{nd} ed., Tottel Publishing Ltd (2009))

\textsuperscript{135} The reason attributed by Eric Engle in his comparative study between the Insider Trading Laws in the U.S. and EU was that SEA was enacted in the wake of the greatest stock market crash in history, whereas the directives were not.; Eric Engle, Insider Trading in U.S. and E.U.Law, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1271868 (last visited Feb 23, 2010)
instruments or on the price of the related derivative financial instruments.” Materiality and publicity arise in both the definitions used by the EEC Directive and that of U.S. However, the difference is that, according to the current legal position in the U.S., the presence of illegal trading is determined on the basis of possession of non-public information and not on the basis of breach of fiduciary duty.

Further, the directive also provides the definition for the term ‘insider’. An insider is a person who due to his relationship in the company as manager, director, employee or major shareholder, possesses inside information (material non-public facts) and knowingly uses such inside information to acquire or dispose of securities to which the information relates for his own account or another. The MAD, 2003 includes members of boards of directors, key management, large shareholders and even employees of the company under the definition of insider. According to the new directive of 2003, prohibition is applicable to those who acquired the inside information not only by virtue of their position as director, manager, employee or majority shareholder but also those who acquired the information illegally. Tipping is also prohibited under the new 2003 Directive. Further, the disclosure of inside information by an employee in the course of his employment is also prohibited, unless there is a close link between the disclosure and the exercise of his employment, profession
or duties and that disclosure is strictly necessary for the exercise of that employment, profession or duties. In such cases, the proportionality of the disclosure will also be factored to assess the liability.

In so far as the prohibition of insider trading is concerned, the MAD, 2003 has specified that the member states shall prohibit any person referred therein who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of the third party, either directly or indirectly, financial instruments to which that information relates.

Although the 2003 and 1989 Directive both required the member states to prescribe sanctions for insider trading, the directives have not identified or defined what the sanctions should be. This can be interpreted to mean that the directives permit a flexible and nuanced response to the problems posed by the market. The directives are only prescribing the minimum standards and the members can always exceed them or interpret them on the case to case basis in insider trading cases. The underlying principle in the European Community directives is that insider trading undermines the investor confidence. The Directive has shifted the focus of insider trading from the traditional approach that insider trading is a breach of fiduciary duty
and affects company's interests, more than that of the investors. Under the new approach, stock holders, employees, managers and the general public are seen as having competing interests to be balanced, and the rationale for the prohibition of insider trading is to maintain market efficiency. The Companies Act, 2006 which came into force in the U.K. in 2009, did not contribute significantly to the insider dealing regulation.

One of the major differences in the U.S.’ and Europe’s enforcement mechanism of insider trading cases is that private action is the norm in the U.S., and state intervention is the exception. Whereas in the EU, state intervention is the norm and private action would be the exception. Further, the prohibition of the short-swing trades is also non-existent in EU. The EU directive on insider trading has made insider trading illegal in all the European countries and the success of the U.S. regime has been the motivation behind the Directives.