CHAPTER 4

COMPARATIVE STUDY OF THE LAW ON INSIDER TRADING IN
U.S., U.K., AND INDIA

Major global economies including the U.S., the U.K., and India also have attempted to address the following basic issues under their legal framework on insider trading, such as (i) what is insider trading; (ii) who can be considered as an insider; (iii) what is the inside information; (iv) how to prevent insider trading; and (v) what sanctions and enforcement measures should be implemented.

This chapter deals with the comparison of the Indian insider trading laws with the laws in the U.K. and the U.S., specifically in respect of the foregoing issues. The last issue relating to the sanctions and enforcement of insider trading are dealt separately in Chapter V.

4.1 WHAT IS INSIDER TRADING

4.1.1 United States of America

It is interesting to note that the U.S. insider trading laws do not have a specific definition of “insider trading”, although insider trading is regarded as an offence and is legally prohibited.
Thomas C. Newkirk, former Chief Litigation Counsel of SEC’s Enforcement Division in one of his speeches, had stated that “Illegal insider trading refers generally to buying or selling of a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, non-public information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.”

As regards the legal framework, the key provisions relating to insider trading under the U.S. law are Rule 10 b-5 (anti-fraud rule), Rule 14 e-3 (relating to tender offers) and Section 16 (b) (recovery of short-swing profits) of the Exchange Act.

### 4.1.1.1 Rule 10 b-5

Rule 10b-5 framed under Section 10(b) of the Exchange Act is also known as the anti-fraud rule and empowers the SEC to enforce the prohibition on insider trading. The Rule provides that:

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198Speech by SEC Staff: Insider Trading – A U.S. Perspective Remarks by Thomas C. Newkirk
“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,

(i) To employ any device, scheme, or artifice to defraud, or …

(ii) 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.”

Contrary to the popular belief, neither Section 10(b)\textsuperscript{199} of the Exchange Act, nor Rule 10b-5, expressly forbids insider trading. Rule 10b-5 prohibits the acts and business practices that amount to fraud or deceit on any person, in connection with the sale or purchase of securities. In order to establish fraud or deceit, the U.S. courts had relied on the principle of fiduciary duty on the part of the insider towards the company or the shareholders, i.e., only if the fiduciary duty existed for an

\hspace{1cm} \textsuperscript{199} Section 10(b) the Securities Exchange Act of 1934 provides that it shall be unlawful for any person, or directly or indirectly, by the use of any means all instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—.... b) 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.
insider, and if there was a breach of such fiduciary duty, the insider could be held liable for fraud under this Rule. The burden of proof that fiduciary duty existed was on the Regulator. However, the U.S. courts’ approach has recently moved towards the principle of parity of information, thus discarding the reliance on the fiduciary duty.\textsuperscript{200}

The SEC brought more clarity to this Rule through new Rule 10b-5-1 in 2000 by explicitly providing 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.” Therefore, the Rule provides that a person is guilty of violation of Rule 10 b-5 or insider trading if it is proved that the person has knowingly possessed material non-public information.

\textbf{4.1.1.2 Rule 14 e-3}

\textsuperscript{200} Erosion of the Fiduciary Duty Requirement in Insider Trading Actions: Posted by Joel M. Cohen, Gibson, Dunn & Crutcher LLP; However, recent reports suggest that in the U.S., the courts moved the insider trading jurisprudence toward the parity of information theory, thus discarding fiduciary duty theory;[http://blogs.law.harvard.edu/.../erosion-of-the-fiduciary-duty-requirement-in-insider-trading-actions; last visited on September 07, 2010]
Apart from Rule 10b-5, specific prohibition against insider trading during tender offer is mandated under at Rule 14e-3 of the Exchange Act, which prohibits any person who is in possession of material non-public information relating to the commencement of a tender offer, directly or indirectly, either of the bidder company or the target company, from trading in the securities of the target company. Under this provision, a complete ban exists on insider trading and unlike Rule 10b-5, there is no need to prove existence of fiduciary duty. The Rule, however, has its exceptions. Sub-section (1) to Rule 14e-3 excludes purchases by a broker or by an agent on behalf of an offering person. This is designed to allow bidders to utilize outside brokers to make open market purchases prior to the filing requirement. The Rule 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. These exceptions are unique, as they do not exist in
India rather such transactions are treated as violation of the
Insider Regulations.

4.1.1.3 Section 16 (b)

Another significant provision relating to insider trading
in the U.S. was the Section 16(b) of the Exchange Act, which
permitted the issuers of securities to recover short-swing profits
from an insider. The trading by corporate insiders in the U.S. is
regulated by Section 16(b)\textsuperscript{201} of the Exchange Act. Under this
provision, the short swing profit (i.e., profits out of opposite
transactions within a period of six (6) months) made by insiders

\textsuperscript{201} Under this provision, an issuer (or a shareholder) has a right to recover any profits made by an officer, director, or controlling shareholder from purchases and sales (or sales and purchase) that occur within six months of each other. Possession of non-public information is immaterial. Liability is triggered by finding that purchase and sale are within the statutory period. In India also, there has been a proposal to introduce similar provisions. SEBI, the Indian securities market regulator circulated a proposal called ‘short swing profit’ regulations in the month of January 2008 stated to be in the lines of Section 16b of the Exchange Act. Subsequently, by an amendment dated November 19, 2008, a new clause was inserted in the place of earlier clause 4.2. The new clause states that directors/employees/designated employees who buy or sell any number of shares of the company shall not enter into an opposite transaction i.e., sell or buy any number of shares during the next six months following the prior transaction. Further, directors/employees/designated employees are also barred from taking positions in derivative transactions in the shares of the company at any time.
is prohibited. Possession of non-public information is immaterial to establish violation of this provision. An issuer or a shareholder, under Section 16(b), has a right to recover any profits made by an officer, director, or controlling shareholder from purchases and sales that occur within six (6) months of each other. Liability is determined solely if the opposite transactions have taken place within the statutory period. This was the only provision under the federal securities law which had identified the categories of insiders such as officer, director and controlling shareholder and the use of the inside information by these corporate insiders. However, the limited restrictions on insider trading under Section 16(b) applied only to transactions falling within the period of six (6) months, to persons who are designated in the statute or to the transactions relating to the registered securities. Another drawback of Section 16(b) was that it was limited to a private enforcement regime, i.e., only the issuer could initiate action against the violator and the Regulator did not have a role for public enforcement. Therefore, the desire and the ability of the issuer was the only driving force in the enforcement of insider trading cases under Section 16(b).
The anti-fraud provision under Rule 10b-5 can be squarely applied to a corporate insider who secretly trades in his own company’s stock while in possession of inside information because such behavior fits within the traditional notion of fraud. Although, the Section 10(b) of the Exchange Act and Rule 10b-5 do not expressly prohibit insider trading by a corporate “outsider”, in 1961, the SEC gave a broad construction of these provisions and applied them to the corporate outsiders in the case of Cady Roberts & Co.\textsuperscript{202} The SEC held that the duty or obligation of the corporate insiders could also attach to certain category of people outside the insiders’ realm, in certain circumstances. The SEC reasoned that: “Analytically, the obligation (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.

\textsuperscript{202} In Cady, Roberts &Co. 40 S.E.C 907 (1961)
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.”

The present insider trading laws in the U.S. is a creation of SEC’s administrative actions and judicial opinions based on interpretation of the statutory language. After the Texas Gulf Sulphur Co.\(^{203}\), any person who possessed material non-public information was required to disclose such information before trading or abstain from trading in the company’s securities. The fiduciary duty of the insider towards the company precluded him from disclosing the information and therefore, abstention was the only option. Subsequently, Chiarella Case made it clear that fiduciary duty was a *sine qua non* for establishing fraud under the Rule 10b-5. Mere possession of non-public information was not sufficient. In Chiarella, the Court also stated that prohibition of insider trading applied not only to a person possessing and trading based on non-public information, but also to the tippees who trade based on the information received from an insider.

\(^{203}\) SEC v. Texas Gulf Sulphur Company 401 F.2d 833 (2d Cir. 1968)
Thereafter, in *Dirks Case*, the court laid down that the liability could also be imposed on the persons who casually tip the material inside information without any intention to profit from such dissemination of information, because it is analogous to the situation in which the tipper trades on the basis of the information and then gives the profits to the tippee. However, the court did not prohibit the corporate insiders from selectively disclosing the information to certain category of people such as analysts, so long as there was a corporate purpose. Therefore, consequent to the decision in the *Dirks Case*, in 2000, the SEC had enacted the Regulation FD and formalised the principle of fair disclosure of information in the securities market.

The U.S. Supreme Court for the first time endorsed the liability of misappropriation of information in *U.S. v. O’Hagan*\(^{204}\) The court had observed that a fiduciary’s undisclosed use of information belonging to his principal for personal gain, constitutes fraud in connection with the purchase or sale of a security and thus, violates Rule 10b-5. The court tagged it as the use of “confidential information for securities trading purposes, in breach of a duty owed to the source of the information.

4.1.2 United Kingdom

The key provisions relating to insider trading or insider dealing under the U.K. law are found in Section 52 of the Criminal Justice Act, 1993 and the FSMA. The approach adopted in the CJA, 1993 follows the EC Insider Dealing Directive, which treats insider dealing as an abuse of the market rather than as a breach of the insider's fiduciary obligations to the company. The insider trading in the U.K., pursuant to the IDD, was regulated under securities legislation rather than the company law.

The offence of insider dealing is based upon the misuse of information which relates to securities. ‘Information’ is defined as ‘knowledge’ communicated concerning some particular fact, subject or event. The definition of “insider dealing” under Section 52\textsuperscript{205} of the

\textsuperscript{205} ‘Insider dealing’ as defined under Section 52 of CJA states as follows:

(1) An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3) he deals in securities that are price-affected securities in relation to the information.

(2) An individual who has information as an insider is also guilty of insider dealing if
(a) he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3); or
(b) he discloses information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person.
CJA, 1993 covers the following three offences: (a) dealing offence; (b) encouragement offence; and (c) disclosure offence.

According to the definition, an offence of “insider dealing” will be committed:

(i) if the insider deals on the basis of inside information; or

(ii) if the insider encourages another to deal on the inside information; or

(iii) if the insider discloses information to others, for reasons other than the performance of his official or professional functions.

The essential ingredients to establish the violation of ‘insider dealing’ are:

(i) the person charged with the offence should be an ‘insider’; and

(ii) the type of information in his possession should be ‘inside information’

The civil jurisdiction of the FSA in respect of the offence of ‘insider dealing’, which forms part of ‘market abuse’, is contained in the FSMA. This is similar to the Rule 10b-5 of the U.S.’ Exchange

(3) The circumstances referred to above are that the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.
Act, which regulates both the manipulation cases and the insider trading, under the single anti-fraud rule. Section 118 of the FSMA defines and prohibits “market abuse.” Market abuse is a broader term which covers both market manipulation\textsuperscript{206} and insider dealing as well. This market abuse provision lists three (3) tests that should be satisfied in order to determine whether a particular behaviour amounts to market abuse:

(i) That the behaviour must occur in connection with a qualifying investment traded on a prescribed market (i.e., recognised investment exchange)\textsuperscript{207};

(ii) one or more of the following elements, ‘misuse of information’, ‘false or misleading impressions’, or ‘market distortion’ should be present; and

(iii) the behaviour must fall below the standard of behaviour that a “regular user” of the market would reasonably expect of a person in the position of the person in question.

Behaviour will amount to ‘market abuse’ only if it satisfies all the foregoing three (3) tests. The specific part referring to ‘misuse of information’ in test 2 above broadly covers the insider dealing offence.

In order to constitute an offence under this part, the person would have

\textsuperscript{206} In India, cases of market manipulation are governed by the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 1996 which is distinct from Insider Regulations.
to act on the information which is not generally available and which would be relevant to an investor’s dealings in a particular investment.

For example, a person who learns from a friend that the friend’s spouse’s company is about to be the subject of a takeover would commit misuse of information if the person buys shares in the spouse’s company in anticipation of making a profit on the rise in the share price once the takeover is announced.

The second category is the creation of ‘false or misleading impressions’ and the third category is ‘distorting the market’ which involves behaviour that interferes with the normal process of supply and demand, and therefore, manipulates the market price of an investment.

Section 119 of the FSMA requires the FSA to issue a Code of Market Conduct (the “Code”) that provides guidance for determining what kind of behaviour amounts to market abuse. The Code gives more extensive explanation of the regular user test, behaviour, misuse of information, false or misleading impressions, distortion, statutory exceptions and the overall scope of the regime. The Code also provides

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208 Creating a misleading appearance on the market is also a breach of the PFUTP Regulations in India
examples of what does and does not amount to market abuse (‘safe harbours’). However, the Code is not exhaustive and it has the effect of codifying the rules on market abuse.

The Code sets out in more detail the standards that should be observed by market participants. The FSA is also empowered for criminal prosecution of the insider trading offences under Section 402 of the FSMA.

4.1.3 India

Indian securities law regulates insider trading under Section 12A (d) & (e) of the SEBI Act read with the Insider Regulations and Section 15G of the SEBI Act. However, none of these provisions or any other provision under the Indian securities law provides a specific definition of “insider trading.” Section 15G is an enabling provision for SEBI to impose penalty in insider trading cases and the SEBI relies on the nature of the violation and description of the prohibited activities under this provision for imposing such penalties. The instances of violation are described within the provision itself. It says:

209 Section 12A (d) & (e) of SEBI Act was part of Chapter VA inserted by the SEBI (Amendment) Act, 2002, which came into effect from 29-10-2002. This amendment, inter alia, incorporated the provisions of Insider Regulations into the SEBI Act.
210 Regulations 3 & 4 of the Insider Regulations.
“If any insider who,-

(i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or

(ii) communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or

(iii) counsels, or procures for any other person to deal in any securities of any body corporate on the basis of unpublished price-sensitive information, shall be liable to a penalty of twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher.”

Contrary to the above Section 15G, the Section 12A of the SEBI Act lists prohibited activities primarily including manipulative trades, insider trading activities and substantial acquisition of securities. The insider trading related prohibitions under Section 12A are:

(i) engaging in insider trading; 211 and

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211 In fact the term ‘insider trading’ has not been defined anywhere in the SEBI Act.
(ii) dealing in securities or communicating to any other person while in possession of material or non-public information to any other person in violation of the provisions of the SEBI Act or the rules and regulations thereunder.

Although the term ‘insider trading’ has not been defined specifically, Regulation 4 of the Insider Regulations provides that contravention of Regulations 3 and 3A of Insider Regulations amounts to the offence of insider trading. Under Regulation 3 of the Insider Regulations, an insider who deals with the securities of a listed company, while in possession of any unpublished price sensitive information is said to be guilty of insider trading. It also prohibits an insider from procuring, counseling and communicating UPSI to any other person. Regulation 3A prohibits the companies to deal in the securities of another company or associates of that other company, while in possession of UPSI.

Although the Regulation 4 extends to that “any insider who deals…..” and is clearly applicable to an “insider”, the Regulation 3A is applicable to companies, and does not refer to the term “insider.” Regulation 3A was included in the Insider Regulations subsequently as Regulation 3 was applicable only to individuals and did not extend to the companies. However, as the Regulation 3A did not apply to
“insiders”, there remained a disconnect between Regulation 4 and Regulation 3A.

Therefore, the offence of ‘insider trading’ as provided under Regulation 3 read with Section 12A of the SEBI Act requires any of the following activities:

a. Dealing in securities, while in possession of UPSI;

b. By encouraging another person to deal;

c. By disclosing the UPSI to another person.

As per the existing provisions under Insider Regulations, the offence of insider trading is constituted if:

(i) person is an ‘insider’ (Regulation 2(e));

(ii) there is a ‘UPSI’ in his possession relating to a listed company or security (Regulations 2(ha) & 2(k)); and

(iii) the insider has dealt in securities or communicated, counselled or procured someone to have dealt in securities.

An analysis of the provisions governing the prohibition on insider trading (Regulation 3 and 4 of the Insider Regulations and Section 12 (d) and (e) and Section 15G of the SEBI Act) is imperative to understand the legal framework of insider trading in India and to demonstrate the efficacy as well as deficiency of the provisions.
Under Section 15G of the SEBI Act, an insider who deals or counsels or communicates on the basis of price sensitive information, shall be liable for a penalty. As discussed in the evolution of insider trading in India in Chapter 3, the clause ‘on the basis of’ was replaced with the words ‘while in possession of’ by an amendment in Regulation 3 of the Insider Regulations in 2002. Earlier, the position was that an insider ought to have dealt in securities on the basis of UPSI. In the case of *Hindustan Lever Limited* \(^{212}\) also, SEBI had held HLL liable for insider trading on the ground that HLL traded on the basis of the UPSI relating to the merger of HLL & BBLIL and the appellate authority also upheld SEBI’s finding in this regard. However, subsequent to the HLL case, in 2002, SEBI had amended this provision, presumably to simplify the burden of proof in the insider trading cases.

Further, in the U.S. also, the controversy among the circuit courts relating to possession v. use was settled by the SEC by amending the Rule 10b-5 in 2000, wherein SEC clarified that purchase or sale of a security of an issuer is on the basis of material non-public information if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale.

212 [1998] 18 SCL 311 (AA)
Therefore, knowing possession became the standard in the U.S. Notwithstanding the U.S. and the Indian amendments, the words “on the basis of UPSI” somehow continued to remain in Section 15G. With the Supreme Court's judgement in *Shriram Mutual Fund case,*\(^{213}\) the SEBI does not require to establish the *mens rea*. However, the consequence of these words continuing in Section 15G is that the SEBI continues to have a higher burden of proof in insider trading cases to impose penalty under the Section 15G on the offenders, which is cumbersome.

Another provision prohibiting instances of insider trading is provided under the SEBI (Buy-Back of Securities) Regulations, 1998 (the “Buy-back Regulations”), in the specific context of buy-back of securities. It provides that “any person or an insider is prohibited from dealing in securities of the company on the basis of unpublished information relating to buy-back of [shares or other] specified securities of the company.” The notable elements of this provision are that this provision specifically includes the category of “insiders” and secondly, this provision also includes the words 'on the basis of UPSI', similar to the provision under Section 15G. The legislative intent behind including the category of 'insider' in the buy back specific provision could be to extend the prohibition of insider trading to

\(^{213}\) *Shriram Mutual Fund v. SEBI* 2006 (5) SCC 361
specific instances of buy back of securities as this was not covered specifically under the Insider Regulations prior to the amendment of 2002. However, with the amendment of 2002, the cases relating to buy-back of securities was specifically included in the Insider Regulations by incorporating the buy-back relating information within the category of deemed price sensitive information. Therefore, with the amendment of 2002, the buy-back related provision has practically become infructuous.

Further, under the SEBI (Merchant Bankers) Regulations, 1992, Regulation 26 provides that “no merchant banker, or any of its directors, partner or manager, or principal officer shall either on their respective accounts or through their associates or relatives, enter into any transaction in securities of bodies corporate on the basis of UPSI obtained by them during of any professional assignment either from the clients or otherwise.”

Although the provision does not use the term “insider trading” in so many words, a close reading of the provision reveals that the provision, in effect, prohibits insider trading by merchant bankers as the provision includes any securities transaction by merchant bankers based on UPSI.
With the amendment of Insider Regulations in 2002, the category of merchant bankers and others under the Merchant Bankers Regulation was included in the definition of “deemed connected person” and thus, merchant bankers were also brought within the purview of the prohibition on insider trading. Consequently, the restrictions under Merchant Bankers Regulation have become practically redundant, similar to the buy-back related provisions.

As discussed above, India has sufficient provisions to explain the prohibited activities in securities transaction and the instances of insider trading. Further, the Insider Regulations amendment of 2002 had introduced significant clarity in the insider trading laws, and has made the Indian insider trading laws comparable to the laws of the developed countries. Although broadly covered under the Insider Regulations, probably, a provision related to insider trading in tender offer cases may be incorporated as a similar provision in the U.S. (Rule 14 e-3 of the Exchange Act) has strengthened the legal regime on insider trading and has proved to be effective.

If India had tender offer specific provisions and the exceptions, similar to the Rule 14 e-3, it is possible that many of the reported cases of insider trading violation in India such as the Rakesh Agarwal
Case\textsuperscript{214} and the KLG Industries Case\textsuperscript{215}, would be interpreted liberally by the courts and had different outcome.

Finally, it is recommended that SEBI may formulate and adopt a more exhaustive and streamlined definition of ‘insider trading’, which will resolve many interpretational issues faced by the regulator and the courts while deciding the insider trading cases.

4.2 WHO IS AN INSIDER - A COMPARISON BETWEEN THE U.S, U.K AND INDIA

4.2.1 Insider in the U.S.

At the outset, the U.S. law on insider trading does not define the term “insider.” The primary provision dealing with insider trading, i.e., Rule 10b of the U.S.’ Exchange Act is worded such that “no person shall employ any device, etc., to defraud another, in connection with the purchase or sale of the security” and does not use the term “insider” and instead uses the term “any person”.

\textsuperscript{214} Rakesh Agarwal v. SEBI, 2004 49 SCL 351 SAT
\textsuperscript{215} KLG Industries Limited, (SEBI’s order dated 10 June 2009)
However, different U.S. courts through the decisions in various cases of insider trading have made a distinction between the liabilities of primary insiders and secondary insiders. The classification of insiders as developed by the courts is given below:

Any person who has an affirmative duty to disclose material information, such as officers, directors and controlling shareholders, who traditionally owe fiduciary duties to the owners or non-controlling owners of the company, is a primary insider. A person is a fiduciary to the other if the person purports to act on behalf of or for the best interests of another, and the other accepts that trust, alternatively, it can be imposed as a matter of law on anyone in a position of dominance over another.\(^\text{216}\).

The category of primary insiders also includes “classical” and “constructive” insiders. A “classical insider” is typically a director or an official of a company. The “constructive insiders” are those who become privy to the corporate information legitimately by virtue of their relationship with the company, such as an underwriter, accountant, lawyer or consultant working for a company and exposed to the company’s inside information. The constructive insiders are

\(^{216}\) Donald C Langovert, Insider Trading: Regulation, Enforcement and Prevention (Vol 18 Clark Boardman Callaghan Securities Law Series 1994) at 3-3.
sometimes also referred to as the “temporary insiders.” The liability for insider trading extends to all the foregoing categories of insiders.

Secondary insiders include the category of tippees. Tippees of insider information would also attract liability for insider trading,

(i) if the tipper was acting in violation of a fiduciary duty by disclosing the information to the tippee; and

(ii) the tippee knew or should have known that the tipper was breaching his duty.\(^\text{217}\) The tipper breaches his fiduciary duty in disclosing the information if the tipper receives a personal benefit, directly or indirectly, from the disclosure.

4.2.2. **Insider in the United Kingdom**

Contrary to the U.S., the U.K. law on insider trading provides a specific definition of “insider.” Section 118B of the FSMA, introduced in 2005, provides the definition of “insider” which is as follows:

“…an insider is any person who has inside information
- as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments, or

\(^{217}\) Supra n.28
as a result of his holding in the capital of an issuer of qualifying investments, or
- as a result of his having access to the information through the exercise of his employment, profession or duties, or
- as a result of his criminal activities, and
which he has obtained by other means and which he knows, or could reasonably be expected to know is inside information.”

The CJA, 1993 also provides the definition of “insider.” Under the CJA, 1993, a person will be termed as an “insider” if he is in possession of inside information, which has come from an “inside source” and he knows that the information has come from an inside source.

The term “inside source” in the second part of the definition is very wide and can cover any person having access to privileged information of the company through employment, such as the officers of the company, independent consultants, as well as the category of people such as night security staff, cleaners, etc., working for the company. Where the direct or indirect source of information is a

218 Under Section 56 of the CJA 1993, a person has inside information, if it comes from a director, employee or shareholder of an issuer of securities and such person has access to information by virtue of his employment, office or profession.
219 Section 57 of CJA, 1993. The test under this would both be subjective as well as objective.
person in one of the above circumstances, the information will be deemed to have emanated from an inside source.

4.2.3. *Insider in India*

Indian law on insider trading contained the definition of “insider” from the inception of the Insider Regulations in 1992. However, the initial definition of “insider” was amended first in 2002\(^{220}\) and subsequently, in 2008. The existing definition under Insider Regulations defines an ‘insider’\(^{221}\) under Regulation 2(e) as any person who:

(a) is or was connected with the company or is deemed to have been connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of the securities of a company, or

(b) has received or has had access to such unpublished price sensitive information.

\(^{220}\) The term ‘by virtue of such connection’ was omitted by the amendment SEBI (Insider Trading) (Amendment) Regulations, 2002. To prove that one has had access to UPSI, by virtue of his/her connection with the company was difficult to prove. The SEBI had also interpreted in its order the third requirement of ‘acquisition of UPSI’ by the insider by virtue of the connection with the company by envisaging two alternate situations, i.e., where the insider is reasonably expected to have access to UPSI by virtue of the connection with the company; or where the insider has actually received or had access to such UPSI. Although this contention of SEBI was upheld by the then appellate authority, the appeal was decided in favor of the appellant. Order passed by SEBI dated March 11, 1998; the appeal decided by appellate authority is [1998] 18 SCL 311 (AA).

\(^{221}\) Inserted by the SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2008 w.e.f. 19 November 2008.
In view of the foregoing, the term “insider” has the following elements:

(i) the person should be a natural person or a legal entity

(ii) the person should be a connected person or a deemed connected person to the company; and

(iii) the person should be reasonably expected to have access to the unpublished price sensitive information of the company; or

(iv) the person has received or has had access to the unpublished price sensitive information of the company.

Therefore, a person will be regarded as an “insider” if the presence of the aforesaid the elements (a), (b) and (c) are established, or if only element (d) is established, i.e., if the person is in possession of the UPSI, it will be sufficient to regard him as an insider.

Further, the terms ‘connected person’ and ‘deemed connected person’ as used in the definition of “insider” have been separately defined under the Insider Regulations as Regulations 2(c) and 2(h) in the following manner:

The definition of connected persons includes:

• a director or shadow director of a company;

• an officer or employee of the company; or
• a person having a professional or business relationship (temporary or permanent), and is expected to have access to UPSI.

The definition of ‘deemed connected persons’ under Regulation 2(h), to an extent, is exhaustive and include:

• a company under the same management or group or subsidiary company within the meaning of Section 370 (IB) of the Companies Act, 1956, or Section 2(g) of the MRTP Act, 1969;\(^\text{222}\)

• an intermediary specified in Section 12 of the SEBI Act, an investment company, trustee company, asset management company, or an employee or a director thereof or an official of a stock exchange or of clearing house or corporation;

• a merchant banker, share transfer agent, registrar to issue, broker, portfolio manager, investment adviser, sub-broker, investment company or an employee thereof, or is a member of the board of trustees of the mutual fund or a member of the board of directors of the asset management company of a

\(^{222}\) The provisions under the MRTP Act, 1969 have been repealed by the Competition Act. However, the consequential definition under Regulation 2(h) (i) of the Insider Regulations in India is awaited.
mutual fund or is an employee who has a fiduciary relationship with the company;

- a member of the board of directors, or an employee, of a public financial institution defined under Section 4A of the Companies Act, 1956;

- an official or an employee of a self-regulatory organisation recognised or authorised by the board of a regulatory body;

- a relative of any of the persons mentioned above;

- a banker to the company;

- relatives of the connected persons; or

- a concern, firm, trust, Hindu undivided family, company or association of persons, wherein any of the connected persons or any of the persons in the previous three (3) items above have more than 10% of the holding or interest.

One of the plausible reasons for the regulator to include such an extensive list of persons under the “deemed connected persons” could be to make it easier for the regulator to bring more categories of persons within the ambit of “connected persons” and thereby, effectively deal with the cases of insider trading.

However, despite this definition, the regulator has been facing difficulties in interpreting the term “insider” in many instances of
insider trading. The SAT has also criticized the above definition of “deemed connected person” for its wide scope encompassing all categories of persons to be insiders.

An interesting observation is that the detailed definitions of the “connected persons” and the “deemed connected person” above have somehow omitted to include the categories of “promoters”\textsuperscript{223} and “controlling shareholders”, despite their crucial involvement in the management and decision making in the company. However, it is unclear whether the omission is deliberate or inadvertent.

One reason for non inclusion of “promoters” could be that once the lock-in period is over, there is no role of the promoters in the management of the company. Another reason could be that if the promoter is in possession of UPSI, he will automatically come within the purview of the definition of “insider.”

\textsuperscript{223} Regulation 2(h) of the Takeover Regulations provide as below: “promoter” means ---- Any person who is in control of the target company; Any person named as promoter in any offer document of the target company or any shareholding pattern filed by the target company with the stock exchanges pursuant to the Listing Agreement, whichever is later; and includes any person belonging to the promoter group.
Another category of insiders are covered under the clause 4.2\textsuperscript{224} of the Model Code of Conduct framed under Schedule I of the Insider Regulations in India, which is the ‘short swing profit’ provision. Under this clause, all directors, employees, designated employees who buy, or sell any number of shares of the company shall not enter into an opposite transaction for a period of six (6) months from the date of prior transaction. The directors and employees are connected persons within the definition mentioned under Regulation 2 (c) of the Insider Regulations. However, the term “designated employees” is not defined under the Insider Regulations. It is also not clear as to who will designate the employees under this category. However, the category of the “designated employees” within the short swing provision has added a new category to that of insiders\textsuperscript{225}. There is a prohibition on the transactions by the specified insiders in entering into reverse transactions for a period of six months from the first transaction, in the shares of the company where they are insiders.

In addition to the specific definition of “insider” in the Insider Regulations, the appellate authority has time and again interpreted the

\textsuperscript{224} The new clause states that directors/employees/designated employees who buy or sell any number of shares of the company shall not enter into an opposite transaction i.e., sell or buy any number of shares during the next six months following the prior transaction. Further, directors/employees/designated employees are also barred from taking positions in derivative transactions in the shares of the company at any time.

\textsuperscript{225} All employees are connected persons within the definition of the Regulation 2 (c) of the Insider Regulations. All connected persons reasonably expected to have access to the inside information or has had access to such information will be considered as an ‘insider’.
definition of “insider.” Some of the relevant cases have been briefly discussed below.

The SAT in *Dr. Anjali Beke’s Case*\(^{226}\), has clarified that a person who has received UPSI or has had access to UPSI is an insider. This position was confirmed subsequently in *Rajiv B Gandhi Case*\(^{227}\).

It is interesting to note that the foregoing decisions of the SAT were given prior to the 2008 amendment\(^{228}\). The 2008 amendment had extended the scope of insider by including that a person merely possessing the UPSI will be regarded as an insider. Thus, the SAT’s decisions were progressive and foresighted.

One of the critics of this 2008 amendment was of the opinion that imposing liability for merely possessing the information is analogous to equating a bank robber with a person who chances across a hundred rupee note on the street\(^{229}\).

The amendment of the definition of “insider” in 2008 providing that any person in possession of UPSI will be regarded as an insider

\(^{226}\) *Dr. Anjali Beke v. SEBI, [Appeal No.148/2005]*

\(^{227}\) Both the judgements are available on [www.sebi.gov.in](http://www.sebi.gov.in)

\(^{228}\) Inserted by the SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2008 w.e.f. 19 November 2008.

\(^{229}\) [Sandeep Parekh, Insider trading laws should not become a booby trap, at http://economictimes.indiatimes.com/articleshow/msid-3806148,flstry-1.cms](http://economictimes.indiatimes.com/articleshow/msid-3806148,flstry-1.cms)
appear to have been carried out with the purpose of easing the burden of proof of the regulator for determining an insider. However, the amendment has been criticised as unfriendly for investors. This is so because, under the amended definition, any person who is in possession of the UPSI without knowing that the information is UPSI, can be held liable for violation of the Insider Regulations.

One of the recommendations to deal with such situation is to rely on the U.S. and the U.K. legal positions, where, in addition to possessing the information by a person, the knowledge of the person that the information in his possession is UPSI is also required to be established to determine a person as an insider.

Whether a person is an “insider” is the most crucial ingredient of the offence of insider trading. However, there are many other criteria which must also be factored while determining the violation of Insider Regulations. Although by widening the scope of the definition of “insider” in the Insider Regulations, SEBI has attempted to overcome this elementary step of proving a person to be an “insider”, SEBI will have to clarify whether mere possession is sufficient to become an insider or the “knowing possession” standards as prescribed under the U.S. and the U.K. would suffice the effective enforcement of the provisions.
4.3 WHAT IS INSIDE INFORMATION OR UPSI

4.3.1 United States of America

The U.S. insider trading laws do not provide any definition for the term “inside information” or any similar term. However, the standard term for inside information used in the U.S., the material non-public information has been interpreted in various court decisions. The leading case which interpreted the standard definition of ‘material information’ used in insider trading cases is the Supreme Court decision in *TSC Industries Inc. v. Northway*[^230^]:

> “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act]…Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

The dispute in this case centers on the acquisition of 34% of the voting securities of the TSC Industries (the “TSC”) by National Industries (the “National”), from TSC’s founder and principal shareholder and his family. The founder and his son promptly resigned

from TSC's board of directors, and five (5) National nominees were placed on the board, including National's president and executive vice-president, who subsequently became, respectively, the chairman of the board and the chairman of TSC's executive committee. Thereafter, the TSC board approved a proposal to liquidate and sell all of the TSC's assets to National by exchanging the TSC’s common and preferred stock for the National’s preferred stock and warrants to purchase the National’s common stock. The TSC and the National then issued a joint proxy statement to their shareholders recommending approval of the proposal. The proxy solicitation was successful, and the TSC was placed in liquidation and dissolution, and the exchange of shares was affected. The respondent, a TSC shareholder, brought this action for damages, restitution, and other relief against TSC and National, claiming that their joint proxy statement was incomplete and materially misleading in violation of the Section 14(a) and Rule 14a-9\(^{231}\) of the Exchange Act as it omitted material facts relating to the extent of the National's control over the TSC, i.e., it failed to disclose the positions in the TSC held by National's president and executive vice-president, and the reports filed with the SEC by National and TSC indicating that National "may be deemed a parent of TSC" and the favorability of the

\(^{231}\) Rule 14a-9, promulgated under Section 14(a) of the Exchange Act provides that no proxy solicitation shall be made "which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."
proposed acquisition to TSC shareholders (i.e., it failed to disclose certain unfavorable information about the proposal contained in a letter from an investment banking firm whose earlier favorable opinion of the proposal was reported in the proxy statement, and also recent substantial purchases of National's common stock, suggestive of manipulation, by National and a mutual fund). The District Court denied the respondent's motion for summary judgment, but the Court of Appeals reversed it, holding that the claimed omissions of fact were material as a matter of law, and defining material facts as "all facts which a reasonable shareholder might consider important."

The U.S. Supreme Court has held that the general standard of materiality best comporting with Rule 14a-9's policies is not the standard applied by the Court of Appeals, but is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with the general description of materiality as a requirement that "the defect has a significant propensity to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote, but contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact
would have assumed actual significance in the reasonable shareholder's deliberations.

The Supreme Court also held that the issue of materiality is a mixed question of law and fact, as it involves the application of a legal standard to a particular set of facts, and only if the established omissions are "so obviously important to an investor that reasonable minds cannot differ on the question of materiality", the ultimate issue of materiality could be appropriately resolved "as a matter of law" by summary judgment. Therefore, none of the omissions claimed to have been in violation of Rule 14a-9 in this case were, materially misleading, and hence the respondent was not entitled to summary judgment. The case was remanded therefore.

General economic theory suggests that price of the exchange-listed and other widely traded securities reflect a consensus among investors about its fair value based on all available information. ‘Materiality’ of information for insider trading purposes depends on the changes in the price of security upon the disclosure of information. According to Langover, the
various types of evidence found to be persuasive in making materiality determinations in the U.S.\textsuperscript{232} are:

a. the actual market impact;
b. the very fact of trading by the insider or tippee; and
c. the way the information is handled by the issuer.

It is quite true that whether the particular information will be deemed material in an instance of insider trading is a question of fact.

“Effective public dissemination” includes disclosing of information in reports filed with the SEC or the exchanges, and publishing that information in press releases. The information must also be material. Materiality is present where there is a substantial likelihood that a reasonable shareholder would consider that disclosure to be important in deciding how to vote\textsuperscript{233}. The above materiality standard laid down in \textit{TSC Industries Case} was explicitly held applicable to the cases under Rule 10b-5\textsuperscript{234}.

\textsuperscript{232} Donald C Langovert, Insider Trading: Regulation, Enforcement and Prevention (Vol 18 Clark Boardman Callaghan Securities Law Series 1994) at 5-2
\textsuperscript{233} Some courts have found that the test is met when a significant movement in stock price occurs subsequent to the public disclosure of the information in question. Other courts have found that the test is met if the information formed a reasonable basis for the defendant’s trade in securities, See Basic Inc Vs Levinson, 485 U.S.224 (1988)
\textsuperscript{234} Joan MacLeod Heminway, Materiality Guidance in the context of insider trading: A call for action, 52 A.U.L.R.1131(2003)
The Examples of material non-public information in the U.S., context include: (i) financial information (such as revenues, expenses, earnings, new sales or investment returns); (ii) information about a transaction that can affect the financial condition or performance of the company; (iii) a pending or a proposed merger; (iv) acquisition or tender offer; (v) earnings estimates; (vi) significant changes in previously announced earnings; (vii) sale of assets or the disposition of a subsidiary; (viii) entering into a significant contract; (ix) changes in management; (x) new products; (xi) and the gain or loss of a substantial customer. The SEC release during the adoption of Regulation FD has listed out seven (7) factors that should be reviewed carefully to determine the materiality of the information. These seven (7) factors include the earnings information, the mergers and acquisitions, the new products or developments regarding customers and suppliers, changes in control or management, the change in auditors, and a default or calling of securities, and bankruptcies.

4.3.2 United Kingdom

In the U.K., the term ‘inside information’ has been defined under Section 56 of the CJA, 1993. The definition provides that

(1) “inside information” means information which—

http://www.sec.gov/speech/spch415.htm (last visited August 10, 2009)
(a) relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;

(b) is specific or precise;

(c) has not been made public; and

d) if it were made public would be likely to have a significant effect on the price of any securities.

(2) For the purposes of this Part, securities are “price-affected securities” in relation to inside information, and inside information is “price-sensitive information” in relation to securities, if and only if the information would, if made public, be likely to have a significant effect on the price of the securities.

Thus, it means that information should not be general in nature and should be about a specific sector of securities. It is also required that the information should have come from specific issuer. However, practically, the information can emanate from many other sources such as, information can even flow from a person or company who intends to make an acquisition in a given sector, which affects the value of securities of a listed company or companies. However, the information
should have a significant impact on the price of securities to be attracting the insider trading violation. For example, the information such as impending takeovers, imminent price forecasts, dividend announcements, etc., are deemed to have significant impact on the price of the securities.

It is noteworthy that “inside information” is also defined under the FSMA under Section 118C. The definition provides that ‘inside information’ means information of a precise nature in relation to the qualifying or related investments, which are not commodity derivatives\(^{236}\), and which

- are not generally available;
- relates, directly or indirectly, to one or more issuers of the qualifying investments or one or more of the qualifying investments; and
- would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of the related investments.

On a close analysis, the definitions of “inside information” under the FSMA and CJA, 1993 have many common features.

\(^{236}\) In respect of commodity derivatives, the difference is that users of the markets on which the derivatives are traded would expect to receive in accordance with any accepted market practices on those markets. Section 118C (7) further elaborates on the information in respect of the transactions in commodity derivatives.
Therefore, the intent for providing different definitions for the same term “inside information” under different statutes is unclear, especially when the definitions do not reflect the difference between civil and criminal aspects of the FSMA and CJA 1993 respectively.

The FSMA also defines the term ‘precise information’ to mean “information which indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur and which is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments.”

An “information” is said to have significant effect on the price if that information is relied upon by a reasonable investor to make investment decisions. Thus, the FSMA and CJA 1993 have provided clear classification of ‘inside information’.

4.3.3 India

Under the Insider Regulations, the corresponding term used for ‘inside information’ is ‘price sensitive information’. The term ‘price sensitive information’ is defined under Regulation 2(ha) of the Insider
Regulations\textsuperscript{237} as “any information, which relates directly or indirectly to a company and which if published, is likely to materially affect the price of securities of company.” ‘Unpublished’ means any information which is not published by the company or its agents and which is not specific in nature (Regulation 2 (k) of the Insider Regulations). The regulation further provides a list of ‘deemed price sensitive information’ which includes information relating to:

(i) periodical financial results of the company;
(ii) intended declaration of dividends;
(iii) issue of securities or buy-back of securities;
(iv) any major expansion plans or execution of new projects;
(v) amalgamation, merger or take over;
(vi) disposal of the whole or substantial part of the undertaking; and
(vii) significant changes in policies, plans or operations of the company.

The original definition was substituted with the existing provision by an amendment in 2002. Prior to the amendment, the term

\textsuperscript{237} Substituted by the SEBI (Insider Trading) (Amendment) Regulations, 2002, w.e.f. 20-2-2002. Prior to its substitution, clause (k) read as under:-

(k) Unpublished price sensitive information means any information which related to the following matters or is of concern, directly or indirectly, to a company, and is not generally known or published by such company” for general information, but which if published or known, is likely to materially affect the price of securities of that company in the market –

(i) financial results (both half-yearly and annual) of the company;
(ii) intended declaration of dividend (both interim/final);
(iii) issue of shares by way of public rights, bonus etc.:
(iv) any major expansion plans or execution of new projects;
(v) amalgamations, mergers and takeovers;
(vi) disposal of the whole or substantially the whole of the undertaking;
(vii) such other information as may affect the earnings of the company.
used in the regulation was ‘unpublished price sensitive information.’

Earlier, the term ‘UPSI’ was defined as the “information that relates to
the list enumerated there under”. The list was similar to the present list
of information except that it had an additional category of ‘such other
information as may affect the earnings of the company.’ This category
has been omitted by the amendment of 2002.

Although a merger per se is included in the list of price
sensitive information, an interesting stand on its interpretation was
taken by the SEBI in the case of Hindustan Lever. In this case, the
SEBI had charged the HLL for insider trading. The SEBI regarded the
information relating to a possible merger of a company to be a material
piece of information from the investors’ point of view. SEBI also took
a view that the materiality of any information will also depend on the
probability that the transaction will be consummated. While deciding
the case against HLL, the SEBI had relied on the judgements of the
U.S. courts\textsuperscript{238} to support its view. The SEBI did not accept HLL’s
argument that the information about merger in its possession was not
specific in nature and therefore, not price sensitive.

\textsuperscript{238} Basic Incorporated, 485 US 224, TSC Industries v. Northway Inc., 408 US 449
In order to complete the offence of ‘insider trading’, the insider must have traded while in possession of unpublished price sensitive information. Subsequent to the amendment in 2002, the Insider Regulations provided a separate provision relating to the information that constitutes ‘unpublished’ information. As stated earlier, the U.S. does not have any statutory provision prescribing what constitutes unpublished information. However, in the U.K, under Section 58(2) & (3) of the CJA, 1993, ‘inside information’ is treated as made public in the following circumstances:

(i) if the information is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisors;

(ii) if the information is contained in records which, by virtue of any enactment are given to inspection by the public;

(iii) if the information can be readily acquired by those likely to deal in securities to which the information relates or of an issuer to which the information relates; or

(iv) if the information is derived from information which has been made public.
In the U.K., the CJA 1993 provides for five (5) circumstances when information may be deemed to have been made public. These circumstances include where the information:

(i) can be acquired only by persons exercising diligence or expertise;

(ii) is communicated to a section of the public and not the public at large;

(iii) can be acquired only by observation;

(iv) communicated only on payment of a fee; and

(v) is published only outside U.K.

In the above circumstances, efforts have to be made to obtain the information.\textsuperscript{239}

Under Indian law, the Regulation 2(k) defines ‘unpublished’ as any information which is not published by the company or its agents and which is not specific in nature. The clause also provides an explanation that speculative reports in print and electronic media will not be treated as ‘published information.’ The definition of “unpublished price-sensitive information” prior to the 2002 amendment required multiple conditions to prove that particular

\textsuperscript{239} This recognises the EC Directive 89/592.
information was UPSI. Further, to establish that the price sensitive information was unpublished, SEBI had to prove that the information was not generally known, which was also vague and difficult to establish.

In the HLL Case, the appellate authority although decided that the HLL was in possession of information relating to the proposed merger, it held that information was not unpublished price sensitive information, as SEBI could not establish that the information was unpublished, i.e., not generally known. The appellate authority had held that in order to meet the test, the information must, *inter alia*, either be generally known or be published by the company. The appellate authority had analyzed various press reports which were produced by the HLL and had concluded that the intended merger was sufficiently reported to have alerted the UTI and therefore, the UTI’s denial of knowledge cannot establish that market in general had no information. However, the SEBI’s order against the HLL, holding the HLL guilty of insider trading was set aside by the appellate authority\(^{240}\), as the SEBI’s direction to the HLL to compensate investors was held to be without jurisdiction.

\(^{240}\) The order was passed on 14.07.98. The decision of the Appellate Authority has been appealed in the High Court by both the parties, i.e., SEBI and HLL.
Therefore, unlike the U.S., India has clear-cut provisions and definitions to prove insider trading cases. The SEC has been resistant towards defining the “offence of insider trading”, “insider” or “inside information”, as according to them, it will constrict the enforcement of the anti-fraud rule. The wide anti-fraud rule under the Rule 10b-5 gives them the potential scope of interpreting it to handle the large number of cases of insider trading, considering the dynamic nature of the facts involved in the new cases that come in the way. Although India has a large volume of detailed, prescriptive and highly complex rules for insider trading, such rules can divert attention towards adhering to the letter of law rather than the purpose of the regulation.

4.4 METHODS OF PREVENTION OF INSIDER TRADING

Insider trading liability (even if it is derivative liability), arises only if the inside information in question is non-public. Thus, a program of prompt public disclosure is always the best preventive\textsuperscript{241}. The securities represent a bundle of rights for both the offerer and the offeree, which are not visible to an offeree of securities at the time of purchase. Therefore, the offeree should know the underlying details relating to the securities and the nature of the

rights before investing. This is the basic intent behind mandating disclosures relating to securities.

The information available with the company requires confidentiality and it is also necessary that the disclosures are made in the best interests of the issuers as well as the shareholders. The disclosure norms for the public companies in India are broadly covered under the Companies Act, the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009 (ICDR), the Insider Regulations, the Takeover Regulations and the listing agreements of the stock exchanges. Insider Regulations in India contains a specific chapter aimed at disclosures mandated in order to prevent insider trading. Regulations 12, 13, 14 and 15 of the Insider Regulations, which mainly include disclosure, related provisions and the code of conduct for the listed companies, are designed to prevent the occurrence of insider trading. These provisions have been termed as the norms for ‘corporate governance’.

4.4.1 Disclosures in the United States of America

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242 If the information is about a project that is not materialised so far, however, if materialised would have a significant effect on the price of the scrip, a disclosure at the stage where it has not become definite may not be in the best of interest of investors.

243 Earlier SEBI regulated the issue of securities etc. through SEBI (DIP) Guidelines, 2000 which is repealed by regulation 111 of ICDR.

In the U.S., the basic object of the Securities Act is the disclosure of the material facts with respect to the securities offered publicly for sale. To this effect, the U.S. law has mandated that the companies should be registered with the SEC if the companies want to publicly issue their securities. The Exchange Act prescribes continuous disclosure and annual updating of information so that the investing public can make an intelligent judgement of the value of any security. Further, there are provisions for updating the companies’ annual reports so that the material events in the company are reported on a timely basis. Among the protective measures provided by the Securities Act and the Exchange Act and the rules promulgated by the SEC, the key requirements were that the publicly traded companies should make corporate disclosures, which are reviewed by the SEC, and that such companies should have an independent auditor, who reviews and approves the company’s financial statements.

Further, the Rule 10b-5 also imposes liability for failure to disclose material non-public information if (i) the duty to disclose is imposed by a statute or rule; (ii) a corporate insider trades on confidential information; or (iii) the corporation makes an incomplete or misleading disclosure.
Section 16(a) of the Exchange Act was the first attempt to prevent insider trading by prescribing disclosures. Under Section 16(a), every officer or director of a company with an equity security registered under Section 12, as well as every person “who is directly or indirectly the beneficial owner of more than 10% of any class of any equity security” so registered, shall file with the commission, as well as any exchange on which the security is listed, an initial report of his or her holdings of all the issuer’s equity securities, and a further report of his or her holdings of all the issuer’s equity securities, and a further report within ten (10) days after the close of each calendar month in which there has been any change in his or her holdings. These persons are presumed to be insiders and also presumed to possess material non-public information. The reporting requirement within a period of ten (10) days has been amended by the Corporate and Auditing Accountability, Responsibility and Transparency Act, 2002, popularly known as the Sarbanes-Oxley Act (the “SOX”) to a period ‘within the end of the second business day after the day of the transaction or such longer period the Commission may establish if it deems such two (2) days’ period is not feasible’.

The Regulation FD adopted by the SEC on 15 August 2000 provides that when an issuer discloses material non-public information to certain individuals or entities the securities market professionals,
such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information, the issuer must make public disclosure of that information. Further, the Regulation FD provides that the disclosure should be fair and not a selective disclosure and to establish the violation of the Regulation FD, the issuer’s or insider’s reckless or intentional act in making a selective disclosure must be proved. However, the Regulation FD also provides that the issuers will not be responsible for the selective disclosures made by the mid-level management and the junior employees.

The ITSFEA in 1988 was designed to encourage closer employer supervision over the employees with access to material non-public information. ITSFEA required the broker-dealers and investment advisers to not only adopt and distribute written policies and procedures to prevent insider trading, but also to vigilantly review, update and enforce these policies. ITSFEA also requires the companies to adopt internal policies to control insider trading by their directors, officers and employees. The Indian Insider Regulations included the similar provisions in the 2002 amendment.

The SOX also provided certain reporting and disclosure requirements designed to prevent insider trading. The SOX requires:
(i) directors, executive officers and large shareholders of public issuers to report transactions in the issuers’ equity securities within two (2) business days of a transaction;

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

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

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

Prior to the SOX, the SEC could not effectively enforce the disclosure requirement under Section 16(a) of the Exchange Act for timely reporting of the securities sales by one person or entity consisting of 10% or more of the equity securities in a publicly traded company. Therefore, the executives of both Enron and Worldcom who held more than a 10% interest in the companies were able to sell their equity securities without reporting the sale. Subsequent to the Enron case, the SOX was enacted to prevent corporate frauds by, inter alia, strengthening the disclosure and reporting regime. The SOX

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245 Carol A. Rolf, Efficacy of the Sarbanes Oxley Act in Curbing Corporate Fraud, Rivier College Online Academic Journal, Volume 1, Number 1, Fall 2005.

246 Enron was a major scam in the U.S. unearthed in the year 2001, where large scale accounting frauds by the executives in Enron Corporation led to investigations by SEC and other investigating agencies. Finally, multiple convictions followed and the executive who was held responsible was sent to jail for 24 years in the year 2006.
requires filing a report with the SEC for sales of more than 10% by the end of the second business day after the sale. Additionally, such sales must be disclosed on the company’s website by the end of the second business day after the SEC filing. The SOX also provides that in the public reports periodically filed with the SEC, the companies must make specific disclosures about the management’s discussions and analyses in the following manner:

(i) the financial reports prepared in accordance with the GAAP must reflect all material correcting adjustments;
(ii) annual and quarterly financial report(s) should disclose all material off-balance sheet transactions;
(iii) annual and quarterly financial reports must disclose relationships with ‘unconsolidated entities’ that may materially affect the company’s financial condition; and
(iv) proforma financial information must comply with the reporting requirements under the Exchange Act and should be accurate and not misleading. SOX also mandated the SEC to conduct an off-balance sheet disclosure study to determine whether such accounting procedure provides investors with sufficient information to make investment decisions.

4.4.2 Disclosure regime in the United Kingdom
The laws in the U.K. providing for the disclosure of interests in securities developed separately from the insider trading laws and have no connection with the insider trading laws\textsuperscript{247}. Prior to 2005, the disclosure provisions in the U.K. were contained only in the listing agreements under the U.K.’s Companies Act, 1985. However, subsequently, it was realized that disclosures was one of the practical tools that could discourage insiders from dealing unlawfully.

The Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003, i.e., the EU Directive on insider dealing and market manipulation (the “Directive” or “MAD”) aims to harmonize market abuse rules across the European Union on insider dealing and market manipulation (market abuse). The ‘MAD’ was due to be implemented in member states by 12 October 2004. MAD included the disclosure requirements for the issuers and many other categories of market participants. Although the ‘MAD’ was applicable to the entire European Community, it was implemented in the U.K. on 1 July 2005.

Thereafter, the Companies Act, 2006 has amended Part VI of the FSMA to give FSA, the power to issue the Disclosure and

\textsuperscript{247} Michael Ashe & Lynne Counsell: Insider Trading(second edition 1993 by Tolley Publishing Company Limited) at page 146
Transparency Rules (the “DTR”) and to create a statutory liability regime for periodic financial information issued under the ‘MAD’. Accordingly, the DTR was framed by the FSA under Part VI of the FSMA, i.e., Section 96A of the FSMA. The DTR replaced the earlier listing rules in the U.K. and was administered by the FSA under the name of U.K. Listing Authority (the “UKLA”). The DTR was framed with the purpose of implementing the disclosure and record keeping requirements for the issuers in U.K. and was similar to the norms under the ‘MAD’. However, the disclosure requirements under the DTR and the ‘MAD’ were different.

For instance, the DTR applied only to the companies whose shares were admitted to the official list and the disclosure requirements of the ‘MAD’ applied to all the issuers whose securities were admitted to trading (or for which a request for admission to trading was made) on the regulated market in the EEA state\(^{248}\).

The ‘MAD’ extends disclosure requirements to the professional third parties, such as lawyers, accountants and the investment banks who advise the issuers. Delayed disclosures are permitted under certain circumstances, provided that such delayed disclosures do not

\(^{248}\) The European Economic Area, i.e. the European Union (EU) member states, Norway, Iceland or Liechtenstein.
mislead the public and are able to ensure the confidentiality of the information.

Article 6(3) of the ‘MAD’ also requires that the issuers must make prompt public disclosure when they have disclosed the inside information to a third party in the course of their employment, profession or duties. Cross-border disclosures to third parties must be made to the relevant authorities of the jurisdictions when such disclosures involve parties in EEA states. The managers of the issuers or other senior officers are required to disclose their share dealings in the issuer. All managers privy to the inside information are required to disclose to the Regulatory News Service,249 every time they buy or sell shares in their employers.

DTR was framed on 20 January 2007. Some of the salient features of the DTR are discussed below:

249The Regulatory News Service (RNS) transmits regulatory and non-regulatory information published by companies and organisations allowing them to comply with local market transparency legislation. It is owned by the London Stock Exchange and distributes over 90% of UK company news and results announcements and over 40% of the United States Securities and Exchange Commission (SEC) filings on behalf of FTSE 100 companies, amounting to several hundred announcements a day.
(i) Under the DTR, Rule 2.2.1, the issuers whose securities are traded on the regulated U.K. markets\(^{250}\), are required to disclose information that is not public knowledge, and if known, would lead to substantial movement in the price of their listed securities through the Regulatory Information Service\(^{251}\).

(ii) The DTR further obligates the issuers in the U.K. to inform the public ‘as soon as possible’ of the inside information. However, such early disclosures are said to be vague mandates, as they may confuse the issuers and the issuers may not be able to assess the relevance of the information at an early stage. This may ultimately result in the issuers refraining from disclosing the information.

(iii) The DTR provides that the issuer has to publish the information without delay in the following circumstances:

(a) when the issuer has certain price-sensitive information about the issuer securities;

(b) when there has been any significant change concerning inside information in certain circumstances; and

\(^{250}\) The Committee of European Securities Regulators (“CESR”), has a consolidated list on the constitution of ‘regulated market’. In the U.K., the term “prescribed market” means those markets prescribed by HM Treasury, which could even be markets in other jurisdictions. As of 2008, the U.K. prescribed markets are: the London Stock Exchange, the London Metal Exchange, Euronext-LIFFE, Virt-X and EDX London.

\(^{251}\) Supra n.48
(c) when an issuer or any person acting on its behalf discloses inside information to a third party.

(iv) Selective disclosure is prohibited under Rule 2.5.6 of the DTR. It may be possible that the selective disclosure prohibition under the U.K.’s DTR was an afterthought of the Regulation FD in the U.S.

(v) Rule 2.5 permits the issuer to delay the public disclosure of inside information in certain circumstances.

(vi) Under Rule 2.2.3G of the DTR, the issuers should have a consistent procedure to determine what information is sufficiently significant for it to be deemed inside information and for the release of that information to the market. Issuers should also identify the employees responsible for communication to analysts and the press and should consider making their internal policies on communication known outside the issuer.

(vii) Rule 2.6.2 of the DTR requires the issuers to make arrangements to keep the inside information confidential until public announcement. A leak of the inside information may
consequently affect the share price and therefore, the issuer should make appropriate formal announcement as soon as possible. Even the mode of dealing with leaks has been prescribed under the DTR’s Rule 1.3.3. The UKLA can also require an issuer to publish such information in such form and within such time limits as it considers appropriate to protect the investors or to ensure the smooth operation of the market. In the event of non-disclosure by an issuer, the UKLA can invoke its powers and direct an announcement or suspend an issuer’s securities.

(viii) Rule 2.8.1 of the DTR requires an issuer to maintain the lists of those persons working for it (as independent advisers or employees) who have access to inside information relating directly or indirectly to the issuer. The issuers must also maintain a list of third parties who are likely to have access to inside information, to be released to the FSA, when required or requested by the FSA.\(^{252}\)

\(^{252}\) This requirement has been criticized because of the significant compliance costs of monitoring information within a business organisation. It has been argued that the cost of maintaining these lists is disproportionate to the regulatory benefit or to the benefit of the market.
(ix) Rule 3 of the DTR obliges persons discharging managerial responsibilities and their connected persons to notify an issuer of all dealings conducted on their own account in the issuer’s shares and other instruments. The issuer is then required to notify the RIS of this information.

In addition to the foregoing, under the FSMA, the civil liability for market abuse arises if any person, professionally arranging transactions in financial instruments, reasonably suspects insider dealing or market manipulation and fail to report the suspected behaviour to the FSA. In other words, the professionals must disclose suspicious transaction. For issuers, the indicative factors that identify suspicious transactions are listed in the guidelines set forth by the FSA. For third party professionals, indicative factors can be determined by the professional codes and guidelines approved by FSA.

Under the new rules, the obligation to disclose is now triggered by a person’s control over a more narrowly defined interest comprising the exercise of voting rights attached to the shares. Further, the disclosure has to be made to FSA along with the company. For the companies in the U.K., the relevant percentages which trigger the requirement to notify are 3% and every whole 1% thereafter. A relevant decrease in the holding will also trigger the obligation to
notify. But no notification is required for additional reductions below 3%. For the non-U.K. companies, the relevant percentage that trigger the requirement to notify are 5%, 10%, 15%, 20%, 30%, 50% and 75%.  

The most obvious type of notifiable interest is that of a person who directly holds shares to which the voting rights are attached. However, an indirect holding of shares with voting rights, including a direct or indirect holding of a relevant financial instrument which entitles the holder to acquire shares with voting rights attached to them also gives rise to a notifiable interest. Failure by a person with a notifiable interest to comply with the disclosure obligations does not constitute a criminal offence, as under the Companies Act. However, financial penalties or public statements may be imposed or made by FSA in relation to such failure.

Section 79 of the FSMA provides a form for ‘Listing Particulars’, which the issuer has to complete with such information which the investors and their professional advisers would reasonably require in order to make an assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the

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253 Disclosure and Transparency Rules ("DTR") at DTR 5
254 MAD
securities; and the rights attached to the securities. This information is in addition to the information required by the listing rules or the competent authority as a condition to the admission of securities to the official list.

The new Companies Act, 2006 has been enacted in the U.K. and enforced since 1 October 2009. It amended Part VI of the FSMA to give FSA, the power to issue the DTR and to create a statutory liability regime for periodic financial information issued under the ‘MAD’. However, there are no other material changes in the disclosure requirements in the new Companies Act, 2006.

Therefore, the disclosure requirements under the FSMA and specifically under the DTR are highly structured and exhaustive unlike India and the U.S. The underlying object of the DTR is to protect the inside information as well as the investors’ interest simultaneously. Although the cost involved in filing the disclosures and the vagueness of certain obligations have been criticised, the DTR still sets a good example to be followed.

4.4.3 Corporate governance norms under Insider Regulations:

India
India is also well aware of the importance of disclosures to curb the insider trading. Although India’s Companies Act and the other legislations included extensive disclosure requirements for the companies, additional disclosures were incorporated under the Insider Regulations, specifically for insider trading cases.

The SEBI, by an amendment to the Insider Regulations in 2002,\(^\text{255}\) inserted a new Chapter IV the Policy on Disclosures and Internal Procedure for Prevention of Insider Trading, which followed the Regulation FD in the U.S. in 2000. Therefore, coupled with the disclosure mandates under Regulation 12(2) of the Insider Regulations read with the Schedule II, the listed companies and other entities in the securities market are obligated to frame a model code of corporate disclosures for prevention of insider trading. The disclosure requirements within the framework of the Insider Regulations are discussed below:

(i) disclosures from persons holding 5% or more shares or voting rights in a listed company to the company within two \(^\text{256}\) working days from the date of either the receipt of intimation of

\(^\text{255}\) Inserted by the SEBI (Insider Trading) (Amendment) Regulations, 2002, w.e.f. 20.02.2002
\(^\text{256}\) The requirement prior to the amendment in 2008 was within ‘four [4] working days’.
the allotment of shares or the acquisition of shares or voting rights as the case may be\(^{257}\); 

(ii) continual disclosures are also required by those holding shares more than 5%, when there is change in holding as compared to the earlier disclosure; 

(iii) disclosures in respect of the holdings of securities by the directors and officers (for their dependants also) of the listed companies to the companies under Regulation 13(2) of the Insider Regulations within two (2) working days from the date of his becoming the director or officer of the company, irrespective of the number of shares held by them; and 

(iv) When there is a change in their holdings that exceeds Rs.5 lakh in value or 25,000 shares or 1% of the total shareholding or voting rights, whichever is lower, disclosures are to be made to the company and the stock exchanges within two (2) working days from the receipt of intimation regarding the allotment of shares or the acquisition or sale of shares or voting rights, as the case may be.

\(^{257}\) Regulation 13 of the Insider Regulations.
The listed companies, in turn, are required to make these disclosures within two (2) days from the date of receipt to all stock exchanges where the company is listed\textsuperscript{258}. Since 2008, the process of e-filing also has been enabled to simplify the disclosure process.

In addition to the mandates under the Insider Regulations as stated above, the specific disclosure provisions under the Schedules I & II of the Insider Regulations are discussed below:

4.4.3.1 Corporate Disclosure Practices for the Prevention of Insider Trading – (Schedule II)

(i) The listed companies have the obligation to give ‘price-sensitive information’ to the stock exchanges and such information has to be disseminated on a continuous and immediate basis. Further, the companies should try to supplement the information given to the stock exchanges by improving the investor access to their public announcements. The listed companies are required to designate a senior official to oversee the corporate disclosures and approve in advance, any dissemination of information or disclosures.

\textsuperscript{258} Regulation 13 (6) of the Insider Trading Regulations.
(ii) the listed companies should have clearly laid down the procedures for responding to queries or requests for verification of market rumours by the exchanges. The Schedule II provides that the official designated for corporate disclosure should be responsible to decide whether a public announcement is necessary for verifying or denying rumours and then make the disclosure.

- disclosures of shareholdings and ownership by the major shareholders and disclosure of changes in the ownership should be made in a timely and adequate manner.

- the listed companies, while dealing with analysts and institutional investors, should only provide information to these persons if the information was public information. Alternatively, the information given to an analyst should be simultaneously made public at the earliest.\(^{259}\)

- disclosures or dissemination of information to the public may be done through various media so as to achieve maximum reach and quick dissemination. The corporate should ensure that the disclosures are made to

\(^{259}\) DTR in the U.K. has identical provision.
the stock exchanges promptly. The company websites can also give the investors a direct access to the analyst briefing material, significant background information and questions and answers. Also, the information filed by the company with the exchanges under continuous disclosure requirement may be made available on the company’s website.

Further, the disclosures made to stock exchanges must be disseminated by the stock exchanges to the investors in a quick and efficient manner through the stock exchange network as well as through the stock exchange websites\(^{260}\). Information furnished by the companies under continuous disclosure requirements should be published on the web sites of the exchanges instantly and the stock exchanges should make immediate arrangement for the display of the information furnished by the companies instantly on the stock exchange web sites.

Thus, these obligations are meticulous to the extent that in order to avoid misquoting/misrepresentation of the company’s information, it insists that at least two (2) company

\(^{260}\) In the U.K., such information has to be made available through the RIS discussed earlier. Supra n.48
representatives should be present at the meetings with analysts, brokers or institutional investors and the discussions at the meeting should preferably be recorded.

4.4.3.2 Other key provisions for the prevention of insider trading

SEBI mandates that the listed companies and the organizations\textsuperscript{261} associated with the securities market\textsuperscript{262} must frame a code of internal conduct and procedure, similar to the Model Code provided in the Schedule I of the Insider Regulations\textsuperscript{263}. Clause 3.2.1 of the Schedule I requires that the directors, the officers, and the designated employees of a company should conduct all their dealings in the securities of the company only in a valid trading window and not deal in any transaction involving the purchase or sale of the company’s securities during the periods when the trading window is closed.

\textsuperscript{261} There is no definition for the word ‘organizations’ associated to the securities market. This clearly requires a definite meaning.

\textsuperscript{262} The intermediaries registered under Section 12 of the SEBI Act, Asset Management Companies, trustees of mutual funds, Self Regulatory organizations (SROs) recognized by SEBI, Stock Exchanges, clearing houses and clearing corporations, public financial institutions defined at Section 4A of Companies Act, professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., who assist and advise listed companies.

\textsuperscript{263} Regulation 12 of Insider Trading Regulations
The Clause 3.3.1 of the Schedule I framed under Regulation 12 of the Insider Regulations mandates that all directors/officers/designated employees of the company (and their dependents as defined by the company) who intend to deal in the securities of the company (above a minimum threshold limit to be decided by the company) should pre-clear the transaction from the company management as per the pre-dealing procedure.

A brief discussion on the provisions of Schedule I for listed companies and other organizations associated with the securities market is given below:

4.4.3.2.1 The Compliance Officer

A compliance officer has to be appointed, whose responsibilities are as follows:-

( ) setting forth policies and procedures;

(i) monitoring adherence to the rules for the preservation of ‘price-sensitive information’;

264 The word ‘organizations’ does not seem to be the correct word. A large list is provided at regulation 12 of the Insider Trading Regulations.
(ii) pre-clearance of the trades of designated employees\textsuperscript{265} and their dependants’ trades directly or through respected department heads as decided by the company;

(iii) monitoring of the trades;

(iv) implementation of the code of conduct under the overall supervision of the Board of the listed company;

(v) maintain a record of designated employees and keep the same updated; and

(vi) assist all the employees with clarifications regarding insider trading regulations and the company’s code of conduct.

\textbf{4.4.3.2.2 \textit{Confidentiality of Price-Sensitive Information}}

Under the code of conduct, all employees/directors of listed companies and organizations associated with the securities market\textsuperscript{266}

\textsuperscript{265} A designated employee has been given an inclusive definition under the Regulation, i.e., i. officers comprising the three tiers of the company management ii. the employees designated by the company to whom the trading restrictions shall be applicable, in lines of the code of conduct applicable under the regulation.

\textsuperscript{266} For other entities (which shall be a firm/organisation), code of conduct is applicable to the partners also.
are required to maintain the confidentiality of all price-sensitive information and should not pass on such information to any person directly or indirectly by way of making a recommendation for the purchase or sale of securities.

4.4.3.2.3 Trading Window and Restrictions

All directors, officers and the designated employees of the listed companies are subjected to the trading restrictions specified below:

a. the company shares should have trading period, called trading window, for trading in the company’s securities; and

b. the trading window should be closed during the time as decided by the company when the following information remain unpublished:

i. declaration of financial results (quarterly, half yearly and annually);

ii. declaration of dividends, interim and final;

iii. public or rights or bonus etc issue of securities;

267 The list of different kinds of information on whose announcements, the trading window for the insiders remain closed is the same as the list of the Price Sensitive Information mentioned under Regulation 2(ha) of the Insider Regulations.
iv. major expansion plans or execution of new projects;

v. amalgamation, mergers, takeovers and buyback;

vi. disposal of whole or substantially whole of the undertaking; and

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

The trading window should be open 24 hours after the information referred to above is made public.

This provision has the purpose of giving sufficient time to the investors to assess the material announcements falling in the above category relating to the company and make informed decisions and further to prevent the insiders from taking informational advantage.

For the ESOPs, the exercise of option\textsuperscript{268} may be allowed during the period when the trading window is

\textsuperscript{268} When employees of the company are issued with ESOPs, they are vested only an option to exercise a right on a future date to purchase or sell the shares. The "exercise" of option means making of an application by the employee to the company for issue of shares against option vested in him in pursuance of the Employees Stock Option Scheme (the "ESOS"); as per the SECURITIES AND EXCHANGE BOARD OF INDIA (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.
closed. However, the sale of shares allotted on the exercise of ESOPs shall not be allowed when the window is closed. Since the provision deal with the shares that are listed for trading, as a logical consequence, the provision is applicable only to the listed company.

4.4.3.2.3 Pre-clearance of trades

All directors, officers, and the designated employees of the company, before dealing in the securities of the company\textsuperscript{269} (above a minimum threshold limit to be decided by the company) should get pre-clearance of trades as per the procedure mentioned therein. An undertaking has to be executed by the directors, officers, and the designated employees and to the effect that the employee, the director or the officer do not have any access or has not received any price sensitive information until the time of the signing of the undertaking, and that in case the employee, the director and the officer, subsequent to the signing of the

\textsuperscript{269} In so far as other entities are concerned, the pre-clearance has to be obtained for directors/employees/ partner of the organisation/firm who intend to deal in the securities of the client company
undertaking and before execution of the transaction, has access to or receives ‘price sensitive information’, he or she shall inform the compliance officer about the change in the position and that he/she would completely refrain from dealing in the securities of the company until such information becomes public, etc.

4.4.3.2.5 Other restrictions

All directors, officers, and designated employees of the company are required to execute their purchase or sale order in respect of the securities of the company within one (1) week after the approval of the pre-clearance of trade is given. If the trades are not executed within one (1) week from the approval, further pre-clearance has to be obtained for the transaction.
Towards the close of 2008\textsuperscript{270}, by way of an amendment to the Model Code of Conduct for Prohibition of Insider Trading, a modified version of 'short swing profit' regulations was introduced in India\textsuperscript{271}. Clause 4.2 was amended and the new clause prohibited all directors, employees, and the designated employees who buy, or sell any number of shares of the company from entering into an opposite transaction for a period of six (6) months from the date of prior transaction. The rationale of this amendment was to restrict insiders who are in possession of UPSI from taking advantage of such information to make profits through short swing transactions. The amendment was in lines with the Section 16 of the Exchange Act in the U.S. The short swing regulations have to an extent, 

\textsuperscript{270} SEBI (Insider Trading Amendment), 2008 dated November 19, 2008. The provision prior to the amendment said that all directors/employees/designated employees shall hold their investments in securities for a minimum period of 30 days, including that of IPOs. However, post amendment, it provided that all directors/employees/designated employees who buy, or sell any number of shares of the company shall not enter into an opposite transaction, i.e., for a period of six months from the date of prior transaction. All directors/employees/designated employees are prohibited from taking positions in derivative transactions in the shares of the company at any point of time. But, if these persons have subscribed to the shares in IPOs, then the restriction is limited to a period of thirty (30) days only. The holding period would commence from the date of allotment.

\textsuperscript{271} The earlier clause 4.2 in Schedule I read as follows prior to the amendment: - All directors/officers/designated employees of the company shall hold the investments the securities to a minimum period of thirty (30) days in order to be considered that it is held for investment purposes. This holding period shall be applicable even for subscriptions in IPOs. In case there is a personal emergency, the compliance officer shall waive the holding period after recording his or her reasons in this regard.
contributed in preventing insider trading by imposing trading restrictions on the insiders, although for short duration. The short swing provisions under the Insider Regulations have been discussed in detail in Chapter 3 of the study.

4.4.3.2.6 Reporting requirements for transactions in securities

Under the reporting provisions in Schedule 1, all directors, officers, and the designated employees of the company are required to forward the following details of their securities transactions to the compliance officer:

(i) all holdings in securities of that company by all directors/officers/designated employees of the company;

(ii) periodic statement of any transactions in securities (the periodicity may be mentioned by the company and the company is free to decide whether the reporting and pre-clearance is to be obtained simultaneously); and

(iii) annual statement of all holdings in securities.
The statements of the dependent family members’ holding in the company also should be forwarded to the company’s compliance officer by all directors, officers, and the designated employees of the company. The compliance officer must maintain the records of all the declarations in the appropriate forms, given by all directors, officers, and the designated employees of the company for a minimum period of three (3) years. The compliance officer must place all details of the dealing in the securities by employees, director, and the officer of the company, and the accompanying documents executed by those persons under the pre-dealing procedure under the code of conduct, before a committee, specified by the company, on a monthly basis.

4.4.3.2.7 Penalty for contravention of the Code of Conduct

Any contravention of the code of conduct can be penalized by the company. The company is also entitled to take disciplinary action against those who violate the code of conduct. These actions may include freezing
the wages, suspension, ineligibility for future participation in the employee stock option plans, etc. However, these actions by the company do not preclude the SEBI from taking any action for violation of the Insider Regulations. Under the code of conduct, it has also been mandatory for a company to inform the SEBI of any violations of Insider Regulations as soon as the company comes to the notice of any such violation. Recently, the SEBI had initiated adjudication proceedings against Manmohan Shetty, the managing director of Adlabs Films Ltd., a publicly listed company, for not complying with the disclosure norms prescribed under Regulation 12 read with clauses 3.2.3 and 3.2.5 of Schedule I of the Insider Regulations, and imposed a penalty of Rs.1 crore under Section 15HB of the SEBI Act. Manmohan Shetty had sold his shares before the expiry of 24 hours of the outcome of the board meeting was made public. The order of SEBI has been appealed and is currently pending before the SAT.

4.4.3.2.8. Additional Codes of Conduct to other entities

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272 Order dated June 09, 2010 (www.sebi.gov.in)
In addition to the rules of conduct that are applicable to the listed companies, the following are the additional codes of conduct applicable to the entities other than the listed companies.

4.4.3.2.8.1 Chinese wall

The organization or firm should adopt a “Chinese Wall” policy to separate ‘inside areas’ (those areas of the organization or firm which routinely have access to confidential information) from the ‘public areas’ (i.e., the areas of sale, marketing, investment advice or other departments providing support services). Therefore, the employees in the inside area should not communicate any price sensitive information to any one in the public area. The employees in the inside area have to be physically segregated from the employees in the public area. The demarcation of the departments into inside area should be
done by the organization or firm. However, in exceptional circumstances, the employees in the public area shall be brought over the chinese wall and be intimated about any price sensitive information on the basis of the ‘need-to-know’ basis, under intimation to the compliance officer. Although it is important to segregate physically, the inside area of a company from public areas, the extent of its compliance is unsure. A periodical inspection on the listed companies or other market participants is also required, in order to ensure that the rules are complied.

4.4.3.2.8.2 Restricted or Grey List

In order to monitor the chinese wall procedures and trading in the client securities based on inside information, other entities should restrict trading in certain securities and designate the said
list of securities to be specified in the restricted or the grey list. The securities of a listed company should be placed on the restricted or the grey list if the organization or firm is handling any assignment for the listed company or is preparing the appraisal report, or is handling the credit rating assignment and is privy to any price sensitive information relating such company. Any security which is being purchased or sold or is being considered for purchase or sale by the organization or firm on behalf of its client, schemes of mutual funds, etc., shall be put on the restricted or the grey list. As the restricted or grey list itself is a highly confidential document, it should not be communicated directly or indirectly to anyone outside the organization or the firm. The restricted or the grey list should be maintained by the compliance officer. Trading in the securities in the restricted or the grey list
shall be blocked or disallowed at the time of pre-clearance of trades.

As regards the disclosures by the specific categories of persons, analysts who are employed with the organization or the firm, while preparing the research reports of the client company, shall disclose their shareholdings/interest in such company to the compliance officer. Analysts who prepare research reports of the listed companies should not trade in the securities of that company for thirty (30) days from the preparation of that report. Further, the intermediaries such as the credit rating agencies, the asset management companies or the broking companies, etc., whose securities are listed on the recognized stock exchanges should comply with both the Part A and Part B of the Schedule I on the model code of conduct, in respect of its own securities and client securities.
The Takeover Regulations also includes certain disclosure related provisions as stated in detail in Chapter 1. These disclosure provisions under the Takeover Regulations overlap some of the disclosures under the Insider Regulations and have invited criticism for such overlap. For example, Regulation 3 of the Takeover Regulations and Regulation 13(6) of the Insider Regulations. However, it is presumed that the overlapping provisions under the Takeover Regulations will be streamlined, probably through the proposed revamp of the Takeover Regulations.

4.4.4 Conclusion about disclosures

The World Bank in its 2004 Report on the Observance of Standards and Codes (ROSC) on the corporate governance practices in India had acknowledged that India had made considerable efforts to reform the corporate governance framework and to improve the
accountability and responsibility of the insiders, fairness in treatment, board practices and transparency. An initiative in September 2006 by the Government of India (in consultation with the RBI) led to the establishment of a Committee on the Financial Sector Assessment (“CFSA”), with the objective of undertaking a self-assessment of financial sector stability and development. In this connection, the CFSA had constituted an Advisory Panel on Institutions and Market Structure (“Advisory Panel”) with a mandate to evaluate the level of corporate governance against the OECD benchmarks. The Advisory Panel had released the assessment report in March 2009 (hereinafter referred to as the 2009 CFSA report/assessment). In this report, the Advisory Panel had stated that a comprehensive corporate governance framework is in place for listed companies, with various legal and regulatory requirements relating to corporate governance and the provisions enabling shareholders to participate in and be informed of the decisions concerning fundamental corporate changes. The roles and responsibilities of different regulators in the corporate world273 are well-defined and the co-ordination mechanisms are in place for interaction among various regulators. The report indicates that the supervisory, regulatory and enforcement authorities should have

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273 Apart from the SEBI, the following are the other regulatory bodies, which has jurisdiction over the companies in India generally, Insurance Regulatory Development Authority (the “IRDA”) for the insurance companies, the Reserve Bank of India (the “RBI”) for the banking companies and the Ministry of Company Affairs (the “MCA”) for all listed companies.
authority, integrity and resources to fulfil their duties in a professional manner.

In view of the foregoing provisions of the Insider Regulations relating to the disclosures, the disclosure norms prescribed under the Insider Regulations in India are very detailed and sufficient for preventing insider trading, for good governance and for strengthening the platform for fair and transparent securities market. Further, the disclosures mandated under the Listing Agreement are also a strong preventive mechanism against insider trading.²⁷⁴

Scrutiny of the disclosures that are made and timely action against the failure to make disclosures well within the statutory period are not prosecuted very seriously. Therefore, strengthening the enforcement regime on disclosures should be given equal importance as mandating such disclosures.

²⁷⁴ This has already been dealt with in the chapter on Historical development of the laws relating to insider trading in India.