CHAPTER 5

SANCTIONS AND ENFORCEMENT: A COMPARATIVE REVIEW

The three essential elements of securities regulations are: the legal framework, the supervision program and the enforcement program. The enforcement of the securities laws primarily depend on the powers and approach of the regulators and the efficiency of the courts. Amongst the various powers of the regulator, the investigative powers remain the core of the enforcement regime. Just as in other countries, enforcement has been a challenging area for the Indian regulators as well. This aspect has been the subject matter of international reviews and reports from time to time. The World Bank in its assessment in 2004 on the Indian regulatory framework with respect to the securities market has observed that despite several legal developments, enforcement and implementation of laws and regulations have remained the important challenges in the Indian securities market. Mere existence of laws regulating insider trading is insufficient to ensure the optimal development of the securities market. One of the major concerns that the World Bank had highlighted in the report mentioned above, was that the sanctions and enforcement for related party transactions and insider trading should ensure the effective alignment of business practices with good corporate governance practices.
Enforcement is the disciplinary function of a regulatory system, i.e., the tangible consequences to non-compliance with regulation and violations of securities law.

In an empirical study, the ‘Securities Laws and Enforcement’\textsuperscript{275}, it has been observed that the cost of capital for securities is unaffected by the mere presence of the insider trading laws. However, the strong enforcement of the insider trading laws can impact the cost of capital for securities.

The IOSCO also has been concerned with the issues affecting enforcement of securities laws and had identified the below mentioned three main principles to be followed for the effective enforcement of securities laws:

"Principle 10: The regulator should have comprehensive inspection, investigation and surveillance powers.

Principle 11: The regulator should have comprehensive enforcement powers.

Principle 12: The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program."

\textsuperscript{275} A survey of Securities Law and Enforcement by Florencio Lopez-de-Silanes (Yale University & NBER) dated October 2003
Pursuant to this, the member countries have made several efforts to comply with these principles. Efforts were carried out primarily through introducing statutory provisions strengthening investigative powers. The different powers available in the U.S., U.K. and India for enforcement of the laws on insider trading and also the specific powers for investigation are discussed below. A comparative analysis of how the major jurisdictions have been implementing IOSCO principles is discussed below.

5.1 POWERS FOR INVESTIGATION: U.S., U.K. AND INDIA

Investigative Powers in the United States

The specific objectives of the SEC in insider trading investigations are as follows:

(i) to establish materiality;
(ii) to identify suspicious traders;
(iii) identify insiders and traders;
(iv) establish possession (connect insiders and traders);
(v) to establish scienter;
(vi) to establish duty (i.e., employment contracts, confidentiality agreements, etc.); and
(vii) to set the stage for disgorgement.

In the U.S., the SEC has broad powers for investigation. Section 21(a) (1) of the Exchange Act provides as follows:
“The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member[and]……….., and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this title, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this title relates.”

Investigative Powers in the United Kingdom

In the U.K., the FSA initiates investigation in ‘market abuse’ cases, based on three (3) criteria:

(i) Whether there has been any impact on the market confidence or have consumers/investors potentially lost money;

(ii) Will prompt action by the FSA prevent further damage; and

(iii) Will action by the FSA have the effect of deterring such behaviour in the future.
In the U.K., the FSA Enforcement Division investigates suspected breaches of the FSA Rules or the FSMA. The investigative powers are conferred under Section 168(2) of the FSMA. This provision enables the FSA, or the secretary of State, to appoint an investigator to conduct an investigation if it appears to it that there are circumstances suggesting that market abuse may have taken place or one of the criminal offences of insider dealing or misleading statements and practices may have been committed. This power is in addition to the general powers of investigation. This enables the FSA to initiate investigation on the basis of information from an exchange showing inexplicable or suspicious price movements. Once the enforcement officer is convinced about the violation, it may investigate and recommend how to proceed against the violators. Once the enforcement team has accepted the case, a project sponsor, a project manager and case team is appointed. The case team will also include a lawyer.

Investigative Powers in India

Although the SEBI has not specifically prescribed the objectives of investigation in insider trading cases, it may very well be presumed on the basis of the SEBI’s enforcement orders that the objective is to find out whether one is an insider, or there has been a UPSI in its/his possession and if there has been trades by the insider. It is necessary to examine as to what are
the specific powers that are available under the U.S., U.K., and the Indian laws to pursue the objectives stated above.

In India, the specific powers to conduct inquiries and inspection against any person whom SEBI suspects to have committed the violation of the Insider Regulations are provided under the Regulations 4A and 5 of the Insider Regulations. The SEBI initiates the investigation based on insider trading related complaints received from the investors, intermediaries or any person, and/or *suo moto*, based on the SEBI’s own knowledge of any alleged violations. Once the SEBI forms a *prima facie* opinion that an investigation is necessary, then the SEBI appoints an internal investigative authority to investigate. Prior to 2002, the SEBI could initiate investigation only on the basis of ‘written information in its possession.’ Therefore, the scope of the SEBI’s investigation has increased post 2002.

SEBI’s general powers for investigation are prescribed under Section 11C of the SEBI Act and the investigation begins with the appointment of an investigating authority. Under Section 11C (3), the I.A. can require any intermediary or any person associated with the securities market to furnish information, produce books or registers or documents or records which are relevant for the investigation. The I.A. has the power to examine persons on oath. Non-cooperation with the I.A. can result in prosecution, and a conviction which can attract imprisonment up to one (1) year and/or a fine of
up to Rs.1 crore. Further, an additional fine of up to Rs.500,000 per day may be imposed for each day of continued refusal to cooperate after the initial date of the refusal. The I.A can approach the court of the Judicial Magistrate of first class for the orders of search and seizure, if necessary. The SEBI can use the foregoing powers against the listed companies as well as a company that intends to get listed on a stock exchange, in case of alleged charges of insider trading and market manipulation against such companies. As opposed to the other regulations within the SEBI’s purview, the Insider Regulations provide for the appointment of an auditor who has wide powers to inspect and investigate insiders and any market participants or intermediaries covered under Section 11(2) of the SEBI Act, who are linked to the insider’s transactions. These powers are similar to those of the inspecting authority as prescribed in Regulation 5 of the Insider Regulations. Powers are vested with the SEBI under Section 11(2A) of the SEBI Act to inspect books, register or other documents of listed companies or companies intending to get listed also, but, only when the company has indulged in insider trading or fraudulent trade practices and not in cases where the Regulator suspects that it is likely to indulge in insider trading. On the contrary, in the U.S., SEC has the power to investigate even if it suspects that any person is likely to indulge in insider trading. The insider is obliged to give the I.A. reasonable access to the premises occupied by such insider and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock-broker or any other person and also provide copies of documents.
or other materials which in the opinion of the investigating authority are relevant. However, as regards the investigation against a company that intends to get listed on a stock exchange, it is unclear at what stage of a company’s process of listing the SEBI can investigate.

### 5.1.1 Provisions for Notice

The Insider Regulations in India requires the SEBI to give a reasonable notice to the insider before the investigation. However, in case the SEBI is satisfied that the investigation is in the interest of the investors or in public interest, such investigation can be conducted without notice to the insider. Neither the FSA nor the SEC mandates a notice to the person under investigation.

### 5.1.2 Scope of Investigation

The SEC’s powers are very wide and extend to any person who is likely to commit a violation. In the U.S., the investigations into cases of insider trading are generally started following a public announcement, which materially affects the price of the issuer's securities. For example, announcements of proposed tender offers and announcements of significant earnings declines frequently warrant investigations of possible insider trading.
The SEC has also identified that illegal insider trading schemes can generate millions of dollars in illegal profits and often involve trading in numerous deal stocks through fictitious names and foreign accounts. The Defendants are identified to be having a wide variety of backgrounds and include corporate employees, attorneys, investment bankers, physicians, students, account executives, housewives and others. SEC has streamlined some of the investigative techniques and considerations, which have arisen in their insider trading investigations, although there cannot be identical situations or facts in insider trading investigations.

Insider trading cases typically involve the use of circumstantial evidence to prove that the defendant possessed the material non-public information. Telephone records frequently provide this circumstantial evidence in tipping cases. The issue whether this type of circumstantial evidence is sufficient, often depends upon the credibility of the defendant who denies, under oath, that a tip took place. For this reason, evidence bearing on the credibility of potential defendants is critical. A false exculpatory statement by a defendant in the course of the investigation is frequently the linchpin of a successful investigative strategy.
Ideally, the sources of cases are informants, anonymous calls, market professionals, disgruntled employees, or the competitors. As measures of market surveillance, Self Regulatory Organizations (SROs) provide the SEC with hundreds of reports of suspicious trading each year. In some instances, these reports are made by telephone on a real time basis. Frequently, the SROs provide detailed written reports of their investigations including back-up materials. SEC also reviews the market trading. The staff at SEC monitors market trading through online data services and through the review of major periodicals. Before a decision is made to pursue an inquiry or investigation, the staff checks the Commission's computerized NRSI system to determine whether any other enforcement personnel are working on the particular case. Depending on the evidence at hand, the staff may then open a MUI (Matter Under Inquiry) to take a further preliminary look at the situation, or the staff may decide to open an investigation immediately.

As regards the U.K., the FSA does not have the powers to investigate when it has a suspicion that market abuse may occur on a future date. Although it has the power to obtain an injunction from the court in such cases, the investigation for suspected cases of market abuse in future against unregulated bodies/persons becomes impossible. However, it is important that specific and broad powers are
available, in the case of insider trading. Further, the FSA can require any person to provide information to the investigator. One even pauses to think that the nature of powers under Section 21 of the Exchange Act in the U.S. could be one of the reasons behind the SEC’s remarkable achievement in enforcement.

The Indian regulator, SEBI, can exercise its investigation powers only in respect of persons who are associated to the securities market or else, intermediaries, etc., who are covered under Section 11C(3) of the SEBI Act, provided, the transactions in securities are being dealt with in a manner detrimental to the investors or to the securities market; or any intermediary or any person associated with the securities market has violated any of the provisions of the SEBI Act or the rules, regulations or directions issued by the SEBI.

Although the Insider Regulations provide for investigating any person suspected to have violated the Insider Regulations, it does not prescribe the powers similar to that of the SEC to investigate the persons who are likely to violate the Insider Regulations. In India, the Insider Regulations confines the scope of such persons to those mentioned at Regulation 7 of the same, i.e., the requests for information can be made either to an insider or those persons mentioned in Section 11(2) (i) of the SEBI Act, which means stock
exchanges, mutual funds, other persons associated with the securities market, intermediaries and self regulatory organizations in the securities market. In the absence of any statutory guideline or rules defining the term ‘persons associated with the securities market’, the judgment of the Gujarat High Court in *Karnavati Fincap v. SEBI*276 has been referred to as a precedent by the administrative authorities and the SAT. In this case, the petitioners, who were the purchasers of the securities, challenged the summons issued by SEBI, Section 11(3) directing them to appear before the investigating authority. The petitioner’s case was that the only persons who are covered by the provisions of Sections 11(2) (i), 11B and 12 of the SEBI Act are stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organizations in the securities market. It was contended that merely because they dealt through a stock broker or stock exchange as an investor, they did not fall into the category of persons against whom inquiry could be instituted or from whom the information could be called. However, the High Court of Gujarat observed that it is inconceivable to think that a buyer or seller of a scrip is not a person associated with the securities market, where or through which he transacts his business, whether as trader or as investor, of selling or buying the required scrip. The scope of investigation, the court held, has to reach the primary source of

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276 *Karnavati Fincap v. SEBI*, (1996) 10 SCL 5 (Guj)
transaction. The court held that all the persons connected with the subject of enquiry should answer the summons. This decision of the High Court of Gujarat extended the scope of investigation to all the buyers and sellers of securities in the market. However, in insider trading cases, the persons involved need not even be buyers or sellers in the market. As in the U.S., it could be a printer such as in the *Chiarella Case* where the printer merely passed on the UPSI which came to his possession during the course of his employment and did not himself trade, or a football coach such as in the *SEC v. Switzer Case*[^277], where the coach had traded based on the information he had overheard from a conversation between his friend and the friend's wife.

Thus, no explicit statutory power vests with the SEBI to investigate the persons who are not directly associated with the securities market, even if such persons are likely to indulge in insider trading.

### 5.1.3 Detection Mechanism

Trading in the securities of public companies takes place primarily through the registered brokers and dealers who are required to make and keep detailed trading records. These trading records are

available to the SROs and the staff at the SEC in the computerized format via the automated Blue Sheet system. The staff receives Blue Sheet records in hard copy and/or computerized format. At the SEC, the staff analyzes and keeps track of thousands of potential or suspect trades made available through the Blue Sheet system.

One of the latest technologies deployed to detect the insider trading cases in the U.K. is the complex event processing (the “CEP”). The CEP employs analytic techniques such as event streams processing, event correlation and abstraction, and event hierarchies to detect complex patterns among many events and relationships between events, such as causality and timing. The FSA had recently announced its use of Progress Apama's Event Processing Platform to monitor the transactions and the detect insider trading and other market abuses as they occur.

The SEBI initiates investigations either *suo moto*, or upon receipt of the complaints, on the basis of the reports of different stock exchanges on abnormal patterns in trading, unusual price rise and heavy volumes traded in scrips. SEBI has an Integrated Market

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278 The term "Blue Sheet" which refers to the forms in which, years ago, the staff used to request trading information from brokerage firms. These forms were blue in color. Hence the phrase "Blue Sheet"

279 www.wallstreetandtech.com/features/showArticle.jhtml (last visited on September 13, 2010)
Surveillance System which is reported by the 2009 Committee on the Financial Sector Assessment (CFSA), as capable of detecting instances of insider trading and front-running. The surveillance system has been set up by the SMARTS, an Australian service provider, to continually detect and analyse market abuse, as well as provide insight and analysis of trading activity. The data captured by such system equips the SEBI to initiate investigation into possible instances of prohibited insider trading activities, apart from the written complaints.

5.1.4 Penalty for refusing to provide information

In India, in case the persons involved in the investigation process refuse to provide information requested by the SEBI for investigation, the SEBI is empowered to impose either civil penalties under Section 15A of the SEBI Act or it could even initiate prosecution followed by an imprisonment for one (1) year and / or with fine up to Rs.1 crore. Further, a fine of up to Rs.5 lakhs can be imposed at the SEBI’s discretion for each day of the failure to provide information. In case of the SEC and the FSA, they do not have the power to impose

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280 SMARTS Group is the leading provider of market surveillance solutions worldwide. Established in 1994 with the aim to build and deploy technology and services to enhance securities markets, SMARTS is part of NASDAQ OMX Group, the world's largest exchange company with trading, technology and public company service capability spanning 6 continents. (www.smartsgroup.com, last visited September 05, 2010)
penalties and have to approach the courts of law, if the parties subjected to investigations refuse to co-operate.

5.2 ENFORCEMENT: REMEDIES AND SANCTIONS

Enforcement methods across jurisdictions are broadly classified as civil and criminal enforcements. The difference between the civil and criminal enforcement mechanisms is that, while civil remedies consists mainly of injunctions, monetary penalty, suspension and private litigation, etc., the criminal sanctions are graver and attracts imprisonment, and / or monetary penalty. Upon review of the international experience, it appears that the criminal sanctions are more effective from a deterrence standpoint. However, in matters of criminal sanctions, the burden of proof on the regulator is much higher, which makes it difficult to obtain a proper sanction.

5.2.1 Civil Remedies

Civil remedies are comparatively quicker and effective, as in civil offences, the element of mens rea need not be proved. In the U.K., the FSA’s enforcement powers are centred on its civil powers under the market abuse regulatory regime under Section 123 of the
FSMA as well as its enforcement powers\textsuperscript{281} against the authorized firms and approved persons. Civil remedies available in the insider trading cases under the three (3) jurisdictions of U.S., U.K., and India are discussed below:

5.2.1.1. **Injunctions**

In the U.S., prior to the ITSA in 1984, the two (2) effective reliefs available in the insider trading cases were the injunctions against future violations and orders against the defendant to disgorge the ill-gotten gains. Section 21(d) of the Exchange Act empowers the SEC to seek an injunction in insider trading cases against any person, who “is engaged or about to engage” in securities law violation. A U.S. federal court has examined the SEC’s injunctive power under Section 21(d) of the Exchange Act and has held that an injunction can be granted only if there is a finding of “likelihood” or “propensity” to engage in future violations,\textsuperscript{282} and the courts have emphasized on the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic

\textsuperscript{281} The term ‘enforcement’ is used for both the powers available to discipline persons involved in market misconduct as well as those powers available to the FSA to secure or confiscate assets.

\textsuperscript{282} Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 394 (2 Cir.) (opinion of Gurfein, J., sustaining denial of injunction)
likelihood of recurrence. The courts have also held that injunctions would be granted only if the circumstances are such that there is reasonable likelihood of future violations.

Injunctions are aimed at preventing further damage and clearly not a penalty. The finding of the violation will act as a disqualification from acting as securities professional and the negative publicity attached to the injunction order will act as a deterrent.

In cases seeking injunctive relieves, the U.S. courts look into the following factors:

(i) whether violation is an isolated occurrence;
(ii) the degree of scienter involved;
(iii) whether defendant acknowledges his past conduct;
(iv) defendant evinces some degree of remorse; and
(v) whether because of the professional occupation of the defendant, the defendant is in a position where future violations could be anticipated, etc.

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283 SEC v. Universal Major Industries, 546 F.2d 1044, 1048 (2 Cir. 1976)
284 SEC v. Commonwealth Chem. SEC., Inc., 574 F.2d 90 (2d Cir. 1978)
In *SEC v. Musella*\(^{286}\), the SEC had filed an application for an injunction and asset freeze before the court. The court granted the injunctive relief on the ground that the defendants who were active traders are likely to involve in insider trading again. The foregoing standards adopted by the court in *Musella* was also applied in the subsequent cases where injunctive relieves were denied.\(^{287}\)

In the U.K., Section 381\(^{288}\) of the FSMA prescribes the injunctive relieves in insider trading cases. Under this provision:

\(^{286}\) SEC v. Musella, 748 F. Supp. at 1038

\(^{287}\) SEC v. Bausch & Lomb Inc, 56 F.2d 8, (18-19), there the second circuit noted: Judge Ward found a sincere and honest man, who, out of an excessive zeal for fairness and accuracy, in an agitated moment, temporarily abandoned his usual caution and allowed material inside information to 'pop out'. Schuman was terribly upset by his error, and candidly expressed this. It is highly unlikely that he will repeat it. Other factors – Schuman’s haste to determine the leaked information to the public, the failure of Schuman or Bausch & Lomb to derive any benefitting from the disclosures, and the SEC’s inability to provide any convincing proof of other instances of misconduct by appellees before or since March 16, 1972 was merely one instance of misconduct not likely to recur

\(^{288}\) Section 381:

(1) If, on the application of the Authority, the court is satisfied—
(a) that there is a reasonable likelihood that any person will engage in market abuse, or (b) that any person is or has engaged in market abuse and that there is a reasonable likelihood that the market abuse will continue or be repeated, the court may make an order restraining (or in Scotland an interdict prohibiting) the market abuse.

(2) If on the application of the Authority the court is satisfied—
(a) that any person is or has engaged in market abuse, and (b) that there are steps which could be taken for remedying the market abuse, the court may make an order requiring him to take such steps as the court may direct to remedy it.

(3) Subsection (4) applies if, on the application of the Authority, the court is satisfied that any person—
(a) may be engaged in market abuse; or (b) may have been engaged in market abuse.

(4) The court make an order restraining (or in Scotland an interdict prohibiting) the person concerned from disposing of, or otherwise dealing with, any assets of his which it is satisfied that he is reasonably likely to dispose of, or otherwise deal with.
(a) FSA can apply to the court for injunction if it is satisfied that there is a reasonable likelihood that any person will engage in market abuse or if he has already engaged, then there is a likelihood that he would repeat or continue with the market abusive trades in the market; and

(b) If the court, on an application made by the FSA, is satisfied that the person has engaged in market abuse, then the court may order such persons to take remedial steps or, issue an order restraining the person from disposing of, or otherwise dealing with any of his assets he is reasonably likely to dispose of, or otherwise deal with.289

The Indian position is substantially different from the position in the U.S. There is no express provision under the Indian securities law for injunctive relief in insider trading cases. Neither the SEBI Act nor the Insider Regulations refer to the term “injunction.”

(5) The jurisdiction conferred by this section is exercisable by the High Court and the Court of Session.
(6) In subsection (2), references to remedying any market abuse include references to mitigating its effect.
289 Sec 381(2) and Sec 381 (3) of FSMA
However, on a close examination of some of the provisions under the SEBI Act and the Insider Regulations, it can be noted that these legislations provide for injunctive reliefs. For example, Section 11(4) provides as follows:

“without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) of Section 11(4) and Section 11B of the SEBI Act, the SEBI may, by an order, for reasons to be recorded in writing, in the interests of investors or securities market, take any of the following measures, either pending investigation or inquiry or on completion of such investigation or inquiry, namely:

(i) suspend the trading of any security in a recognised stock exchange;

(ii) restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;

(iii) ------------;

(iv) impound and retain the proceeds or securities in respect of any transaction which is under investigation;

(v) ------------

(vi) direct any intermediary or any person associated with the securities market in any manner not to dispose of or
alienate an asset forming part of any transaction which is under investigation.”

These measures could also be taken in respect of any listed public company or a public company (not being intermediaries referred to in Section 12 of the SEBI Act) which intends to get its securities listed on any recognized stock exchange where, SEBI Board has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to the securities market.

Section 11B of the SEBI Act also grants wide powers to the SEBI to pass orders that are appropriate in the interest of the investors and the securities market. Further, if the SEBI finds, after an inquiry, that a person has violated or is likely to violate any regulation or rule or provisions of the SEBI Act, it can, using its specific power conferred under Section 11D of the SEBI Act, pass an order requiring such person to ‘cease and desist’ from committing or causing such violation. Such directions can be issued even to the corporations\textsuperscript{290}, if there are reasonable grounds to believe that they have indulged in insider trading.

\textsuperscript{290} Companies that are listed or intends to get listed in a stock exchange
trading or market manipulation. Thus, it is clear that a person who intends to trade while in possession of insider information can be prevented from executing the trades prior to the trade itself, so as to prevent an irreparable injury.

Further, under Regulation 11(a) of the Insider Regulations, the SEBI can issue directions restricting the insider from dealing in securities in any particular manner, and Regulation 11 (c) empowers the SEBI to restrain the insider from communicating with or counsel any person to deal in securities. Hence, these directions under the Insider Regulations can be considered as injunctive reliefs.

The provisions under Section 11B of the SEBI Act also enables the SEBI to issue injunctive orders in cases of insider trading. In the case of Dr. Nalamothu Venkata Krishna where a possible violation of the Insider Regulations was involved, the SEBI had issued a ‘cease and desist’ order under Section 11D of the SEBI Act. The defendant in his blog, “stockmarketguide.in”, made an online offer for unpublished price sensitive information in return for a share in the profits.

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291 Both these directions can be issued by SEBI only to an insider or persons mentioned under Regulation 11(a) which includes intermediaries and self regulatory organization or other persons associated with the stock market

ranging between Rs.10,000 and Rs.1 Lakh. The online offer was noticed by the SEBI. The SEBI considered many questions, such as whether the blog would induce an insider to communicate information, whether the blog encourages soliciting, etc. SEBI held that the defendant’s action qualified as ‘soliciting’ and hence the defendant was directed to cease and desist from issuing or continuing to issue online offers soliciting unpublished price sensitive information from the insiders in violation of the Insider Regulations.

The notable distinction between the powers available under the three (3) jurisdictions discussed above is that in India, the regulator exercises the injunctive powers and not a court.

5.2.1.2 Disgorgement

Disgorgement or restitution of profits is one of the oldest remedies adopted by the SEC.\textsuperscript{293} Disgorgement is not the same as damages or restitution. It means depriving the violator of his or her “ill-gotten gains” obtained as a result of the violation. In a way, the SEC had set the standards for the other countries as well in respect of disgorgement. \textit{SEC v.}

\textsuperscript{293} Section 21B(f) of the Exchange Act
Macdonald\textsuperscript{204} was one of the important cases in which the courts set out the standard for disgorgement of profits. The SEC filed a case against James E. MacDonald, Jr., before the district court to disgorge profits of US$53,012 realized on the purchase and subsequent sale of 9,600 shares of Realty Income Trust stock. The district court found that the defendant had violated the antifraud provisions of the Exchange Act, by making the purchases without disclosing certain material inside information learned in his capacity as the chairman of the RIT's board of trustees. The defendant, MacDonald appealed against this, contending that the court erred in its findings of materiality and scienter; in excluding certain evidence, and also in the measurement of the profits to be disgorged.

The Federal Court agreed with the finding of the district court. However, it rejected the SEC’s claim for disgorgement of an amount higher than the profit and held that any disgorgement higher than the amount of profit would not hold good. On remand, the district court had to determine a figure for the disgorgement amount, based upon the price of the RIT stock at a reasonable time after public dissemination of the inside information.

\textsuperscript{204} SEC v. Macdonald, 699 F.2d 47 (1983)
The court in this case propounded the ‘equal foot doctrine’ holding that the proper computation of the “benefit” is the difference between the unlawful purchase or sale price and the price at a reasonable time after the public disclosure of the inside information. Thus, when the inside information is released to the public, the defendant no longer possess the informational advantage and any loss or profit coming after that point was not unjustly obtained. The money obtained as disgorgement in an insider trading case is generally paid into an escrow account, supervised by a trustee or receiver, established for the benefit of those injured by the illegal activity\textsuperscript{295}. It can be a corporation\textsuperscript{296}, contemporaneous traders\textsuperscript{297}, etc. In the U.S., wherever appropriate recipients of the fund cannot be located, the disgorgement fund can be transferred to the United States Treasury.

U.K. does not have specific provisions for disgorgement. However, the restitution of profits prescribed under Section 383 of the FSMA in effect amounts to disgorgement of the profits. Under this provision, the court can pass an order of restitution if it is satisfied that a person is

\textsuperscript{295} SEC v. Lund, 570 F.Supp.1397 (C.D. Cal 1983)
\textsuperscript{296} SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968)
\textsuperscript{297} SEC v. Wang, 944 f.2d 80 (2d Cir 1991)
engaged in market abuse or due to his action or inaction he has caused market abuse. A further important condition is that the profits must have accrued to the person concerned and one or more persons must have suffered loss or adversely affected. Under the FSMA, the court can then issue a restitution order for the profit appearing to have accrued or to the extent of loss to the investors or both. The court can then order the disgorged money to be given back to the ‘Qualifying Person’.

In India, the disgorgement of profits is not explicitly prescribed under the statute. However, despite the absence of specific provisions in the SEBI Act, SEBI had started pursuing disgorgement actions under the Section 11B of the SEBI Act, under which the SEBI has the power to issue directions in the interest of the market. Further, under the Insider Regulations, the SEBI can direct the violator to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher, to the investor protection fund of a recognised stock exchange. Furthermore, under the Regulation 11(e) of the Insider Regulations, SEBI can direct

298 “Qualifying person” means a person appearing to the court to be someone—
(a) to whom the profits are attributable; or
(b) who has suffered the loss or adverse effect
299 By which SEBI has the power to issue directions (Under Section 11B) in the interest of the market.
300 Clause (f) of Regulation 11 of SEBI (Prohibition of Insider Trading) Regulation, 1992
the insider to deliver the securities back to the seller and if the buyer is not in a position to deliver the securities, to pay the seller the market price of the shares at the time of issuing the directions\textsuperscript{301}. However, the scope of the provisions in the Insider Regulations in India is different from the actual restitution\textsuperscript{302} or disgorgement, as they include the cost price and market price as a whole, where the amount would be higher than the profits.

SEBI, for the first time, had exercised its powers under Section 11B of the SEBI Act read with Regulation 11 of the Insider Regulations and directed the Hindustan Lever Limited to compensate the UTI to the extent the UTI had suffered losses. In this case, SEBI held HLL guilty of insider trading, as HLL traded in the shares of BBLIL prior to the merger between HLL and BBLIL, based on the UPSI about the impending

\textsuperscript{301} SAT in the case of Rakesh Agarwal v SEBI has held that “Regulation 11 merely empowers the Board to pass certain interim directions, for the purpose of maintaining the status quo during the course of the investigation and/or, immediately thereafter upon receipt of the said investigative report. Further, that the directions which may be passed pursuant to Regulation 11 are limited to the purposes enumerated therein, which do not include compensating any aggrieved parties. Further that the said Regulation 11 does not empower the Board to arrive at any final and/or conclusive determination as to whether any person has acted in breach of the said Regulations for reasons more particularly stated above”.

\textsuperscript{302} According to Black's Law Dictionary (1968), restitution is an "Act of restoring; restoration of anything to its rightful owner; the act of making good or giving equivalent for any loss, damage or injury; and indemnification". Black's Law Dictionary defines disgorgement as "the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion". Application of the Regulation 11 does not strictly fall into both these concepts, since the rightful owner (Investor Protection fund or the seller) can at certain situations be entitled more than profits.
merger. SEBI had estimated the loss caused to the UTI on account of the insider trading at Rs.3.04 crores. The basis for this calculation was the difference between the market price of the shares of BBLIL at which the shares were sold by UTI to HLL after the announcement of the merger and the price of the shares prior to the announcement of the merger, excluding the premiums. In this matter, the rationale given by the SEBI to have issued such an order was that the action was taken as corrective step.

Thereafter, the SEBI had exercised the power to disgorge ill gotten gains, in a case where the violation of Insider Regulations were established against Rakesh Agarwal, the director of a company ABS Industries. SEBI had directed Rakesh Agarwal to deposit a sum of Rs. 34,00,000 with the investor protection fund of the BSE and NSE to compensate the investors who may come forward at a later period of time seeking compensation for the loss incurred by them in selling at a price lower than the offer price. Simultaneously, adjudication proceedings under Section 15G of SEBI Act was also initiated against Rakesh Agarwal.

303 Detailed facts are discussed in chapter 3 of this study.
304 Rakesh Agarwal v. SAT, 2004 49 SCL 351 SAT
Whereas the appellant challenged the power to direct disgorgement by SEBI, the regulator relied on the judgement in *B. P. Plc v. SEBI*[^305] wherein the Bombay High Court had upheld SEBI’s directions to the appellants to pay interest to the aggrieved investors. Further, it was also argued that the disgorgement of alleged profits is always directed as a measure of deterrence and not of compensation[^306]. The appellant’s contention was that the directions of disgorgement are penal in nature and therefore, SEBI cannot pass such an order under Section 11B because only remedial directions[^307] can be passed under Section 11B. Regarding the power to direct disgorgement, the SEBI’s defence was that on a proper and purposive interpretation of Section 11(2)(g) of the SEBI Act read with Regulation 9(2) and Regulation 11[^308] of the Insider Regulations, SEBI has the power to order a person found guilty of insider trading under the Regulations 3 and 4 to whom

[^305]: [SEBI Appeal number 10 of 2001 and appeal number 37 of 2001] dated May 2, 2002. This was not a case of insider trading. In this case, it was on a conjoint reading of the provisions of Regulation 44 of Takeover Regulations and Section 11B of the SEBI Act, that the court upheld SEBI’s power to direct the payment of interest. Regulation 44 of the Takeover Regulations confers wide powers upon the Board which include taking action against the person concerned, in the interest of the securities market. SEBI was of the view that the power to direct disgorgement of alleged profits to aggrieved investors is an equitable power and a disgorgement order is compensatory in nature. However, equitable powers can only be exercised by courts and not any quasi-judicial tribunals/bodies and the appellant argues that SEBI does not have the power to direct disgorgement of any alleged profits.


[^307]: Decisions in Sterlite Industries v. SEBI, BPL v. SEBI Appeal Nos. 14/2001 to 19/2001, Videocon v. SEBI 23/2001, 26/2001 were relied on by appellant to support this.

[^308]: Subsequently, there were amendments to both the SEBI Act, 1992 and the Insider Trading Regulations in the year 2002.
directions under Regulations 11(a), (b), (c) are applicable and pass direction to call upon the insider to take such measures including to disgorge profits made as a result of insider trading. The SEBI had referred to the *SEC v. David E. Lipson*\(^{309}\) as an example that disgorging of profits is the one of the various remedies in the cases of insider trading.

In this case, the District Court found that David Lipson has traded in the stock of a publicly traded corporation on the basis of inside information, in violation of the SEC's anti-fraud rule. The district judge found Lipson to have violated the relevant provisions of the securities laws, ordered him to disgorge US$621,875 (the court's estimate of the loss his insider trading had avoided) plus prejudgment interest of US$348,097, and imposed punitive damages of US$1,865,625, which was equal to three (3) times the amount ordered disgorged and was the maximum civil penalty permitted by the ITSA. Lipson appealed before the Court of Appeals, Seventh Circuit against the judgment of the District Court. The appellate

\(^{309}\) 278 F.3d 656 (2002)
court upheld the trial court judgment and decided against the Lipson.

The absence of specific powers for SEBI to direct the disgorgement of ill-gotten gains continued to be debated for long. Recently, in 2009, the SAT has upheld the power of SEBI to disgorge the illegal gains in several cases\textsuperscript{310}. In the \textit{Dhaval Mehta}’s case\textsuperscript{311}, the IPO irregularities and subsequent unjust enrichment by the appellants caused the SEBI to issue an order of disgorgement for Rs.7,200,000 against the appellants. This order was upheld by the SAT. The SAT held that, “Disgorgement is a monetary equitable remedy to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct. Disgorgements of illegal gains are ordered against those who violate the securities laws and make unlawful gains. The amount should not exceed the total profits realized as a result of unlawful activity and the amount ordered to be disgorged should be approximately be equal to the amount of unjust enrichment. In the instant case, the whole time member has worked out the amount from the prices that were


\textsuperscript{311} Appeal No. 155 of 2008, dated 08.09.2009
available and we find no ground to interfere with the order in this regard.”

Further, the SAT in the case of Shadilal Chopra\textsuperscript{312}, which was also an IPO related case, where SEBI had directed disgorgement, while upholding the disgorgement order of SEBI held that: “Disgorgement is the forced giving up of profits obtained by illegal or unethical acts. It is a repayment of ill-gotten gains that is imposed on wrongdoers. It is a monetary equitable remedy that is designed from unjustly enriching himself as a result of his illegal conduct. It is not a punishment. In this view of the matter, no fault can be found with the impugned order passed by the whole time member.”

5.2.1.3 Penalties

In the U.S., the disgorgement and injunctions as enforcement mechanisms were found to be less effective in so far as deterrence is concerned. With the introduction of the ITSA in 1984, the persons who were found guilty of insider trading violations faced the possibility of a civil penalty of up to three times the profits made (or losses avoided) as a result of

\textsuperscript{312} Shadilal Chopra v. SEBI, Appeal No. 201 of 2009 dated 02.12.2009
the insider trading. Section 21 of the Exchange Act permits a court in an action brought by SEC to impose a civil penalty of up to three times the trading gains, or losses avoided, upon a finding that the defendant violated Rule 10b-5, Rule 14e-3, or any other provision or rule under the Exchange Act that prohibits insider trading.

In one of the insider trading cases in the U.S., the federal circuit court had invoked a three part enquiry into the egregiousness of the violation, the isolated or the repeated nature of the conduct, and the degree of scienter to set the penalty. This is more or less in the lines of what is stated at Section 15J of the SEBI Act.

The FSA, in the U.K., has the power to impose a penalty under Section 123 of FSMA, if a person has engaged in market abuse. However, such imposition is completely discretionary, and Section 123 provides no guidelines about the circumstances in which it might take action, publish a statement or impose a penalty, or about the amount of any penalty which may be imposed.

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In India, under Section 15G\textsuperscript{314} of the SEBI Act, the adjudicating officer of SEBI is empowered to impose penalty for insider trading up to Rs.25 crores or three times the profit made, whichever is higher. The mode and manner of the adjudication is prescribed under the provisions of the SEBI (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 1995, which also addresses the natural justice principles to be followed in the proceedings. Further, the guidelines for determining penalty are provided under the Section 15J of the SEBI Act such as:

(i) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(ii) the amount of loss caused to an investor or group of investors as a result of the default; and

(iii) the repetitive nature of the default.

The adjudicating officer, who is also an official of the SEBI, functions independently during the adjudication proceedings.

\textsuperscript{314} Chapter VI A which dealt with penalties were introduced in the year 1996. Penalties were prescribed for all range of possible violations of securities laws. Similar provisions find place under the Securities Contract Act, 1956 and the Depositories Act, 1996.
In the U.S., the maximum penalty that could be imposed for securities fraud is three (3) times the profits made. In India, until 2002 the penalty for violation was a maximum amount of Rs.500,00. Thereafter, the SEBI had realized that because of lesser monetary value of the penalty it failed to act as a deterrent for the violators. Therefore, in 2002, the SEBI, following the U.S. example, amended the SEBI Act to provide that a person who deals in securities with inside information has to pay the penalty of three (3) times the profit made. Not only this, the SEBI went a step ahead and fixed the penalty of up to Rs.25 crore, which the SEBI can impose at its discretion.

5.2.1.4 Other Civil remedies/directions

Historically, the SEC has the power to institute administrative proceedings either as an alternative or in addition to a civil action. Administrative proceedings are initially heard and decided by the Administrative Law Judge (the “ALJ”), with rights of appeal to the SEC and to the courts of appeals in the U.S. thereafter. Administrative sanctions that could be imposed by the ALJ include censure, imposition of a cease and desist order, order of the accountings, disgorgement of ill-gotten gains, suspension or revocation of securities
licenses, restriction from association with securities industry firms, suspension and revocation of the registration of the security, restrictions on the lawyers, accountants and other professionals from practicing before the SEC, barring persons serving as director or officer of the public company and with respect to regulated entities and their associated persons and civil monetary penalties.

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990\textsuperscript{315} (the “Remedies Act”) expanded the administrative remedies available to the SEC. Prior to the Remedies Act, the SEC could initiate administrative proceedings only against the regulated entities. With the Remedies Act, the SEC could reach “any person” who violated or caused violation of the federal securities laws. The SEC could issue a cease and desist order under Section 21C of the Exchange Act against any person who violates or is a cause of a violation of the federal securities laws.\textsuperscript{316} During the exercise of such powers, SEC could issue any of the following orders:

\textsuperscript{315} This Act was enacted to amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws and to eliminate abuses in transactions in penny stocks, and for other purposes. This Act also empowered the SEC to directly impose civil liabilities on violators of securities laws.

\textsuperscript{316} Similar powers were available under Section 8A of the Securities Act, 1933, Section 203(k) of the Investment Advisers Act, 1940, and Section 9(f) of the Investment Company Act, 1940.
(i) cease and desist orders for primary violations;
(ii) cease and desist orders for causing violations;
(iii) temporary cease and desist orders;
(iv) accountings and disgorgement;
(v) requiring affirmative corrective action; and
(vi) officer and director bars.

Further, in 2002, with the SOX, the SEC obtained the power to bar the fraudsters who violated the anti-fraud rule under the Exchange Act, any person who is found to have violated Section 17(a) (1) of the Securities Act, Section 10(b) of the Exchange Act, and whose conduct demonstrates “unfitness” to serve as an officer or director\(^{317}\) from serving as an officer or director of the public company.

These powers are akin to the power of SEBI to issue directions under Section 11B and 11(4) of the SEBI Act. The power to issue directions under Section 11B of the SEBI Act, a very unique and wide one, was inserted in 1995\(^{318}\). Incidentally, this was the provision resorted to by the SEBI for

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\(^{317}\) Section 1105 of the SOX.

disgorgement, in the cases of *HLL* and *Rakesh Agarwal*. The SEBI had exercised powers under this provision to hold persons who were found guilty of violations not to hold office in their capacity as the directors of the company, etc., without having such specific power conferred by the statute. This provision of law is a potential weapon for SEBI’s enforcement and is widely discussed by the courts. Under Section 11B, the SEBI can issue directions to all the intermediaries and other persons associated with the securities market in the interests of investors, and in the interest of orderly development of the securities market and also to prevent the affairs of any intermediary including a mutual fund from being conducted in a manner detrimental to the interest of the investors or of the securities market, or to secure the proper management of any such entity.

The SEBI’s powers under Section 11B and the scope of this section has been subjected to judicial scrutiny on a regular

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319 2004 49 SCL 351 SAT
320 In the matter of D. A. Gadgil v. SEBI, Appeal No:2/2000 (www.sebi.gov.in) decided on August 11, 2000, by the SAT, the impugned order was passed by SEBI on February 01, 2000 under section 11 and 11B of SEBI Act, 1992, in the case of Shriram Assets Management Company Limited in respect to transactions in the shares of Videocon International Limited, issued by Respondent No.2 as Chairman of the Securities & Exchange Board of India, whereby the appellant was rendered ineligible “to hold any public position in any capital market related public institution for a further period of 3 years”.

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basis. In the case of *Alka Synthetics*\(^{321}\), the Gujarat High Court had examined the powers of the SEBI under Section 11B and held that the power under Section 11B to impound or forfeit the money received by the stock exchanges was justified on the ground of investors’ interest. In another case, the SAT had overruled the penal directions issued by SEBI against the market participants under Section 11B on the ground that Section 11B was not a penal provision and that it was preventive or remedial in nature\(^{322}\).

By an amendment in 2002, specific powers were conferred on SEBI under Section 11(4) of the SEBI Act to take the following measures in the investors’ interest or in the interest of the securities market:

(i) *suspend the trading of any security in a recognised stock exchange;*

(ii) *restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;*

(iii) *suspend any office-bearer of any stock exchange or self-regulatory organisation from holding such position;*

\(^{321}\) *Alka Synthetics v. SEBI, 1995 95 Comp Cas 663 Guj*

\(^{322}\) *Sterlite Industries v. SEBI, 2001(6) CLJ 279*
(iv) impound and retain the proceeds or securities in respect of any transaction which is under investigation;

(v) attach, after passing of an order on an application made for approval by the Judicial Magistrate of the first class having jurisdiction, for a period not exceeding one month, of any intermediary or any person associated with the securities market

(vi) direct any intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of any transaction which is under investigation.

The powers are available against the companies, if there is a case of manipulation or insider trading against such companies. In the case of Karvy Stock Broking Ltd v. SEBI\(^{323}\) the SEBI’s action under Sections 11B and 11(4) (b), restraining intermediaries from accessing the market, in a case of alleged commission of grave irregularities adversely affecting the interests of the investors or the market, pending enquiries against them, was upheld by SAT. The SAT had observed that the provisions of the SEBI Act were initially enacted for taking promotional or protective measures for the protection the interests of the investors and to promote the market. Although the power to take

\(^{323}\) Appeal no. 92/2006 Date of decision: 08.01.2007
preventive or punitive measures was implicit since its enactment, after the amendments in 1995 and 2002, it has been expressly extended to taking even the preventive or punitive measures.

The SEBI also has the power to order suspension or cancellation of certificate of registration, although, only which against the market intermediaries, under Section 12 of the SEBI Act. These actions shall be pursuant to an enquiry as prescribed under the SEBI (Intermediaries) Regulations, 2008. An enquiry under these Intermediaries Regulations can be held for the purpose of passing an order for the contravention of any of the provisions of the Regulations referred to in Regulation 4 of these Regulations. Prior to 2008, enquiries and pursuant actions against intermediaries such as the suspension or cancellation of the certificate of registration or warning were issued according to the SEBI (Procedure for Holding Enquiry and Recommending Penalty) Regulations, 2002, read with the SEBI (Stock Broker and Sub-broker) Regulations, 1992 or any other relevant regulation relating to the respective intermediaries.

The provisions under the Insider Regulations which are in the nature of injunction and disgorgement have been discussed already in the preceding paragraphs. The provisions of the Insider Regulations empower SEBI to issue directions that are varied in nature. Some of
the SEBI’s powers under the Insider Regulations are enumerated below:

a. directing the insider or such other person not to deal with securities in any particular manner;

b. prohibiting the insider or such other person from disposing off the securities acquired in violation of the insider trading regulations;

c. restraining the insider to communicate or counsel any person to deal in securities;\(^{324}\);

d. declaring the transactions as null and void;

e. directing the person who acquired the securities to deliver such securities back to the seller and if he is not in a position to deliver, to pay the market price of such securities prevailing at the time of issuing of directions or at the time of the transactions;\(^{325}\); and

f. directing the person who has dealt in securities in violation of the regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher to the investor protection fund of a recognised stock exchange.

### 5.2.2 CRIMINAL SANCTIONS

\(^{324}\) Injunctive in nature and already discussed under the relevant title in previous paragraphs

\(^{325}\) Provisions akin to that of disgorgement
Criminal Sanctions, known for their deterrent effect are available to almost all the regulators in their enforcement of insider trading laws. Despite the difficulty faced with burden of proof, and the obligation to prove *mens rea*, the rationale for providing criminal enforcement against insider trading is the threat of imprisonment, which itself poses to be a great deterrence to insider trading. Most of the regulators, world over, have faced major set backs because of the heavy burden of proof attached with the criminal enforcement of insider trading laws\(^\text{326}\).

The SEC brought out forty seven (47) cases of insider trading in 2001, of which only four (4) were referred to the Department of Justice for criminal action\(^\text{327}\). Due to the complexities in enforcement, many regulators have opted for civil remedies, but that doesn’t mean criminal sanctions are completely extinguished. Most of the regulators

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\(^{326}\) The difficulty associated with criminal enforcement is visible in the BolsWessanen Insider Trading case that occurred in Netherlands in the year 1998. In June of the year 1988, following a two year investigation, Dutch prosecutors began their case against four individuals charged with insider trading in options on shares of a Dutch company. Prosecutors alleged that one of the defendants, a director of the company, alerted three option traders of price sensitive information in advance of the company’s announcements. The prosecutors based their case on evidence that the defendants met regularly in a restaurant during the relevant time period. The judges dismissed the case against all of the defendants on the grounds that the evidence was circumstantial, and, therefore, did not satisfy the heavy burden of proof that must be met to support a criminal conviction. The interesting part of this case was that in May of 1998 the Dutch authorities proclaimed that their Insider Trading laws are the toughest in the world. Excerpts from Speech by SEC Staff: Insider Trading – A U.S. Perspective Remarks by Thomas C. Newkirk

\(^{327}\) SEC Annual Report, 2001
still pursue criminal sanctions together with civil remedies, as the outcome of criminal prosecution acts as a more successful deterrent.

The criminal enforcement existed in the U.S. from the very beginning and was the only enforcement available to the SEC until 1984. In 1984, along with the introduction of civil enforcement, the U.S. Congress had gradually enhanced the criminal enforcement in U.S.\textsuperscript{328} Therefore, currently, the U.S. securities laws are enforced through both civil and criminal actions. On the civil side, the SEC has broad investigative powers and can bring civil enforcement actions seeking monetary penalties, injunctions, bars against serving as a director or officer of a public company, and other civil remedies as discussed above.

It is interesting to note that the SEC does not have the authority to bring criminal actions. Criminal violations of the federal securities laws are prosecuted by the Department of Justice. The DOJ may seek indictments for criminal violations of the securities laws on their own initiative or through formal or informal referrals from the SEC.\textsuperscript{329}

\textsuperscript{328} Under the ITSA, there was a ten-fold increase in criminal penalties from $10,000 to $100,000.

The U.S. Congress had later on enhanced the criminal enforcement regime from time to time\textsuperscript{330} essentially to bring deterrence for insider trading by criminal enforcement. On July 11, 2003, Samuel Waksal, the former president and CEO of ImClone Systems, was sentenced for his illegal insider trading to more than seven (7) years (87 months) in prison and was ordered to pay a US$3 million fine and US$1.26 million in restitution.

Under Section 32(a) of the Exchange Act\textsuperscript{331}, the essential ingredient for enforcing criminal liability is that the person must ‘wilfully’ violate the statutory provisions. The term “wilful” is of utmost importance for criminal enforcement.

\textsuperscript{330} In 1988, the Insider Trading and Securities Fraud Enforcement Act was enacted, which increased the maximum terms of imprisonment from 5 to 10 years, with maximum criminal fines for individuals from $0.1 million to $1 million and for corporations from $0.5 million to $2.5 million. The Sarbanes-Oxley Act of 2002 significantly increased the criminal penalties for all forms of frauds, including insider trading. The maximum fine for individuals was increased five-fold, i.e. $5 million and the maximum penalty for corporations was increased from $2.5 million to $25 million. The maximum term of imprisonment was raised from 10 to 20 years.

\textsuperscript{331} Section 32(a) of Securities Exchange Act, 1934 provides that : Any person who wilfully violates any provision of this title (other than section 30A), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who wilfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.
In *United States v. Chiarella*, the court had held that the term 'wilfully' refers to the violations that occur with some realization on the defendants’ part that he was performing a wrongful act and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred. The basis of imposing liability under the Exchange Act is the fact that there should be an intention or knowledge. Such a criterion is evident under the misappropriation theory and the principle in *Chiarella*. In the U.S., apart from the federal securities law, the criminal enforcement of insider trading is brought as federal mail and wire fraud cases as well as the securities law violations.

The history of insider dealing prosecutions in the U.K. has not been a distinguished one. This is partly because of the legal complexities involved and the difficulties in identifying the insider, as the evidences that are available are mostly circumstantial. The offence of insider dealing as such is found under Section 52 of the CJA 1993. The Section 52 mainly identifies the three ingredients for

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332 588 F. 2d 1358 - Court of Appeals, 2nd Circuit, 1978
333 United States v. Winans, it would be enough that the defendant was aware that what he was doing was prohibited by his employer, 612 F. Supp. 827, 849-50 (S.D.N.Y. 1985),
334 Intent to benefit from breach of fiduciary duty is more than enough to impose liability.
335 Mail fraud statute was enacted by U.S. Congress to secure the integrity of U.S. postal service. Similarly, the wire fraud statute was enacted to respond to the need to protect against scheme that began to utilize wires specifically radio and television. Thus, insider trading case in U.S. mostly involved mail or wire fraud also.
336 dealing in securities, encouraging another person to deal in securities and disclosing inside information.
establishing an offence of insider dealing in securities. Although there is no mention of ‘intention’ under Section 52, Section 53 which deals with the defences available to an insider against charges of insider trading have the elements of the intention of the person and his knowledge, thus fulfilling the *sciente* requirement as ingredient.

Indian Insider Regulations do not explicitly provide for criminal sanctions. However, the criminal consequences for the offence of insider trading is primarily contained under Section 24 of the SEBI Act, which attracts the liability if any person contravenes any of the provisions of the SEBI Act or the rules and regulations made under the SEBI Act. Therefore, this provision for criminal prosecution is not specific to the enforcement of insider trading laws alone. The criminal prosecution under Section 24 of the SEBI Act, if successful, could result in a punishment of up to an imprisonment of ten (10) years and / or fine which may extend up to Rs.20 crores or with both.

In criminal cases, the *sciente* requirement is an essential ingredient for fixing the liability. For the first time, in India, it was in the case of *Hindustan Lever* that the SEBI had issued an order directing prosecution of HLL along with a direction against HLL to compensate UTI. However, the appellate authority, while deciding the appeal filed by HLL held that “*an order of prosecution should be*
based on conclusive determination of all aspects of insider trading and on specific jurisdiction in terms of the gravity of the offence”. Thus, the criminal prosecution ordered by SEBI was set aside by the appellate authority, in the absence of conclusive determination of all aspects of insider trading.

5.2.3 DEFENCES TO INSIDER TRADING CASES

In India, defences are provided at Regulation 3B of the Insider Regulations, but only for the companies in respect of the proceedings against it for the violation of Regulation 3A.

Regulation 3B provides as below:

(1) In a proceeding against a company in respect of regulation 3A, it shall be a defence to prove that it entered into a transaction in the securities of a listed company when the unpublished price sensitive information was in the possession of an officer or employee of the company, if:

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

(ii) such company has put in place such systems and procedures which demarcate the activities of the company in such a way that the person who enters into transaction in securities on
behalf of the company cannot have access to information which is in possession of other officer or employee of the company; and

(iii) it had in operation at that time, arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transactions or agreement was given to that person or any of those persons by that officer or employee; and

(iv) the information was not so communicated and no such advice was so given.

(2) In a proceeding against a company in respect of regulation 3A which is in possession of unpublished price sensitive information, it shall be defence to prove that acquisition of shares of a listed company was as per the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

These defenses generally referred to as “Chinese walls’ are only available to the companies and not to the individuals. The provisions have similarity to the Australian law on insider dealing. Section 1043F of the

337 The use of Chinese wall was first endorsed by the SEC in 1968 in its administrative proceedings in SEC v. Merill Lynch, Pierce, Fenner & Smith, Inc.
Corporations Act in Australia provides an exception for body corporate that enters into a transaction or agreement merely because of information in the possession of an officer or employee of the body corporate provided the following three factors are present:

(i) The decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and

(ii) It had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and

(iii) The information was not so communicated and no such advice was so given.

But the Australian law also provide for exception for partnerships who enter into a transaction or agreement merely because one or more (but not all) of the members, or an employee of the partnership, are in actual possession of information, under the Section 1043G of the Corporations Act.
Unlike in India, the U.K. securities law provides defenses for insider trading to the individuals as well, under the Section 53 of the CJA 1993. The general defenses identified under the CJA 1993 are briefly stated below.

(i) that the insider did not at the time expect the dealing to result in a profit, attributable to the fact that the information in question was price-sensitive information in relation to the securities; and

(ii) his belief being *bona fide* and reasonable grounds that the information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information; or

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338 (1) An individual is not guilty of insider dealing by virtue of dealing in securities if he shows—
(a) that he did not at the time expect the dealing to result in a profit attributable to the fact that the information in question was price-sensitive information in relation to the securities, or
(b) that at the time he believed on reasonable grounds that the information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information, or
(c) that he would have done what he did even if he had not had the information.

(2) An individual is not guilty of insider dealing by virtue of encouraging another person to deal in securities if he shows—
(a) that he did not at the time expect the dealing to result in a profit attributable to the fact that the information in question was price-sensitive information in relation to the securities, or
(b) that at the time he believed on reasonable grounds that the information had been or would be disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information, or
(c) that he would have done what he did even if he had not had the information.

(3) An individual is not guilty of insider dealing by virtue of a disclosure of information if he shows—
(a) that he did not at the time expect any person, because of the disclosure, to deal in securities in the circumstances mentioned in subsection (3) of section 52; or
(b) that, although he had such an expectation at the time, he did not expect the dealing to result in a profit attributable to the fact that the information was price-sensitive information in relation to the securities.

(4) Schedule 1 (special defences) shall have effect.

(5) The Treasury may by order amend Schedule 1.

(6) In this section references to a profit include references to the avoidance of a loss.
he would have done what he did even if he did not have the information.

Although the defences are available under both civil and criminal proceedings in India, there does not appear to be any cogent reason for not devising defenses for individuals. Also, if an intermediary or any firm which does not have the legal structure of a company cannot avail these defences, when held liable for insider trading, which is unfair.

Another important difference between the Indian and the U.K. law on criminal sanctions is that in the U.K., it only applies to natural persons ("individuals"). Individuals are liable irrespective of whether they act on their own behalf or on behalf of some other natural person or entity\textsuperscript{339}. Thus, the insiders cannot avoid the prohibition merely by using a corporate or other entity to trade. Various reasons have been put forward for confining the insider trading law to natural persons. One reason is because of the difficulties faced by the merchant banks when one department of the bank had unpublished price-sensitive information about the securities of a client company and other departments had successfully been kept in ignorance of that information by a ‘Chinese Wall’ or otherwise. One of those other departments might deal in the shares, in which event the bank as a single

\textsuperscript{339}“Insider Trading Discussion Paper”;Companies and Securities Advisory Committee; June 2001,Pg 22
corporate body would arguably have committed an offence had the act applied
to corporate bodies\textsuperscript{340}.

5.2.4 Relevance of Mens Rea and Burden of Proof in Insider Trading Offences

Mens rea and burden of proof are the two most essential concepts of any offence, civil or criminal. As the offence of insider trading has both civil and criminal sanctions, it is imperative to analyze the concepts of mens rea and burden of proof as applied to the offence of insider trading in different jurisdictions.

*Mens rea*

‘There is a presumption that *men rea*, or evil intention, or knowledge of the wrongfulness of the act, is an essential ingredient of every offence; but that presumption is not absolute and can be displaced either by the words of the statute creating the offence or by the subject-matter with which it deals, and both must be considered.’

This is the well-known statement of Wright J. in *Sherraz v. De*

which talks about a presumption in favour of *mens rea*. Lord Reid had also reaffirmed it subsequently that it is a universal principle that if a penal provision is reasonably capable of two interpretations, that interpretation which is most favourable to the accused must be adopted.”

Intention, in other words, *mens rea*, is the state of mind of the wrong doer, is generally a straightforward issue as a person intends something if he acts with the purpose of causing that result. *Mens rea* by necessary implication can be excluded from a statute only when it is absolutely clear that the implementation of the object of a statute would otherwise be defeated and its exclusion enables those put under strict liability by their acts or omission to assist the promotion of law.

The Indian regulator, SEBI, has a view that the Insider Regulations attract strict liability, and that there is no need to prove ‘*mens rea*’. However, in the *Rakesh Agarwal Case*[^344], the SAT has observed that *mens rea* is a necessary ingredient to determine the offence of insider trading. The SEBI had filed an appeal in the

[^341]: [1895] 1 QB 918 at 921, SHC 166
[^342]: Smith & Hogan, Criminal Law, 10th Edn, at pg 120
[^343]: K.N.Chandrasekhara Pillai: General Principles of Criminal Law (published by Eastern Book Company; reprinted 2007)
[^344]: Rakesh Agarwal v. SEBI, 2004 49 SCL 351 SAT
Supreme Court of India against the SAT’s order but as the case got settled in the Supreme Court, there was no conclusive finding of the Supreme Court on whether the element of *mens rea* is required in the insider trading cases. Subsequently, in *SEBI v. Cabott International Corporation*[^345], the Bombay High Court had observed that “for breaches of provisions of SEBI Act and regulations, according to us, which are civil in nature, *mens rea* is not essential.” Also, the Supreme Court of India in the Shriram Mutual Funds Case has held that in order to determine the monetary penalties under Chapter VI A of the SEBI Act, it is not necessary to establish the element of *mens rea*. In view of the foregoing, although the SAT’s approach towards the requirement of *mens rea* is contrary to the SEBI’s view, the Indian courts have to an extent clarified that *mens rea* need not be proved for determining the securities law offences. Notwithstanding, a cogent ruling specific to the cases of insider trading is required from the Supreme Court to conclude the ambiguities regarding the applicability of *mens rea* in insider trading cases. Although the foregoing ruling is applicable specifically to determine the monetary liability under Chapter VIA, SEBI has interpreted this to mean that *mens rea* is excluded from all securities law offences. The SAT, in the HLL case, had ruled out the requirement of motive in order to establish the violation of Regulation

[^345]: SEBI v. Cabott International Corporation, 2005 (123) CC 841 (Bom). See also Cabot International v. SEBI, [Appeal No. 24/2000]
3(1) of the Insider Regulations. However, the motive and mens rea are two different things. Motive is an irrelevant issue in the determination of criminal liability. A person who committed robbery in a bank may have done it with the ultimate motive to give the money to charity. But this does not alter the criminal liability of the robber for the act of robbery and the intention to commit a robbery is the basis for determining liability.

On the contrary, in other jurisdictions, mens rea is considered to be an essential element even for the civil liability. In the U.S., under Rule 10b-5, the elements of a civil cause of action and a criminal prosecution are similar. However, in criminal cases, the standard of ‘intent’ is wilfulness and in civil cases, the plaintiff has to establish ‘scienter’ on the part of the defendant. In the U.S., the Congress has even enacted Private Securities Litigation Reform Act (PSLRA) in 1995, which provided that in any action alleging a violation of the anti-fraud provision, Section 10 b, any facts constituting a strong inference of the defendant’s “required state of mind” must be stated with particularity. Regarding the ‘intent’, the eleventh court in John Bryant v. Avado Brands has held that the motive and opportunity themselves cannot lead to a conclusion that a person traded in the securities with an intent to capitalize on his informational advantage.

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346 John Bryant v. Avado Brands, 187 F.3d 1271 (11th Cir. 1999)
over the other party. These, however, can be used as evidence that the defendant knew the consequences of his act, shut his eyes to them and still traded on the securities.

In the U.K., although the offence of market abuse does not expressly require an ‘intent’ element, there are various defenses to the imposition of a fine or restitution order for market abuse by the FSA, if the defendant believed on reasonable grounds that his behaviour did not amount to market abuse or that he took all reasonable precautions and exercised all due diligence to avoid committing market abuse. Therefore, in the U.K., the civil offence of insider dealing under the FSMA presupposes the existence of insider’s mens rea in insider dealing cases and the burden is on the insider to prove it otherwise.

To conclude, there does not appear to be any strong justification for excluding the requirement of mens rea in insider trading cases. One reason could be that it would be cumbersome for the SEBI to establish the mens rea because of the complicated facts and the circumstantial evidence involved in the insider trading cases. The U.S. and U.K. regulators have built up a much stronger enforcement regime as compared to the SEBI, despite the requirement of mens rea and the higher burden of proof on the regulators.
Burden of Proof

The burden of proof is an obligation that remains on a single party for the duration of the claim to shift the accepted conclusion away from an oppositional opinion to one's own position. In the cases of insider trading, the burden of proof remains debated and has been subjected to the analysis by the appellate body in various cases.

The first occasion to analyse the implication and scope of burden of proof arose in the case of *Samir Arora v. SEBI*[^347]. In this case, the proof under question before the SAT was in respect of the appellant to be held as an insider, i.e., it was to be proved whether the appellant had received or had access to UPSI. The SEBI had argued that the fact of such “connected” or “deemed to be connected” persons having received information will have to be established by evidence satisfying reasonable standard of proof. The SEBI had relied on the standard of proof in civil proceedings as settled by the Constitutional Bench in *Gulabchand v. Kudilat*[^348], which held that, saying that in a civil case involving allegations or charges of criminal or fraudulent character, the insistence on proving charges clearly and beyond reasonable doubt was wrong. The SAT relied on its earlier judgment in the case of

[^347]: [2005] 59 SCL 96(SAT). The judgement of SAT is appealed by SEBI in the Supreme Court and is pending final decision.

[^348]: (AIR 1966 SC 1734)
Imperial Corporate Finance and Services Pvt. Ltd., Mumbai v. SEBI, and held that in disputes relating to the securities market, it is not necessary for the respondent to prove the case beyond reasonable doubt. Although they had observed that the degree of proof vary from case to case, the SAT gave the finding that even in a civil dispute, there must be legally sustainable evidence before a person is held guilty of violation of Insider Regulations.

A different criterion, similar to the U.K. approach, was adopted by the SAT in the case of Rajiv B. Gandhi. The SAT held that “if an insider trades or deals in securities of a listed company, it would be presumed that he traded on the basis of the unpublished price sensitive information in his possession unless he establishes to the contrary.” Facts necessary to establish the contrary being especially within the knowledge of the insider, the burden of proving those facts is upon him. The presumption that arises is rebuttable and the onus would be on the insider to show that he did not trade on the basis of the unpublished price sensitive information and that he traded on some other basis. He shall have to furnish some reasonable or plausible explanation of the basis on which he traded. If he can do that, the onus shall stand discharged or else the charge shall stand established.” Therefore, although the SAT had presumed the insider’s mens rea in the act of insider trading, the

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349 Appeal No. 56/2003
350 Appeal No. 50 of 2007 decided by SAT on 9.5.2008
SAT had shifted the burden of proof and imposed the onus of disproving the charge of insider trading upon the defendant.

The SAT followed this in *Dilip Pendse v. SEBI*\(^{351}\). It declined to accept the facts constituting the violation of Insider Regulations as stated by SEBI and upheld the defence raised by the appellant that on the date of alleged insider trading, there was no transaction at all and the records of BSE produced by the appellant in his support, were accepted by the SAT.

Further, in the case of *Dilip Pendse*,\(^ {352}\) it also held that the charge of the insider trading is one of the most serious charges in relation to the securities market and having regard the gravity of this wrong doing, higher must be the preponderance of probability in establishing the same\(^ {353}\); i.e., the charge of insider trading is to be established not beyond reasonable doubt but on the preponderance of probability. The SAT set aside SEBI’s order of stating on the ground that SEBI had failed to establish the charge of insider trading against the appellant with a required degree.

The inconsistency in the SAT’s orders in different cases on the same issue has resulted in confusion. Although India has a significant position in

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\(^{351}\) Appeal no:80/2009 decided on 19.11.2009

\(^{352}\) Dilip Pendse v. SEBI; Appeal no:80/2009 decided on 19.11.2009

\(^{353}\) The SAT relied upon pronouncement made by the Supreme Court of India recorded in (2003) 12 SCC 377 that “It is also a settled principle of criminal jurisprudence that the more serious the offence, the stricter the degree of proof, as a higher degree of assurance is required to convict the accused”
the global markets, it does not have commendable enforcement actions, irrespective of identifying the reasons such as lack of experience, precedents, or investigative machinery. It must be noted that the insiders as a class are not illiterate. The approach followed by the SAT in the Rajiv B. Gandhi Case was logical as well as practical. Unless that approach is followed, charges of insider trading will be difficult to establish.

As direct evidence is almost always absent in cases of insider trading, the higher degree of proof insisted by the courts could pose a problem. The Law Commission in India in its 47th Report has strongly recommended that burden of disproving the mens rea should be placed on the accused in the white collar crimes. 354

Therefore, if we recognize insider trading as a white collar crime and that it is a strict liability offence, then it advances the proposition that the burden of proof should be shifted to the accused which shall be ‘balance of probabilities’ and not ‘beyond reasonable doubt’. Further, the Dhanuka Committee355 also had recommended insertion of a provision to this effect in the SEBI Act.

354 Para 3.20 of the 47th Law Commission Report
355 On 28th February,1997, SEBI had appointed a Committee under the Chairmanship of Justice D.R.Dhanuka, former judge of the High Court of Bombay to examine areas of deficiency in the SEBI Act,1992, SC(R) Act,1956 and the Depositories Act,1996 to suggest the amendments to the provisions of the SEBI Act,1992; SC(R) Act,1956, Depositories Act,1996 with a view to enable SEBI to regulate and develop the securities market and protect the interests of investors and to examine the provisions of the Companies Act,1956 and to
A reference to the 47th Law Commission Report and the Dhanuka Committee Report suggested that a different approach should be followed.

In the draft Securities Bill proposed by the Dhanuka Committee Report, at section 60 & 61, under the title of ‘Presumption of culpable mental state’, the Dhanuka Committee stated as below:

(1) In any proceeding or prosecution for any offence relating to fraudulent and unfair trade practices in respect of the securities market and insider trading under this Act or the Regulations, which requires a culpable mental state on the part of the accused, the Court shall presume the existence of such mental state but it shall be a defence for the accused to prove the fact that he had no such mental state with respect to the act charged as an offence in that prosecution.

Explanation: In this section, "culpable mental state" includes intention, motive, knowledge of a fact and belief in, or reason to believe a fact.

(2) For the purposes of this section, a fact is said to be proved only when the Court believes beyond reasonable doubt and not merely when its existence is established by a preponderance of probability.

make recommendations for amendments in the Companies Act in order to enable SEBI to better regulate issue of capital, listing of securities, transfer of securities and to protect the interests of investors.
(3) The provisions of this section shall, as far as may be, apply in relation to any proceeding before an adjudicating officer as they apply in relating to any prosecution for an offence under this Act.” This is in line with the thinking on corporate liability, reflected in the 47th Law Commission Report which deals with white collar crimes.

5.3 SETTLEMENT OF THE ENFORCEMENT ACTIONS

Most of the SEC enforcement proceedings are settled and not litigated. The SEC has calculated that in each of fiscal years 2004-2006, 98% to 99% of its enforcement cases were “successfully resolved”\(^{356}\), by either obtaining a settlement or a favourable judgement or a default judgement. The incentives to settle the cases as compared to getting into trials are more:

(i) SEC staff resources to go ahead with trial;

(ii) Avoidance of costs in litigation;

(iii) Publicity attendant to a trial;

(iv) Risk of an adverse judgment on the record, etc.

As regards India, the Indian securities market regulator has also formulated a settlement scheme\(^{357}\) in 2007 under Section 15T of the SEBI Act and Section 23A of the Depositories Act, 1995. Further, there is a provision

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for compounding of offences under Section 24A of the SEBI Act, Section 23N of the SCRA and Section 22A of the Depositories Act.

The cases that are settled through the consent orders are said to achieve twin goals of an appropriate sanction and deterrence without resorting to a long drawn litigation before SEBI/Tribunal/Courts. Any person who is notified or who has reasonable ground to believe that a civil or administrative proceeding may, or will be instituted against him/her or any party against whom proceedings have already been initiated can apply for consent.

When a proposal to settle the case is filed by an applicant, the SEBI examines the proposal and refers it to the high powered committee consisting of a retired judge of a High Court and two other external experts. The consent terms finalized by the committee and agreed to by the party are forwarded to the Adjudication Officer for passing a suitable order in line with the consent terms. Further, the SEBI’s circular on consent terms lists certain factors that the committee should consider for consent such as the objective of the respective statute, the interests of investors and securities market, and other factors.\(^\text{358}\)

Passing of consent orders are also stated to be reducing the regulatory costs and saving time and efforts in pursuing the enforcement actions. In its

\(^{358}\) Point no:11 in the circular.
annual report for 2009-2010, against 680 applications received for consent, 359 is stated to have been disposed of and 333 as rejected. For 2008-2009, against 692\(^{359}\) applications, 440 applications were settled by passing consent orders.

Although time and again there have been inconsistencies in the interpretations of statutory provisions and the degree of proof and the position as to the burden of proof has weakened the enforcement process, the sanctions and the enforcement regime in India still appear to be strong. However, detection of the instances of insider trading has to be given primary focus.

\(^{359}\)This includes the figure for applications for compounding also.