CHAPTER 7

CONCLUSION

As discussed in the previous chapters, although different jurisdictions have framed adequate laws and regulations to regulate insider trading, the key challenge has been that of the effective enforcement of the laws and regulations. Notwithstanding the fact that the legislations have been modified from time to time to address various situations in the dynamic markets, and that the judiciary, the regulators, the business community, the academic experts, the enforcement agencies and the media have been continuously monitoring the efficacy of the legal framework and have been suggesting appropriate modifications from time to time, there is no complete solution to prohibit insider trading. Although the Indian law on insider trading is relatively new compared to the developed markets and has adopted various features from the time and tested legal framework in other countries, India is no exception as regards the enforcement challenges.

In this backdrop, to assess the robustness of India’s insider trading enforcement regime, one should analyse the adequacy of India's insider trading laws, the history of enforcement, the regulator's approach and the deterrent or remedial impact created in the market. Further, an analysis of the key enforcement mechanisms in other jurisdictions would assist in
understanding whether India should incorporate any of those principles or experiences into the Indian enforcement mechanism.

In India, the insider trading regulatory mechanism consists of the following:

The SEBI Act read with the Insider Regulations prohibits an insider from dealing in securities while in possession of the unpublished price-sensitive information (Section 12A of the SEBI Act and Regulations 3 and 4 of the Insider Regulations). The Insider Regulations provides an exhaustive definition of the terms ‘insider’, and ‘unpublished price sensitive information’.

As regards enforcement, the SEBI Act and the Insider Regulations prescribe civil remedies such as, cease and desist orders, debarment of violators, monetary penalties, directions to transfer the securities or pay equivalent amount to the investor protection funds of the stock exchanges, and criminal prosecution. Additionally, the introduction of the settlement scheme (plea bargaining) under which the violators would pay to the SEBI a mutually agreed upon amount depending upon the gravity of the offence and the estimated profit or loss arising out of a transaction, also contributes to the Indian enforcement mechanism.
The foregoing features of the Indian regulatory regime are similar and comparable to those in the U.S. and the U.K. from the adequacy standpoint.

As discussed in chapter 4, the U.S. insider trading regulatory mechanism comprises of the anti-fraud rule under the Rule 10 b-5, Rule 14 e-3 (for prohibition of insider trading during tender offers) and the short swing profits regulation under Section 16(b) of the Exchange Act. Civil sanctions such as injunctions, disgorgement, monetary penalties up to three times the profits made (or losses avoided) as a result of the insider trading, debarment orders, cease and desist orders and criminal sanctions resulting in imprisonment up to twenty (20) years and fine, order of accountings, disgorgement of ill-gotten gains, suspension or revocation of the securities licenses, etc.

Further, the UK regulates insider trading through a specific criminal prosecution provision under the Section 52 of the CJA 1993 and the market abuse prohibition provisions under Section 118 of the FSMA. U.K. also has similar powers for enforcement such as injunctions, restitution of profits, monetary penalties, and criminal prosecution.

Therefore, it can be concluded from the comparative analysis that India has adequate legislation and regulatory mechanism, comparable to those of the U.S. and the U.K., which are regarded as the most sophisticated and
experienced insider trading enforcement regimes. However, while reviewing
India's experience in enforcement of insider trading regulations, a key factor
that gets highlighted is that India did not have many cases of successful
enforcement or precedents that have created deterrent value in the market.
Further, considering that India is one of the fast-growing markets, there is the
likelihood that India may also have several instances of insider trading
activities, as is the case in other countries. Notwithstanding, the absence of
many such reported cases provokes a market observer to believe that either the
regulatory infrastructure is extremely efficient that it does not permit the
prohibited categories of insider trading or that the surveillance or enforcement
mechanism may have some deficiencies which result in the insider trading
activities remaining unnoticed.

In this backdrop, a critical approach to the effectiveness of the Indian
regulatory regime reveals certain issues that require careful consideration and
modifications.

1. At the outset, India does not have one specific statute governing insider
trading. Section 12A of the SEBI Act prohibits insider trading, without
defining the term ‘insider trading’. Detailed provisions under the SEBI
Act and the various regulations under the SEBI Act, including the
Insider Regulations either prohibit insider trading or provide for the
enforcement mechanism in respect of the offence of insider trading. As
these are covered under multiple laws, the provisions under different legislations have to be reviewed and compared and the lack uniformity in various statutes in their approach to insider trading creates significant interpretational difficulties. For instance, there are redundant provisions under the Buy-Back Regulations which should have been removed, but they still exist. Further, the provisions under the Merchant Banker Regulations must be aligned with Section 12A of the SEBI Act. Detailed discussions in this regard are included in chapter 4 of this study.

2. The definition of ‘insider’ under Regulation 2(e) of the Insider Regulations is very complex. Under the definition of ‘insider’, the SEBI is required to prove that an individual is an ‘insider’, inter alia, if he is a ‘person connected to the company’ or ‘deemed to be connected’ which terms are defined under the other provisions of the Insider Regulations. Further, the definitions of ‘person connected to the company’ or ‘deemed to be connected’ are again typical and include multiple categories of persons who can be regarded as insiders. Furthermore, the SAT and the courts have also faced difficulties in interpreting this complex definition. Although this was partly resolved by the amendment to the Insider Regulations in 2008, whereby any person in possession of the UPSI has been made an insider, this wide scope for the definition of ‘insiders’ could impede the effective
enforcement as the courts may not uphold the mere possession factor for determining who is an insider. Therefore, to simplify the procedure to establish that a person is an insider, the definition of “insider” may be done away with and simultaneously, the prohibition on insider trading under Regulation 3 may be rephrased in lines with Section 12A of the SEBI Act, i.e., the clause may begin with the words “No person shall…” instead of “No insider shall…” Further, as in the U.S. and the U.K., the 'knowing possession' standards for UPSI may be adopted.

3. Neither the appellate bodies nor the courts have the patience to weed out the unwanted problems posed by the definitions in the existing legislation, irrespective of the whether the problems are minor or significant. However, this is a required step as any ambiguity in definitions can undermine the fundamental principle of justice that even if all the guilty are let go, not a single innocent should be punished. An instance of a minor issue is that the Regulation 5 talks about powers of SEBI to investigate an insider or any person referred to under Section 11(1)(i) of the SEBI Act. However, Section 11(1)(i) does not refer to any category of persons and instead Section 11 (2)(i) include category of persons. Therefore, the reference to Section 11(1)(i) appears to be a typographical error and should have been removed as soon as this was identified. Although an error may be
small and inadvertent, it causes lack of clarity which is most important in any law.

4. Another issue is that in the definition of the ‘connected person’, the UPSI that is required to be in a person’s possession is required to be in “relation to the company” under Regulation 2(c), whereas the definition of “insider” under Regulation 2(e), refers to the UPSI “in relation to the securities of the company.” The UPSI, “in relation to the company” and that “of the securities of the company” could be different, although there may be converging factors. Therefore, the definitions must be harmonized to avoid the discrepancies and ambiguities.

5. The Regulation 3A of the Insider Regulations provide that “no company” shall deal in the securities of another company or associate of that other company while in possession of UPSI. Regulation 4 provides that “any insider” who deals in securities in contravention of the provisions of Regulation 3 or 3A shall be guilty of insider trading. The rationale for using the term ‘no company’ in Regulation 3A and ‘no insider’ in Regulation 4 is unclear. Although under Regulation 3A, the company does not require to be an insider, Regulation 4 demands that a company must be an insider. This is contradictory and vague. Therefore, Regulation 4 may be amended and the term ‘no person’
may be used instead of ‘no insider as this will provide consistency and would also ease the burden of proof for SEBI.

6. The definition of “price-sensitive information” under Regulation 2(ha) does not include the information, relating to change in top management or the board of directors, etc., of the company as price-sensitive information. However, this information may be material information in some cases and may also affect the price of the securities. Therefore, this category of information may be included as a specific category of price-sensitive information.

7. The reference to Section 2 of the MRTP Act, 1969 under Section 2(h)(i) is redundant as the MRTP Act, 1969 has been repealed.

8. The defenses for Insider Regulations violations under the Regulation 3B are only available to the companies and not to the individuals and other entities in the securities market if they do not have the legal framework of that of the company. There does not appear to be any cogent reason for such omission. Therefore, similar to the U.S., the defenses should also be available for individuals and other entities relating to the securities market.
9. The disclosure obligations on the companies and the persons relating to
the company are considered as the most effective preventive
mechanism for the offence of insider trading. However, the sanctions
or the penalties imposed for improper disclosures or failure to disclose
the information are minimal such as lower monetary penalties. These
sanctions are not sufficient to provide the required deterrence.

Additionally, there are certain specific reasons for the failure or the
lack of enforcement in insider trading cases. Some of these reasons are
analyzed below.

a. One of the reasons for unsuccessful enforcement could be the
ambiguity in the principle on which the law relating to insider trading
is founded. One can look at the ‘securities law violation’ as either a
‘fraud’ on the investors or as ‘violation of fiduciary duty’ owed to the
source of the UPSI. In India, heavy reliance is placed by the Indian
regulator on the existence of ‘fiduciary duty’ theory. If the fraudulent
activity underlying the insider trading has to be prohibited, the fraud
theory must be adopted treating insider trading as a fraud like in the
U.S. Otherwise, if the intent is only to restrain all insiders from trading
on the basis of UPSI, the theory of fiduciary approach is more than
sufficient.
Another reason is that there exists lack of clarity as to whether the violation of the Insider Regulations is criminal in nature. This must be clarified to ascertain the nature of the violation and accordingly, prescribe the regulatory and enforcement mechanisms to prevent the offences of insider trading. There is no conclusive view of the SEBI or of the Indian courts on whether the violation of the SEBI Regulations in general is of civil or criminal nature. In the case of *Rakesh Agarwal v. SEBI*\(^{367}\), the SAT has observed that *mens rea* is an important ingredient of the criminal cases and that the same is absent in the facts before the SAT. Therefore, it may interpreted that the SAT proceeded on the premise that insider trading is a criminal offence. However, in the case of *Cabot International v. SEBI*\(^{368}\), the Bombay High Court had given the finding that all violations of the SEBI Act, and the rules and regulations made thereunder are civil in nature. This observation has been referred by the Supreme Court when it decided that the imposition of the monetary penalties under Chapter VI A of the SEBI Act do not require *mens rea* in *Shriram Mutual Fund & Anr Case*\(^{369}\). Therefore, there is inconsistency in the opinions and until date there is no conclusive ruling on whether the offence of insider trading is a civil or a criminal offence. Both in U.S. and U.K. *mens rea* is considered as necessary ingredient for the offense of insider trading although the

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\(^{367}\) Rakesh Agarwal v. SEBI, 2004 49 SCL 351 SAT

\(^{368}\) Cabot International v. SEBI, SAT order dated 1 January 2001 in the Appeal no. 24/2000

burden of proof is shifted to the defendant to prove that he had a different intention to undertake the trades, i.e., there was a pre-arranged plan, there was genuine need for money, etc. Although the SAT adopted the similar approach specifically for insider trading offence in the case of Rajiv B Gandhi\textsuperscript{370}, such an approach also needs a statutory validation for effective enforcement.

c. Another issue is the nature of evidence required in the insider trading cases, whether it should be of beyond reasonable doubt or on the preponderance of probabilities. Generally, it is difficult to collate direct or documentary evidences for the offence of insider trading. Therefore, the evidences obtained are weak and circumstantial in nature. Consequently, the investigations in such cases are difficult as isolating trades based on private information is difficult.\textsuperscript{371} Thus, the standards of ‘preponderance of probabilities’ is justified and may be relied on in all cases of insider trading.

d. Based on the U.S. experience, it is noted that the regulator’s power to direct disgorgement of profits or to compensate the affected investors creates a deterrent effect. The existing legal consequences of insider trading violation are insufficient to discourage the potential offenders.

\textsuperscript{370} Rajiv B. Gandhi v. SEBI, Appeal No. 50 of 2007 decided by SAT on 9.5.2008
\textsuperscript{371} Manish Agarwal & Harminder Singh; Merger Announcements and Insider Trading Activity in India: An Empirical Investigation (NSE Research Initiative, Paper No:8)(www.nseindia.com)
This is because the SEBI does not have a clear cut provision for disgorgement. The SEBI is empowered to direct depositing the cost of the securities or the proceeds of the transaction with the investor protection fund of the stock exchanges under Regulation 11 of the Insider Regulations. This power, however, cannot be equated with disgorgement, although it constitutes an effective remedial measure in certain cases. The power to direct the disgorgement, a power to affect the property of any person or entity must be derived from the statute and not from a delegated legislation such as the Insider Regulations. In this regard, the SEBI had invoked its powers under Section 11B to disgorge the profits and the SAT has upheld this power also recently. However, it is not subjected to the scrutiny of the higher courts in the country and a specific provision under the SEBI Act is most desirable.

e. The regulatory framework in India should treat insider trading as a grave white collar crime and insert provisions in the SEBI Act itself prescribing this as a crime, followed by the consequence of imprisonment. Currently, there is no separate provision for penal consequences for the offence of insider trading. Section 24 of the SEBI Act provides for criminal prosecution if any person contravenes any of the provisions of the Act or rules or regulation made under the Act and could result in a punishment up to an imprisonment of ten (10) years with or without fine which may extend to Rs.20 crores. This provision
for criminal prosecution is not specific to the enforcement of insider trading laws alone.

f. Currently, Section 26 of the SEBI Act provides that no court shall take cognizance of any offence punishable under the SEBI Act or the rules or regulations made thereunder, except on a complaint filed by SEBI. The FIRE Report\textsuperscript{372} has observed that expanded private rights of action and class action overseen by easily accessible and quickly responsive courts are needed to protect investors and enforce the securities laws. Indian investors reportedly do not have the ability to bring a meaningful private action or class action for violation of securities laws. Therefore, the SEBI Act must incorporate provisions permitting private actions.

g. In the U.S., the system of ‘consent decrees’ are also said to be an effective deterrent, which punishes the defendant without imposing the higher burden of proof on the regulator. Hiren.B. Mistry\textsuperscript{373} says that this system cannot be made applicable in the U.K. as the social attitudes are more moralistic and guilt will have to be attributed. The process of ‘consent orders’ originated in India in 2007. However, the

\textsuperscript{372} Report prepared in pursuance of the Indo-USAID programme on Financial Institutions Reform and Expansion (FIRE)

\textsuperscript{373} Hiren.B.Mistry, Battle of the Regulator. Is the U.S.System of Securities Regulation better provided for than that which operates in the United Kingdom, Journal of International Financial Markets, (2002), at page 141
percentage of success is yet to be ascertained as a comparative study has not been carried out as yet with the previous regime or with the other jurisdictions.

h. In India, insider trading thrives during mergers and acquisitions. In the U.S., the Rule 14e-3 relating to insider trading during tender offers exists with certain exceptions. This provision prohibits any person who is in possession of material non-public information relating to the commencement of a tender offer, directly or indirectly from either the bidder or the target company, from trading in target company securities. Under this provision, a blanket ban exists and there is no need to prove the requirement of fiduciary duty. There are also exceptions to this rule. One such exception is available to purchases by a broker or by another agent on behalf of an offering person. Again at sub-clause (2), sales by any person to the offering person are excluded from the ‘abstain or disclose’ proscription. This means that a person who gets information from the bidder and then sells the shares to the bidder at a price above the market price does not violate the rule. If the provision similar to Rule 14e-3 existed in India, Rakesh Agarwal would have been automatically exempted from the violation of insider trading. Considering the fact that season of mergers are fertile land for

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374 Donald C. Langevoort, *Insider Trading: Regulation, Enforcement, and Prevention* § 7.03 (Vol 18, CBC Securities Law Series)
the offence of insider trading, we need a prohibition similar to that in the Rule 14e-3 in the U.S with its exceptions, so that there can be a focus on the trades during such period, that too for the right cases.

In reality, a lot of insider trading cases go undetected because a person who is in possession of the UPSI transfers shares (as a buy or sell transaction) to his family, as off-market deals and are not carried out on the stock exchanges. These instances are difficult to curb, although the Insider Regulations mandate that a person in possession of the UPSI cannot trade in the company’s securities.

Although Indian law on insider trading has been tested in very few cases, each time, when the law on insider trading or the SEBI’s approach has been scrutinized by the courts, it has resulted in the amendment of the Regulations.

Enforcement is one of the most formidable challenges that the Indian regulator face. To investigate the cases involving insider trading, it is important that sophisticated modes be deployed to detect the violation, carry out investigation and collate the evidences. The difficulty in cases of insider trading is that the underlying act of buying and selling securities is a legitimate activity. It is the nature of information and the kind of people that make this legal activity a prohibited act of insider trading. Piecing together an insider
trading case is a complex process. Many insider trading cases involve secret communications between two people, the tipper and the tippee and assembling compelling circumstantial evidence is a task.

To detect such activities and for evidentiary purposes, wire tapping will have to be carried out. Wire tapping is regulated under Section 5(2) of the Indian Telegraph Act, 1885, which allows the central and state government or any officer authorized by such governments to direct any message relating to any subject to be detained or intercepted or stopped from transmission, if it is satisfied that it is necessary for preventing an incitement to the commission of the offence. In *PUCL v. Union of India*, the Supreme Court held that telephone tapping is a ‘serious invasion of an individual’s privacy’ and that an order for a tap can be issued only by senior government personnel such as the Union Home Secretary or his counterparts in the states.

A further method for tracking insider trading is by accessing the data or information of any suspect in such insider trading cases. Section 69 of the Information Technology Act, 2000, allows the Central or the state government to intercept, monitor, decrypt any information generated, received transmitted or stored in any computer resource if it is satisfied that it is expedient to do so for the investigation of any offence. Similar to the system in the U.S., in India also, the SROs, mainly the exchanges monitor the markets for unusual peaks.

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375 *PUCL v. Union of India* (1997) 1 SCC 301
and valleys in trading, sudden changes in a security’s price or other unusual market activity. The Surveillance Department of SEBI monitors the market movements and detects potential breach of the SEBI Act or regulations, analyzing the trading in securities and initiate appropriate action when required. SEBI also has a comprehensive IMSS (Integrated Market Surveillance System), which generates alerts arising out of unusual market movements.

Therefore, a suggested way forward for the increased efficiency of the Indian system would be to adopt certain statutory and other changes to achieve the key goals of the Insider Regulations and to improve the enforcement scenario.

Ideal goals for a securities market regulator shall be maintenance of market confidence, promotion of awareness amongst public about the financial system, provide maximum protection for investors and reducing financial crimes.

Price of any product, whether in the stocks or of the consumer products should reflect the supply and demand, based on best possible information available to all in the market. When certain people having informational advantage engage in the criminal activity misusing such information, the normal skills and judgment on the best price will be hidden by such criminal
activity. Suspicious price movements prior to takeover announcements are global phenomena.

Effective deterrence means two things: (i) ensuring that people fear being caught, which can be done through efficient surveillance and intelligence mechanism, (ii) that people fear the consequences of being prosecuted. Identifying potential instances of insider trading is a challenging task. Regulators across the world also recognize that pursuing insider trading cases is challenging. There are no smoking guns. The transactions are complex and not jury friendly. The principle of unjust enrichment as the basis for liability in the instances of insider trading demonstrate that securities regulation is not solely concerned with the economic value of market efficiency, but also is significantly influenced by public values.

Powers conferred under the SEBI Act and the Insider Regulations are limited to investigating an insider and also the categories of persons mentioned in the Section 11(2)(i) of the SEBI Act. Thus, SEBI cannot investigate upon any person in relation to ‘insider trading.’

It must be noted that although the U.S. and the U.K. enforcement regime are perceived to be more efficient, they also had faced a variety of issues similar to what India had faced. The major issues in the U.S. enforcement regime were that the controversy regarding possession v. use of
inside information continued for a long time in the 1980s in the U.S. Thereafter, the introduction of Rule 10b-5-1 setting the ‘knowing possession’ standard in the insider trading cases in 2000 increased the efficiency in the U.S. system. Increased sanctions such as higher penalties and longer terms of imprisonment under the ITSA and ITSFEA in 1984 and 1988 respectively, also enhanced their efficiency. SOX, with an imprisonment term for twenty (20) years for financial frauds, thus strengthened the enforcement capabilities of the U.S. regulator.

As the pedigree of successful and effective enforcement of the regulations in an extremely dynamic and complex market counts much more than a theoretical legislative or regulatory framework, emerging economies such as India has a lot to learn from the U.S. experience. Considering the exponential growth of the Indian securities market and its exposure to the U.S. and other global economies, which also exposes India to the complex challenges existing in those countries, it is essential that India must focus on establishing a more efficient enforcement regime such as that of the U.S., as opposed to introducing or elaborating the legislations.
American Court Systems Flow Chart

Top Level: Courts of Last Resort on Appeal

**U.S. Supreme Court**
The U. S. Supreme Court is free to accept or reject the cases it will hear. It must, however, hear certain rare mandatory appeals and cases within its original jurisdiction as specified by the Constitution.

**State Supreme Courts of Appeal**
Called the State Supreme Court in almost all states. It’s the final court of appeal for all but a small number of state cases. If a case involves a right protected by the U.S. Constitution, a party may appeal to the U.S. Circuit Court of Appeals.

**Intermediate Courts of Appeal**

**State Intermediate Courts of Appeal**
40 states have ICAs. These courts are the first court of appeals for most state cases. (In Iowa, this is the Court of Appeals.) In 10 states the state Supreme Court is the only court of appeals.

**U. S. Circuit Courts of Appeal**
There are 12 of these courts. Each state and U.S. District Court is in one of the 12 circuits. Each court reviews cases from the U. S. District Courts in its Circuit. Appeals go to the U.S. Supreme Court.

**U. S. Court of Appeals for the Federal Circuit**
This court reviews civil appeals dealing with minor claims against the U.S. government; appeals in patent-right cases and cases involving international trade disputes.

Base Level: Trial Courts

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1 http://facstaff.uww.edu/reidl/American_Courts_System_Diagram.htm
State Trial Courts
Almost all cases involving state civil and criminal laws are initially filed in state or local trial courts. They are typically called Municipal, County, District, Circuit, or Superior Courts. In Iowa, they are called “District Courts;” there is one in each county. [See a diagram of the Iowa court system]

Appeals from the state trial court usually go to the state intermediate court of appeals.

About 95% of all court cases in the U.S. come through the state trial courts.

U. S. District Courts
There are 94 federal district courts, which handle criminal and civil cases involving:
1. Federal statutes
2. The U.S. constitution
3. Civil cases between citizens from different states and the amount of money at stake is more than $75,000 (This is the most common type of case in the U.S. District Court.)

Most appeals from here go to the U.S. Circuit Court of Appeals; some go to the U.S. Court of Appeals for the Federal Circuit.

U. S. Court of International Trade
Specializes in cases that involve international trade. Appeals go to the US Court of Appeals for the Federal Circuit (CAFC)

U. S. Claims Court
For federal cases involving amounts over $10,000, conflicts from Indian Claims Commission and cases involving some government contractors. Appeals go to the CAFC.