Chapter 5

Problems of Insider Trading in the event of Mergers & Acquisitions (M&As)

5.1 Introduction

Last two chapters have examined the complexities of insider trading through Indian and foreign case studies. We have found number of insider trading cases in the event of mergers and acquisitions (M&As). In good number of cases alleged company officials charged with insider trading activities were convicted of violations of insider trading regulations\(^1\). Each of the major case provided information that led to the subsequent conviction of other violators. Illegal insider trading costs millions of dollars a year by inflating the cost of M&As\(^2\). During 1974, insider trading has been found to be costly for the bidding companies when insiders increased the stock price of the company being acquired before the announcement. Buyers have paid 30% higher premium for the company on an average than they otherwise would have\(^3\).

In the era of fierce competition no corporate entity can ensure its own survival and growth without having a strong base in respect of capital resources, technology, market and management. Changing technology and socio-economic environment has made it quite impossible for each and every company to acquire adequate strength in the aforesaid aspects through its own efforts only. Therefore, co-operation among each other is the only way out. Merger is an important form of co-operation in which the participant companies lose their identities and become one entity whose ability in terms of capital, technology, market and management is greater than the sum of the abilities of the companies being merged. This synergic effect of merger boosts up the growth potential of the
corporate bodies and their intrinsic values increase significantly. That is why almost every corporate merger is cordially welcome by the general investors.

M&As process begins when the management of one firm contacts the company's management often through the investment bankers of each firm. The management of the firms keep the respective boards of directors up to date on the progress of the negotiations because mergers in most of the cases require the board’s approval. Sometimes this process works smoothly and leads to a quicker merger agreement. Except the hostile transactions, mergers usually are the product of a negotiation process between the management of the merging companies.

At the time of merger or an acquisition of the transaction communication has to be made effectively so that rumours do not become the main source of information to the stakeholders. Before the public announcement of M&As is made, negotiators should prepare a communication plan. The messages should be conveyed to all the stakeholders who are most effected by any change. All stakeholders should be made aware of the realistic limits and goals so that they are prepared to face any worst scenario. Potential changes must be explained honestly and precisely so that they may understand why M&As deal is at all being made. M&As announcements are to be made through various channels. Internal communications should be made through newsletter, videotapes, internal memos and specifically face-to-face interaction. All external communications in the press releases should be co-ordinated with the public relations department.

A communication plan during an integration effort typically consists of four phases. In the first phase M&As deal is announced to everybody. In the second phase, various issues that may arise during the integration process are identified. These issues would arise from all the stakeholders who would like to know what the prevailing rumours are and what the employees find most confusing. In the third phase the rollout occurs where communication should include information about the proposed changes. In the final stage feedback is
obtained and the implementation of the integration plan is fine tuned wherever warranted.

Generally it is found that when the information of a mega-merger (i.e. a merger of a company with a giant company or a merger of a two mini-giant companies into a giant company) is made public, a buying spree grows among the common investors which leads to a surge in the prices and trading volumes of the stocks of the merging companies.

Such price behaviour is well familiar to Indian stock exchanges after a mega merger is announced. But increase in prices and trading volumes of such shares well before the formal announcement of a mega-merger is an overwhelming experience which the stock markets of the country have experienced of late in a number of cases. Some major instances may be cited below to highlight the nature of the same.

(i) Amalgamation of Reliance Polypropylene Ltd. (RPPL) and Reliance Polyethylene Ltd. (RPEL) with Reliance Industries Ltd. (RIL) [November, 1994]: The share price of RPPL and RPEL moved up dramatically from the Rs.35 to Rs.100 before their amalgamation with the parent RIL.

(ii) Merger of Ciba-Geigy and Sandoz [March, 1996]: On 6.3.1996 the trading volumes on the counter of Hind Ciba-Geigy, the Indian subsidiary of Ciba-Geigy, touched the peak of 2045 shares with its daily average trading bring 10 shares to 270 shares.

If such abrupt reaction of stock markets before the information of impending merger is made public, it may give rise to a number of issues:

- Who are responsible for such flare-up in scrip prices before merger news is announced?
- What are the motives behind it?
- Is it harmful to the interest of common shareholders?
• How can such illicit trading be curbed?

In view of the above, this chapter has been arranged in the following sequence. Section 5.2 deals with the types of M&As. Section 5.3 deals with different ways in which insider trading takes place in the event of M&As. Section 5.4 deals with legal provisions to combat insider trading problems in the event of M&As. Next two sections i.e. section 5.5 and section 5.6 deal with case studies on M&As- India and the USA. Section 5.7 concludes the chapter.

5.2 Types of Mergers and Acquisitions

Business combinations may take shape of any legal forms. For the purpose of clarity let us name companies as A, B, and C. In one form, A acquires B’s assets and liabilities through direct negotiations with management. Here B is liquidated after distributing the assets or securities received from A to its shareholders. A survives and carries on the combined business. In another form both A and B companies are dissolved and their combined assets and liabilities are transferred to a newly created company C. The new company carries on the combined business. In the third form A acquires controlling interest in another company either through the acquisition of a majority of voting shares or otherwise. Both the companies continue to operate as separate but related legal entities. The relationship between them is referred to as a holding-subsidiary relationship. If A controls B, then A is holding and B is subsidiary company.

One special type of business acquisition is called reverse acquisition. Occasionally an enterprise obtains ownership of the shares of another enterprise as a part of exchange transaction. It issues enough voting shares as purchase consideration resulting into passing of control in the combined enterprise to the owner of the enterprise whose shares have been acquired. In substance the entity issuing shares has been acquired by another entity. This situation is described as reverse acquisition7.
Merger is defined as a combination of two or more companies into a single company. A merger is a combination of two companies in which only one company survives and merged company goes out of existence. A merger can take place either as an amalgamation or absorption. Amalgamation means fusion of two or more companies. After the amalgamation two companies lose their individual identities and a new company comes into existence. The merger of Brooke Bond India Ltd. (BBIL) with Lipton India Ltd. (LIL) resulted in the formation of a new company Brooke Bond Lipton India Ltd. (BBLIL). Absorption involves takeover of a small company with a large company. After the absorption the smaller company ceases to exist. The absorption of Oriental Bank of Commerce with Global Trust Bank (GTB), GTB ceased to exist while Oriental Bank of Commerce expanded and continued. Mergers can also be categorised as horizontal, vertical and conglomerate. A horizontal merger occurs when two competitors combine. If a horizontal merger causes the combined firm to experience an increase in market power then it will have anti-competitive effects. Vertical mergers are combinations that have a buyer-seller relationship. A conglomerate merger occurs when the companies are not competitors and do not have a buyer-seller relationship.

The Companies Act 1956 deals with mergers under the head ‘amalgamation’ and sets out the procedural requirement for the same. Apart from an amalgamation of Indian companies, the Companies Act also envisages amalgamation between an Indian company and an ‘unregistered company’ which may include a foreign company or a branch of a foreign company. Amalgamation in India has to be sanctioned by the High Courts of the respective States in which the registered offices of the companies are situated.

Section 2(1B) of the Income Tax Act, 1961 deals with amalgamation. It deals with the merger of one or more companies with another company or the merger of two or more companies to form one company. Those companies have been amalgamated with other company called amalgamated company and the
other company is called amalgamating company. Shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company by virtue of amalgamation.

The following stages of amalgamation are being followed in India:

- A draft scheme of amalgamation has to be prepared including details regarding the valuation of the shares of the respective companies and establishing a method by which to arrive at the swap ratio\(^9\).
- The scheme is required to be approved by the board of directors of the respective companies.
- An application is required to be made to the respective High Courts seeking direction to convene meetings of the shareholders and creditors to obtain their consent. The scheme would have to be approved by a majority in number representing 75\% in value of the shareholders (special resolution) and creditors present and voting at such meetings.
- A petition thereafter has to be filed with the respective High Courts seeking approval of the scheme.
- The views of the Regional Director of the Department of Corporate Affairs and in the case of the Transferor Company, the views of the official liquidator are also ascertained prior to the sanction of the scheme by the High Courts.

Acquiring competitive strength through corporate restructuring has been increased manifold particularly after globalisation and liberalisation movement where regulations within and across borders have become less stringent. Technology, finance and human capital have started moving across borders with fewer hassles. This free movement brings in competition. In order to face enhanced competition more and more companies are going for different forms of strategic alliances. A company may go for restructuring due to a number of reasons such as providing better service to customers, creditors, bankers and
stakeholders. Restructuring or strategic alliances are also arranged to capture greater market share, technological or tax advantages, setting off prior losses, having good brands or brand images. There are many ways in which corporate restructuring may take place viz., amalgamation, absorption, holding-subsidiary relationship, merger or demerger, tender offers, takeover defences, leveraged buyout, employees stock options plans (ESOP) etc.

M&As have assumed a significant characteristics among other form of corporate restructuring. M&As represent a change in the management of public companies often through a change in the ownership of the company. In M&As various management teams compete for the right to control the decision-making within the target firms. It is a complicated strategic decision that involves legal compliance of corporate legislation such as company law, securities law or income tax law. Compliance of accounting standards is also applicable in the specific situation. But only a small numbers of top managers and their advisors make M&As decisions. M&As creates significant new wealth for the shareholders of the target company and in most of the cases this M&As deal is taken care of by highly paid company lawyers and investment bankers.

Consequent upon the adoption of liberalisation policy in Indian economy, a merger-cult is witnessed among the corporate entities. Many giant corporate houses in their thrust to become stronger in terms of investment, technology, market and global competitiveness show a growing inclination towards adopting the courses of M&As.

5.3 Insider trading in the event of M&As

Most of the decisions on M&As are taken in the Board Room and actual implementation involves a series of steps. The moment when decision about M&As are taken, the information becomes available to a select few who trade companies’ shares on the basis of information, which does not become available to the common investors at that same point of time. But the result of their trading
creates havoc in the securities market that results into losses of millions of common investors simply due to the fact that information about M&As is not accessible to them at same point of time when the same piece of information is available to the insiders who have acted upon them either to save their losses or to book profit.

The decision of a merger involves participation of a number of outsiders from the stage of its very inception. Before deciding a merger scheme, the companies need to obtain legal advices of its solicitors, recommendations in respect of swap ratio from the merchant bankers, audit reports on the financial statements from the auditors and so on. Therefore, there is a great chance of the information on ensuing merger being leaked by any one or more of the said outsiders. The junk bond market was largely a creation of Michael Milken who ran the High Yield Convertible Bond Department at Drexel Lambert from his Beverly Hills office. He disseminated confidential information and helped clients to conceal ownership of large blocks of stock. Insiders must be able to accumulate majority stock positions. Arbitrageurs and off-exchange traders can create the necessary market swings that promote accumulation. Arbitrageurs try to make profit from the difference between the market price and the offer price for the stocks of companies involved in mergers, acquisitions and restructuring. They purchase the shares of the suspected takeover company and wait until the takeover is announced. When the public announcement is made, the share price goes up and the arbitrageur sells at a substantial profit.

The existing regulations are too helpless to identify the sources of the leaks arising particularly under the present system. Neither the stock exchanges nor the SEBI keep any constant watch over the investment activities of the insiders and the employees of the outside bodies connected with the mergers who are so vast in numbers and widely dispersed. It is suspected that the corporate insiders (i.e. managers, officers, employees and other persons having professional or business relationship with the companies who possess inside information by dint of their
Knowing it very well that the share price is highly sensitive to information on merger and an insider who comes to know about the impending merger proposal may be tempted to trade in the shares of the concerned companies just when the proposal was being mooted by the top management of the companies. He buys a large quantity of such shares at a low price well before the merger announcement is made either in his own name or in the names of his friends and family members. After capturing a big lot of shares he leaks the information in order to manipulate the price in his favour. With the information being spread over the market through brokers and media reports more and more common investors rush to the market to buy same shares. Simply out of demand supply interaction share price starts moving up and touches its peak level on the date of merger announcement. This is the desired moment for which the insider waits. He now begins to offload all the shares at the highest possible price in order to make a substantial amount of short-term capital gain.

In fact, this is sort of price-rigging which enables investors to capitalise the common investors’ ignorance about the impending mergers to make a high profit. The unloading of the shares by the insider causes its price to fall sharply instead of rising further. The sudden fall in price results in an unexpected loss to the unfortunate small shareholders who have just bought the shares at a higher price.

This practice amounts to a despicable betrayal of the fiduciary obligations of the insiders towards the shareholders of their companies in respect of the safeguarding in the latter’s interest. If this type of trading occurs in the market, the ordinary investors would lose their faith upon it and shy away from investing through it. In view of the awful perils of the insider trading relating to mergers, the legislative framework of the country should be strict enough to curb it. But, so far, the role of the SEBI is not satisfactory at all in the matter of the remedy of this malady.
Although we have already made an attempt in chapter-2, to identify who
the insiders are, it is imperative, once again to characterize insiders in the event of
M&As. True insiders are those who have intimate knowledge of firm specific or
transaction specific information. The other extreme is a person who knows fully
what he or she reads in the newspapers or learns from the media. Exhibit 5.1
suggests a cast of players associated with M&As.

**Exhibit 5.1: Participants in securities trading in the event of takeovers**

<table>
<thead>
<tr>
<th>I. Corporations (Bidders and Targets)</th>
<th>II. Investment bankers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Top executives</td>
<td>• Top executives</td>
</tr>
<tr>
<td>• Board of directors</td>
<td>• Arbitrage departments</td>
</tr>
<tr>
<td>• Secretaries</td>
<td>• Research analysts</td>
</tr>
<tr>
<td></td>
<td>• Secretaries</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>III. Law firms</th>
<th>IV. Banks and other lenders</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lawyers assigned to cases</td>
<td>• Executives who participate</td>
</tr>
<tr>
<td>• Associates with whom they</td>
<td>in the transactions</td>
</tr>
<tr>
<td>discuss cases</td>
<td>• Secretaries</td>
</tr>
<tr>
<td>• Secretaries</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>V. Financial intermediaries</th>
<th>VI. Other intermediaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Independent arbitrage firms</td>
<td>• Journalists</td>
</tr>
<tr>
<td>• Brokers</td>
<td>• Proxy solicitors</td>
</tr>
<tr>
<td>• Dealers</td>
<td>• Printing firms</td>
</tr>
<tr>
<td>• Security analysts</td>
<td></td>
</tr>
<tr>
<td>• Market makers</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>VII. Institutional investors</th>
<th>VIII. Individual investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Insurance companies</td>
<td>• Active analysts</td>
</tr>
<tr>
<td>• Investment companies</td>
<td>• Receives public information only</td>
</tr>
<tr>
<td>• Trust departments of banks</td>
<td></td>
</tr>
<tr>
<td>• Pension funds</td>
<td></td>
</tr>
</tbody>
</table>

From exhibit 5.1, eight categories of participants have been recognised. The
traditional investors are the top executives or the member of the board of directors
of companies. They are presumed to have the opportunity of learning information
about a company before anybody else.
5.4 Legal provisions to combat insider trading problems in the event of M&As

The purpose of this section is to examine the effectiveness of the regulatory provisions to combat insider trading problems that crops up in the event of mergers and acquisitions.

5.4.1 M&As regulations in India

Although many of the provisions available in the Income Tax (IT) Act relates to transfer of shares between holding and subsidiary company, there is no specific provision available in the IT Act either regarding insider trading or any penal measure in this connection. Like IT Act, Companies Act in India is also silent about insider trading or its penal measure. Main regulatory measures have been taken by Securities and Exchange Board of India in its SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Section 6 of the Indian Companies Act, 1956 offers classification for the term ‘relative’ under three categories. A person shall be deemed to be relative of another if (a) there are members of the Hindu Undivided Family (HUF) (b) they are husband and wife (c) the one is related to other in the manner indicated in Schedule- IA. Exhibit 5.2 shows the list of relatives.

Exhibit 5.2: List of Relatives under Indian Companies Act, 1956

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Father</td>
<td>12. Son’s daughter</td>
</tr>
<tr>
<td>2. Mother (including step-mother)</td>
<td>13. Son’s daughter’s husband</td>
</tr>
<tr>
<td>3. Son (including step-son)</td>
<td>14. Daughter’s husband</td>
</tr>
<tr>
<td>4. Son’s wife</td>
<td>15. Daughter’s son</td>
</tr>
<tr>
<td></td>
<td>16. Daughter’s son’s wife</td>
</tr>
<tr>
<td>5. Daughter (Including step-daughter)</td>
<td>17. Daughter’s daughter</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>6. Father’s father</td>
<td>18. Daughter’s daughter’s husband</td>
</tr>
<tr>
<td>8. Mother’s mother</td>
<td>20. Brother’s wife</td>
</tr>
<tr>
<td>10. Son’s son</td>
<td>22. Sister’s husband</td>
</tr>
<tr>
<td>11. Son’s son’s wife</td>
<td></td>
</tr>
</tbody>
</table>

From exhibit 5.2 it has been found that there are 22 different types of persons who are treated as relative. These persons come under the concept of ‘insider’ as defined under SEBI (Prohibition of Insider Trading) Regulations 1992. They may be punished as per SEBI insider trading regulations if they violate regulations.

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997 has been made effective on and from February 20, 1997 and it has been amended on September 9, 2002. This regulation mainly deals with acquisitions and takeovers. It is divided into five chapters. Chapter-I deals with preliminary matters. Chapter-II discusses with disclosure of shareholding and control in a listed company. Chapter-III deals with substantial acquisition of shares or voting rights in an acquisition of control over listed company. Chapter - IV deals with bail out takeovers and Chapter-V deals with investigation by the board.

Acquirer may take different percentage of stake in a target company at different point of time. At every stage he is required to disclose to the company and to the stock exchange where shares of the target company are listed. The stages at which he is supposed to inform are 5%, 14%, 54% or 74%\textsuperscript{13}. Every person including a person mentioned in regulation 6 who holds more than 15%...
shares or voting rights of any company shall within 21 days from the financial year make yearly disclosure to the company in respect of his holdings as on 31st March of the year. The public announcement is to be made in all editions of one national daily with wide circulation, one Hindi national daily and a regional language with wide circulation at the place where the registered office of the target company is situated and at the place of the stock exchange where the shares of the target company is most frequently traded\textsuperscript{14}. Four transitional provisions from 6(1) to 6(4) and five annual disclosure mechanisms are being applicable. For non-compliance of transitional provision companies, persons holding 5% or more, promoters and persons in control may be held responsible to pay an amount of Rs.10,000. So far as non-compliance of annual disclosure is concerned Rs.10,000 is payable for each year and in some cases an amount is payable for each record date\textsuperscript{15}.

The M&As activities bring complex issues relating to laws and regulations impacting such decisions. Exhibit 5.3 offers relevant provisions of the Companies Act, 1956 that are required to comply at the time of M&As deals.

**Exhibit 5.3: Compliance under the Indian Companies Act**

<table>
<thead>
<tr>
<th>Section 376</th>
<th>Condition prohibiting reconstruction or amalgamation of company;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 391</td>
<td>Power of Compromise or make arrangements with creditors and members</td>
</tr>
<tr>
<td>Section 392</td>
<td>Power of National Company Law Tribunal (NCTL) formed as per the Companies Amendment act 2002 and the power of the High Court relating to reduction of capital, amalgamation and disputes to Enforce Compromises and Arrangements</td>
</tr>
<tr>
<td>Section 393</td>
<td>Information as to Compromises or Arrangements with Creditors and Members</td>
</tr>
</tbody>
</table>
To ensure fair play and transparency the first attempt was made in India by the incorporation of Clause-49 in the Listing Agreement. Subsequently the SEBI’s Takeover Code was introduced in 1994.

SEBI (Insider Trading) Regulations, 1992 has defined the term ‘insider’. However, there remain a lot of ambiguities as to who is an insider. Sometimes mergers are arranged by the Board for Industrial and Financial Reconstruction (BIFR). An officer of the Board or the Investment Banker may trade in shares of the merging companies upon his knowledge about impending merger. In such cases he/she may be escaped from being termed as an insider on the plea that Clause 2(h) of the said regulations excludes bank employees and government employees while providing an inclusive nature of definition of persons deemed to be insiders. It can be said that in our country mergers and amalgamations are the areas where protection to the general investors against insider trading is the least under the present legal system. In a bid to crack down the same, a lot of measures should be undertaken by the central government.
5.4.2 M&As Regulations in the USA

Tender offers in the United States of America (USA) were largely unregulated before the enactment of Williams Act of 1968\textsuperscript{16}. Even by 1974 only seven states had enacted statutes in this area. Early laws regulating hostile takeovers were declared illegal by the courts. The disclosure requirement of the Securities Act of 1933 provided some limited regulation on tender offers. The Williams Act provided an amendment to the Securities Exchange Act, (SE Act) 1934 a legal cornerstone of securities regulations. These laws provide for greater disclosure of information by firms when they issue securities. The Williams Act has four major objectives:

a) to regulate tender offers;

b) to provide procedures and disclosures requirements for acquisitions;

c) to provide shareholders with time to make informed decisions regarding tender offers; and

d) to increase confidence in securities markets.

The Williams Act also provides disclosure of information of tender offers through Section 14(d). The time period of the tender offer may be crucially important in a contested takeover battle. Tender offers are accompanied by a press release by the bidder announcing the offer.

The SEC adopted Rule 14e-3 to combat insider trading specifically within the context of tender offers\textsuperscript{17}. This rule prohibits transactions in securities on the basis of material non-public information in the context of tender offers. Trading is prohibited until a reasonable time after the public release of such information.

The SE Act of 1934 requires that Form 8K filing must be made within 15 days after the occurrence of certain specific events. Such events include the acquisition and disposition of a significant amount of assets including companies. The disclosure requirements aim to give the target shareholders information that will enable them to receive more of the profits associated with the rise in the share
price of the takeover target. The 20-day waiting period gives the target company more time to evaluate the offer and/or to tailor a defence or seek multiple bids.

Section 16 of the SEA, requires insiders to report the trading in their own companies stock by corporate officers, directors and other insiders to the SEC on a regular basis. Rule 10b-5 is a general prohibition of fraud and deceit in the purchases of sale of securities. The Insider Trading Sanctions Act of 1984 provides for triple damage for penalties in insider trading cases as the Racketeer Influenced Corrupt Organizations Act of 1970 (RICCO) which allows immediate seizure or assets and which is invoked in some of the more notorious cases of insider trading. The SEC rules are somewhat ambiguous but a long series of court cases have clarified the key concepts. It is illegal to trade on inside information, whether obtained as a result of long drawn fiduciary relationship with a firm or through misappropriation.

5.4.3 M&As Regulations in the UK

The Monopolies and Mergers Act of 1965 created the Monopolies and Mergers Commission (MMC) in the United Kingdom (UK). In 1968 self-regulation in the form of City Code on Takeovers and Mergers was promulgated and administered by the Takeover Panel. The hostile takeover phenomenon and the appearance of regulation were the catalysts for a long–lasting academic and political debate. The main functions of economic benefits of takeovers can be identified first with the possibility of hostile takeovers. It is often seen as a way of disciplining corporate managers to use the assets of the company in an efficient way. The second function of takeovers is not mainly related to hostile takeovers but relates to whole range of agreed takeovers and mergers. Thirdly, there exists considerable empirical evidence about the positive effect of takeovers and shareholders wealth, particularly of the target shareholders.

A new era in M&As regulation was established by introduction of the Fair Trading Act of 1973. This Act created an Office of Fair Trading (OFT) headed by
a Director General (DG). The DG of the OFT is required to review all mergers in which the combined firm would have a 25% market share or where the assets of the target exceed 30 million pounds. After review by the OFT, its DG advises the Secretary of State for Trade and Industry whether a referral should be made to the Monopolies and Mergers Commission (MMC). The secretary of state has discretion whether or not to make the referral. If a referral is made to the MMC although the current bid lapses then it may be renewed if the MMC approves. The MMC review the case and may take as long as six months. Its report is made to the OFT and the secretary of state. If the MMC recommends for approval the secretary of state cannot override. However, if the MMC recommends prohibition, the secretary of state is not required to accept its findings, but such instances are rare. As a practical matter, a referral to the MMC, which lapses the current bid and involves a long time lag is likely to kill the transaction. In 1999 MMC’s name was changed to the Competition Commission.

The City Code on Takeovers and Mergers has no statutory or other legal authority. It is promulgated, supervised and administered by the Takeover Panel which comprises a select body of representatives mainly from financial institutions primarily engaged in the business of takeovers and certain other bodies. This Code applies to offer for all public companies either listed or unlisted residents in UK. It also applies to offer for certain resident private companies which have in some way been involved in public markets only where certain requirements are also satisfied. It is made clear that ‘offer’ in this context includes partial offers by a parent company for shares in its subsidiary and certain other transactions where control of a company is required to be obtained or consolidated. It is available to the parties for consultation on the applicability and meaning of the Code and in making speedy decisions. It gives effect to the spirit rather than the letter of the rules. However, it is almost equally well known that while the City Code has been self-regulatory on the sense that those engaged in the takeover industry are by and large the people who make an input into the content and operation of the City
Code, it has nevertheless been the voluntary. There have been considerable practical pressures, which have made compliance with the Code essential.

The City Code is comprised of 10 general principles and 38 detailed rules with notes, together with an introduction, definitions and appendices. The overall aim is to ensure that all shareholders are treated fairly and equally in relation to takeovers. Part of the mechanism for doing this lies in the orderly framework and timetable which the Code lays down. These are designed to prevent shareholders from being panicked into accepting an offer without time to consult with their financial advisers. Great emphasis is laid on equality and high standards of information, both in offer documents and in the advertisements and announcements.

5.4.4 M&As Regulations in Australia

Insider trading was frequently related to a takeover activity in Australia. There is a requirement under the Corporation Law to prohibit persons connected with a body corporate not to breach their fiduciary duty and use confidential information for their personal advantage. Prior to the imposition of Section 235 of the Corporation Law in December 1995 for disclosure of director’s interests, there was no continuous legislative disclosure requirement for directors’ change of interests. After the amendment of said section directors have the obligation to notify within 14 days after they become appointed as a director to the Australian Securities and Investment Commission (ASIC) or the Australian Stock Exchanges of their relevant interests in the company’s securities.

Chapter 6 of the Corporations Act 2001 deals with takeover regulations in Australia. As per section 648J of the Corporations Act, the bidder or target company must make a clear sound recording of all telephone calls the recorder makes during the bid period: (a) to a person (the holder) who holds securities in
the bid class; (b) to discuss the takeover bid (whether or not for some other purpose as well). Failure to comply with this subsection is an offence.

If the target company invites the holder to call the recorder to discuss the takeover bid (whether or not for some other purpose as well), then the recorder must make a clear sound recording of all telephone calls that: (a) the holder makes to the recorder during the bid period; and (b) are made by the holder to discuss the takeover bid (whether or not for some other purpose as well)\(^{25}\). A person who is involved in a contravention of these provisions would be punished.

The target company must notify the holder that the call is being recorded for the purposes of this Act of section 648K. The target company will commit an offence under the Telecommunications (Interception) Act 1979 if it fails to notify the holder. The target company must mark the medium in which the recording is stored so as to identify: (a) the parties to the conversation; and (b) the date and time it was made. The target company must create an index (in electronic form or otherwise) of all recordings made by the recorder in relation to the takeover bid.

The index must state in relation to each recording: (a) the parties to the conversation; (b) the time and date in which the recording was made; and (c) the exact place where the recording is being stored; and (d) any other matter required by the regulations to be stated in the index. The recording custodian must store the recording at the place specified in the index. The recording custodian must securely store the recording in a manner that protects it from: (a) misuse, loss and modification; and (b) unauthorised access and disclosure. The recording custodian must not allow a person to make a copy of an entry in the index or the recording if the person is not authorised to do so.

5.5 Selected Indian cases

We have selected a few leading cases on M&As related to insider trading within India and foreign countries. On the basis of decisions of the cases, the

124
legislative authorities of the respective country have changed their insider trading regulations.

5.5.1 Hindustan Lever Ltd. (HLL) vs. SEBI (1996)\textsuperscript{26}

Hindustan Lever Ltd. (HLL) and Brooke Bond Lipton India Ltd. (BBLIL) were controlled by the Unilever Inc. of United Kingdom (UK). They were under the same management. HLL purchased a total of 19.74 lakh shares of BBLIL in three phases from the Unit Trust of India (UTI). The first lot of 7 lakh shares was purchased prior to January, 1996. HLL bought it from UTI on the basis of unpublished price sensitive information about the swap ratio. In second phase HLL purchased 8 lakh shares in March, 1996 at Rs.350.35 per share. After 25 days of the said deal i.e. on 19\textsuperscript{th} April 1996, the HLL announced its mergers with BBLIL and notified the same to the stock exchanges. After the announcement of the merger, BBLIL’s share price shot up to Rs.400. As a result of such acquisition, the direct and indirect interest of Unilever in BBLIL increased to 51% only after the purchase of the third lot in December, 1996. HLL claimed that the reason behind such acquisition was Unilever’s global policy in achieving a target of 51% beneficial holding with subsidiaries.

UTI made a compliant against HLL that it was using unpublished price sensitive information at the time of merger. On August 4, 1997 SEBI issued a show cause notice to HLL claiming that there was prima facie evidence of the company indulging in insider trading through the use of unpublished price sensitive information prior to its merger with BBLIL. The market regulator concluded that the purpose and motive right from the beginning, when the decision to acquire 8 lakh shares was taken, was to move towards reaching 51% holding of Unilever in combined with HLL. It was not just to reach 51% of Unilever holding in BBLIL. The SEBI has further argued that the actual transaction had taken place just prior to the actual announcement of the merger.
and if this acquisition was merely pursuant to the group policy of Unilever to have 51% share in BBLIL, the purchase could have been at any stage prior to decision of Unilever to grant the in-principle approval. After investigation SEBI came to a conclusion that the common directors of HLL and BBLIL were liable for insider trading causing a huge loss to UTI. SEBI directed HLL to pay UTI an amount of Rs.3.4 crore in compensation and also initiated criminal proceedings against the five common directors of HLL and BBLIL viz. Sri S.M. Datta, Sri K. V. Dadiseth, Sri R. Gopalkrishnan, Sri A. Lahiri and M.K. Sharma who were on the core team which discussed the merger. The whole episode from 1996 to 1998 is given below in Exhibit 5.4

**Exhibit 5.4: HLL vs. SEBI (1996)**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-January, 1996</td>
<td>UTI sold 7.0 lakh shares of BBLIL to HLL.</td>
</tr>
<tr>
<td>March 19, 1996</td>
<td>UTI sold another 8 lakh shares to HLL @ Rs. 350.</td>
</tr>
<tr>
<td>April 19, 1996</td>
<td>HLL, BBLIL informed the stock exchanges about their proposal of merger.</td>
</tr>
<tr>
<td>April 22, 1996</td>
<td>Boards approved merger in the ratio of 9 equity shares of HLL for 20 equity shares of BBLIL; market price was Rs. 390 per share.</td>
</tr>
<tr>
<td>April 30, 1996</td>
<td>SEBI commenced investigation into insider trading.</td>
</tr>
<tr>
<td>December, 1996</td>
<td>Third lot of 4.7 lakh shares of BBLIL was sold to HLL, taking Unilever’s direct and indirect holding in BBLIL to 50%.</td>
</tr>
<tr>
<td>August 4, 1997</td>
<td>SEBI issued communication of findings to HLL.</td>
</tr>
<tr>
<td>March 11, 1998</td>
<td>SEBI issued order for presentation for HLL and its five directors and for payment of compensation of Rs. 3.08 crore to UTI.</td>
</tr>
<tr>
<td>April 2, 1998</td>
<td>HLL appealed to Securities Appellate Tribunal against SEBI’s order.</td>
</tr>
</tbody>
</table>
HLL contended that when shares were bought from UTI, it had no information on the ratio recommended in April 1996. The company argued that the then CEO of BBLIL bought 2500 shares in August 1995 just to show his commitment to the company. On the other hand SEBI argued that CEO was the key advisor on the merger.

This case unfolds the issues related to the insider trading charges against HLL with regard to its merger with BBLIL. It focuses on the legal controversy surrounding these charges. SEBI was suspecting insider trading and conducted enquiries. But the SEBI's definition of an insider has to be fleshed out in order to provide a clearer picture. The definition of price sensitive information has been changed after this case in 2002. Earlier it would imply any information which was related to the listed matters of concern, directly or indirectly to a company, and which were not generally known or published by such company for general information. Now it has modified and 'price sensitive information' now includes any information, which relates directly or indirectly to a company and which if published, is likely to materially affect the price of securities of company. "Unpublished" means information, which is (i) not published by the company or its agents and is (ii) not specific in nature.

HLL defence would violate a fundamental concept of Company Law, which the management of a company may never act in the interests of only one group of shareholders. Instead, management must take decisions which protect the interests of the company as a whole. The basic underpinning of corporate democracy is to protect interest of all the shareholders' interests and not of a select few. However, in this case, HLL's purchase of eight lakh shares in BBLIL by depleting its reserves was clearly an act which favoured Unilever's interests at the expense of the interests of its remaining shareholders. HLL took defence to conceal violations of the legal rules governing preferential allotment of shares.
contained in Section 81(1A) of the Companies Act. In essence, HLL's purchase of shares in BBLIL was intended to raise Unilever's holding in the merged company to 51%. It constituted a backdoor preferential allotment of shares to Unilever.

By disguising the preferential allotment of shares to Unilever as an ordinary purchase of shares by HLL, the company avoided the requirement of passing a special resolution of shareholders as required in Section 81(1A) of the Companies Act. Unilever also avoided complying with the pricing formula set forth in the RBI guidelines. Importantly, structuring the transaction as a share purchased by HLL instead of a preferential allotment of shares eliminated the need to obtain any governmental approvals for increasing Unilever's shareholding in the merged company.

5.5.2 Global Trust Bank Case (2000)27

The controversy is related to the rigging of share prices of a private bank, Global Trust Bank (GTB). Ketan Parekh used to operate through a strong network of over 50 brokers and his average daily turnover was estimated to be Rs.4000 million. It had been alleged that Ketan Parekh and his associates rigged the share prices of the GTB prior to its merger with the UTI Bank in order to improve the swap ratio in favour of GTB. Parekh and his associates were the major traders. The share price of GTB rose from Rs.70 in October 2000 to Rs. 117 within three weeks. By that time bank merger had already announced and investigations had been launched to look into the Ketan Parekh’s role in alleged insider trading. The interim investigations were carried out by India’s regulatory authority, SEBI. It found “evidence of a nexus” between Ketan Parekh and Ramesh Gelli, promoter of GTB28.

In a written reply to the Lok Shaba, Mr. P. Chidambaram said that the enquiry revealed that two overseas corporate bodies based in Mauritius- Far East Investment Corporation Ltd. and European Investment Ltd.-started selling their
shares of GTB from June 17, after five days after they became eligible to trade in
the shares. A total of 95 lakh shares were sold by the two entities up to July 19,
2000.

Unfortunately, in most of the instances the responses of the regulatory
agencies have been reactive rather than proactive. Regulatory agencies intervened
into the picture when damages had already been done. This is despite the fact that
regulatory authorities have of instruments at their disposal to prevent such frauds.
Even when actions were taken, they were adhoc in nature in most of the cases.
Because of these reasons there is a growing feeling that the regulatory authorities,
particularly the SEBI tend to protect the interests of big players rather than small
investors.

5.6 Selected foreign cases

Corporate restructuring have been found to be a common practice in most
of the foreign countries. Like India, insider trading has also been noticed in the
event of M&As in foreign countries. However, nature and degree of complexities
varies. We have studied two cases from the USA—not simply because of the fact
that the country was the pioneer in financial market regulation but also because of
the fact that it formed its insider trading squad first among the world. For another
reason we have taken two cases from the USA. Percentages of white colour crime
have been found to be more in the USA in relation to other advanced countries.

5.6.1 SEC vs. Michael Milken (1986)

In 1986, Dennis Levine an investment banker at Drexel Burnham Lambert
pleaded guilty to securities fraud, tax evasion and perjury. He had acquired
information on upcoming merger deals through payments to other investment
bankers. Levine was an important link in the conviction of Ivan F. Boesky, a
leading risk arbitrageur. Boesky anticipated that the firms would be taken over and
he would purchase its stocks. If he had bought these stocks before any increase in the target price, he could realise significant profit. It was alleged that Boesky had illegally acquired insider information from investment bankers on deals before a public announcement of a merger or acquisition.

Information provided in turn by Boesky and others such as Boyd Jefferies, a broker who was already a guilty of breaking securities laws that led to Michael Milken's guilty plea for serious crime accused in 1990. Milken was sentenced to a 10-years imprisonment. Milken, the leading figures in the junk bond market was the government’s most significant conviction and its campaign to stamp out insider trading. His legal problems were one of the major factors that led to collapse of Drexel Burnham Lambert and the junk bonds. Series of legal steps involved in Milken case are summarised in Exhibit 5.5.

**Exhibit-5.5: SEC vs. Michael Milken**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1986</td>
<td>The SEC and federal prosecutors accused Dennis Levine of making $12.6 million in insider trading.</td>
</tr>
<tr>
<td>November 1986</td>
<td>Ivan F Boesky agreed to pay a $100 million penalty to settle SEC charges of insider trading. Drexel Burnham Lambert and Michel received subpoenas.</td>
</tr>
<tr>
<td>February 1987</td>
<td>Levine was sentenced to two years imprisonment.</td>
</tr>
<tr>
<td>February 1987</td>
<td>Robert Freeman, Richard Wigton and Timothy Tabor were arrested on insider trading charges. Martin Siegel admitted insider trading and was identified as cooperating in the governments’ investigation.</td>
</tr>
<tr>
<td>May 1987</td>
<td>The indictments of Freeman, Wigton and Tabor were dismissed.</td>
</tr>
<tr>
<td>October 1987</td>
<td>The stock market crashed.</td>
</tr>
<tr>
<td>December 1987</td>
<td>Boesky was sentenced to three years imprisonment.</td>
</tr>
<tr>
<td>Date</td>
<td>Event</td>
</tr>
<tr>
<td>------------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>February 1988</td>
<td>John Mulheren was arrested on weapons charges for allegedly trying to kill Boesky.</td>
</tr>
<tr>
<td>September 1988</td>
<td>The SEC accused Drexel, Milken, and others of insider trading manipulation and other violations of securities laws.</td>
</tr>
<tr>
<td>December 1988</td>
<td>Drexel agreed to plead guilty for serious crime settlement; SEC charged and paid a record $650 million.</td>
</tr>
<tr>
<td>March 1989</td>
<td>Milken and his brother Lowell were indicted by 98 counts for racketing and securities fraud.</td>
</tr>
<tr>
<td>August 1989</td>
<td>Freeman pleads guilty to one count of insider trading. The investigation of Wigton and Tabor was dropped.</td>
</tr>
<tr>
<td>October 1989</td>
<td>The Junk-Bond market collapsed.</td>
</tr>
<tr>
<td>February 1990</td>
<td>Drexel filed for bankruptcy-court protection.</td>
</tr>
<tr>
<td>April 1990</td>
<td>Milken agreed to plead guilty for serious crime and to pay $600 million.</td>
</tr>
<tr>
<td>June 1990</td>
<td>Siegel was sentenced to two months of imprisonment.</td>
</tr>
<tr>
<td>July 1990</td>
<td>Mulheren was convicted, the conviction was later reversed.</td>
</tr>
<tr>
<td>November 1990</td>
<td>Milken is sentenced to ten years of imprisonment.</td>
</tr>
</tbody>
</table>

5.6.2 United States vs. James Herman O'Hagan (1997)

James Herman O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988. Less
than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey & Whitney were still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options. By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor. O'Hagan also purchased 5,000 shares of Pillsbury common stock in September 1988 at a price just under $39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock raised nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock and making a profit of more than $4.3 million.

The SEC initiated an investigation into O'Hagan's transactions, culminating in a 57 count indictment. The indictment alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using non-public information regarding Grand Met's planned tender offer for his own trading purposes. According to the indictment, O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds. O'Hagan was charged with (i) 20 counts of mail fraud, (ii) in violation of securities fraud, (iii) in violation of section 10(b) of the Securities Exchange Act of 1934 of fraudulent trading in connection with a tender offer and (iv) in violation of section 14(e) of the Exchange Act, and SEC Rule 14e-3(a). A jury convicted O'Hagan on all 57 counts, and he was sentenced to a 41-month term of imprisonment.

A divided panel of the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions. The Eighth Circuit based on the misappropriation theory of securities fraud on which prosecution was relied charged liability under Section 10(b) and Rule 10b-5 of SE Act. The Court of Appeals also held that Rule 14e-3(a) which prohibits trading while in possession of material, non-public
information relating to a tender offer exceeds the SEC's Section 14(e) rulemaking authority because the rule contained no breach of fiduciary duty requirement. The Eighth Circuit further concluded that O'Hagan's mail fraud and money laundering convictions rested on violations of the securities laws and therefore could not stand once the securities fraud convictions were reversed. Lord Justice Fagg dissented and stated that he would recognize and enforce the misappropriation theory, and would hold that the SEC did not exceed its rulemaking authority when it adopted Rule 14e-3(a) without requiring proof of a breach of fiduciary duty. Decisions of the Courts of Appeals are in conflict on the propriety of the misappropriation theory under Sec 10(b) and Rule 10b-5 and on the legitimacy of Rule 14e-3(a) under Section 14(e).

5.7 Conclusions

This chapter has focused on the problem of insider trading that arises in the event of large scale M&As. Out of four case studies; Global Trust Bank and Hindustan Lever Ltd. were selected from India. In HLL case loosely drafted regulation has been found to be the main reason of SEBI's defeat. In Global Trust Bank case Ketan Parekh has been found to be engaged in insider trading with one of the promoters of Global Trust bank. In both cases regulators have been found to be reactive than to be proactive. Two cases have been selected from the USA.

From our study of regulations and case studies on insider trading practices in the event of M&As both foreign as well as Indian, we end up with following pertinent observations:

a. There exists difference in regulatory practices among countries relating to M&As;

b. There exist lack of insider trading regulations in the Companies Act in India;
c. There lies significant variation among countries relating to insider trading disclosure practices in the media.

The SEBI regulations should not provide any confusing definition of insider trading as it may provide loopholes to the insiders. Just like the Takeover Panel of the UK an independent Merger and Takeover Panel may be set up in India with the object of investigating shareholding around the times of mergers and takeovers. The stock exchanges should keep close watch on the share price movements and trading volumes of the concerned companies at the time of every merger. Online trading can help a lot in this regard. The government should make it obligatory for every company to disclose all material information on its proposed merger fully and accurately to the shareholders and investors just when the merger negotiation is in process. Following the Sachar Committee recommendations, an insider should be allowed to deal in his company’s shares during a specified deal just before and after the date of the merger announcement.

There are various reasons for the abnormal performance of a target company’s share price ahead of the announcement of the bid. These include (1) insiders acting upon inside information, (2) stake building by the bidders, (3) the spotting of potential targets by objective analysis and research namely by private individuals and newspapers commentators and (4) an increased speculation in the shares as a result of rumour brought by 1, 2 and 3 above.

Till date we do not have any codified act specifically and wholly on M&As. However, in UK self-regulation exists. Top management of the target companies would be involved in either direct negotiations or to be informed about an upcoming offer. It is natural to expect that they might use this information in some way. If insiders buy large amount of securities prior to M&As announcements, this can signal to outsiders that something important is likely to happen. Other investors may claim damages from a company which falsely denied that it was involved in negotiations that resulted in a subsequent merger.
Notes and References


7. Let us assume A Ltd. and B Ltd. are having 2000 shares and 1200 each respectively. Every shareholder of B Ltd. gets 2.5 shares of A Ltd. in lieu of a single share. Therefore A Ltd. had to issue 3000 equity shares. As a result out of the total number of shares of the combined companies i.e. 5000 shares. A Ltd. is having 40% shares but B Ltd. owns 60% of the combined entity. In this situation A Ltd. is the acquirer by law but B Ltd. is the acquirer purpose. This is a case of reverse acquisition.

This is an exchange rate of the shares of the companies that would undergo a merger. This is calculated by the valuation of various assets and liabilities of the merging companies.


Arbitrage generally means the practice of trading like articles or shares in different markets to make profit from price discrepancies between them.


Regulation 7 of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

Regulation 15(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

Shareholders whose names are appearing in the register of the company upto the record date are entitled to get bonus share, right share and divided. Persons who become shareholders after the record date are not entitled to those benefits.


Rule 14e-3, of Securities Exchange Act, 1934

19 F. Easter Brook and D. Fishel (1991) "The economic Structure of Corporate Law" Harvard University Press, p- 171

20 Referral means who needs professional to a person or place that can provide it


22 City Code, London, Introduction Para 4(a)


25 Failure to comply with this subsection is an offence under section 1311(1) of the Corporation Law.

26 The Economic Times, 15th July 1998


28 Ibid

29 Business Line, December 04, 2004


31 Lie told after swearing to tell the truth
A bond that involves greater than usual risk as an investment and pays a relatively high rate of interest typically issued by a company lacking an established earnings history or having a questionable credit history.

Subpoenas mean written order to appear before the court of law.

In one way of measurement

United States v. O'Hagan, 92 F.3d 612 (8th Cir., 1996)

Call option gives the buyer the right to buy and writer of a call option has an obligation to sell at a predetermined price on or before the expiry date depending on the nature of the contract i.e. European or American

A written statement that accuses

However, we have SEBI (Substantial Acquisition of shares & Takeovers) Regulations 1997