CHAPTER 3

HISTORICAL DEVELOPMENT OF LAWS ON INSIDER TRADING

IN INDIA

This chapter tracks the evolution of the insider trading laws in India and the historic events relating to the enactment of insider trading laws.

The earliest record of dealings in securities in India traces back to the East India Company’s loan securities, in the 18th century. By 1830s, there was a qualitative as well as quantitative broadening of the business and the shares of banks, including those of Chartered Bank, Oriental Bank and Bank of Bombay, along with those of the cotton presses commenced trading in Bombay. In 1840, there were no more than six (6) brokers in stocks and shares recognized by the banks and the merchants in Mumbai (erstwhile Bombay), and in 1887, the Native Share and Stock Brokers Association of Bombay was formally constituted, which was later named as Bombay Stock Exchange and was the first stock exchange in India.

The first Indian legislation to regulate the stock exchange was the Bombay Securities Contract Act, 1925, enacted on 1 January 1926. It was enacted to regulate and control the contracts for the purchase and sale of securities in the city of Bombay and elsewhere in the Bombay presidency.
However, this legislation had several shortcomings which resulted in multiple unrecognized stock exchanges and individuals carrying on business in forward contracts. Consequently, huge losses were incurred by investors during the period from 1928 to 1938. Therefore, the Government was compelled to appoint certain committees\textsuperscript{136} to assess the shortcomings of the legislation and regulation of the stock exchanges.

Thereafter, the Defense of India Act, 1939 also included a provision relating to capital issues. The Defense of India Act was introduced in May 1943, and, \textit{inter alia}, imposed restrictions on capital issues for the first time. This was the result of the government of India’s resolution during the World War II to conserve the scarce capital resources and to use it for war purposes and for national development.

The Defense of India Act stipulated that prior Government approval was mandatory for capital issues. When India got independence in 1947, the earlier rules continued to be in force and were finally incorporated in the Capital Issues (Control) Act, 1947. Under the Capital Issues Act, the office of Controller of Capital Issues was set up, which was the authority to approve issue of securities, the amount, type and price of securities, etc. The Capital

\textsuperscript{136}Morrison Committee in 1936, the Thomas Committee in 1948, and the Gorwala Committee whose report was submitted in 1951
Issues Act was however, repealed in 1992, and the office of CCI was abolished in 1992, as part of the liberalization process in India.

The stock market witnessed different phases during 1946-1947. For instance, trading brought large profits to speculators and vast losses to the investing public. Stock market was an integral part of the country’s financial system and was regarded as important as banks. Therefore, a need for tightening government control on stock market became imperative.

In view of the foregoing, that the government constituted the Thomas Committee in 1948 under the chairmanship of P.J. Thomas, the then Economic Adviser to the Finance Ministry. The agenda before the Thomas Committee was framing a central legislation for the regulation of stock market activities and also setting up a competent public authority to administer the laws framed. Thomas Committee advised that an independent and quasi-judicial authority with the fullest powers of supervision could only discharge such a function and thus, recommended adopting the U.S. model of setting up a commission such as the SEC, and proposed to set up the National Investment Commission. Additionally, Thomas Committee gave multiple noteworthy recommendations, many of which were included in the Companies Act, 1956, and in the present day law on insider trading.
The present SCRA, was a result of the recommendations of Gorwala Committee, set up by the Government to address the regulatory issues in the securities market. The SCRA empowered the Government with the regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision; (b) the contracts in securities; and (c) listing of securities on stock exchanges. However, the SCRA did not include insider trading specific provisions.

### 3.1 INDIA’S FIRST ENCOUNTER WITH INSIDER TRADING

Instances of insider trading in India were first reported in the 1940s. Directors, agents, auditors and other officers of companies were found to be using inside information for profitably speculating in the securities of their own companies. Thomas Committee had analysed these instances and observed that insider trading occurred due to (i) the possession of information by these people; (ii) before everybody else; (iii) regarding the changes in the economic condition of companies and more particularly, regarding the size of the dividends to be declared, or of the issue of bonus shares or the impending conclusion of a favourable contract.

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137 At paragraph 63 of Chapter VI titled ‘The Indian Security Market as It Is’ of Thomas Committee Report.
The president of the Bombay Stock Exchange, in his pre-independence speech on 14 June 1947, cited instances of leading companies not providing prompt public declaration of dividends and issue of bonus shares\textsuperscript{138}. As a result, in each and every case where the bonus and the right shares were issued, the information had leaked out much prior to the official announcement. The reaping of unjust profits by ‘inspired’ operators on such occasions was very common.

However, during the 1940s, this organized fraud did not receive the “public indignation” that it deserved. A reason could be the lack of awareness among the public that the profits made by the company’s directors and their friends are extracted from the investing public’s share. The legislators while deliberating on the laws to curb these practices compared these ‘inspired operators’\textsuperscript{139} with thieves.

\section*{3.2 COMPANIES ACT AND INSIDER TRADING PROVISIONS}

India’s Company Law was enacted in 1956. However, it did not include any provisions to charge the directors and the managing agents of companies for making the unfair use of inside information. Although the

\textsuperscript{138} Supra n2 at page 84.
\textsuperscript{139} Ibid
Thomas Committee had pointed out the lack of a special legislation to deal with the ‘unfair use of inside information’ in 1948 itself, it took a few decades to actually formulate a legislation to curb insider trading\textsuperscript{140}.

Various committees were constituted in India from time to time to assess the corporate regulation framework in India. These committees had also examined the then existing framework in the U.S.\textsuperscript{141}, as the U.S. had elaborate laws on the subject. The provisions in the U.S. law, under the Exchange Act were considered effective\textsuperscript{142}. For instance, the regulations framed by the SEC under Section 14(d) of the Exchange Act, facilitated active participation by security-holders and the investors in the affairs of the companies.

\textsuperscript{140} SEBI (Prohibition of Insider Trading) Regulations, 1992 came into force on 19th November, 1992.

\textsuperscript{141} In the year 1948, U.S.A already had the provision at section 16 of the Securities Exchange Act of 1934 which says that directors and officers of companies (whose shares are registered for trade) and stockholders who own a more than 10% of any registered issue or stock have to file with the SEC and with the Exchange a statement of each such security, together with such changes of ownership as have occurred during each month. Such persons are also prohibited from either selling short or selling against stock, permanently held, of the issuing corporation. Any profit realized by corporate insiders from certain short-term transactions is recoverable from them by the issuer and under certain conditions by a security holder also.

\textsuperscript{142} The provisions discussed by the Thomas Committee as effective in curbing the insider trading in the U.S. in addition to section 16 were:

\begin{itemize}
  \item[a.] Section 12 of SEC Act, 1934 forbids trading in a security unless it is registered with the SEC (or exempted from registration), the commission insists on detailed returns being submitted to them, not only annual reports but current reports in the event of certain material changes occurring in the affairs of the company (eg:- declaration of dividends etc.) to be promptly telegraphed to it.
  \item[b.] SEC’s power under the then section 10 (a) (2) of the Act to suspend or withdraw the registration of a security if the issuer fails to comply with the above provision.
  \item[c.] SEC is authorised to prescribe rules under section 14(d) of SEC Act, 1934 concerning the solicitation of proxies, etc. in connection with listed securities. SEC has made regulations under this in the public interest or for the protection of investors.
\end{itemize}
On the other hand, in the absence of any similar structure in India, the investing public in India did not even realize the extent of monetary loss caused to them by unfair use of information by the directors, managers, etc., in a company. Clear suggestions as to the changes required in the company law to curb insider trading were provided by different committees, way back in 1948\textsuperscript{143}.

The committees had also recommended that the companies listed on the stock exchanges should be made to publish material events such as the declaration of the dividends, although the effectiveness of such disclosures was not assured. These recommendations took very long to evolve as law.

\textsuperscript{143} The suggestions were:

a. in the case of new floatations, information regarding distribution of holdings at the time of allotment should be reported to the National investment commission (Thomas Committee in the year 1948 had recommended setting up of a regulatory body for the entire country in order to regulate the stock market, in line of Securities Exchange Commission in the USA and the National Investment Commission was one such proposed body), or other authority established for stock market regulation

b. immediately after the issue or on original sale of shares, a separate statement containing detailed information regarding allotment to directors, their relations and friends, and underwriters, if any, for the purpose of holding beyond the period agreed to for underwriting should also be sent to the above authority. It was recommended that for such reporting a definite period should be stipulated in the act.

c. any change within a period of six months in the holdings of shares of a company by any of its directors or officers or even its auditors, directly or indirectly, should be forthwith reported to decide authority by the secretary of the company.

d. stagging (practice of buying shares at the initial public offering at the offering price and then reselling them at a substantial profit once the trading has begun) by the directors or other officers of the company, directly or indirectly in the names of others, whether relations or otherwise, should be prohibited and even penalised by the forfeiture of such office.

e. any purchase or sale of securities of a company by any of its own directors or officers or even its auditors, directly or indirectly, at any time within six months prior to declaration of dividend, whether the security is registered or held in bank, should be reported to the said authority by the company as well as by the person concerned with the transaction.

f. declaration of dividends should be communicated to the said authority and the various stock exchanges, telegraphically or otherwise in minimum time, so that it may be published simultaneously in the different trade centres.

g. companies should be statutorily required to submit quarterly balance sheets.
It is noteworthy that all the committees were foresighted and all the suggestions were focused on disclosures. The Bhaba Committee was constituted in 1952 in order to revamp the then existing Companies Act, 1913. In its report, the committee observed the trend of fraudulent dealings in the shares by the directors of the companies\textsuperscript{144}. The report observed that there existed evil of the directors dealing in the shares of their own companies, exists although on a limited scale.

The Bhaba Committee also discussed the Cohen Committee Report in England and the report of Millin Commission in S. Africa. These reports made a distinction between the directors who buy or sell shares while in possession of general information and those who buy or sell shares based on the specific information, such as the conclusion of a favourable contract or the intention a company’s board to recommend an increased dividend. The committees in England had even envisaged situations where the directors register the shares of company in the names of nominees. The reports also expressed that if the laws framed for curbing the speculative transactions by directors while in possession of crucial information, are not meant for suppressing the transactions of these kind, at least the laws should mandate that such persons maintain high standards of conduct. Emphasis was also made on the need to apprise the public about the impropriety involved in the profits made by the

\textsuperscript{144} Para 100 of the report
directors or managers or others in a company as a result of special knowledge, not available to the general shareholders.

Further, the Bhaba Committee had considered the requirement of a provision in the Companies Act similar to Section 96 A of the Canadian Companies Act, 1934, which provides that a director of a public company should not speculate for his personal account, directly or indirectly, in the shares or other securities of the company of which he is a director. A contravention of this provision attracted a fine up to CAD 1000 or six (6) months’ imprisonment. However, the Bhaba Committee had finally, decided not to adopt this provision for India. Further, in view of the difficulty in defining the phrase “speculative buying and selling of shares”, the committee had decided to rely on Section 195 of the English Companies Act, 1948. Section 195 of the English Companies Act, 1948 provides that, “every company is required to maintain a register showing in respect of each director, the number, description and the amount of shares in and the debentures of the company or any other body corporate, being the company’s subsidiary or holding company, or a subsidiary of the company's holding company, which are held by him or even in trust for him or of which he has a right to become the holder whether on payment or not. Whenever there is a purchase or a sale of shares or debentures by directors, this register should also show the date, prize or other considerations for the transaction. This register is maintained at the company’s registered office, and is open to inspection by any member or
the debenture holder of the company in the manner referred to in sub-section 5 and at all times by any person acting on behalf of the Board of trade.”

However, it is interesting to note that the term ‘insider trading’ does not find place in the report prepared by the committee, especially when Thomas Committee has elaborately discussed this issue way back in 1948.

Further to these provisions, in order to enforce these sections, the committee also felt it necessary to impose a duty on the director of a company and on every person who is deemed to be a director to give notice to the company of all matters relating to the shares and debentures held by the director, as required under this section. It was viewed that unless a director or a person who is deemed to be a director is required by law to intimate the relevant facts to a company, it will not be possible for the companies to maintain the register of directors’ holdings in the company.

Thus, Sections 307 and 308 were incorporated in the Companies Act of 1956. Section 307 provided for maintenance of a register by the companies to record the directors’ shareholdings in the company. Section 308 prescribed to the duty of the directors and persons deemed to be the directors to make disclosure of their shareholdings in the company. Thereafter, by the Companies Amendment Act, 1960, had extended this requirement to the shareholdings of a company’s managers as well.
Section 307 of the Companies Act, 1956 covers all directors, including deemed directors, i.e., every person in accordance with whose directions or instructions, the Board of Directors is accustomed to act. The register of shareholdings to be maintained by the companies, must carry details regarding names, description and the amount of the shareholding of each of the directors and the deemed directors, and also the nature and the extent of the interest or right in or over any shares or debentures of such person. If a right or interest exists, irrespective of its nature or whether it is direct, indirect or remote it must be disclosed. This recordal requirement applies even in respect of such persons the holdings, interest or right in or over the shares or debentures of the company, or any body corporate in which the Board of directors is accustomed or bound to act according such persons’ directions or instructions. Further, even if the body corporate or its Board of Directors are not accustomed or bound to act according to such persons’ directions or instructions, if the person hold or control one third of the total voting rights in that body corporate the recordal is mandatory.

Section 308 casts a statutory responsibility on the directors and managers to disclose to the company the prescribed particulars so that these can be entered by the company in the register.

Thus, even before the formal laws directed towards prohibition of insider trading were framed in India, attempts were made to curb the
malpractice, with the primary focus on disclosures by insiders. The inertia on the part of the committee members to define ‘speculative profits’ could be one of the reasons that prevented the legislators from framing clear-cut legislation for insider trading, although the recommendation was made as early as 1952.

3.3 DISCLOSURES UNDER SECTION 307 AND 308 OF THE COMPANIES ACT AND INSIDER TRADING

In 1977, Sachar Committee\(^ {145} \), a high powered committee was set up to review the provisions of the Companies Act and the Monopolies and Restrictive Trade Practices Act, 1969 (the current Competition Act, 2002). This Committee opined that Sections 307 and 308 of the Companies Act, were insufficient to curb insider trading. The Committee’s view was that the statutory provisions which require disclosures to the shareholders regarding the transactions in the sale and purchase of shares by the directors and other key managerial persons are insufficient to solve the problem of certain class of people securing unfair profits by the use of non-public confidential information.

The committee observed that the recent developments in corporate law in India and in other countries have been placing strong emphasis on the need for increased disclosures by management. Transparency and openness in a company’s affairs was considered the best method to secure responsible

\(^{145} \) This committee was headed by Justice Shri Rajindar Sachar, the then judge of the High Court of Delhi
behaviour by the directors and other key managerial employees. According to
the committee, the disclosure requirements were primarily fulfilled by
submitting balance sheets and profit and loss accounts of the company once in
a year. However, with the need of increased disclosures, the annual
disclosures became insufficient.

Therefore, the committee recommended including a provision in the
Companies Act to the effect that that all public limited companies whose
shares are listed on any stock exchange should publish an abstract of the half-
yearly unaudited accounts of the company along with a brief report. Further,
such a report should be published in a public daily within sixty (60) days of
the close of the half-year and the report should highlight the important
financial and other developments in the company during the half-year. The
committee expected that such a provision would benefit the investing public,
creditors and others connected with the affairs of the company.

The Sachar Committee had also identified certain category of persons
who may be included in the category of insiders, such as the company's
directors, statutory auditors, cost auditors, financial accountants or financial
controller, cost accountants, tax management consultants or advisers and the
whole time legal advisers or solicitors who would generally have access to the
price sensitive information not available to the outsiders. Although the
Thomas Committee had also earlier suggested a broader category of insiders
to be identified within the regulatory purview, no legislative actions were pursued in this regard.

Further, the Sachar Committee had identified that it is often difficult to prove whether or not the material non-public information has been actually put to use in a transaction. The committee was of the view that the law should provide that an insider including the categories mentioned above, should be prohibited from purchasing or selling the shares of the company, either directly or indirectly, for a period of two (2) months’ prior to and after the closing of the accounting year of the company. This period was specifically considered crucial as there was a presupposition that an insider would possess confidential information during such time. The proposal was that once it is proved that the deal by an insider has resulted in one party taking advantage over the other by misusing the information relating to the company, then the insider shall be liable at law to the other party: i.e., the person with whom the insider has then dealt, the company in whose shares he has dealt or whose information he has used in so doing.

Another recommendation made by the Sachar Committee had also opined that the law should confer a remedy on persons who can establish an identifiable loss by reason of the misuse of materially significant information; and in addition, an insider should be held to be accountable to the company for his unjustifiable profits. Despite the foregoing recommendations, until date,
the Indian securities laws do not provide for sufficient remedies to the persons suffering losses due to misuse of information. In this regard in India, the SEBI has made efforts to disgorge the profits illegally made by market manipulators and insiders, by exercising its powers under Section 11B of the SEBI Act, 1992, which provides extensive powers to the SEBI to issue directions in the interest of the investors and to protect the integrity of the securities market. However, until 2009, the SAT had not upheld any such enforcement order for disgorgement, as the SEBI did not have any specific statutory powers to order disgorgement. In 2009, the SAT, for the first time, recognized SEBI’s power to direct disgorgement of illegal profits made by market manipulators. ¹⁴⁶ This issue has been dealt in detail in Chapter 5.

In a bid to extend the coverage to key employees of a company the committee had recommended that Section 307 of the Companies Act should be extended to also cover the employees of the company drawing a remuneration of more than Rs. 3000 per month, statutory auditors, cost auditors, financial accountants or financial controller, cost accountant, tax and management consultants or advisers, whole time legal advisers or solicitors, and the provision should also be extended to their spouses and children and also the shareholdings of private companies, partnership firms, and joint ventures or trusts in which the above categories of persons have any pecuniary

¹⁴⁶ Dhaval Mehta v. SEBI, appeal number 155 of 2008, dated September 8, 2009 (www.sebi.gov.in)
interest. The committee also recommended that the register maintained at the company should contain details relating to the purchase and sale of the shares of the company, its holding company and its subsidiary companies by the foregoing category of persons.

The key recommendations of the committee were twofold:

(i) maximum disclosure of transactions by those who have ‘price-sensitive information; and

(ii) prohibition of transactions by persons possessing price-sensitive information during certain specified periods, unless there are exceptional circumstances. However, the Sachar Committee recommendation regarding the prohibition of transactions by persons possessing price-sensitive information during specific period was only implemented recently in 2008, i.e, the short swing regulations.

More specifically, the Sachar Committee had recommended additional requirements for the disclosures under the Companies Act and the disclosures by other persons, who are temporary insiders or who become insider by virtue of their possession of information. The corporate governance norms

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147 The recommendations of Sachar committee are reproduced verbatim here.

(i) Any Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time legal Adviser or Solicitor of the company and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest should, prior to actual purchase
or sale, notify in writing the Board of Directors of the company his or their intention to buy or sell the shares of the company.

(ii) Full disclosure as to the number of shares, price at which they were bought or sold shall be made by persons mentioned at (i) above to the shareholders of the company by annexing a suitable statement to the published accounts.

(iii) The requirements of (i) and (ii) above should apply to the spouse and dependent children of persons mentioned at (i) above.

(iv) Any Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time Legal Adviser or Solicitor of the company and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest should be prohibited from either purchasing or selling the shares of the company, two months prior to the closing of the accounting year of the company and for a period of two months thereafter. Such prohibition should extend for a period of two months prior to any Rights issue or Bonus issue.

(v) If for compelling reasons the Director, Statutory Auditor, Cost Auditor, Financial Accountant or Financial Controller, Cost Accountant, Tax and Management Consultant or Adviser and whole-time Legal Adviser or Solicitor and any private company, partnership firm/joint venture or trust in which the above category of persons have any pecuniary interest, desire to buy or sell the shares of the company within the prohibited period, he or they must give prior intimation in writing of the proposal to purchase or sell to the Board. If the Board does not, within the period of fifteen days from the date of receipt of such notice at the registered office of the company, refuse permission, the person concerned would be entitled to sell or purchase shares in the company within the prohibited period, as proposed.

(vi) The spouse and dependent children of the persons referred to at (i) above should also be subject to similar disability during the specified periods.

(vii) In addition to the existing provisions of disclosure, we consider that it is necessary that all public companies should maintain a register disclosing dealings in shares of the company by the above category of persons have any pecuniary interest. The said register should additionally disclose dealings in shares of the company by the spouses and dependent children of the above category of persons and also by those in full-time employment of the company and drawing a salary of not less than three thousand rupees per month. This disclosure should be full and should include the number of shares, the price at which the shares are sold or purchased and the date of the transaction – we would recommend that the information in a summarised form be published as a part of the published Annual Report of the company.

(viii) Suitable provision should be made for assuring a civil remedy to persons who can establish that by reason of the misuse of significant information by any of the above category of persons, they have suffered an identifiable loss – the remedy should be by way of an application to the Company Law Board. Accountability should be ensured by adequate provision.
included in the Insider Regulations in 2002 mandated exhaustive disclosures by insiders.

3.4 DEMAND FOR A PROHIBITORY REGIME: PATEL COMMITTEE REPORT

The Government of India had constituted a high power committee in May 1984 headed by G. S. Patel (the “Patel Committee”) to make a comprehensive review of the functioning of the stock exchanges.

The Patel Committee had highlighted that insider trading was unethical as it involves misuse of confidential information and betrayal of fiduciary position of trust and confidence. The Patel Committee had suggested that a malpractice such as ‘insider trading’ should be made a cognizable offence\textsuperscript{148}. The report submitted by the Patel Committee defined ‘insider trading’ as

Regarding the notice provision at s.308 it was recommended as below:

(i) Such notices must be given by all persons referred for s.307.

(ii) Such notices must be given within fourteen days of conclusion of the relevant transaction or within fourteen days from the date when the concerned person has entered into a contract for such purchase or sale of shares of the company or of its subsidiary companies.

(iii) Such notices should also contain the details relating to the price that was actually paid or received for the shares and, if the shares were listed in any Stock Exchange, the rate quoted in the Official List of the Stock Exchange for the shares on the date of transaction or the latest quotation that was available on the date of transaction.

\textsuperscript{148} Para 2.49 of the Patel Committee Report
“trading in the shares of the company by the persons who are in the management of the company or are close to them, on the basis of unpublished price sensitive information, regarding the working of company, which others do not have.”\textsuperscript{149} This was the first time that the term “insider trading” was defined and proposed as an area that required legislation, to the Indian Government.

Further, it was for the first time in India that a government committee had recommended a specific statutory prohibition of insider trading. Although the Sachar Committee had recommended that transactions by directors and key managerial persons of like nature should be prohibited, the activity by the name of ‘insider trading’ was sought to be prohibited for the first time by the Patel Committee.

The Patel Committee had recommended that a codified legislation similar to the Australian law should be drafted in India also to counter the malpractice of ‘insider trading.’ The committee had also submitted draft legislation for prohibiting insider trading.

As regards the legal mechanism, the Patel Committee had recommended the introduction of provisions relating to insider trading as an amendment to the SCRA, on the lines of the Australian legislation.

\textsuperscript{149} Para 7.25 of the Patel Committee Report
Additionally, the committee also recommended incorporating some of the important provisions of the U.K. Company Securities (Insider Dealing) Act, 1985.

As illustrated above, the contributions by the Patel Committee to the laws on ‘insider trading’ are significant. This committee dealt with the offence of insider trading in a thorough and comprehensive manner. For example, the committee had suggested that insider trading should be fined heavily for first offence\footnote{Para 7.27 of the Patel Committee Report}, and imprisonment up to five (5) years should be given for second and subsequent offences. The Patel Committee report also acknowledged that in the U.S., other than the specific legislation, the Supreme Court and the Court of Appeals of various states have issued guidelines on insider trading, to maintain proper ‘fiduciary standards’, ensure justice and equity in the securities market, and to protect the interests of the investing public.

Further, the committee had also briefly discussed the insider trading laws in the U.S. and U.K. Although the committee appreciated that SEC in 1983 recommended civil penalties in addition to the criminal proceedings for insider trading cases, and that the U.K. has made insider trading a criminal offence in certain eventualities by amending its Companies Act in 1981, the Patel Committee recommended that insider trading be made a criminal offence in India. Also, the committee did not discuss about imposing civil penalties
for insider trading under Indian law. The Patel Committee also discussed in its report regarding the U.K.’s model code with regard to restrictions on the transactions carried out by directors and their relatives and employees of listed companies.

Therefore, although, the Patel Committee had reviewed and analyzed the insider trading legislations in U.S.A, U.K and Australia, and some of the recommendations of the committee reflected these legislations, the committee overlooked certain significant provisions in those jurisdictions relating to insider trading which, if introduced in India, would have significantly improved the Indian laws on insider trading.

The committee’s report also suggested certain remedial measures for tackling the menace of insider trading. The Committee had identified that one of the reasons for excessive speculation in the stock exchanges during 1980s, was the lack of prompt disclosure of corporate news by the companies whose shares are listed with the stock exchanges. For instance, at the time of announcement of the annual results, rumours would start spreading in the market about the working results of the company, the quantum of the dividends or the possibilities of bonus or right or convertible bond issues by the companies. These rumours, in turn, lead to the speculative activity in the shares of the companies concerned.
Therefore, as remedial measure, the Patel Committee had recommended that all the listed companies should publish their un-audited working results at least on a half-yearly basis, and on a quarterly basis if the paid-up capital of the company is more than Rs.10 crores. The committee further recommended that the stock exchanges should be immediately informed about any significant financial or other news or developments affecting the price of the company’s securities, as soon as such matters are placed on the agenda of the board meetings and circulated to other directors.

The committee also proposed that if any company fails to comply with the provisions of the listing agreement (entered between the companies and the stock exchanges) relating to material disclosures by the company, the person in-charge of the management of the company should also be penalized for non-compliance. The committee recommended that such statutory responsibility for non-compliance of disclosure obligations should be introduced under the Companies Act, 1956, and the SCRA. However, it was only after 20 years in 2002, that a provision imposing monetary penalty for non-compliance of listing agreement was inserted in SCRA as Section 23E.  

3.5 DISCLOSURES UNDER THE LISTING AGREEMENTS

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151 Section 23E of SCRA, 1956 imposes a penalty of upto Rs 25 crores on a company, collective investment schemes or mutual fund for failure to comply with listing conditions.
As discussed earlier, the Sections 306 and 307 of the Companies Act, relating to disclosures from directors and other insiders was the first step towards regulating ‘insider trading’ in India. The reasoning behind initial attempts keeping focus on the maximum possible disclosures to the public was that the mischief involved in cases of insider trading primarily resulted from disparity of information.

The concept of listing was formally introduced in India under the Companies Act and the SCRA, i.e., a company was required to register itself with the recognized stock exchange (s) prior to offering its securities to the public. Section 73 of the Companies Act mandates that a company offering its securities to the public through prospectus must get itself listed in one or more recognized stock exchanges. Further, Section 21 of the SCRA mandated compliance of the conditions prescribed under the listing agreement between the company and the stock exchange. Each stock exchange can formulate its own terms and conditions of the listing agreement.

The listing agreement mandates several disclosures by the companies in addition to the disclosures required under the Companies Act and the SEBI Takeover Code and Insider Regulations. Provisions of the listing agreement with a focus on preventing insider trading are discussed below:
Under clause 41 of the listing agreement, it is mandatory for every public company whose securities are listed on a recognized stock exchange to publish unaudited working results twice a year.\footnote{The first attempt towards publication of half-yearly unaudited working results of listed companies was by way of a request to those companies to publish their half-yearly results on a voluntary basis which was suggested by the Ministry of Finance of the Government of India through a press note No: F2/5/SE/76 dated 14 November 1977.}

In 1985, the Ministry of Finance proposed an amendment that clause 41 of the listing agreement should be substituted with a new clause 41\footnote{The proposed new clause 41 of the listing agreement has been stated below:} with

\begin{enumerate}
\item[a.] That the company has to give an undertaking to the stock exchange that within 10 days from the date of admission to listing on the exchange, a statement on the number of equity shares held by any director, statutory auditor, cost auditor, financial accountant, tax and management consultant or adviser and whole time legal adviser or Solicitor of the company. The statement shall also contain information about the number of equity shares held by the spouse and children of each one of them. Thereafter, the company shall submit a statement to the stock exchange indicating the ownership of equity shares by each one of the officers mentioned above, their spouses and the dependent children as at the close of the calendar month and the changes which have occurred in this said on a ship during the month within 10 days following the calendar month. The statement shall contain information about the prices at which shares have been bought or sold during the previous month.
\item[b.] But the company has to incorporate the above information in the annual report of the company as an annexure.
\item[c.] The company to agree that it will not register the transfer by way of either purchase or sale of equity shares of the company effected by the persons mentioned above during the period of two months prior to the close of the accounting year of the company and two months thereafter;
\item[d.] However if for any compelling reasons, the persons mentioned above want to register such transfers within the prohibited period, they should intimate their intention to the board before the transaction is effected. If the board does not refuse within a period of 15 days from the date of receipt of such intimation, the person concerned would be entitled to complete the transaction within the prohibited period;
\item[e.] The company shall maintain a register disclosing the holdings and dealings in the equity shares of the company by the persons mentioned above. This disclosure shall be full and complete and also it should include the number and price at which the shares are sold or purchased along with the dates of the transactions. The register should be available for information to the public at the registered office of the company during business hours
\end{enumerate}
regard to insider trading\textsuperscript{154}. These disclosure provisions were further strengthened in 1991 by providing disclosure of the financial performance of the listed companies to the investing public. Under the amended clause 41, a new comprehensive format for publication of the financial results was prescribed. Also, a more effective and faster mode of publication was provided for.

In order to protect the interests of the shareholders who were not concerned with the takeover, and to regulate the secret takeover bids, the listing agreement was amended in April, 1984, to incorporate disclosure provisions in relation to the takeover bids as clause 40. Later on, in May 1990, this provision was split into two separate provisions 40 A and 40B. Clause 40A dealt with the disclosures relating to substantial acquisition of shares and Clause 40B dealt with takeover offers. These provisions mandate disclosures to the stock exchanges, shareholders and the public about any change in control of the company by acquisition of shares. Thus, under this provision, the target company as well as the acquirer is required to disclose all relevant information regarding the acquisition of shares.

\textsuperscript{154} This is also considered as a step taken pursuant to the recommendations of the Patel committee. (Bharat, Compendium on SEBI, Capital Issues and Listing) at page 668. The wordings used in this communication are similar to the recommendations of the Patel Committee.
Further, Clause 36 requires the company to promptly inform the stock exchange about the events having a bearing on the performance/operations of the company, such as the strike, etc., as well as the price-sensitive information. This clause 36 was amended in 1998 through a circular issued by SEBI: no: SMD/Policy/Cir-12/98, dated 7-04-1998 to include additional material events to be disclosed. The material events that were included in the amended clause, *inter alia*, included the following:

(i) change in the general character or nature of business;
(ii) disruption of operations due to natural calamity;
(iii) commencement of commercial production/commercial operations;
(iv) developments with respect to pricing/realization arising out of change in the regulatory framework;
(v) litigation/dispute with a material impact;
(vi) revision in ratings;
(vii) any other information having bearing on the operation/performance of the company as well as price sensitive information, including but not restricted to:

(a) issue of any class of securities;
(b) acquisition, merger, de-merger, amalgamation, restructuring, scheme of arrangement, spin off or selling divisions of the company, etc.;
(c) change in market share of the company, sub-division of equity shares of company;
(d) voluntary delisting by the company from the stock exchange(s);

(e) forfeiture of shares;

(f) any action, which will result in alteration in the terms regarding redemption/cancellation/retirement in whole or in part of any securities issued by the company;

(g) information regarding the status of ADR, GDR, or any other class of securities issued / to be issued by the company abroad; and

(h) cancellation of dividend/rights/bonus, etc.

A major contribution towards the inclusion of corporate governance norms in the listing agreement was the amendment of clause 49 of the listing agreement, mandated by the SEBI in 2006. Clause 49 was initially meant to adopt certain elementary corporate governance practices in Indian companies, such as the minimum number of independent directors required on the board of a company, the setting up of an Audit Committee, and a Shareholders’ Grievance Committee as mandatory. The Narayana Murthy Committee set up by SEBI to review the adequacy of corporate governance clauses under Indian Securities Laws culminated in the amendment of Clause 49 in 2004, by integrating the global best practices within Indian disclosure regime, which became effective from 1 January 2006.
The amended clause 49 clarified the independence criteria for the directors. The roles and responsibilities of the board of directors in public companies were enhanced by the amended clause. The disclosure mechanism had improved. The roles and responsibilities of the Audit Committee in all matters relating to internal controls and financial reporting were consolidated, and the accountability of top management, specifically the CEO and CFO, were enhanced.

The additional disclosure requirements specified in the revised clause 49 are as follows:

(i) Statement on transactions with related parties in the ordinary course of business shall be placed before the Audit Committee periodically;

(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the Audit committee;

(iii) Details of material individual transactions with related parties or others, which are not on arm’s length basis, should be placed before Audit committee together with management’s justification for the same;

\[155\] The word ‘material’ has not been defined. Listed companies should ascertain from their respective audit committees the frequency of reporting such transactions.
(iv) Financial statements should be disclosed together with the management’s explanation of any accounting treatment different from that prescribed in Accounting Standard;

(v) The company shall disclose to the Audit committee on a quarterly basis the use of funds raised through public or rights or preferential issues. Annually, a statement showing use of funds for purposes other than those stated in offer document and prospectus should be placed before the audit committee, certified by the statutory auditors; and

(vi) New disclosure requirements have been prescribed for remuneration of directors, which include the criteria of for making payments to non-executive directors, shares and convertible instruments held by non-executive directors and shareholding (both own and held on beneficial basis) of non-executive directors to be disclosed in the notice of general meeting called for approving appointment of such director.

Therefore, the concept of the listing agreement and the robust disclosure regime introduced under the listing agreement is one of the most significant and effective contributions towards prohibiting insider trading in India.

3.6 ABID HUSSAIN COMMITTEE ON CAPITAL MARKETS
In 1989, the Abid Hussain Committee was set up to examine the adequacy of the existing institutions, instruments and the structures in the Indian capital market and the rules governing its functioning. One of the first and foremost problems identified by the committee was insufficiency of the basic rules of the capital market. The basic rules were adjudged to be insufficient because of the fast changing needs capital market especially in the area of investor protection and guidance. The committee also acknowledged that despite the continuing efforts on the part of various authorities, many aspects of trading practices still required improvement. Rules and standards emphasizing fairness in securities dealings were perceived to be insufficient and amenable to misuse by the traders. The committee also observed that the absence of effective checks and penalties was encouraging the speculators and not the genuine investors.

In April 1988, the Government of India constituted the SEBI, with the primary mandate of investor protection. During the deliberations of the Abid Hussain Committee, the SEBI had initiated the process of incorporating the legal framework to regulate the conduct of all the major players in the market, i.e., the issuers, intermediaries and the exchanges.

Although the Abid Hussain Committee had admitted its difficulty in prescribing remedies to each one of the trading malpractices in the Indian stock market, it is observed that problems of insider trading and secret
takeover bids could be tackled to a large extent by appropriate regulatory measures. The committee proposed that insider trading should be regarded as a major offence, punishable with civil as well as criminal penalties. The committee recommended that the SEBI should be asked to formulate the necessary legislation, empowering itself with the authority to enforce the provisions.

3.7 INTENSIFIED TRADING AND THE SEBI

The CCI was the first authority to approve issue of securities, and the amount, type and the price of securities, as well. The CCI was set up in 1947, under the Capital Issues Act. However, with the repeal of Capital Issues Act, the CCI also was abolished and the SEBI was set up in April 1988, for healthy growth of capital market and investor protection as its primary objective.

The SEBI Act had established SEBI as a regulatory body to protect the interests of the investors in securities, promote the development of the securities market, and to regulate the securities market. SEBI assumed the statutory status on 21 February, 1992, by way of an ordinance promulgated on 30 January, 1992. This Ordinance was replaced by the SEBI Act on 4 April, 1992. The Preamble to the SEBI Act mandates SEBI to ensure investor protection and healthy and orderly development of the securities market.
In July 1988, before the Ordinance, the SEBI had prepared an approach paper on a complete legislative framework for securities market which included measures to curb fraudulent and unfair practices.

Relying on the ‘high standard of conduct’ stressed by the Cohen Committee with respect to insider dealing, the SEBI had issued a press release dated 19 August 1992 with a recommendation to formulate the

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156 The Cohen Committee on Company Law Reform in England had observed: "Even if legislation is not entirely successful in suppressing improper transactions, a high standard of conduct should be maintained, and it should be generally realised that a speculative profit made as a result of special knowledge not available to the general body of shareholders in a company is improperly made. Bharat, Compendium on SEBI, Capital Issues & Listing, 657

157 The press release issued on August 19, 1992 reads as follows:

“The smooth operation of the securities market, its healthy growth and development depends to a large extent on the quality and integrity of the market. Such a market can alone inspire the confidence of investors. Factors on which this confidence depends include, among others, the assurance the market can afford to all investors, that they are placed on an equal footing and will be protected against improper use of inside information. Inequitable and unfair trade practices such as insider trading, market manipulation, price rigging and other security frauds affect the integrity, fairness and efficiency of the securities market, and impairs the confidence of the investors.

The Securities and Exchange Board of India Act, 1992 has empowered SEBI to prohibit insider trading in securities and SEBI is in the process of framing regulations for this purpose. The consultative paper on the subject issued by SEBI and widely circulated through the press in December 1991 outlines the broad framework for the Regulations. After the regulations are notified and brought into effect, violation of these regulations would be an offence punishable under the SEBI Act.

In this context, SEBI has recently written to the banks, financial institutions, stock exchanges, mutual funds, merchant bankers and other intermediaries and professional bodies such as the Institute of Chartered Accountants of India, Institute of Company Secretaries of India, Institute of Cost and Works Accountants in India and Chambers of Commerce about the desirability of evolving an internal code of conduct and setting up internal procedures and checks and balances in these institutions and among the members of the professional bodies, to ensure that their employees or members as the case may be, who may from time to time be privy to unpublished price sensitive information regarding company is listed on the stock exchange in the normal course of business, do not use such information for the purpose of trading in the securities of such companies or companies belonging to the same group for the purpose of personal profit or avoidance of loss. SEBI is of the view that besides creating awareness within these organisations about the fact that using insider information is unethical and would be punishable under law once regulations have been notified, such a measure
‘internal code of conduct’ for the companies to check the practice of insider trading.

3.8 SEBI (PROHIBITION OF INSIDER TRADING IN THE SECURITIES MARKET), REGULATIONS, 1992

Under the SEBI Act, Section 11(2) (g) \(^{158}\) empowered the SEBI to take such measures, *inter alia*, to prevent insider trading, to protect the interest of investors and to promote the development of and regulate the securities market. The SEBI has been further empowered to make regulations consistent with the SEBI Act under Section 30 of the SEBI Act. Pursuant to such powers, the SEBI had framed the SEBI (Prohibition of Insider Trading in the Securities Market), Regulations, 1992 on 19 November, 1992 for prohibiting

would serve to minimise the risks of the employees or members of such organisations becoming liable to action under Insider Trading Regulations. SEBI requests the companies to take appropriate act in this regard and institute similar checks and balances through periodic disclosure and reporting requirements for the securities transactions by their directors and employees. Such voluntary preventive action on the part of companies, banks, financial institutions, stock exchanges and professional bodies would help SEBI in implementing the provisions of the SEBI Act and insider trading regulations. ”

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\(^{158}\) Section 11 (1) Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit.
(2) Without prejudice to the generality of the foregoing provisions, the measures referred to therein may provide for----
(a)-----------------
(b)-----------------
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(g)prohibiting insider trading in securities;
the offence of ‘insider trading.’ Thus, the Insider Regulations were framed by SEBI seven (7) months after the Indian Parliament enacted the SEBI Act.\textsuperscript{159}

The Insider Regulations is a brief regulation consisting of 12 clauses spread out in three chapters. Chapter I consists of the provisions such as short title, commencement and definitions. Chapter II deals with the prohibition on dealing, communicating or counseling on matters relating to insider trading. Regulation 3, under which the offence of insider trading is prohibited\textsuperscript{160} is part of Chapter II. Chapter III relates to the SEBI’s powers to investigate and issue directions in cases of insider trading. Subsequently, Chapter IV was also incorporated in 2002 including two (2) Schedules, regarding the disclosures and corporate governance, which are discussed later in this Chapter.

\textsuperscript{159} SEBI Act came into effect from 4 April, 1992
\textsuperscript{160} Regulation 3 lays down the prohibition as given under:

No insider shall-

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

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

(iii) counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.

Regulation 4 provides that:

“Any insider who deals in securities or communicates any information or counsels any person dealing in securities in contravention of the provisions of regulation 3 shall be guilty of insider trading.”
The offence of insider trading is prescribed under Regulation 4 of the Insider Trading Regulations. Regulation 4 provides that any insider who deals in securities\textsuperscript{161} in contravention of Regulation 3 (or 3A) is guilty of ‘insider trading’. Regulation 3 seeks to prohibit dealing, communication and counseling on the basis of unpublished price sensitive information (“UPSI”). Therefore, the ingredients for the offence of insider trading are identified in Regulation 3.

The Insider Regulation defines the term “insider” as any person who, is or was connected with the company or is deemed to be connected with the company and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information (Regulation 2(e) of the Insider Regulations). If a person is an ‘insider’ and if he is in possession of ‘unpublished price sensitive information’\textsuperscript{162}, then he will be covered within the prohibition contained in

\textsuperscript{161} The amendment dated 20-2-2002 removed the clause “or communicates any information or counsels any person dealing in securities”.

\textsuperscript{162} Under regulation 2(k), ‘unpublished price sensitive information’ means any information which relates to the following matters or is of concern, directly or indirectly, to a company, and is not generally known or published by such company for general information, but which if published or known, is likely to materially affect the price of securities of that company in the market.

i. financial results (both half yearly and annual) of the company
ii. intended declaration of dividends (both interim and final)
iii. issue of shares by way of public rights, bonus, etc
iv. any major expansion plans or execution of new projects,
v. Amalgamation, merger and takeovers
vi. disposal of the whole or substantially the whole of the undertaking
vii. such other information may affect the earnings of the company
Regulation 3 of the Insider Regulations. However, prior to the amendment of 2002, the prohibition applied to situations where the insider had actually used the UPSI while dealing in securities. The reason attributed for this shift from liability for use of the UPSI to mere possession of the UPSI is because of the difficulty to prove that the insider had actually used the UPSI while dealing in the securities, whereas it is easier to prove that the insider dealt in securities while in possession of UPSI. This is where the historic debate on possession v. use in the instances of insider trading becomes relevant. However, the issue remained in cases where there was the casual connection between a person’s possession of UPSI and his dealing in securities.

In 1993, the SEBI once again advised the companies to prescribe certain internal norms relating to the company’s information vis-à-vis the Insider Trading Regulations. The suggested parameters under the press release were:

(i) Identification of the types of information which could be considered as price sensitive information in relation to the business of the company and its subsidiaries and associate companies, for example:

(a) earnings forecast or material changes therein;

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

163 Discussion on Possession v Use is available in chapter II of this study. In the U.S., Rule 10b5-1 was brought in during 2000 to resolve the issue. Soon after, in 2002, India also amended its law to substitute ‘possession’ as its standard in insider trading cases.
164 SEBI Press note dated September 13, 1993
(b) proposals for mergers & acquisitions;
(c) significant changes in investment plans;
(d) acquisition or loss of a significant contract;
(e) significant disputes with major suppliers, consumers or sub-contractors; and
(f) significant decision affecting the product pricing, profitability, etc.

(ii) Identification of the employees or officers or sections of employees/officers of the company who are likely to have access to such information and considered as insiders.

(iii) Nomination of an officer or officers of a company who would give clarifications to the employees of the company on their ability to deal in the company’s shares without attracting the charges of insider trading.

(iv) Controls on handling the price-sensitive information identified above and the publication of such information, wherever possible, so as to eliminate the non-public character of the information.

(v) The norms to be followed by all officers and the employees of the companies, such as not dealing in the shares of the company for a particular period (before and after the declaration of periodical financial results), the time period for which the employees and officers of the company have to wait before they deal in the shares of the
company (after any price-sensitive information has been made public), etc.

(vi) Declaration of purchase and sale of the shares of the company to be obtained from employees and officers including transactions done by the relatives of employees and officers.

(vii) The procedure to be laid down for handling information which may affect the price of the securities of other companies in situation such as mergers, takeovers, etc.

In 2002, the above norms were further modified and the Model Code of Conduct framed under the Insider Regulations came into force.

Further, it was only in 2002 that a specific provision regarding the prohibition on insider trading was inserted in the SEBI Act\textsuperscript{165}. Section 12A of the SEBI Act prohibits manipulative trades, insider trading activities and substantial acquisition of securities.

Section 12A provides as below:-“No person shall directly or indirectly –

(i) use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in

\textsuperscript{165} Chapter V A was inserted in the SEBI Act in 2002 and Sections 12A (d) & (e) of Chapter VA specifically related to insider trading. This amendment, \textit{inter alia}, incorporated the provisions of Insider Trading Regulations into the SEBI Act.
contravention of the provisions of this Act or the rules or the regulations made thereunder;

(ii) employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;

(iii) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made thereunder;

(iv) engage in insider trading;

(v) deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules or the regulations made thereunder;

(vi) acquire control of any company or securities more than the percentage of equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange in contravention of the regulations made under this Act.”

As regards sub-clauses (d) and (e) above, although the SEBI had incorporated the provisions relating to insider trading in the SEBI Act, the SEBI Act did not define the term “insider trading.” Further, these provisions
on insider trading are inconsistent with the provisions in the Insider Regulations. For instance, Section 15G of the SEBI Act and Regulations 3 and 4 of the Insider Regulations are worded differently.\textsuperscript{166}

Although the Section 12A did not have any material impact on the analyses and enforcement of the insider trading cases in India, the demand among the jurists for a specific provision under the SEBI Act prohibiting insider trading was recognized.

Subsequently, the SEBI amended the Insider Regulations on several occasions. A close look at the timing of these amendments even makes it possible to think that the experiences gained through the process of testing various enforcement actions of the Indian regulator and the views of the courts and tribunals/appellate authority on the subject, was the background of these amendments.

### 3.9 INDIA’S FIRST INSIDER TRADING CASE

The first case where SEBI had initiated action against the violators of insider trading laws was the \textit{Hindustan Lever Case}.\textsuperscript{167}

\textsuperscript{166} A detailed analysis is made in chapter IV on the different provisions under Indian securities law on insider trading.

\textsuperscript{167} Order passed by SEBI dated March 11, 1998
In this case, Hindustan Lever Limited (HLL) and Brooke Bond Lipton India Ltd (BBLIL) were subsidiaries of the common parent company, Unilever. A merger announcement between BBLIL and HLL was intimated to the stock exchanges on 19 April, 1996. SEBI was notified about the leakage of the merger information and insider trading by the market as well as the media. Therefore, the SEBI had initiated investigations into the matter. SEBI found that HLL as an insider had purchased the securities of BBLIL from the Unit Trust of India (“UTI”) on the basis of the UPSI about the impending merger, thereby violating the provisions of the Insider Trading Regulations and the SEBI Act. As a result, UTI incurred losses. SEBI, in exercise of its power under Section 11B of the SEBI Act read with Regulation 11 of the Insider Regulations had directed the HLL to compensate the UTI to the extent the UTI had suffered losses. SEBI 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 premiums. SEBI justified its action as corrective steps.

UTI and HLL filed separate appeals against the SEBI’s order before the appellate authority, the central government.\textsuperscript{168}

\textsuperscript{168} Initially, the orders of SEBI were appealable before the central government by the aggrieved party. Section 20 of the SEBI Act, 1992 provides that any order of the Board
The interpretation of the term ‘insider’ under regulation 2(e) was one of the key issues under consideration before the appellate authority in this case. In this regard, the appellate authority observed that the definition of “insider” should have three ingredients:

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

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

(iii) acquisition of the UPSI should be by virtue of the connection.

The SEBI had also interpreted in its order, the third requirement of ‘acquisition of UPSI’ by the insider by virtue of the connection with the company by envisaging two alternate situations:

(i) where the insider is reasonably expected to have access to UPSI by virtue of the connection with the company; or

(ii) where the insider has actually received or had access to such UPSI.

SEBI had concluded that if a connected person actually gains or receives such information independently, notwithstanding his position in the passed before the Securities Law Amendment, 1999 shall be appealable to the Central Government. It was in the year 1995, with the insertion of chapter VI A of SEBI Act, 1992 that the Securities Appellate Tribunal (SAT) was set up. Initially only the orders of A.O. were appealed before the SAT. However, with the amendment of 1999, SAT was conferred with the powers to decide the appeals preferred against orders of SEBI as well as that passed by A.O.
company, such person will fall within the definition of ‘insider’ and therefore, SEBI regarded HLL as an insider. This was upheld by the appellate authority.

However, the appellate authority overruled the SEBI’s order, inter alia, on the following grounds: (i) the news about the merger was not a UPSI as it was generally known and acknowledged by the market; (ii) the information relating to merger could not have significant impact on the price at which the transaction was concluded; (iii) the SEBI’s decision to award compensation to UTI suffers from procedural deficiencies; (iv) SEBI’s direction to HLL to compensate UTI lacks jurisdiction; and (v) SEBI’s direction for prosecution under Section 24 of the SEBI Act was bad in law as the order did not state the reasons for prosecution and also SEBI did not invoke its specific powers for adjudication under Section 15G of the SEBI Act. Therefore, the SEBI’s decision to prosecute HLL was set aside by the appellate authority.

3.10 KUMAR MANGALAM BIRLA COMMITTEE

In early 1999, the SEBI had set up a committee headed by Kumar Mangalam Birla, a member of the SEBI Board, to promote and raise the standards of good corporate governance. The Kumar Mangalam Birla Report on Corporate Governance elaborately discussed about the importance of
prohibition of insider trading for good corporate governance. Some of the relevant recommendations in the report are as follows:

(i) suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;

(ii) drafting a code of corporate best practices; and

(iii) safeguards to be instituted within the companies to deal with the inside information and insider trading.

Para 1.4 is quoted below: “1.4 Another important aspect of corporate governance relates to issues of insider trading. It is important that insiders do not use their position of knowledge and access to inside information about the company, and take unfair advantage of the resulting information asymmetry. To prevent this from happening, corporates are expected to disseminate the material price sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. The principle should be ‘disclose or desist’. This therefore calls for companies to devise an internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its directors and employees and other insiders. For example, in many countries, there are rules for reporting of transactions by directors and other senior executives of companies, as well as for a report on their holdings, activity in their own shares and net year to year changes to these in the annual report. The rules also cover the dealing in the securities of their companies by the insiders, especially directors and other senior executives, during sensitive reporting seasons. However, the need for such procedures, reporting requirements and rules also goes beyond corporates to other entities in the financial markets such as Stock Exchanges, Intermediaries, Financial institutions, Mutual Funds and concerned professionals who may have access to inside information. This is being dealt with in a comprehensive manner, by a separate group appointed by SEBI, under the Chairmanship of Shri Kumar Mangalam Birla.”
The report also observed that the existence and enforceability of regulations relating to insider information and insider trading are crucial to good corporate governance. Further, the provisions regarding existence and enforceability of insider trading regulations were examined separately by a group appointed by SEBI under the Chairmanship of Kumar Mangalam Birla. However, no separate report is publicly available prescribing safeguards for companies to deal with insider trading or suggesting any changes in the Insider Regulations. Nevertheless, the 2002 amendment to the Insider Regulations is presumed to be an outcome of the deliberations of this committee.

3.11 INSIDER TRADING AMENDMENT REGULATIONS, 2002

Insider Trading Amendment Regulations, 2002 brought about the much awaited amendments in the Insider Regulations, which included the conceptual alterations. The below mentioned significant amendments were introduced under different headings of the Insider Regulations:

3.11.1 ‘Insider’

(i) The definition of ‘connected person’ at Regulation 2 (c) that existed earlier was substituted with a new definition of ‘connected person’. The amendment included the persons having both temporary and permanent professional or business

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170 Para 2.9 of the Kumar Mangalam Birla Report
relationship with the company under in the definition of "connected person." Therefore, the scope of the term "insider" was broadened by including temporary professionals as well. Further, connection was given a periodical existence, i.e., a person connected within six (6) months prior to the act of insider trading was regarded as connected person.

(ii) The definition of "insider" was modified and the words 'by virtue of such connection' were deleted from the definition.\textsuperscript{171} SEBI’s argument in the \textit{Hindustan Lever Case} that the acquisition of UPSI by an insider could be independent of the insider’s connection with the company was upheld by the appellate authority. On similar lines, by the amendment in 2002, the SEBI had altered the law to avoid any contrary interpretations in future.

(iii) A clause was included in the definition of "insider" whereby the intermediaries such as the Investment Company, the Trustee Company, the Asset Management Company or an employee or director of stock exchange or clearing house or clearing corporation were also included in the scope of

\textsuperscript{171} The detailed discussion on the amended definition of “insider” has been included in Chapter IV of this study.
This description of “intermediary” was taken from Section 12 of the SEBI Act.\textsuperscript{173} The relatives of connected person were also included in the category of deemed connected person.

Further categories were included in the definition of ‘deemed connected person’, such as a person who is a concern, firm, trust, Hindu undivided family, company or association of persons wherein, either the director or deemed director\textsuperscript{174} or any of the persons mentioned at Regulation 2(h) (vi) to (viii), (i.e., relative of the persons mentioned in the initial clauses of definition of ‘deemed connected person’), who have more than 10\% of the holding or interest.

\textbf{3.11.2 Unpublished Price Sensitive Information}

The definition of ‘unpublished price sensitive information’ was bifurcated into “unpublished information” and “price-sensitive information”. The new definition for ‘price-sensitive information’ was inserted at Regulation 2(ha) and the term ‘unpublished’ was defined at Regulation 2(k). The term ‘unpublished’ was defined separately as

\textsuperscript{172} The term ‘deemed connected person’ was subjected to a lot of criticism before the SAT in the case of Samir Arora.

\textsuperscript{173} This provision has certain elements contained in the following clause (iii) under the definition of ‘deemed connected person’. There is an overlapping of the provisions under clauses (ii) and (iii).

\textsuperscript{174} As defined to be connected persons at regulation 2 (c) (i) of SEBI (Prohibition of Insider Trading) Regulations, 1992.
‘information which is not published by the company or its agents and is not specific in nature.’ The explanation to the provision stated that “speculative reports in print or electronic media are not considered to be published.” The term “price-sensitive information” was defined as “any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company.” The definition also provided an inclusive list of kinds of information which are deemed to be price-sensitive information. Thus, the new definition of ‘price sensitive information’ seems to have taken care of the ambiguity pointed out by the appellate authority in the *Hindustan Lever Case* relating to the ‘unpublished price sensitive information.’

### 3.11.3 Offence of insider trading

(i) The definition of “dealing in securities” was amended to include the term ‘subscribe’, in addition to the existing actions of buying and selling. Therefore, the offence of insider trading was extended to the primary market by covering the cases of initial public offers.

(ii) Earlier, the liability of insider trading could be imposed if the insider dealt in the securities on the basis of the UPSI.
However, the amendment altered this requirement and provided that mere possession of the UPSI is sufficient to impose the liability for insider trading. The words ‘on the basis of’ in Regulation 3 was substituted with the words ‘while in possession of’.

This amendment was similar to the Rule 10 b-5-1 of the U.S.’ Exchange Act relating to possession v. use of UPSI. This amendment in the Insider Regulation was very significant in the Indian scenario as well, as the amendment eased SEBI’s difficulties in proving the liability of an insider who had traded on the basis of UPSI. Consequently, this resulted in better enforcement of insider trading cases in India.

(iii) Tipping *per se* was made an offence under the amendment. Earlier, if the tippee did not trade using the tipped UPSI, the tippee and the tipper could not be held liable. However, after the amendment, the tippers’ and the tippees’ liability was made absolute and they could be held liable even if the tippee himself did not trade on the tipped UPSI. Therefore, Regulation 3 (ii) was amended to prohibit tipping UPSI, irrespective of whether the tippee trades using the tipped UPSI.
(iv) Prior to the amendment, a company could not be held liable for insider trading. This became an issue as many companies also involved in insider trading and made huge profits. Therefore, the Regulation 3A was inserted to prohibit companies from dealing in the securities of another company or associate of that other company while in possession of UPSI. This amended was warranted as companies and not just persons were stakeholders in other companies and during takeovers, the potential bidders (which were companies) were in possession of UPSI.

3.11.4 Provisions on Investigation

(i) The amendment conferred SEBI with additional powers to conduct inquiries and inspection against an insider to establish the liability for violation of Insider Regulations.

(ii) Prior to the amendment, SEBI could not proceed with an action for insider trading violation, if the SEBI did not have written information about the violation. However, now the requirement of ‘written information’ to be in the possession of SEBI has been dispensed with. Now, SEBI can initiate investigation by appointing an investigating authority if SEBI is of the *prima facie* opinion that it is necessary to investigate.
(iii) The scope of investigation has been extended to more categories such as stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisations in the securities market.

(iv) The timeframe of one (1) month to complete the investigation and submit the investigation report has been substituted by ‘reasonable time’. Although this amendment may cause delays in enforcement of insider trading cases, SEBI will get adequate time to carry out detailed investigations as required and collect evidence, before concluding the liability of insider trading on an insider.

(v) Time limit of twenty-one (21) days was prescribed to a person who had to file a reply upon receipt of the communication with the findings of the investigation.

3.11.5 Enforcement

The amendment gave additional powers to SEBI to issue appropriate directions to an insider for insider trading violations, focusing on the investors’ interests. Under the amended provisions, the SEBI had powers to declare a transaction underlying an insider trade null and void. SEBI also procured additional power to issue directions to 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) to the seller.
Post 2002 amendment, SEBI could also direct a person who has dealt
in securities in violation of the regulations to transfer a fixed 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.

3.11.6 Corporate Governance

The most important amendment introduced was the mandatory
good governance provisions in Chapter IV of the Insider Regulations
and the Model Code of Conduct for the listed companies and other
entities, and relating to disclosures, for prevention of insider trading as
Schedules I and II respectively.
Some of the corporate governance norms for the companies are as
follows:
(i) Officer, director and substantial shareholder to disclose their
shareholding on certain events or at certain intervals;
(ii) Appointment of a compliance officer;
(iii) Setting forth policies and procedure to restrict the possibility of
abuse of insider trading;
(iv) Monitoring and pre-clearance of trades by designated persons;
(v) Restricts trading by such insiders within a certain period of time, i.e., before corporate announcements, buy backs, etc.

(vi) The company has to communicate all the significant insider activity and corporate disclosure in a uniform publicly accessible means to the public-and to the stock exchange;

(vii) Chinese walls within a firm to prevent information of one department of the firm which deals in sensitive information from going to the other departments of the firm, which have an inherent conflict of interest with such other departments;

(viii) Minimum holding period of securities by insiders as six (6) months;

(ix) No selective disclosures to analysts and wide dissemination of information.

Based on the foregoing, it can be concluded that the amendments of 2002 have significantly strengthened the regulatory regime of insider trading in India. Emphasis was given to the inclusion of corporate governance norms as a method for prevention of insider trading in companies and other entities associated with the capital market. The ‘possession’ requirement for deciding the liability in the cases of insider trading also resolved the problems faced by the regulator in proving the cases. Substantial changes were made to the provision of UPSI, all of which had enhanced the SEBI’s enforcement capability, specifically with respect to insider trading cases.
3.12 RAKESH AGARWAL CASE

It was before the amendments of 2002 that SEBI by its order dated 10 June, 2001 held Mr. Rakesh Agarwal, the Managing Director of ABS Industries, guilty of insider trading. According to the facts of this case, a German pharmaceutical company, Bayer, had acquired ABS Industries during October 1996. The allegation of ‘insider trading’ in this case related to the period prior to the acquisition.

Based on the allegations of purchase of shares prior to the announcement of Bayer’s acquisition of ABS Industries, SEBI conducted investigation and initiated action against Rakesh Agarwal. Upon investigation, SEBI found that a huge chunk of the shares were bought by certain brokers on behalf of one Mr. Kedia, the brother-in-law of Rakesh Agarwal. The purchases made by Mr. Kedia were done on behalf of Mr. Rakesh Agarwal. SEBI found that:

(i) Rakesh Agarwal is a “connected person” within the meaning of Regulation 2 (c) and he is also an “insider” as he negotiated on behalf of ABS Industries and knew about the impending merger.

(ii) The information about the takeover was ‘price-sensitive information’ within the meaning given under the Insider Regulations.

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175 Rakesh Agarwal v. SEBI 2004 49 SCL 351 SAT
In view of the foregoing, SEBI held Rakesh Agarwal liable for insider trading. The reasoning given by SEBI was that when the shares were purchased on or after 9 September 1996, the information regarding merger was not available to persons who had sold these shares to Mr. Kedia. According to SEBI, Mr. Kedia/ Rakesh Agarwal were the insiders and were under a fiduciary duty towards the sellers. Therefore, SEBI held that the purchase made by Rakesh Agarwal of 1,82,500 shares was in violation of Regulation 3 (i) of Insider Regulations. Further, SEBI, vide its order, directed Rakesh Agarwal to deposit a sum of Rs.34,00,000 with the investor protection fund of BSE and NSE to compensate the investors who may come forward at a later stage seeking compensation for the loss incurred by them in selling at a price lower than the offer price\textsuperscript{177}. SEBI also ordered adjudication proceedings under Section 15 (G) of SEBI Act against Rakesh Agarwal, and found this to be a fit case to launch prosecution.

The enforcement order of SEBI in \textit{Rakesh Agarwal Case} was more or less similar to the order of SEBI in \textit{Hindustan Lever Case}, in terms of compensation to investors and prosecution against insiders. The additional

\textsuperscript{176} SEBI relied on the two decisions in the US: Basic Incorporated 484 US 224; TCS Industries v. Northway 426 US 449
\textsuperscript{177} SEBI has said in its order that in these kind of cases in U.S., the regulatory body and the courts have ensured that the investors who have suffered disadvantage, due to the lack of information available only to the insider, are suitably compensated. SEBI also thought it necessary to identify and locate the investors.
feature was that SEBI had invoked its specific adjudication powers provided under Section 15 (G) of the SEBI Act, unlike in the *Hindustan Lever Case.*

Rakesh Agarwal appealed against the SEBI’s order before the SAT. Although the SAT found that Rakesh Agarwal was an insider and that the information about the merger was UPSI, the SAT set aside the SEBI’s finding that Rakesh Agarwal was guilty of insider trading. The reasoning given was that there was no unfair advantage gained by the insiders and the act of Rakesh Agarwal of making the shares of ABS Industries available for Bayer was only to ensure the successful acquisition, which was crucial for ABS Industries’ business.

Although the SEBI took the plea before the SAT that Regulations 3 and 4 are “plain vanilla” sections without the specific mention of motive or intention, the SAT was of the opinion that Insider Regulations in India, if read with the objective of prohibiting the insider trading, makes clear that motive is built in and the insider trading without establishing the motive factor is not punishable. SAT was of a firm view that Insider Regulations in India seek to prohibit gaining of unfair advantage by the insider by indulging in insider trading. Hence, the SAT ruled that Rakesh Agarwal was acting in the interest of the company and therefore, he was not guilty of violating Insider Regulations. Although the order of SEBI to compensate investors was set aside by the SAT, it held that it did not have the jurisdiction to interfere with
the SEBI’s direction to launch prosecution and initiate adjudication against Rakesh Agarwal. SEBI filed an appeal against this decision of the SAT, in the Supreme Court of India. However, the case was settled through the SEBI’s consent scheme and thus, there was no occasion for the Supreme Court to analyze of the facts of the case and law involved. If the case had been disposed of on merits, the Indian law on insider trading would have had more clarity as regards the significance of “motive” and “intention” in the insider trading cases.

3.13 AMENDMENT OF 2002 FOR CHINESE WALL DEFENSES

It is interesting to note that another amendment was introduced in the same year 2002 in the Insider Regulations. The amendment was introduced as Regulation 3B, which provided for general defences available to a company for defending the charge of insider trading. These defences are popularly referred to as ‘chinese wall defences’ for the companies and are similar to the provisions under the Australian Corporations Act.

The defences available in India are that the UPSI was in the possession of an officer or employee, and:

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178 The second amendment in the year 2002 was on 29-11-2002, known as the SEBI(Prohibition of Insider Trading)(Second Amendment)Regulations, 2002
(i) that the decision to enter into the transaction or the agreement was taken on the company’s behalf by person or persons other than that officer or employee;

(ii) the company has put in place the system of demarcating the activities of the company in such a way that the person who enters into a transaction on behalf of the company cannot have access to information which is in the possession of other officer/employee of the company;

(iii) arrangements were made to ensure that 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;

(iv) the information was not communicated or no such advice was given; and

(v) the acquisition of shares of a listed company were as per the SEBI’s Takeover Regulations.

In view of the foregoing, the defences for insider trading under the Insider Regulations are available only to the companies and not to the individuals. It is surprising that no defences have been made available to the entities other than the companies. An intermediary or other entities in the securities market who is alleged to have indulged in insider trading, while in possession of UPSI, and if it was the intermediary’s/entities’ employee who
actually committed the insider trading stealthily, cannot have a defence under Regulation 3B. But if it has the legal structure of the company, the defences are available. It is unfair that the norms prescribed for prevention of insider trading apply to all entities including the companies, whereas the defences are available only to the companies. The specific inclusion of Regulation 3A and 3B (relating to offence of insider trading by a company and the defences) was on the premise that a company is a juristic person and not a natural person, and therefore, a company cannot indulge in insider trading. However, this explanation is untenable from a legal and logical standpoint.

3.14 AMENDMENTS OF 2003

Minor amendments were again introduced in the Insider Regulations in 2003 regarding the formats in which the disclosures were to be made under the Insider Regulations. For instance, the Form A under Regulation 13 (filing of disclosures) was part of this amendment.

3.15 SEBI’S DECISION IN THE RELIANCE INDUSTRIES CASE

Another decision on the interpretation of the existing insider trading laws was delivered by the SEBI in the case of Reliance Industries Ltd. This case related to the involvement of Reliance Industries Ltd (“RIL”), Mukesh Ambani and Anil Ambani in the scrip of Larsen & Toubro Industries

179 www.sebi.gov.in order dated January 21, 2004
SEBI had received a complaint regarding the sale of 10.05% of L&T shares by RIL to Grasim India Ltd (“GIL”). The allegation was that RIL had increased their holding in L&T from 6.62% (in March 2001) to 10.05% (in November 2001) immediately prior to L&T’s deal with GIL. RIL was alleged to have sold its stake to GIL (at the rate of Rs.306.6 per share) thereby making huge profits as they had purchased the additional equity shares at an average price of Rs.150 per share from the market. Based on the complaint received the SEBI conducted an investigation into the alleged transactions. SEBI was of the *prima facie* view that RIL and the Ambanis were insiders, the acquisition of RIL’s stake in L&T by GIL was a price-sensitive information, and that the acquisition of L&T shares by RIL, prior to the sale to GIL was on the basis of UPSI. Based on the above, SEBI had issued a show-cause notice to RIL.

The Ambanis denied that they were insiders and also said that they did not have access to the alleged price-sensitive information. RIL had also contended that RIL did not receive the alleged UPSI through L&T. The Ambanis further contended that Regulation 3 of the Insider Regulations does not prohibit a person from trading in the shares of a company of which such person is a director. It only prohibits dealing on the basis of UPSI in respect of that company. A director, who knows of some other company selling its stake in the target company by virtue of his directorship of the other company, and that too, at a point of time prior to this information reaching the target
company, is not an insider vis-à-vis the target company under the definition of “insider” nor would he be affected by the Regulation. RIL stated that in the present case, a fortiori, RIL, which is a corporate entity and, which has sold its shares, was twice removed from the Board of Directors of L&T, and any allegation of insider trading merely because it is a “connected company” within the artificial meaning of that term under the Insider Regulations is utterly misconceived.

Therefore, the primary issue before the SEBI was the interpretation of the term ‘insider’ whether Mukesh Ambani and Anil Ambani were ‘insiders’ within the meaning of Regulation 2(e) of the Insider Regulations and whether they can be termed as ‘connected persons’ or ‘deemed to be connected persons’ in terms of Regulation 2 (c) and (h) of the Insider Regulations. In its order dated 21 January 2004, the SEBI ruled that as the Ambanis were the directors on the board of L&T and were reasonably expected to have access to the L&T’s UPSI, the Ambanis were ‘connected persons’ within the meaning of Regulation 2 (c) of the Insider Regulations. SEBI also observed that RIL and L&T may be deemed to be bodies corporate under the same management as per Section 2 (g) of the MRTP Act, 1969, and therefore, RIL would be “deemed to be a connected person” with L&T. Thus, although the SEBI concluded that the Ambanis can be regarded as “insiders”, the finding regarding insider trading violation was that as the UPSI was not received by
RIL or Ambanis as insiders of L&T, they cannot be held liable for violation of Regulation 3.

3.16 SAMIR ARORA CASE\textsuperscript{180}

In this case, Samir Arora was the fund manager in Alliance Capital Mutual Fund (ACMF), which had a substantial stake in Digital Globalsoft (“DGL”). The funds managed by Samir Arora consisted of 9.5% of the paid up capital of DGL in September 2002. He sold the entire holding of the funds managed by him in DGL in four (4) consecutive trading days starting from 8 May 2003 based on UPSI pertaining to the demerger of HP-ISO into DGL. Samir Arora and his analysts had the practice of making regular visits and interaction with the management and the senior officials and used to discuss with the performance and future plans of the companies in which they invested. The funds managed by Samir Arora were the single largest shareholder group of DGL, after Compaq Computer Holdings Ltd, i.e., almost 10% of the total paid up equity capital and therefore, the fund had a special interest in DGL and vice versa.

Based on the media reports about the fluctuations in the price of DGL due to the proposed sale of stake by ACMF and other related matters, the SEBI initiated \textit{suo moto} investigation into the alleged violation of the Insider

\textsuperscript{180} Samir Arora v. SEBI [2005] 59 SCL 96 (SAT). The judgment of SAT is appealed by SEBI in the Supreme Court and is pending final decision.
Regulations amongst other violations. SEBI’s case was that by trading on the UPSI, Samir Arora took an undue advantage and succeeded in avoiding losses to the tune of Rs.23.57 crores at the cost of buyers who had no such information. As the incentives of the fund managers are linked to the performance of the funds managed by them, he was alleged to have been motivated by the personal gain that could accrue to him. In view of the foregoing facts, SEBI held that Samir Arora had violated Insider Regulations.

Samir Arora filed an appeal against the SEBI’s order before the SAT, and Samir Arora had challenged the interpretation of the term ‘insider’ by SEBI, stating that his normal functions as a fund manager was wrongly interpreted and that by no stretch of imagination, he could be considered as an “insider” to the DGL. SAT, in its order dated 15 October 2009, although observed that the SEBI’s interpretation of the definition ‘deemed to be connected person’ was too wide and would make every market player vulnerable to the charge of insider trading, the SAT accepted the SEBI’s interpretation that Samir Arora was an insider on the basis of the term “deemed to be connected person”, and that there was a UPSI and the trading. However, as the SEBI failed to establish how Samir Arora received the UPSI, the SAT reversed the SEBI’s order and ruled as follows:

“persons not reasonably expected to have such access who are covered after the conjunction ‘or’ but who have actually received or have had actual access
“to such information can be treated as insiders only if they have received price sensitive information or have had in fact had such access to such information.” Therefore, the SAT accepted that although Samir Arora was an insider and that merger ratio was a UPSI, in the absence of adequate evidence as to how Samir Arora had received the UPSI, SAT set aside the order of SEBI. SEBI filed an appeal against the SAT’s order in the Supreme Court of India. The appeal is still pending disposal before the Supreme Court.

3.17 DSQ HOLDINGS LTD CASE

This was another case where the SEBI and the SAT had interpreted the Insider Regulations. SEBI had initiated investigations into the sudden rise in the price and volumes of DSQ Biotech Limited (“DSQ”). It found that a substantial quantity of the company’s shares were purchased by DSQ Holdings Ltd, (DSQH), one of the promoter group company, with the knowledge of the impending rights issue of DSQ. The shares purchased by DSQH prior to the aforementioned rights issue also entitled them for rights in the rights issue. Therefore, it was *prima facie* found that DSQH violated the Insider Regulations. SEBI passed an order dated 27 February 2003 holding DSQH liable for insider trading and debarring DSQH from dealing in the securities market for five (5) years. DSQH appealed against the SEBI’s order before the SAT. One of the contentions raised by the DSQH was that the

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181 DSQ Holdings v. SEBI Appeal No: 50/2003 decided by SAT on 15.10.2004 (www.sebi.gov.in)
information regarding the rights issues was not a UPSI. SAT ruled against DSQH and held that information about the rights issue was a UPSI, and was in the possession of DSQH by virtue of it being a group company of the other. Therefore, the purchase of the shares of DSQ made by DSQH violated Insider Regulations. Although DSQH pleaded that they were not privy to the UPSI, and that they had not made any profit, the SAT did not accept these contentions. The SAT observed the fact that the shares were pledged by the promoters of DSQH with banks as collateral security indicates that the appellant did obtain profit. The facts that appellant is an insider, and that he traded in the shares of DSQH, subsequent to his possession of UPSI have been established by SEBI and therefore, the SEBI had conclusively proved that DSQH had committed insider trading violation.

3.18 DR. ANJALI BEKE CASE

The case of Dr. Anjali Beke is relevant as this case had widened the scope of the term “insider.” The facts of the case are that Anjali Beke was the proprietor of Anjudi Property and Investment Pvt. Ltd. ("API"). One, Mr. Dilip Pendse, the Managing Director of Tata Finance Limited, closely knew Anjali Beke and passed on the UPSI regarding financial losses of TFL to Anjali Beke. Anjali Beke and API sold 2.5 lakhs shares of TFL based on the UPSI regarding TFL’s financial losses. Pursuant to its investigations into the dealings in the scrip of TFL, SEBI imposed a monetary penalty of Rs 5 lakhs

on Anjali Beke and API, for trading in the shares of TFL in violation of the Insider Regulations.

The definition for “insider” under Insider Trading Regulations reads as follows: “Insider means any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access by virtue of such connection to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information.”

SEBI held that it was not necessary to show that in all cases of insider trading, a person (insider) is connected with or deemed to be connected with the company. It was the first time, when the SEBI had interpreted the definition of ‘insider’ to include persons who has received or had access to UPSI. The logic explained by SEBI was that it was possible that sometimes an insider may not be connected with or deemed to be connected with the company, but, would nevertheless become an insider for a limited period when he is in possession of the UPSI which is not known to others, and if such person trades on the basis of the said UPSI, such trading would be in contravention of the Insider Regulations. Based on these facts, SEBI held that Anjali Beke and API were insiders and violated Insider Regulations.
Anjali Beke appealed against the SEBI’s order before the SAT and one of the contentions was that she had never traded in the shares and it was Dilip Pendse who traded on her and API’s behalf.

The SAT, upheld the SEBI’s reasoning that when a person has received UPSI or has had access to such UPSI, the person becomes an insider\(^{183}\). It is not necessary that the person should be a connected person to the company. Thus, the SAT upheld the SEBI’s order in view of Anjali Beke’s closeness to Dilip Pendse, as she was an insider and had access to the UPSI. However, SAT took a different view in the case of Dilip Pendse, which is discussed later in this chapter.

3.19 RAJIV B. GANDHI’S CASE\(^{184}\)

Rajiv B. Gandhi (“Gandhi”) was the Company Secretary and Chief Financial Officer of Wockhardt Limited (the “Company”). SEBI found that the results for the quarter ending December 1998 showed a negative performance of the Company over the previous quarter and Gandhi, his wife and sister (jointly referred to as “Gandhis”) sold 3600 shares of the Company on 21 January 1999 and 22 January 1999 based on this UPSI, prior to the

\(^{183}\) The definition of ‘insider’ was amended by SEBI in the year 2008, whereby it was the legislative provision clearly provided that any person in possession of UPSI was an insider.

\(^{184}\) Rajiv B Gandhi v. SEBI. In this case, SEBI’s order was passed on November 30, 2006 and the SAT passed its order in appeal No. 50 of 2007 decided by SAT on 9.5.2008 (www.sebi.gov.in)
board meeting itself, when the negative financial results were not available to the general investors. Although the Gandhis denied the charges against them, they pleaded that Gandhi’s wife and sister were not insiders within the meaning of the Insider Regulations and, therefore, no action was maintainable against them. It was further pleaded that Gandhi himself had not executed any trades and could not be held liable for insider trading. Subsequent to its investigations, SEBI imposed a penalty of Rs.5 lacs on each one of Gandhis, for the violation of Regulations 3 and 4 of the Insider Regulations.

Gandhis filed appeal before SAT. Although, they conceded before the SAT that they were insiders and that they were in possession of the UPSI, they took a position that they did not trade “on the basis of” that information. The SAT examined whether Gandhi traded on the basis of the information that was in his possession and not available to any other investor or trader. SAT held that on a plain reading of Regulation 3, the prohibition contained therein shall apply only when an insider trades or deals in securities “on the basis of” any UPSI and not otherwise. The words “on the basis of” are significant and mean that the trades executed should be motivated by the information in possession of the insider. In other words, the information in the possession of the “insider” should be the factor or circumstance that should induce him to trade in the scrip of the company.
The SAT held that if an insider trades or deals in the securities of a listed company, it would be presumed that he traded on the basis of the UPSI in his possession unless he establishes the contrary. As the facts necessary to establish the contrary will be within the knowledge of the insider, the burden of proving those facts is upon him. The SAT observed that 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 UPSI and that he traded on some other basis. He should 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.

As Gandhis could not establish beyond doubt that they did not trade “on the basis of” the UPSI, the SAT upheld the findings of SEBI and held Gandhis guilty of insider trading.

3.20 SHORT SWING PROFIT REGULATIONS

In 2008, the SEBI made an attempt to introduce the concept of short swing profits in the Insider Regulations. SEBI sought to prohibit certain category of insiders from making short swing profits, i.e., profits made from the sale of securities followed by their repurchase within six (6) months.

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185 On January 1, 2008, a concept paper was posted on SEBI’s website titled ‘Short Swing Profit’ Regulations in India.
However, the proposal as contemplated in SEBI’s concept paper did not materialize in its entirety.

Prior to this, the Thomas Committee of 1948, *inter alia*, had evaluated the U.S. regulations on short swing profits under Section 16 of the Exchange Act. Section 16 of the Exchange Act provides for a three-fold attack against the possible abuses of inside information by corporate insiders, which, *inter alia*, include: (i) reporting by certain insiders of their stock holdings and transactions in the company’s securities; (ii) makes it unlawful for the same insiders to engage in short sales of their company's equity securities; (iii) permits the company or a security holder to initiate an action on behalf of the corporation to recover the benefits of the short swing profits.

The adequacy of the Section 16 of the Exchange Act has been subject to judicial and academic scrutiny over the years. Donald C. Langevoort\(^\text{186}\), one of the leading securities law attorney and an academician in the U.S. states that the scope of Section 16(b) is limited for the following reasons and that Rule 10b-5 is a more effective and widely used weapon against abusive trading practices: (i) Section 16 (b) applies to only “high level” insiders and it does not cover other insiders and tippees, who have access to sensitive corporate data; and (ii) Section 16 (b) covers only short swing profits and not

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the situations where high level insiders buys the securities and do not sell them within a six (6) month period (or sells securities without having bought them). Section 16(b) of the Exchange Act has been termed as ‘unique’ in terms of securities law enforcement as under this section, the SEC did not have specific authority to initiate proceedings against the insiders dealing in short swing trades. Enforcement of Section 16(b) could be initiated only by the affected persons or the company.

Finally, the provisions relating to “short swing profits” were introduced in India in 2008, by way of an amendment to Clause 4.2 in Schedule I of the Insider Regulations, i.e., the Model Code of Conduct for Prohibition of Insider Trading. 187 Clause 4.2 prohibited all directors /employees/designated employees who buy, or sell any number of shares of the company from entering into an opposite transaction for a period of six (6) months from the date of prior transaction. The rationale of this amendment was to prevent insiders who are in possession of UPSI from taking advantage of such information to make short swing profits.

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187 SEBI (Insider Trading Amendment), 2008 dated November 19, 2008. The provision prior to the amendment said that all directors/employees/designated employees shall hold their investments in securities for a minimum period of 30 days, including that of IPOs. However, post amendment, it read that all directors /employees/designated employees who buy, or sell any number of shares of the company shall not enter into an opposite transaction, i.e., for a period of six months from the date of prior transaction. All directors/employees/designated employees are prohibited from taking positions in derivative transactions in the shares of the company at any point of time. But, if these persons have subscribed to the shares in IPOs, then the restriction is limited to a period of 30 days only. The holding period would commence from the date of allotment.
However, the amendments were not received well by all categories of traders or investors and certain shortfalls were pointed out to the SEBI. Some of the issues have been discussed below:

(i) If a person purchases fresh shares in addition to his existing holding, then the person is statutorily prohibited from selling his added as well as previous shareholding for a period of six (6) months from the date of purchase transaction. Therefore, certain segments amongst the public had regarded this as unfair.\textsuperscript{188}

(ii) The amendments did not prescribe the principle of First In First Out (FIFO), i.e., the shares purchased first can be sold first.

(iii) The amendment did not specify the method of calculation of short swing profits.

(iv) There was confusion regarding the ESOPs and selling of shares by employees, etc., in an emergency situation. This aspect was not covered by the amendments. However, subsequently, the SEBI had issued clarifications in this regard and stated that an employee can subscribe to the ESPOs even if he has sold shares during the previous six (6) months. However, once the shares acquired through ESOPs are sold in the market, the restriction on buying would become applicable for the next six (6) months. SEBI also clarified that while exercising ESOPs, the code of conduct framed by the company and the

\textsuperscript{188} Rajesh Relan, SEBI’s attempt to plug short swing profits lack clarity 90 SCL 2009 71 SEBI clarified in a subsequent FAQ that it is the date of last purchase from where the period of 6 months are to be calculated.
fundamental principles for prohibition of insider trading as specified in the Insider Regulations must be complied with.

(v) The amendment did not clarify regarding the purchases made before the amendment. The SEBI had clarified that the designated person may be allowed to sell the shares brought prior to the amendment, if such sale is permitted under the code of conduct of the company.

Therefore, the SEBI had considered all the criticisms of the amendment and had issued clarifications to most of these issues. However, the enforcement of the short swing prohibitions still remained ineffective to an extent as discussed below.

As regards the enforcement of the short swing prohibitions, SEBI had proposed that the liability of the insiders making profits in a sale and purchase within a gap of six (6) months shall be strict and the intention behind the trade as well as that the insider traded on the basis of insider information need not be proved. In a way, SEBI made the time period as the only determining factor to impose the liability of the insiders for violation of short swing prohibitions.

This provision is prophylactic and designed to preclude transactions with a potential for abuse irrespective of the fact whether the actual abuse took place. Further, SEBI’s powers to initiate prosecution and impose
imprisonment and fine up to Rs.25 Crores emphasizes on the comfort that SEBI wants to provide for the investors in the market. Stringent penalties and effective enforcement could have been one of the reasons for including short swing prohibitions under the Model Code of Conduct of Insider Regulations.

To conclude, it was important to regulate the short swing trades and the Short Swing Regulations have provided the necessary framework. However, for effective enforcement, it is imperative to make a specific system to identify the instances of short swing trades and thereafter empower the regulator to initiate *suo moto* action against the violator. Further, the SEBI should be empowered to direct the insider to surrender the profits in short swing violations. Thus, a clear and transparent system for dealing with the short swing trades under the Insider Regulations is contemplated to act as a deterrent.

Notwithstanding, if a separate regulation for short swing trades did not come into force, SEBI still had adequate statutory provisions to regulate the trades entered into by specific categories of insiders. The Insider Regulations provide for a specific trading window for trading by the company's directors/employees/designated employees, as well as a pre-clearance option to take permission before their trades.
Besides the short swing profit regulations, the other key features of the 2008 amendment are as follows:-

(i) The term ‘insider’ was amended once again, finally resolving a lot of issues\(^{189}\) relating to the interpretation of the term ‘insider’. Thus, with the amendment in 2008\(^{190}\), the definition of “insider” has been simplified and is made applicable to any person who has or has had access to the UPSI of the company. Therefore, any person, irrespective of whether the person is within the company or outside, who chances upon UPSI can be held liable for insider trading.

(ii) Prior to the 2008 amendments, the Regulation 13 provided that certain category of persons had to make certain disclosures within four (4) working days. The amendment of 2008 has reduced this reporting time period from four (4) days to two (2) working days.

(iii) The provision at Regulation 13(4) has been substituted with the new clause that any person who is a director or officer of a listed company, shall disclose to the company and the stock exchange the total number of shares or voting rights held, and change in shareholding or voting rights, if there has been a change in such holdings of such person and his dependents (as defined by the company) from the last disclosure made under sub-regulation (2) or under this sub-regulation, and the change exceeds Rs.5 lakh in value or 25,000 shares or 1% of total

\(^{189}\) In majority of the litigations involving violations of Insider Regulations, SEBI found it strenuous to establish whether one is an insider.

\(^{190}\) SEBI(Insider Trading) (Amendment) Regulations, 2008, w.e.f 19-11-2008
shareholding or voting rights, whichever is lower. These disclosures were to be made within two (2) working days from the receipt of the intimation of allotment of shares, or the acquisition or sale of shares or voting rights, as the case may be. Prior to the amendment, there was no disclosure requirement to the stock exchanges. Further, the furnishing of information regarding the change in the shareholding of the dependants did not exist earlier.

(iv) The procedure of e-filing\textsuperscript{191} was introduced to simplify the disclosure procedure.

(v) The amendment made it mandatory for all the shareholders to provide their Permanent Account Number (PAN) in all the forms relating to the disclosures under the Insider Regulations.

3.21 SADHANA NABERA’S CASE\textsuperscript{192}

Dilip Nabera was the auditor of the company, Sun Infoways Ltd. (“SIL”), during the period July-October 2000. When he joined SIL, Dilip Nabera held 10,700 shares in the name of Dilip Nabera HUF. His wife Sadhana Nabera held 5,300 shares all of which were disclosed to SIL. Sadhana Nabera was the whole time director of a company, Adhunik Finance Pvt. Ltd. (“Adhunik”), which also traded in SIL’s shares but its holdings were

\textsuperscript{191} A new clause (7) has been introduced at Regulation 13
\textsuperscript{192} SEBI’s order is dated November 06, 2006 and in Appeal no:26/2007 decided on 19.02.2008
not disclosed to SIL. SIL was planning to take over the business of Zap
Infotech. Prior to the public announcement of this information, Dilip Nabera,
Sadhana Nabera and Adhunik traded in the shares of SIL.

SEBI had initiated investigations against Naberas and Adhunik and
found that the Naberas were insiders and violated the Insider Regulations.
According to SEBI, the trades had occurred during periods closely before and
after Dilip Nabera’s entry and exit from SIL. SEBI considered Naberas and
Adhunik as “insiders” in view of the explanation to Regulation 2(c) regarding
the words ‘connected person’ which provides that a “connected person” shall
mean any person who is connected to the company six (6) months prior to an
act of insider trading. Accordingly, the SEBI vide its order dated 6 November
2006 imposed a penalty under Section 15G of the SEBI Act, 1992, on Dilip
Nabera, Sadhana Nabera and Adhunik for insider trading. According to Dilip
Nabera, Adhunik had traded as a sub-broker on behalf of its clients and that
those trades were not the trades of Naberas. Neither Nabera nor his wife
traded in the scrip of SIL between their date of joining the company and the
public disclosure of the UPSI.

Naberas appealed against SEBI’s order before the SAT. The SAT set
aside the SEBI’s order on the ground that Nabera was an auditor in the SIL
and could not be expected to have access to the UPSI, which was a policy
decision. According to the SAT, an auditor is not concerned with the policy of

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the company nor is he involved in management decisions, policies or the
commercial prudence of the transactions. SAT was of the view that Nabera
had no concern with the merger related information nor was it a part of his
duty to have access to such information. Further, the SAT also found that
there was no restriction on any person, including those who were earlier
insiders, to trade on the basis of that information. SAT said that when Nabera
and his wife did not trade between the period Dilip Nabera joined SIL and the
public disclosure of the company, they cannot be said to have violated the
Insider Regulations.

The reasoning of SAT that trades made after the public announcement
of the price-sensitive information would not amount to ‘insider trading’ looks
appropriate. However, the SAT’s observation that an auditor cannot be
expected to have access to the company’s UPSI is not tenable because,
practically, persons such as auditors, chartered accountants, legal counsels,
etc., although may not be involved the process of policy decisions, they may
be aware of the UPSI by virtue of their positions in the company. Further at
Regulation 2(g) of the Insider Regulations, an “officer of a company” is
defined to mean any person as defined in clause (30) of Section 2 of the
Companies Act, 1956 (1 of 1956) including an auditor of the company. This
clearly brings an auditor within the purview of ‘insider’ within Insider Regulations\textsuperscript{193}.

This lacunae was, however, identified by SEBI and the amendment of the definition of “insider” in 2008 extended the definition of “insider” to such categories of people who have or have had access to the UPSI, irrespective of their position in the company.

In this context, the 2008 amendment to Insider Regulations in India is in harmony with the U.S. insider trading laws where persons such as accountants, auditors, legal counsels are regarded as “temporary insiders” of a company as they may have access to the company’s UPSI by virtue of their position in the company.

3.22 DILIP PENDSE CASE\textsuperscript{194}

This case originated when the SEBI received a complaint from M/s Tata Finance Limited (“TFL”), alleging various irregularities committed by Dilip Pendse, who was the managing director of TFL at the relevant time. The primary grievance of the complainant was that at the instance of Pendse, Pendse’s friends, relatives, and associates sold 2,90,000 shares of TFL on the

\textsuperscript{193} It was also one of the recommendations of the Sachar Committee to consider the auditors as “insiders”.

\textsuperscript{194} Appeal no:80/2009 decided on 19 November 2009
basis of the UPSI in his possession in March 2001 that TFL had incurred financial losses. SEBI conducted investigations into the dealings and found Pendse and others guilty of insider trading. In support of this plea, Pendse produced documentary evidence to show that the transaction of shares was made prior to the TFL incurring losses.

Therefore, the main issue before the SAT was whether the alleged sale transactions of shares of TFL took place in September 2000 (when there was no UPSI) or end of March 2001 to hold Pendse and others guilty of insider trading. SEBI contended that the shares of TFL were sold by Dilip Pendse’s relatives in March 2001. SAT relied upon the BSE’s reports relating to sale of shares and held that the trades were done by Pendse and others in September 2000. SAT further held that in September 2000, neither Pendse nor his relatives were “insiders” within the meaning of Insider Regulations. In March 2001, they became “insiders” by virtue of the fact of Pendse possessing UPSI.

The SAT observed that the charge of insider trading is one of the most serious charges in relation to the securities market and having regard to the gravity of this offence, higher is the preponderance of probability and the burden of proof in establishing the offence. The SAT also relied on a 2003 Supreme Court judgment\(^\text{195}\) where the Supreme Court had observed that “it is also a settled principle of criminal jurisprudence that the more serious the

\(^{195}\) Mousam Singha Roy v. State of West Bengal (2003) 12 SCC 377
offence, the stricter the degree of proof, since a higher degree of assurance is
required to convict the accused.” Thus, SAT had extended this principle to the
civil cases as well where the charge is to be established not beyond reasonable
doubt but on the preponderance of probability.

The SEBI has appealed against the SAT order in the Supreme Court of
India and the appeal is pending disposal.

3.23  KLG INDUSTRIES LIMITED CASE

In this case, SEBI had charged the executives of a company, SKIL
Infrastructure Limited (“SKIL”), for trading in the scrip of KLG Capital
Services Ltd. (“KLG”), on the ground that SKIL’s executives had traded in
KLG’s shares based on the information that a company, Awaita Private
Properties Limited (“APPL”) was acquiring KLG, prior to the public
disclosure of this information. The executives had contended that they were
not “insiders” although they were in possession of the UPSI and that they had
traded. According to the executives, they were not “connected persons” to the
KLG and hence, cannot be regarded as “insiders” under the Insider
Regulations.

196 Decided by SEBI on June 10, 2009 (www.sebi.gov.in)
The SEBI relied on the decision of the SAT in *Dr. Anjali Beke Case* and gave a finding that any person in possession of UPSI will be deemed to be an “insider.” SEBI held that as SKIL was a promoter group company of APPL, and had a role KLG’s acquisition, the SKIL’s executive will be deemed to be insiders.

The executives appealed against this order before SAT and SAT has remanded the case to SEBI\textsuperscript{197} for a fresh action.

In this case, the SEBI did not rely on the legal provisions as available under the Insider Regulations such as the definition of “connected persons” provided under Regulation 2 (c) which clearly includes person having professional or business relationship, whether temporary or permanent, with the company. SKIL being the promoter group company of APPL and involved in the acquisition, could be brought within the purview of the “connected person” under Regulation 2 (c). SEBI, inadvertently, did not apply the direct statutory provision and relied upon the SAT’s decision in Anjali Beke Case.

The final decision in this case will be relevant as it will clarify the status of the cases which occurred prior to the 2008 amendment of the

\textsuperscript{197} Appeal decided on 21 October, 2010 (www.sebi.gov.in)
definition of “insider” and the applicability of the Insider Regulations to the persons who are deemed insiders by virtue of their possession of the UPSI.

While analyzing the case law decided in India, it becomes evident that successful enforcement actions in insider trading cases was a hard task for the Regulator, be it the loopholes exiting in the legal framework, or the inconsistency on the part of appellate bodies in interpreting the existing legal provisions. However, India has a well-structured regulatory framework in respect of insider trading. The minor inconsistencies could easily be fine-tuned. The awareness of inherent difficulties of proving the cases of insider trading in view of the complex facts amongst the appellate bodies and a consistent approach in resolving the important issues is what is required.