CHAPTER 1

FUNDAMENTALS OF INSIDER TRADING

Majority of the countries have framed laws prohibiting or regulating insider trading. As per available statistics, about 87 countries had adopted the insider trading laws by the end of 20th century\(^1\). The pioneer country to recognize the need to regulate insider trading and, introduced the insider trading laws is the U.S. Although the U.S. had formulated its first insider trading law in 1942, it had commenced enforcing the restrictions on insider trading only since the 1960s. Following the U.S. example, many countries had enacted laws to regulate insider trading. Canada had laws relating to insider trading as early as 1966, closely followed by the French government which regulates the insider trading offence by the ordinance instituting a *Commission des Operations de Bourse* since September 1967. Australia enacted the laws governing the insider trading in 1991 under the Securities Act. Singapore was probably one among the first countries in Asia to have framed laws regulating insider trading in 1973. The United Kingdom enacted the Criminal Justice Act, 1985 prohibiting insider dealings. India had enacted its insider trading regulations in 1992. The primary concern for all the countries which have enacted legislations on insider trading was to ensure fair transaction in the

securities market by mandating disclosure of the material information affecting the trading in the market.

1.1 MEANING OF INSIDER TRADING

1.1.1 All insider trading are not illegal

Insider trading is a familiar term for all investors and it is generally associated with an illegal conduct. But the term actually includes both legal and illegal conduct. Simply stated, insider trading means trading in a company’s stocks or other securities by a corporate insider\(^2\). This can also be stated as legal insider trading.

A corporate insider, also referred to as classical insider, is typically a director or an official of a company. The category of insiders in a company also includes the “constructive insiders” who become privy to the corporate information legitimately by virtue of their relationship with the company. For instance, an underwriter, accountant, lawyer or consultant working for a company and exposed to the company’s inside information are regarded as the constructive insiders. This implies that if any corporate or constructive insider of a

\(^2\) Majority of the academicians who have conducted studies on insider trading laws have classified insiders into a. classical insiders, and b. the constructive insiders. Classical insiders are typically the directors and officials of the company whereas the constructive insiders are those to whom corporate information is revealed legitimately by virtue of their relationship with the company/issuer, i.e., an underwriter, accountant, lawyer or consultant working for the Corporation who has a fiduciary relationship with the shareholders.
company trades in the company’s securities, such insider will be regarded as carrying on insider trading.

1.1.2 Illegal Insider Trading

Only if the corporate or constructive insider of a company trades in the company’s securities, knowing that he is in possession of the unpublished price sensitive inside information, it becomes a legal wrong. Therefore, insider trading may not always be a prohibited activity.

1.2 THEORIES OF INSIDER TRADING

There are various theories of liability which the U.S. courts have applied to determine the liability of an insider in the insider trading cases. The U.S. courts have applied these theories to interpret the “anti-fraud rule”, under Rule 10b-5 of the Securities Exchange Act, 1934, which is the primary provision dealing with the enforcement of insider trading cases. These theories have also been relied upon by many other countries while laying the foundation for the respective laws relating to insider trading. Although the Chapter 2 of this study includes detailed discussion on the theories of liability, a brief overview of the theories is given below.
Currently, there are three important theories on which the liability of an insider in the insider trading cases is based. These theories are the “theory of abstain or disclose”, “theory of fiduciary duty” and the “misappropriation theory.”

1.2.1 Abstain or Disclose Theory

Until 1980, the U.S. courts used only the theory of abstain or disclose to base an insider’s liability in the insider trading cases. According to this theory, when an insider is in possession of certain material corporate information and the insider intends to deal in the company’s securities using such information which may affect the price of the securities, the insider should either disclose such price sensitive information to the market, or abstain from trading in the company’s securities. This classical theory was set forth by the second circuit court in the US in the case of SEC v. Texas Gulf Sulphur\(^3\) and in the case of SEC v. Cady Roberts\(^4\). In these cases, the court has observed that an insider in possession of material inside information must either disclose the information to the investing public or, if the insider is disabled from disclosing it in order to protect a corporate

\(^{3}\) SEC v. Texas Gulf Sulphur 401 F.2d 833 (2d Cir. 1968). Anyone in possession of material insider information must either disclose it to the investing public or, if he is disabled from disclosing it in order to protect a corporate confidence, or, if he chooses not to do so, must abstain from trading in or recommending the securities concerned while such insider information remains undisclosed.

\(^{4}\) SEC v. Cady Roberts 40 SEC 907 (1961)
confidence, or, if the insider chooses not to disclose the information, the insider must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

However, it is crucial to assess the timing of the disclosure of information. For example, if the insider of a company makes disclosure regarding any new business venture it may be planning, such disclosure if too early, may result in an opponent competing against the company. Moreover, until the information is disclosed by an insider, the insider bears the corporate as well as the market specific risks. The deal as well as the stock market or both may fall any time. On the other hand, the early disclosures will minimise the risks of an insider, if the insider has indulged in insider trading.

1.2.2 Fiduciary Duty Theory

The U.S. recognised the concept of fiduciary duty vis-à-vis the directors of a company in 1903, in the case of *Oliver v. Oliver*. A U.S. Supreme Court has ruled that “where the director obtains information giving added value to the stock by virtue of the director’s official position, the director holds such information in trust for the benefit of the shareholders”. Until this case, the U.S. courts had

---

5 *Oliver v. Oliver* [45 S.E.232 (Ga 1903)]
6 This rule is called the “minority” or “duty to disclose” rule. Supra n.5
rejected the fiduciary duty on the part of the corporate officers and the directors in their private dealings with the shareholders.

Thereafter, in 1909, the U.S. Supreme Court, in the case of *Strong v. Repide*\(^7\), had ruled that the concealment of relevant information regarding the company by a director at the time of purchase of shares from the shareholder was in violation of his duty as a director to disclose such information, and amounted to deceit.

Further, in 1933, in the case of *Goodwin v. Aggassiz*\(^8\), the Supreme Judicial Court of Massachusetts while analyzing the concept of directors’ fiduciary duty, had considered the applicability of affirmative disclosure obligation. In this case, the defendants were the directors and the senior officers of a mining corporation. A geologist working for the company had suggested that there might be substantial copper deposits in Northern Michigan. The company considered this prospect and began securing mineral rights on the relevant tracts of land. The plaintiff was a former stockholder who had sold his shares of the company in the stock market to the defendants without knowledge of the geologist’s prediction. Finally, while the plaintiff knew that the defendant had bought the shares based on the geologist’s information about the mining project, the plaintiff sued the directors,\(^7\) *Strong v. Repide* 213 US 419 (1909),\(^8\) *Goodwin v. Aggassiz* 186 N.E.659 (Mass.1933).
on the ground that he would not have sold the shares if the geologist’s propositions had been disclosed to him. The Massachusetts Court rejected the plaintiff’s claim and held that the defendants had no duty to disclose the geologist’s propositions before trading. The court ruled that “Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might find later and that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equal basis as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud.”

As regards the fiduciary duty in the insider trading cases, the U.S. court for the first time, identified the element of fiduciary duty in
the insider trading cases in the case of *U.S. v. Chiarella*⁹. In this case, the second circuit court took a view that if a person is in possession of undisclosed price-sensitive information, he should not trade as he owes a fiduciary duty to the investors in the market. However, the U.S. Supreme Court reversed this decision and ruled that merely trading on non-public information was not sufficient to trigger the violation of Rule 10b-5. The court had also ruled that the defendant, Vincent Chiarella, a printer in a press who traded on the basis of company’s non-public confidential information, owed no duty to the shareholders of the target company, and therefore, did not breach the fiduciary duty.

The judicial interpretations of the U.S. courts over the years had concluded that the fiduciary duty of insiders means a duty owed by persons who are in a fiduciary relationship with the company, to the investors or to the source of material price sensitive information. The courts held that insider trading is not the breach of a general fiduciary duty, but the breach of a specific fiduciary duty to refrain from self-dealing based on material price sensitive information which is confidential in nature.

Therefore, based on the reasoning given by the U.S. courts, a better approach to regulate insider trading on the basis of fiduciary

---

duty theory would be to treat it as a breach of insider’s fiduciary duty to the company. This is so because, the insider owes no fiduciary duty to the shareholders, or to an unknown buyer in the securities market.

1.2.3 Misappropriation Theory

The third theory of ‘misappropriation’ was formulated by the federal courts in the U.S. during the early 1980s. Under this theory, a person commits a fraud in connection with the purchase or sale of a security, if the person misuses the information given to him for legitimate reasons, for such trading and trades for personal gain. The liability for insider trading arises when an insider trades based on an inside information about a company that has emanated from a source other than from the company where the insider has passed on the information without the breach of fiduciary duty. For example, if an employee of an investment banking firm comes to know that his company’s customer is planning on a tender offer for another company X, and the employee trades on the basis of that knowledge, there is no violation of ‘abstain or disclose’ rule, because the employee does not have any fiduciary duty to the company X, but he owes a fiduciary obligation to his employer and he ought to have refrained from

---

10 Read also Ian Ayres & Stephen Choi, Internalizing Outsider Trading, 101 Mich. L. Rev. 313
profiting on the confidential information entrusted to him in the course of his employment. This is the basis of the theory of misappropriation.

The U.S. Supreme Court recognized the theory of misappropriation in the case of Carpenter v. United States. In this case, a Wall Street Journal Reporter and his confederates had misappropriated certain information belonging to the Wall Street Journal. The Supreme Court ruled against the plaintiff, Winans, an author for the Journal and Carpenter, who aided and abetted Winans, and held that the plaintiff had misappropriated the employer’s insider information for personal gain and has therefore, violated the Rule 10b-5. Thereafter, in 1997, the U.S. Supreme Court had reiterated the theory of misappropriation in the case of U.S. v O’Hagan. In this case, the court had recognised that “deception through non-disclosure is central to the theory of liability for which the government seeks recognition.” Further, the court had held that if a misappropriator has disclosed his trading plans to the source of the information prior to trading, there will not be any violation of the Rule 10b-5.

The facts of the case were as follows: O'Hagan was a partner in a law firm, Dorsey&Whitney retained to represent a corporation, Grand Met, in a potential tender offer for the common stock of the

---

Pillsbury Company. When O’Hagan learned about the potential deal, he began acquiring options in Pillsbury stock, which he sold after the tender offer and earned a profit of over US$4 million. O’Hagan argued, essentially, that because neither he nor his firm owed any fiduciary duty to Pillsbury, he did not commit any fraud by purchasing Pillsbury stock on the basis of material, non-public information. The Second Circuit Court rejected O’Hagan’s arguments and upheld the conviction of O’Hagan by the trial court. The Court held, that O’Hagan had committed a fraud in connection with his purchase of the Pillsbury options, thus had violated the Rule10b-5, based on the misappropriation theory. In the Court's words:

“The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.”
In the course of its opinion, the court identified two reasons for prohibiting insider trading. First, the court emphasised that prohibiting insider trading will ensure honest securities markets and thereby promote investor confidence. Further, although informational disparity is inevitable in the securities markets, the investors may hesitate to venture their capital in a market where trading based on misappropriated non-public information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator’s advantageous position with material non-public information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. The second reasoning was based on the "information as property" rationale underlying insider trading prohibitions, i.e., a company's confidential information qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of a fiduciary duty constitutes fraud akin to embezzlement and the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.

13 Read also Jesse M. Fried, Insider Abstention, 113 Yale L.J. 455.
Therefore, the decision in *O'Hagan Case*\(^{16}\) was a significant milestone in the development of insider trading regulations in the U.S.\(^{17}\)

Another relevant case was of *U.S. v Chestman*\(^{18}\), where the U.S. courts have analyzed the liability for fraud in insider trading cases. In this case, Ira Waldbaum was the controlling shareholder of Waldbaum, Inc. In 1968, Ira decided to sell the corporation to the Great Atlantic and Pacific Tea Company. He informed his sister, Shirley Witkin, three of his children, and his nephew about the proposed sale. He asked them to keep the news confidential and offered that their shares in Waldbaum may also be tendered together with his controlling shares. Shirley shared the information with her daughter, Susan, who in turn told about it to her husband, Keith. Keith passed on the information to Chestman (a broker), who executed purchases of Waldbaum stock for himself and several customers including Keith.

Subsequently, the U.S.’ securities market regulator, the Securities Exchange Commission launched an investigation. The trial court held Keith and Chestman liable for aiding and abetting

---

\(^{16}\) U.S. v O'Hagan 117 S.Ct.2199 (1997)

\(^{17}\) Read also Saikrishna Prakash, Our Dysfunctional Insider Trading Regime, 99 Colum. L. Rev. 491

\(^{18}\) U.S. v Chestman 947 F.2d 551
misappropriation under Rule 10b-5. However, the Second Circuit court set aside the convictions on the following grounds.

(i) It is a settled position of law that to be liable as an aider and abetter under the misappropriation theory, the tipper must owe a fiduciary duty of confidentiality to the corporation and the aider and abetter must know of the tipper’s breach of fiduciary duty;

(ii) To find liability under Rule 10b-5 for aiding and abetting, there must be evidence to show that (a) Keith breached a duty owed to the Waldbaum family or his wife, based on a fiduciary or similar relationship of trust and confidence; and (b) Chestman knew that Keith had breached this duty; and

(iii) Fiduciary relationship does not arise simply by entrusting a person with confidential information, nor does marriage or family automatically create a fiduciary relationship.

Therefore, the court held that Keith could not be held liable because he did not breach any fiduciary duty in order to commit fraud under Rule 10b-5. The Court held that Keith owed neither Susan nor the Waldbaum family a fiduciary duty or its functional equivalent, and
therefore, he did not defraud them by disclosing news of the pending tender offer to Chestman. *Absent a predicate act of fraud by Keith Loeb, the alleged misappropriator, Chestman could not be derivatively liable as Loeb's tippee or as an aider and abettor.* Therefore, Chestman's Rule 10b-5 conviction also was reversed.

### 1.3 NEED TO REGULATE INSIDER TRADING

The fundamental purpose of the insider trading laws is to protect the investor interest and integrity of the securities market. An ideal securities market is one which accurately reflects the risks involved in trading and the returns for the investors.

The proponents of law prohibiting insider trading did not regard all instances of insider trading as illegal, but sought to prohibit certain instances of insider trading carried out using non-public material information. This is to ensure parity of the information available in the market to all the traders in the securities market. Additionally, most of the legislators all over the world had intended to enact a law which would enable an honest director of a company to trade in the company’s securities, and simultaneously, conduct the management of the company in good faith. However, the legislators could not foresee that it is not possible for a company’s director (the insider), to verify the identity of those with whom he is trading and make all disclosures relating
to the company. Therefore, the expectation from the insider director trading in
the company’s securities was to publicly disclose the material facts affecting
the price of the securities in their possession, before trading. Else, the
directors should refrain from trading. Apart from ‘parity of information’
theory, the above reasoning also seems to be a premise on which the insider
trading laws has been developed in all the countries.

In the U.S., the first legislation relating to insider trading, the
Exchange Act incorporated a transactional disclosure regime mandating the
insiders to make periodic disclosures of information affecting the price of the
securities to the U.S.’ securities market regulator, the SEC. This is because
the main purpose of the federal law on insider trading was to advance
mandatory disclosure of information by an insider to bring about parity in the
securities market. However, the Exchange Act did not mandate
comprehensive disclosure of information. This is probably because the
legislators had realized the need for balancing between the protection of the
investors’ interest by mandating disclosure and the company’s need for
secrecy of material information by not providing for comprehensive
disclosure.

1.3.1 Non-Economic Reasons
In addition to the foregoing reasons, there are both economic and non-economic reasons for regulating insider trading\(^\text{19}\). The major economic reasons include economic injury to investors and the firms, and claims relating to the property rights in information. The non-economic reasons broadly include protection of mandatory disclosure system and the element of fairness in insider trading.

1.3.1.1 Mandatory Disclosure

Insider trading prohibition becomes absolutely necessary for the effective working of the mandatory disclosure system, as it ensures that insider’s confidentiality obligations to the company is not abused for personal benefit of the insider. This is the primary non-economic reason to prohibit insider trading and the investors’ interests. In this regard, major jurisdictions such as the U.S. and the U.K., and countries such as India, have heavily stressed upon the need for protecting the disclosure system and this is reflected in these countries’ respective securities related legislations. For instance, India’s major legislations relating to regulation of the companies and securities market mandate public disclosure of all material information by the companies. Some of these legislation

include the Companies Act, 1956, the Listing Agreement under the Securities Contract Regulation Act, 1956, the statute specific to insider trading, the SEBI (Prohibition on Insider Trading) Regulations, 1992\textsuperscript{20}, and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1996, which mandate various kinds of disclosures to be made by the companies to the regulators. Some of the disclosure related provisions are discussed below:

(i) Listing of securities of a company with stock exchanges is governed by the Companies Act, 1956 and the SCRA and also subject to the compliance with SEBI norms. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 specifies that no company is allowed to make public issue of securities, unless draft prospectus is filed with SEBI. The issuer company has to submit the list of promoters and their individual shareholding.

(ii) SEBI has also specified under Chapter IV and the Schedule II of the SEBI (Prohibition of Insider Trading)

Regulations, 1992, disclosure norms. Under Insider Regulations, disclosures are required from persons holding 5% or more shares or voting rights in a listed company, about their holdings to the company within four (4) working days from the date of either the receipt of intimation of the allotment of shares or the acquisition of shares or voting rights as the case may be. Continual disclosures are also required under the Regulations by those holding shares more than 5%, when there is change in holding as compared to the earlier disclosure. These disclosures are also applicable to those who are directors or officers of listed company. The listed companies in turn are required to make these disclosures to stock exchanges.

(iii) Chapter II of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the “Takeover Regulations”) addresses the disclosures required in relation to shareholding and control in a listed company. The main provisions are as follows:

(a) Regulation 6 of the Takeover Regulations was a transitional provision which dealt with the

21 Regulation 13 of the Insider Trading Regulations
22 Regulation 13 (6) of the Insider Trading Regulations
disclosures required at the time when the Takeover Regulations came into effect;

(b) Regulation 7 of the Takeover Regulations demands disclosures by acquirers who acquire shares or voting rights which would entitle them to exercise 5% or 10% or 14% or 54% or 74% of voting rights in a company, regarding their aggregate of share holding or voting rights in the company at every stage. Every person who hold 15% or more but less than 55% shares or voting rights, must disclose to the target company and the stock exchange where the shares are listed, about any purchase or sale by such person of 2% or more of the share capital of the target company by him. These disclosures must be made within two (2) days of the receipt of intimation about the allotment of shares or acquisition of the shares or the voting rights, as the case may be. The stock exchanges, where the securities of the company are listed have to display the information received from the acquirer on the trading screen, the notice board, and also on its web site. Additionally, the companies involved in such
transactions also make the disclosures to the stock exchanges, within seven (7) days of receipt of intimation by the acquirer; and

(iv) Regulation 8 of the Takeover Regulations provides that yearly disclosures must be made by persons who hold 15% or more of shares and voting rights in any company. This should be done within twenty-one (21) days from the financial year ending March 31. This is applicable for a promoter or any other person having control of the company. Also, all listed companies are required to make disclosures in respect of any change in holdings of the persons or promoters or persons having control of the company, to the respective stock exchanges.

Therefore, among other countries, India has also endeavoured to protect the disclosure regime by incorporating the disclosure related provisions in most of the relevant statutes.

1.3.1.2 Fairness
The other non-economic reason for regulation of insider trading is to ensure fair dealings in the securities market. The element of fairness in the securities market is crucial for developing and maintaining investors’ confidence in the securities market and to ensure that they are at par with all other investors and will be protected against the abuse of insider information. This investor confidence can only be achieved by affording equal access to all the investors to the price-sensitive information and prohibiting an insider from misusing the company’s confidential information for personal gain. Notwithstanding this, obviously, “fairness” alone cannot be a justification for prohibiting insider trading.

1.3.2 Economic Reasons

1.3.2.1 Injury to investors

The primary economic reason for prohibiting insider trading is to protect the investors from any kind of injury including monetary injury. This is because, in insider trading, the insider who possesses the corporate inside information about the company, through his trades misusing such information, can generate incorrect or unreal expectation about
investing in the company. Therefore, the investors may be induced to trade at the wrong price when dealing with an insider or in an insider induced transaction, as the insider is in possession of inside information, which the investors do not possess. The insider may abuse the corporate insider information for personal gain in multiple ways. For instance, an insider may choose not to disclose the price-sensitive information at all to the buyer or the seller of the securities. Further, the insider may decide to delay the disclosure of the information or make early disclosures, which in both cases will result in the price variation of the securities. Therefore, to minimise the harm caused by the information asymmetry between the insiders and investors, it is a must to regulate the insider trading.

However, according to Professor Stephen M. Bainbridge, investor protection and maintenance of confidence among investors seem to be insufficient theoretical justifications for the prohibition of insider trading.

---

23 Professor Bainbridge is a corporate law professor at the UCLA School of Law. He has written several papers on insider trading laws and the significant court pronouncements related to insider trading in the U.S., which has been extensively referred during this study.
One suggested way to deal with the information asymmetry was to make immediate public disclosure of the material information by a company\(^{24}\). However, the legislators have not supported this view considering the risks involved in the untimely disclosure of the information and also the correctness of such information.

1.3.2.2 Injury to the company

Information, as opposed to tangible property can be used by more than one person without lowering its value. The potential injuries that could be caused to a company due to insider trading are as follows:

1.3.2.2.1 Delay

Insider trading may adversely affect the company as it may delay the decision making process by the management and also the effective implementation of the company’s policies. This is because the insider may retain any material information of the company for trading for personal gain and may

deliberately delay the transmission of the information within the company. Further, there are chances of the information getting distorted. This can be harmful for the company as well as for the investors.

1.3.2.2 Interference with corporate plans

If insiders or persons in-charge of a merger or acquisition or other similar corporate plans indulge in insider trading using such information, the trading may have financial implications on the deal, such as the stocks of the entities involved may vary thereby affecting the overall price and profits involved in the deal. Further, the insiders may manipulate the revenues by delaying the payables, such as the dividends, or by expediting the receipts. Also, the insiders may structure the corporate deal to advance their personal benefits. Sometimes, an acquirer company itself may be interested in publicly disclosing the information, such as the name of the target company in an acquisition transaction.
1.3.2.3 Injury to Reputation of the Company

The instances of insider trading in a company may damage the company’s reputation, thereby adversely affecting the shareholders’ relations with the company and undermining the investors’ confidence in the company’s stock. This will also result in loss of the company’s goodwill among the public as well as the regulators. Further, such injury to the company’s reputation may consequently translate into a financial injury to the company.

1.3.2.3 Property Rights

A company has proprietary rights in all the information relating to the company. The existence of property rights in intangible property is well established. For example, the property rights in trade marks, copyrights, patents, and trade secrets are a few of them. If an insider misuses the company’s inside information for trading in the company’s securities for personal gain, the insider is actually infringing the company’s proprietary rights in such information.

---

25 Issuer in the present context means the company whose shares are issued, listed and being traded.
In India, private enforcement of insider trading cases are rare and the enforcement of the insider trading cases are only initiated by the SEBI *suo moto* or on receipt of a complaint from an interested party. In a way, the regulator has substituted the private rights with its regulatory powers. Therefore, the discussion about the property rights involved in insider trading prohibition becomes significant.

Similar to the case of patent infringement or theft of trade secrets, in insider trading cases also, the aim is to protect the economic incentive of the developer of the information to produce socially valuable information. Considering that an insider can easily appropriate such information for personal gain, the property right should be created in the information to prevent such misappropriation of information and enable the person who developed the information to profit out of the information or at least recover the costs involved in developing the information.

---

26 In securities law matters generally, private litigation is barred under Section 26 of the SEBI Act, 1992
Therefore, in the insider trading cases, the property rights are attached to the information primarily to prevent someone other than the developer of the information from misappropriating the information before the developer can recover its costs of developing the information. But, sometimes, the insider trading may not affect the value of the information to the corporation, and therefore, legalising insider trading may not have much impact on the corporation’s incentive to develop new information.

As such, a rule allowing insider trading will assign the property rights to the insider, while a rule prohibiting insider trading will assign it to the corporation. The solution is to assign the property rights in information to the company, rather than to an insider. This is because, if an insider is trading in the company’s securities based on the information obtained by him solely because of his position in the company, and the property rights in the information are assigned to the insider, this will prejudice the company’s interests financially and otherwise. Therefore, this justifies assigning property rights to the corporation and not to an insider.
In view of the foregoing, it is recommended that property rights should be created in the information, notwithstanding the resultant loss or profit to the company from the use of such information by the company itself or by an insider. The rights to the company in its information will be an incentive for the company to encourage its employees to develop new information. To conclude, even the property rights solely does not make a case for prohibition of insider trading.

Notwithstanding, the U.S. courts have acknowledged the relevance of property rights in information, specifically in the insider trading cases. For instance, in the leading case of United States v. Carpenter, the second circuit court has ruled that the journalist’s sharing of pre-publication information amounted to theft of the property owned by the journal. In this case, R. Foster Winans, a journalist, used to write the Wall Street Journal's "Heard in the Street" column, containing a daily report on various stocks. The Journal’s confidentiality policy expressly treated the column's contents as ‘confidential’ and solely belonging to the newspaper. Despite this, Winans provided the pre-publication confidential information relating to the timing and contents of the future columns to several co-

28 United States v. Carpenter, 791 F.2d.1024
conspirators. The conspirators thereafter traded in the stocks based on the expected impact of the column on the stock’s prices, and made profits from the trade. The SEC approached the court alleging violation of Rule 10b–5, the anti-fraud rule, which is the primary provision dealing with enforcement of insider trading cases, by the journalist.

The court held that the journalist was liable for the breach of the fiduciary duty that he owed to the Wall Street Journal. Further, the court also ruled that the pre-publication information shared by the journalist belonged to the Journal, and that the Journal was free to use the information. The court also observed that Winan’s use of the information amounted to theft of the property owned by the Journal.

This decision of the circuit court was later upheld by the Supreme Court.

Another leading case involving the liability of a tippee is the *U.S. v. Dirks Case*. Raymond Dirks, an officer of a New York broker-dealer firm specializing in investment analysis of insurance company securities, received information from Ronald Secrist, a former officer of Equity Funding of America,

---

that its assets were grossly overstated as a result of fraudulent corporate practices. Dirks investigated into this information by contacting various employees of Equity Funding who corroborated the fraud charges. Although Dirks and his firm did not own or trade any of equity funding’s securities, Dirks discussed the information he had obtained from his investigation with his clients and investors. Some of them sold their holdings in Equity Funding. SEC held that Dirks had aided and abetted violations of the federal securities laws including Section 10(b) of the 1934 Act and Rule 10b-5.

However, the Supreme Court held that Dirks had not violated Rule 10b-5. The Supreme Court observed that a duty to disclose arises from the relationship between the parties and not merely from one's ability to acquire information because of his position in the market. The court also clarified that imposing a duty to disclose on Dirks solely because he has received inside information would inhibit market analysts from ferreting out important information about securities. The court also highlighted the role and need of market analysts because the market efficiency is significantly enhanced by the efforts of market analysts in seeking out and analyzing information regarding securities, thus beneficial for all investors.
To ascertain whether a tippee has a duty to disclose or abstain, it is necessary to determine if the insider’s tip involves a breach of the insider’s fiduciary duty\(^\text{30}\). Breach of fiduciary duty depends on the purpose for which the insider is revealing the information. In the *Cady Roberts Case*\(^\text{31}\), the court had applied the standard whether the insider will personally benefit from the disclosure. The courts followed this standard in *Dirks Case*\(^\text{32}\) also. The court concluded that even if the insider does not benefit directly, there must be some personal gain in order to constitute a breach of the fiduciary duty to the stockholders. Without a breach by the insider, there can be no derivative breach by the tippee.

Certain public accountants, outside counsels, underwriters, or consultants working for a company under certain circumstances would be treated as ‘insiders’ where corporate information was revealed legitimately to them. These individuals, *viz.*, ‘temporary insiders’ are treated as fiduciaries of the stockholders.

---

\(^{30}\) Although the court in Chiarella and Dirks insisted a breach of fiduciary relationship to determine the liability under Rule 10b-5, neither opinion defined such a relationship or specified to whom it applies. To say that ‘a man is fiduciary usually only begins the analysis; it gives direction for further enquiry.’ Nevertheless, both these based the fiduciary duty upon a relationship of trust and confidence. Willis W. Hagan, Insider trading under Rule 10b-5: the theoretical basis of the liability, 44 Bus Law 13.

\(^{31}\) SEC v. Cady Roberts 40 S.E.C’907 (1961)

\(^{32}\) U.S. v. Dirks 463 U.S.646 (1983)
After the *Dirks Case*[^33], market analysts were exempt from insider trading liability with respect to non-public information they develop because they usually owe no fiduciary duty to the firms they research for. But, the *Dirks Case*[^34] assigned property right to such information to the market analyst rather than the affected corporation. But these findings were confusing from the disclosure perspective. All analysts will trade on the basis of information, which other investors lack. From the property perspective, the rule is justifiable as it encourages market analysts to spend resources to develop socially valuable information about firms and thereby promote the market efficiency.

The Supreme Court’s opinion in *Dirks Case*, like its earlier decision in *Chiarella Case*, protected the property interests of those who made socially desirable investments in acquiring certain information.

Another relevant case that analysed the significance of property rights was the *U.S. v. Chestman Case*[^35]. In this case, the court had observed that “*Information is perhaps the most

[^33]: Ibid.
[^34]: Ibid.
[^35]: U.S. v. Chestman 947 F. 2d 551
precious commodity in the commercial markets. It is expensive
to produce and because it involves facts and ideas that can
easily be photocopied or carried in one’s head, there is a
ubiquitous risk that those who pay to produce information will
see others reap the profit from it. Where the profit from that
activity is likely to be diverted, investment in that activity will
decline. If the law fails to protect the property rights in
commercial information, therefore, less will be invested in
generating such information.”

1.4  DEREGULATION OF INSIDER TRADING

Many academicians and scholars in the U.S. have strongly advocated a
legalization of insider trading. Henry Manne\textsuperscript{36}, an academician, was one
amongst them and opposed the prohibition on insider trading as early as in
1966. This was the time when SEC was aggressively enforcing the insider
trading cases and the U.S. courts had interpreted the anti-fraud rule vis-à-vis
insider trading.

According to Henry Manne, a ban on insider trading could adversely
affect the market efficiency and impede an effective way to compensate

\textsuperscript{36} Henry Manne, currently, a resident of Naples, Florida, is the Dean Emeritus of the George
Mason University School of Law. He teaches a course on insider trading at the University of
Chicago Law School.
managers\textsuperscript{37}. The primary reasons on which Henry Manne had based his stand for legalizing insider trading are as given below:

\textit{1.4.1 Accurate Price Discovery}

Henry Manne argued that insider trading is a compromise between the need for preserving incentives to produce information and the need for maintaining accurate securities prices. An example given by him is as follows: a firm's stock currently sells at US$50 per share. The firm has discovered new information which if publicly disclosed, would cause the stock to be sold at US$60. If insider trades on this information, without disclosing to the investor, the price of the stock will gradually rise towards the correct price. On the other hand, in the absence of insider trading, the company's stock's price will remain at US$50 until the information is publicly disclosed, and then rapidly rise to the correct price of US$60. Thus, insider trading acts as a replacement for public disclosure of the information, preserving market gains of correct pricing.

\textsuperscript{37} Many academics, building on the work of Nobel prize winning economist James M Buchanan, have tried to show that insider trading laws are a form of special interest legislation promoted mainly by market professionals to deprive corporate insiders of a legitimate competitive advantage and by corporate managements to protect themselves against takeovers. Read also Daniel M. Harris & Leo Herzel, USA: Do we need insider trading laws? Comp. Law. 1989, 10(1), 34-35.
while permitting the corporation to retain the benefits of non-
disclosure.

Bainbridge has also analyzed Manne’s argument that insider trading leads to correct price discovery and the derivatively informed trading mechanism of market efficiency. The derivatively informed trading affects market prices through a two-step mechanism. First, the insiders possessing material non-public information begin trading without disclosing the information. This will have only a small effect on the price of the security. Thereafter, certain other traders come to know about the insider trading through leakage or tipping of information or by observing the insider trades. Further, there is still a third class of traders, who trade based on the price fluctuations of the securities. Finally, when the market reacts to these insider trades, the prices of the securities move towards the correct direction. However, this derivatively informed trading affects the price very slowly and hence, according to Bainbridge, accurate price discovery is not a justification for legalizing insider trading.

1.4.2 Insider Trading as an Efficient Compensation
Henry Manne has distinguished between the corporate entrepreneurs, who contribute to the company by producing new valuable information and the corporate managers, who merely function based on the company’s pre-determined policies and guidelines. According to Manne, the entrepreneurs’ compensation must be proportionate to the value of their contribution to the company and give them incentives to produce more information. Further, Henry Manne thought that it was not possible to ascertain information’s value to the company in advance, and a pre-determined compensation such as salary would be inappropriate for the entrepreneurs. When insider trading was first outlawed in the U.S. in the 1960s, the SEC and many academics were certain that stock-option plans provided all the incentive necessary for appropriately aligning the interests of managers and shareholders. According to Manne, this argument was convenient and therefore adopted by the legislators at that point of time, to explain the prohibition on insider trading.

In an analysis on whether the stock options form a sufficient compensation for the entrepreneurs, Manne had concluded that without proper incentives for growth, the people who run publicly-held corporations will behave like salaried bureaucrats, averse to anything new and risky. Stock options, he believes, are given more often as a reward than as an incentive and its impact will be no greater than a
bonus paid in shares. Once the option is exercised, the executive becomes a larger shareholder. Stock ownership pushes the management to maximize share price, especially if the shares represent a substantial part of an employee's undiversified portfolio. However, as the employee's shares represent only a tiny fraction of all shares outstanding, the induced incentive for risky choices may still fall short of what would be dictated by the interest of shareholders. In other words, stock options offer no greater incentive than a similar number of shares held by the manager, however acquired.

According to Manne, insider trading, is an incentive for risky decisions because the insiders are able to fetch reward for innovations on their own as soon as they occur and they are able to trade without harm to any investors. Further, the incentive received from insider trading by insiders is not dependant on the stock-price variations independent of his trading/holding of stocks. As previously discussed, Manne and his supporters also believe that the effect of insider trading will always be to move the stock price in the correct direction quickly and accurately, irrespective of what accounting entries are made for the underlying event.

Contrary to the incentive of profits accrued from insider trading, when stock options are used to encourage risky decisions and
insider trading is outlawed, the financial focus of corporate officials necessarily will be on accounting information. When real-world events underlying those entries cannot be traded on directly, the books become their crude proxies. The legal flow of information to the market will be via the formal release of SEC-sanctioned disclosures, such as quarterly reports etc.

As the future expected profits can not be shown on the books and trading on the underlying information is not allowed, the urge to make the accounting picture look better in order to have it conform to the management's view of the company's prospects may become irresistible. This is the view adopted by the supporters of insider trading vis-à-vis what occurred at Enron and WorldCom.

Therefore, insider trading can be an effective way to compensate these entrepreneurs for their innovation and contribution to the company. Manne says that the increase in the price of the security resulting from the public disclosure would give an accurate measure of the value of innovation to the company. Similarly, the entrepreneur can recover the value of his innovation by purchasing the securities of the company prior to the disclosure and selling them after the price rises.
Supporters of Manne consider insider trading as a means to enhance efficiency of markets\(^{38}\).

According to Carlton and Fischel, insider trading is efficient because it reduces agency costs\(^{39}\).

In addition to the foregoing, Manne has suggested other reasons for deregulating insider trading, such as the following:

(i) Insider trading does not cause much harm to the company or the investors; and

(ii) Permitting insider trading would result in automatic disclosure of the information and therefore, serves the purpose of prompt disclosure of new information.

In his inquiry into the proposition of Manne that insider trading laws are detrimental, Laura Beny\(^{40}\) had conducted a study using multivariable regression analysis\(^{41}\) and found that countries with more

---

\(^{38}\) Beny explains that if insider trading reduces the divergence between shareholders and manager’s interests, then it reduces agency costs. Laura N. Beny, Insider Trading Laws and Stock Markets around the World, at http://www.umich.edu/centresandprograms/olin/papers.htm (last visited August 2010)


\(^{41}\) In statistics, regression analysis includes any techniques for modeling and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables.
stringent insider trading laws have more dispersed equity ownership, more liquid stock markets; and more informative stock prices.

However, if corporate insiders are allowed to trade on non-public information, they will have a virtual monopoly on the profits from insider trading. This will discourage informed outsiders from investing in information gathering and analysis. But if insider trading is banned, more informed outsiders will participate in the market.\footnote{Read also Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1345-46 (1999)}

Majority of the countries have prohibited insider trading, after weighing the pros and cons of insider trading. Therefore, it can be concluded that the disadvantages of insider trading have pushed all major jurisdictions towards outlawing of insider trading.

1.5 REASONS FOR THE INSIDER TRADING REGULATIONS IN INDIA: A SHORT NOTE

As a detailed discussion of the history of the insider trading laws in India is addressed in chapter 3 of this study, a brief discussion is made in this chapter on the fundamentals of Indian regulation.
In India, the Patel Committee\textsuperscript{43}, constituted by the Government of India while reviewing the functioning of the stock exchanges, had briefly stated the need for regulating the insider trading in India. One of the reasons identified was that the insider trading involves misuse of a company’s confidential information, and is unethical as it involves abuse of the insider’s fiduciary position of trust and confidence in the company. However, no specific legislation was formulated until the year 1992.

Thereafter, in a leading case\textsuperscript{44}, the Indian regulator, the Securities and Exchange Board of India, expressed its views on India’s insider trading laws. According to the SEBI, “the whole philosophy on which the securities regulation are based and have evolved all over the world, is to ensure availability of common information and fair play to the participants in the securities market, so that informed decisions can be taken.” The SEBI had observed that “insider trading regulations also emanate from such obligations which prohibit buying or selling of securities in breach of fiduciary duty or the relationship of trust and confidence, while in possession of material non-public information.” The SEBI had also highlighted that insider trading laws are essential to create investor confidence, integrity and fairness in the market.

\textsuperscript{43} This committee, headed by G S Patel, was set up in May 1984 to make a comprehensive review of the functioning of the Stock Exchanges and make its suggestions.

\textsuperscript{44} In Hindustan Lever Case, the enforcement order was passed by the SEBI on March 11, 1998.
Subsequently, in the case of *Rakesh Agarwal v. SEBI*\(^{45}\) in 2004, in an appeal filed by Rakesh Agarwal challenging SEBI’s findings of insider trading violations against him, the SEBI had contended before the SAT that an investor’s confidence in the securities market can only be achieved by ensuring that all the participants in the securities market have equal access to all price-sensitive information so that the investors can make an informed decision. On similar lines, the SAT had observed that in order to inspire confidence in investors, besides placing the investors on an equal footing, it was also imperative to protect the investors against the improper use of inside information.

Therefore, on an analysis of the various judgements of the tribunals, ‘parity of information’ seems to be the only rationale behind the prohibition of insider trading in India.

However, the Indian appellate authorities have placed heavy reliance on the fiduciary duty of the insiders to the company and the shareholders as against relying on “fraud” as in the U.S. Although the U.S. courts had insisted on the presence of fiduciary duty in the insider trading cases, recent reports

\(^{45}\) Rakesh Agarwal v. SEBI, 2004 49 SCL 351 SAT.
have revealed that the significance of the fiduciary duty has diminished and U.S. courts currently rely on the element of “fraud” in insider trading cases.\(^{46}\)

In India also, fraud\(^{47}\) in the securities transaction is broadly observed under two (2) categories, i.e., firstly, under “manipulation cases” and secondly in “insider trading cases”. However, these two (2) categories are significantly different. The first category takes the market away from the correct price as the price or the volumes of securities are manipulated, and the second helps the market in the accurate price discovery as the trades are based on relevant or material information, which reflects the correct price of the securities and which actually takes the securities to the correct price.

---


\(^{47}\) The term ‘fraud’ has been defined under regulation 2(c) of the SEBI (Prohibition of Fraudulent and Unfair Practices in the Securities Market), Regulations, 1996 in India as below:- “fraud” includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include—

1. a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;
2. a suggestion as to a fact which is not true by one who does not believe it to be true;
3. an active concealment of a fact by a person having knowledge or belief of the fact;
4. a promise made without any intention of performing it;
5. a representation made in a reckless and careless manner whether it be true or false;
6. any such act or omission as any other law specifically declares to be fraudulent;
7. deceptive behaviour by a person depriving another of informed consent or full participation;
8. a false statement made without reasonable ground for believing it to be true;
9. the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price.

And “fraudulent” shall be construed accordingly;

Nothing contained in this clause shall apply to any general comments made in good faith in regard to—

(a) the economic policy of the government;
(b) the economic situation of the country;
(c) trends in the securities market;
(d) any other matter of a like nature whether such comments are made in public or in private;
Under Indian law, the price manipulation cases are booked by the regulator under the SEBI (Prohibition of Fraudulent and Unfair Practices in the Securities Market) Regulations, 1996, whereas, insider trading cases are dealt under the Insider Regulations. Insider trading in India is definitely a class of fraud in itself. Also, the Indian securities market regulator, SEBI, has maintained the stand that the liability for the violation of the Insider Regulations is one of strict liability\(^\text{48}\). The Patel Committee in its report has said that insider trading involves misuse of confidential information and therefore, is unethical as it involves betrayal of the fiduciary position of trust and confidence.

While SEBI relies on the fiduciary duty of the insiders in the case of *Rakesh Agarwal Case*\(^\text{49}\), the SAT, without giving a finding on the fiduciary duty, held that the acquisition of shares by insiders were in the best interests of the company, and thus had set aside the SEBI’s order. This paved the way for the theory that motive or intention on the part of the insiders was crucial to determine the violation of Insider Regulations\(^\text{50}\). Impliedly, the absence of

\(^{48}\) In the judgement of SAT on Rakesh Agarwal v. SEBI, dated November 3, 2003, it is mentioned that “…a bare reading of regulation 3 it is clear that prohibition of insider trading by an insider is an absolute offence and that benefit or gain is not an ingredient of the offence.” (at page 78). However, SAT differed on this and said that motive should not be ignored in the cases charged with violation of insider trading regulations. In this matter, although SEBI had appealed before Supreme Court on the finding that without motive factor, it is not punishable, the matter was settled through consent.

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

\(^{50}\) Shriram Mutual Fund v. SEBI 2006 (5) SCC 361. In a different context, the Supreme Court of India held that there is no requirement for mens rea to be established in respect of all the violations under SEBI Act and Regulations administered by SEBI. Heavy reliance was placed on the earlier decision of the Bombay High Court in SEBI v. Cabot International Capital.
fraud on the part of the defendant was what absolved his liability before the SAT. It is seen that the appellate bodies have refrained from discussing the fiduciary duty or the fraud aspect in many of the cases\textsuperscript{51}, whereas, the SEBI has relied on fiduciary duty in some cases\textsuperscript{52} and the theory of fraud in others. Therefore, the effectiveness of the fiduciary or the fraud elements has been under constant debate, and the Indian authorities could take cue from the U.S. and rely on the fraud element, which is what the U.S. noted for better enforcement of insider trading cases has relied on.

\textsuperscript{51} Samir Arora’s Case
\textsuperscript{52} Order of SEBI against J E Talaulicar (WTO/9/IVD/10/03) dated October 14, 2003.