INSIDER TRADING- AN ANALYSIS OF INDIAN LEGAL POSITION

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ABSTRACT

As a means of conflicting and reconciling interests and rights of its citizens, a wide variety of behavioral rules are established by every country. To govern individual social interaction rules are designated. The absence of information symmetry and failure to establish conditions for a perfect competition gives an upper hand to some participants through utilizing regulatory inadequacy to avail the unfair advantage of investors. With the aim to assure that no individual in a market gains an advantage by trading on 'unpublished' information or 'insider', insider trading regulations and laws are designed. The foundations of such laws lie to form a level playing field whose essence is to allow all participants to access the information equally. Decreasing the cost of equity and increasing market liquidity are some factors which the enforcement of insider trading laws results in.[1] Based on the foundation of efficiency and equity, insider trading laws aim to ensure access of the same set of information to all the participants and discloser of material information available to a participant to all the participants.

[1] Chapter 6, *Indian Regulations on Insider Trading*
https://shodhganga.inflibnet.ac.in/bitstream/10603/174708/11/11_chapter%206.pdf

EVOLUTION OF INSIDER TRADING REGULATIONS IN INDIA

The P.J. Thomas Committee presented its first report concerning the need of regulations on the stock market in India in the year 1948. The committee made suggestions that restrictions and obligations should be imposed on the stock market traders who were producing 'short-swing profits'. Incorporated in Section 307 and 308 of the Companies Act of 1956[2], the suggestions made an attempt to create certain disclosures by managers and directors i.e insiders but were proved inefficient in achieving the goal of preventing insider trading in India.[3] The absence of a formal separate regulations and rules can be identified as a major factor contributing to this ineffectiveness. Subsequently, many committees have refined and defined the P.J. Thomas Report, but its essence and intent behind establishing insider trading laws have remained prevalent by recognizing the public importance and need to properly regulate and supervise the investment market which would otherwise amount to abandoning of public duty. Based on it, the Sachar committee and Patel committee in the years 1978 and 1986 respectively reviewed Section 307 and 308. Constituted with the idea of suggesting effective control measures to deal with insider trading, both the committees recommended in their reports the need of enacting separate statutes for insider trading. In the year 1989, a similar recommendation was also seen to be made by the Abid- Hussain Committee. Based on the recommendations by the several committees, the SEBI Regulations of 1992 was brought into existence by the Central Government. The litigation before the Securities Appellate Tribunal and the SEBI highlighted the loopholes in the legislations which were subsequently covered by the amendment of 2002. The SEBI (Prohibition of Insider Trading) Regulations of 2015[4] have replaced and repealed the PIT Regulations of 1992[5]. On April 1, 2019 an amendment was further made to the SEBI Regulation of 2015. Read with the SEBI Act of 1992, these regulations give investigatory and regulatory power to the SEBI.

The understanding of the objectives and approach adopted by the committees behind the 2015 and 2019 amendment will help us explain the position and interpretation of insider laws in an appropriate sense. To review the 1992 PIT Regulations, the High Level Committee was

[2] The Companies Act, 1956, No. 1, Acts of Parliament, 1956 (India).
[3] *Insider Trading Regulations - A Primer*, NISHITH DESAI ASSOCIATES (July 2013)
[4] Amendment to SEBI (Prohibition of Insider Trading) Regulations, 2015 [hereinafter 2015 PIT amendment]
[5] Securities and Exchange Board of India (Insider Trading) Regulations, 1992, Gazette of India, pt. III sec. 4, Regulation 2(c) (ii) (Nov. 19, 1992) [hereinafter "1992 PIT Regulations"].

constituted under the chairmanship of Justice N.K Sodhi.[6] This committee recommended repealing and then replacing the 1992 PIT regulations and made various recommendations on the legal framework of insider trading precisely by targeting the regulations more precise and predictable through the combination of rules backed up by principle and principle-based regulations. The approach of "parity of information" was highly recommended by the committee. The approach lays strict prohibition on insiders from deriving any undue profit or benefit from their asymmetrical access to unpublished, price-sensitive information (UPSI) so that investor confidence and integrity of the market is prevented from being affected. In 2017, another committee to revise the 2015 PIT amendment, under the chairmanship of Dr. T.K. Vishwanathan was constituted. Based on the report provided by this committee[7] the 2019 Amendment was made which consisted of three major recommendations: (a) fraud and market manipulation, (b) association of code of conduct, and (c) recommendations relating to enforcement process, investigation and surveillance.[8] The recommendations of T.K. Vishwanathan's report was duly observed in the 2019 Amendment which also relied on the importance allowing the board of directors of companies to design their own practices and policies as to concerning the 'legitimate purpose' of their business operation. The definition of the legitimate purpose by the board of directors is allowed as long as it falls under the ambit of the law. A more flexible and dynamic approach was adopted.

2015 AND 2019 AMENDMENT ANALYSIS

The definition of the term 'insider' as been kept the same in the 2019 Amendments as it was defined in the 2015 PIT Regulations, with an exception of the addition of an explanation added to the new amendment. A person falls under the category of a 'connected person' defined under 2(d) of the 2015 PIT Regulations if he is or were indirectly or directly associated with the company and had indirect or direct access to the unpublished, price-sensitive information or there are reasonable reasons that such person can have access because of: (i) being in

[6] N.K. SODHI, REPORT OF THE HIGH LEVEL COMMITTEE To REVIEW THE SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992, SEBI (Dec. 7, 2013), at 1, 1 1 https://www.sebi.gov.in/sebi data/attachdocs/13867589458 03.pdf

[7] T.K. VISHWANATHAN, REPORT OF COMMITTEE ON FAIR MARKET CONDUCT, SEBI (Aug. 8, 2018), https://www.sebi.gov.in/reports/reports/aug2018/report-of-committee-on-fair-market-conduct-for-public-comments_398 84.html [hereinafter "T.K. VISHWANATHAN REPORT"].

[8] Chapter 6, Insider Trading and Corporate Governance, https://shodhganga.inflibnet.ac.in/bitstream/10603/125485/12/12_chapter%206.pdf

employment, fiduciary or contractual relationship, (ii) being in frequent touch or communication with the company's officers, (iii) being in a business or professional relationship with the company or (iv) they were the employees, officers or directors of the company. It also includes any such relationship on a temporary basis. Though Regulation 2(d) has an enhanced and wider interpretation, it resembles with 2 (c) of the 1992 Regulations. The Regulation 2 (d) of the 2015 PIT Regulations further explains and remove doubt by clarifying that any person having access or due to close association with the company's operation would possess UPSI will fall under the category of a 'connected person'.[9]

'Generally available information' is defined as information available or accessible by people without any discriminatory basis under 2 (e) of the 2015 PIT Regulations. The information which is posted on the website of a stock market also falls under the same definition. The interpretation of the legislative note explains the objective of adding such a definition in the regulations was to appreciate and make it easier to differentiate what UPSI is. Any information that a person obtains through a discriminatory basis will fall under the definition of unpublished price sensitive information under Regulation 2 (n).

Any person who either has assessed or is in possession of UPSI or is a connected person under 2 (d) is referred to as an "insider" defined by Regulation 2 (g) of the 2015 PIT Regulations. The relevant legislative note further clarifies that the fact how a person had access or came in possession of such information is irrelevant. The burden of prove that a person is an insider is on the SEBI but once it has been established, the burden of proof is shifted and the onus is on the insider to prove that he did not have any access or possession of UPSI at the time of trading. These exceptions are made available to an insider under Regulation 3 and 4 of the 2015 PIT Regulations. Though the same definition of insider is observed in the 2019 Amendment, it also requires a notice to be sent to an insider. The requirement of the notice must be met to maintain the confidentiality of the UPSI. But the amendment fails to address who is required to send the notice to an insider and creates confusion in accountability or responsibility or fixing liability.

Prohibition on trading including UPSI and communication of UPSI is put by Regulations 3 and 4. The prohibitions laid down by these regulations do not cover the exception when such activities are done for the performance of duties, legitimate purposes or when legal obligations are discharged. The 2019 Amendment becomes important since in its Regulations 3 (5) a digital

[9] Prateek Bhattacharya, *India's Insider Trading Regime: How Connected Are You?*, 16 N.Y.U. J.L. & Bus. 1 (2019).

database is mandatory which is to be maintained by a company's board of directors. The digital database must be made comprising of all the entities and persons to whom UPSI is shared, which falls under 'Codes of Fair Disclosure and Conduct'. This regulation helps SEBI during the investigation of cases related to insider trading as it discloses the list of people who are under suspicion. The 2019 Amendment provides that the persons in possession of UPSI and who trade securities are presumed to do that trade because of being motivated by the UPSI. This is an explanation added to the 4 (1) 2015 PIT Regulations. The proviso however provides exceptions and mentions grounds in which the innocence of a person falling as an insider under the law can be proved. It is a claim that can be used as a defense by the insider.

With the 2019 Amendment, a new informant mechanism to safeguard the interest of the investors and prevent insider trading was introduced. Where on the suggestion of a person possessing reasonable knowledge or basis, notify the SEBI through the Voluntary Information Disclosure Form about an insider trading occurring or about to occur.[10] The informant will be kept in close cooperation with an independent wing known as the Office of Informant Protection ('OIP'). The appropriate enforcement action will be taken on the suggestion made by the SEBI on the basis of the processing of information by OIP. The amendment has also kept the confidentiality of the informant and will be maintained during the ongoing procedure of the SEBI. Though an incentive is kept to motivate the informant to whistle the blow, information involving lower transactions are highly disincentives since an informant will be entitled to reward only when the information is of value INR 1 crore or more. Which will eventually make a vide number of cases to fall out of the preview of the amendment as the threshold to get rewarded is quite high. The Amendment also gives opportunities to people to misuse it by filing false and misleading cases since it does not have any necessary tools to dispose of such cases in the initial investigation. Though the amendment keeps the confidentiality of the informant as its priority, the exception where the identity can be disclosed is during the recording of evidence discourages the whistle-blower where they know that there is a possibility of recording of evidence.

CASE ANALYSIS

[10] *Code of Conduct for Prevention of Insider Trading*, CIPLA https://www.cipla.com/sites/default/files/2020-02/Code%20of%20Conduct%20for%20Prevention%20of%20Insider%20Trading_1.pdf

One of the recent judicial decisions which has expanded the scope of insider trading was passed in the infamous case of 'WhatsApp leak'[11] that has been in news since November 2017. During this time, SEBI took note of articles in mainstream media alleging circulation of UPSI on various private WhatsApp groups. These were in relation to certain companies stock exchanges and this information was released ahead of its official announcement. The court acted promptly and passed interim order so that the individual persons responsible for this leak could be tried for the offence of insider trading. Evidence was gathered from the WhatsApp groups and market operators, brokerage firms, auditors, analysts, investment advisors and company executive were questioned.[12] Unfortunately, the original source could not be traced and it could not be sufficiently concluded that the companies were involved in any internal leaks. However, SEBI continued with its enquiry and conducted search and seizure of incriminating material. After a detailed examination, the regulator found 12 companies whose earnings data and some relevant financial information was leaked in public domain.[13] This included companies like Ambuja Cements Ltd., Bajaj Auto and some other famous corporate giants.

There are certain settled legal positions on the basis of which the court pronounced its judgment. These are:

- When the leaked information was exactly the same as the public announcements made by the company, the inability to trace the source of such leak of information becomes irrelevant in the determination of whether this information qualifies as UPSI.[14]
- If there is no evidence suggesting that the information shared amongst the people prior to its public announcement was actually based on information generally available in public domain or that such market research was accessible on a non-discriminatory basis to the public, it is suggestive of insider trading.[15]

[11] *Adjudication Order in respect of Neeraj Kumar Agarwal and Shruti Vishal Vora in the matter of circulation of UPSI through WhatsApp messages in the scrip of Ambuja Cements Ltd*., ADJUDICATION ORDER NO. Order/BD/NR/2020-21/7591/7592; *Adjudication Order in respect of Neeraj Kumar Agarwal and Shruti Vishal Vora in the matter of circulation of UPSI through WhatsApp messages in the scrip of Bajaj Auto Ltd.,* ADJUDICATION ORDER NO. Order/BD/VS/2O20-21/7583/7584; *Adjudication order in respect of Ms. Shruti Vora in the matter of circulation of UPSI through WhatsApp messages with respect to Bata Ltd.*, ADJUDICATION ORDER NO. Order/BD/VS/2020-21/7840

[12] Vijay Parthasarathi et al., *SEBI and WhatsApp leaks: Every link in the chain matters*, CYRIL AMARCHAND MANGALDAS (Jun 24, 2020) https://corporate.cyrilamarchandblogs.com/2020/06/sebi-and-whatsapp-leaks-every-link-in-the-chain-matters/

[13] *Ibid.*

[14] *Ibid.*

[15] *Ibid.*

- Even though the people accused in this case were financially literate and associated with the securities market, they allowed themselves to be an 'instrument in the chain of communication' of UPSI and did not raise an alarm when the information circulated by them matched the subsequent announcements almost accurately.[16]

In this case, a distinction has been drawn between HOS ('Heard on The Street') and UPSI since it was the primary argument of the accused that the information which was in question in this case was HOS. SEBI rejected this argument on certain grounds and held that the accused fulfilled the elements required to be called an 'insider' within the statute. It imposed a penalty on the accused.

The cases of insider trading have increased manifolds in the recent years. It is often seen that development in any law governing a particular aspect happens when people find out a way around the law and figure out how to get away with it. This is exactly what has led to the many recent amendments in laws related to insider trading. Initially, when the provision prohibiting insider trading was introduced in the statutes regulating corporations, this law was barely as detailed as it is today. But, in the coming times, this law would be even more detailed as is the case in many other countries around the world.

SUGGESTIONS FORWARDED AND CONCLUSION

In this part of the paper, I suggest some basic advancement that can be made in the insider trading laws in India. These are not very technical suggestions since that would require a more detailed research in the subject, and given the paucity of time and limited resources, these are the suggestions that were relevant.

One of the main difficulties related to insider trading that must be kept in mind while formulating or amending any insider trading law is that the detection and prosecution of perpetrators remains a challenge even today. This is majorly because of the dearth of clinching primary evidence which can prove complicity of ones who commit this offence.[17] Insider trading, qualifying as a criminal offence in india, needs a burden of proof which must be beyond

[16] *Ibid.*
[17] 2019 SCC OnLine Blog OpEd 19

reasonable doubt. In the absence of such evidence, the accused is often not convicted in such cases. As is evident from the case of 'WhatsApp leak', the regulator often is unable to conduct an investigation into the charges and the powers of SEBI to investigate such cases are limited. Like in the case of whistleblowers, even in insider trading, the investigating authority has to largely depend on circumstantial evidence. This issue is not limited to SEBI or India alone- "in the past, the U.S. Securities and Exchange Commission (SEC), as well as the Federal Bureau of Investigation (FBI) have expressed concerns over the usage of encrypted apps by Wall Street traders to hide illicit communication from internal compliance programs and regulators to disguise financial crimes."[18]Following such difficulties, SEBI has been looking to acquire technology for unstructured data analysis so that it could monitor and regulate market manipulation.[19]

Additionally, to reduce the practice of insider trading and protect informative that is sensitive to the companies, the officers of the company must take steps to maintain high standards of ethical behavior.[20] The penalisation for not abiding by the standards of ethical behavior must be good enough to have a deterrent value ensuring compliance of these standards. Insider trading penalties in India, though having monetary quantification, do not have severe punishments/penalties, as is prevalent in other countries by way of imprisonment, supervised release and substantial payments in form of fines/penalties.[21]

Furthermore, it must be kept in mind that incentivisation is one of the key factors in the ability to detect and punish an act of insider trading. For this, the reward and protection granted to the informant must be high. This is similar to encourage reporting of offence of whistleblowing. It must be kept in mind, while formulating any policy on insider trading or similar offences, that the accused in these offences are often the powerful people in a company, who have a substantial say in the affairs of the company. And, the informants may be shareholders, employees or any other person even remotely related to a company. Giving information about insider trading in public domain can affect a person's life very negatively if enough safeguards are not provided by the law. The regulators appear optimistic that the increased protection and potential for financial awards available to the informants will foster increased transparency and

[18]Marc Butler, *On Insider Trading, SEC Fights Technology with Technology*, INTELLIGIZE, (Aug.22, 2017)
[19] Parthasarathi, *supra*, at 13
[20] 10 CPJLJ (2020) 145
[21] 2020 SCC OnLine Blog OpEd 98

a culture of accountability within the financial market.[22] But, this must not be done at the cost of other requirements such as internal compliances of the company or false information about such offence. Under American law, the non-inclusion of the internal reporting requirement in the informant mechanism has been criticised as it tempts the employees to bypass internal compliance in pursuit of rewards. However, it is suggested that the internal compliance committee of a company should be combined with the informant mechanism so that SEBI does not face the same obstructions which regulators in US face owing to the short-sighted policy existing there in this regard.[23]

Lastly, I suggest that the upper limit of the penalty imposed for insider trading must be quashed, since this is a factor that must be decided on a case to case basis taking into consideration all things such as reputational loss to the company. The analysis of the punishment given to a person convicted of insider trading has to be specifically gauged with respect to his intentions and the circumstantial evidence found against him. A minimum amount of penalty could be provided by the statute in case the tribunal finds him guilty of the offence, but the upper limit is not really a requirement.

To conclude, it can be said with certainty that insider trading harms the market and the corporate governance of the country and the provisions must be amended time to time to incorporate advancements made in technology and other modes through which insider trading can be done. The law on insider trading can no more be static since new nuances unfold regularly and the Indian legislature deserves appreciation for all the recent amendments which have developed the law on insider trading, but surely this is not where it end and the laws on insider trading in other countries can also be analysed, moulded to Indian corporate governance and adopted to make further developments in the field of insider trading.

[22] *Supra*, at 18
[23] *Supra*, at 18