Insider Trading In India

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PREVENTING INSIDER TRADING

INTRODUCTION

It was only about three decades back that insider trading was recognized in many developed countries as what it was - an injustice; in fact, a crime against shareholders and markets in general. At one time, not so far in the past, inside information and its use for personal profits was regarded as a perk of office and a benefit of having reached a high stage in life. It was the Sunday Times of UK that coined the classic phrase in 1973 to describe this sentiment - "the crime of being something in the city", meaning that insider trading was believed as legitimate at one time and a law against insider trading was like a law against high achievement. "Insider trading" is a term subject to many definitions and connotations and it encompasses both legal and prohibited activity. Insider trading takes place legally every day, when corporate insiders – officers, directors or employees – buy or sell stock in their own companies within the confines of company policy and the regulations governing this trading. It is the trading that takes place when those privileged with confidential information about important events use the special advantage of that knowledge to reap profits or avoid losses on the stock market, to the detriment of the source of the information and to the typical investors who buy or sell their stock without the advantage of "inside" information. Almost eight years ago, India's capital markets watchdog – the Securities and Exchange Board of India organised an international seminar on capital market regulations. Among others issues, it had invited senior officials of the Securities and Exchange Commission to tell us how it tackled the menace of insider trading.

Insider & Insider Trading Defined

Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, does not directly define the term "insider trading". But it defines the terms-

- "insider" or who is an 'insider';
- who is a "connected person";
What are "price sensitive information".

Obviously an insider, who has deep insight into the affairs of the corporate body and holding knowledge about "price sensitive information" relating to the performance of the corporate body that could have a decided impact on the movement of the price of its equity, is at a vantage position with regards to a prospective trading in the shares of the company to the detriment of the common investors. Taking this fact into account the Regulation prescribes several "do-s" and "don'ts" with reference to these "insiders". The effect of the regulatory measure is to prevent the insider trading in the shares of the company to earn an unjustified benefit for him and to the disadvantage of the bonafide common shareholders.

According to the Regulations "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, connection, to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information;

The above definition in turn introduces a new term "connected person". The Regulation defines that a "connected person" means any person who-

1. (i) is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 (1 of 1956) of a company, or is deemed to be a director of that company by virtue of sub-clause (10) of section 307 of that Act or
2. (ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company whether temporary or permanent and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company;

"Price Sensitive Information" means 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.
INSIDER TRADING AS A CRIME

Insider trading is an extraordinarily difficult crime to prove. The underlying act of buying or selling securities is, of course, perfectly legal activity. It is only what is in the mind of the trader that can make this legal activity a prohibited act of insider trading. Direct evidence of insider trading is rare. There is no smoking guns or physical evidence that can be scientifically linked to a perpetrator. Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial. The investigation of the case and the proof presented to the fact-finder is a matter of putting together pieces of a puzzle. This is why providing civil, as well as criminal, liability is vital to an effective insider-trading program. The importance of making insider trading both a criminal and civil offense is illustrated by two recent decisions by U.S. federal courts.

In September 1998, the Ninth Circuit Court of Appeals held in the case of United States v. Smith. That in a criminal insider trading case, the government must prove that even a defendant who is a traditional insider (rather than a misappropriator) actually used material nonpublic information in making the decision to trade, rejecting the SEC's position and the position of the Second Circuit expressed in an earlier decision1 that it is enough for the government to show that the defendant was in possession of the information at the time he traded. Several months ago, the Eleventh Circuit Court of Appeals reached the same decision in SEC v. Adler, a civil case, but to alleviate the difficulties of proof raised by the standard, adopted a rule providing that although "use" is a required element of a Rule 10b-5 insider trading violation, when an insider trades in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading.2 The burden then shifts to the trader to rebut the inference by adducing evidence that there was no causal connection between the knowledge and the trade. Such an inference is unavailable in the criminal context, where

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the burden remains on the government to prove each element of an offense beyond a reasonable doubt. These two cases demonstrate the importance of having both civil and criminal prosecution available to the regulator. ³

**Insider Trading Law in the United States**

Rooted in the common law tradition of England, on which our legal system is based, we have relied largely on our courts to develop the law-prohibiting insider trading. While Congress gave us the mandate to protect investors and keep our markets free from fraud, it has been our jurists, albeit at the urging of the Commission and the United States Department of Justice, who have played the largest role in defining the law of insider trading.

After the United States stock market crash of 1929, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, aimed at controlling the abuses believed to have contributed to the crash. The 1934 Act addressed insider trading directly through Section 16(b) and indirectly through Section 10(b). Section 16(b) prohibits short-swing profits (profits realized in any period less than six months) by corporate insiders in their own corporation's stock, except in very limited circumstance. It applies only to directors or officers of the corporation and those holding greater than 10% of the stock and is designed to prevent insider trading by those most likely to be privy to important corporate information. Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful for any person "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." To implement Section 10(b), the SEC adopted Rule 10b-5, which provides, in relevant part:

It shall be unlawful for any person, directly or indirectly,

(a) To employ any device, scheme, or artifice to defraud,

³ 137 F.2d 1325 (1998).
(b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security\(^4\).

These broad anti-fraud provisions, make it unlawful to engage in fraud or misrepresentation in connection with the purchase or sale of a security\(^5\). While they do not speak expressly to insider trading, here is where the courts have exercised the authority that has led to the most important developments in insider trading law in the United States.

The breadth of the anti-fraud provisions leaves much room for interpretation and the flexibility to meet new schemes and contrivances head on. Moral imperatives have driven the development of insider trading law in the United States. And the development of insider trading law has not progressed with logical precision as the reach of the anti-fraud provisions to cover insider trading has expanded and contracted over time. The anti-fraud provisions were relatively easy to apply to the corporate insider who secretly traded in his own company's stock while in possession of inside information because such behavior fit within traditional notions of fraud. Far less clear was whether Section 10(b) and Rule 10b-5 prohibited insider trading by a corporate "outsider." In 1961, in the case of In re *Cady Roberts & Co*.\(^6\) the Securities and Exchange Commission, applying a broad construction of the provisions, held that they do. The Commission held that the duty or obligations of the corporate insider could attach to those outside the insiders' realm in certain circumstances. The Commission reasoned in language worth quoting:

\(^4\) 17 C.F.R. § 240.10b-5.

\(^5\) Section 17(a) of the Securities Act of 1933 reaches similar fraud in the initial offering or sale of a security.
Analytically, the obligation [not to engage in insider trading] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited7.

Based on this reasoning, the Commission held that a broker who traded while in possession of nonpublic information he received from a company director violated Rule 10b-5. The Commission adopted the "disclose or abstain rule": insiders, and those who would come to be known as "temporary" or "constructive" insiders, who possess material nonpublic information, must disclose it before trading or abstain from trading until the information is publicly disseminated.

Several years later in the case of SEC v. Texas Gulf Sulphur Co. a federal circuit court supported the Commission's ruling in Cady, stating that anyone in possession of inside information is required either to disclose the information publicly or refrain from trading8. The court expressed the view that no one should be allowed to trade with the benefit of inside information because it operates as a fraud all other buyers and sellers in the market9. This was the broadest formulation of prohibited insider trading. The 1980s were an extraordinary time in this country's economic history, marked by a frenzy of corporate takeovers and mergers involving what then were dazzling amounts of money.

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7 Id.
9 Id. at 851-52.
Insider trading reached new heights. Ironically, it is during this period that courts narrowed the scope of Section 10(b) and Rule 10b-5 in the insider trading context.

In the 1980 case of *Chiarella v. United States*, the United States Supreme Court reversed the criminal conviction of a financial printer who gleaned nonpublic information regarding tender offers and a merger from documents he was hired to print and bought stock in the target of the companies that hired him\(^{10}\). The case was tried on the theory that the printer defrauded the persons who sold stock in the target to him. In reversing the conviction, the Supreme Court held that trading on material nonpublic information in itself was not enough to trigger liability under the anti-fraud provisions and because the printer owed target shareholders no duty, he did not defraud them. In what would prove to be a prophetic dissent, Chief Justice Burger opined that he would have upheld the conviction on the grounds that the defendant had "misappropriated" confidential information obtained from his employer and wrongfully used it for personal gain.

In response to the Chiarella decision, the Securities and Exchange Commission promulgated Rule 14e-3 under Section 14(e) of the Exchange Act, and made it illegal for anyone to trade on the basis of material nonpublic information regarding tender offers if they knew the information emanated from an insider\(^{11}\). The purpose of the rule was to remove the Chiarella duty requirement in the tender offer context – where insider trading was most attractive and especially disruptive.

In 1981, the Second Circuit adopted the "misappropriation" theory, holding in the case of *United States v. Newman*\(^{12}\) that a person with no fiduciary relationship to an issuer nonetheless may be liable under Rule 10b-5 for trading in the securities of an issuer while in possession of information obtained in violation of a relationship of trust and

\(^{10\,}445\text{ U.S.} 222\text{ (1980)}.\)

\(^{11\,}\text{The Commission's authority to promulgate rules under Section 14(e) of the Exchange Act is confined to the tender offer context. It reads, in relevant part: "It shall be unlawful for any person . . . to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer .The [SEC] shall . . . by rule or regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative." 15 U.S.C. §78m(e).}\)
confidence. Newman, a securities trader, traded based on material nonpublic information about corporate takeovers that he obtained from two investment bankers, who had misappropriated the information from their employers.

Three years later in Dirks v. SEC\textsuperscript{13}, the Supreme Court reversed the SEC's censure of a securities analyst who told his clients about the alleged fraud of an issuer he had learned from the inside before he made the facts public. Dirks were significant because it addressed the issue of trading liability of "tippers": those who receive information from the insider tipper. Dirks held that tippers are liable if they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper received a direct or indirect personal benefit from the disclosure. Because the original tipper in Dirks disclosed the information for the purpose of exposing a fraud and not for personal gain, his tipper escaped liability.

A significant aspect of the decision was contained in a footnote to the opinion, which has come to be known as "Dirks footnote 14." There, Justice Powell formulated the concept of the "constructive insiders" – outside lawyers, consultants, investment bankers or others – who legitimately receive confidential information from a corporation in the course of providing services to the corporation. These constructive insiders acquire the fiduciary duties of the true insider, provided the corporation expected the constructive insider to keep the information confidential.

The Second Circuit again addressed the misappropriation theory in the 1986 case of United States v. Carpenter\textsuperscript{14}. The case centered on a columnist for the Wall Street Journal, whose influential columns often affected the stock prices of companies about which he wrote. The columnist tipped information about his upcoming columns to a broker (among others) and shared in the profits the broker made by trading in advance of

\textsuperscript{12} 463 U.S. 646 (1983).
\textsuperscript{13} 31 791 F.2d 1024 (2d Cir. 1986), aff'd 484 U.S. 19 (1987).
\textsuperscript{14} Echoing the Carpenter case, German prosecutors reportedly are considering bringing insider trading charges against a German television journalist, known as "Germany's first international stock market guru," for allegedly telling his friends which stock he was going to recommend on his weekly program. German TV Journalist is Accused of Insider Trading, AP Worldstream, August 17, 1998, financial pages
In upholding the convictions of the columnist and the broker for securities fraud under Rule 10b-5 and mail and wire fraud, the Second Circuit rejected the defendants' argument that the misappropriation theory only applies when the information is misappropriated by corporate or constructive insiders, holding “the misappropriation theory more broadly proscribes the conversion by insiders' or others of material non-public information in connection with the purchase or sale of securities."

The case was appealed to the Supreme Court. The Supreme Court unanimously agreed that Carpenter engaged in fraud, but divided evenly on whether he engaged in securities fraud. But in unanimously affirming the mail and wire fraud convictions, the Court quoted an earlier New York decision that ruled: "It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principle for any profits derived therefrom."

Over the next nine years, the misappropriation theory gained acceptance in federal courts. Then in 1995 and 1996, two federal circuit courts rejected the misappropriation theory on the grounds that the theory "requires neither misrepresentation nor nondisclosure" and that "the misappropriation theory is not moored in [section] 10(b)'s requirement that the fraud be "in connection with the purchase or sale of any security.""

Last year, in a landmark victory for the SEC, the Supreme Court reversed one of these decisions and explicitly adopted the misappropriation theory of insider trading in the case.

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15 791 F.2d at 1029
18 See, e.g., SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1990); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).
21 117 S. Ct. 2199 (1997)
of *United States v. O'Hagan*\(^\text{22}\). O'Hagan was a partner in a law firm retained to represent a corporation, Grand Met, in a potential tender offer for the common stock of the Pillsbury Company. When O'Hagan learned of the potential deal, he began acquiring options in Pillsbury stock, which he sold after the tender offer for a profit of over $4 million. O'Hagan argued, essentially, that because neither he nor his firm owed any fiduciary duty to Pillsbury, he did not commit fraud by purchasing Pillsbury stock on the basis of material, nonpublic information.

The Court rejected O'Hagan's arguments and upheld his conviction. The Court held, significantly, that O'Hagan committed fraud in connection with his purchase of Pillsbury options, thus violating Rule 10b-5, based on the misappropriation theory\(^\text{23}\). 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\(^\text{24}\).

In the course of its opinion, the Court identified two discrete arguments for prohibiting insider trading. First, the Court stressed that prohibiting insider trading is well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby

\(^{22}\) The Court also rejected O'Hagan's argument that the Commission's Rule 14e-3, which prohibits trading in securities based on nonpublic information about a tender offer (see supra note 28 and accompanying text), is invalid because the Commission exceeded its statutory authority in promulgating it.

\(^{23}\) 117 S. Ct. at 2207

\(^{24}\) 117 S. Ct. at 2207
promote investor confidence. Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.

Second, the Court acknowledged the "information as property" rationale-underlying insider trading prohibitions:

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 – the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.

Although the law of insider trading in the United States is continuing to evolve, the decision in O'Hagan is a significant milestone in defining the scope of Rule 10b-5 insider trading prohibitions.

**The European Community Directive on Insider Trading**

As United States lawmakers, courts and regulators struggled to refine prohibitions on insider trading, insider trading in the rest of the world markets, with few exceptions, went virtually unregulated prior to the 1980s. The first wide-ranging development outside the United States in efforts to ban insider trading was the European Community Directive Coordinating Regulations on Insider Trading, adopted on November 13, 1989 (the "EC Directive"). The EC Directive arose out of the 1957 Treaty of Rome Establishing the

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European Economic Community, which mandated creating a single internal European financial market\textsuperscript{28}.

The EC Directive was thirteen years in the making; the first deliberations beginning in 1976\textsuperscript{29}. In the 1980s, highly publicized insider trading scandals in New York involving Ivan Boesky and Michael Milken, among others, and in Europe involving the Guinness brewing group, gave a new urgency to developing a European-wide ban on insider trading\textsuperscript{30}.

The Directive was modeled after French and English insider trading prohibitions and went through a number of incarnations. In its final form, the Directive has an appealing structural simplicity. In sum, it defines "inside information" as information of a "precise nature" about security or issuer which has not been made public which, if it were made public, "would likely have a significant effect on the price" of the security (Article 1);

It prohibits insiders from taking advantage of inside information (Article 2);

It prohibits insiders from tipping or using others to take advantage of inside information (Article 3);

It applies its prohibitions to tippers with "full knowledge of the facts" (Article 4);

It requires each member to apply the prohibitions to actions taken within its territory with regard to securities traded on any members' market (Article 5);

It provides that members may enact laws more stringent than set out in the Directive (Article 6);

It requires issuers to inform the public as soon as possible of major events that may affect the price of the issuer's securities (Article 7);

It requires members to designate an enforcement authority, to give it appropriate powers and to bind it to professional standards of confidentiality (Articles 8 and 9);


\textsuperscript{29} Id. at 1043-44

It requires members to cooperate with each other in investigation efforts by exchanging information (Article 10);
It leaves it up to individual members to decide on penalties for insider trading (Article 13); and finally,
It required all members to enacted legislation complying with the Directive by June 1, 1992 (Article 14)\(^{31}\).

Much has and can be said about how the Directive compares to the United States law on insider trading. A fundamental difference between the EC Directive and the United States' prohibition against insider trading under Section 10b and Rule 10b-5 as developed by the courts, is that the Directive does not require that the insider trader breach a fiduciary duty to the source of the information for liability to attach. In this respect, it mirrors the United States' prohibition against trading on the basis of nonpublic information about a tender offer under Section 14(e) of the Securities Exchange Act of 1934 and the Commission's Rule 14e-3. As noted, the Supreme Court recently upheld this rule in the O'Hagan case.

It is too soon to make any intelligent generalizations about how legislation modeled on the Directive has fared jurisprudentially. In the scheme of things, insider-trading laws fashioned under the Directive are in their infancy. At the time the Directive was passed, four of the 12 members of the EC – West Germany, Belgium, Italy and Ireland – had no insider trading legislation on the books and the remaining eight members – France, England, Luxembourg, the Netherlands, Denmark, Greece, Portugal and Spain – had widely varying statutes\(^{32}\). Several of the members took time well beyond the 1992 deadline to get legislation in place. Luxembourg, for example, enacted its version of the Directive just last year\(^{33}\). And, obviously, the statutes are not self-enforcing – getting

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\(^{31}\) EC Directive, supra note 44. Article 11 provides that the EC may enter into agreements with non-member countries on insider trading issues and Article 12 provides for a Contact Committee to deal with problems that may arise under the Directive.


them on the books is only the first step to effecting a change in practice. Germany and Italy, in particular, have had trouble surmounting cultures, which traditionally viewed insider trading as an acceptable practice. One commentator recently observed as to Italy "In spite of the passage of laws on takeovers and insider trading since 1992, the bourse has not shaken its reputation as a fiefdom of an inward-looking financial community that treats small shareholders shabbily." By contrast, Chairman Levitt recently observed as to the U.S. markets: "Individual investors think – and I passionately believe – that the proverbial little guy' on Main Street should have the same fair chance as the big guys."

**Insider trading relatively high in India**

Insider trading a punishable offence in the United States, which increases stock market volatility, is relatively high in India, China, Russia, Venezuela and Mexico, according to a study done for the International Monetary Fund. The Global Competitiveness Survey prepared by Julan Du, Professor at the Chinese University of Hong Kong, and Shang-Jin Wei, an Advisor in the IMF's Research Department, looked at 50 countries. Insider trading involves the trading of stocks by people who have access to information that is relevant to the value of the company and, hence, the price of the stock. The United States has arguably the most stringent regulations in regard to insider trading, the study notes. While the US has expanded its definition of 'insider', in most other countries the definition is less broad. Du and Wei say that because insider trading tends to be illegal, it is difficult to measure directly. "You must use perceptions to estimate the degree of insider trading; you cannot count the amount of money changing hands," says Du. Wei said that the results of their study "clearly show a positive association between the degree of insider trading and the degree of market volatility." "Furthermore, we find the effect to be quantitatively significant. For example, the Chinese stock market is much more

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volatile than the US market. Our study suggests that the greater prevalence of insider trading in China has a lot more to do with this higher volatility than, say, more volatile economic fundamentals or economic policies in China."

**Cooperation Among International Enforcement Authorities**

Insider trading often crosses borders: a foreign national engages in insider trading in the domestic market; nationals effect insider trading through foreign accounts or important evidence of domestic insider trading lies outside domestic borders. Successful investigations and prosecutions of these cases require international cooperation. Perhaps one the most progressive aspects of the EC Directive is that it requires members to cooperate with each other "whenever necessary for the purpose of carrying out their duties" in connection with the EC Directive. The significant benefit of this provision is that it requires no further agreements between or among states regarding cooperation. The SEC has entered into\(^{36}\) arrangements with foreign counterparts for information sharing and cooperation in the investigation and prosecution of securities law violations. These agreements have taken primarily two forms: Mutual Legal Assistance Treaties in Criminal Matters and Memoranda of Understanding. The United States has entered into Mutual Legal Assistance Treaties have been entered into with a number of countries, including Switzerland, the United Kingdom and Northern Ireland, the Cayman Islands, the Netherlands, Turkey, Canada, the Bahamas and Italy. The treaties generally provide for assistance in criminal matters, including assistance in locating witnesses, obtaining statements and testimony of witnesses, production and authentication of business records and service of judicial and administrative documents. The major advantage of these treaties is that they are binding on the parties to the treaty. The other form of agreement the United States has relied on in the international context is the Memorandum of Understanding. MOUs are non-binding statements of intent between regulators providing for the exchange of information and mutual cooperation. The Commission has entered

\(^{36}\) Echoing the Carpenter case, German prosecutors reportedly are considering bringing insider trading charges against a German television journalist, known as "Germany's first international stock market guru," for allegedly telling his friends which stock he was going to recommend on his weekly program. [German TV Journalist is Accused of Insider Trading](https://apworldstream.com/).
into MOUs or similar agreements with Switzerland, Japan, the U.K., Brazil, the Canadian Provinces of Ontario, Quebec and British Columbia, Italy, the Netherlands, France, Mexico, Portugal and Germany. Experience has shown that MOUs provide an effective means of obtaining information in securities enforcement and assist in developing a framework for cooperation and improved communication.

Domestically, the United States has passed laws to facilitate its cooperation with foreign governments. The Insider Trading and Securities Fraud Enforcement Act of 1988 expanded the Commission's ability to provide assistance to foreign regulators by allowing it to use its compulsory powers to compel testimony and production of documents obtain information at the request of a foreign securities authority. The International Securities Enforcement Cooperation Act of 1990 enlarged the Commission's ability to address international securities issues in several ways. It amended the securities laws to permit the Commission to institute an administrative proceeding barring, sanctioning, or otherwise placing conditions on a securities professional's ability to engage in Commission-regulated activities if a foreign court or securities authority has found that the professional engaged in illegal or improper conduct. The law also amended the securities laws to provide confidential treatment for records produced under reciprocal arrangement with foreign securities authorities by exempting the documents from the disclosure obligation of the Freedom of Information Act if a good faith representation is made that disclosure would violate that country's confidentiality requirements. In addition, the law makes explicit the Commission's rulemaking authority to provide access to nonpublic documents and other information to both foreign and domestic authorities. Finally, it authorizes the Commission to accept reimbursement from a foreign securities authority for expenses incurred by the Commission in providing assistance. In 1997, the SEC made 240 requests to foreign governments for enforcement assistance and responded to 363 requests for enforcement assistance from foreign governments. In the summer of 1998, the SEC had a notable success in obtaining information under the Hague Convention, which prescribes certain procedures by which a judicial authority in

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one contracting state may request evidence located in another contracting state in civil cases. In an emergency action filed in the Southern District of New York, the Commission filed a complaint against two Singapore residents, alleging that the defendants engaged in insider trading prior to the public announcement that APL Limited would be acquired by Singapore-based Neptune Orient Lines, Ltd. The court granted the Commission's request for a temporary asset freeze and orders requiring the defendants to identify themselves, allowing expedited discovery, and granting other ancillary relief. The Commission applied to the High Court of the Republic of Singapore under the Hague Convention for the appointment of an examiner to take evidence from witnesses in Singapore to be used in the proceeding in the Southern District of New York. The Singaporean defendants opposed the appointment of an examiner, arguing that despite the U.S. classification of the action as civil, violations of Section 10(b) and Rule 10b-5 are penal in nature and, therefore, the Hague Convention does not apply. The Singapore court held for the SEC, finding that an action for an injunction under Section 10(b) and Rule 10b-5 is a civil proceeding according to the law of the United States and the law of Singapore. This decision, if followed in other Hague signatory countries, opens yet another mode of international information gathering available to the SEC's enforcement program.

**SEBI guidelines on insider trading are preventive in nature**

The recent draft guidelines issued by Sebi for public discussion are the latest of the developments in India in this direction. Earlier, one would recollect the 1992 regulations, which, at best, would be described as a sleeping beauty (or a sleeping giant?) since they did not appear to be aggressively pursued or enforced. In this article, the latest guidelines as proposed have been discussed. The importance of these guidelines cannot be understated. The insider trading regulations are basically punitive in nature in the sense

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that they describe what constitutes insider trading and then seek to punish this act in various ways. The new guidelines are basically preventive in nature. More importantly, they will have to be complied with by all listed companies; all market intermediaries (such as brokers) and all advisers (such as merchant bankers, professional firms, etc.). These guidelines require that each of these entities should take steps in advance. The guidelines provide for very detailed procedures that each of such entities would have to follow. In a sense, this approach makes sense since such offenses are easier to prevent but far more difficult to prove and prosecute. Even the classic cases in the west such as the celebrated Dennis Levine case in the United States shows the vigorous and extensive efforts the authorities had to take including pressurizing so-called tax havens to reveal information when such havens are otherwise known for their strict confidentiality. Such cases do serve as an example for those who may think of carrying out such acts. But preventive measures are likely to substantially reduce such acts as also educate the innumerable insiders of the law relating to insider trading. Interestingly, Sebi has sought to delegate most of the procedures almost up to the last stage on the entity concerned and usually it will be up to the entity to carry out initial investigation for final submission to Sebi for taking punitive action. Further, such entities have been required to provide for internal punitive measures such as monetary penalties, forfeiting Esops, etc. The guidelines provide for a set of procedures and code of conduct for those entities whose employees; directors and owners are most likely to be in a position to take advantage of inside information for personal gain. These guidelines are separately prescribed for listed companies, market intermediaries and professional firms. Quite expectedly, the guidelines for listed companies are given the most attention and place more responsibility on such companies. Before we go further, it is necessary to first understand what the offense of insider trading is. For this purpose, one has to understand two important terms. The first is the term "insider". This term is very broadly defined and all those who have access to unpublished price sensitive information in one way or the other are included. The other term is "unpublished price sensitive information", that is, that information relating to the company, which is unpublished, and with respect to which the market price of the share is very sensitive. To give an example, if it is known that a company is being merged with another company at very favorable terms, it is information that the market
price of the company can be quite sensitive about. If a person, who has access to
information that is not published, such as a director, trades in the shares of the company
on the basis of such information, he would be deemed to have committed the offense of
insider trading. Note that it is not necessary that the person should have traded in the
shares. He may have communicated such information to another person so that such other
person makes use of such information. This also constitutes insider trading. Other similar
acts are also covered. The insider trading regulations are the parent regulations in this
respect. The guidelines now proposed are expected to serve the function of percolating
down to the level of those entities where such acts actually occurred. The broad pattern of
these guidelines and features common to all groups of entities covered can be first
reviewed. The first step that an entity needs to take is to lay down and declare a policy
relating to insider trading. It also involves the basic step of providing copies of the
statutes to all concerned. The second step is to create a compliance department. This
department is to be headed by a compliance officer who should report to the chief
executive of the entity. The compliance department would have a great responsibility in
this matter and it is submitted that there is overkill in this regard. So much responsibility
and requirements have been placed on the compliance department as well as the
compliance officer, apart from too many procedures, that it is likely that this department
and the compliance officer may be drowned in paperwork. The important concept of
materiality and exception reporting has not been applied. For example, every executive
has been required to first clear and report his share transactions with the department.
Further, they are also required to give monthly reports. Further, it would have been better
if a cutoff point in this regard could have been laid down so that small transactions in
shares need not be reported. Of course, this is not to encourage small offenses but there
could be separate procedures for such acts. Similarly, a reporting should be only by
exception and thus only where a person actually trades in the shares that he should report
or clear such transaction. Presently, it appears that all listed companies, all market
intermediaries and all professional firms having some connection to listed companies will
be required to follow the same procedures and guidelines. It may be worthwhile to
consider whether some cut off can be made so that companies and firms below a certain
size are either exempted or can follow alternative summary procedures. Since the
requirements are quite detailed (perhaps the largest of companies and firms have also been kept in mind), not all such entities can afford or even require such detailed procedure and infrastructure such as an elaborate compliance department headed by a compliance officer. Nor would it be possible for professional firms in all cases to have the so-called Chinese walls. Incidentally, to explain the term Chinese Walls, it means those physical and intangible barriers created between departments of a firm whereby those departments having access to such inside information of companies are separated with other departments which have no concern with such information or who may misuse such information. It may also be not out of place to mention here that the success of maintaining Chinese Walls in controlling insider trading is at best mixed in the West.

The Securities and Exchange Board of India's (SEBI) new regulations on insider trading has made it mandatory for investors to disclose their holding in a company beyond five per cent, for every additional two per cent stake acquired. In addition, any fall in the holding below five per cent will also have to be disclosed mandatory, according to the new guidelines. Earlier regulations had provision for disclosure just after crossing the five per cent for the first time and there was no provision for disclosure if the holding falls below the five-per cent limit. The new regulations come into effect from February 20. The regulations follow the final recommendations of the SEBI Insider Group headed by Mr Kumarmangalam Birla on March 31, 2001, that was approved by the SEBI Board on May 14, 2001. According to the Section 13 of the Insider Trading Regulations, any person who holds more than five cent shares in any listed company shall disclose to the company the number of shares held and change in shareholding, even if such changes result in shareholding falling below five per cent. If the holding falls below five cent, it has to be disclosed if there has been change in such holdings from the last disclosure made. Investors will have to continuously disclose acquisition of additional shares every time such acquisition rises by two per cent above the threshold limit of five per cent.
In its bid to tighten insider-trading norms, the SEBI group has prescribed a code of internal procedures and conduct for listed companies and for entities associated with the capital market.

In an informal chat with the media, the Senior Executive Director of SEBI, Mr L.K. Singhvi, said these guidelines are being prescribed to create an internal framework of compliance at every level in order to prevent or minimize insider trading. Once approved by the board, the SEBI Insider Trading Regulations of 1992 would be amended to incorporate these guidelines. "Internal enforcement of this is mandatory", Mr Singhvi added. He, however, clarified that compliance with this prescribed code does not mean that you cannot be proceeded against under the main regulations. "These guidelines provide a supplementary framework and are to serve as a preventive measure. This will also put the onus of responsibility on corporate and other entities like broking firms, merchant bankers etc., to create an atmosphere of compliance internally," Mr Singhvi said. The code also stipulates mandatory disclosures on two counts. One, with respect to disclosure of interest/holdings by directors and other officers who are insiders in the company and thereafter accumulating continuously for every 5,000 shares or shares worth Rs 5 lakh, whichever is higher. Two, shareholders or those holding at least five per cent stake in a company and thereafter accumulating every additional two per cent. These disclosures will initially be made at the company level, which would then inform the stock exchanges. The objective is to preserve the confidentiality of information, prevent its misuse and ensure commitment to transparency," Mr Singhvi explained. The code of internal procedure and conduct for listed companies will broadly detail what would be violation of the insider trading code, what is price-sensitive information etc. It also stipulates that every company must have a compliance department, which would serve as a nodal agency to collate information, specify policy requirements etc. It suggests following the principle of 'need to know' with regard to unpublished information. Access should be limited to those who need it. To prevent misuse of information, it has been suggested that companies provide a trading window during special events, whereby trading in those shares would be curtailed. In this case, we are talking of events like declaration of dividend, company results etc.," he said. The trading window would thereafter be opened a day or two after information is made public. The code also prescribes mandatory pre-clearance of trades and reporting to compliance officer. Further, it prescribes a minimum holding period of one month for directors, officers and designated employees. Violation or non-compliance of this would attract a penalty. The code of procedures and conduct for intermediaries or entities associated with capital markets includes stock exchanges, legal firms, professional firms, depositories, and associations such as AMFI, AMBI etc.
Conclusion

The importance of policing insider trading has assumed international significance as overseas regulators attempt to boost the confidence of domestic investors and attract the international investment community. Reports from the international press confirm a proliferation of law-making and regulatory actions within just the last several months in countries across the globe aimed at curbing insider trading. For example, in 1998 alone: Hong Kong regulators unveiled new measures to combat insider trading, including the introduction of new electronic surveillance capability. Malaysia amended to its securities laws, for the first time giving investors a private right of action against insider traders. In its efforts to curb insider trading, the Securities and Exchange Board of India enacted regulations requiring that corporate deals be reported to stock exchanges within 15 minutes of finalizing. Vietnam announced a decree establishing its first public securities market, which includes prohibitions on insider trading.

The government of Egypt announced that it is working on a comprehensive reform of its regulation of the Cairo Stock Exchange, to bring it into line with world standards. The Netherlands Securities Board announced that it is launching an investigation into whether the Amsterdam Exchanges have sufficient systems in place to detect and investigate insider trading. These developments herald a new era of universal recognition that insider trading, in the words of the SEC's Chairman Levitt, "has utterly no place in any fair-minded law-abiding economy."
40 Stewart Oldfield and Sauw Yim, Regulators Aim to Hit Market Regulation, South China Morning Post, July 22, 1998, at 1.


