

Insider Trading: Legal Position in India vis-à-vis the UK and the US

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Introduction

In 2009, Mr. Rajat K Gupta, a former Goldman Sachs board member, while delivering a speech at a leading business school in India said, “Try to make other people successful. If you work on making other people successful, they will, in turn, make you successful beyond your dreams”. Being a man of his words, he endeavoured to make other people successful but through illegal means. A few years later, he was charged by the US Securities and Exchange Commission (“SEC”) with illegal insider trading and was convicted in the year 2012 and was imposed a penalty of \$13.9 million. Gupta had passed confidential information about Goldman Sachs and P&G to his friend Raj Rajaratnam, the head of the Galleon Group, a New York-based hedge fund management firm. This case is a testimony to the fact that regulation of insider trading is not merely a paper tiger and stringent norms exist across the globe to curb this evil practice. In the light of the above, an attempt has been made through this paper to analyse the Indian insider trading provisions and draw a comparison with similar laws in the UK and the US apropos this morally and legally deplorable practice.

What Is Insider Trading?

Black’s Law Dictionary defines Insider trading as “The use of material non-public information in trading the shares of a company by a corporate insider or any other person who owes a fiduciary duty to the company.” It involves the deliberate exploitation of unpublished price sensitive information (“UPSI”) obtained through or from a privileged relationship for trading in shares and securities for the purposes of gain (or to avoid a loss) at the expense of the uninformed public when the price of

securities would be materially altered if the information were disclosed. Corporate insiders are usually persons who are in employment with the firm (executives, directors, other employees) or who have privileged ingress to the firm’s internal affairs (auditors, consultants, large shareholders, lawyers, investors, etc.), which makes them privy to valuable information.

Regulations against the practice of Insider Trading

United States

The US was the first country to formally enact a legislation and has been one of the leading enforcers of insider trading provisions. Thomas Newkirk and Melissa Robertson of the SEC summarize the development of U.S. insider trading laws as:

“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.”¹

As a follow-up action of the Great Depression of 1929, The Congress enacted the Securities Act, 1933 and the Securities Exchange Act of 1934 (“1934 Act”). The term insider trading was referred to in Sections 16(b)² and 10(b)³ of the 1934 Act. The US courts have provided the requisite jurisprudence relating to insider trading in order to assist the SEC, which can be illustrated as follows:

- ***The Classical or Disclose or Abstain theory***: the insider must disclose UPSI to the public before making the trade or abstain from making the trade at all.⁴ This theory is applicable to directors, officials, employees or other associated or connected persons.
- ***The Tipper/Tippee Theory***: a person who has received a tip in the form of material non-public corporate information is liable which has been formalized in the US under Rule 10b-5 of the 1934 Act. Such a liability is generally called the tipper/tippee theory of liability.⁵
- ***The Misappropriation theory***: this theory is designed to protect the integrity of securities markets against abuses by outsiders to a company who have access to UPSI that may affect the company’s security price when revealed, but who

¹ Insider Trading- A U.S. Perspective www.sec.gov/news/speech/speecharchive/1998/spch221.htm (accessed on 3 January 2018)

² Section 16(b) prohibits short swing profits by corporate insiders in their own corporations’ stock except in certain circumstances. 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, Securities Exchange Act, 1934.

³ Section 10(b) 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, Securities Exchange Act, 1934

⁴ Cady Roberts & Co, 40 SEC 907 (1961)

⁵ Dirks v. SEC, 463 U.S. 646 n.14 (1983), Id, at 661 (citing In re Investors Mgmt. Co., 44 SEC 633, 651 (1971) (Smith, Comm’r, concurring in result)

otherwise owe no fiduciary or any other duty to the shareholders of the company.⁶

The Congress promulgated The US Sanction Act, 1984, which requires all directors, officers and beneficial owners of more than 10% of its registered equity securities to mandatorily file an initial statement with the SEC as well as with the exchanges on which the stock may be listed.⁷ The US has developed a number of supplementary rules such as the Insider Trading and Securities Fraud Enforcement Act 1988, Remedies and Penny Stock Reform Act of 1990, Rule 14e-3 Tender Offer Rule, Regulation FD as well as the Sarbanes-Oxley Act of 2002.⁸ Insider trading enforcement actions in recent years highlight the SEC's foray into newer areas, including actions taken against IT professionals and hackers who misappropriate sensitive corporate data, as well as providers of political intelligence.⁹

United Kingdom

The term insider dealing¹⁰ has been used in British law since 1980. After several aborted tries to pass legislation through the Parliament, on 23 June 1980, sections 69-73 contained in Part V of the Companies Act 1980 came into force and made insider dealing a criminal offence.¹¹ Presently, the Financial Services and Markets Act, 2000 ("FSMA") provides for a regime for preventing market abuse and also empowers the UK Financial Services Authority ("FSA") to sanction anyone who engages in market abuse. Section 118(2)¹² of the FSMA defines 'market abuse'. This abuse is regarded as a civil offence and therefore does not require that a person must have acted deliberately or recklessly.¹³ The Criminal Justice Act, 1993 provides for criminal liability for insider trading. It prohibits dealing in price-affected securities on the basis of insider information, encouragement of another person to deal in price-affected securities on the basis of insider information and knowing disclosure of inside information to another.¹⁴ Recently, the conviction of former corporate brokers Martyn Dodgson and Andrew Hind in May 2016 brought the FSA's largest and

most complex insider dealing investigation, code named *Operation Tabernula*, to a near end. The sentences handed down by the regulator, of 4.5 and 3.5 years imprisonment respectively, are the harshest in its history for insider trading.

India

In 1948, the Thomas committee was constituted to recommend suitable restrictions that could be imposed on short swing profits. Consequently, the Sachar Committee¹⁵, Patel Committee¹⁶, and Abid Hussain Committee¹⁷ were established for further recommendations in the area of restricting insider trading. The recommendations made by these committees eventually led to the formation of Securities Exchange Board of India (Insider Trading) Regulations, 1992. By virtue of the enactment of Companies Act, 2013, the concept of prohibition of insider trading of securities was incorporated in Section 195¹⁸. In 2015, Securities Exchange Board of India (SEBI), the Indian watchdog of capital markets, replaced the 1992 regulations with the SEBI (Prohibition of Insider Trading) Regulations, 2015 in order to revamp the existing capital market regulatory structure. The new regulations have brought significant changes in the regulation of trading in Indian capital markets. It has broadened the scope of the definition "connected person" to a far extent. It includes persons connected on the basis of being in any contractual, fiduciary or employment relationship during six months prior to the concerned act that allows such person access to UPSI. The charge of insider trading has now been extended to securities listed and to those proposed to be listed on stock exchanges. The 2015 regulations appear to be promising, more practical and largely in consonance with the global outlook to insider trading.

Comparative Analysis

Scope

investments in relation to such qualifying investments, and

(b) falls within any one or more of the types of behaviour set out in sub-sections (2) to (8)

¹³ Noam Noked, "Differences Between US and UK Market Abuse Regimes", 7 April 2012, available at <http://blogs.law.harvard.edu/corpgov/2012/04/07/differences-between-us-and-uk-market-abuse-regimes/>

¹⁴ Section 52, Criminal Justice Act, 1993

¹⁵ 1979

¹⁶ 1986

¹⁷ 1989

¹⁸ Companies Act 2013, Section 195: (1)- No person including any director or key managerial personnel of a company shall enter into insider trading: Provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or employment or under any law. (2)- If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.

⁶ United States v. Vincent F Chiarella, 445 U.S. 222 (1980)

⁷ Section 16 of the Securities Exchange Act of 1934

⁸ Shen, Han, 'A Comparative Study of Enforcement of Insider Trading Regulation between the U.S. and China' (February 21, 2007), available at SSRN: <http://ssrn.com/abstract=964548>

⁹ Mark Fagel and Elizabeth Dooley, "The unrelenting pace of SEC insider trading actions" available at www.globalinvestigationsreview.com/article/1149624/the-unrelenting-pace-of-sec-insider-trading-actions (accessed on 1 January 2018)

¹⁰ Insider trading is known as Insider dealing in the UK.

¹¹ <https://www.lawteacher.net/free-law-essays/trading-law/regulation-of-insider-trading-law-essays.php>

¹² (1) For the purposes of this Act, Market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert) which-

(a) occurs in relation to-

- (i) qualifying investments admitted to trading on a prescribed market,
- (ii) qualifying investments in respect of which a request for admission to trading on such a market has been made, or
- (iii) in the case of subsection (2) or (3) behaviour, investments which are related

In UK, both the liabilities, civil and criminal are determined by different statutes but in India and US, the same statute is applied to both liabilities. But the scope of Indian Law can be seen as narrower when compared with the UK law as Indian Law is limited to dealing only with limited Companies while no such criteria is mentioned in the latter. It is also to be noted that under the Indian law, a person is deemed to be a connected person if he has been connected to the Company during a period of 6 months prior to the insider trading act but no such time period has been prescribed under the UK law.¹⁹

Mens rea

In the U.K., the offence of insider dealing requires a proof that the accused has intentionally exploited his position to engage in insider dealing. It will be necessary for the prosecution to institute that the individual charged with the offence of insider dealing has mindfully dealt in the securities knowing that he is linked to the company.²⁰ In the US, the 1934 Act provides that a person would be held criminally liable for the violation of Sec 10(b) if his action is expressly considered to contain a wilful violation of the securities crimes under Section 32(a) of the 1934 Act, thereby absolutely recognising the principle of Mens rea.²¹ The legal framework of India does not seem to take the intent of the offender into account. A person may be convicted of insider trading regardless of whether he has committed it knowingly, deliberately or intentionally.

Insider

Under the US law, an insider, affiliate or control person is defined as an officer, director or owner of more than 10% of the voting stock in a company, or the immediate family of any of these persons. No such criteria of holding a percentage of voting stock has been prescribed under the Indian law.

Penalty

In the UK, Criminal sanctions for insider trading can incur custodial sentences of up to 7 years²² and unlimited fines.²³ In India, Insider Trading is punishable with a penalty extending up to INR 250,000,000, or three times the profit made, whichever is higher. Any person contravening or attempting to contravene or abetting the contravention of the Act may be sentenced to imprisonment for a term, which could extend to 10 years or a fine, which may extend to INR 250,000,000 or both.²⁴ The punishment in US for committing insider trading is 20 years in prison or a maximum fine up to

US\$5 million. The civil penalty for a violator may be an amount up to three times the profit gained or loss avoided.

Critical Evaluation of Indian Laws

In India, there is no provision to impose a penalty or even ensue investigation on a foreign national involved in insider trading. With respect to the trans-border character of securities trade in the present times, this is a huge drawback. SEBI finds the regulation of insider trading as a huge task and often ends up calling it 'the unwinnable war'. According to the Annual Report of SEBI²⁵ (2016-2017), It took up 34 cases of Insider trading this year against 12 cases in the previous year. Sadly investigation got completed only in 15 cases. Since the charges of insider trading are mostly based on circumstantial evidence, it is difficult to be detected. Even where it is detected, the rate of successful prosecution has been very low. Despite the presence of a robust regulatory mechanism, SEBI lacks the required technological expertise and manpower required to effectively carry out investigations. As the Kotak Committee²⁶ report highlighted, SEBI has just one employee for six listed companies, while the SEC has about one employee for every listed company. In the division that looks after the quality of financial reporting, SEC has about 10 times more employees as compared to SEBI.

However, the recent action taken by SEBI in reprimanding Axis Bank to strengthen its internal system with regard to the recent WhatsApp leak case²⁷ is rather commendable. India has also done well in the 'protecting minority investors indicator' of the World Bank's Doing Business rankings by securing the fourth position in 2017.²⁸

Conclusion

Thus, despite having evolved much slower as compared to the US and European capital markets, Indian capital markets have caught up with its international counterparts and have emerged successful in developing and enforcing stringent provisions for tackling the evil of insider trading.

¹⁹ Mohini Varshenya, "Insider & Connected Persons", available at www.corporateprofessionals.com/insilysis-an-analysis-of-insider-laws (Accessed on 1 January 2018)

²⁰ Bose Jaishree, "Insider trading perspectives and cases" The ICFAI University Press Publication, (1st ed., 2007) at 35-55

²¹ Javish Valecha, "Anticipative and Statistical Analysis of Insider Trading", *Journal of Legal Studies and Research* <http://jlsr.thelawbrigade.com/index.php/2017/04/21/anticipative-and-statistical-analysis-of-insider-trading/> (accessed on 20 December 2017)

²² Section 61, Criminal Justice Act, 1993

²³ Section 123, Financial Services and Markets Act, 2000

²⁴ Section 15G, Securities Exchange Board of India Act, 1992

²⁵ https://www.sebi.gov.in/reports/annual-reports/aug-2017/annual-report-2016-17_35618.html

²⁶ https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html

²⁷ <http://www.firstpost.com/business/sebi-crackdown-on-whatsapp-leaks-is-a-step-in-preventing-rather-than-punishing-insider-trading-4279119.html>

²⁸ <http://www.doingbusiness.org/data/exploretopics/protecti-ng-minority-investors>