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INSIDER TRADING:
Contours of Liability and Judicial Approach

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INSIDER TRADING: Contours of Liability and Judicial Approach

Girjesh Shukla[*] *& Adity Dehal*[**]

[Abstract: *Insider trading, characterised by the clandestine trading of stocks based on privileged information capable of impacting market prices if revealed, has undergone meticulous examination by judicial entities. On the one hand, courts in other jurisdictions, such as in the United States, have gone beyond the traditional conceptualisation of insider trading, viz, shadow trading; the Indian courts are still hovering around the classical theories of insider trading. This conventional approach is damaging the prospects of curbing the menace of insider trading in the Indian securities market. While the Supreme Court of India and the Securities Appellate Tribunal (SAT) have refrained from relying solely on circumstantial evidence to establish insider trading cases, they have nonetheless assigned significant importance to such evidence when exonerating corporations. These occurrences have played a pivotal role in shaping a novel standard of proof to guide the Securities and Exchange Board of India (SEBI) in insider trading cases. However, they have also stirred doubts regarding the consistent application of legal principles. To effectively unearth instances of insider trading, a comprehensive assessment is imperative, encompassing an analysis of the relevance and application of undisclosed price-sensitive information (UPSI) alongside scrutinizing the trading behaviour of implicated companies.*

The paper begins by theorizing insider trading in the present context, including shadow trading, and after that, scrutinizes the loopholes and misinterpretations surrounding the proof of insider trading by the Supreme Court while ignoring the potential rationales and legislative intent.]

I

Introduction

The capital market has become one of the most sought-after destinations for entrepreneurs seeking capital for their businesses and investors looking for good returns on their investments. The growth trajectory in the capital market has shown

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these characteristics across the jurisdictions. The urge to make a quick profit from the capital market has driven many market players, including stakeholders, towards market manipulations and fraudulent activities. This is causing a loss to investors and a dent in the stability and faith towards the market regulators.

While trading in the secondary market, i.e., the stock market, there are many ways and means towards market manipulations and other fraudulent activities; insider trading is considered the most heinous. Insider trading refers to trade by a person being an insider or having undisclosed price-sensitive information (UPSI). Hitherto, many jurisdictions consider insider trading a crime and civil wrong.[1] However, with new types of insider trading, such as shadow trading, the regulators have tilted towards a civil-wrong approach to enforcing insider trading regulations.[2] The Indian legislation criminalising insider trading was withdrawn in 2018.[3] However, the Regulations are now being made stricter.[4] This change towards prohibiting and regulating insider trading, as this paper explores, probably has not impacted judicial scrutiny. Thus, the courts are still taking up these matters as criminal cases, demanding proof beyond a reasonable doubt, failing which order of acquittals are being passed. Cases of insider trading often begin as violations of the securities market regulations end up in criminal appeals, thus resulting in the overall failure of the regulatory framework.

The present work explores the idea of regulating insider trading from the perspective of the securities market *dehors* any criminal intent to achieve the very purpose of these regulations. The work explores the very inherent fallacy of the free market theory, that presupposes free-flow of information along with the availability of information equally to all. The author argues that the very formation of securities market is of such a nature that makes impossible to ensure the availability of information as well as its accessibility equal amongst the participants. This inevitably creates fertile ground for insider trading. It further argues that the new, unique ways of insider trading, such as shadow trading, are a serious challenge to

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1 This approach is visible by bare analysis of Section 195 of the Companies Act, 2013 (18 of 2013). Under Section 195, insider trading was a punishable offence with the punishment of imprisonment of up to five years with or without a fine. See also the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, replaced by the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

2 *Securities and Exchange Commission* v. *Matt Panuwat*, Litigation Release No. 25970 / April 8, 2024; See also, *SEBI* v. *Kishore R. Ajmera*, (2016) 6 SCC 368.

3 The Companies Amendment Act, 2017 (1 of 2018) repealed Section 195 of the Companies Act, 2013.

4 The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

regulators, and the judicial interpretations of these rules should be expansive enough to cover emerging challenges.

Securities Market: Alternative Opportunities

With the rapid growth in capital-intensive firms, there is quite a high demand for capital for the survival and expansion of these firms. The supply of capital, especially the borrowed capital, has costs and limitations. This drives the firms towards alternative methods, primarily alluring the people at large to share their savings into the firm's capital and receive a fraction of the benefit in the form of dividends. The arrangement is quite alluring and lucrative. The stock market with average trading, such as in Index Funds and/or Exchange Traded Funds (ETF), often provides a return on investment (**ROI**) of 12% or more.[5] This is high and attractive if compared with the ROI on bank savings. The ROI of investments in distinct companies with sound business and phenomenal growth is quite attractive.[6]

Lately, the securities market has become the most sought-after zone due to its capacity to provide alternative opportunities for entrepreneurs and investors. Entrants to this market are attracted to it by its unexplored capacity to fetch availability of huge capital through Initial Public Offer (IPO), Further Public Offer (FPO), etc. Hitherto, this strength of the securities market was not so explored. People engaged in business are often forced to look towards banks and other lending agencies for capital. The recent upsurge in the number of IPOs indicates this fact.[7] According to the Economic Survey 2024, fund mobilisation through equity, debt, and hybrid modes increased by 24.9%, 12.1%, and 513.6% in the financial year 2024 compared to the previous year 2023. The number of IPOs increased by 66% in the financial year 2024, rising from 164 in the financial year 2023 to 272 in the

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[5] The NIFTY 50, the flagship index fund on the National Stock Exchange of India Ltd. (NSE), has given an ROI of 29% for the Financial Year 2023-24. The Index tracks the behavior of a portfolio of blue-chip companies, the largest and most liquid Indian securities. It includes 50 of the approximately 1600 companies listed on the NSE, captures approximately 65% of its float-adjusted market capitalization, and reflects the Indian stock market.

[6] For example, the ROI for the Financial Year 2023-24 has been quite high for Tata Motors (up by 136.42%), Bajaj Auto (up by 134.28%), Adani Ports (up by 112.53%), Coal India (up by 103.14%), and Hero Motocorp (up by 101.42%).

[7] A Ksheerasagar, *Economic Survey 2024: Total number of IPOs rises 66% in FY24 with amount raised growing by 24%*., MINT, (July 22, 2024) available at - https://www.livemint.com/market/stock-market-news/economic-survey-2024-total-number-of-ipos-rises-66-in-fy24-with-amount-raised-growing-by-24-says-nirmala-sitharaman-11721636184671.html (last visited on August 22, 2024).

financial year 2024, while the amount raised grew by 24%, from ₹54,773 crores in 2023 to ₹67,995 crores in 2024.[8]

This phenomenon is not a sudden development. Credit goes to the successive governments, which focused on developing India's capital market, making it dynamic and affordable to all without proper regulatory setups. The regulatory mechanism flowing from the Reserve Bank of India (SEBI), the Securities and Exchange Board of India (SEBI), and other large and small sectoral regulators such as the Insurance Regulatory and Development Authority have given this market more space and dynamism. These regulators, being representative of the sovereign and direct stakeholders of the market, have given it new hope. This has enabled even small investors to enter the securities market without being under excessive risk. This resulted in a massive flow of capital in the market. It may be pointed out here that the entry of ordinary individuals, retail and small investors has not only pumped enough funds into the market but also created ripple effects on household savings and expenditure behaviour.

However, the story of the phenomenal growth of the stock market is not without rough patches. The stock markets from across jurisdictions, including the United States, the United Kingdom, other parts of Europe, and India, have continuously suffered shocks and upheavals. These shocks and upheavals have resulted from the circumstances *vis*., pandemics, recessions, economic slowdown, etc. However, some of these disruptions were sudden, momentous, and caused by sudden market failures. For example, the Ponzi Scheme by Charles Ponzi (1920), the Enron Scandal (2001), the WorldCom Accounting Fraud (2002), and the Bernie Madoff Ponzi Scheme (2008) led to upheavals in the US stock Exchange. Similarly, the Indian Stock Exchanges (BSE & NSE) experienced disruptions due to the Harshad Mehta Scam (1990), the C. R. Bhansali Scam (1997), the Ketan Parekh Scam (2001), the Satyam Scam (2008), the NSEL Scam (2013), the Saradha Scam (2013), etc.

It is not that the state or the market regulators, like SEBI, were unaware of this likelihood. Right from the beginning, the state has the role of facilitator and the market regulator, with a duty to regulate the market by immunising it from these upheavals, prescribing various legal frameworks to stabilise it, and making it more dynamic for the investors. The extent and the limits of the regulations have always been contentious issues. Free market theorists argued that the state should not interfere in the market.[9] The *invisible hands* of the market have enough strength to regulate possible pernicious activities.[10] The free market theorists often placed their argument against state intervention in the market with *an a priori assumption that*

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[8] *Id*.

[9] C. Rangarajan, *State, Market and the Economy: The Shifting Frontiers*, XXXV EPW 1386 (2000).

[10] Milton Friedman, CAPITALISM AND FREEDOM (1962).

such interference would necessarily tilt the balance towards the one preferred by the state and thus would be counter to the market-based fairness principle.[11] The above assumption is not necessarily illogical. History is filled with instances where the state has intervened in the market with a bias to protect the interest of firms or individuals favourable to itself. Quite often, apprehensions have been expressed that the state and its instrumentalities trod with caution to firms favourite to the state.[12]

Theorists opposing the philosophy of the free market argue that the market, being an abstract idea, does not deal with firms/entities indifferently. The market *sans* state regulations can result in market failure, primarily because the unregulated market leads to unequal distribution of wealth, inefficient allocation of goods and services, and, lastly, the non-consideration of negative externalities.[13] For example, free market theorists would successfully argue that a stock market without state interference would attract many investors since such a stock market would inevitably be considered a place for good ROI, having greater access to information and opportunities. However, at the same time, a free market would raise apprehension about the information's trustworthiness and the opportunities. Thus, investors may be reluctant to invest their money unless the state provides assurance. The assurance of the state could be in any form, including mandatory disclosures, authentication of information, vigilance, and monitoring, and, in case of default, imposing legal consequences, including penalties. However, is it possible for a state to ensure that all forms of information about the functioning of the market are accessible to all the market players without distinction or discrimination? Further, can a state ensure that all relevant information, which makes the market dynamic, is available equally to other market participants? These questions are fundamental since they are the minimum required assurance towards working in a stable and dynamic market. Any violation thereof would result in manipulation and fraudulent practices, including but not limited to insider trading.

Securities Market, Asymmetry of Information and Insider Trading

The capital market is filled with numerous constituents, stakeholders, and market players from within and outside. The very composition of the capital market makes it inevitable to avoid the flow of information to all with the same degree and depth. The free-marker foundational philosophy is that all market participants act based

[11] C. B. Macpherson, *Elegant Tombstones: A Note on Friedman's Freedom* I CJPS 9 (1968).

[12] Arun Ghosh, *State Intervention versus Free Market*, XXVII EPW 1365 (1992).

[13] Joseph E. Stiglitz, *Markets, Market Failures, and Development*, LXXIX AER 197 (1989). Charles Wolf Jr., *Market and Non-Market Failures: Comparison and Assessment*, VII Jnt'l Publ. Pol. 43 (1987).

on equal access to information. The only permissible inequality concerns the participant's ability to analyse and utilise the information.

For example, the prevailing hierarchy in any listed company would reveal the degree of difference in the availability of information regarding policy and financial matters. Similarly, the personnel deputed by market regulators or intermediaries would have different degrees of information depending on their position/hierarchy. Even the market players who participate in the market from outside would have access to such privileged information depending on the nature of the task assigned to them by the market players. For example, a company's chartered accountant would have more information on financial matters than a lawyer providing legal consultancy. Even if the chartered accountant and law firm had the same information about the company, the depth of the information used by the chartered accountant and the law firm would be different. The chartered accountant uses the depth of the information to provide more financially intricate information to the company. At the same time, the law firm provides more information on the legal side to enhance the business. This difference in depth of information may be used differently when the person with the privileged information starts trading with it.

It is thus reiterated that the asymmetry of information in the capital market is a fact, and the same cannot be removed completely. What could be the best approach to deal with the asymmetry of information? The first approach may be to leave the matter for the market to regulate. However, this non-interventionist approach, often argued by free-market thinkers, would deter investors from continuing their savings in the market due to fear of losing the same against possible manipulations, etc.[14] The second approach would be to ensure that all relevant information is available to all stakeholders as quickly as possible, including retail investors.[15] Here, the market regulators would be required to assure all the stakeholders that the same will be addressed effectively in case of any damage due to information asymmetry.

Indian capital market has been plagued by issues related to its functioning, especially of '*asymmetric information*', which can be exploited by those who possess it.[16] Asymmetric information, a form of market power, can be and has been utilised, manipulated, and exploited differently by the person privy to such information. The core assumption is that the market does not treat all individuals equally or rationally. It creates layers due to which some individuals would have significant

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14 George J. Stigler, "Public Regulation of Securities Markets", Journal of Business, Vol 37, No. 2 [1964]; See Also, George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934."American Economic Review 63 (1973).

15 The Sachar Committee, 1979; The Patel Committee, 1986; and Abid Hussain Committee, 1989.

16 *Hindustan Lever Ltd.* v. *SEBI*, (1998) 18 SCL 311 MOF.

information with greater depth and commercial utility than others, leading to its potential exploitation, including insider trading.[17]

Insider trading is characterised by trades executed by insiders or connected persons, leveraging insights gained while discharging the duties of an insider. Succinctly put, insider trading entails trading securities by insiders privy to or with access to unpublished price-sensitive information.[18] While the apparent consequences of insider trading may predominantly pertain to the financial aspects of the securities market, the repercussions are more far-reaching. The act constitutes a breach of trust, or more precisely, a breach of fiduciary duty on the part of the insider when acting upon UPSI pertaining to shares. This results in financial losses for the public and undermines the trust among stakeholders in the company's share market. Consequently, stakeholders may abstain from future transactions upon realising they lack equitable opportunities to participate in the market.

There exists a pervasive sentiment of distrust among investors, stemming from the belief that the playing field lacks parity, with certain individuals enjoying a distinct advantage in avoiding substantial losses or accruing profits. Since insiders typically hold positions within the company, they owe a fiduciary duty to the company and potential investors. Access to confidential company data significantly influences investment decisions and potential profitability. When insiders manipulate transactions, breaching their fiduciary duties, trust within the securities market is eroded.

Given its inequitable nature within the stock market, insider trading is deemed unlawful by legal standards. SEBI enforces stringent regulations to prevent insider trading and rigorously monitors trading activities to detect suspicious behaviour. Moreover, insider trading can distort the allocation of resources, as capital is allocated based on manipulated or incomplete information rather than on genuine performance and prospects. Perpetrating insider trading carries severe legal and reputational ramifications for individuals and firms involved. Hence, a thorough examination of insider trading practices is imperative to comprehend their origins and impacts and to devise effective deterrent measures.

The continuous analysis of the insider trading framework in India remains essential, as it represents a financial transgression undermining the fairness and integrity of financial markets, evolving in tandem with legislative amendments. Insiders leveraging non-public information for trading possess unfair advantages over others, resulting in substantial losses for those devoid of such insights. Such actions

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[17] Joseph E. Finnerty, "Insiders and Market Efficiency", The Journal of Finance, Vol. 31, No. 4 (Sep. 1976), pp. 1141-1148.

[18] M Anil Kumar and Rajesh H. Acharya, *An Empirical Study of Legal Insider Trading in India*, XVIII The IUP Journal of Corporate Governance 20 (2019).

undermine trust and confidence in the stock market, which are pivotal for its stability and growth.

In India, the earliest recorded dealings in securities can be traced back to the transactions involving the loan securities of the East India Company during the first half of the 1800s. Initially, insider trading was not a well-defined concept, and it was perceived more as gambling, with security holders being likened to a group of gamblers. It wasn't until the establishment of banks such as the Chartered Bank and Oriental Bank in the 1830s that shares of these institutions became available. Subsequently, six stock exchanges recognized by the banks were operational in Mumbai by the following decade. The Bombay Stock Exchange (**BSE**), formerly the Association of Bombay, was formally established in 1875, emerging as India's first official stock exchange. In 1947, the then President of the BSE shed light on early instances of insider trading during the 1940s. During this period, companies refrained from publicly announcing dividends and bonus shares, resulting in significant losses for the general public. Investors were left without recourse for such grievances without proper awareness and regulatory oversight.

These stock exchanges operated with a club-like culture, barring outsiders from participation. Many insiders exploited the unregulated market environment to mitigate losses and augment profits. With the introduction of Initial Public Offerings (**IPOs**), outsiders gained entry into the market. However, insiders possessed greater knowledge about specific shares than outsiders, leading to *information asymmetry*. Insiders appropriated this information, whether acquired through fair means such as research and rumour analysis or unfair means such as personal connections with insiders, thereby exploiting their privileged position.

The Securities and Exchange Board of India Act of 1992 was amended to address these issues. Chapter VA titled 'Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities or Control' was inserted to curb the market manipulations, specifically targeting insider trading and deceptive practices.[19] Relevant parts of the provisions of Section 12A of the SEBI Act, 1992 are reproduced below:

> "**12A. Prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities or control. —** *No person shall directly or indirectly—*
> *(d) engage in insider trading;*
> *(e) deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules or the regulations made thereunder."*

[19] The Securities and Exchange Board of India (Amendment) Act, 2002 (59 of 2002).

Further, another Chapter VIA was inserted titled 'Penalties and Adjudications', which prescribes the penalty for violation of Section 12A.

In exercising its rule-making power, the SEBI notified the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.[20] At the outset, while the PIT Regulations, 2015 Regulations define the words "insider" and "trading" under Sections (2)(1)(g) and 2(1)(l), respectively, it does not define insider trading.[21] The term "insider trading" is referenced in a report submitted by a high-level committee constituted under the chairmanship of former chief justice N.K. Sodhi.[22] The report defined insider trading as '*trading in securities with the advantage of having asymmetrical access to UPSI*.' Various jurisdictions have adopted different nomenclatures; however, it was noted in the N.K. Sodhi Committee Report, 2013, that there is no difference between the universally used word '*material non-public information* (MNPI)' and '*unpublished price sensitive information* (UPSI)' adopted through the SEBI Act, 1992 in India.[23]

The Regulations, 2015 defines 'insider' in a very broad manner. Under these Regulations, insider means a person who is a 'connected person' and also a person '*in possession of or having access to unpublished price sensitive information*'[24]. The note attached along with Rule 2(1)(1) further states that *"anyone in possession of or having access to unpublished price sensitive information should be considered an "insider" regardless of how one came in possession of or had access to such information. Various circumstances are provided for such a person to demonstrate that he has not indulged in insider trading. Therefore, this definition is intended to bring within its reach any person who is in receipt of or has access to unpublished price-sensitive information."*

The above note further clarifies that "*the onus of showing that a certain person was in possession of or had access to unpublished price sensitive information at the time of trading would be on the person levelling the charge after which the person who has traded when in possession of or having access to unpublished price sensitive information may demonstrate that he was not in such possession or that he has not traded or he could not access or that his trading when in possession of such information was squarely covered by the exonerating circumstances*".

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20 Securities and Exchange Board of India Act, 1992, S. 30 read S. 11(2)(g) and S. 12A(d) &(e).

21 SEBI (Prohibition of Insider Trading) Regulations 2015, Cl. 2(1)(g) and Cl. (2)(1)(l).

22 Security Exchange Board of India, REPORT OF THE HIGH-LEVEL COMMITTEE TO REVIEW THE SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992.

23 SEBI (Prohibition of Insider Trading) Regulations 2015, Cl. 2(1)(n).

24 The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, R.2(1)(g). *See also* the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992.

While fixing the liability, the note attached to Rule 2(1)(m) states that "*when a person who has traded in securities has been in possession of unpublished price sensitive information, his trades would be presumed to have been motivated by the knowledge and awareness of such information in his possession….. He traded when in possession of unpublished price sensitive information is what would need to be demonstrated at the outset to bring a charge. Once this is established, it would be open to the insider to prove his innocence by demonstrating the circumstances mentioned in the proviso, failing which he would have violated the prohibition.*"

Thus, the Regulations 2015 have adopted a distinct route for tackling insider trading. The approach so adopted is quite apparent. The SEBI, being a quasi-judicial body, has limited power. It does not have jurisdiction to create penal legislation, and thus, the approach of 'civil wrong' is being adopted.

II

The US and the Shadow of Trading: The Expanding Dynamism

While the jurisprudence on Insider Trading is developing exponentially, the act of 'Shadow Trading' has recently attracted the attention of securities market regulators worldwide. The act of shadow trading is an extension of insider trading. In 2021, the phenomenon was dubbed 'shadow trading' by Mihir Mehta, David Reeb, and Wanli Zhao in their work titled 'Shadow Trading'.[25] To contextualise the same, the concept of shadow trading is straightforward: a piece of information held by the insider about a company may also have some relevance for the economically-linked company, and accordingly, such information could be exploited by him to make profits from such other companies. In other words, confidential information emerging from the "source company" may be price-relevant for the "linked company" as well.

Shadow trading is rooted in the 'misappropriation theory' propounded in the United States. Based on the idea that secret information from one company may also be relevant for other economically linked companies, shadow trading regulations aim to prohibit those insiders who may profit from trading in the scrip of such economically linked companies. Until 2021, these trades in securities through shadow trading were treated as part of the free-market strategy and thus were out of the Regulatory domains.

The United States Securities Exchange Commission (SEC) in 2021 charged one Mathew Panuwat based on a complaint of shadow trading. In January 2022, the United States District Court for the Northern District of California addressed a

[25] Mihir Mehta *at. El.*, *Shadow Trading* ACCOUNT. REV 23 (2021).

motion to dismiss filed by Matthew Panuwat against a complaint brought by the SEC.[26] The case centered on Panuwat's alleged involvement in what the SEC termed 'shadow trading.' Panuwat, a Senior Director at 'Medivation,' a mid-sized oncology-focused biopharmaceutical company, was implicated in purchasing competitor Incyte's securities based on confidential information indicating Medivation's impending acquisition by Pfizer.

The case raised pivotal questions regarding the 'materiality' of the acquisition knowledge to Incyte and Panuwat's 'duty' towards Medivation's confidential information. The SEC contended that Panuwat engaged in shadow trading under the 'misappropriation theory' of insider trading, asserting that he knowingly misused Incyte's information for personal gain while breaching his duty to Medivation. Conversely, Panuwat argued that the SEC's shadow trading theory overreached existing securities laws and lacked explicit prohibition. This is based on the '*classical theory of insider trading*'.[27]

Traditionally, insider trading involves individuals trading securities based on privileged information related to their own or associated companies, known as the classical theory. However, Panuwat's actions align more with the misappropriation theory, where outsiders breach confidentiality when trading securities. While Panuwat's direct financial ties to Incyte were absent, arguments were made regarding extending 'fiduciary duty' to similarly situated companies when material non-public information is shared, particularly in highly concentrated markets.

This case marks a novel application of insider trading laws, prompting considerations for market participants regarding future implications of shadow trading enforcement. It underscores the importance of reviewing and determining appropriate actions within this evolving area of insider trading jurisprudence.

The fate of the first shadow trading case has been decided recently,[28] and the SEC argued for the first time that a corporate official engages in insider trading when they purchase securities of a company based on material non-public information (MNPI) about a different company. The *Panuwat* case, which survived motions to dismiss and for summary judgment and has now produced a verdict in favour of

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[26] Complaint filed by Security and Exchange Commission, available at: https://www.sec.gov/litigation/complaints/2021/comp-pr2021-155.pdf (last visited on Sep. 5, 2022)

[27] Randall Quinn, '*The Misappropriation Theory of Insider Trading in the Supreme Court: A (brief) response to the (many) critics of United States vs. O'Hagan*', VIII Fordham J. Corp. & Fin. L 865 (2003).

[28] *Securities and Exchange Commission* v. *Matt Panuwat*, Litigation Release No. 25970 / April 8, 2024

the SEC, paves the way for increased enforcement under this new "shadow trading" theory.

Now, the current situation begs an essential question in the Indian context, i.e. the applicability of shadow trading doctrine in India. A corollary to this question is: "Does SEBI (like SEC in Panuwat's case), under the extant legal framework, bring similar claims in India successfully?"

A complete understanding of the country's insider trading laws, i.e., PIT Regulations, 2015, is vital to assess the shadow trading doctrine's applicability in India. The best approach to determine the applicability of shadow trading in India is to check if *a Panuwat-like* scenario can happen in India. In this regard, at first blush, the definition of "UPSI" under Section 2(1)(n)[29] would reveal two things. First, the information must *directly or indirectly* "relate" to a company or its securities. Second, upon becoming generally available, the information should be "*likely*" to materially affect the price of the securities. The first hurdle might be that the information on acquisition did not concern Incyte, but this could be regarded as an indirect relationship. This is because, according to the facts of Panuwat's case, just a few prospects remained in 2016, notably Medivation and Incyte, for large-cap companies willing to purchase mid-caps. This made it a highly concentrated market, and thus, each purchase was extremely crucial for the remaining possible targets since it increased their appeal.

Consequently, upon the information becoming publicly known, the price of securities will likely change. As noted, each purchase significantly influenced the other targets and raised their stock values. This is evidenced by a comparable announcement of the purchase of a different firm in 2015, which significantly raised the stock prices of both Medivation and Incyte.[30] With this backdrop, if it is answered in the affirmative that the information was UPSI for Incyte's scrips, the question is whether Panuwat qualifies as an Insider for Incyte under Indian law. As per the definition of "Insider" under Regulation 2(1)(g),[31] it is not a *sine qua non* for an insider to be connected. Even mere possession of or access to UPSI will be sufficient to attract the definition of Insider. Therefore, in India, Panuwat can be readily regarded as an insider under rule 2(1)(g)(ii) since he had access to this information.

As is evident from the above paragraph, the definition of 'insider' is more comprehensive in India than in the USA since "*mere possession*" is sufficient to trigger the threshold; it does not require the intention of the parties to commit the contravention.[32] However, historically, that has not always been the case. Until such

[29] SEBI (Prohibition of Insider Trading) Regulations 2015, R. 2(1)(n).

[30] *Supra* note 26.

[31] SEBI (Prohibition of Insider Trading) Regulations 2015, Cl. 2 (1)(g).

[32] SEBI (Prohibition of Insider Trading) Regulations, 2015, CL 2(1)(g).

a motive was proved, a trade would not contravene the 1992 regulations (as originally enacted) and consequently would not trigger liability under the SEBI Act, 1992. This only changed in 2002, when the SEBI amended the 1992 regulations to adopt the "possession" standard. From then on, mere possession of UPSI during trading would trigger the contravention of the SEBI Act, 1992. This continued under the PIT, 2015, which *states that ex-facies do* not require proof of use or any motive to commit insider trading. That said, an insider may escape the clutches of this contravention by proving his innocence, including by applying the defences set out in Regulation 4.[33] Therefore, based on the foregoing analysis, if SEBI adopts the SEC's practices, it may successfully bring comparable claims in India. Will this be approved in the judicial forum? That would be a distinct question.

III

Insider Trading: Limits of Criminalisation

Insider trading constitutes a violation within the domain of securities law whereby individuals possessing or having access to privileged information that could impact the prices of securities, not publicly available, utilise such information for trading in securities to realise gains or mitigate losses to the detriment of other market participants. The SEBI is mandated to regulate and oversee the securities market. It is a vigilant guardian against insider trading due to its overarching impact on the securities market.[34] Succinctly put, insider trading entails trading securities by insiders privy to or with access to unpublished price-sensitive information.[35]

Insider trading, though often characterised by trades executed by insiders, leveraging their position in the company while discharging their duties, has far-reaching repercussions. The act of insider trading constitutes a breach of trust, or more precisely, a breach of fiduciary duty on the part of the insider. This results in financial losses and undermines the trust among stakeholders. A pervasive sentiment of distrust among investors stems from the belief that the playing field lacks parity, with certain individuals enjoying a distinct advantage in avoiding substantial losses or accruing profits.

Recognising the detrimental effects of information asymmetry on outsiders not part of this insider circle, authorities attempted to address information asymmetry

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[33] SEBI (Prohibition of Insider Trading) Regulations, 2015, Cl. 4.

[34] Constituted on the Resolution by Department of Economic Affairs No.1 (44) SE/86.

[35] M Anil Kumar and Rajesh H. Acharya, *An Empirical Study of Legal Insider Trading in India*, XVIII The IUP Journal of Corporate Governance 20 (2019).

through distinct approaches, including criminalisation. Central to this debate is whether such actions can be deemed criminal. While undoubtedly fraudulent, the issue lies in determining the intent to defraud and identifying the victim. J.S. Mill's *Harm Principle* provides a framework, suggesting that individuals should be free to act as long as their actions do not harm others, and criminalisation should only occur when harm cannot be mitigated otherwise.[36] Applying this principle to securities markets, identifying the harmed party proves challenging, as the information is typically accessible to many others. Even if victims were identified, they would be equally at risk as any other conscious participant.

Criminal law has an accused, a victim, and the state acting as a safeguard against criminal aggression. However, the securities market operates independently and is governed by market forces. Consequently, the state's interference, especially under the guise of criminal misappropriation of information, raises questions. Moreover, even if misappropriation of information was established, the requirement for criminal misappropriation remains dubious. Section 403 of the Indian Penal Code, 1860 defines dishonest misappropriation as "*Whoever dishonestly misappropriates or converts to his own use any movable property, shall be punished with imprisonment of either description for a term which may extend to two years, or with fine, or with both.*" Section 23 of the Indian Penal Code, 1860 defines wrongful gains / wrongful loss, etc. As per these provisions, wrongful gain is gain by unlawful means of property to which the person gaining is not legally entitled. The question of 'entitlement' is always examined from the perspective of 'ownership' of a given property. Since insider trading is merely trading of UPSI, it would be difficult to assess whose property rights have been violated by such trading. However, individuals are not legally entitled to specific better scrip prices in an open market; instead, fair play is expected. While technically, the information may result in some loss, it does not constitute dishonest misappropriation. For instance, if A purchases ten shares of XYZ Company and B, with insider information, buys 1000 shares, both A and B profit when the share prices rise. While B may have acquired more shares, the profit margins remain similar. Thus, it is debatable how A suffers harm when both parties profit. Authors argue that this scenario constitutes a civil wrong but viewing it through a criminal lens presents challenges as it fails to meet the criminality criteria. Further, these provisions require strict proof of the highest form of measure, i.e. '*intention of causing wrongful gain to one person or wrongful loss to another person*'.[37]

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[36] Melina Constantine Bell, *John Stuart Mill's Harm Principle and Free Speech: Expanding the Notion of Harm*, XXXIII UTILITAS 162 (2021).

[37] The provisions of the Bhartiya Nyaya Sanhita, 2023 on 'dishonestly', 'Wrongful gain', 'wrongful loss', and 'Dishonest Misappropriation' are in *pari materia* similar to the provision of the Indian Penal Code, 1860.

In 2002, the parliament amended the SEBI Act, 1992 and inserted Chapter VA & VIA to deal with these challenges.[38] Sections 12A and 15G, inserted through these chapters, indicate de-criminalisation. However, through the Companies Act, 2013, the parliament attempted to criminalise insider trading again *vide* Section 195. However, this has sparked a debate between proponents of a state-controlled market, favouring criminalisation, and advocates of a free market, which only views such practices as civil wrongs.[39]

The prohibitory orders contained in Section 12A are backed by penalties only.[40] Section 15G deals with penalties for insider trading, which reads as follows:

> *"**15G. Penalty for insider trading**. —If any insider who,*
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> *(i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange on the basis of any unpublished price sensitive information; or*
> *(ii) communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or*
> *(iii) counsels, or procures for any other person to deal in any securities of anybody corporate on the basis of unpublished price-sensitive information,*
>
> *shall be liable to a penalty which shall not be less than ten 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."*

The provisions prescribed above do not prescribe any criminal liability. This is in line with the contemporary argument for the decriminalisation of corporate law. Notably, the SEBI Act, 1992, does not define 'insider' or 'insider trading'. It seems that this was quite deliberate. The parliament, not being an expert body in securities and financial matters, refrained from defining the offence of 'insider trading' and left it to the SEBI, a statutory body created by the parliament to regulate the securities market.

Section 12A of the SEBI Act, 1992 implies that these acts are civil wrongs. When an individual engages in insider trading, the primary intent is profiting, not necessarily defrauding others. The act does not always involve *mens-rea* (criminal intent) but rather a self-profit motive, making criminalisation problematic. Criminal acts require *actus reus* (a guilty act) and *mens-rea* (a guilty mind), which may not be present in insider trading cases, often driven by profit motives. Exploiting company information constitutes a breach of confidentiality agreements, a civil wrong unless

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38 The Securities and Exchange Board of India (Amendment) Act, 2022 (59 of 2002).

39 *Supra* note 3. *See also*, Statement of Objects and Reasons, The Companies (Amendment) Bill, 2016 (Bill No. 73 Of 2016).

40 Securities and Exchange Board of India Act, 1992, Chapter VIA.

otherwise defined. Further, criminalising insider trading can cause severe hardship on the fronts of investigation, trial, the requirement of proof beyond a reasonable doubt, etc. Furthermore, the primary victim of 'information exploitation' would be a company, not individual investors. The ordinary investor would surely lose a better chance to make money, but that could not be considered mischief or criminal fraud.

As an executive body, SEBI does not have the authority to create offences; only the legislature can do so, as mandated by Article 20 of the Indian Constitution, which requires all offences to be predefined by the law. The principle that the legislature must predefine all offences is rooted in the legal concept of '*nullum crimen sine lege*' (no crime without law), which is a fundamental aspect of criminal law ensuring that one cannot be punished for an act that was not clearly defined as a crime at the time it was committed. This principle is embodied in Article 20 of the Indian Constitution.[41]

In insider trading and deceptive practices under the SEBI Act, 1992, the argument is that these actions should be clearly defined as offences by legislative action rather than by executive bodies like SEBI. Whenever the law creates penal statutes, it defines the offence and creates specific punishment. The SEBI Act, 1992, nowhere defines 'insider trading' as an offence. It simply provides categories of prohibited acts under Section 12A. Further, no chapter under the SEBI Act, 1992, deals with Offences and Punishment. The SEBI Act 1992 does have one chapter title, i.e., chapter VIA titles, such as 'Penalties and Adjudication', wherein Section 15G provides penalties for insider trading. Thus, the legislative drafting of the SEBI Act, 1992, rules out any insider trading provision as an 'offence' or 'punishment'. Further, as an executive body, the SEBI enforces regulations but does not have the constitutional authority to create criminal offences. The power to define criminal offences lies exclusively with the legislature, which is in line with the constitutional requirement that laws must be predefined to ensure legal certainty and fairness. These are safeguards against arbitrary enforcement and ensure that individuals know what constitutes a criminal act, thereby protecting fundamental rights and upholding the rule of law.

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[41] The Constitution of India, 1950. Art. 20(1) reads as "*No person shall be convicted of any offence except for violation of a law in force at the time of the commission of the act charged as an offence, nor be subjected to a penalty greater than that which might have been inflicted under the law in force at the time of the commission of the offence*."

IV

Judicial Dilemma on Insider Trading

A brief survey of some recent judicial decisions on insider trading would reveal that the apex court of India still sticks with the jurisprudence of penal law and is accustomed to applying the adversarial criminal justice pattern. Thus, while considering the cases on insider trading, the apex court has sought the proof on 'profit motive,' a heavy burden of proof of guilt from the State, i.e., SEBI, and proof beyond a reasonable doubt, etc. A critical inquiry arises as to why matters under the purview of regulatory bodies (like the SEC or SEBI) are often treated as civil wrongs. However, once these matters reach the Supreme Court, they are reclassified as criminal wrongs.

On September 19, 2022, the Supreme Court, in a significant decision on insider trading law, in *Securities and Exchange Board of India v. Abhijit Rajan,*[42] ("Abhijit Rajan") held that an insider's profit motive is essential to establish an insider trading charge. The apex court dismissed the SEBI appeal against the SAT order, which exonerated Abhijit Rajan from the charges of selling shares in Gammon Infrastructure Projects Limited ("GIPL") as an insider. Abhijit Rajan, Chairman of GIPL, was framed for insider trading for his alleged involvement in selling the shares before disclosing the termination of a significant agreement with stock exchanges. SEBI ordered the disgorgement of gains, but Mr Rajan defended his actions as necessary for corporate debt restructuring. The Supreme Court ruled that while the information was price-sensitive, Mr Rajan's sale, under distressed circumstances, wasn't insider trading.

Interestingly, neither the 1992 nor the 2015 Regulations mandate proving a 'profit motive' for insider trading charges. The 2015 Regulations allow insiders to defend themselves with specified defences.[43] The NK Sodhi Committee considered specific defences but did not find a place in their final recommendation. Despite later revisiting defences in 2018, this specific defence was not considered.

Requiring a profit motive contradicts the strict liability principle of insider trading regulations, where proving innocence falls on the accused. The Supreme Court's decision complicates the regulator's task of proving insider trading charges. In criminal law, the state plays a central role in investigations, whereas civil wrongs are typically addressed through inquiries without direct state involvement. The structure of SEBI suggests a civil law-centric approach, as evidenced by the absence of agencies like the police, Central Bureau of Investigation, or National Investigation

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[42] *Securities and Exchange Board of India* v. *Abhijit Rajan*, 2022 S.C.C OnLine S.C 1241.

[43] *Supra* note 12.

Agency, etc., in its apparatus during the whole investigation process. SEBI officers handle investigations internally, indicating a civil law orientation. Philosophically and structurally, insider trading does not align inherently with criminality, despite being labeled as such due to the association with "fraud," which can be both criminal and civil.

Similarly, in *Balram Garg v. SEBI,*[44] *w*hile reversing the SEBI order, the Supreme Court of India rules that trading patterns without material on record to establish communication of Unpublished Price Sensitive Information (**UPSI**) cannot lead to the imposition of penalty under PIT Regulations. It implies that the trading pattern would just be classified as circumstantial evidence, and additional material would be needed to indict an alleged violator. The case involved family members of P.C. Gupta, the Chairman of PC Jewellers Ltd., who SEBI accused of insider trading. SEBI alleged that the family members, including the petitioner, shared sensitive price information related to the company's shares due to their close ties with the company's directors, violating insider trading Regulations. SEBI imposed penalties on them and barred them from accessing the securities market. The Securities Appellate Tribunal (**SAT**) upheld the above order. However, the apex court observed that no illegality could be inferred if the information was publicly available and not linked to the petitioner. There was no direct evidence implicating the petitioner in disseminating insider information. The accused family members had resigned from their positions in the company and had no current involvement with it. Moreover, the burden of proving possession and disseminating UPSI rested with SEBI, not the accused. The allegations were inconsistent with the movement of sensitive information and the timing of share sales. According to the apex court, merely frequent communications between family members alone were insufficient to presume the dissemination of insider information, especially without evidence of discussions regarding share prices. The apex court came heavily on the SAT for not adequately addressing the factors and other evidence raised by the parties.

Referring to the judgments of *Hanumant v. State of M.P.*,[45] it was held that wherever evidence is circumstantial in nature, the conclusion of guilt to be drawn from such circumstantial evidence must be fully established, and the facts to be established must be consistent only with the hypothesis of the guilt of the accused, and no one else. Referring to the judgment of *Chintalapati Srinivasa Raju v. SEBI,*[46] it was further held that the expression "reasonably expected" cannot be mere *ipse dixit* regarding access to UPSI. There must be '*material*' to show that such a person can have '*reasonable access*' and that he took advantage of the same. Presumptions unsupported by the law of an unwarranted nature cannot be raised precisely when

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[44] *Balram Garg* v. *SEBI*, (2022) 9 S.C.C. 425 (India).

[45] *Hanumant Govind Nargundkar* v. *State of Madhya Pradesh*, A.I.R. 1952 S.C. 343(India).

[46] *Chintalapati Srinivasa Raju* v. *Securities and. Exchange Board of India*, (2018) 7 S.C.C. 443(India).

the relation between the petitioners and other family members had ceased to exist, and they were completely financially independent of the appellant and had nothing to do with his decision-making process in relation to securities or otherwise. Accordingly, the judgment of SAT was set aside while allowing the appeal preferred against the same.

Given the restraints imposed upon SEBI, which shall be elaborated upon further, gathering '*absolute evidence*' to prove the communication of UPSI beyond a reasonable doubt is near impossible. This very loophole is the saving grace for most violators as they realise that SEBI cannot access the damning evidence which shall prove their guilt beyond a reasonable doubt.

Furthermore, the absence of punishment for imprisonment in insider trading cases raises questions about enforcement, especially concerning corporate entities engaging in such practices. While enterprises are encompassed within the definition of "person" under the Prohibition of Insider Trading Regulations, 1992, identifying the liable party for penalties becomes complex, particularly in cases involving a corporate entity.

V

Conclusion & Suggestions

The cases discussed above not only suggest a rigid and traditional approach on the part of the court but also leave a greater scope for insider trading, which is absolutely against the securities market interest. Prohibition of any possible scope to insider trading is required to promote market dynamism, necessitating a clear distinction between civil obligations and criminal sanctions. This distinction would be in the line of long-standing argument for de-criminalisation of the corporate law. The *Balram Garg* and *Abhijit Rajan* rulings, where insider trading was inadvertently perceived as criminal in nature, are due to the interpretation of '*motive*' and the association of '*penalty*' with criminal connotations. This misconstruction of law may be rooted in the significant financial repercussions linked with white-collar crimes and the widespread societal harm they cause. Both judgments necessitate revaluation from a perspective that refrains from categorising the act of insider trading as a criminal act rather than a civil wrong.

It is argued that the state should primarily regulate 'asymmetric information' and the damage caused. However, the 'free market' concept mandates limited state intervention. This could easily be accommodated by decriminalising corporate laws. The cost-benefit analysis of criminalising such behaviour is critical: what does the

state gain by imprisoning individuals for market activities? Typically, companies that engage in malpractices like declaring bankruptcy do not face criminal prosecution, indicating a double standard in the treatment of corporate versus individual wrongdoings. It is further argued that manipulating specific information for financial gain should be handled through fines and civil penalties rather than criminal prosecution. No company has been ruined due to insider trading, although individuals have been expelled from the market when proven guilty. Civil measures can achieve this outcome, where the cost is significantly lower than criminal proceedings.

Thus, the SEBI's current approach, which treats such issues as civil wrongs, is the most suitable in the present context. This perspective aligns with the US case of *SEC* v. *Panuwat*, where the court equated "shadow trading" with "insider trading" as a civil wrong. The US court's decision underscores the feasibility of expanding civil wrongs, not criminal offences. Criminal law requires precise definitions, making doctrinal interpretation challenging. Thus, if tomorrow, a case of shadow trading arises in India, it is more likely to be addressed under civil law as insider trading rather than creating a new criminal offence.