Paper 11

INSIDER TRADING: A COMPARATIVE STUDY©

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Synopsis:

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A. Introduction

The recent insider trading controversy involving Hindustan Lever Limited's (HLL) purchase of 8 lakh shares of Brooke Bond Lipton India Limited (BBLIL) in March 1996, two weeks prior to the public announcement of the merger of the two companies has inspired this paper. The primary focus of this article is on the insider trading regulations which are applicable to the offending transaction. An attempt has been made to analyze the Indian insider dealing provisions as they stand. The notice to HLL is the first time that SEBI has brought an insider trading action. The law in India on this subject is not well developed and both parties are expected to rely heavily on the insider trading laws of other jurisdictions while presenting their respective cases. Therefore, the paper includes a comparative study between the Indian laws and the laws of the EC, UK and US. The purpose of such a comparison is to point out the international trends and standards in connection with the control of this pernicious practice.

B. What is Insider Trading

Insider dealing is seen as an abuse of an insider's position of trust and confidence and as harmful to the securities markets because outsiders can be cheated by insiders who are not able to deal on equal terms: as a result the ordinary investor loses confidence in the market. The rules are more important in relation to equities where prices are more sensitive to financial conditions. But the principles could impact upon bonds and of course upon convertibles or other bonds with an equity element.

Essentially insider trading involves the deliberate exploitation of unpublished price sensitive information obtained through or from a privileged relationship to make profit or avoid loss by dealing in securities of a company when the price of securities would be materially altered if the information were disclosed.

In other words, insider dealing is understood broadly to cover situations where a person buys or sells securities when he, but not the other party to the transaction, is in possession of confidential information because of some connection and such information would affect the value of those securities. Furthermore, the confidential information in question will generally be in his possession because of some connection which he has with the company whose securities are being dealt in or are to be dealt in by him (e.g. he may be a director, employee or professional adviser of that company) or because someone in such a position has provided him, directly or indirectly, with the information.

The rationale behind the prohibition of insider trading is "the obvious need and understandable concern.... about the damage to public confidence which insider dealing is likely to cause and the clear intention to prevent, so far as possible, what amounts to cheating when those with inside knowledge use that knowledge to make a profit in their dealings with others."[1]

The misuse of confidential information is frowned upon for several reasons as:

[1] Attorney General's Reference No.1 of 1988 (1988) BCC 765.

- it involves taking a secret, unfair advantage;
- it gives rise to a potential conflict of interests in which the company's best interest may wrongfully take second place to the insider's self interest, and ;
- it brings the market into disrepute and may be a disincentive to investment.
- it is unethical as it amounts to breach of fiduciary position of trust and confidence. [2]

Public confidence in directors and others closely associated with companies requires that such people do not use inside information to further their own interests. Furthermore, if they were to do so, they would frequently be in breach of their obligations to the companies, and could be held to be taking an unfair advantage of the people with whom they are dealing.

The nature of the offense is such that no piece of legislation, however carefully drafted, can hope to cover and thereby suppress this practice in its entirety. Even if legislation is not entirely successful in suppressing improper transactions, a high standard of conduct should be maintained, and it should generally be realized that a speculative profit made as a result of special knowledge not available to the general body of shareholders in a company is improperly made.

C. Protection Under General Law

Insider dealing under the general law the general law has proved ineffective in controlling insider dealing. The protections available under general law may be summarized as follows:

a. where a trader makes an affirmative misrepresentation about the security to his counter party, he may be liable for misrepresentation under normal rules.

b. where a trader omits to disclose a material factor about a security, he may in exceptional circumstances be liable for non-disclosure. Generally, however, there is no liability for non-disclosure.

D. Insider trading law in India

In India, the first legislative attempt to curb insider trading was in the shape of a disclosure requirement regarding company directors' shareholdings[3]. Considerable progress has since been made in legislation. Presently the *Securities and Exchange Board of India (Insider Trading) Regulations of 1992* lays down the governing law for this category of offenses.

The term "insider" is defined in clause (e) of regulation 2 as:

"*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, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or had access to such unpublished price sensitive information*."

The definition has two limbs. The two limbs form the two essential ingredients of the definition, both of which may be split and presented as follows:

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[2] 'Company Directors' - Liabilities, Rights & Duties, by Christopher L. Ryan, Second Ed. 213

[3] Sections 307 and 308 of the Companies Act, 1956

insider means any person -

who, is or was connected with the company

or

who is deemed to have been connected with the company,

and

who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company,

or

who has received

or

had access to such unpublished price sensitive information.

In order to brand a person an insider any one of the two tests stipulated in the first limb, and one of the three tests stipulated in the second limb, of the definition must be established.

Clause (c) of regulation 2 defines the expression "*connected person*" and the following persons will be treated as connected persons:

- a director or shadow director of a company,
- an officer or employee of the company,
- a person having professional or business relationship with a company, if he may reasonably be expected to have access to unpublished price-sensitive information in relation to that company.

Clause (h) of regulation (2) defines the phrase "*deemed to have been connected*", these secondary insiders are connected persons, but they are not directly connected with the companies. Regulation 2(h) identifies seven broad categories of secondary insiders within which there are a few sub-categories. Sub-clause (I) which is relevant for the HLL transaction reads as under:

" is a company under the same management or group or any subsidiary company thereof within the meaning of section(1B) of Section 370[4], or sub-section (11) of section 372, of the Companies Act, 1956 (1 of 1956) or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969) as the case may be."

The expression "*unpublished price sensitive information*" is defined in clause(k) of regulation 2. Whether any information is price sensitive, notwithstanding that it relates to one or more of the specified matters will always be a question of fact to be answered having regard to the facts and circumstances in each case.

Regulation 3 lays down that the offense of insider trading can be committed in three ways :

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[4] By virtue of the provisions of section 370 (1B) of the Companies Act, two bodies corporate shall be deemed to be under the same management in the following circumstances:
iv)if the holding within the meaning of clause(i), clause(ii) or clause(iii)

- dealing in securities the price of which will be affected by the inside information which is in that person's possession.
- by encouraging another person so to deal and
- by disclosing the inside information to another person.

E. The EC Directive

The EC Directive[5] states in the preamble that the smooth operation of the secondary market in transferable securities depends to a large extent on the confidence it inspires in investors and that the factors on which the confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of insider information.

The directive also states[6] that, each member state shall prohibit any person who by virtue of his membership of the administrative, management or supervisory bodies of the issuer, or by virtue of his holding in the capital of the issuer, or because he has access to such information by virtue of the exercise of his employment, profession or duties; possesses inside information "from taking advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates."

Where the person concerned is a company, the prohibition applies to the actual persons who take part in the decision to carry out the transaction for the account of the legal person concerned.[7]

The prohibition applies to any acquisition or disposal of transferable securities effected through a professional intermediary[8].

Article 3 prohibits tipping.

Article 4 deals with tippees by providing that each member state must also impose the prohibition provided for in Art. 2 on any person other than those referred to in that article who with full knowledge of the facts possess inside information, the direct or indirect source of which could not be other than a person referred to in Art. 2. These are secondary insiders.

Article 6 provides that each member state may adopt provisions more stringent than those laid down by the Directive.

F. The law in the UK

[5] The EC Directive of November 13, 1989, coordinating regulations on insider dealing (89/592/EEC) company of the one body corporate is under the same management as the other body corporate
[6] Art 2(1)
[7] Art 2(2).

In the UK insider dealing was made a specific criminal offense in 1980 and was incorporated in the *Company Securities Insider Dealing Act 1985* which was reenacted in 1993 and is contained in Part V of the *Criminal Justice Act of 1993 (CJA)*.

Under the UK regulation "inside information"[9] means information which relates to particular securities or the issuer of particular securities and is specific or precise and has not been made public and if it were made public would have a significant effect on the price of any securities.

Interestingly, under the law[10] as it exists in the UK only individuals can be held liable. In India individuals as well as corporations can be guilty of the offense. In this regard the law in India is similar to the law in the US where corporate liability is recognized under certain circumstances.

UK regulations state that information can be said to have been made public if [11]-

- it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisors;
- it is contained in records which by virtue of any enactment are open to inspection by the public;
- it can be readily acquired by those likely to deal in securities (a) to which information relates (b) or an issuer to which the information relates; or
- it is derived from information which has been made public .

Indian regulations are silent on when and how information is considered to be public. Unlike the Indian regulations, the UK enactment also provides for defenses[12] available to an individual against action for insider trading. An individual is not guilty of insider dealing if he shows -

- he did not at the time of dealing expect the deal to result in profit attributable to the fact that the information in question was price sensitive information in relation to the securities.
- that he believed on reasonable ground that information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having information
- that he would have done what he did even if he did not have the information. Defenses on the same lines are available to persons who are considered guilty of encouraging other persons to deal in securities or disclosing price sensitive information to others.

In the UK insider trading is considered a criminal offense and hence, the standard of proof required for conviction is high. Knowledge is an essential ingredient to be proved in an insider trading case, which under criminal law must mean more than constructive knowledge. The *mens rea* or the intent therefore assumes significance. Indian laws do not seem to take the 'intent' of the offender into account. Given the complexity of insider trading

[9] See generally Section 56(1) of Part V of CJA

[10] Section 52(2) of Part V of The CJA. Although he may commit the offense by encouraging dealing by, or disclosing information to, a company.

[11] Sec. 58(2)

[12] Sec. 53(1)

offenses it is recognized that the task of successful prosecution is not easy. Indeed in the UK it is common experience that in contested insider trading cases, the prosecution has a notable lack of success.

As a result, there has been a broadening of the scope of the regulations and a visible shift in the burden of proof from the prosecutors to the defendants. This trend is in tune with the changes observed internationally.

G. Insider Trading law in the US

The US Federal securities regulations do not have a specific insider trading code. Instead, rules have been developed by case law grafted on to the ubiquitous anti fraud Rule 10b-5. The *Securities Exchange Act of 1934* empowers the SEC to ensure that the markets remain honest in order to promote investor confidence. Section 10(b) of the Act provides:

"*It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,*

a. *

b. *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 [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."*

The SEC, pursuant to its section 10(b) rulemaking authority, has adopted Rule 10b-5, which provides:

"*It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,*

a. To employ any device, scheme, or artifice to defraud, [or] ...

*b.**

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 any security."

The main prohibitions are:

- an insider takes advantage of unpublished price sensitive information by acquiring or disposing of securities;
- the insider recommends or procures a third party to acquire or dispose of securities;
- an insider discloses inside information (usually with intent) to a third party otherwise than in the proper performance of his office, employment or profession.

Outside the US, the tendency is to limit the insider trading prohibition to publicly available or listed securities. There is no such limitation under the US Rule 10b-5 that applies to any purchase or sale of a security, as defined, whether or not listed.

The US has the most comprehensive and effective insider trading regulations in the world. Insider trading has been controlled since 1934. In fact the SEC has single-handedly pursued the task of bringing insiders to book even when the offenders were outside the US. Such aggressive extraterritorial application of the US laws has forced other jurisdictions to frame insider trading regulations where none existed and where regulations did exist enforcement has been substantially increased. In the US, from various case laws two broad theories of insider trading liability have emerged.

The traditional or classical theory[13]*:*

Under the "traditional" or "classical theory" of insider trading liability, section 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. The thrust of this theory is that an insider when dealing on inside information should disclose the information or must abstain from dealing. The theory rests on two propositions. First, that there exists a relationship giving access to confidential information to be used for corporate purposes. Second, it is inherently unfair for a person to take advantage of that information knowing that it is not available to those with whom he is dealing. The US Supreme Court stated[14] that "a relationship of trust and confidence (exists) between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." That relationship "gives rise to a duty to disclose (or to abstain from trading) because of the 'necessity of preventing a corporate insider from . . . taking unfair advantage of . . . uninformed stockholders." The classical theory applies to officers, directors, and other permanent insiders of a corporation as well as to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.

The Misappropriation Theory:

The recent validation of the "misappropriation theory"[15], has led to an expansion of the SEC's enforcement powers. The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction and thereby violates section 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. The misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information. Under this theory a person is liable for insider trading if he converts for personal use, information which has been entrusted to him. Two elements appear necessary for liability under the misappropriation theory; (1) there must be a fiduciary type relationship between the person who trades and the source of the information; and (2) trading must be in breach of duty not to misuse that information. Accordingly the mere giving

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[13] also known as the abstain or disclose theory
[14] In Chiarella v. United States, 445 US 222 (1980),
[15] in United States v. O'Hagan, 1997 WL 345229 (US)

of information is unlikely to be sufficient. There needs to be something more. The source of the information must be justified in relying on the recipient not to abuse the confidence of information being reposed in him.

The two theories are complementary. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed to the source of the information and not to a trading party.

H. The Difficulty in framing insider trading Laws

Specific information v general information:

Generally, inside information is that which is likely to materially affect the price of securities if it were public. The problem here is drawing the line between specific information and mere hunches based on rumors or guesswork and research or fact-finding on commercial or economic trends or businesses.

Sanctions:

Sanctions_may be civil or criminal or both. Any form of sanction runs into the difficulty of identifying the insider and obtaining the necessary discovery, especially if the insider arranged the transactions from abroad through a bank that raises the bank secrecy defense against foreign subpoenas. A further problem with civil liability arises from the fact that there is no relationship between the insider dealer and his counterpart in the market. It is not practicable to show which counterpart dealt with the insider amongst the many transactions that may have taken place between the time the insider dealt and the time the inside information became public. If the insider were to be liable for losses to all counterparts in the market (e.g. the difference between the price with and without the information) then the liability could be vast and disproportionate to the offense. In the *Texas Gulf Sulphur* case it has been estimated (as opposed to an actual award) that the liability to sellers of the shares was in the region of US $ 350 million - that is US$ 150 million more than the net worth of the corporation.

Conflict of duties:

Conflict of duties often arise when dealing in securities. When directors told a broker that the dividend would be cut. If the broker sold the company’s stock for his client’s price sensitive information, there may be a conflict between his duty not to trade and his duty to act in the best interests of his customer. The prohibition on insider trading is usually overriding. Held:[16] the broker was liable notwithstanding that he had a conflicting duty to do his best for his clients.

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[16] Re Cady Roberts & Co, 40 SEC 97 (1961).

A retired middle level employee of the Equity Funding Corporation of America told a securities analyst that there was a massive fraud in fictitious insurance policies with the corporation. The analyst confirmed the allegations with specified employees and disseminated the information to institutional investors whom he knew were likely to and in most instances did sell their holdings. He also informed the outsider auditors and the Wall Street Journal. The SEC found that Dirks had violated Rule 10b-5 because he came into possession of non-public, corporate information from persons he knew were insiders and transmitted that information to persons likely to trade on the basis of such information before it became public. However, because of his role in revealing the fraud and his efforts to alert the auditors, the sanction was a censure only[17].

The recent trend of decision in the Court of Appeal in the UK emphasizes that the fiduciary rule is not a loose canon. In *Kelly v Cooper (1993) AC 205* Lord Brown Wilkinson giving the Judgment of the board stressed the scope of fiduciary duties and in particular the alleged duty not to put themselves in a position where their duty and their interests conflicted.

Negative profits:

Generally, where an insider holding securities is influenced not to sell because of inside information and thereby avoids a loss, it is impracticable to impose liability because of the difficulty of proving intent to sell which was subsequently doused by the inside information. In the US, the plaintiff must have purchased or sold a security. Thus a counter party has no claim where he refrains from doing anything but would have dealt if he had known.[18] Therefore a defendant who suffers a loss when insiders sell on unfavorable news and the price falls as a result may have no standing since he did not sell.

Intent:

Intent is usually an important factor in establishing guilt. There must be actual knowledge by the insider that he is an insider and that the information is inside information, i.e. the insider dealing must be knowing and deliberate.

Exemption for stabilization:

Stabilization[19] is essentially insider trading because the managers are dealing in bonds while in the possession of insider information. As they knew the market's reaction to the original invitations. The main purpose of stabilization is to even out the market in the primary distribution period so that it reflects the real value of the securities and not speculative dealings. US, UK and EC contemplate specific exemptions.

Territoriality:

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[17] In Re Dirks, 681 F 2d 824 (DC Cir 1982),
[18] Birnbaum v Newport Steel Co, 193 F 2d 461 (2d Cir 1952).
[19] Dealing undertaken with a view to even out the market in the primary distribution period so that it reflects the real value of the securities and not speculative dealings

A major problem for the control of insider dealing is the territorial scope of the prohibition. If the prohibition is strictly territorial it is a simple matter for the insider to trade from abroad or on a foreign stock exchange - through a dummy company if necessary. As regards the UK position, the CJA applies (in the case of dealing) where the individual was in the UK when he did an act constituting or forming part of the offense or where the regulated market or professional intermediary is in the UK. In the case of offenses of disclosing inside information, or encouraging insider dealing, the offense is committed if the individual or the recipient was in the UK when the disclosure or encouragement took place.

The US Rule 10b-5 applies where the fraud is achieved "by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange". Insider dealing abroad may be subject to US jurisdiction if the fraud has an effect on the US securities markets [20].

I. The HLL controversy in India:

On August 4, 1997 SEBI issued a show cause notice to the Chairman, all the executive directors, the company secretary and the previous chairman of HLL to explain the controversial purchase of BBLIL's shares. The controversy involved HLL's purchase of 8 lakh shares of BBLIL two weeks prior to the public announcement of the merger of the two companies. SEBI alleges that:

- some top officials of HLL had prior i.e. inside information on the crucial swap ratio
- the deal resulted in the price of BBLIL share spurting from Rs. 320 to around Rs. 410 on the day of the announcement of the merger. This put those who acquired these shares prior to the announcement in an advantageous position.

Before HLL can be held guilty for insider trading SEBI would have to prove the following:

a. that HLL was an insider with respect to BBLIL. For which it is necessary to establish
- that HLL is a "connected person" or "deemed connected person" and
- that HLL could reasonably be expected to have access or had access or has had access to undisclosed price sensitive information

b. that HLL acted or dealt in BBLIL securities on the basis of that information.

If SEBI can show that Unilever Worldwide controlled[21] BBLIL then HLL would be termed as a deemed connected person under regulation 2(h) of the Regulations of 1992.

SEBI would then be required to show that the HLL possessed or had access to the information in question. This is a question of fact and it remains to be seen whether SEBI can lead conclusive evidence to this effect. Having established that HLL was a connected person/deemed connected person and further that it did possess the information in question, SEBI would have to show that the information was price sensitive information which was undisclosed. This last bit should be an easy task, as the swap ratio would definitely be

[20] the "effects" doctrine

[21] as per the requirements of s. 370 (1B) or s.372(11) of the Companies Act of 1956 or sub-clause (g) of section 2 of the Monopolies and restrictive Trade Practices Act, 1969,

considered to be price sensitive information. And at the time of the deal it was definitely not public knowledge.

Having carried out this onerous task SEBI would still need to establish that HLL entered into the transaction pursuant to the information i.e. HLL dealt on the basis of that information. It is therefore clear that the burden of proof on SEBI is substantial. And since most of the information required to carry out this burden is generally with the company it becomes that much more difficult for SEBI to establish guilt.

The fact that no profit was made is not relevant for establishing guilt. Arguably, HLL did in fact profit from the transaction by potentially avoiding a loss in the future. It is well settled that for the purposes of insider trading profit would include avoidance of loss. HLL management may have assumed that it would be costlier to buy the necessary shares after the merger, anticipating a rise in BBLIL's share price once the merger was formally announced. In *R v Rushbrooke* a UK case, Rushbrooke a former executive in a subsidiary of Midlands Radio knew that Picadilly Radio was due to merge with Midlands Radio. He bought shares two days before the public announcement of the merger. The deal misfired in so far Rushbrooke expecting to make a profit actually made a loss on the transaction. He was found guilty and fined 2,000 pounds sterling. It will be noticed that profit[22] or loss in the transaction in securities dealt is not a criterion for judging whether offense of insider trading is committed or not.

SEBI is not concerned with the purpose behind the transaction. While some jurisdictions do take notice of the intent of the transaction there is nothing in the Indian regulation that would require SEBI to take notice of the intent. Therefore HLL's contention that the shares were purchased for the specific purpose of cancellation would not hold water. Regulatory agencies, such as SEBI, do not concern themselves with the motives behind such transactions. And rightfully so as their primary concern is to promote investor confidence and they should not be distracted from pursuing that goal.

If one were to follow the principle of the classical theory as expounded above then even if the sole intention of HLL was to acquire a controlling block of the merged company, it should have purchased the shares after the merger. Alternatively, if it wanted to acquire the shares prior to the merger, it should have notified the market of its intentions.

It would be interesting to point out that from the facts of the case, as generally known, it would be possible to exonerate Mr. Gopalakrishanan and implicate HLL but not vice-versa. Mr.Gopalakrishnan acquired the shares in August-September 1995. HLL purchased the shares in March 1996. It would be easier to impute knowledge of the impending merger to HLL than to Mr. Gopalakrishanan. An argument could certainly be made, subject to no evidence to the contrary, that August 95 was too early to draw any conclusion as regards the possibility of a merger and March 1996 was proximate enough to the merger to impute such knowledge.

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[22] Under Sec. 53(6) of the CJA, profit includes avoidance of loss

J. Conclusion

The smooth operation of the securities market, its healthy growth and development depends to a large extent on the quality and integrity of the market. Such a market can alone inspire the confidence of investors. Factors on which this confidence depends include, among others, the assurance the market can afford investors, that they are placed on an equal footing and will be protected against improper use of inside information. Inequitable and unfair practices such as insider trading, market manipulation, price rigging and other security frauds affect the integrity, fairness and efficiency of the securities market and impairs the confidence of the investors. [23]

Irrespective of the outcome of the HLL case it would be more equitable if the regulations were amended to require SEBI to *prima facie* establish that insider trading has indeed occurred and then shift the onus of proof on to the defendant to establish his bonafides. Such an approach has the following advantages:

- it would reduce the cost of enforcement
- it would lead to more effective enforcement where offenders will not go scot free because of insufficient evidence. At the same time it would enable innocent parties to prove their credentials.
- it would act as a deterrent as companies would be doubly careful to ensure that they not only refrain from insider dealing but would also take care to prevent practices which appear to be insider deals even though they actually are not.

In the contemporary scenario securities markets around the world are competing for the fixed pool of capital. Investors will surely prefer markets where the regulatory agencies are most effective. Protecting the investors, enforcing securities laws and creating confidence in the system by ensuring the fairness and integrity of the market should therefore be a priority. Investor confidence is extremely fragile and should be maintained with care. The securities markets should therefore be treated like Caesar's wife; they must not only be above suspicion but must also be perceived to be so.

The contents of this paper should not be construed as legal opinion or professional advice.

[23] See SEBI Press Release issued on August 19, 1992