CHAPTER – 1
INTRODUCTION

1.1 BACKGROUND

Insider trading is a prohibited activity in many jurisdictions, including the United States and India.\(^1\) A popular online business dictionary\(^2\) defines insider trading as buying or selling the securities of a publicly traded firm by an insider to benefit from inside information. This definition rather nicely captures the textual contours of the term. However, in the context of the evolving state of insider trading prohibition in the United States and India, this definition is rather simplistic and may have been under or over inclusive at different times, as will be discussed later in this Dissertation. This is because the reach of the prohibition has not always been restricted to company insiders (i.e. directors, officers and other employees). On the other hand, not all such persons have always been covered by the prohibition under all circumstances.

The United States was the first legal jurisdiction to prohibit insider trading.\(^3\) In India, the earliest legislation dealing with insider trading was the Securities and Exchange Board of India Act, 1992 (SEBI Act).

There is an interesting contrast between the ways insider trading law has evolved in the two jurisdictions. The United States has chosen not to define insider trading. As explained below, insider trading law there is judge made. On the other hand, the insider trading law in India (existing during the last two decades) attempts to give an explicit definition of the term. Two things are noteworthy in this regard. One, insider trading is not defined at one place. Rather, the definition has to be pieced together from the definitions of various constituent elements such as “insider”, “price sensitive


information” and “unpublished (price sensitive information)
4 Second, the definitions are contained not in SEBI Act, but in the Regulations made by the Indian capital market regulator – the Securities and Exchange Board of India (SEBI)5 from time to time. Thus, it may be argued that insider trading law in India has been largely regulator made.

United States and Indian Securities Markets
Before moving ahead, it would be helpful to comment briefly on the relative size and structure of the securities markets in these two jurisdictions. While the United States has had a well-functioning and regulated market since 1930s, the impetus for the development of the Indian market came post the economic liberalization drive in 1990s.

A useful metric to assess the relative size of the securities market in the context of the national economy is the ratio of market capitalization to Gross Domestic Product (usually expressed in percentage terms). In the context of a listed company, market capitalization refers to the aggregate valuation of the company based on its current share price and the total number of outstanding shares. It is calculated by multiplying the current market price of the company's share with the total outstanding shares of the company. Analogously, the total market capitalization in the context of the national economy is arrived at by aggregating the market capitalization of all the companies listed on the domestic stock exchanges.

In 2003, the market capitalization to GDP ratio in the US and India was 124% and 45% respectively. In 2015, it was 139% and 72% respectively. Thus, it can be seen that the importance of the securities market in the national economy is steadily growing in India. It is also notable that this ratio climbed to 150% in the US as well as

4 The term “material non-public information” is used in the US. SEBI Act and Regulations use this term as well as the term “unpublished price sensitive information” at different places. In this dissertation, both terms are used interchangeably.
5 SEBI (Prohibition of Insider Trading) Regulations, 2015 are currently in force.
India in 2014 and 2007 respectively. Thus, the securities market today occupies an important position in the economies of both countries.

The last two decades have also witnessed a significant deepening and broad basing of the Indian market in terms of the financial instruments that are traded, the types of market participants and the market structure.

Today, a number of instruments such as equity shares, debentures, Public Sector Undertaking (PSU) bonds and other hybrid instruments are issued and traded in the Indian market. A vibrant market in exchange traded financial and commodity derivatives has emerged in India. With the recent regulatory initiatives, new instruments such as the Real Estate Investment Trusts and Infrastructure Investment Trusts have made an entry into India.

A diverse set of institutional investors now operate in the Indian market. These include the domestic mutual funds, insurance companies, Foreign Portfolio Investors (FPIs) and the Alternative Investment Funds (AIFs). The AIFs are further classified into three categories depending on their risk appetite, the complexity of the trading strategies that they wish to adopt and the positive spill over effects of their operations on the economy.

The Indian market structure has also evolved with the introduction of dematerialized holding of securities; the advent of electronic trading platforms, automatic order matching and guaranteed settlement process through a Central Counterparty (CCP) as well as algorithmic trading. Thus, it can be fairly said that in terms of market sophistication, the Indian market is almost on par with that in the US.

More important, from the perspective of the insider trading prohibition specifically, it has been noted by a leading scholar of insider trading law that the discussion on

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insider trading jurisprudence is strongly skewed towards US law.\textsuperscript{9} This focus is not arbitrary. This is due to the fact that the US was the first jurisdiction to prohibit insider trading and this is where a live debate among the academicians regarding the policy and doctrinal underpinning of the prohibition continues to this date. Thus, in any discussion and analysis of the insider trading prohibition, the importance of the United States is undeniable.

The rationale for focusing on India as the other jurisdiction is primarily due to the relevance factor from the perspective of the researcher. In this respect, it is notable that some of the earlier Committees such as Thomas Committee (1948), Sachar Committee (1978), and Patel Committee (1986) did make a reference to the US insider trading prohibition regime, while discussing the advisability of putting in place a mechanism to monitor and regulate the trades made by company insiders.

However, at present, there seems to have been a remarkable lack of debate in India regarding the appropriate doctrinal foundation for the insider trading prohibition and the relevant policy considerations. Moreover, it seems that the implicit doctrinal basis of the current insider trading law in India has also not been adequately analyzed and articulated. This dissertation makes an attempt to fill this major gap in the literature.

1.1.1 Insider Trading Law in the United States
As noted above, the term insider trading is not defined anywhere in the United States law. The prohibition on insider trading has been read into the general anti-fraud provisions of the securities law - Section 10(b) of the Securities Exchange Act of 1934\textsuperscript{10} (SEA) and Rule 10b-5\textsuperscript{11} thereunder. This has been done through a series of judicial pronouncements. Thus, it is said that insider trading law there is judge made. The Courts have evolved certain doctrines of insider trading prohibition and


\textsuperscript{10} 15 U.S.C. § 78j(b). Section 10(b) makes it unlawful for any person, directly or indirectly "to use or employ, in connection with the purchase or sale of any security ..., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

\textsuperscript{11} 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that: It shall be unlawful for any person, directly or indirectly, ..., to employ any device, scheme, or artifice to defraud, ..., or ..., 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.
attempted to define the scope of the prohibition with reference to these doctrines. To that end, a number of doctrines have been evolved and applied by the Courts, with the Securities and Exchange Commission (SEC) weighing in with administrative rulemaking at times. Each of these doctrines characterizes insider trading as a particular type of misconduct with reference to an underlying policy rationale for prohibiting the same. The evolution of these doctrines over the years has been a tortuous, involved and controversial process.

The doctrinal basis of the insider trading prohibition in the United States continues to be unsettled. There is an ongoing scholarly debate regarding the proper doctrinal foundation for the prohibition. Pritchard\textsuperscript{12} praises the United States Supreme Court for having put the insider trading law in the United States on a firm foundation. On the other side, Prakash\textsuperscript{13} terms the current United States insider trading regime dysfunctional. Nagy\textsuperscript{14} argues that a hodgepodge of theories, rules, and decisions form the basis of today's insider trading law in the United States. The doctrinal evolution and the current state of the US insider trading law is discussed in Chapter 3.

1.1.2 Insider Trading Law in India

In India, a number of earlier Committee reports dealt with the issue of insider trading - Thomas Committee (1948), Sachar Committee (1979) and Patel Committee (1986).\textsuperscript{15} However, the insider trading prohibition is of relatively recent origin.

Section 11(2)(g) of the SEBI Act, 1992 enumerates prohibiting insider trading as one of the measures that SEBI may take for protecting the interests of investors and promoting the development and regulation of the securities market.\textsuperscript{16} Insider trading is

\textsuperscript{15} SUMIT AGARWAL & ROBIN J. BABY, A LEGAL COMMENTARY ON SEBI ACT, 1992 303-304 (2011).
\textsuperscript{16} 11. (1) Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. (2) Without prejudice to the generality of the foregoing provisions, the measures referred to therein may provide for - (g) prohibiting insider trading in securities.
specifically prohibited under Section 12A (d) and (e) of the SEBI Act.\(^\text{17}\) Neither Section 11(2)(g) nor 12A (d) define insider trading. It may be argued that Section 12A(e) indirectly defines it by prohibiting dealing in securities while in possession of material non-public information, but such dealing is prohibited only if it is in contravention of the other provisions of the Act, or the Rules and Regulations. There are no such provisions in the Act or Rules. Thus, even in India, the precise scope of the prohibition has not been defined in the principal statute relating to the securities markets, but is regulator made.

SEBI issued the Prohibition of Insider Trading Regulations, 1992 (1992 Regulations). These were later replaced by the Prohibition of Insider Trading Regulations, 2015 (2015 Regulations). The 2015 Regulations came into effect from May 15, 2015 and are currently in force. In this dissertation, both are collectively referred to as the Regulations. Both Regulations contained a substantive prohibition against insider trading. However, in order to ascertain the precise scope of the prohibition, it is necessary to read the provision along with the definitions of the constituent elements viz. insider, price sensitive information, and unpublished information. It should be noted that the Regulations cover dealing in the securities of only those companies that are listed (or proposed to be listed) on a stock exchange. The 1992 Regulations underwent two major amendments – in 2002\(^\text{18}\) and 2008.\(^\text{19}\)

The Companies Act, 2013 specifically defines insider trading and prohibits it.\(^\text{20}\) This provision came into force only on 12\(^{th}\) September, 2013 and no enforcement action under this has yet been taken. The Companies (Amendment) Bill, 2016 that has been introduced in the Lok Sabha proposes to omit this Section.

Moreover, neither the SEBI Act or the 1992 Regulations, nor the Companies Act, 2013 articulate any clear policy, doctrinal basis behind the insider trading prohibition.

\(^{17}\) 12A. 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.

\(^{18}\) The Securities and Exchange Board of India (Insider Trading) (Amendment) Regulations, 2002.

\(^{19}\) The Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2008.

\(^{20}\) Section 195.
Thus, it is necessary to unravel the implicit doctrinal basis of the Indian law (as it existed till 2015) by analysing the relevant legislation and case law.

In March 2013, SEBI constituted a High Level Committee (Sodhi Committee) to review the 1992 Regulations under the Chairpersonship of Mr. N K Sodhi, Former Chief Justice of the High Courts of Kerala and Karnataka and a Former Presiding Officer of the Securities Appellate Tribunal (SAT). The Committee submitted its Report in December 2013. The Committee attempts to sketch out an explicit doctrinal basis behind the insider trading prohibition, though not in great detail. The 2015 Regulations are largely modelled on the Sodhi Committee recommendations, but there are certain departures as well.

In March 2011, the Government of India, Ministry of Finance constituted the Financial Sector Legislative Reforms Commission (FSLRC) which submitted its Report in 2013.21 The setting up of FSLRC was the result of a felt need that the legal and institutional structures of the financial sector in India need to be reviewed and recast in tune with the contemporary requirements of the sector. The Report contains a draft India Financial Code (IFC). The FSLRC Report also makes certain recommendations regarding the prohibition of insider trading.

The analysis of the evolution and current state of the Indian insider trading law from the doctrinal perspective is the subject matter of Chapter 4. As part of the analysis, it will be shown that the 2002 and 2008 amendments to the 1992 Regulations amended the substantive prohibition as well the definition of certain constituent terms such as “insider” and “unpublished information” which together had the effect of expanding the scope of the prohibition quite considerably. Also, case law dealing with the legal controversy surrounding the basic issues regarding the prohibition would also be discussed there.

1.2 REVIEW OF THE LITERATURE

The doctrinal controversy and the resulting multiplicity of doctrines underlying insider trading law stems from the peculiar nature of insider trading. Securities law treats insider trading as a species of securities market related abuse. However, it stands apart from other forms of market abuse.

Some of the other forms of abuse dealt with by securities law are misstatements in financial and other corporate disclosures, and Ponzi Schemes. These practices are universally acknowledged to have a harmful impact on the market – by undermining market confidence and / or moving the market prices of securities away from their intrinsic value. The intrinsic value of a security is the present value of the expected future cash flows from such security, discounted at the appropriate rate commensurate with the level of risk. For example, in case of equity shares, the cash flows consist of dividends that in turn depend upon profitability. Information regarding past financial and operational metrics help analysts estimate future profitability, the expected level of future dividends and in turn the best estimate intrinsic value. Any misstatement in corporate disclosures is likely to distort this process. For example, overstatement of past and current reported profit could result in overestimating the future profitability, future dividend streams and in turn the intrinsic value and the market price of the equity shares.

In a Ponzi scheme, investors are assured high returns with relatively low risk. In reality, there is no productive deployment of funds. Rather, a portion of incoming funds is used to make redemptions, and the rest is often siphoned away. The scheme collapses as soon as the inflow dries up and redemptions mount, exposing investors to huge risk, and also undermining the confidence of investors in the financial market. Thus, the need for as well as the rationale behind prohibiting these practices is well established.

22 See, e.g., RICHARD A. BREALEY et al., PRINCIPLES OF CORPORATE FINANCE (8th ed. 2010).
23 See AGARWAL & BABY, supra note 15, at 297. They also mention certain other manipulative practices such as pump and dump, self-trades, poop and scoop and order book manipulation. These too have the effect of steering the securities prices away from their intrinsic value and undermining investor confidence.
In contrast, while there is a worldwide trend towards prohibition of insider trading, there is no unanimity on the policy and doctrinal basis for the same. It has been argued that insider trading actually benefits the markets and its stakeholders, and thus must be legalized. Even among those who favour prohibition of insider trading, there is no consensus on the rationale behind the prohibition. There is another important distinction between the other forms of market misconduct and insider trading. In case of Ponzi schemes, investors directly rely on the misstatements in the process of making their investment decisions. In case of corporate misstatements also, the reliance may be direct. Alternatively, investors may indirectly rely on the integrity of the price of the company’s shares, as set by the market, which in turn is based on an assessment by the professional analysts of the total available information mix (which is polluted by the misstatements). In case of insider trading, there may be no such reliance as the counterparty would probably have anyway traded regardless of the presence or absence of the insider traders. The presence of these issues in the context of insider trading has resulted in uncertainty and there are a number of grey and contentious legal issues regarding the optimal scope and nature of the prohibition.

**Arguments for Legalization of Insider Trading**

At the first level, the debate focuses on the very desirability of insider trading prohibition. Some scholars have argued the case for legalization of insider trading, Henry Manne being the most prominent among them. According to him, trading by insiders on the basis of undisclosed price sensitive information actually causes share prices to converge to their intrinsic value and in fact enhances market efficiency. Thus, insider trading may be seen as an effective mechanism by which the companies can withhold actual disclosure of sensitive confidential information, while at the same time allowing the market prices to converge to the intrinsic value of a company’s shares (through trades done by people privy to inside information).

Another argument advanced in support of insider trading is that it acts as an effective compensation scheme for company executives. Manne argues since there is a tendency towards bureaucratization of large companies, insider trading provides one

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25 Id. at 936.
possibility for appropriate entrepreneurial compensation. Carlton and Fischel\textsuperscript{26} argue that companies should have the option to opt out of the regulatory prohibition on insider trading. On this view, legalizing insider trading may encourage corporate executives to innovate and enhance corporate value. Executives can reap the benefits of their innovation by buying company shares before the information regarding their innovations and their positive effects on corporate value becomes public, and sell those once information is publicly disclosed and is reflected in the share price.

**Arguments for Prohibition of Insider Trading**

On the other hand, a number of arguments have been advanced to make out a case for the prohibition of insider trading, and indeed its strict enforcement. However, there is a fair amount of disagreement over the precise rationale behind prohibiting insider trading.

Dent\textsuperscript{27} questions the benefits of insider trading. He argues that the prevalence of insider trading implies that persons other than the insiders would always have an informational disadvantage and thus would be reluctant to trade, reducing liquidity. It would also result in non-insiders demanding higher bid-ask spreads so as to compensate them for their informational disadvantage. This, in turn, would increase the cost of capital for the companies.

A similar argument is that insider trading undermines investor confidence in the fairness and integrity of the securities markets.\textsuperscript{28} This argument focuses on the reputational harm caused to the market by insider trading as the non-insiders would perceive that the market is rigged against them and question the fairness and integrity of the market mechanism.

Another argument that has been made is that insider trading directly harms the outsider traders by inducing them to trade on the basis of “incorrect” prices. For


\textsuperscript{27}George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247 (2013).

example, an insider may buy a company’s shares at Rs. 100 before the company announces better than expected financial results, based on her access to this non-public information. Once the results are announced, the price rises to Rs. 110. The insider then sells the shares. In this case, the outsider shareholder who sold before the public announcement received less than the “correct” price due to her non-access to price sensitive information. Thus, insider trading is unfair to such counterparty and such counterparty is the direct victim of insider trading. In other words, the outsider trader has been deprived of that extra Rs. 10 “hidden” in the undisclosed information.29

Wang30 argues that each act of stock market insider trading has specific, although anonymous, victims. When insiders sell their company’s shares based on some negative material, non-public information, the market price of the security would go down as a result of such trading. The reduction in price would induce a person to go in the market and buy the company’s shares or dissuade a potential seller from selling the shares. According to Wang, such induced buyer and / or dissuaded seller is the victim of insider trading, even though in practice, it is difficult to ascertain whether there was any such buyer / seller and if so, who they are.31 It must be noted that Wang does not posit the counterparty to the insider’s trade as the victim of such trading.

Finally, there is a family of arguments that focuses on the harm caused to the company itself. Haft32 argues that prohibiting insider trading enhances the internal efficiency of large companies. If insider trading is permitted, it would impair corporate decision making since the employees would stall the free flow of information within the company, so as to enable them to trade on such information.

29 See Roy A. Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1448 (1967). His focus is on the harm caused to the long-term outside investors, but his argument can be generalized to all outside shareholders in general.
31 Id. at 34-35.
Bainbridge argues that insider trading prohibition actually serves the purpose of protecting property rights in corporate information. Allocating the property rights to the company would allow it to prevent the insiders and others from trading on non-public information if such trading is to the detriment of its corporate interests. For example, if the executives of Company A learn that the company is likely to launch a takeover bid for Company B, and start buying Company B’s shares, the consequent increase in the share price may increase the cost of acquisition for Company A. This could frustrate the acquisition plans of Company A.

Bainbridge also notes the argument that allowing insider trading may create perverse incentives for the executives to engage in activities that generate more insider trading opportunities, such as following policies that increase fluctuations in the price of the company’s shares. Such large fluctuations would enable the executives to maximize their profits from insider trading since they can buy when the prices are low and sell when they are high.

The question whether and under what conditions insider trading is harmful, and if so, who are its victims, continues to be debated in the literature.

Some scholars have sought to make a distinction between insiders trading on positive versus negative information. Grechenig argues that allowing insider trading on the basis of negative information acts as a substitute for whistle blowing and aids in an early detection of fraud. To take one example, a group of insiders may come to know that the company has been engaging in a massive accounting fraud, by overstating its profitability. If insider trading is permitted, they would start selling company shares and possibly derivative contracts with the company’s shares as the underlying

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34 Id..


security. A sudden drop in the company’s share price would alert the market as well as the regulator to the fraudulent conduct. Thus, he argues that permitting insider trading on negative (and only negative) information makes sense from the efficiency perspective.

A detailed consideration of the arguments for and against the legalization of insider trading is taken up in the next Chapter. However, as is to be expected, this policy level controversy regarding the very need for as well as the precise rationale behind prohibiting insider trading has translated into a multiplicity of legal doctrines underlying the insider trading prohibition. Thus, the doctrinal basis of the prohibition continues to be uncertain.

**Insider Trading Prohibition – Theories and Doctrines**

At this point, it is imperative to emphasize a point. In the literature, the term “theories of the insider trading prohibition” is often employed interchangeably with “doctrines”. This may partly be attributable to the fact that a large part of this literature is from the “law and economics” tradition in legal research. However, the term “theory” is also used in another sense. As Kim notes, in insider trading law commentary, the term theory is (also) used loosely as a concept, policy, metaphor, or framing that both describes the body of law and helps justify its content. In view of this, the term “doctrine” is more precise and appropriate in the context of this Dissertation.

It is of course important to understand the concept and the various policy justifications that have been offered for the prohibition of insider trading as the different legal doctrines are informed by these. Therefore, the next Chapter is

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exclusively devoted to that aspect. However, ultimately it is necessary to focus on the underlying core legal doctrines themselves – legal rules or principles established through the repeated application of legal precedents\(^\text{39}\) in order to flesh out the content of the insider trading prohibition. Tiller and Cross explain this doctrinal distinction by noting that Rules are strict requirements that define the answer to a dispute, once the predicate facts are established. Standards, by contrast, are more amorphous guides to resolving disputes, often listing a set of factors to be considered and balanced. They term legal doctrines to be the currency of the law.\(^\text{40}\) More generally, the term “doctrine” is used to refer to an established method of resolving similar fact or legal issues.\(^\text{41}\) In addition to the Court evolved doctrines, a number of alternative doctrinal proposals have been advanced in the literature. These too are discussed and critically evaluated in this Dissertation.

Therefore, the primary focus of the discussion and analysis in this Dissertation is on the legal rules or principles evolved by the Courts or those proposed in the literature. For example, the misappropriation doctrine as enunciated by the US Supreme Court is that 1) when a person owes a fiduciary or similar duty of trust or confidence to the source of confidential information, 2) she converts such information for a personal gain by using it for securities trading, 3) such conversion is without disclosure to the source; it amounts to a violation of the insider trading prohibition read into Section 10(b) of the Securities Exchange Act of 1934 (SEA) and Rule 10b-5 thereunder. Of course, while critically analysing this (or any other) doctrine, the analysis would draw heavily on considerations of the background aspects such as the framing of the concept by the Court (or the legal scholar) and particularly the policy objective that informed or was sought to be achieved by the respective doctrine.

**Evolution of Insider Trading Prohibition Doctrines in the US**

As noted earlier, the United States was the first legal jurisdiction to prohibit insider trading. Significantly, the term insider trading is nowhere defined under US law. Section 16(b) of the Securities Exchange Act, 1934 deals with “short swing profits”.


Under this, profits earned by certain insiders by paired purchase and sale (or sale and purchase) transactions within six months of each other may be recovered by the company. However, such trades are not *per se* prohibited and do not give rise to any civil or criminal liability. Insider trading prohibition *per se* has been read into Section 10(b) of the Securities Exchange Act, 1934 and Rule 10(b)-5 of the Securities and Exchange Commission (SEC) Rules. Thus, insider trading is treated as a form of securities market manipulation or deception.

Over the period, the US Courts have struggled to characterize the exact nature of the manipulation or deception involved. As a result, insider trading law in the US is “judge made” – the US Courts have evolved a variety of legal doctrines on which the insider trading prohibition is based. The major doctrines among these are the equal access to information doctrine, the classical doctrine and the misappropriation doctrine.

The equal access to information doctrine was first articulated and endorsed in 1968 by the US Court of Appeals for the Second Circuit. Under this doctrine, all securities market participants owe a general and universal duty of disclosure to the counterparty before entering into a securities trade. In this context, any participant who wishes to trade must either disclose to the counterparty, any material non-public information she has access to, or abstain from trading (the disclose or abstain rule). Thus, any trade based on non-disclosure amounts to deception on the counterparty. The presumption here is that the counterparty, with her lack of access to material, non-public information was the victim of such trading. This doctrine may also be justified on the ground that equal access to information is a prerequisite for ensuring fairness in the securities markets. On the other side, there seems to be some tension between this doctrine and the efficiency argument, as permitting insider trading would arguably move the prices closer to their intrinsic value by ensuring that non-public information

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42 15 U.S.C. § 78j(b). Section 10(b) makes it unlawful for any person, directly or indirectly "to use or employ, in connection with the purchase or sale of any security ..., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

43 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that: It shall be unlawful for any person, directly or indirectly, ... to employ any device, scheme, or artifice to defraud, ... or ... 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.

gets reflected in the market price of the security. Also, a strict application of this
docctrine in the context of anonymous, screen based, computerized order matching
trading environment would be challenging, as there is no contact or negotiations
between the counterparties, either directly or through their brokers.

The US Supreme Court squarely rejected the equal access doctrine in United States v.
Chiarella.\textsuperscript{45} The Court reasoned that absent a duty to speak, there is no legal
obligation among the securities market participants in general to disclose any
information prior to trading. Rather, such an obligation can only be based on a pre-
existing fiduciary relationship between the parties, e.g. between the directors and
officers of a company on the one hand and the company and its shareholders on the
other hand. The Chiarella doctrine is now standardly called the classical doctrine.

The classical doctrine purportedly protects the shareholders against self-dealing by the
directors and other officers of the company at their expense. This doctrine also treats
the counterparty as the victim – but not as a counterparty, but rather as a victim of a
breach of a fiduciary duty. Here, the fact that the person who traded on the basis of
material non-public information had a fiduciary duty towards the counterparty and she
breached it by trading without disclosure of the impugned information is the crucial
factor. An officer of Company A, who is working on a proposal regarding a potential
acquisition of another Company B has a fiduciary duty towards Company A and its
shareholders but not towards Company B or its shareholders. Therefore, if she trades
in the shares of Company B based on her access to non-public information regarding
the impending acquisition, there is no violation of the insider trading prohibition
predicated on the classical doctrine. Thus, this doctrine reduced the reach of the
insider trading prohibition, as compared to the equal access doctrine.

The scope of the insider trading prohibition again expanded with the acceptance of the
misappropriation doctrine by the US Supreme Court in United States v. O’Hagan.\textsuperscript{46}
The misappropriation doctrine prohibits trade by a trader on the basis of non-public
information if she owes a fiduciary duty or any similar duty of trust and confidence to
the source of the information. A person who has a fiduciary or similar duty to the

\textsuperscript{45} 445 U.S. 222 (1980).
\textsuperscript{46} 521 U.S. 642 (1997).
source is guilty of violating the prohibition when she pretends loyalty to such source while converting the information for personal gain by trading on it, without disclosure to the source.\textsuperscript{47}

The officer in the example cited earlier who trades in the shares of Company B would be covered by an insider trading prohibition based on the misappropriation doctrine. This is because she owes a duty of trust and confidence to the source of the information – Company A. Therefore, trading on such information without disclosure to the source amounts to a violation of the insider trading prohibition. However, a rank outsider who has no relationship of trust and confidence with either Company A or B or their shareholders may get access to the material non-public information regarding the impending acquisition (accidently or even by theft). Even if she trades based on such information, there is no violation of the insider trading prohibition predicated on the misappropriation doctrine. Therefore, while this doctrine widened the reach of the insider trading prohibition, it does not cover all cases of trading on material non-public information.

The question of `tipper – tipee liability’ (where an insider tips an inside information to another person who then trades on the basis of such information) has also been a vexing issue for the US Courts. The difficulty here is in determining under what conditions the tipper, who has a fiduciary duty to the company and its shareholders and who does not herself trade but passes on the information to another person should be held liable for violating the prohibition. In \textit{Dirks v. US}, the US Supreme Court held that a tipper is guilty of violating the prohibition under the classical doctrine only if she personally benefits from the disclosure.\textsuperscript{48} On the other hand, in India, there is an absolute prohibition on an insider from communicating any unpublished price sensitive information, relating to a company or securities listed or proposed to be listed to another person, unless it is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.\textsuperscript{49}

\textsuperscript{47} Id. at 653.
\textsuperscript{49} Regulation 3(1) of SEBI (Prohibition of Insider Trading) Regulations, 2015.
Pritchard\textsuperscript{50} praises the adoption of the misappropriation doctrine, claiming that it has put the insider trading law in the US on a firm foundation by drawing primarily on the common law of agency that provides a more comprehensive and coherent basis for dealing with the problem of insider trading.

On the other side, Prakash\textsuperscript{51} argues that O’Hagan actually reveals the dysfunctional nature of the US insider trading regime. He points out that the misappropriation doctrine actually permits trading on material, non-public information so long as the trader discloses to the source an intent to trade the relevant securities while using such information.\textsuperscript{52} At the same time, this doctrine implies a vast, unwitting, and wholly unwarranted expansion of the prohibition as it also covers deception of parties wholly outside of and unconnected to the securities markets.\textsuperscript{53} He argues that the US insider trading prohibition regime has always been in a state of policy and doctrinal mess, or dysfunctional as he emphatically highlights in the title of his article. \textit{O’Hagan} only highlights and accentuates this state of affairs.\textsuperscript{54}

Thus, the current insider trading prohibition regime in the United States has been aptly characterized by Nagy as a hodgepodge of theories, rules, and decisions. She argues that the lower courts have actually been moving away from predating insider trading liability based on a relationship of trust and confidence, as required by Supreme Court precedent, and instead finding mere wrongful use of information a sufficient condition for triggering the liability.\textsuperscript{55}

**Doctrinal Proposals in the Literature**

In addition to the Court evolved doctrines, certain other doctrinal proposals have been advocated in the literature, setting out alternative approaches to the insider trading prohibition.

\textsuperscript{52} \textit{Id.} at 1495.
\textsuperscript{53} \textit{Id.} at 1496.
\textsuperscript{54} \textit{Id.} at 1493.
Under the property rights approach\textsuperscript{56}, the insider trading prohibition is treated as essentially a property rights issue. Property rights in corporate information are assigned exclusively to the company. Therefore, trading in securities on the basis of such information that has not yet been disclosed by the company is treated as a violation of this property right.

Another proposal that has been made is an insider trading prohibition regime predicated on deceptive acquisition of information.\textsuperscript{57} Under this, trading on material non-public information acquired by way of deception would be prohibited. It would still leave out cases where the information has been accessed accidentally or even by outright theft, but without any deception.

Yet another proposal is to treat trading on material non-public information as fraud on the market (FOTM).\textsuperscript{58} FOTM was first advocated in the context of granting a class certification in case of class action suits pertaining to securities fraud. The US Supreme Court first endorsed it in \textit{Basic v. Levinson}.

Recently, the Court declined to overrule \textit{Basic}.\textsuperscript{59} Thus, FOTM remains good law in the US. Coffee argues that if FOTM works for other securities fraud action, it should work for insider trading as well. In particular, FOTM may provide a plausible basis for regarding the counterparty as the victim of insider trading even in the context of anonymous, impersonal markets; in spite of lack of the element of any direct or indirect reliance.\textsuperscript{61}

Coffee offers two more approaches to the insider trading prohibition. One, the prohibition may be framed in terms of the duty to hold lost or stolen information in confidence.\textsuperscript{62} Thus, a person who finds or steals material non-public information has a duty to hold it in confidence and not to use it for, \textit{inter alia}, trading in securities on its basis.


\textsuperscript{59}485 U.S. 224 (1988).

\textsuperscript{60}Halliburton v. Erica P. John Fund, 573 U. S. ____ (2014).

\textsuperscript{61}Coffee, \textit{supra} note 58, at 298.

\textsuperscript{62}Id. at 299.
Two, the insider trading prohibition may be conceptualized as an agency law issue.\(^{63}\) Under this approach, an agent who acquires confidential information in the course of her employment has a duty to account for any profits made by the use of such information, although this does not harm the principal.

**Position in India**

In India, while not much scholarly attention seems to have been paid to the policy and doctrinal foundation of the insider trading prohibition, there has been a legal controversy over the definitions of the basic constituent terms which in turn define the scope of the prohibition itself. For example, the precise meaning and scope of “unpublished information”\(^{64}\) as well as “insider”\(^{65}\) has been contested. This, in turn, has resulted in uncertainty regarding the scope of the prohibition itself. The Regulations underwent two major amendments in 2002 and 2008 which have significantly expanded the scope of the prohibition.

### 1.3 RATIONALE AND SIGNIFICANCE OF THE STUDY

It is submitted that the multiplicity of insider trading prohibition doctrines in the United States, the lack of consensus on the issue, the legal controversy in India surrounding the basic issues in the prohibition and the frequent and substantive amendments to SEBI Regulations reveal that the basic doctrinal issues have remained unclear.

It is pertinent to clarify the appropriate doctrinal underpinning of the insider trading prohibition. This is because the different doctrines are informed by different policy considerations and respond to the core issues in totally different ways – the nature of the misconduct involved, the scope of the prohibition, the classes of persons / entities that should be covered by the prohibition, the nature of information that is relevant here, the classes of persons who suffer injury (if any), and the appropriate legal remedies.

\(^{63}\) *Id.* at 309.


Also, an ambiguous doctrinal base is likely to result in an ambiguous framework, resulting in too frequent amendments, as seems to have happened in India over the last two decades. The earlier SEBI Regulations underwent two major amendments in the last two decades – in 2002 and 2008. More important, these amendments go to the very heart of the scope of insider trading prohibition, and have resulted in expanding the scope of the prohibition in a considerable way. The question is whether the amendments effectuate a well thought out policy rationale or at least some of them are a mere reaction to certain adverse rulings by the quasi-judicial authorities.

SEBI takes a serious view of the insider trading violations. The Securities and Exchange Board of India (Settlement of Administrative and Civil Proceedings) Regulations, 2014 were notified on January 9, 2014 to provide for the terms and procedure of settlement (popularly known as the consent mechanism). These Regulations specifically exclude insider trading violations from the purview of this mechanism unless there are adequate grounds for considering the same, to be recorded in writing.\textsuperscript{66} Under SEBI Act, there are severe civil\textsuperscript{67} as well as criminal\textsuperscript{68} penalties attached to insider trading prohibition violations.

In spite of this, there seems to have been a remarkable lack of debate in India regarding the appropriate doctrinal foundation for the insider trading prohibition and the relevant policy considerations. Moreover, it seems that the implicit doctrinal basis of the current insider trading law in India has also not been adequately analyzed and articulated.

In this respect, it has also been argued that when it comes to insider trading cases, the atmosphere is really quite toxic.\textsuperscript{69} There is also a real possibility that this lack of doctrinal clarity would prompt the Regulator and prosecutors to advance novel, expansive interpretations of the prohibition.

\textsuperscript{66} Regulation 5.
\textsuperscript{67} Penalty of twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher (Section 15G).
\textsuperscript{68} Imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both (Section 24(1)).
In particular, the current unclear doctrinal basis of the prohibition has given rise to a number of contentious open issues regarding the optimal scope of the prohibition, and the appropriate legal remedies. While a detailed discussion of the legislative provisions and case law in the US and India pertaining to these issues is taken up in the later Chapters, these are enumerated below:-

• How should material information be defined? Should the definition be restricted to the information originating from the company such as profits, or even information that is external to the company but which is material from the viewpoint of its share price should be included within its scope– such as soon to be announced monetary policy, or general election results?
• What should be the criteria to determine when particular information became public, particularly in the context of the advent of the social networking media?
• Should trading on the basis of information received not involving any deception / theft be illegal?
• Should insider trading be prohibited only in listed companies?
• Should all trading based on unpublished, price sensitive information be prohibited, or only by a subset of market participants?
• What should be the nature of insider trading liability in the context of a tipper – tipee relationship? In the US, the liability is only derivative, and attaches only if the tipper receives a “benefit” in exchange for the tip, whereas in India, it is absolute.
• Should motive be a relevant factor in defining the scope of the insider trading prohibition?
• Which is the appropriate standard for the insider trading prohibition – “trading while in possession of inside information” or “trading on the basis of inside information”? (Possession v. use standard).
• Is front running a species of insider trading or a distinct abuse?
• Does insider trading have identifiable victims? Who are they? If so, should there be a right of private action available to the wronged party for restitution?
• What should be the nature of sanctions available – monetary penalties, disgorgement of profits, restitution, debarment from operating in capital
market, criminal sanctions? In tipper / tipee cases or cases involving trading on account of institutional investors, who should be liable?

- Should insider trading in non-equity securities such as debt securities and security based derivatives and index based derivatives be prohibited?

As each insider prohibition doctrine is informed by its own unique set of policy considerations, the resolution of these issues would be dependent on the doctrine that is adopted (along with the underlying policy rationale). In view of this, it is imperative to critically analyze and evaluate the existing doctrines, and suggest an appropriate doctrinal framework. This would ensure that the insider trading prohibition regime is based on a doctrinally coherent and stable foundation.

1.4 OBJECTIVES OF THE STUDY

- To examine and articulate the implicit doctrinal underpinning/s of the Indian insider trading prohibition.
- To critically assess the existing Court evolved doctrines as well as the doctrinal proposals advocated in the literature, with reference to the mandate behind securities law.
- To suggest the most appropriate doctrine for the insider trading prohibition, and propose a legal framework based on the same.

1.5 RESEARCH QUESTIONS

- What is the implicit doctrinal foundation of the insider trading prohibition in India? Is this doctrinal foundation coherent? Has it remained stable over the period?
- Which is the most appropriate insider trading prohibition doctrine from the standpoint of the mandate behind securities law (protection of investors’ interests and development of the securities markets)?

1.6 METHODOLOGY

The focus of the study is to articulate the implicit doctrinal basis underlying the current insider trading law in India, to critically evaluate the existing insider trading prohibition doctrines and suggest the most appropriate doctrine. As such, the study is
situated primarily in the tradition of legal doctrinal research. The basic aim of such research is to discover, explain, examine, analyze and present - in a systematic manner – the facts, principles, provisions, concepts, theories or the working of certain laws or legal institutions. The underlying aim of such research is to gain and present new knowledge and ideas or to suggest change and reform.\textsuperscript{70} Doctrinal research, at its best, involves rigorous analysis and creative synthesis, the making of connections between seemingly disparate doctrinal strands, and the challenge of extracting general principles from an inchoate mass of primary materials.\textsuperscript{71}

For the study, data has been collected from both primary as well as secondary sources. Primary sources are insider trading legislation (principal as well as subordinate) and case law. Secondary sources are expert committee reports, reference works on the subject, law review articles and internet resources.

As the insider trading law in the US is “judge made”, case law as well as occasional Congressional legislation and SEC Rulemaking are analyzed in order to gain a detailed understanding of the various doctrines evolved by the US Courts. Scholarly commentary on these doctrines has been useful in understanding the interrelationship between the doctrines, the tensions and contradictions inherent within and among them, the underlying policy considerations that these different doctrines attempt to respond to and the policy – doctrine fit. In addition, the doctrinal proposals made in the legal literature have also been analyzed.

The Indian law as well as the various Expert Committee Reports (except the Sodhi Committee Report) do not articulate any explicit policy or doctrinal basis for the insider trading prohibition. In order to unravel the doctrinal base(s) implicit in the Indian law, it was imperative to study in detail its evolution. For a historical perspective, the reports of various Expert Committees were studied. The principal and subordinate legislation - SEBI Act and 1992 as well as 2015 Regulations as amended from time to time and case law on the subject was analyzed. This analysis helped the researcher gain a deeper insight into issues such as whether the Indian law has a

\textsuperscript{70} ANWARUL YAQIN, LEGAL RESEARCH AND WRITING METHODS 7 (2008).
coherent doctrinal foundation, or it conflates the various doctrines and also whether the doctrinal basis has remained stable over the period or there have been significant doctrinal shifts. The analysis also revealed whether the doctrines underlying the Indian law are the same as those in the US, or the Indian law has implicitly evolved its own unique set of insider trading prohibition doctrines.

In order to evaluate the relevance or effectiveness of laws, concepts or legal institutions, the legal doctrinal researcher uses certain criteria. In the present case, insider trading involves trading in securities on unpublished price sensitive information. Therefore, insider trading has been treated as a securities market related misconduct. The provisions regarding insider trading prohibition are part of securities law. Also, the powers to enforce the prohibition are entrusted to the securities market regulator.

Therefore, the appropriate criteria for the analysis and evaluation of the various insider trading prohibition doctrines would be protection of the interest of investors in securities and development of the securities market – which is the basic mandate of the securities law. In fact, as mentioned in Section 1.1, SEBI Act, 1992 enumerates prohibiting insider trading as one of the measures that SEBI may take for protecting the interests of investors and promoting the development and regulation of the securities market. Thus, the various doctrines have been evaluated and the most appropriate doctrine has been suggested based on the touchstone of these two related criteria through discussion, analysis and rational argumentation. Based on the suggested doctrine, a legal framework has been proposed covering the open issues enumerated above in Section 1.3.

In particular, the study aims to situate the insider trading law within the context of the institution of the securities market. Further, a primary rationale for the existence of the securities market is to facilitate the optimal allocation of capital and other economic resources through efficient price discovery mechanism. This particular aspect is central to this study. Therefore, the study engages with the specifics of the current market structure and context such as the advent of anonymous and screen-

72 See YAOIN, supra note 70.
based trading, automated order matching, algorithmic trading, trading in derivative products, the role and mechanics of dissemination of corporate information and the impact of the growth of the internet and particularly social media on the issue of information dissemination. Therefore, this study is situated in the “law and economics” paradigm in legal research.

The study employs a blend of inductive and deductive approaches. The inductive approach has been used in discovering the underlying general doctrinal principles at work in Indian insider trading law by analyzing the material on the specific details of legislative provisions and their interpretation by (quasi)judicial authorities through case law. The deductive approach has been employed for studying the interrelationships between the doctrines, coherence / contradictions within and across the doctrines, and their appropriateness in the context of the criteria adopted.

Even though this is primarily doctrinal research, interviews with senior level professionals associated with the securities market were conducted for ascertaining their views on the policy and doctrinal aspects of the insider trading prohibition and in particular their views on the plausibility of the new insider trading prohibition doctrine - termed the Market Property Rights (MPR) doctrine - proposed in this Dissertation. The interviewees were selected so as to ensure representation to a diverse range of stakeholders in the securities market such as practicing lawyers and company secretaries, compliance officers as well as investment officials of institutional investors, securities market regulator, research analysts, brokers, proxy advisory firms, academicians, directors of listed companies and market infrastructure institutions such as stock exchanges.

1.7 SCOPE AND LIMITATIONS OF THE STUDY

- The study covers only the doctrinal basis of the insider trading prohibition. Enforcement issues such as the detection and investigation of insider trading are beyond the scope of the study.
- The study excludes from its scope the empirical aspects such as measuring the incidence of insider trading.
The study examines the doctrinal basis of insider trading prohibition with specific focus on the United States and India. These jurisdictions have been chosen since the United States was the first jurisdiction to prohibit insider trading and this is where a live debate among the academicians regarding the policy and doctrinal underpinning of the prohibition continues to this date. The rationale for choosing India is due to the relevance factor. In spite of the frequent amendments to SEBI Regulations and the legal controversy over the basic issues, there seems to have been a remarkable lack of debate in India regarding the appropriate doctrinal foundation for the insider trading prohibition and the relevant policy considerations. Moreover, it seems that the doctrinal principles underlying the current insider trading law in India have not been adequately analyzed and articulated.

1.8 CHAPTERIZATION SCHEME

1) Introduction
2) To prohibit, or not to prohibit – the policy debate over the insider trading prohibition
3) The evolution of insider trading prohibition doctrines in the United States
4) Unravelling the doctrinal base(s) of the insider trading prohibition in India
5) The insider trading prohibition doctrines – a critical assessment
6) A proposed policy, doctrinal foundation and a legal framework
7) View from the market

1.9 CHAPTER PLAN

Chapter 2 sets the background by examining the policy level controversy regarding the necessity of and the rationale for insider trading prohibition. This is important because it is this underlying policy level controversy that has translated into a multiplicity of doctrines and the controversy regarding the appropriate legal doctrinal basis of the prohibition. The discussion in this Chapter regarding the policy debate will be relevant in an assessment of these doctrines in Chapter 5 as well as in the course of discussing the proposal for an appropriate policy and doctrinal foundation for the insider trading prohibition in Chapter 6.
With this background, Chapter 3 is devoted to tracing the doctrinal evolution in US law by analysing case law, SEC rulemaking, occasional Congressional lawmaking and academic literature. While the standard literature largely focuses on the three “big” doctrines – equal access, classical and misappropriation – the analysis in that Chapter has enabled the researcher to attempt a more nuanced classification. Thus, apart from these three “big” doctrines, three more doctrinal strands in US insider trading jurisprudence have been identified – the special relationship doctrine and also the version of the misappropriation doctrine and the structural disparity doctrine enunciated by the Chief Justice’s and Justice Blackmun’s respective dissents in *Chiarella v. United States.* A first cut analysis and critique of some of these doctrines has also been covered in Chapter 3, though a detailed treatment is reserved for Chapter 5. Chapter 3 also introduces certain doctrinal proposals that are advocated in academic literature, the assessment of which would again be taken up in Chapter 5.

Chapter 4 focuses on the doctrinal basis of the Indian prohibition. Since the Indian regime (except to some extent the recent Sodhi Committee Report) does not explicitly articulate its doctrinal basis, inductive reasoning has been applied for discovering the underlying general doctrinal principles at work in Indian insider trading law by analysing the material on the specific details of expert committee reports, legislative provisions and their interpretation by (quasi)judicial authorities through case law.

In Chapter 5, a critical assessment of each of those eleven doctrines has been taken up. Out of these, six have been judicially evolved – special relationship, equal access, classical, two versions of misappropriation and structural disparity. The other five doctrinal proposals have been advocated in academic literature - property rights approach, deceptive acquisition of information, fraud on the market, duty to hold lost or stolen information in confidence and insider trading as an agency law issue.

There are two aspects to this assessment. First, it is necessary to look at each of these doctrines from the angle of internal coherence. This is because an internally

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incoherent doctrine cannot obviously serve as a foundation for a robust insider trading prohibition regime.

Apart from internal coherence, there is another more fundamental issue here. Since the insider trading law is part of securities law and the powers to enforce it are entrusted to the securities market regulator, the doctrine must respond to the basic mandate of securities law - protection of the interest of investors in securities and development of the securities market. As Dooley notes, the rationale for (or demand, as he calls it) for the insider trading prohibition determines the legitimacy of the substantive prohibition. Thus, investors and / or the securities market must be the primary beneficiaries of the insider trading prohibition to justify its existence.\(^{74}\)

In Chapter 6, a proposal for a policy and doctrinal foundation for the insider trading prohibition has been presented. While developing such foundation, it is important to remember that insider trading implicates the use of a particular resource for a particular purpose – viz. the use of material, non-public information for the purpose of securities trading. This fact suggests that any policy and doctrinal framework for the insider trading prohibition must be responsive to the special characteristics of information, and moreover to how these characteristics play out in the specific context of securities trading.

Next, the overall contours of the insider trading prohibition based on the proposed policy and doctrinal foundation are worked out. This is done with specific reference to the open issues as set out in Section 1.3 above. Next, a legal framework that seeks to operationalize the contours of the prohibition as detailed out has been presented.

In Chapter 7, the key points that emerged from the interviews that were conducted with senior level professionals associated with the securities market are explained and synthesized in the Dissertation. The broad conclusions emerging from the interviews have also been summarized.

Finally, the conclusions of the study as these have evolved from Chapter 2 through 5 and have been summarized at the end of each Chapter have been recapitulated and synthesized. A summary of the recommendations covering the proposed policy and doctrinal foundation, contours of the prohibition and the suggested legal framework has been given. Scope for carrying out further research based on this study has been identified.