

INSIDER TRADING REGULATIONS, 2015 – DOOMED TO FAILURE?

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Abstract

With the liberalization of Indian economy, the importance of capital market in Indian economy has increased multi-fold and with it, the threat of market manipulation. For prevention and penalization of such capital market offences, a need was felt for market regulator leading to the creation of the Securities and Exchange Board of (“SEBI”) In furtherance of the objective to prevent market fraud, the SEBI (Prohibition of Insider Trading (PIT) Regulations) 1992 and 2015 were notified. However, in course of time, due to various developments, the law on insider trading has gone through tremendous change, on account of several legislative amendments and subsequent judicial pronouncements. The aim of the paper is to analyse the jurisprudence of insider trading in India by interpreting various legal provisions

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*in light of settled principles of statutory interpretation and various decisions of Securities Appellate Tribunal (“SAT”). More specifically, with the help of the decision of Hon’ble SAT in **M/s Chandrakala v. The Adjudicating Officer, SEBI (2012)** author has strived to demonstrate the existence of anomalies in the aforementioned regulation and provide solutions therefor.*

I. INTRODUCTION

In pursuit of fulfilling the objective of protecting the interests of investors, SEBI has, regularly come up with tighter regime on insider trading¹ so as to ensure and maintain transparency and fair play in the capital market. This paper examines the discrepancy between charging provisions and penal provisions of Securities and Exchange Board of India Act 1992.² The charging provision disregards the relevance of ‘intention’ or ‘motive’ in insider trading³ whereas the penal provision of the Act takes motive into account at the time of imposing penalty.⁴ This dichotomy has led to an undesired situation where a judge adjudicating upon a case of insider trading may find that even

¹Insider Trading refers to an act of trading in securities with the advantage of having asymmetrical access to unpublished information which when published would impact the price of securities in the market. See Justice Sodhi Committee Report at ¶ 1.

²Securities and Exchange Board of India Act, 1992, No. 15, Acts of Parliament, 1992 (India) [Hereinafter SEBI Act].

³Legislative note appended to Regulation 4 of SEBI (PIT) Regulations 2015. See in detail in Part III.

⁴Hon’ble SAT has interpreted on the basis of UPSI widely to include motive. See *infra* Part II.

though the defendant is liable for breach of the law, penalty cannot be imposed unless said breach was motivated by the UPSI. The root cause of the conflict is Section 15G of the Act and its interpretation by the courts.

To demonstrate the existence of such anomaly, the author has discussed various decisions of SAT and their paradoxical approach on the subject, which defeats the very purpose the Act. The last Part of the Paper concludes the topic and seeks to identify the contentious legal issues in insider trading and provide solution thereto.

II. WHAT IS PAST IS PROLOGUE

To facilitate SEBI in fulfilling its objectives, the SEBI was armed with widest possible power including power to take measures providing for prohibition on insider trading as it thinks fit.⁵ In pursuance of powers conferred on SEBI under Section 11 and Section 30 of the Act,⁶ SEBI came up with SEBI (Prohibition of Insider Trading) Regulations 1992,⁷ prohibiting trade by an insider in securities of a company *on the basis of*

⁵SEBI Act, § 11.

⁶§ 11(2)(g) of the Act confers power on SEBI to regulate insider trading in securities market. § 30 of the Act confers power on the Board to, by notifications, make laws in consistence with other provisions of the Act and the Rules made thereunder to carry out the purpose of this Act. Hon'ble Supreme Court in *Sahara v. SEBI* has held that the object and purpose of the Act is protection of the interest of investors. *See supra* note 4.

⁷By an amendment to SEBI Act in 2002, word 'prohibition' was added before the title of the Regulations and Regulations were renamed as SEBI (Prohibition in Insider Trading) Regulations, 1992 [Hereinafter old Regulations or SEBI (PIT) Regulations, 1992]. Hereinafter author shall be referring to PIT Regulations as they stood before 2002 amendment as 'un-amended PIT Regulations'.

unpublished price sensitive information (“**UPSI**”).⁸ Here, the SEBI had powers to initiate criminal prosecution,⁹ suspend or cancel the certificate of registration of an intermediary,¹⁰ or issue certain directions.¹¹

With an object to equip the Board with more power so as to secure better compliance with the provisions of the Act and Regulations made thereunder, SEBI Act was amended in 1995¹² and Section 15G¹³ was added to confer additional power on the

⁸Regulation 3 of un-amended PIT Regulations 1992 prohibit, *inter alia*, trading in securities by an insider in securities of a company on the basis of UPSI. Regulation 3 of the Regulations reads as follow:

Regulation 3. Prohibition on dealing, communicating or counselling on matters relating to insider trading.

No insider shall—

(i) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange on the basis of any unpublished price sensitive information; or

(ii) communicate any unpublished price sensitive information to any person, with or without his request for such information, except as required in the ordinary course of business or under any law; or

(iii) Counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.

However, Regulation 3 was amended in 2002 and, *inter alia*, words ‘on the basis of’ were substituted with words ‘when in possession of’.

⁹SEBI Act, § 24.

¹⁰*Id.* at § 12(3).

¹¹SEBI (PIT) Regulations, 1992, Regulation 11.

¹²Statement of objects and reasons of 1995 amendment Act.

¹³Section 15G of the Act reads as follow:

Section 15G Penalty for insider trading.

If any insider who,—

(i) either on his own behalf or on behalf of any other person, deals in securities of a body corporate listed on any stock exchange *on the basis of* any unpublished price-sensitive information; or

(ii) communicates any unpublished price-sensitive information to any person, with or without his request for such information except as required in the ordinary course of business or under any law; or

(iii) counsels, or procures for any other person to deal in any securities of anybody corporate on the basis of unpublished price-sensitive information, shall be liable to a penalty which shall not be less than ten lakh rupees but

board to impose penalties on those indulging in insider trading in securities of a company *on the basis* of Unpublished Price Sensitive Information. Interpreting the nature of liability sought to be enforced by Section 15G of the Act, the SAT in ***Rakesh Agrawal v. SEBI***¹⁴ has observed that the party committing breach cannot be punished without ill motive and that person engaging in insider trading must do so with an intention to make unfair advantage/gain. Further in ***Rajiv B. Gandhi v. SEBI***¹⁵ it was held that to impose penalty under Section 15G of the Act, it must be established that trading was motivated by the UPSI. The tribunal also gave an example of good motive of the charged insider. To quote the tribunal:

*“If an insider who sold the shares were to plead that he wanted to raise funds to meet an emergency in his family say, marriage of his daughter or bypass surgery of a close relation and could establish that fact, it would be reasonable to hold that even though he was in possession of unpublished price sensitive information, the motive of the trade was to meet the emergency. He would not be guilty of the charge of insider trading.”*¹⁶

Both of the above cited cases were decided under un-amended PIT Regulations 1992 i.e. as they stood before 2002 amendment where under dealing in securities was prohibited if done on the basis of UPSI. However, law on insider trading went through a complete overhaul by way of an amendment in 2002 whereby

which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher.

¹⁴Rakesh Agrawal v. SEBI, (2004) 1 Comp.L.J. 193 (S.A.T.) at ¶ 152-3 [hereinafter Rakesh Agrawal].

¹⁵Rajiv B. Gandhi v. SEBI, S.A.T., Appeal No. 50 of 2007 (May 9, 2008), http://www.sebi.gov.in/cms/sebi_data/sat/ST0632.PDF.

¹⁶*Id.* at ¶ 7.

trading was prohibited by an insider '*while in possession of UPSI*'. This was done to secure departure from fault based liability¹⁷ rule and make insider trading a strict liability wrong.¹⁸ However, no such corresponding amendment was made to the penal provision of the Act i.e. Section 15G. This led to conflict between amended charging provisions of the Act¹⁹ and Regulations²⁰ in one hand and penal provision of the Act on other.

¹⁷'Fault based liability' is a type of liability in which the plaintiff must prove that the defendant's conduct was either negligent or intentional; fault-based liability is the opposite of strict liability. See <http://www.oxfordreference.com/view/10.1093/oi/authority.20110803095812106>.

¹⁸Strict Liability is one when neither care nor negligence, neither good nor bad faith, neither knowledge nor ignorance will save defendant. See HENRY CAMPBELL BLACK, BLACK'S LAW DICTIONARY 1591 (Revised 4th ed., West Publishing Co., 1968).

¹⁹By an amendment to the SEBI Act in 2002, a new section i.e. Section 12A was inserted in the Act which, inter alia, prohibited insider from trading in securities of a company while in possession of UPSI. Section 12A reads as follow:

Section 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;

²⁰SEBI (PIT) Regulations, 1992, Regulation 3 was also amended and word 'on the basis of' was substituted with 'when in possession of;' SEBI (PIT) Regulations, 2015, Regulation 4 which replaces SEBI (PIT) Regulations, 1992, also proscribes insider trading by an insider when he is in possession of UPSI. Regulation 4 of the new regulations read as follows:

Regulation 4. Trading when in possession of unpublished price sensitive information.

(1) No insider shall trade in securities that are listed or proposed to be listed on a stock exchange *when in possession* of unpublished price sensitive information.

III.2002 AMENDMENT: A PARADIGM SHIFT

With the experience gained from the past, especially from prosecution of Rakesh Agrawal for insider trading,²¹ in 2002 an amendment was brought in SEBI Act and various other Regulations including PIT Regulations 1992.

In 1996, Rakesh Agrawal, managing director of ABS Industries Ltd. entered into an agreement with Bayer AG, a German company whereby later undertook to acquire 51% of the shares of ABS Industries Ltd. The news of said acquisition being UPSI, the accused sold a substantive amount of his shareholding in ABS Industries which he held through his brother-in-law Mr. I. P. Kedia. Contending Mr. Kedia to be a connected person, SEBI held that Mr. Rakesh Agrawal was guilty of insider trading. On appeal before SAT, it was held that even if Mr. Agrawal had traded in securities while he was in possession of UPSI, he was not guilty of insider trading because his act was done in the best interest of the company so as to facilitate the acquisition of company (as Bayer AG was not willing to acquire company unless it is able to acquire minimum of 51% of the shares) and there was no intention to make profit.²²

Before amendment, trading by an insider *on the basis* of UPSI was prohibited which means that intention to make profit was a *sine qua non* for insider trading. However, in 2002, words '*on the basis of*' were substituted with '*while in possession of*' thereby changing the nature liability sought to be imposed by PIT Regulations from 'fault based' to 'strict'. Examining the scope of intention or motive for breach of statutory obligations, Hon'ble Supreme Court in *State of Maharashtra v. M.H.*

²¹Rakesh Agrawal, *supra* note 14. For detailed analysis, *see infra*, second section of this part.

²²*Id.*

*George*²³ held that unless the presumption is overborne by the language of the enactment read with objects and purposes of the Act, no such presumption can be drawn. To identify the nature of liability sought to be imposed by an enactment, the Act must be seen holistically so as to comprehend the *deha* and *dehi* i.e. the body and the soul of the Act.²⁴

A. Examining 'The Deha': Literal Rule of Interpretation

The first and foremost rule of interpretation of statute is literal rule of interpretation;²⁵ so long as the words of a statute are clear, unambiguous and unequivocal and do not lead to absurd results, they should be given their ordinary meaning.²⁶ SEBI Act and PIT Regulations, as amended in 2002, prohibit an insider from trading in securities of a company *while in possession* of UPSI thereby imposing strict liability on him. In case of ***State of Maharashtra v. M.H. George***,²⁷ a provision of Foreign Exchange Regulations Act, 1974 imposing strict liability of person to possess gold beyond certain quantity, was analysed by the Supreme Court. The Hon'ble Supreme Court following the literal rule of construction held that state of the mind of the accused is not relevant and mere possession of prohibited gold would render accused liable for punishment. Therefore, it can be inferred from literal construction of the SEBI Act and PIT

²³State of Maharashtra v. M.H. George, A.I.R. 1965 S.C. 722, affirmed in The Chairman, SEBI v. Shri Ram Mutual Fund, (2006) 131 Comp. Cases 591 (S.C.) [hereinafter M.H. George].

²⁴V.R. Krishna Iyer J. held that a statute must be interpreted in light of its *deha* (*body*) text and *dehi* (*soul*) context. He was of the view that strict adherence with rule of literal construction may not always be able to serve the object and purpose of the Act and such an approach would be “*to see the skin and miss the soul.*” See Board of Mining Examination v. Ramjee, (1977) 2 S.C.C. 256 (India) at ¶ 9.

²⁵Lalita Kumari v. Govt. of U.P. & Ors., (2008) 7 S.C.C. 164 (India).

²⁶M/s Hiralal Rattanlal v. State of U.P., (1973) 1 S.C.C. 216 (India).

²⁷M.H. George, *supra* note 23 at ¶ 70.

Regulations that *mens rea* or *motive* or *intention* is not required to prove charge of insider trading and trading in good faith cannot be taken as a defence.

Nonetheless, the issue is put to rest by the new regulations. The legislative note appended to Regulation 4 of PIT Regulations 2015 categorically states that the reasons for which the trade is done or the purposes for which the proceeds of transaction are applied are irrelevant for establishing charge of insider trading.

*B. Ascertaining the Dehi: The Intention of the
Legislature*

According to Salmond, “The essence of the law lies in its spirit, not in its letter, for the letter is significant only as being the external manifestation of the intention that underlies it.”²⁸ Hence, where words of a statute are capable of bearing two meanings, they should be given the meaning which would cure the mischief and advance the object of the enactment in light of the events preceding the enactment of the Act.²⁹

The SAT in *Rakesh Agrawal v. SEBI*³⁰ held that to penalise insider for committing breach the Regulations, it must be proved that insider had made unfair gain from such trading. The tribunal also rejected the stand of SEBI that jurisprudence of insider trading is based on principle of ‘disclose or abstain’³¹ and an

²⁸P. J. FITZGERALD, SALMOND ON JURISPRUDENCE 132-3 (12th ed., Sweet and Maxwell, London, 1966).

²⁹This principle has subsequently been affirmed by Hon’ble Supreme Court in various cases. See *Bengal immunity Co. v. State of Bihar*, A.I.R. 1955 S.C. 661.

³⁰*Rakesh Agrawal*, *supra* note 14.

³¹SEBI, in its order, cited the Judgement of the U.S. Court in *Shapiro v. Merrill Lynch* (495 5 F 2d.235) wherein it was held that doctrine of disclose or abstain is to protect the investing public and to secure fair dealing in the securities market by promoting full disclosure of insider information so that

insider in possession of UPSI cannot trade in securities of a company until he discloses the said UPSI. After revisiting the entire jurisprudence of insider trading on requirement of mens rea under Indian legal system, the tribunal held that:

“Taking into consideration the very objective of the SEBI Regulations prohibiting the insider trading, the intention/motive of the insider has to be taken cognizance of. It is true that the regulation does not specifically bring in mens rea as an ingredient of insider trading. But that does not mean that the motive need be ignored.”

It is in this background that SEBI Act and PIT Regulations were amended in 2002. The intention of the legislature was to make a categorical declaration that to prove charge of insider trading, it is not necessary to establish that the trading was motivated by UPSI or insider had actually made unfair profit by trading in securities and mere possession of UPSI would bar an insider from trading in securities till the existence of UPSI.

IV. SECTION 15G OF THE SEBI ACT: A

FRANKENSTEIN’S MONSTER

The inadvertent omission by legislature in amending Section 15G has resulted into emergence of inconsistency between charging provision of the Act which, *inter alia*, prohibits trading ***while in possession*** of UPSI and penal provision of the Act which empowers the Board to impose penalty only when trading was done on the ***basis of UPSI***. This inconsistency becomes

an informed judgment can be made by all the investors. See submission of SEBI in Rakesh Agrawal, *supra* note 14.

more intense in light of decision of Hon'ble Supreme Court in ***Shri Ram Mutual Fund v. SEBI***³² wherein the apex court, while dealing with chapter VIA (includes Section 15G) of the SEBI Act,³³ declared that provisions under the said chapter imposes statutory liability and thus, intention of the person committing the breach of such provisions becomes absolutely irrelevant. It was further held that as soon as breach of statutory obligation is established, penalty must be imposed and adjudicating officer does not have any discretion to not to impose penalty.³⁴ However, there have been instances wherein despite the breach of SEBI Act and PIT Regulations being established and clear mandate of the Apex Court in ***Shri Ram Mutual Fund***, the adjudicating authority has taken motive into consideration and chose to not to impose penalty.

A. *The Chandrakala Case*

The above anomaly was evident in the decision of Hon'ble SAT in case of ***M/s Chandrakala v. The Adjudicating Officer, SEBI***.³⁵ In the Chandrakala case, the appellant, being wife of the promoter and sister-in-law of the director of the company, was a deemed connected person and, therefore, an insider. SEBI held that appellant traded in securities of the company while she was in possession UPSI and hence guilty of insider trading. Appeal against the order of Adjudicating Officer directing appellant to pay penalty of Rs. 8 lakh was before SAT. The SAT, while

³²Shri Ram Mutual Fund v. SEBI, (2006) 131 Comp. Cases. 591 (S.C.).

³³Chapter VIA of the Act was inserted in the SEBI Act 1992 by way of an amendment in 1995. The said chapter provides for imposition of monetary penalty for violation of provisions of the Act.

³⁴Section 15J provides for grounds which should be taken into account by adjudicating officer while deciding quantum of penalty under Section 15 of the Act.

³⁵ M/s Chandrakala v. The Adjudicating Officer, SEBI, (2012) 2 Comp. L.J. 391 (S.A.T.).

setting aside the order of the Adjudicating Officer, held that since trading was done in normal course of business and therefore not being motivated by knowledge of UPSI, no penalty can be imposed. To quote the tribunal:

“The prohibition contained in regulation 3 of the regulations apply only when an insider trades or deals in securities on the basis of any unpublished price sensitive information and not otherwise. It means that the trades executed should be motivated by the information in the possession of the insider.”

The decision of the tribunal in this case suffers from infirmity in as much as it takes motive into account for establishing charge of insider trading. However, in light of Section 15G of the Act, motive or *mens rea* of party committing breach of insider trading becomes indispensable for imposing penalty. Hence, the decision of the tribunal to not to impose penalty for unintentional or *bona fide* breach of the law stands lawful because as per mandate of Section 15G penalty can only be imposed when trading was motivated by UPSI. The decision of the tribunal hereinabove emphatically demonstrates the existence of anomaly between charging provisions of the Act and penal provisions of the Act where in spite of charge of insider trading being established, no penalty could be imposed on the wrongdoer simply because she has been able to prove that her trade was a bona fide transaction and was not motivated by UPSI.

V.CONCLUSION

Renowned jurists Lon L. Fuller says that a law to be valid law, it must not be contradictory.³⁶ Section 12A(e) of the Act, Regulation 3 of the PIT Regulation 1992 and Regulation 4 of PIT Regulations 2015 on the one hand and Section 15G of the Act on other, by providing for two different and contradictory legal scenarios, epitomizes lack of one of the inner morality of law i.e. rules should not be contradictory. Contradiction, as has been demonstrated hereinabove, is that of between charging provisions and penal provisions of the Act, wherein breach of law can occur without motive but same cannot be punished in absence of guilty mind.

Also, as has been held by the Supreme Court in **M. H. George case**,³⁷ in case of breach of statutory obligation, unless the language of the enactment emphatically suggests so, no presumptions as to requirement of intention or motive can be drawn. The reason being such statutes are not meant to punish the vicious will but to put pressure on the thoughtless and inefficient to do their whole duty in the interest of public health or safety or morals.³⁸ However, as the analysis of relevant provisions of the Act suggests, SEBI Act suffers from contradiction between two separate provisions within the statute. Further, requirement of motive, which has been read as an inherent requirement for imposing monetary penalty for breach of PIT Regulations, also goes against the very principle of statutory construction that statutes imposing statutory obligations must be considered as strict liability statute and

³⁶LON L. FULLER, THE MORALITY OF LAW 202 (Yale University Press, New Haven and London, 1964).

³⁷M.H. George, *supra* note 23 at ¶ 70.

³⁸DEAN ROSCOE POUND, THE SPIRIT OF THE COMMON LAW 52 (Boston: The Marshall Jones Company, 1921).

unless the statute itself requires motive or intention for its breach explicitly, no such presumption can be drawn.

This leads to very peculiar situation where an insider may always remain clueless about legality of his transaction as to whether he can trade in securities of a company while he is in possession of UPSI with good motive or not. Therefore, to achieve one of the basic feature of law i.e. certainty,³⁹ it is suggested that SEBI Act be suitably amended and certainty be brought about relevance of motive in insider trading.

³⁹Union of India v. Raghubir Singh, (1989) 2 S.C.C. 754 (India).