

# LEGALFOXES LAW TIMES

## "INSIDER TRADING"

### A BRIEF COMPARATIVE OVERVIEW OF LEGAL SYSTEM IN USA, U.K., INDIA AND NEPAL

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#### INTRODUCTION

Insider trading in laymen's term is the buying or selling of a publicly-traded company's stock by someone who has non-public, material information about that stock<sup>1</sup>. Insider trading is briefly defined as a malpractice wherein the trade of a company's securities is mainly undertaken by people who by their work and have access to the otherwise non-public information which can be crucial or sensitive for making investment decisions<sup>2</sup>. For layman's understanding, one can say that Insider trading is an unfair practice, wherein the other stockholders are at a significant disadvantage due to lack of important insider non-public information. However, in some instances, if this sensitive or crucial pieces of information or data have been made public, in a way that all concerned investors have access to it that will not be a case of insider trading thus will not be punishable.

Insider trading takes place when someone makes an investment trade based on "material" information that's not publicly available. In market terms, material information is any detail that could affect a company's stock price. This information gives the individual an edge that few others have<sup>3</sup>.

<sup>1</sup> <https://www.investopedia.com/terms/i/insidertrading.asp>

<sup>2</sup> <https://economictimes.indiatimes.com/definition/insider-trading>

<sup>3</sup> <https://www.thebalance.com/what-is-insider-trading-and-why-is-it-illegal-356337>

Black's Law Dictionary meaning of Inside Trading is as follows: -"The use of material non-public facts in trading the shares of the company by a corporate insider or any other person who owes a fiduciary duty to the company"<sup>4</sup>.

The trader must characteristically be someone who has a fiduciary duty to another person, institution, corporation, partnership, firm, or entity. One can get into trouble if one makes an investment decision based upon information that's related to that fiduciary duty if that information is not available to everyone else<sup>5</sup>.

### **How Insider Trading Works**

Insider trading can also ascend in cases where no fiduciary duty is present, but another crime has been committed, such as corporate espionage. For example, an organised crime ring that infiltrated individual financial or legal institutions to gain access to systematically and feat and use secretive facts might be found remorseful of such trading, amid other charges for the related criminalities.

Insider information gives a person a chance to profit in some cases and to avoid loss in others. In either case, it is an abuse of someone's knowledge or position of power. It is illegal because it gives an unfair advantage to people "in the know."

Those who have already been prosecuted for insider trading include corporate officers, employees, government officials, and those who have tipped them off with insider information<sup>6</sup>.

### **LEGAL SYSTEM IN USA**

Insider trading was not considered unlawful at the beginning of the 20th century. A Supreme Court decision once referred to it as a "perk" of being an executive. It was a ban along with a severe penalty which was being imposed on those who were engaged or were in any way part of the practice, after the excesses of the 1920s.

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<sup>4</sup> Garner, B. A., & Black, H. C. (2009), Black's Law Dictionary, 9th Ed. St. Paul, Mn: West.

<sup>5</sup> U.S. Securities and Exchange Commission. "Sec Enforcement Actions." Accessed June 26, 2020.

<sup>6</sup> U.S. Securities and Exchange Commission. "Insider Trading." Accessed June 26, 2020.

The S.E.C. became involved after the Securities Exchange Act was passed in 1934, but the Act did not forbid such trading, and it did not even really define it, so the S.E.C. was limited when it came to taking enforcement actions<sup>7</sup>.

Section 17 of the Securities Act of 1933 states the prohibitions of fraud in the sale of securities which were significantly strengthened by the Securities Exchange Act of 1934<sup>8</sup>.

The 1934 Act addressed insider trading directly through Section 16(b) and indirectly through Section 10(b)<sup>9</sup>.

Then in 1988, Congress enacted another legislation to combat insider trading with much deterrent effect, which was the Insider Trader and Securities Fraud Enforcement Act 1988.

That changed the era of the matter. In recent years, the S.E.C. reports that it has filed insider trading objections in contradiction to hundreds of financial professionals, attorneys, corporate insiders, and hedge fund managers<sup>10</sup>.

Self-Regulatory Organizations (S.R.O.s) and S.E.C. play an essential role in investigating insider trading cases in the U.S.A. The S.E.C. has its investigation department with highly technical professionals.

Insider trading often crosses borders. A foreign national may be engaged in insider trading in the domestic market through foreign accounts or necessary evidence of domestic insider trading that lies outside domestic walls.

U.S. S.E.C. Rule 10b5-1 explained that the prohibition against insider trading does not require proof that an insider used material non-public material when conducting a trade<sup>11</sup>. The possession of such information alone is sufficient to violate the provision, and the S.E.C. would infer that an insider in possession of material non-public information used this information when conducting a trade.

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<sup>7</sup> Securities and Exchange Commission Historical Society. "Fair to All People: The Sec and The Regulation of Insider Trading." Accessed June 26, 2020.

<sup>8</sup> American Insider Trading Law, Available At [Http://Www.Stocks.Gi/American-Insider-Trading-Law2.Html](http://www.stocks.gi/american-insider-trading-law2.html)

<sup>9</sup> Insider Trading – A U.S. Perspective, Available At [Http://Www.Sec.Gov/News/Speech/Speecharchive/1998/Spch221.Htm](http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm)

<sup>10</sup> U.S. Securities and Exchange Commission. "Sec Enforcement Actions." Accessed June 26, 2020.

<sup>11</sup> Cui, J., Jo, H. & Li, Y. Corporate Social Responsibility and Insider Trading. *J Bus Ethics* 130, 869–887 (2015).

However, S.E.C. Rule 10b5-1 also bent for insiders an affirmative defence if the Insider can validate that the transaction conducted on behalf of the Insider was executed as part of a pre-existent agreement or engraved binding plan for trading in the future<sup>12</sup>.

Various economists and legal scholars such as Henry Manne, Milton Friedman, Thomas Sowell, and Frank H. Easterbrook and many more have debated that laws in contradiction of insider trading should be revoked. They also claim that insider trading based on material non-public information benefits investors, in general, by more quickly introducing new information into the market<sup>13</sup>.

Laws governing insider trading in the U.S. are as follows:

- Chapter 2A - Securities Act of 1933
- Chapter 2B - Securities Exchanges
- Chapter 2B-1 - Securities Investor Protection Act
- C.R.S. Annotated Constitution
- Federal Regulations: Title 17 C.F.R., Chapter. II - Securities and Exchange Commission

U.S. Supreme Court: Important Decisions

- Stoneridge v. Scientific-Atlanta<sup>14</sup>.
- Tellabs, Inc. v. Makor Issues & Rights, L.T.D<sup>15</sup>.
- The United States v. O'Hagan<sup>16</sup>
- Dirks v. S.E.C.<sup>17</sup>

**S.E.C. vs Switzer<sup>18</sup>**

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<sup>12</sup> "Rule 10b5-1". Investopedia. Sep 17, 2019. Archived From The Original On February 4, 2020. Retrieved February 9, 2020.

<sup>13</sup> "James Altucher: Should Insider Trading Be Made Legal?" Huffingtonpost.Com

<sup>14</sup> 552 U.S. 148 (2008)

<sup>15</sup> 551 U.S. 308 (2007)

<sup>16</sup> 521 U.S. 642 (1997)

<sup>17</sup> 463 U.S. 646 (1983)

<sup>18</sup> 590 F. Supp. 756 (W.D. Okla. 1984)

Barry Switzer, who was an Oklahoma's football coach in 1981, was prosecuted that year by the S.E.C. after he and his friends purchased some shares in an oil company named Phoenix Resources.

It was found that Switzer was at a track meet when he eavesdropped a conversation which was taking place between executives concerning the liquidation.

He acquired the stock at \$42 per share and later, sold it at \$59 per share, which lead earning of about \$98,000 in the process.

A federal judge later dismissed the charges against him due to a lack of proof. Switzer most likely would have been fined and served jail time only if one of his players was the descended of the executives and if they revealed the tip to him off.

The Supreme Court established that the tipper had not penetrated their fiduciary duty for personal gain<sup>19</sup>.

### **The U.S. vs O'Hagan<sup>20</sup>**

James O'Hagan was an attorney with the firm of Dorsey & Whitney in 1988. The firm began representing Grand Metropolitan P.L.C., which prearranged to introduce a tender offer for Pillsbury. O'Hagan subsequently acquired a large number of options in the company, knowing that the possibilities would wheel following the announcement of the tender offer.

O'Hagan sold his options and realised approx. a gain of \$4.3 million. He chose to obtain the options based on information that was not obtainable to other investors and did so without notifying his firm. As a result of the Act he was found guilty on 57 charges, but his conviction was overturned on appeal<sup>21</sup>.

Most recently, numerous U.S. senators were scrutinised for insider trading charges related to selling and buying stocks after Senate sessions in January and February 2020, right before the market crashed due to the coronavirus pandemic<sup>22</sup>.

## **LEGAL SYSTEM IN UK**

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<sup>19</sup> University Of Pennsylvania Journal of Business Law. "The Sec's Neglected Weapon: A Proposed Amendment to Section 17 (A) (3) And the Application of Negligent Insider Trading." Page 276-277. Accessed June 26, 2020.

<sup>20</sup> 521 U.S. 642

<sup>21</sup> Oyez.Org. "United States vs. O'hagan." Accessed June 26, 2020.

<sup>22</sup> Forbes. "How Senators May Have Avoided Insider Trading Charges." Accessed June 26, 2020.

United Kingdom (U.K.) is one of the first countries to enact laws against insider trading. Insider trading regulation in the U.K. is primarily based on the British Common Laws and various companies' legislation in force in England and Wales.

The Companies Act 1980 was the first legislative intervention in the United Kingdom to combat insider dealing. Insider dealing in the United Kingdom have been affected by the Criminal Justice Act, 1993.

Insider trading became a criminal offence in the U.K. under the Company Securities (Insider Dealing) Act, 1985<sup>23</sup>. The legislation was strengthened by the passage of Part VII of the Financial Services Act, 1986.

The Financial Services Authority (F.S.A.) regulates the financial services industry in the U.K. It is an independent non-governmental body which has been given statutory powers by the Financial Services and Markets Act 2000. The financial services industry finances it.

F.S.A. sets a code which is also known as the Code of Market Conduct. The FSMA introduced the broader offence of market abuse; this covers 'insider dealing', 'disclosing inside information', 'dissemination of false' and 'misleading information', 'employing fictitious devices', and market distortion. All these offences encompass insider dealing. The Code sets out in an extra detail the criteria that should be observed by everyone who uses the U.K.'s markets. The Code of Market Conduct, through the Misuse of Information Act, regulates the Insider trading legislation.

The Financial Services and Markets Act 2000 (Market Abuse) Regulations<sup>24</sup> 2005 has been enacted.

The definition of the criminal offence of Insider dealing under the Criminal Justice Act 1993 is very similar to the description of the civil crime of Insider dealing under FSMA 2000.

The U.K. was the first European country to make Insider dealing with a criminal offence. The contract is unaffected as in *Percival v Wright*<sup>25</sup>. Keenan, Denis, Smith

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<sup>23</sup> <https://api.parliament.uk/historic-hansard/acts/company-securities-insider-dealing-act-1985>

<sup>24</sup> <https://www.jdsupra.com/legalnews/financial-services-and-markets-act-2000-00513/>

<sup>25</sup> (1902) 2 Ch 421

and Keenan's Company Law (12th Edition, Pearson Education Ltd, 2002) 242 makes it clear that the sanctions are criminal, the maximum sentence being seven years' imprisonment and/or a fine of an unlimited amount.

The British insider trading model is deemed to be a more effective model due to it having two distinct regimes that specifically address and combat insider dealing. The M.A.R. regime complements the criminal power under the C.J.A. 1993 as the M.A.R.: extends the meaning of insiders and inside information; clarifies offences and other definitions through the recitals and lastly, provides practical administrative proceedings and civil sanctions. Furthermore, the E.U. regularly updates its regulations on insider dealing and market abuse thereby, ensuring that the Member States (including the U.K.) are equipped with advanced and straightforward laws that combat a plethora of Insider dealing offences.

### LEGAL SYSTEM IN INDIA

India being the country whose statutory provisions on insider trading does not have a long history; nevertheless, efforts through amendments are taken and put into action to make this offence more punitive and preventive.

Thomas Committee of 1948 was the one which evaluated, among other things, the regulations in the U.S. on short-swing profits under Section 16 of the Securities Exchange Act, 1934.

Provisions concerning with the Insider Trading was incorporated in the Companies Act, 1956 under Sections 307 and 308<sup>26</sup>.

Sachar committee report followed by the Patel Committee in 1986 recommends amending the Securities Contract (Regulation) Act, 1956, to empower the securities exchange to curb insider trading and unfair stock deals.

Abid Hussain Committee report in 1989 was the base of the Securities and Exchange Board of India (Insider Trading) Regulations 1992, and later it got renamed SEBI (Prohibition of Insider Trading) Regulations 1992 Act in 2002. Later, SEBI (Insider

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<sup>26</sup> Chahar, Himanshu And Sodhi, Sumeer, Insider Trading: A Critical Analysis

Trading) (Amendment) Regulations, 2002 and SEBI (Prohibition of Insider Trading) (Second Amendment) Regulations, 2002 has been enacted.

The term 'insider trading' has not been defined in the SEBI Act or these regulations. The definition of Insider Trading can be ascertained from a combined reading of the intention of 'insider' and 'dealing in securities', in the definition clause.

According to Regulation 2(d) of Securities and Exchange Board of India ('Prohibition of<sup>36</sup> Insider Trading) Regulations 1992, Dealing in securities means 'an act of subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in any securities by any person either as principal or Agent'<sup>27</sup>.

Furthermore, according to Regulation 2(e): 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 expect to have access to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information'<sup>28</sup>.

Chapter 2 of the SEBI (Prohibition of Insider Trading) Regulations, 1992 deals with the prohibition of insider trading.

SEBI (Insider Trading) (Amendment) Regulations, 2002 added Regulation 3A that prohibits the company from dealing in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information but, Regulation 3B provides certain cases where Regulation 3A does not apply<sup>29</sup>.

India through Securities and Exchange Board of India (Insider Trading) Regulations 1992, prohibited this fraudulent practice and a person convicted of this offence is punishable under Section 24 and Section 15G of the SEBI Act 1992. The Act now permits SEBI to initiate criminal prosecution simultaneously. The regulation does not comprise of any provision prescribing a penalty for insider trading. Generally, the penalty provision as contained in section 24 of the SEBI Act provides that without prejudice to any award of a sentence by the Adjudicating Officer under this Act, if

<sup>27</sup> <https://www.jdsupra.com/legalnews/financial-services-and-markets-act-2000-00513/>

<sup>28</sup> <https://www.jdsupra.com/legalnews/financial-services-and-markets-act-2000-00513/>

<sup>29</sup> Regulation 3b Has Been Inserted By Sebi (Prohibition Of Insider Trading) (Second Amendment) Regulations, 2002.

any person or persons contravenes or attempts to contravene or abets the contravention of the provisions of this Act or any rules or regulations made thereunder<sup>30</sup>, he shall be punishable with 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 15G provides for insider trading penalty of 'twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher.'<sup>31</sup>

### LEGAL SYSTEM IN NEPAL

Nepal has recently enacted legislation prohibiting insider dealing. It was only through the Securities Act, 2007 that Insider Dealing has been define and made an offence in Nepal. Other jurisdiction came to this problem much earlier on, as mentioned above. However, Section 127(h) of Company Act 1996 prescribed punishment with fine not exceeding twenty thousand rupees or with imprisonment for a term which shall not be exceeding two years or with both where any director or secretary of a company dealt the share is contrary to the said Act, making it way too vague to prohibit insider trading.

SECURITIES ACT, 2063 (2007)<sup>32</sup> is the primary statutory documents which deal with inside trading of Nepal.

Section 91(1) of Securities Act, 2007<sup>33</sup> provides that 'if any person deals in securities or causes any other person to deal in securities based on any insider information or notice that are unpublished or communicates any information or notice known to such a person in the course of the discharge of his or her duties in a manner likely to affect the price of securities such a person shall be deemed to have committed an insider trading in securities' thus prohibiting dealing in securities, causing any other person to deal in securities and communicating any information or notice in a manner likely to affect the price of securities. In an explanation to this

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<sup>30</sup> The Securities And Exchange Board Of India Act, 1992

<sup>31</sup> The Securities And Exchange Board Of India Act, 1992

<sup>32</sup> [Http://www.lawcommission.gov.np/en/archives/category/documents/prevailing-law/statutes-acts/securities-act-2063-2007](http://www.lawcommission.gov.np/en/archives/category/documents/prevailing-law/statutes-acts/securities-act-2063-2007)

<sup>33</sup> Securities Act, 2063(2007)

section, "insider information or the notice" had been defined as 'any such specific kind of information or notice not published by a corporate body issuing any securities as may be capable of affecting the price of such securities if such information or notice discloses.'

Section 91(2) of Securities Act 2007<sup>34</sup> states that 'notwithstanding anything contained in subsection (1), any transactions already carried on shall not be deemed to be affected at all merely by the reason that an insider trading has been committed' thus making the transaction out of the purview of the Acts on the ground of retrospective effect.

Securities Act 2007 in section 92<sup>35</sup> delivers and states that when a person is probable to be involved in insider trading are:

- (a) A director, employee or a person, who can obtain any information or a notice in the capacity of a shareholder of that body corporate,
- (b) A person who can receive any information or a notice in the capacity of a professional service provider to that body corporate,
- (c) a person who can obtain any information or a notice having direct or indirect contact with the person or source as specified in clauses (a) and (b).

A person who commits an insider trading a referred to in Section 91 shall<sup>36</sup>, upon being convicted of the offence of insider trading, be accountable to the punishment with a fine equal to the amount in controversy or with imprisonment for a term not exceeding one year or with both sentences<sup>37</sup>.

## CONCLUSION

In as early as 1934, U.S. legislation by making the use or employ of manipulative and deceptive device unlawful for the protection of investors initiated to combat insider trading. After half a century, Insider Trading Sanction Act 1984 and Insider Trader and Securities Fraud Enforcement Act 1988 were aptly promulgated to curb

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<sup>34</sup>SECURITIES ACT, 2063 (2007)

<sup>35</sup>SECURITIES ACT, 2063 (2007)

<sup>36</sup> Securities Act, 2063 (2007)

<sup>37</sup> Securities Act 2007, S 101.

insider trading. Enactments of U.K. legislation on insider trading have been made to take account of the E.C. Directive. The law on Insider Trading of India evolved as a summation of the recommendations made by several committees that culminated as SEBI (Insider Trading) Regulations 1992. Regular amendments of legislation in these countries are further bringing obnoxious practices within the purview of the law.

The law on insider trading in Nepal is in the nascent state compared to these countries.

There is no statutory definition of insider trading in the U.S.A., unlike U.K. and India where the conjunctive reading of 'insider' and 'dealing in securities' connotes insider trading, thus judiciary has played inessential role in forming a large part of the law. In the U.K. according to C.J.A. 1993 dealing or encouraging to deal in price affected securities or disclosing of the inside information amounts Insider dealing and according to FSMA 2000 dealing or attempting to deal in a qualifying investment or related investment amounts to insider dealing. In India, dealing in securities when in possession of any unpublished price sensitive information or communicating, or counseling or procuring unpublished price sensitive information amounts insider trading—in Nepal, dealing or causing any other person to deal in securities based on any insider information or communicating any information in a manner likely to affect the price of securities amounts insider trading. In these countries, both the civil and criminal penalty is provided to deter the menace of insider dealing. Both in U.S.A. and India, the only civil penalty is provided for insider trading, and together the criminal penalty is imposed on the violation of any provisions of Securities Exchange Act 1934 and SEBI Act 1992 or any rules or regulations made there under in case of U.S.A. and India respectively. In the U.K., C.J.A. 1993 provided an only criminal penalty for insider dealing, but later FSMA 2000 introduced civil, administrative sanction for market abuse under which insider trading is included as one of the offence. Like in the U.K., the criminal penalty is provided by Securities Act 2007 for insider trading in Nepal, but there is no civil penalty regime.