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CRITIQUING INSIDER TRADING'S PRESUMPTION OF GUILT MODEL: THE FALLACY OF NOT EXAMINING MENS REA

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Introduction

Insider Trading has been argued to be unjust and based in opportunism.[1] It has also been argued that although insider trading may be unjust,[2] it cannot be considered to be fraud.[3] Nevertheless, it is easily observable how insider trading puts the unassuming shareholder at a disadvantage to the director, or anybody else, who might use the company's Unpublished Price Sensitive Information (**"UPSI"**) to trade and make a profit that otherwise would not have been accessible to them. On the basis of, *inter alia*, the activity's ethical immorality, the *P.J. Thomas Committee Report*[4] suggested criminal and civil liabilities for insider trading in India. These suggestions were incorporated, although in a tokenistic manner, in the Companies Act, 1956[5] wherein directors were obligated to disclose their shareholdings in the company. These obligations were then translated into Section 184 of the Companies Act, 2013 which states that *"Every director shall … disclose his concern or interest in any company … which shall include the shareholding…"*

Through this obligation of disclosure, the logical basis for the prohibition of insider trading was set in place, since the Directors were now prevented from concealing the undue profits that they would have made in trade using UPSI. The statutory provision for such prohibition is laid down in the SEBI Act, 1992 which makes insider trading a punishable offence.[6] The SEBI (Insider Trading) Regulations, 1992 and later the SEBI PIT Regulations of 1992[7] and 2015[8] were subsequently implemented to provide for the manner of prohibition of insider trading.

In this paper, I will be considering the landmark judgement in *Ms. Chandrakala v. SEBI*[9] (**"Chandrakala"**) to address the fallacy of the Presumption-of-Guilt model of ascribing liability under insider trading, due to mere possession of UPSI. This fallacy will be addressed through the lens of the *Misappropriation Theory* and the *Critical Theory* of Insider Trading wherein I will argue that (i) the Presumption-of-guilt model must be done away with; (ii) the significance given to 'conduct' of trading must be enhanced.

Case Brief

The judgement in *Ms. Chandrakala*[10] (dated 31.12.2012) emanates from the appeal preferred at the Securities Appellate Tribunal (**"SAT"**) by the Appellant, one Ms. Chandrakala, against the order (dated 30.08.2011) of the Adjudicating Officer of SEBI which held her guilty of insider trading under regulations 3(i) and 4 of the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 (**"1992 Regulations"**).

The Appellant is the wife of one Uttam Kumar Kothari (**"Mr. Uttam"**). Mr. Uttam held the position of a Promoter at M/s. Rasi Electrodes Ltd. (**"Company"**) alongside his brothers who held positions of Chairman and Managing Director, and Director, respectively. Due to this proximity, it was contended by SEBI that the

Appellant was a *connected person**[11]*** and an *insider**[12]*** who had traded the Company's scrip while in possession of UPSI that related to financial results,[13] dividend[14] between 19 June and 30 June, 2007, and bonus issue[15] between 15 July and 17 July, 2007. This contention was supported by the fact that the Appellant and the aforementioned three parties shared the same residential address. Additionally, it was contended that the UPSI was decided prematurely through internal discussions rather than scheduled Board Meetings.

The Appellants had contended that Mr. Uttam had relinquished his interest as a promoter in the Company as early as 31 March 2005, and that he was only a shareholder and was protected under the principles of the *Doctrine of Indoor Management*.[16] Further, that he had no knowledge of the day-to-day functioning of the Company and hence had no access to the UPSI. Additionally, it was contended that the Appellant made transactions independently of corporate announcements where she bought and sold shares.

The SAT, per P.K. Malhotra, held that this case was not one *pari materia* its judgement in *Ranjana R. Kothari*.[17] The SAT relied on the "trading pattern"[18] and the "normal course of business"[19] of the appellant herein, which did not match with the trading pattern of the appellant therein. It was opined that if the transactions were made relying on UPSI, then the appellant would not have sold the shares prior to the publication of the price sensitive information. Further, the court held that the Appellant had put enough material on record so as to disprove the *presumption* of insider trading against her.

Critiquing the Presumption-of-Guilt Model of Ascribing Liability due to Mere Possession of UPSI

It was observed by the SAT in *Chandrakala* that the burden of proof for proving a situation where insider trading is not committed through possession of UPSI lies on the insider (the accused).[20] Similarly, on a bare reading of Regulation 2(1)(g) of the SEBI PIT Regulations, 2015, it is obvious that:[21]

> *"[I]n India, the very possession of UPSI is seen as an attempt to make undue profit from such UPSI, and the burden of proving otherwise falls upon the person who has been found to be possessing or having access to UPSI."*

This presumption of guilt is violative of the common law principle of *Right to Silence* which is enshrined in Article 20(3) of the Indian Constitution.[22] This principle observes that guilt cannot be presumed merely on the silence of the accused party, and is "based on *'nemo debet prodere ipsum'*"[23].[24] By following the present model, where the "very possession" exposes one to punishments for insider trading, disclosure of possession would amount to self-incrimination. Article 11.1 of the Universal Declaration of Human Rights,[25] 1948 and Article 6(2) of The European Convention for the Protection of Human Rights and Fundamental Freedoms[26] also reflect this principle of Right to Silence.

The primary issue with such presumption of guilt is that it shifts not merely the evidential burden[27] but also the persuasive burden of proof[28] unto the accused. Due to this shift, the quasi-judicial bodies fail to conduct a preliminary critical analyse the existence of *mens rea* when deciding a case of insider trading.

To strengthen the argument against such presumption, I shall rely on the following two approaches:

I. Misappropriation Theory

The Misappropriation Theory[29] is based on the idea that anybody with a fiduciary duty, which arises out of possession of UPSI, to a company may perform insider trading within the ambit of that fiduciary relationship. This theory also includes persons who are not directly related to the company through shareholding.[30] Furthermore, this theory posits that insider information is "a valuable commodity owned

by the company"[31] which effectively makes such information the intellectual property of the company. The possession of such information (UPSI) by persons unauthorised to possess it would, according to this theory, amount to intellectual theft against the company.[32]

Under this theory, it is understood that the mere possession of UPSI creates a fiduciary duty toward the company since any person, by the very virtue of possession, gains access to such information that grants her unfair advantage and the potential to jeopardise the company. I, however, contend that the mere possession of UPSI; ergo creation of the fiduciary duty, does not amount to a breach of the said fiduciary duty.

Regulation 3(1) of the SEBI PIT Regulations, 2015 prohibits the communication of UPSI by any 'insider'. The conception of 'insider' as covered under regulation 2(g)(ii) is any person who *is already* in possession of UPSI, and not anybody who *may come to be* in possession of it – this implies that an insider must also have a *pre-existing* fiduciary duty toward the company. Regulation 3(1) does not provide for the liability of a non-insider (or anybody who does not have a pre-existing duty), hence, persons who receive information without any pre-existing fiduciary duty should only be held liable if they "know or should know of [the] breach"[33] that the insider has committed under this regulation. Therefore, the mere possession of UPSI should not amount to the presumption of guilt by (quasi) judicial bodies under regulation 3(1).

According to section 378 of the Indian Penal Code (**"IPC"**),[34] although specifically in the context of movable property, 'intention' is a tenet of theft. If expanded, notwithstanding the type of property, the aforementioned intellectual theft can only be committed by persons with *mens rea*, which in turn can only be possessed by persons intending to break their *pre-existing* fiduciary duty toward the company. If a person has no pre-existing fiduciary duty toward the company, then without the fulfilment of *actus reus*,[35] she cannot have breached it. After the judgement in *Rakesh Agarwal v. SEBI*[36] the (quasi) judicial bodies have disregarded the need for consideration of *mens rea* which has allowed the presumption-of-guilt model to prosper, despite it being in clear breach of the principle of "innocent until proven guilty".

II. Classical Theory

The Classical Theory[37] is based on the idea that anybody who, with a direct fiduciary relation to a company, trades using UPSI would be held liable for insider trading. In the case of *Cady, Roberts & Co.*

[38] the SEC said that "taking advantage of such a relationship [by the insider], without due disclosure, would be unfair" in pursuance of the rule of "Abstain or Disclose". According to this rule, the insider who is in possession of the information has the duty to abstain from trading the securities of the company on the basis of such UPSI, unless she fulfils her "affirmative duty" to disclose her possession of the information as well as the information itself.

The two elements that were highlighted by the Court in *Cady*[39] were (i) possession of the information, and (ii) the act of using the information so possessed, without disclosure, in trade. In the Indian context, this element of "trading"[40] consists of positive acts like buying and selling, which would ascribe liability under the insider trading regime. With respect to the element of possession, however, it was held in *Chiarella v. United States[41]* that merely the fact of possession does not give rise to an affirmative duty to disclose information. Therefore, since mere possession cannot give rise to the duty to disclose information, it also cannot justify the presumption of liability; "trading" by itself must give rise to liability under insider trading.

In *Chandrakala*, this stance was advanced by the learned counsel for the Appellant, that liability under Regulation 3 should be brought only when trading is done on the basis of UPSI, and not otherwise.[42] The Court had then considered the "trading pattern" of the appellant.[43] A similar opinion was passed by the SEC in *Chiarella v. United States[44]* wherein it took support of the fact that the petitioner had "no prior dealings with [the corporation]". By doing this, I contend that the Courts have set good precedent for the significance of "trading" as a positive act – one that should solely determine the liability of insider trading. Further, by establishing the antecedents of the 'insider' the Courts have departed from the effect of the judgement of *Rakesh Agarwal v. SEBI,*[45] by examining *mens rea*.

Conclusion

Regulation 3(1) of the SEBI PIT Regulations, 2015 has been interpreted to ascribe presumptive guilt on persons who possess UPSI. This, as indicated over the course of this paper, has led to an unreasonable and unconstitutional burden of proof on the deemed insider. The presumption of guilt in matters of insider trading requires the accused to disprove that she violated Regulation 3(1), and further that she abstained from trading on the basis of the information. This process is time-consuming, causes unnecessary delay in the proceedings, and leaves the Court to examine *mens rea* nonetheless. I believe that a continuance of such a model of presumption-of-guilt in the insider trading regime of India would be detrimental to public welfare, especially considering the rapid development in technological communication. Departing from such a model of presumption would require the Courts to apply the two aforementioned Theories in consonance with each other rather than in isolation and I believe that the Courts must make every endeavour to do so.

[1] Steven R. Salbu, 'Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis, The ' (1992) 15 Harv J L & Pub Pol'y 223.

[2] Robert W. McGee and Walter E. Block, 'Information, Privilege, Opportunity and Insider Trading' (2011) 10 Nor. Illi. U. L Rev. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1890819> accessed 10 April 2022.

[3] Ibid. at 5, 6. See, By referring to Aquinas and *Kaufman Inv. Corp. v. Johnson* 623 F.2d 598, it was said that since insider trading causes unidentifiable loss, and since it does not emulate out of deception by the buyer, it fails to fulfil the tenets of fraud.

[4] P.J. Thomas, *Report on the Regulation of the Stock Market in India*, SEBI <https://www.sebi.gov.in/sebi_data/commondocs/may-2019/HistoryReport1948_p.pdf>

[5] , Companies Act, 1956, ss. 305, 307, 308. See, Prateek Bhattacharya, 'India's Insider Trading Regime: How Connected are You?' (2019) 16 NYU J. L & B, No.1 at 4.

[6] Securities Exchange Board of India Act, 1992, s. 15G.

[7] Through amendment of the Securities Exchange Board of India (Insider Trading) Regulations, 1992 in 2002.

[8] Securities Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015

[9] *Ms. Chandrakala v. SEBI* (Securities Appellate Board, Appeal No. 209 of 2011).

[10] Ibid.

[11] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, reg. 2(c).

[12] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, reg. 2(e).

[13] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, reg. 2(ha)(i).

[14] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, reg. 2(ha)(ii).

[15] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, reg. 2(ha)(iii).

[16] Per the *Doctrine of Indoor Management* the shareholders are protected from being liable for the lapses of a company in the course of business owing to the 'indoorness' of the functions of a company.

[17] *Ranjana R. Kothari v. SEBI* (Appeal No. 125 of 2011).

[18] *Ms. Chandrakala* (n 10) 9, para 7.

[19] ibid.

[20] *ibid.*

[21] Prateek Bhattacharya, 'India's Insider Trading Regime: How Connected are You?' (2019) 16 NYU J. L & B, No.1.

[22] *Nandini Satpathy vs Dani* (P.L.) 1978 AIR 1025. The Court opined that the right to silence is derived from the ban on self-incrimination, and so is enshrined under Art. 20(3) of the Indian Constitution.

[23] *nemo debet prodere ipsum* means that no one is obliged to accuse oneself.

[24] Law Commission of India, 'Article 20(3) of the Constitution of India and the Right to Silence' COM (2002) 180.

[25] See, "Every person accused of committing a penal offence has the right to be presumed innocent until proven guilty in a public trial during which he has every guarantee necessary for defending himself."

[26] See, "According to law, unless the person accused of an offence is proved guilty, he shall be accorded the presumption of being innocent."

[27] Law Commission of India, 'Article 20(3) of the Constitution of India and the Right to Silence' COM (2002) 180.

[28] ibid.

[29] Established in *United States v O'Hagan*, 521 U.S. 642 (1997).

[30] Troy Cichos, 'The Misappropriation Theory of Insider Trading: It's Past, Present, and Future' (1995) 18 Seattle U L Rev, 391.

[31] Narayan Prasad Sharma, 'A Reading into Insider Trading: Concept, Cases, Consequences and Countermeasures' (2018) 12 Nat'L Jud. Acad. L.J. 113, 123.

[32] cf Bhattacharya (n 21) 16.

[33] William K.S. Wang, 'Introduction: Insider Trading' [2010] Oxford U. Pr. *Insider Trading* at 5.

[34] Indian Penal Code, 1860, s.378.

[35] In the manner of actively stealing UPSI from the company.

[36] *Rakesh Agarwal v. SEBI* (2004) 1 CompLJ 193 SAT at 8.

[37] Established in *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

[38] *Cady, Roberts & Co.* 40 S.E.C. 907 (1961).

[39] ibid.

[40] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, reg. 2(1)(1). See, ""trading" means and includes subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, deal in any securities, and "trade" shall be construed accordingly;"

[41] *Chiarella v. United States*, 445 U.S. 222, 227 (1980), 231-235.

[42] *Ms. Chandrakala* (n 10) 7, para 6.

[43] *Ms. Chandrakala* (n 10) 9, para 7.

[44] *Chiarella* (n 41) 231-235.

[45] *Rakesh* (n 39).