II. PROHIBITION OF UNEXPLAINED SUSPICIOUS TRADING ACTIVITIES IN THE SECURITIES MARKET: EFFECTIVENESS AND CHALLENGES OF SEBI'S PROPOSAL

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ABSTRACT

In India, there has been a surge in the number of new retail investors participating in the securities market. This shift in the financial landscape of the Indian economy reflects a growing preference for investing in the securities market over traditional methods of saving. One of the primary factors contributing to this inclination towards shares as an investment option is the trust instilled in the system by the Securities and Exchange Board of India ("**SEBI**"), which ensures fairness. In a further stride towards safeguarding fairness and investor security, SEBI has introduced a consultation paper titled "SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023." This consultation paper includes a draft bill outlining a framework for addressing cases of insider trading based on suspicion. It seeks to increase the enforcement rate of SEBI in insider trading cases by reducing the burden of proof on SEBI. However, the proposed consultation paper does come with inherent limitations. These limitations include the absence of precise definitions, variability in materiality thresholds, and a reversal of the burden of proof onto the accused. In light of these issues, this article aims to accomplish several key objectives. Firstly, it seeks to identify the materiality threshold in India and compare it to other jurisdictions. Secondly, it examines the concept of burden-shifting and the use of circumstantial evidence in the "Prohibition of Unexplained Suspicious Trading Activities" ("**PUSTA**") Regulation, in comparison to existing Indian and other international standards. Finally, it puts forward practical and viable alternatives to address the shortcomings of tackling insider trading more effectively.

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I. INTRODUCTION

Securities market is a part of financial market which allows people to channelise their savings among a number of investments. In last few years, capital market is witnessing a rapid surge in number of retail investors participating in the market. Hence, in the best interest of retail investors, it is the duty of the SEBI to ensure symmetry of information because access to unpublished/non-public information in the securities market places genuine investors at a disadvantageous position.[1] The prime example of this is insider trading. Insider trading occurs when an individual trades a company's securities using non-public, price-sensitive, or material information to gain profit or avoid losse.[2] This practice not only erodes the interests of investors but also compromises the integrity of the market.[3] The problem of insider

[1] Cornell Education Blog, 'Asymmetric Information in the Stock Market' (1 December 2016) <https://blogs.cornell.edu/info2040/2016/12/01/asymmetric-information-in-the-stock-market/> accessed 24 July 2023.

[2] Merriam-Webster, <https://www.merriam-webster.com/dictionary/insider%20trading> accessed 24 July 2023.

[3] Julan Du and Shang-Jin Wei, *Does Insider Trading Raise Market Volatility,* IMF Working Paper, WP/03/51, (2003), <https://www.imf.org/external/pubs/ft/wp/2003/wp0351.pdf> accessed 24 July 2023.

trading has garnered increased attention from global securities watchdogs. In India, insider trading is regulated by the SEBI (Prohibition of Insider Trading) Regulations, 2015.[4] However, rapid technological changes and evolving insider trading methods have necessitated adjustments to SEBI's regulatory framework. These changes are essential to maintain governance principles that foster free and fair trading in line with the times.[5] In this context, SEBI recently introduced draft regulations for the Prohibition of Unusual Suspicious Trading Activities in the Securities Market through a consultation paper. The new regulation introduces significant changes, including a reversal of the burden of proof, a new materiality threshold, and recognition of circumstantial evidence in proving insider trading cases. However, it's important to note that the proposed regulation is not without its shortcomings. The proposed regulation contains several vague terms and appears to deviate from globally accepted materiality thresholds. It presumes that a person is guilty of insider trading solely based on two factors- trading patterns and the timing of the trade. This presumption has generated considerable discussion. In this paper, the author comprehensively addresses these key issues and seeks to provide viable solutions to mitigate potential future anomalies.

[4] N. K. Sodhi, 'Report of the High-Level Committee to Review the Sebi (Prohibition of Insider Trading) Regulations, 1992' *SEBI* (7 December 2013), <https://www.SEBI.gov.in/SEBI_data/attachdocs/1386758945803.pdf> accessed 25 July 2023

[5] SEBI, *Consultation paper on draft SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023,* SEBI, (May 18, 2023) https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-draft-sebi-prohibition-of-unexplained-suspicious-trading-activities-in-the-securities-market-regulations-2023_71385.html.

II. LEGISLATIVE FRAMEWORK OVER *"MATERIALITY"* IN FOREIGN JURISDICTIONS

United States - To safeguard investors against insider trading, Congress has implemented measures that prohibit trading in securities of the issuer based on material non-public information concerning that security or issuer. These provisions are outlined in Section 10(b) of the Securities Exchange Act of 1934 and, more specifically, Rule 10b5-1.[6] Materiality, a cornerstone of these regulations, has been legally defined as encompassing all particular facts or information that a prudent investor would deem pivotal in their decision-making process.[7] This principle was exemplified in the case of *Elkind v. Liggett & Myers*, where the Court ruled that information is material if its disclosure is likely to have a substantial impact on the market prices of the security.[8] This principle was subsequently reaffirmed in *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*[9] A significant milestone in the U.S. Supreme Court's examination of materiality was the case of *TSC Industries, Inc. v. Northway, Inc.*[10] In this instance, the Court emphasized that *"an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it significant in deciding how to vote."*[11] This test, as articulated in the case, does not necessitate that the information had an actual effect on the investor's decision. Rather, it suffices

[6] Rule 10b5-1 of the Securities and Exchange Commission Rule, codified at 17 CFR 240.10b-5.
[7] *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
[8] *Elkind v. Liggett & Myers Inc.,* 635 F.2d 156, 166 (2d Cir. 1980).
[9] *Securities & Exchange Commission v. Texas Gulf Sulphur Co.,* 258 F. Supp. 262 (S.D.N.Y. 1966).
[10] *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976); Basic, 485 U.S. at 231.
[11] ibid.

for the information to hold 'actual significance' in the investor's decision-making process.[12] Moreover, this case was followed by the *Basic case*, wherein Justice Blackmun viewed that the definition of materiality propounded in *TSC case* in respect of voting also applies to a shareholder deciding whether to buy or sell a security.[13] More specifically, the information will be material, if its disclosure would be *"viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."*[14] This notion was further adopted in the case of *Matrixx Initiatives, Inc. v. Siracusano,* where the Court held that information is material "*if it is substantially likely that a reasonable investor would have regarded this information as having significantly altered the 'total mix' of available information."*[15] Both these judgments underscore that the significance of undisclosed information is the determining factor for materiality.[16] It can be discerned from the approach adopted by the U.S. Judiciary that the test for materiality is objective and does not adhere to a strict formula.[17] Moreover, as per Rule 12b-2 of the SEC Act, the term 'material' refers to *"information to which there is a substantial likelihood that a reasonable investor would attach*

[12] Tommy Brennan, 'A Critical Analysis of New Zealand's Insider Trading Regime' University of Otago (2019) <https://www.otago.ac.nz/law/research/journals/otago734236.pdf>, accessed 25 July 2023, Page 15.
[13] *Basic Inc. v. Levinson,* 485 U.S. 224, 231–32 (1988).
[14] ibid.
[15] *In Matrixx Initiatives Inc. v. Siracusano,* 563 U.S. 27 (2011).
[16] Thomas M. Madden, 'Significance and the Materiality Tautology' (2015) 10 Journal of Business & Technology Law 2 <https://core.ac.uk/download/pdf/56359826.pdf> accessed 27 July 2023.
[17] Willkie Farr & Gallagher LLP, 'Supreme Court Reaffirms "Total Mix" Standard for Assessing Materiality in Federal Securities Actions' (*Willkie*, 24 March 2011), <https://www.willkie.com/~/media/Files/SupremeCourtReaffirmsTotalMixStandardpdf/FileAttachment/Supreme-Court-Reaffirms-Total-Mix-Standard.pdf> accessed 29 July 2023.

importance in determining whether to buy or sell the registered securities."[18] Materiality, in practice, is a fact-based determination that must be evaluated on a case-by-case basis.[19]

United Kingdom - The Companies Securities (Insider Dealing) Act 1985 is widely regarded as the inaugural statute in the United Kingdom aimed at criminalizing insider trading.[20] However, the application of this Act and the liabilities it outlined were rather narrow in their scope. Consequently, it was replaced by a more comprehensive legislation, the Criminal Justice Act of 1993.[21] Part V of the Criminal Justice Act of 1993 deals explicitly with insider dealing. One of the essentials for establishing the case of insider dealing is to prove that an insider is having inside information which if made public would be likely to have a significant effect on the price of any securities.[22] Furthermore, Section 118 of the Financial Services and Markets Act 2000, subsequently repealed by the UK Market Abuse Regulation, delineated the framework for civil liability concerning insider trading.[23] In accordance with the "Requirement to disclose inside information" as stipulated by the Financial Conduct Authority ("**FCA**"), information pertaining to several key aspects such as *"the issuer's assets and liabilities, the performance of the issuer's business, the financial condition of the issuer, and significant new*

[18] Rule 12b-2 of the Securities Exchange Act of 1934, codified at 17 C.F.R. § 240.12b-2 (2020).
[19] J. Anthony Terrell, 'Materiality in Review' (*Bracewell*) <https://bracewell.com/sites/default/files/knowledge-center/Materiality%20in%20Review_0.pdf> accessed 02 August 2023.
[20] Company Securities (Insider Dealing) Act 1985, (United Kingdom).
[21] Kern Alexander, 'Insider Dealing and Market Abuse: The Financial Services and Markets Act 2000' ESRC Centre for Business Research, University of Cambridge Working Paper No. 222 (December 2001), <https://www.cbr.cam.ac.uk/wp-content/uploads/2020/08/wp222.pdf> accessed 03 August 2023.
[22] Criminal Justice Act 1993, §56 and §57 (United Kingdom).
[23] The United Kingdom Market Abuse Regulation [Regulation 596/2014 ("MAR")].

developments in the issuer's business" are deemed relevant.[24] These factors are crucial for a reasonable investor in making informed decisions about buying or selling securities associated with the company in question. Moreover, the FCA has also underscored that the size of the issuer, recent developments, and the prevailing market sentiment concerning the issuer and its sector can provide significant indicators of whether the information is likely to substantially impact the prices of the securities.[25]

Singapore - Section 218 of the Securities and Futures Act, 2001 pertains to insider trading.[26] It prohibits individuals connected to a corporation from trading in its securities if they possess non-public information that could materially affect the securities' price or value upon disclosure.[27] The Court of Appeal of Singapore, in the case of *Lew Chee Kevin v. Monetary Authority of Singapore,* has clarified the element of materiality in insider trading. They established that it's not necessary to demonstrate actual price fluctuations in the company's securities following the information disclosure.[28] They also noted that while market impact can serve as relevant evidence, it shouldn't be considered as conclusive proof.

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[24] Disclosure Guidance and Transparency Rules sourcebook, 'Chapter 2 - Disclosure and control of inside information by issuers' (*Financial Conduct Authority*) <https://www.handbook.fca.org.uk/handbook/DTR/2.pdf> accessed 04 August 2023.
[25] ibid.
[26] Securities and Futures Act, 2001 (Singapore).
[27] The Monetary Authority of Singapore, 'Guidelines on the Regulation of Markets' (*CFTC*, 1 July 2005), <https://www.cftc.gov/sites/default/files/groups/public/@otherif/documents/ifdocs/orgfbotapdxddsfamr160615.pdf> accessed 07 August 2023.
[28] *Lew Chee Kevin v. Monetary Authority of Singapore*, (2012) [SGCA] 12.

III. DICHOTOMY OVER MATERIALITY THRESHOLD IN INDIAN LEGISLATIVE FRAMEWORK

The term "Unpublished Price Sensitive Information" ("**UPSI**") is frequently used interchangeably with "Material Non-Public Information" ("**MNPI**"), as both convey similar meanings.[29] Generally, information that is not publicly disclosed would be classified as UPSI/MNPI if it holds material significance. In essence, materiality is understood as information that is likely to substantially influence the decision-making process of a reasonable investor. The SEBI regulations that directly or indirectly pertain to the concept of materiality are discussed below.

- **SEBI (Prohibition of Insider Trading) Regulations, 2015 -** As per Regulation 2(1)(n) of the PIT Regulation, 2015, the term UPSI refers to any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the prices of the securities.[30] In accordance with the provided definition, information is deemed material if it has the potential to impact the prices of the company's stocks.
- **SEBI (Listing Obligations Disclosure Requirements) Regulations, 2015 -** Regulation 30(4) of SEBI (LODR) Regulations, 2015 set out total three disjunctive criteria for deciding materiality of

[29] Heena Ladji, Shreyas Bhushan and Ruchir Sinha, 'Private Funds: AIF Investors Holding UPSI in Breach of Insider Trading Norms for AIF's Investment Decisions' (*Mondaq*, 11 May 2022) <https://www.mondaq.com/india/fund-management-reits/1192024/private-funds-aif-investors-holding-upsi-in-breach-of-insider-trading-norms-for-aifs-investment-decisions> accessed 09 August 2023.

[30] Regulation 2(1)(n) of the Prohibition of Insider Trading Regulations, 2015.

an event/information.[31] The first two criteria are as follows – 1) *"the omission of an event or information, which is likely to result in discontinuity or alteration of event or information already available publicly"* and 2) *"the omission of an event or information is likely to result in significant market reaction if the said omission came to light at a later date"*.[32] Both these conditions are qualitative in nature. Also, these conditions are very much in line with the interpretation given by the U.S. Supreme court in *TSC case* which is considered to be one of the widely accepted cases across jurisdictions on materiality.[33]

- **SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023 -** The PUSTA Regulations, 2023, have also provided a definition for MNPI (which is synonymous with UPSI). Within these regulations, three distinct scenarios have been outlined, specifying when non-public information can be considered material. The condition pertinent to our discussion is as follows –

  Material Non-Public Information encompasses "*information about a company or security that was not generally available, and upon becoming generally available, had a reasonable impact on the price of the company's securities."*[34]

[31] Regulation 30(4) of the SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015.
[32] ibid.
[33] *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
[34] Regulation 2(1)(f)(i) of SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023.

After a thorough analysis of the concept of materiality as defined in the three SEBI Regulations and in line with international practices for the determination of materiality, it becomes evident that the definition of materiality under the PUSTA Regulations is notably narrower in scope. The PUSTA Regulations specifically emphasise that information should be deemed material when it reasonably impacts the prices of a company's securities, while the other SEBI regulations consider information material if it is likely to affect the prices of the company's securities. Certainly, as opposed to the PUSTA regulations, other SEBI regulations do not necessitate an actual impact on the prices of the company's securities.

Consequently, it is strongly recommended that, in order to eliminate any ambiguity surrounding the definition of materiality within SEBI's regulations, a revision of the materiality definition is imperative. This revision is also warranted due to the significant deviation of the current definition under the PUSTA Regulations from the standards adopted by countries such as the United States, Singapore, Australia, and other comparable jurisdictions.

IV. MATERIAL NON-PUBLIC INFORMATION UNDER PUSTA REGULATIONS *VIS-À-VIS* INFLUENCERS

As per the proposed PUSTA Regulations, *"information about an impending recommendation, advice by name, in a security, by an influencer, to the public/followers/subscribers, and which when became generally available to the public/followers/sub-scribers, reasonably impacted the prices of that security"* will be considered as a material non-public information.[35] A

[35] Regulation 2(1)(f)(iii) of SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023.

genuine Finfluencer/Influencer analyses the already available information about a company, such as its financial statements, various accounting ratios, executed material contracts, and the potential growth of the sector in which the company operates. Based on this analysis, they offer advice or tips in good faith through their social media platforms, making their analysis accessible to the public. Subsequently, their subscribers often purchase the company's securities, which can reasonably impact the prices of those securities. However, according to the Proposed Regulation, advice given by Influencers that reasonably impacts the price of a security would fall under the ambit of Material Non-Public Information ("**MNPI**").

In this context, the author highlights that categorizing advice from Finfluencers as MNPI is problematic. The fundamental principle of materiality stipulates that information must not be generally available to the public. In the case of Finfluencers, their advice and tips are typically based on information that is already publicly accessible.[36] Therefore, the author expresses scepticism about including the recommendations of Finfluencers as material non-public information. Finfluencers do not provide advice based on non-public information about a company; rather, they analyse publicly available information about the company and its operating sector. They leverage their analytical and research skills when offering recommendations. The information upon which they base their advice is already accessible to the general public. Consequently, other market participants are not placed at an unfair or disadvantageous position, which is a prerequisite for declaring information as MNPI. Hence, it is essential to reconsider the inclusion of

[36] Sue S Guan, 'The Rise of the Finfluencer' (*Oxford Law Blog,* 22 May 2023) <https://blogs.law.ox.ac.uk/oblb/blog-post/2023/05/rise-finfluencer> accessed 13 August 2023.

advice and recommendations within the scope of MNPI from the perspective of SEBI.

V. STANDARD OF PROOF IN SECURITIES MARKET ABUSE CASES

After a thorough examination of the materiality issue under the PUSTA Regulations, we shall now delve into the matter of burden-shifting as stipulated by these regulations. To begin, the Burden of Proof refers to which party in a legal case or suit bears the responsibility of proving a fact that is in dispute and essential to the case, typically by adducing evidence.[37] In the United States, the courts have established that the Securities and Exchange Commission ("**SEC**") can meet its burden of proof in enforcement proceedings by a preponderance of evidence.[38] Moreover, in the case of *Roberts v. Woods,* it was determined that, in cases involving fraud, wrongdoing must be substantiated by "clear and convincing evidence," even when measured against the preponderance of probability.[39] Consequently, the burden of proof placed on the SEC in the violation of anti-fraud provisions is of a somewhat lower standard compared to the more rigorous "beyond a reasonable doubt" criterion. The preponderance of probabilities standard implies that, while both conflicting versions of events are possible, one is more

[37] Juhi Gupta, 'Interpretation of Reverse Onus Clauses' (2012) 5 NUJS Law Review 49 <http://nujslawreview.org/wp-content/uploads/2016/12/juhi-gupta.pdf> accessed 15 August 2023.

[38] 'High Court Backs S.E.C. on Fraud Proof Standard' *The New York Times* (26 February 1981) <https://www.nytimes.com/1981/02/26/business/high-court-backs-sec-on-fraud-proof-standard.html> accessed 16 August 2023. *See also,* Russell G. Ryan, 'The SEC's Low Burden of Proof' *Wall Street Journal* (14 July 2013) <https://www.wsj.com/articles/SB10001424127887323297504578582213820533922> accessed 17 August 2023.

[39] *Roberts v. Woods, 82 III App 630, 640 (1898); Woodby v. Immigration and Naturalization Service,* 385 US 276, 286 (1966); *Addington v. Texas,* 441 US 418, 433 (1979).

likely than the other.[40] The adoption of this standard of proof within securities laws serves to ensure that individuals with doubtful suitability do not continue trading in the market. It guarantees that only market participants with unquestionable suitability operate within the market. This, in turn, fosters fair trading and eradicates any form of unfair practices within the market. This standard of proof is also suitable for insider trading cases, as "beyond reasonable doubt" evidence is rarely available in such cases. Consequently, securities regulators may struggle to apprehend perpetrators of securities violations, allowing them to persist in the market, undermining the core objectives of market regulation.

From the perspective of the Indian judiciary, in the case of *Kishore Ajmera v. SEBI,* the Supreme Court established that the standard of preponderance of probabilities applies to civil proceedings under the SEBI Act, 1992, or the rules and regulations derived from it.[41] One of the early instances where the Securities Appellate Tribunal ("**SAT**") deliberated on the degree of preponderance of probabilities applicable in securities market violations was in the case of *Sterlite Industries (India) Ltd. v. SEBI*.[42] In this case, SAT emphasized that a higher degree of probability must be established when addressing offenses related to market manipulation.[43] Moreover, in 2009, in *Dilip S. Pendse v. SEBI,* the SAT ruled that *"the charge of insider trading is one of the most serious charges in relation to the securities market*

[40] Dr. Rangin Pallav Tripathy, 'Standard of Proof in Inquiry Against Judges: A Case for a Lower Threshold' (2018) 5(2) National Law University Jodhpur Law Review 85, <http://nlujodhpur.ac.in/uploads/5%20(2)%20NLUJ%20Law%20Review%2085%20(2018).pdf> accessed 18 August 2023.
[41] *Kishore Ajmera v. SEBI, (2016) 6 SCC 368.*
[42] *Sterlite Industries (India) Ltd. v. SEBI (2001) SCC OnLine SAT 28*.
[43] ibid.

and having regard to the gravity of this wrong doing, higher must be the preponderance of probabilities in establishing the same."[44] This rationale was influenced by the case of *Mousam Singha Roy v. State of West Bengal*, where the Supreme Court established that in criminal jurisprudence, the seriousness of the offense dictates the stringency of the burden of proof. The same principle applies to civil cases, where the standard of proof for establishing a charge is a "preponderance of probabilities."[45] It is worth noting that within each standard of proof in both civil and criminal cases, there are varying degrees of probability.[46]

In 2010, in *R.K. Global Shares and Securities Ltd. v. SEBI,* the SAT reaffirmed its stance from the Dilip S. Pendse case, asserting that, when proving a serious offense, SEBI must meet a high degree of probability.[47] Similar view was further reiterated in *V.K. Kaul v. SEBI*.[48] Subsequently, in *DLF Ltd. v. SEBI,* the SAT emphasized that securities fraud and market manipulations are serious allegations and that, although these offenses must be established on the basis of a "preponderance of probabilities," the level of probability within this standard must be high. [49]

Based on the aforementioned judicial decisions, it is evident that under securities laws, even when violations may have penal consequences, the burden of proof is based on a preponderance of probabilities. This is because

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[44] *Dilip S. Pendse v. SEBI,* (2009) SCC OnLine SAT 177.
[45] *Mousam Singha Roy v. State of West Bengal,* (2003) 12 SCC 377.
[46] *Hornal v. Neuberger Products Ltd.,* (1956) 3 All E.R. 970. *See also, Bater v. Bater,* (1950) 2 All E.R. 458.
[47] *R.K. Global Shares and Securities Ltd. v. SEBI,* (2010) SCC OnLine SAT 285.
[48] *V.K. Kaul v. SEBI,* (2012) SCC OnLine SAT 203, *See also, Manoj Gaur v. SEBI,* (2012) SCC OnLine SAT 176; *Chandrakala v. SEBI,* (2012) SCC OnLine SAT 21.
[49] *DLF Ltd. v. SEBI* (2015) SCC OnLine SAT 54.

proving violations with direct evidence can be exceedingly challenging.[50] Moreover, it is now clear that a higher degree of probability is required for serious offenses concerning the securities market, including insider trading.[51]

However, in the present "PUSTA Regulations" under consideration, SEBI has significantly lowered the degree of preponderance of probabilities by only necessitating the trading pattern and timing of the trade to invoke a presumption of guilt. This approach deviates significantly from the positions taken by the SAT and the Supreme Court. Therefore, the author contends that, given the seriousness of insider trading charges, the preponderance of probabilities should be higher. The chilling effect of these proposed regulations could lead to innocent market participants being wrongly held accountable. To prevent such anomalies, the proposed regulations should adopt a higher standard of preponderance of probabilities.

VI. SHIFTING THE BURDEN OF PROOF ON ACCUSED *VIS-À-VIS* INSIDER TRADING

In insider trading cases, according to the Prohibition of Insider Trading ("**PIT**") Regulations, 2015, the onus lies with SEBI to establish a prima facie case against an insider who is not affiliated as a connected person. SEBI must demonstrate that this individual had possession of or access to Unpublished

[50] Rajat Sethi, Misha Chandna, and Aditi Agarwal, 'Insider Trading: Circumstantial Evidence Is Evidence Enough?' (2020) 32 National Law School India Law Review, <https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1083&context=nlsir> accessed 20 August 2023.

[51] Armaan Patkar and Diya Uday, 'Standard of Proof: Civil Securities Fraud, Market Manipulation, and Insider Trading in India' (2018) 8 SCC J-25 <https://www.scconline.com/blog/post/2018/10/08/2018-scc-vol-8-october-7-2018-part-4/> accessed 22 August 2023.

Price Sensitive Information ("**UPSI**") at the time of trading.[52] Whereas, under the proposed Prohibition of Unlawful Securities Trading Activities ("**PUSTA**") Regulations, SEBI can, merely by alleging suspicious trading activity, presume that a person has access to Material Non-Public Information ("**MNPI**"). Accordingly, SEBI can establish a case of insider trading. In contrast to the Prohibition of Insider Trading ("**PIT**") Regulations, where the primary burden of proving that a person has access to UPSI rested with SEBI, the PUSTA Regulations have relieved SEBI of this primary responsibility. Instead, SEBI can presume that a person has access to MNPI/UPSI based on unusual trading patterns and MNPI. This shift has, in essence, transferred the onus of burden.

VII. INDIAN JUDICIARY OVER REVERSAL OF BURDEN OF PROOF

India boasts a rich judicial history concerning the validity of reversing the burden of proof. In the case of *Noor Aga v. State of Punjab,* the Supreme Court ruled that the policy decision to reverse the burden of proof is constitutionally valid. The Court also clarified that burden of proof is shifted only after the *"prosecution has met the threshold of establishing the actus reus and foundational facts".*[53] Furthermore, in the case of *Sheikh Zahid Mukhtar v. State of Maharashtra,* the Bombay High Court held that a reverse onus clause under Section 9B of the Maharashtra Animal Preservation Act is ultra vires the constitution for failing to meet the criteria of being just, reasonable, and fair, which are fundamental prerequisites for a fair trial under Article 21

[52] SEBI (Prohibition of Insider Trading) Regulations, 2015.
[53] *Noor Aga v. State of Punjab,* (2008) 16 SCC 417. *See also, M/s. Seema Silk and Sarees v. Directorate of Enforcement,* (2008) 5 SCC 580.

of the Constitution.[54] The Court contended that the present Act overlooked the primary condition for the prosecutor to prove foundational facts before invoking the presumption of guilt, rendering the provisions under Section 9B of the Act unreasonable and unfair.

In the context of insider trading, the Supreme Court, in *Balram Garg v. Securities and Exchange Board of India,* determined that proving access to non-material public information constitutes a foundational fact.[55] The consultation paper for the PUSTA Regulations, while citing special statutes that impose a reverse burden of proof, has shifted the burden of proof to the accused in cases of insider trading and front running. However, even in special statutes like the NDPS Act, the prosecutor is still required to prove the prima facie case beyond a reasonable doubt against the accused.[56] Applying the aforementioned decisions of the Courts to SEBI's reversal of the burden of proof under the PUSTA Regulations, it is argued that SEBI has overlooked the requirement of proving foundational facts and has instead presumed them solely on the basis of two circumstantial pieces of evidence - trading patterns and the timing of trades. This constitutes a significant drawback of the proposed Regulations that needs rectification to align with the existing legal jurisprudence on the reversal of the burden of proof.

Based on existing legal theories and judicial precedents, it is established that before any presumption is raised, foundational facts must be

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[54] *Sheikh Zahid Mukhtar v. State of Maharashtra,* (2016) SCC OnLine Bom 2600.
[55] *Balram Garg v. Securities and Exchange Board of India*, (2022) 9 SCC 425.
[56] Livelaw News Network, 'Stringent Provisions Of NDPS Act Does Not Dispense With The Requirement To Establish A Prima Facie Case Beyond Reasonable Doubt: SC' *(LiveLaw,* 5 August 2020*)* <https://www.livelaw.in/top-stories/stringent-ndps-act-does-not-dispense-with-requirement-to-establish-prima-facie-case-161012> accessed 03 September 2023.

proven by the prosecutor. Recognizing the challenge of producing direct evidence to prove possession or actual access to UPSI or MNPI, the author proposes a balanced approach under the PUSTA Regulations. In this approach, SEBI's standard of proof should neither be as high as "proving beyond a reasonable doubt" nor as low as "based on mere suspicion." Instead, the standard of proof should be that which requires SEBI to demonstrate that a reasonable investor can logically infer that the defendant is likely to have access to MNPI.

The author suggests that, rather than presuming access to MNPI, the proposed Regulations should place a higher preponderance of probabilities on SEBI to prove that there is a reasonable likelihood that a person is likely to have access or possession of UPSI/MNPI. Therefore, in addition to repetitive unusual trading patterns and consequential material non-public information, SEBI should also demonstrate that a reasonable person can draw a logical inference from all the surrounding facts and circumstances that there is a reasonable likelihood that the accused is likely to have possession of UPSI/MNPI.

Further, the author proposes that, instead of proving the actual possession of MNPI, if SEBI can produce evidence showing that a reasonable investor can establish a connection between repetitive unusual trading patterns and MNPI, it should be considered sufficient to raise the presumption that the accused is likely to have access to UPSI/MNPI.

Thus, based on this reasoning, the proposed definition of suspicious trade activities should include unusual trading patterns, material non-public information, and a reasonable connection between repetitive unusual trading

patterns and MNPI. Once all three conditions are met, SEBI can invoke the presumption that the person had access to or was in possession of MNPI, leading to a charge of insider trading. Moreover, by introducing a reasonable connection as an additional condition, a prudent investor can draw a logical inference that the defendant is likely to have access or possession of MNPI/UPSI, thereby aligning with the judicial precedent set by the Supreme Court of India.

VIII. INTRODUCING OF 'REASONABLE CONNECTION' REQUIREMENT *VIS-À-VIS* ACCESS TO MNPI/UPSI IN INSIDER TRADING CASES

The primary concept put forth by the author regarding the reasonable connection requirement is to ensure that a rational market participant can deduce a logical inference that the defendant or accused had access to or possession of MNPI at the time of trading. According to the SEBI Prohibition of Insider Trading ("**PIT**") Regulations, 2015, SEBI is tasked with establishing that an individual had access to UPSI at the time of trading. SEBI typically relies on direct evidence, and in the absence of such evidence, resorts to circumstantial evidence to demonstrate that the individual had access to UPSI at the time of trading.

Furthermore, under the current legal framework, SEBI is required to prove insider trading with a higher degree of probability. SEBI can achieve this by considering the totality of all the relevant facts and circumstances. However, in the proposed Regulations, SEBI presumes that the individual had access to MNPI at the time of trading based solely on two events - the trading pattern and the timing of the trade. In essence, SEBI relies on just two pieces

of circumstantial evidence to invoke a presumption of guilt. Given the gravity of insider trading as a serious offence and the fact that it entails a reversal of the burden of proof, SEBI should be held to a high standard of proving foundational facts with a strong degree of probability.

Hence, it is suggested that, in order to establish that the accused reasonably had access to MNPI at the time of trading, SEBI should consider a cumulative analysis of all relevant facts and circumstances. By requiring SEBI to take into account the totality of the facts and circumstances surrounding the event, a high degree of probability can be assured. This concept of a high degree of probability is a precedent established by the Indian and U.S. judiciary when dealing with charges related to serious offences in the securities market, and it should not be disregarded. The proposed Regulations appeared to deviate from this established norm, and it is imperative to rectify this deviation. The correct course of action would be to mandate SEBI to once again adhere to the traditional yet effective approach of requiring a "higher degree of probabilities" through a cumulative analysis of all the facts and circumstances pertaining to insider trading cases in order to demonstrate that the individual is likely to have had access to material non-public information.

IX. RELEVANCY OF CIRCUMSTANTIAL EVIDENCES IN INSIDER TRADING CASE IN U.S. AND CANADA

By introducing the notion of 'reasonable connection', the author seeks to emphasis on non-exhaustive circumstantial evidences to prove access to MNPI/UPSI which is a foundational fact in insider trading cases. In this background, this section will examine the validity of circumstantial evidences in establishing insider trading cases. In U.S., the Hon'ble District Court

Southern District of New York in the matter of *United States of America v. Raj Rajaratnam*, has held that insider trading convictions can be sustained based on circumstantial evidences in considering such factors as *"(1) access to information; (2) relationship between the tipper and the tippee; (3) timing of contact between the tipper and the tippee; (4) timing of the trades; (5) pattern of the trades; and (6) attempts to conceal either the trades or the relationship between the tipper and the tippee."*[57]

Cases of establishing insider dealing based on circumstantial evidence can be found in Canada as well. In the case of *Walton v. Alberta*, the Alberta Court of Appeal has held that insider trading cases can be proved by using circumstantial evidences.[58] The Court also clarified that logical inferences cannot be drawn from mere speculations. Similarly, in the case of *Finkelstein v. Ontario Securities Commission*, the Ontario Court of Appeal held that since there is generally a lack of direct evidence in establishing insider trading, hence it is reasonable to find insider trading based on circumstantial evidence.[59]

X. JUDICIAL PRECEDENT OVER RELEVANCY OF CIRCUMSTANTIAL EVIDENCES IN INSIDER TRADING CASES

- **Supreme Court cases –**
  - In the case of *SEBI v. Kishore Ajmera,* the Supreme Court held that in the absence of direct evidence, the Court can take note of the immediate and proximate facts and other circumstances

[57] *United States of America v. Raj Rajaratnam 09 Cr. 1184 (RJH); see also United States v. Larrabee,* 240 F.3d 18, 21-22 (1st Cir. 2001).
[58] *Walton v. Alberta (Securities Commission),* (2014) ABCA 273.
[59] *Finkelstein v. Ontario Securities Commission*, (2018) ONCA 61.

surrounding the event to arrive at a reasonable conclusion.[60] In other words, *"totality of the attending facts and circumstances surrounding the allegations"* is what matters. In this case, the Court contemplated a non-exhaustive list of circumstantial factors to arrive at a reasonable conclusion, including but not limited to the volume of the trade affected, the duration of persistence in trading in the particular stock, and the proximity of time between two relevant factors, etc. The Court also cautioned that circumstantial evidence will be sufficient only when it leads to an "irresistible conclusion" that the accused had access to unpublished price-sensitive information.

- Similarly, in the case of *SEBI v. Rakhi Trading Private Limited,* the Supreme Court has reiterated its decision in *Kishore Ajmera case*.[61] In this case also, the Apex Court has cumulatively analysed several circumstantial factors to derive a reasonable inference.
- The Apex Court in the *SEBI v. Kanaiya Lal Baldevbhai Patel* has held that *"an inferential conclusion from proved and admitted facts would be permissible and legally justified so long as the same is reasonable."*[62] Hence, it can be inferred from the said judgment that a conclusion drawn on the basis of circumstantial evidence is legally valid as long as it is reasonable.

[60] *SEBI v. Kishore Ajmera, (*2016) (6) SCC 368.
[61] *SEBI v. Rakhi Trading, (*2018) 13 SCC 753.
[62] *SEBI v. Kanaiya Lal Baldevbhai Patel,* (2017) 15 SCC 753.

- **Orders of Securities Appellate Tribunals -**

  - In the case of *Ketan Parekh v. SEBI*, the SAT held that list of circumstantial factors cannot be exhaustive. It went of observing that *"any one factor may or may not be decisive and it is from the cumulative effect of attending circumstantial factors that an inference will have to be drawn."* Also, it can be inferred from SAT's reasoning that the difficulty in proving facts, which are especially within the knowledge of the parties concerned, is a valid ground for using circumstantial evidence to establish violations in the securities market.[63]
  - Going further, in the case of *V.K. Kaul v. SEBI,* in the absence of sufficient direct evidence, the SAT based its decision on circumstantial evidence, including telephonic records, the timing of the trades, bank transactions, and Mr. Kaul's attempt to conceal his telephonic conversation. It held that Mr. Kaul had engaged in insider trading.[64]

- **Committee Report –**

The N.K. Sodhi Committee has also reported that obtaining direct evidence in all insider trading cases is very challenging. Accordingly, the facts and circumstances of the case need to be assessed to draw a reasonable

[63] *Ketan Parekh v. SEBI,* (2006) SCC OnLine SAT 221.
[64] *V. K. Kaul v. SEBI,* (2012) SCC OnLine SAT 203.

conclusion that a person has access to Unpublished Price-Sensitive Information (UPSI).[65]

Based on above decisions and report of the N.K. Sodhi Committee, it can be said that in the absence of direct evidence, circumstantial evidences can be taken by SEBI to arrive at a reasonable conclusion. However, in Balram Garg case, the Supreme Court gave a contradictory judgement. In this case, the Court asked SEBI to produce e-mails, letters, witnesses, or any other cogent evidences to prove communication of UPSI. Simply, the Court has applied the standard of proof of proving the case beyond reasonable doubt. Hence, the judgment has been heavily criticised for not treating direct and circumstantial evidences at same pedestal and mandating the SEBI to produce direct evidences to establish communication without paying heed to the fact that it is very difficult to adduce direct evidences in insider trading cases.[66]

Taking into account international practices, Indian judiciary's decisions validating the use of circumstantial evidence, the challenge of producing direct evidence, and the imperative to enhance the success rate in insider trading cases, SEBI took a deliberate step to codify circumstantial evidence as valid grounds for demonstrating that an individual had access to MNPI or UPSI. Nevertheless, the proposed Prohibition of Insider Trading and Unfair Trade Practices Regulations ("**PSUTA Regulations**") only mentions

[65] N. K. Sodhi, 'Report of the High-Level Committee to Review the Sebi (Prohibition of Insider Trading) Regulations, 1992' (7 December 2013), <https://www.SEBI.gov.in/SEBI_data/attachdocs/1386758945803.pdf> accessed 05 September 2023.

[66] Harsh N. Dudhe and Pranay Bhardwaj, 'Evaluating the Standard of Evidence Used in Insider Trading Cases' (*SCConline*, 3 January 2023) <https://www.scconline.com/blog/post/2023/01/03/evaluating-the-standard-of-evidence-used-in-insider-trading-cases/> accessed 06 September 2023.

two specific circumstantial evidences – trading patterns and the timing of trades, to invoke the presumption of guilt against the defendant/accused. In contrast, the Courts have provided a non-exhaustive and comprehensive list of circumstantial evidence that SEBI can employ to establish access to MNPI or UPSI.

As a result, the proposed Regulations have limited the scope of circumstantial evidence, contrary to the original intent of the judiciary. Moreover, the proposed Regulations have elevated the presumption to a higher standard and have not considered the totality of the facts and circumstances surrounding the event. This raises concerns that not mandating SEBI to consider the complete chain of circumstances when declaring an individual as an insider may have a chilling effect on the market. Parties may be deterred from participating in the securities market, which runs counter to SEBI's fundamental mandate.

Furthermore, to arrive at an incontrovertible conclusion that an individual has access to UPSI, a cumulative analysis of all relevant facts and circumstances is indispensable. However, under the PSUTA Regulation, it is presumed that an individual has access to UPSI based solely on two circumstantial evidences – unusual trading patterns and MNPI. This approach lacks the cumulative analysis of all relevant facts and circumstances.

Consequently, the author proposes the inclusion of a "reasonable connection" requirement in addition to the two contemplated circumstantial evidences. SEBI can establish a reasonable connection based on several other circumstantial evidences, such as financial records, telephonic records, trade volume, trade timing, ability to access MNPI, and the timing of contact

between tipper and tippee. This list is non-exhaustive, and SEBI can consider any other relevant facts and circumstances it deems appropriate to prove the requirement of a reasonable connection. This way, the introduction of the reasonable connection requirement allows SEBI to consider the totality of attending facts and circumstances to effectively discharge its burden of proving that an insider likely had access to MNPI or UPSI at the time of trading.

Ultimately, by introducing the reasonable connection requirement, SEBI can not only establish foundational facts but also meet the high burden of proof by cumulatively analysing all attending facts and circumstances. This approach aligns SEBI with existing judicial decisions and legal jurisprudence.

XI. NEED FOR ENHANCING THE INVESTIGATION POWERS OF SEBI

The Author commends the commendable initiatives undertaken by SEBI to safeguard the interests of investors. However, the Author also posits the argument that, alongside implementing specific regulations to combat insider trading, SEBI should consider a comprehensive overhaul of its investigative techniques.[67] As per the author, the following factors are contributing in SEBI's lower success rates in investigations and convictions -

- **SEBI's inability to wiretap phone calls –** According to the Indian Telegraph Act of 1885, both the state and central governments

[67] Souvik Ganguly, Renjith Nair, and Krishna Nair, 'Prove your innocence: Insights into the proposed securities trading regulations' (*Acuity Law,* 28 July 2023) <https://www.lexology.com/library/detail.aspx?g=6d3cf007-35b1-4f4c-8459-006c9c2b861a> accessed 08 September 2023.

possess the authority to intercept telephone communications.[68] Numerous investigative agencies, including the Central Bureau of Investigation ("**CBI**"), the Enforcement Directorate ("**ED**"), the Intelligence Bureau ("**IB**"), the Narcotics Control Bureau, and the National Investigation Agency, are granted prior permission by the Union Home Secretary to tap phone calls. However, SEBI has not been endowed with similar powers.[69] The Committee on Fair Market Conduct, in its report, recommended granting SEBI the authority to intercept phone calls, as such interceptions can serve as substantial evidence in establishing insider trading.[70] It is worth noting that SEBI's foreign counterparts, such as the SEC, possess the power to intercept calls. In the widely publicized Galleon insider trading case, wiretap recordings were admitted in court to substantiate the allegations of insider trading.[71] Therefore, the Author suggests that to enhance the rate of successful investigations, SEBI should be vested with the authority to intercept telephonic communications, provided that proper checks and balances are in place. An argument frequently raised in the context of wiretapping concerns the potential erosion of an individual's privacy. In the case of *K. S. Puttaswamy v. Union of*

[68] Indian Telegraph Act 1885, §5(2).

[69] HT Correspondent, '10 government agencies can tap phones, Lok Sabha told' (*The Hindustan Times* 20 November 2019, 02:10 AM) <https://www.hindustantimes.com/india-news/10-govt-agencies-can-tap-phones-ls-told/story-oY1vlfevUwacGRJIC7jnCN.html> accessed 08 September 2023.

[70] Dr. T. K. Viswanathan, 'Report of Committee on Fair Market Conduct' (*SEBI*, 09 August 2018) <https://www.SEBI.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html> accessed 10 September 2023.

[71] Kenneth Herzinger, Amy M. Ross, and Katherine C. Lubin, 'Court allows use of wiretap evidence in Galleon insider trading case' (*Orrick, Herrington & Sutcliffe LLP*, 29 November 2010) <https://www.lexology.com/library/detail.aspx?g=1e3ef747-3fd2-46ab-beae-a20617d49529> accessed 13 September 2023.

India, the Supreme Court ruled that the Right to Privacy is a fundamental right, subject to reasonable restrictions. State intrusion can be justified if it meets a three-fold test: 1) the existence of a law, 2) the pursuit of a legitimate aim, and 3) restrictions that are proportionate to the objective being sought (a rational nexus).[72] Therefore, based on the aforementioned reasoning, the author contends that SEBI can encroach upon an individual's right to privacy only when it satisfies the three-fold test.

- **Dearth of human resources at SEBI –** As of March 30, 2022, SEBI had a total of 980 employees,[73] while its U.S. counterpart, the SEC, boasts a workforce of approximately 4,500 individuals.[74] Furthermore, in the financial year 2020-21, SEBI initiated only 30 investigations into insider trading cases, a number that decreased to 17 in the subsequent financial year, 2021-22.[75] These statistics imply that SEBI faces limitations in conducting a significant number of investigations related to insider trading, primarily due to a shortage of human resources. Considering the vast expanse of the Indian securities market, the quantity of investigations undertaken by SEBI is notably inadequate. Consequently, the author recommends that, in order to ensure effective and expeditious handling of investigations,

[72] *K. S. Puttaswamy v. Union of India,* (2017) 10 SCC 1.
[73] SEBI, 'Employee Profile In SEBI' (*SEBI*, 31 March 2022).
[74] U.S. Securities and Exchange Commission, 'About the SEC' (06 April 2023) <https://www.sec.gov/strategic-plan/about> accessed 13 September 2023.
[75] SEBI, 'Annual Report 2021-22' (*SEBI*, 10 October 2022) <https://www.SEBI.gov.in/reports-and-statistics/publications/oct-2022/annual-report-2021-22_63812.html> accessed 14 September 2023.

SEBI should consider bolstering its workforce by hiring additional employees.

In addition to enhancing SEBI's surveillance capabilities through the authorization to intercept telecommunications and electronic communications, as well as augmenting its workforce, the Author proposes that the regulatory body should establish Memoranda of Understanding ("**MoUs**") with other investigative agencies, such as the CBI and the ED. These MoUs would facilitate the routine and automated exchange of information and data. Furthermore, beyond regular data sharing, SEBI and other relevant agencies should commit to sharing information from their respective databases upon request or proactively for the purposes of conducting examinations, inspections, investigations, and prosecutions. To oversee and improve the effectiveness of this data-sharing mechanism, a dedicated unit or group should be constituted. It is noteworthy that there are no legal impediments to the formation of such MoUs, as SEBI has already executed a MoU with the Central Board of Direct Taxes ("**CBDT**") for data exchange.[76] The establishment of such MoUs would promote enhanced cooperation and synergy between SEBI and various government agencies, thereby facilitating their collaborative efforts in conducting investigations, scrutiny, and prosecutions.

XII. CONCLUSION

The Author's conclusion applauds the SEBI for its progressive measure of reversing the burden of proof in cases of insider trading. This

[76] SEBI, 'SEBI signs MoU with CBDT' (*SEBI*, 08 July 2020) <https://www.SEBI.gov.in/media/press-releases/jul-2020/SEBI-signs-mou-with-cbdt_47030.html> accessed 17 September 2023.

commendation is rooted in the recognition of the inherent complexities associated with proving insider trading, which, in turn, places the onus on SEBI to ensure judicial efficiency and acknowledges the unique knowledge possessed by the defendant.

Throughout this paper, the author introduces the notion that, by introducing an additional requirement of establishing a reasonable connection, SEBI can systematically evaluate all relevant facts and circumstances. This, in turn, enables SEBI to fulfil its burden of proof by establishing that the insider likely had access to MNPI or UPSI. It is emphasised that neither the 'beyond reasonable doubt' standard nor a 'lower degree of preponderance of probabilities' is the optimal approach to combat insider trading. Instead, the author advocates for a more balanced strategy.

By incorporating a 'reasonable connection' requirement alongside factors such as unusual trading patterns and MNPI, a higher degree of preponderance of liabilities can be attained. Consequently, this approach strikes a middle ground that ensures that both wrongdoers do not escape SEBI's scrutiny and that innocent individuals are not wrongly targeted.

Additionally, the current legal landscape reveals conflicting judicial decisions on the admissibility of circumstantial evidence to prove that an individual was in possession of UPSI/MNPI during a trading episode. Therefore, there is an urgent need for the judiciary to adopt a consistent and uniform approach. This is imperative to safeguard the interests of investors and maintain the integrity of the market.

The author further posits that, in addition to adopting a balanced approach under the Prohibition of Insider Trading Regulations, it is paramount

to modernise SEBI's investigative techniques. The amalgamation of all these elements forms a comprehensive strategy that would empower SEBI to fulfil its core mandate of eradicating unfair practices in the securities market. This approach serves the dual purpose of safeguarding investors' interests, instilling confidence in the securities market, and preserving its overall integrity.