



# INSIDER TRADING: CIRCUMSTANTIAL EVIDENCE IS EVIDENCE ENOUGH?

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**Abstract** The Securities and Exchange Board of India (‘SEBI’) is under constant pressure to secure the integrity of the securities market while also ensuring that development of the securities market is not deterred by its overreach. Accordingly, striking the right balance in respect of punitive measures against persons accused of insider trading and the standard of proof required for establishing such offence assumes significance. In this context, this article examines the role of circumstantial evidence in proving violations of insider trading norms and the evolution of this role, particularly in light of SEBI’s recent order in a matter involving an ex-employee of Morgan Stanley India Company Private Limited (a SEBI-registered merchant banker).

## I. INTRODUCTION

The key legislation dealing with insider trading in India is the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (‘Insider Trading Regulations’)<sup>1</sup> read with the Securities and Exchange Board of India Act, 1992 (‘SEBI Act’). The Indian insider trading laws were formulated with the objective of protecting the interests of investors in securities, and promoting the development and regulation of the securities market. Given such dual purpose sought to be achieved by SEBI, the Securities Appellate Tribunal (‘SAT’) has observed that “SEBI is the watchdog and not a bulldog. If there is an infraction of a rule, remedial measures should be taken in the first instance and not punitive measures.”<sup>2</sup>

In determining the balance between investor protection and incentivizing investment in the securities market, the standard of proof and nature of

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<sup>1</sup> The Insider Trading Regulations repealed the Securities Exchange Board of India (Prohibition of Insider Trading) Regulations 1992 (‘1992 Insider Trading Regulations’).

<sup>2</sup> *Piramal Enterprises Ltd v SEBI* 2019 SCC OnLine SAT 134 [24].

evidence required to establish insider trading violations would be key factors. These issues become controversial given the distinct character of insider trading offences – insiders usually indulge in insider trading through a proxy to whom the relevant information is communicated and direct evidence of such communication is seldom available.<sup>3</sup> Most jurisdictions appreciate the difficulty in obtaining direct evidence for such violations (which may not exist) and therefore place higher reliance on circumstantial evidence.

In India, circumstantial evidence has long been accepted as admissible evidence, including in cases of securities laws' violations. However, the weightage given to such evidence varies based on the nature of the offence and the factual circumstances under which the offence was committed. In the specific context of insider trading violations, there appears to have been a shift in the approach taken by Indian tribunals and courts – from a conservative reliance on circumstantial evidence and an insistence on corroborative evidence, to an increasing willingness to rely entirely on such evidence.

## II. EVOLUTION OF THE STANDARD OF PROOF AND RELIANCE ON CIRCUMSTANTIAL EVIDENCE

The Insider Trading Regulations prohibit trading in securities listed, or proposed to be listed by 'insiders', when in possession of unpublished price sensitive information ('UPSI'). The term 'insider' includes all 'connected persons' or persons in possession of or having access to UPSI. Conviction under the Insider Trading Regulations would therefore depend on proof of fulfilment of two conditions: (i) the person is an 'insider'; and (ii) such 'insider' had traded in the relevant securities while in possession of UPSI.

### A. Standard of Proof

The first key consideration for proving the abovementioned elements of insider trading would be the standard of proof that must be met for a conviction for insider trading. Earlier, there was some ambiguity on this issue. For instance, in the matter of *Samir C. Arora v. SEBI*,<sup>4</sup> SAT observed that in offences relating to the securities market, it is not necessary for SEBI to prove the case beyond reasonable doubt; however, "legally sustainable evidence" must be present to hold a person guilty of such offences. On the other hand, in the case of *Dilip S. Pendse v. SEBI ('Pendse')*,<sup>5</sup> SAT observed that "the charge of insider trading is one of the most serious charges in relation to the securities

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<sup>3</sup> See SEBI, 'Discussion Paper on amendment to the SEBI (Prohibition of Insider Trading) Regulations, 2015 to provision for an informant mechanism' <[https://www.sebi.gov.in/reports/reports/jun-2019/discussion-paper-on-amendment-to-the-sebi-prohibition-of-insider-trading-regulations-2015-to-provision-for-an-informant-mechanism\\_43237.html](https://www.sebi.gov.in/reports/reports/jun-2019/discussion-paper-on-amendment-to-the-sebi-prohibition-of-insider-trading-regulations-2015-to-provision-for-an-informant-mechanism_43237.html)> accessed 2 March 2020.

<sup>4</sup> 2004 SCC OnLine SAT 90 [57].

<sup>5</sup> 2009 SCC OnLine SAT 176 [13].

market and having regard to the gravity of this wrongdoing, *higher must be the preponderance of probabilities in establishing the same.*" [emphasis authors']

However, the issue now has been largely settled in favour of the lower standard by the Supreme Court in *SEBI v. Kishore R. Ajmera* ('Ajmera').<sup>6</sup> In such case, while dealing with a violation of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, the Supreme Court opined that "the test would always be that what inferential process that a *reasonable/prudent man* would adopt to arrive at a conclusion".<sup>7</sup> [emphasis authors'] In another case,<sup>8</sup> the Supreme Court relying upon its own judgment in *Ajmera*, held that even though the relevant violations would invite penal consequences on the defaulters, the correct standard of proof would be that of preponderance of liabilities as opposed to proof beyond reasonable doubt.

It is difficult to disagree with the above conclusion of the Supreme Court. In cases where only monetary penalty under the SEBI Act is being imposed, subjecting SEBI to the standard of proof applicable in criminal cases would render the Insider Trading Regulations largely meaningless, given the difficulty in collecting evidence to prove a charge of insider trading.

## **B. Use of Circumstantial Evidence**

The second crucial element to prove a charge of insider trading would be the acceptable evidence in proving such charge. As mentioned above, the nature of the offence of insider trading will generally require reliance on circumstantial evidence. However, the permissible degree of such reliance appears to have evolved over the years, with the tribunals and courts showing an increasing willingness to rely almost entirely on circumstantial evidence.

In *Pendse*, the only evidence before SAT against the accused was a statement made by one of the co-accused. SAT, while exonerating the petitioner, observed that "there is absolutely no corroboration in support of such a statement and a serious allegation like insider trading cannot be established on the basis of such uncorroborated evidence."<sup>9</sup> Similarly, in at least two other matters,<sup>10</sup> SAT dismissed charges of insider trading violations against the accused. SAT took note of the close familial relationship between the insider and the traders in the relevant securities and their trading patterns, and concluded that this would not constitute sufficient evidence to prove that the traders had received UPSI from the insider and traded on the basis of such UPSI. From

<sup>6</sup> (2016) 6 SCC 368.

<sup>7</sup> Ibid[26].

<sup>8</sup> *SEBI v Kanaiyalal Baldevbhai Patel* (2017) 15 SCC 1 [62].

<sup>9</sup> *Pendse* (n 5) [9].

<sup>10</sup> *Manoj Gaur v SEBI* 2012 SCC OnLine SAT 176; *Chandrakala v SEBI* 2012 SCC OnLine SAT 21.

these cases, it appears that there was some reluctance in respect of reliance only on circumstantial evidence for insider trading offences.

There was a significant shift in the above position in *V.K. Kaul v. SEBI* ('*Kaul*').<sup>11</sup> In that matter, SAT, referring to certain observations of the U.S. District Court of the Southern District of New York in *United States of America v. Raj Rajaratnam* ('*Rajaratnam*'),<sup>12</sup> came to the conclusion that insider trading convictions could be sustained solely on circumstantial evidence under the Indian regulatory framework. It is relevant to note that SAT had statements of two 'connected persons' which made no reference to personal contact with Mr. V.K. Kaul (the accused), during the relevant period, establishing actual possession of UPSI by the accused. However, SAT found that the statements of such connected persons did not inspire confidence and could not be considered to be 'direct evidence' proving the innocence of the accused. Therefore, it found no fault with the adjudicating officer holding Mr. V.K. Kaul guilty based on the available circumstantial evidence. From the order of SAT in *Kaul*, it appears that when the totality of the evidence, even if only circumstantial, reasonably points to the conclusion of guilt of the accused, the onus would be on the accused to produce 'direct evidence' to rebut such inference of guilt.

A further dilution in the above position may be observed in certain recent cases, where the circumstantial evidence relied upon by SEBI is primarily the *relationship* between the 'insider' and the traders.

For instance, in a recent decision relating to *Insider trading in the scrip of CRISIL Limited* ('*CRISIL Limited*'),<sup>13</sup> SEBI held Mr. Utsav Pathak, an ex-employee of Morgan Stanley India Company Private Limited guilty of unlawfully communicating UPSI (as an 'insider') to other persons under the SEBI (Prohibition of Insider Trading) Regulations, 1992. The allegation was that Mr. Pathak had communicated UPSI to his sister, sister's husband and his parents (together, 'the Tippees') and that on the basis of such information, his sister and sister's mother-in-law had engaged in unlawful trades. SEBI appears to have concluded that the Tippees received the UPSI from Mr. Pathak solely based on the fact that the Tippees had invested in a listed stock during the UPSI period while Mr. Pathak had been working on an open offer transaction involving that listed stock. Certain other evidence such as the trading pattern of the Tippees was also relied upon by SEBI.

However, the trading pattern could have been relevant solely to infer that the Tippees engaged in unlawful trades, i.e. that they were in possession of UPSI; it could not have established that the UPSI was, in fact, passed on to the Tippees by Mr. Pathak. In arriving at its conclusion, SEBI appears to have

<sup>11</sup> 2012 SCC OnLine SAT 203.

<sup>12</sup> Order dated 11 August 2011, 09 Cr. 1184 (RJH).

<sup>13</sup> SEBI order dated 30 August 2019, AO/SBM/EAD-1/12/2019.

been heavily influenced by the relationship between Mr. Pathak and the persons who purportedly undertook the unlawful trades. SEBI also dismissed the fact that the Tippees were themselves engaged in financial journalism/services and could have received the information from public sources, or any person other than Mr. Pathak.

In an earlier matter of *Insider trading in the scrip of Deep Industries Limited ('Deep Industries')*,<sup>14</sup> certain persons were held to be 'connected persons' by SEBI under the Insider Trading Regulations based on their status as 'friends' on the social media platform, Facebook. In other words, SEBI held that the burden of proving that these persons were in a position that allowed them, or was reasonably expected to allow them access to UPSI, was satisfied by the mere fact of such persons having interacted on social media.

It is relevant to note that under the Insider Trading Regulations, certain specified categories of relationships result in such persons being deemed to be 'connected persons', though this is a rebuttable presumption.<sup>15</sup> For individuals, an 'immediate relative', defined as "a spouse of a person, and includes parent, sibling, and child of such person or of the spouse, any of whom is either dependent financially on such person, or consults such person in taking decisions relating to trading in securities" has been expressly included as a deemed connected person.<sup>16</sup> Given that the Insider Trading Regulations specifically make certain categories of relationships relevant to a charge of insider trading, substantial reliance on the relationship between the insider and the trader (such as, the 'friend' in *Deep Industries* and sister's in-laws in *CRISIL Limited*) which falls outside the purview of the deeming fiction under the Insider Trading Regulations is questionable. Such relationship may, at the maximum, be only one of several factors evidencing possession of UPSI; it could not be the primary basis for a finding of guilt without sufficient corroborative evidence.

### III. CONCLUSION

Given the nature of the offence of insider trading, it is often difficult to procure direct evidence of such wrongdoing. It is, therefore, understandable that the SEBI would have to rely on circumstantial evidence in proving insider trading violations. At the same time, it is necessary to develop sound principles governing reliance on circumstantial evidence to ensure that such reliance does not become a source of unbridled power in respect of findings of insider trading violations, which could deter investment in the securities market. SEBI's

<sup>14</sup> SEBI order dated 16 April 2018, SEBI/WTM/MPB/IVD/ID-6/162/2018.

<sup>15</sup> Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 2(1)(d)(ii).

<sup>16</sup> Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 2(1)(f).

recent reliance solely on the relationship of the traders with insiders, including in the context of social media, to convict persons of insider trading appears to reflect a failure to strike the right balance regarding the standard of proof required for establishing such offence.

While there can be no hard and fast rule regarding the extent and nature of circumstantial evidence required to prove a charge of insider trading, the factors listed by the New York District Court in *Rajaratnam* provide some useful guidance on the broad categories of evidence which may be relevant: (i) access to information; (ii) relationship between the tipper and the tippee; (iii) timing of contact between the tipper and the tippee; (iv) timing of the trades; (v) pattern of the trades; and (vi) attempts to conceal either the trades or the relationship between the tipper and the tippee. The securities regulator may use a combination of such categories of evidence to evaluate the culpability of the accused. In this regard, the authors recognize that procurement of such evidence would depend largely on the fact-finding powers and technology for monitoring the securities market available with SEBI.

SEBI has relatively restricted fact-finding powers in comparison to the securities regulators in certain other jurisdictions.<sup>17</sup> In fact, SEBI has been seeking the authority to intercept phone calls which is provided to certain other regulatory authorities, such as the Central Bureau of India and Central Board of Direct Taxation under the Indian Telegraph Act, 1885, but has not been granted such powers yet.

The recent introduction of the whistle blowing mechanism by SEBI (Prohibition of Insider Trading) (Third Amendment) Regulations, 2019 may provide assistance to SEBI in its fact-finding process for insider trading violations. Under this mechanism, persons may voluntarily disclose information in relation to an alleged violation of insider trading laws to SEBI and such persons would be rewarded upon collection or substantial recovery of monetary sanction from the alleged violators.

While SEBI continues to seek wider investigative powers, measures such as (i) use of better technology to track price movement of a stock in the period immediately before and after major business announcements by listed companies, (ii) increase in SEBI's surveillance workforce, (iii) use of the recently introduced whistle blowing mechanism, and (iv) implementation of streamlined processes for SEBI to be able to liaise with other regulatory authorities having wider investigative powers, such as the Economic Offences Wing of the State Police, Enforcement Directorate etc., could potentially aid SEBI in the effective enforcement of the Insider Trading Regulations.

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<sup>17</sup> For instance, the Securities and Exchange Commission has powers to intercept and wire-tap telephone calls and such records have been successfully used in several high profile investigations resulting in convictions.