Chinese Walls Defence to Insider Trading in India

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Abstract

The Indian law prohibits the offence of insider trading, which is committed when a person who "possesses" unpublished price-sensitive information ("UPSI") relating to securities of a publicly listed company is traded in securities of such company. The prohibition is on the possession; even if UPSI is not used, it is not a defence. The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015**,** provide various defences to the presumptive charge of insider trading. These defences aim to establish that parity of information exists between the parties to a trade. One such defence is that of Chinese walls. This paper critically examines the defence of the Chinese wall in the Indian securities market by critically analysing the regulations and related case laws. The paper explains the elements that need to be established to claim the defence of the Chinese wall and highlights the issues that might arise in proving the same in light of Indian law. The paper also discusses the paradox in the defence of the Chinese wall whereby, on the one hand, it's an obligation to prevent insider trading and defence against insider trading on the other. The author has used foreign cases and laws due to the dearth of Indian case laws in this area. Based on the analysis, the author has also outlined the recommendations for making this defence more specific and uniform.

Introduction

The Indian law prohibits the offence of insider trading, which is committed when a person who "possesses" unpublished price-sensitive information ("UPSI") relating to securities of a publicly listed company is traded in securities of such company. The prohibition is on the possession; even if UPSI is not used, it is not a defence. The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015**,** provide various defences to the presumptive charge of insider trading. These defences aim to establish that parity of information exists between the parties to a trade. One such defence is that of Chinese walls. Chinese walls are procedures an organisation puts in place to ensure that UPSI is not leaked. These arrangements can be physical, documentary and electronic barriers. This is a prevention mechanism against leakage of UPSI and a defence in relation to insider trading regulations. In India, the defence of Insider Trading is present in The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (hereinafter called "Insider Trading Regulations"). The defence absolves the organization from allegations of insider trading if it's proved that an employee was in possession of UPSI at the time the organization traded and the person who traded was separate from the one in possession of the UPSI.

However, it is not easy to prove this defence, and the position is not very clear in India as to how the requirements of the defence are to be fulfilled. There are limitations to this defence.

This paper has analyzed the defence of Chinese walls in the Insider Trading Regulations in India by looking at various case laws of Indian jurisdiction and foreign jurisdiction. The author has asked and analyzed the following questions:

i) How did the Chinese wall's defence have evolved?

ii) What are the requirements that need to be fulfilled to establish the defence of insider trading?

iii)What are the problems in Chinese law defence in India?

iv)How can the Chinese Walls defence be made more efficient in the Insider Trading Regulations, 2015?

Evolution of Chinese Walls Defence

The evolution of the defence of the Chinese wall could be traced back to the United States case of *Re Merrill Lynch, Pierce, Former and Amith, Inc.*[i] Merrill Lynch reached a settlement with the Securities and Exchange Commission(SEC) in relation to an insider trading claim against Merrill Lynch. The allegation was that Merrill Lynch, a lead underwriter in an upcoming public offering of an aircraft company, shared sensitive information with respect to the revised estimate of projected earnings in future of the aircraft company to the sales department, which was then spread to other institutional clients. Henceforth, this information was used to trade with the aircraft company.

In the settlement, Merrill Lynch gave an undertaking that it would implement greater and stricter policies and procedures between its departments for the business and adopted a statement of policy that *"prohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation.., and not disclosed to the investing public."*

Later on, these structures were widespread and used by Multinational corporations and Investment Banks to prevent them from insider trading investigations.

Henceforth, the Chinese Walls were incorporated as a part of the Securities Exchange Act of 1934 in terms of an addendum under section 15(f), which was then formed as a part of the Insider Trading and Securities Fraud Enforcement Act of 1988.[ii]

Chinese Walls Defence in India

The Chinese walls defence in India is found in the Insider Trading Regulations, 2015, as amended in 2019. It is pertinent to look at the evolution of these regulations to better understand how these regulations have responded to the tests of time.

The foremost regulations with respect to insider trading in India were in 1992, which were the SEBI (Prohibition of Insider Trading) Regulations, 1992 (hereinafter called the 1992 regulations)[iii]. These regulations did not have any reference to the Chinese walls, neither as a defence to an allegation of insider trading nor as an internal mechanism to ensure better corporate practice between departments in order to manage UPSI.

Later on, there was an amendment in 2002 that introduced Chinese walls in defiance of the 1992 regulations in these 1992 Regulations in the form of Schedule I, Part B, 'Model Code of Conduct for Prevention of Insider Trading for Other Entities'. In this Reg. 2.4 mandates organizations and firms to separate departments considered as “inside areas” from that of “public areas”. Also, the organizations that fall under the listed entities under these regulations have to follow the “*Minimum Standards for the Code of Conduct to Regulate, Monitor and Report Trading by Insiders*."[iv]

Basically, “Inside areas" were those in possession of confidential information, and "public areas" were those related to sales, markets, and investments or those departments providing support services.[v]

Employees in the inner area are not allowed to disclose any UPSI to anyone in a public location, and the company is obligated to separate these workers physically. On a "need-to-know" basis and with the compliance officer's knowledge, employees from the public areas may occasionally be brought "over the wall" and given sensitive information.

Also, regulation 3B was inserted by this amendment.

Requirements of regulation 3B:[vi]

1) that someone other than an officer or employee of the company that owns UPSI made the decision on its behalf to enter into the transaction or arrangement and
2) that the company has put in place systems and practices that clearly define its business operations so that the person who transacts in securities on the company's behalf cannot obtain information (including UPSI) that is in another officer or employee's possession; and
3) Arrangements were in place at the time that might be expected to prevent the information from reaching the person or persons who make decisions, and to no advice with respect to the transactions or agreement was given to that person or any of those persons by that officer or employee; and
4) Factually, neither the information nor such advice was so conveyed.

The Insider Trading Regulations lay down the Chinese Walls defence in following words:

"(a) the individuals who were in possession of such unpublished price sensitive information were different from the individuals taking trading decisions and such decision-making individuals were not in possession of such unpublished price sensitive information when they took the decision to trade; and

(b) appropriate and adequate arrangements were in place to ensure that these regulations are not violated and no unpublished price sensitive information was communicated by the individuals possessing the information to the individuals taking trading decisions, and there is no evidence of such arrangements having been breached."

Regulation 3B is now in the form of clause(v) to sub-clause (1) of regulation 4 in the SEBI(Prohibition of Insider Trading Regulations), 2015[vii](hereinafter called as the Insider Trading Regulations, 2015).

Meaning of "Appropriate and Adequate Arrangements"

There is no clear definition in India as to what is "appropriate and adequate arrangements"

There are no standards specified by SEBI.

Since the Indian jurisprudence on Insider Trading is inadequate in defining this phrase, recourse must be given to other jurisdictions.

There is a similarity between Indian Insider Trading Regulations and section 1043F of the Australian Corporations Act, 2001[viii]. This act outlines the federal and interstate legislation that governs business enterprises in the Commonwealth of Australia. Although it also engages with other entities, such as partnerships and managed investment schemes, businesses make up most of its clients. With all Australian states having approved the Act, it serves as the primary foundation for Australian corporation law.

Section 1043F constitutes an exception to section 1043A of the Corporations Act if:

(i) "The decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee and

(ii) (ii) it had in operation at that time an arrangement that could reasonably be expected" to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and

(iii) the information was not so communicated, and no such advice was so given."

In *Australian Securities Investments Commission v. Citigroup Global Markets Australia Pty. Ltd.,*[ix]

In this case**,** Citigroup Global Markets Australia Pty Ltd conducted business through various business divisions. One of the issues, in this case, was whether the procedures set in place needed to be revised.

Among other things, the Corporations Act provides (at s 912A(1)(aa)) that an AFS licensee must 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business. This is one of the statutory provisions on which ASIC's civil proceedings against Citigroup were based.

The judge relied on the UK Law Commission's Consultation Report No. 124("Report") to lay down five criteria to determine the adequateness of the procedures, which are as follows:

"(i) the physical separation of departments to insulate them from each other;

(ii) an educational programme, commonly recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information;

(iii) strict and carefully defined procedures for dealing with situations where it is thought the wall should be crossed and the maintaining of proper records where this occurs;

(iv) monitoring by compliance officers of the effectiveness of the Chinese wall; and

(v) disciplinary sanctions where there has been a breach of the wall."

The judge also gave words of caution that "*Adequate arrangements require more than a raft of written policies and procedures. They require a thorough understanding of the procedures by all employees and a willingness and ability to apply them to a host of possible conflicts."*

Based on these criteria, Citigroup's arrangements were adequate for establishing the defence of Chinese walls.

Prince Jefri Bolkiah v. KPM:[x]

The facts of this case related to that of KPMG functions as that of legal counsel of Prince Jefry as well as the advisor to Brunei Government's investigation which was against Prince Jefry in relation to the whereabouts of his assets which were alleged to be utilised by him for his own benefits.

In this case the judge held that if consent has not been given by the party to act in adverse to its interests, then the efficiency of the Chinese walls will be determined based on the following characteristics:

"(i) the physical separation of the various departments in order to insulate them from each other - this often extends to such matters of detail as dining arrangements; (ii) an educational programme, normally recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information; (iii) strict and carefully defined procedures for dealing with a situation where it is felt that the wall should be crossed and the maintaining of proper records where this occurs; (iv) monitoring by compliance officers of the effectiveness of the wall; and (v) disciplinary sanctions where there has been a breach of the wall."

In this case, even though the Chinese walls were constructed on an ad hoc basis within a single department since the procedures in place were so stringent that there was an information barrier created between the departments, the Court upheld these arrangements as sufficient.

Issues with Chinese Walls in Indian Insider Trading Law

Appropriate and adequate arrangement

In India, the law talks about "appropriate and adequate arrangement" under Regulation 4(i)(v) , but what is appropriate and adequate is not defined clearly by SEBI under these regulations. It is yet to be known what the yardstick is for measuring adequateness and appropriateness.

Thus, there is a need to resort to other criteria as well, like the established industry procedures for Chinese walls, cases, and other related statutes.

However, while looking at other regulations, it is to be kept in mind that the standards required for the Chinese walls in insider trading would be higher than those required by other SEBI regulations.

There can be recourse to the ASIC case.[xi] as seen above; however, the standards laid down in these cases can only be considered partial. Also, these standards are very general, and SEBI needs to go into the merits of each case to decide the "appropriateness and adequateness".

In *Re: v. Prateek Sarawgi*[xii]

The matter was related to an investigation carried out by SEBI in relation to the circulation of Unpublished Price Sensitive Information(UPSI). The notice was served with a show cause notice with regard to the same. The notice was working as an associate manager of company finance and was a "designated person" under Insider Trading Regulations from January 1 to January 15, 2017. The Noticee was a member of a team that created a powerpoint presentation (hence referred to as "PPT") on the financial results for the quarter that ended in December 2016 for the board of directors and audit committee.

One of the arguments that the notice raised was that proviso(v) of regulation 4(1) of the Insider Trading Regulations, 2015 provides a defence if it shows that individuals who were in possession of UPSI were different from the individuals taking trade decisions. He claimed that even though he was the one possessing UPSI, his father was the one who made the business decisions.

However, SEBI rejected this argument by relying on the text of the regulation, which talks about a "non-individual insider". SEBI also relied on the report of the high-level committee to

review the SEBI (Prohibition of **Insider Trading**) Regulations, 1992, formed under the chairmanship of former Chief Justice N.K Sodhi, which said:

This provision is intended to enable business organisations or groups of entities that trade in securities to put in place arrangements to comply with these regulations, such as **Chinese Walls** and segregation of roles to ensure that unpublished price-sensitive information is cordoned off and other arms of the same organisation do not get access to the same. Therefore, if the organisation or group adheres to these safeguards, they would not violate the prohibition in sub-regulation (1).” (emphasis supplied).

SEBI concluded that this defence is only available to organisations and not to individuals.

Kinds of Arrangement

In the Insider Trading Regulations, 2015, it needs to be clarified as to what constitutes arrangements. Are they physical separation arrangements or virtual separation arrangements, ad-hoc or established arrangements?

Since there is no clear answer in India, recourse must be had to foreign judgements.

In the *ASIC case*[xiii], the arrangements were established, while in Prince Jefri's case, the arrangements were prospective to be put in.

Halewood International Case[xiv], there was an emphasis on the need for a “physical separation” while in *Koch Shipping Case*[xv]

, the emphasis was on the “virtual separation”.

" information was communicated by the individuals possessing the information to the individuals taking trading decisions."

This phrase also needs to clearly state what kind of communication we are talking about here.

Is it a passive communication or an active communication? For instance, A company has established Chinese walls. A member X of the organisation visits a separate branch and looks at the papers kept on the table of another member Y in their short absence, which is a UPSI or looks at the member's computer, and the tab is opened. Will it be considered communication

of UPSI by member Y? Can Y's negligence be considered communication? These legal issues can arise in the absence of certainty as to the meaning of information communicated.

This points to how even after having established Chinese walls, the UPSI may be leaked, and thus, it highlights the porous nature of the Chinese walls.

In *ASIC Case*[xvi]

The Court acknowledged that the communications that took place between the Investment Banking Division executives and the proprietary trader's manager did "reveal the potential fragility of Chinese Walls" when determining whether any inside information was communicated or "advice given with regard to the transaction." 79 The manager of the proprietary trader was "astute to ensure that confidential information should remain quarantined, "80 but the Court did note that, due to the pressured nature of the investment banking environment, such a result might not always prevail. These discussions, however, did not amount to the communication of any inside information or advice because of their ambiguous nature.

In *Asia Pacific Communications Limited v Optus Networks Pty Limited*[xvii], Bergin J stated that 'there will always be an element of some risk of disclosure where its prevention depends upon human contact because people make mistakes'.

Recommendations

The biggest drawback of the Chinese Wall defence as a possible defence to an accusation of insider trading against a firm is the need for more assurance. As the only genuine advice is included in very generic court remarks complemented by regulatory guidelines and market practice principles, there needs to be more clarity on the prerequisites for an adequate Chinese Wall. As a result, it is unclear if insider trading truly takes place and whether firms are subject to insider trading liability. The application of the many general law and statute methods that can be used to ascertain whether a corporation participates in specific behaviour has information and has pertinent knowledge adds to this confusion.

As has been seen in the above case in India, Chinese walls defence is not available to individuals possessing UPSI; it is only available to non-individuals under the Insider Trading Regulations in India.

There is a need for legislative reforms; SEBI should release some guidelines laying down the meaning of what is "adequate and appropriate", what the meaning of arrangements is, etc. This will grant certainty to the Chinese wall's defence and overcome the limitations and uncertainty in this application.

It should be made clear when an individual possesses UPSI and when information was communicated by the individuals possessing the information. Was it a passive communication or an active communication? The threshold should be made clear as to what are the minimum standards that SEBI has to look into to determine whether information was communicated.

The perspective points that SEBI can include in its guidelines on Chinese walls can be as follows:

1. Physical Separation:

If possible, departments or teams working on conflicting issues should be housed in distinct buildings; if not, they should work in different parts of the office building. When required, internal talks on issues should not take place in common office space, visitors should always be escorted, and client meetings should only be done in client conference rooms. Chinese Box rooms should be set up with access restricted to particular deal team members in order to support the latter argument. When it comes to physically separating information, separate, monitored, private information storage systems and facilities should be set up, which may also entail locking up sensitive data.

2. Formal Code of Ethics:

Physical separation can be supported by a formal code of ethics, which each employee is expected to read, comprehend, and formally pledge to abide by. Only when the official written code of ethics is further presented as an "Educational Program" that gets to the heart of a company's corporate culture can an employee truly grasp and become immersed in this respect and in response, the SEC stated that no educational programme should be static or permanent. To reflect the changing business "good practise" and the changing marketplace, it should be

revised often. It is suggested that a business employ a Compliance Officer to provide an adequate "Educational Programme" given the technical expertise needed.

3. Review and Evaluation of Chinese Walls:

Regular review and evaluation of Chinese walls are essential to assess their adequacy and effectiveness in preventing unauthorized disclosure of sensitive information. This process involves scrutinizing the existing mechanisms, procedures, and protocols in place to identify any weaknesses or gaps that may compromise the integrity of the Chinese walls. By conducting periodic reviews, organizations can proactively address emerging risks and adapt their Chinese wall strategies to evolving regulatory requirements and market dynamics. Additionally, thorough evaluations enable organizations to fine-tune their internal controls and ensure that Chinese walls remain robust and resilient.

4. Disciplinary Sanctions:

Internally enforcing disciplinary sanctions for breaches of Chinese walls is paramount to uphold the integrity of these barriers and deter misconduct. Establishing clear and stringent disciplinary measures sends a strong message across the organization about the seriousness of maintaining confidentiality and complying with insider trading regulations. Such sanctions may include reprimands, suspensions, or even termination of employment, depending on the severity of the breach. By holding individuals accountable for violations of Chinese walls, organizations demonstrate their commitment to ethical conduct and strengthen the overall culture of compliance within the company.

5. Documentation and Periodical Audit:

Comprehensive documentation of Chinese wall mechanisms and regular audits is vital in providing evidentiary support and demonstrating compliance with insider trading regulations. Organizations should maintain detailed records of all Chinese wall-related policies, procedures, communications, and training sessions. These documents serve as tangible evidence of the organization's commitment to preventing unauthorized disclosures of sensitive information. Additionally, conducting periodic audits of Chinese walls ensures that employees effectively implement and adhere to the measures. Audits also help identify any deficiencies or areas for improvement, allowing organizations to take corrective action promptly. By maintaining robust

documentation and conducting regular audits, organizations can strengthen the evidentiary value of their Chinese walls defence and effectively rebut allegations of insider trading.

Conclusion

The conclusion drawn from the analysis underscores the critical role of Chinese walls in mitigating conflicts of interest within corporations and institutions. Despite their widespread use globally, the jurisprudence surrounding Chinese wall defence in India remains limited. Corporations in the country have yet to harness the potential of Chinese walls fully, and the existing defence framework suffers from foundational weaknesses within the Insider Trading Regulations.

The ambiguity surrounding key terms and phrases within the regulations introduces significant subjectivity for regulators and corporations alike. This ambiguity not only hampers effective compliance but also creates uncertainty regarding the standards required for an adequate defence of Chinese walls. As a result, there needs to be more in the development of optimal arrangements for implementing Chinese walls in India.

In today's modern and technology-driven business landscape, the imperative for robust procedures to combat insider trading and promote sound corporate governance practices is more pronounced than ever. Therefore, it is imperative to address the current regulatory framework's deficiencies to provide corporations clarity and certainty regarding the requirements for effective Chinese walls defence.

Efforts should be directed towards refining the Insider Trading Regulations to establish clear guidelines and standards for establishing and maintaining Chinese walls. By enhancing regulatory certainty and promoting uniformity in compliance practices, such reforms can bolster the defence against allegations of insider trading but also foster a culture of transparency and accountability within corporations. Ultimately, the development of robust Chinese wall mechanisms is essential for upholding market integrity and investor confidence in India's securities markets.

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