IV. SHINING A LIGHT ON SHADOW TRADING: UNDERSTANDING ITS IMPLICATIONS WITHIN INDIA'S INSIDER TRADING REGULATIONS

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ABSTRACT

Shadow trading encapsulates a theory of insider trading. It finds its roots in the misappropriation theory propounded by the United States. Based on the idea that secret information from one company may also be relevant for other economically linked companies, shadow trading aims to convict those insiders who may profit from trading in the scrip of such economically linked companies. Regulatory scrutiny has been avoided for these kinds of market transactions up until August 2021 when the Securities Exchange Commission of the United States targeted one Mathew Panuwat based on a complaint of shadow trading. This paper aims to analyze this case and then explore the viability of this theory in the context of Indian law. Further, this paper attempts to examine under what pigeonhole will this theory fit in the existent insider trading laws of the country. Lastly, the authors will recommend policy changes to ensure that the integrity of the securities market in India is balanced against its development and increased participation.

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I. SHADOW TRADING – SETTING THE TONE

Insider trading is when an insider, having access to price-sensitive confidential information, illegally trades in securities listed on the organized securities market.[1] While Indian securities regulations employ a robust disclosure regime that necessitates listed companies to disclose certain information to ensure informed trading by investors, it also effectively allows companies to withhold disclosure of premature information to protect corporate interests. As a corollary to this, share prices in markets are only decided using publicly available information.[2]

For the same reason, insiders are prohibited from trading in securities based on non-public information. If allowed, such trading will be in contravention of two fundamental objectives endorsed by the International Organisation of Securities Commissions ("**IOSCO**")[3] – investor protection and maintenance of fairness, efficiency, and transparency in the securities markets. Adherence to these principles is crucial since the Indian securities market regulator sits on the IOSCO Board, which is responsible for overseeing and setting standards for the organization.[4] In fact, it even goes against the

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[1] CS Bhuwneshwar Mishra, *Law relating to Insider Trading – A comprehensive commentary on SEBI (Prohibition of Insider Trading) Regulations 2015* (Taxmann 2015).
[2] Armaan Patkar, *Insider Trading Law and Practice* (Eastern Book Company 2019).
[3]Objectives and Principles of Securities Regulations, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> accessed 21 September 2022.
[4] IOSCO Board, <https://www.iosco.org/about/?subsection=display_committee&cmtid=11> accessed 05 April 2022.

foremost objective of the Securities and Exchange Board of India Act, 1992[5] *i.e.,* the protection of investors' interest in the securities market. Not only that, but such acts can also undermine public confidence in the securities market.

On the contrary, some economists argue that Insider Trading ought to be encouraged rather than outlawed it. One such thinker is the famed economist and Nobel Laureate, Milton Friedman, who advocated insider trading in a 2003 interview with CNBC. In his interview, he stated "*here you have got a company like Enron which is doing fraudulent things. People on the inside know about it. One of the best ways to bring it out is to make it profitable. A whistle-blower takes a chance, does not gain anything by it, but a person on the inside who knows things are going wrong, can make money on it and at the same time serve the market purpose of driving down the price of the stock and that alerts other people*".[6]

While the jurisprudence on Insider Trading is prospering exponentially, it is the offence of Shadow Trading that has recently attracted the attention of securities market regulators worldwide. The offence of shadow trading is nothing but an extension of insider trading. In 2021, the phenomenon was dubbed "shadow trading" by Mihir Mehta, David Reeb, and Wanli Zhao in their work titled "Shadow Trading".[7] To contextualize the same, the concept of shadow trading is straightforward: a piece of information held by the insider about a company may also hold some relevance for the economically-linked company and accordingly can be exploited by him to make profits. Put simply,

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[5] Preamble, Securities and Exchange Board of India Act, 1992 (Act 15 of 1992) preamble ("SEBI Act 1992").

[6] Pratap Ravindran, 'Using Insider-Trading as a Weapon' (*The Hindu Business Line*, 17 September 2003) <http://www.thehindubusinessline.com/2003./09/17/stories/2003091701330900.htm> accessed 07 September 2022.

[7] Mihir Mehta, David Reeb and Wanli Zhao, 'Shadow Trading' (2021) Account. Rev. 23, 27.

confidential information emerging from the “source company” may be price-relevant for the “linked company” as well. This paper is divided into seven chapters, with each chapter analyzing different aspects of shadow trading. The paper begins by introducing the concept of shadow trading and discussing its potential impact on market integrity. It then analyzes the case of *SEC v. Mathew Panuwat* and its implications for future shadow trading cases. The paper then delves into Indian jurisprudence and examines how it applies to shadow trading. The extension of the shadow trading doctrine in India and its incorporation into existing laws and regulations are discussed in Chapter 4. The challenges to the shadow trading regime are explored in Chapter 5, and Chapter 6 proposes policy recommendations to strengthen market integrity while promoting its growth and development. The paper concludes by summarizing its key findings and proposing pragmatic solutions to the issue of shadow trading.

II. SEC SHINES A LIGHT ON SHADOW TRADING: *SEC V. PANUWAT*

In January 2022, the United States District Court for the Northern District of California, rejected a motion to dismiss filed by Matthew Panuwat against a compliant brought by the Securities and Exchange Commission (“**SEC**”).[8] What is interesting to note here is that the enforcement action was brought under the regime of ‘shadow trading’, a novel doctrine that seeks to punish the use of insider knowledge for the trading of securities of a peer company.

[8] *Complaint filed by SEC* <https://www.sec.gov/litigation/complaints/2021/comp-pr2021-155.pdf> accessed 28 September 2022.

A. Mathew Panuwat's lucrative windfall in the oncology-focused biopharmaceutical companies

Matthew Panuwat held the designation of Senior Director at a company named 'Medivation', a mid-sized oncology-focused biopharmaceutical company. Incyte was another competitor in the same highly concentrated market of oncology-focused biopharmaceutical companies. Both the companies, being value and mid-cap companies had become a target of acquisition by large-cap biopharma companies. Using his previous knowledge, Panuwat realised that back in 2015, another large-cap company had acquired one of their competitors which resulted in a substantial increase in the stock prices of both the competitors – Medivation and Incyte.

Panuwat, by getting access to asymmetrical information via a confidential e-mail, came to know that Medivation would be acquired by a large-cap pharmaceutical company, Pfizer. As soon as he received this information, Panuwat purchased Incyte's securities even though the prices were way above Incyte's stock price at the time. As soon as the acquisition announcement became public, Medivation and Incyte's stock price rose substantially. His action allegedly resulted in profits of $107,066.[9]

B. Sneak Peek at the substantive contentions in Panuwat's Case

The case involved two key questions (a) whether the knowledge of the acquisition can be 'material' to Incyte in order to constitute a violation of insider trading laws? (b) whether Panuwat owed a duty to Medivation to not use its confidential information to trade in the securities of another company?

[9] ibid.

The SEC argued that Panuwat had engaged in shadow trading, which falls under the misappropriation theory of insider trading. Specifically, the SEC alleged that Panuwat knowingly misappropriated Incyte's securities, recognizing that the confidential information was material to both Incyte and Medivation due to the highly concentrated market and potential for acquisition. Further, he also breached the duty that he owed to Medivation. On the other hand, Panuwat filed for the motion to dismiss on the grounds that the SEC's shadow trading theory constitutes an unnecessary attempt to improperly expand the umbrella of the existing violations of securities law. Any conviction based upon the theory would be unlawful as there is no explicit policy prohibiting such conduct.

The matter is currently sub-judice.

C. The ripple effects and future implications of Panuwat's case

Usually, any claim under insider trading typically involves a person who uses 'insider information' by virtue of his position in relation to a corporation, to trade in the securities of the same corporation or its associated companies. This is based on the 'classical theory of insider trading.'[10] However, Panuwat did not commit any such violation. In fact, his action was based on the misappropriation theory of insider trading –

"*a corporate outsider trades in breach of duty of trust or confidentiality that they owed to the source of their information*."[11]

Essentially, if Panuwat had traded in the securities of the large-cap

[10] Randall Quinn, 'The Misappropriation Theory of Insider Trading in the Supreme Court: A (brief) response to the (many) critics of United States vs. O' Hagan' (2003) Fordham J. Corp. & Fin. L., 8, 865.
[11] *United States v O' Hagan* [1997] 521 U.S. 642.

biopharma company that was to acquire Medivation, a strong case could have been made out by the SEC against him under the existing jurisprudence. However, because there is no direct financial relationship between Incyte and the source of knowledge, the duty owed cannot be proven.

However, one can argue that the fiduciary duty which was owed to Medivation is not confined only to the corporation itself but also extends to the misappropriation of "material non-public information used to trade in the securities of the employer company, or the acquirer company, but also a similarly situated company, as long as it can be proven that the information was material to the third company as well." [12]

This linking becomes more relevant when the market is highly concentrated, with only a few key players sharing the same kind of characteristics. Usually, there are a limited number of mid-caps, oncology-focused biopharmaceutical companies, and it becomes fairly obvious that the acquisition of one of these corporations would automatically make the other attractive in the market, thus leading to an increase in its stock price. One cannot turn its head away from the fact that the information in question is material to Incyte as it can be used by any reasonable investor to make an informed decision about buying or selling Incyte's stock.

In the current jurisprudence, there appear to be no other cases where an insider has been held liable for insider trading by using material information regarding his own company to make a trade of another company having a

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[12] Mihir Desmukh, 'Shadow Trading – An Indian Perspective' (*IndiaCorpLaw*, 22 January 2022) <https://indiacorplaw.in/2022/01/shadow-trading-an-indian-perspective.html> accessed 07 September 2022.

[12] *Complaint filed by SEC* <https://www.sec.gov/litigation/complaints/2021/comp-pr2021-155.pdf> accessed 17 September 2022.

connection to his own company. However, one cannot undermine its potential implications on future convictions based on shadow trading. In fact, market participants should deliberate on reviewing and determining their future actions following the enforcement of this new area of insider trading.

III. TRACING THE INDIAN JURISPRUDENCE

In India, the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PIT Regulations**") governs the violations of insider trading obligations in the market. The PIT Regulations prohibits "an insider i.e., a person who is in possession of or has access to Unpublished Price Sensitive Information ("**UPSI**") from trading in securities on a stock exchange when in possession of UPSI."[13] UPSI has been defined to mean *"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 price of the securities*."[14]

The definition of UPSI has a wide ambit that aims to include within itself, all information that is related to the company. This also, interestingly, includes direct and indirect information that has the potential to materially affect the price of the securities. This view has been endorsed by the Securities and Exchange Board of India ("**SEBI**") several times. It has liberally taken the view that because of an existing financial relationship between subsidiaries and/or group companies, any information that is relayed between them can hold the power to be price sensitive. This threshold is subjected to the test of its likelihood of having a material effect on the price of the securities even if

[13] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, reg 4 ("SEBI Regulations 2015").
[14] SEBI Regulations 2015 reg 2 (1) (n).

it indirectly relates to the company.

This is elucidated in In Re: Insider Trading in the Scrip of 63 Moons Technologies Limited,[15] where SEBI affirmed that UPSI is information that not only pertains to the company in question but also to a group company. The information in question was regarding a regulatory notice to the National Spot Exchange Limited ("**NSEL**"), a subsidiary of Financial Technologies (India) Limited ("**FTIL**").

It was argued that such UPSI was not material enough to sustain a charge of insider trading from a trade in the shares of FTIL. SEBI clarified that any kind of such information shall be subjected to the test of the likelihood of material effect on the price of the securities, even though it is not directly related to the company itself. The reasoning behind the same is that in spite of an indirect relationship, because of them being subsidiary-holding companies, any adverse impact on one will cause a similar impact on the other.

In fact, even in the matter of In Re: Insider Trading in the Scrip of Multi Commodity Exchange of India Limited,[16] SEBI clearly held that UPSI regarding a regulatory notice to NSEL can have an adverse impact on the trade of securities of the Multi Commodity Exchange of India Limited ("**MCX**"), another subsidiary of FTIL. SEBI stated that:

"MCX and NSEL were companies under the same holding company i.e. FTIL. Any adverse impact on the business and operations of NSEL was likely to have a contagion, cascading, and materially adverse impact directly

[15] *In Re: Insider Trading in the Scrip of 63 Moons Technologies Limited,* WTM/MPB/EFD/129/2018.
[16] *In Re: Insider Trading in the Scrip of Multi Commodity Exchange of India Limited,* WTM/MPB/EFD/116/2018.

on the holding company (FTIL) and indirectly on the associate company (MCX).”[17]

It could further be argued that business decisions by, or events in respect of, a customer, supplier, or competitor of a company indirectly relate to such company and may have an effect on the price of the company's securities given the broad definition of UPSI under the Indian Insider Trading Regulations. Such commercial relationships and their effect on the price of a firm's securities have not yet been tested in the Indian context; instead, the Indian case law that has been developed so far has only dealt with circumstances where the pertinent information concerned a subsidiary or a group company.

In light of this, the Panuwat case serves as a timely reminder that a clear-cut definition of the scope of Indian insider trading regulations is still lacking, particularly with regard to the situations in which trading in securities of one company while in possession of information about another company may be regarded as a violation. According to the authors, the facts of a given instance could support an accusation of insider trading with the help of such information. In the meanwhile, Indian listed companies and other stakeholders and participants in the Indian securities market would be well served in tracking this development and taking it into consideration in documenting their insider trading policies.

A. Scienter (Intention)

In the USA, scienter refers to “a mental state embracing intent to deceive, manipulate, or defraud” which forms the very foundation of insider

[17] Ibid para 21.

trading conviction.[18] In India, as per the recent interpretation given to the PIT Regulations, an insider's attempt to encash the benefit of the information is indispensable which is not exactly the same as mens rea.[19] Therefore, if a similar situation had arisen in India wherein the case was to be decided by SEBI, it would have been imperative for SEBI to prove Panuwat's profit motive. SEBI would have had to test whether the act of Panuwat was an attempt to take advantage of or encash the benefit of the information in his possession.[20]

In the USA, the prosecution needs to prove that the perpetrator acted with intent to deceive or to cause actual harm.[21] However, when the 'necessary result' of the actor's scheme is to injure others, fraudulent intent may be inferred from the scheme itself.[22] The Court, in the present case, noted uncertainty within the Ninth Circuit as to whether the scienter requires proving that the defendant used the material information to make the trade or if it is enough that the defendant that knowledge of such material information. The Court preferred the latter explanation that the defendant can merely be aware of the information. It was easier to prove nonetheless, since Panuwat traded Incyte's securities within a minute of learning the information, despite not having traded such securities before. These facts are thus sufficient to show *Panuwat's* mental intention—the fact that he acted knowingly or recklessly.

IV. EXTENSION OF INSIDER TRADING REGULATIONS TO SHADOW TRADING

[18] *Ernst & Ernst v Hochfelder* 425 U.S. 185, 194 n. 12 (1976).
[19] *Securities and Exchange Board of India v Abhijit Rajan* 2022 SCC OnLine SC 1241, para 42.
[20] ibid.
[21] *United States v Stavroulakis* 952 F.2d 686, 694 (2d Cir. 1992).
[22] *United States v D'Amato* 39 F.3d 1249, 1257 (2d Cir. 1994).

A. Whether SEBI (PIT) Regulations contemplate for Shadow Trading in India*?*

The fate of the first shadow trading case is still up in the air since the case is still pending final adjudication. While the matter is still sub judice in the United States, the current situation begs an important question in the Indian context i.e. "What is the applicability of shadow trading doctrine in India?". A corollary to this question would be – "whether SEBI (like SEC in the panuwat's case), under the extant legal framework, may be able to successfully bring similar claims in India?"

To assess the shadow trading doctrine's applicability in India, a complete understanding of the country's insider trading laws *i.e.* SEBI Prohibition of Insider Trading Regulations, 2015 is of vital importance. At the outset, while the PIT regulations define the word "Insider" and "Trading" under Sections (2)(1)(g) and 2(1)(l) respectively, it does not define insider trading.[23] The term "Insider Trading" finds a reference in a report submitted by a high-level committee constituted under the chairmanship of former chief justice N.K. Sodhi.[24]

The report defined insider trading as *"trading in securities with the advantage of having asymmetrical access to UPSI."*[25] Various jurisdictions have adopted different nomenclatures; however, it was noted in the N.K. Sodhi report that there is no difference[26] between the universally used word "material non-public information" and "unpublished price sensitive information"

[23] SEBI regulations 2015, reg 2(1)(g) and reg (2)(1)(l).
[24] Report of the high-level committee to review the SEBI (PIT) Regulations, 1992.
[25] ibid 5.
[26] ibid 24.

adopted by the SEBI Act in India.[27]

B. Examining *SEC v. Panuwat* from the lens of SEBI (PIT) regulations

The best approach to determine the applicability of shadow trading in India is to check if *SEC v. Panuwat* can happen in India. In this regard, at first blush, the definition of "UPSI" under Section 2(1)(n)[28] would reveal two things. First, the information must directly or indirectly "relate" to a company or its securities. Second, upon becoming generally available, the information should be "likely" to materially affect the price of the securities.[29] Now, the first hurdle might be that the information on acquisition did not really concern Incyte, but this could be regarded as an indirect relationship. This is because, according to the facts of Panuwat's case, just a few prospects remained in 2016, notably Medivation and Incyte, for large-cap companies willing to purchase mid-caps. This made it a highly concentrated market and thus each purchase was extremely crucial for the remaining possible targets since it increased their appeal.

Consequently, upon the information becoming publicly known, the price of securities should be likely to change. Each purchase, as previously noted, had a major influence on the other targets and raised their stock values. In fact, this is evidenced by a comparable announcement of the purchase of a different firm made in 2015 which significantly raised the stock prices of both Medivation and Incyte.[30]

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[27] SEBI Regulations 2015, reg 2(1)(n).
[28] SEBI Regulations 2015, reg 2(1)(n).
[29] cf Desmukh (n 12).
[30] *Complaint filed by SEC* <https://www.sec.gov/litigation/complaints/2021/comp-pr2021-155.pdf> accessed 17 September 2022.

C. All-embracing definition of Insider under PIT Regulations

With this backdrop, if it is answered in the affirmative that the information was UPSI for Incyte's scrips, the following question would be – whether Panuwat qualifies as an Insider for Incyte under Indian law?

As per the definition of "Insider" under Regulation 2(1)(g),[31] it is not a sine qua non for an insider to be a connected person. In fact, even mere possession of or access to UPSI will be sufficient to attract the definition of Insider. Therefore, in India, Panuwat can be readily regarded as an insider under rule 2(1)(g)(ii) since he had access to this information. As is obvious from the above paragraph, the definition of Insider is wider in India than in the USA since "mere possession" is sufficient to trigger the threshold. It does not require the intention of the parties to commit the contravention. However, historically, that has not been the case always. In fact, until such a motive was proved, a trade would not amount to a contravention of the 1992 regulations[32] (as originally enacted) and consequently would not trigger liability under the SEBI Act.

This only changed in 2002, when the SEBI amended the 1992 regulations to adopt the "possession" standard. Then onwards, mere possession of UPSI at the time of trading would trigger the contravention of the SEBI Act.[33] Ostensibly, this continued under the 2015 PIT regulations which ex-facie neither requires proof of use nor any motive to commit insider trading.[34] That said, an insider may of course escape the clutches of this contravention by proving his innocence, including by applying the defences

[31] SEBI Regulations 2015, reg. 2 (1)(g).
[32] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 ("SEBI Regulations 1992").
[33] SEBI Act 1992.
[34] cf Patkar (n 2).

set out in Regulation 4.[35]

Therefore, based on the foregoing analysis, if SEBI chooses to adopt the SEC's practises, it may be successful in bringing comparable claims in India. In light of the foregoing, it can be said that the Indian regime contemplates the offence of shadow trading.

D. Can PFUTP regulations save shadow trading's bacon?

On the other hand, even if one were to argue that the extant framework for insider trading i.e., SEBI (Prohibition of Insider Trading) Regulations 2015[36] does not contemplate the inclusion of shadow trading doctrine, one other legislation might come to the rescue of this doctrine, i.e., the Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market 2003 ("**PFUTP**"). [37]

The aforementioned argument is solidified on a comparison of the offences of Front-running and Insider Trading. Front running is buying or selling securities ahead of a large order to benefit from the subsequent price move.[38] Although fundamentally distinct, front-running is similar to insider trading,[39] with the difference that the broker works for the client's brokerage rather than being an insider. However, despite noted similarities, front-running is prohibited under PFUTP regulations and not PIT Regulations since SEBI

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[35] SEBI Regulations 2015, reg 4.
[36] SEBI Regulations 2015.
[37] SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulation 2003 ("SEBI Regulation 2003").
[38] P Ramanatha Aiayr, *Major Law Lexicon* (4th edn, LexisNexis 2010).
[39] Khyati G, 'What is Front Running – A Q&A Piece in light of the SEBI Order against dealers of Reliance Securities Ltd' (*CAM Corporate Law Blog*, 10 September 2020) <https://corporate.cyrilamarchandblogs.com/2020/09/what-is-front-running-a-qa-piece-in-light-of-the-sebi-order-against-dealers-of-reliance-securities-ltd/> accessed 18 August 2022.

recognises[40] it as an undesirable manipulative practice punishable under regulation 4(2)(q) of PFUTP.[41]

Likewise, even shadow trading could come within the clutches of PFUTP regulations considering that the prohibition against deceptive practices is broad. In fact, the United States' handling of insider trading, which renders a person liable under both the "classical theory" and the "misappropriation theory," lends weight to this viewpoint.[42]

The classical theory of insider trading is where a corporate insider—i.e., an employee, director, or officer—commits securities fraud by trading in securities of their own company on the basis of MNPI. Whereas, the misappropriation theory goes a step further in extending liability to those who are not insiders at the company (outsiders) and forbids them from engaging in trading based on information which was obtained by them in breach of a duty owed to the source of the information.[43]

Therefore, if India decides to subscribe to the misappropriation theory of the USA i.e., consider such offences in violation of anti-fraud provisions, it may still be able to bring claims under PFUTP regulations. Without prejudice to the foregoing analysis, the nitty-gritty of the problem has to be worked out by the judiciary as and when such questions of interpretation surface in India. However, the possibility of shadow trading coming under the pigeonhole of

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[40] Securities & Exchange Board of India, *Consultative Paper dated 16 March, 1995* (reference no PR 34/95).
[41] SEBI Regulation 2003, reg 4.
[42] Troy Cichos, 'The Misappropriation Theory of Insider Trading: Its Past, Present, and Future' (1995) 18 Seattle Univ. Law Rev 390.
[43] Era Anagnosti, 'SEC Extends the Misappropriation Theory of Insider Trading Beyond Targets of Acquisitions to Companies "Economically Linked" to Such Targets' (*White & Case*, 02 October 2022) <https://www.whitecase.com/insight-alert/sec-extends-misappropriation-theory-insider-trading-beyond-targets-acquisitions> accessed 09 September 2022.

PFUTP regulations cannot be completely ruled out.

V. CHALLENGES OF A SHADOW TRADING REGIME

A. Is the expansion of the insider trading law desirable in India?

SEBI's orders in the context of insider trading have always followed the classical theory of insider trading. Meaning, the PIT Regulations define insider trading as trading in securities with the advantage of having asymmetrical access to UPSI.[44] This is unlike the USA where there needs to be first, an established fiduciary duty between the insider and the corporation. Thus, in India, it is easier to include a variety of instances under the provisions. The question then arises as to whether SEBI must tread on the sensitive path and follow the SEC which will enable SEBI to successfully bring claims of shadow trading in India. Is such a path desirable?

Insider trading laws exist to restrict trade in the market for people who have an unfair advantage. However, this inside information, because it cannot be used to trade in the securities of that company, forces the people to use it to the next best use, i.e., trade of securities in the peer stocks.[45] However, such an encouragement, in our opinion, still constitutes an unfair advantage. A shadow trader also has an edge over the other market participants by virtue of him being privy to information that is exclusively accessible to him.

Thus, SEBI is to examine the extent to which it can outlaw shadow trading: a complete restriction on shadow trading by virtue of the insider's

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[44] Securities & Exchange Board of India, *Report of the High-Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992* (2013).

[45] Prachi Deuskar, Aditi Khatri and Jayanthi Sunder, 'Insider Trading Restrictions and Informed Trading in Peer Stocks' [2022] <http://dx.doi.org/10.2139/ssrn.4210203> accessed 29 September 2022.

exploitation of UPSI or just to prevent the insider from making a sound investment decision based on his asymmetrical information. Although we agree with SEBI that a charge of insider trading is one of the most serious charges in the realm of securities law,[46] a balance needs to be meted out to ensure that the scope of such a charge is not so wide that becomes a tool for harassment of the market participants. A mere 8% rise in stocks of Incyte has caused Panuwat to lose his entire career.

This concern is especially in light of the context that the securities market in India is extremely undeveloped[47] with only a handful of participants who regularly have access to the market. With the preamble of the SEBI Act[48] ensuring that the market is developed while maintaining its integrity, SEBI needs to introduce policies that do not impede market access to the public. Additionally, bringing the stocks of competitor firms within the ambit of the insider trading policy of firms is a very difficult task.

First, Indian firms will have to "alter their insider trading policies." Stock Substitutes can be identified as: "a firm's competitors, suppliers, customers, or manufacturers of complementary products."[49] However, identifying a particular set of companies that serve as stock substitutes is neither possible nor is it desirable. On this count, shadow trading does seem to obstruct the integrity of the securities market in India, the authors

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[46] *Order against Shri Dilip S. Pendse, In The Matter Of Insider Trading In The Shares Of M/S Tata Finance Ltd*, SEBI (29 December 2006).

[47] GN Bajpai, 'Development of the Securities Market in India' in Jahangir Aziz, Steven Dunaway and Eswar Prasad (eds), *China and India: Learning from Each Other - Reforms and Policies for Sustained Growth* (International Monetary Fund 2006) <https://www.elibrary.imf.org/downloadpdf/book/9781589065192/ch004.pdf> accessed 29 September 2022.

[48] SEBI Act 1992, preamble.

[49] Ian Ayres and Joseph Bankman, *Substitutes for Insider Trading* [2001] <http://dx.doi.org/10.2139/ssrn.265408> accessed 29 September 2022.

are of the opinion it may not be desirable to introduce it in India.

B. Falling under the scope of 'trade analyst'

> Trade analysts are the drivers of market efficiency. It was the SEC itself who noted that: "the value to the entire market of analysts' efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by their initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.[50]

However, implementing the shadow trading theory by SEC will have a direct effect on the professional analysts who advise their clients to trade as well as traders who pose as analysts. Their careers will be at substantial risk. In the Panuwat case, the UPSI that he had access to was not used to trade in the stocks of Medivation or the company that was to acquire Medivation. In fact, he used it to trade in the securities of another peer company in a highly concentrated market. In this context, he acted as an analyst.

As a senior director of the corporation, he based his choices on his personal experience and knowledge. He gained expertise in the "biopharmaceutical industry" as a result of his experience, which he then used to his own advantage. He kept a close eye on the stock prices, pharmaceutical offerings, and product development plans of other biopharmaceutical firms, including Incyte. He was not a Medivation executive; instead, he worked as a trader.

C. Trading in a highly focused market

People who work in a certain industry frequently choose to invest in other businesses in that same industry. They regularly monitor and attempt to

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[50] *Dirks v SEC* [1983]463 U.S. 646, 658.

understand their sector. When investing in a business in a sector where the investor has prior experience, they should bear in mind the "invest in what you know" maxim. However, employees of such public companies may frequently be privy to proprietary information about their own industry. Additionally, when information regarding one firm in an industry becomes public, the stock values of other companies in the same industry are quickly impacted.

Similarly, investment professionals like advisers and analysts concentrate on specific industries. These specialists may learn important information about a certain business in an industry while they conduct their research, which may include speaking with company officials in interviews. A savvy investment professional won't trade a business's shares until the information is made public if such insider information about the company might be regarded as UPSI.

The investment expert, who concentrates on the industry as a whole, will nonetheless be aware of such information when forming overall industry opinions, giving advice to customers and others investing in related companies, and possibly even when making personal trades in related companies. Thus, information about a company will have a direct impact on the trading activities of a similar company, which in itself makes it difficult for regulators to create a boundary that will define what information becomes inside information.

D. Challenges with Compliances

As aforementioned, enforcement of shadow trading actions will result in companies needing to redefine and expand their insider trading policies and training programs. It will be difficult to convey this clearly and ensure that all staff grasps it. And for many businesses, accomplishing this may take years.

Employees who are trading in the interim but are uninformed of the new idea will be in danger.[51] Employee restrictions, whether they involve asymmetrical information or not, become problematic from a legal standpoint because the counsels cannot support them.

VI. POLICY RECOMMENDATIONS

All in all, the jurisprudence on shadow trading in India is almost non-existent, and the following points shall help address the issues raised in the previous sections as and when India decides to incorporate this doctrine in its jurisprudence.

A. Defining stock substitutes or economically linked companies

As mentioned earlier, shadow trading refers to the practice in which insiders use UPSI to facilitate trading in economically-linked entities to avoid insider trading laws.[52] A cursory look at the existing definition (given by academics) of this doctrine would reveal that the wording "economically linked entities" has ambiguity attached to it.

In the sense that it might be challenging to define what counts as an economically related firm stock and what does not. To contextualize, it cannot be said that all other companies will be off limits for investment to those with possible UPSI about the first company.[53] A line has to be drawn somewhere, which makes defining shadow trading all the more difficult task.

The issue that arises on the enforcement of the Panuwat claim is what

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[51] Stephen Crimmins, 'Shadow Trading Becomes Insider Trading' (*CLS Blue Sky Blog*, 28 March 2022) <https://clsbluesky.law.columbia.edu/2022/03/28/shadow-trading-becomes-insider-trading/#_ftn18> accessed 29 September 2022.
[52] cf Mehta, Reeb and Zhao (n 7) 27.
[53] cf Crimmins (n 52).

constitutes a 'relevant market' to bring claims for shadow trading. SEBI, in order to pursue claims under this doctrine also needs to define the scope and boundary of what constitutes a relevant market for the purposes of insider trading. Will it be different for large markets with a number of competitors? Or will it encompass the entire market in the case of a highly concentrated industry such as the biopharmaceutical one in the present case. There is no readily available jurisdiction for the present case in India.

Thus, if at all India decides to accord recognition to this doctrine, it will be imperative to have a definition of "economically linked entities" or "stock substitutes". While pinning down a workable solution to this knackering problem, a similar standard adopted by the Competition Act 2002[54] might come in handy. Under the Competition Act, while assessing the "abuse of dominance" offence, the relevant market as defined under Section 2(r)[55] is delineated by the regulator. It is categorized into two limited domains, namely relevant product market and relevant geographic market by the Competition Commission of India ("**CCI**"). To give a definite answer, one needs to look at the factors to be considered to determine what will be a relevant market.

As per section 19(6) of the Competition Act, the factors enlisted for the relevant geographic market for CCI's consideration are many[56] such as regulations that govern trade barriers, national policies, consumer preferences, linguistics, local requirements, etc. Similarly, as per section 19(7) of the Competition Act, the factors enlisted for the relevant product market for CCI's consideration are many such as the physical characteristics of the goods,

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[54] The Competition Act, 2002 (Act 12 of 2003) ("Competition Act 2002").
[55] Competition Act 2002, s 2(r)
[56] *M/s Saint Gobain Glass India Ltd. v M/s Gujrat Gas Company Limited,* CCI No. 20 of 2013.

special producers, classification of these products under law, etc.

The CCI, and consequently SEBI, needs to determine the relevant market in its sphere so as to define the boundary of what constitutes insider trading and whether in India, shadow trading can fall under the same domain. This will introduce a restraint and imposes costs so as to discourage traders with asymmetrical information to promote unfair competition in the market. However, the end result of the competition law us restrain unfair abuse of dominant position in the relevant market and damage the healthy competition in it.

In doing so, the impact on entities falling in the defined relevant market is assessed. If consumers consider two goods to be close substitutes, those two goods are considered to be in the same relevant market. Drawing parallels, a similar standard can be adopted by the securities regulator of India to determine the stock substitutes of a company while assessing the offence of shadow trading. This too can be based on the factors like – prices of stocks, characteristics of the products and services (provided by the company), consumer perception as to the interchangeability, etc.

B. Amendment to Regulation 2 of the PIT Regulations

Till now, the doctrine has been defined only in academic work and addressed in a handful of cases, some of which are still sub judice. However, the offence is yet to find its legislative recognition. This can be remedied by including a definition to this account in Regulation 2. While shadow trading is arguably an extension of insider trading, it might still be advantageous to define it separately in the regulations. Additionally, the authors also suggest that "Insider Trading" shall also be defined in the regulations since the extant

regulations define "insider" and "trading" separately under regulations 2(1)(g)[57] and 2(1)(l)[58] respectively.

VII. CONCLUDING REMARKS

With the advent of shadow trading in *SEC v. Panuwat*,[59] it is demonstrated that the boundaries of Insider trading regulations are not clearly drawn particularly with regard to the situations in which trading in securities of one company while in possession of information about another company may be regarded as a violation.

While this concept's expansion to information about subsidiaries or group companies was manifested by 63 Moons[60] and MCX Case,[61] it is unclear if and under what conditions this principle will also apply to information about any economically-linked companies. However, based on the foregoing analysis, the authors opine that the insider trading regime of India does, in fact, contemplate such an offence.

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[57] SEBI Regulations 2015, reg 2(1)(g).
[58] SEBI Regulations 2015, reg 2(1)(l).
[59] *Securities and Exchange Commission vs. Matthew Panuwat* - <https://www.sec.gov/litigation/litreleases/2021/lr25170.htm> accessed 16 September 2022.
[60] *In Re: Insider Trading in the Scrip of 63 Moons Technologies Limited,* WTM/MPB/EFD/129/2018.
[61] *In Re: Insider Trading in the Scrip of Multi Commodity Exchange of India Limited,* WTM/MPB/EFD/116/2018.