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THE BLIND SPOTS OF INDIAN CORPORATE LAW: SHADOW TRADING, FRONT, RUNNING, AND INFORMATIONAL ASYMMETRY

~ *Bhounika Sarang*

ABSTRACT

“Indian securities law structures its prohibition of trading abuses around a single conceptual trigger: unpublished price sensitive information relating to a listed company and its securities. That framework works tolerably well for the classic case of an insider trading in his own company’s shares.¹ It works poorly and, to the point, not at all for the insider who trades not in his own company’s securities, but those of an economically connected third party. This paper sets out to show why. That trading practice, known these days as shadow trading, poses problems to Indian law that cannot be explained away as a drafting oversight to be corrected by lengthening an enumerated list by one item. Rather, the trouble flows from the architecture of the prohibition itself. Indian law places trading abuses inside regulatory compartments defined by references to the securities traded on; it polices boundaries that shadow trading does not cross. But that is because it has identified the wrong boundary. The wrong in shadow trading is the disloyal use of an informational advantage acquired in corporate office. And that wrong is fiduciary. Read together with the market abuse regime, India’s statutory codification of the directors’ fiduciary duties at section 166 of the Companies Act 2013 already condemns the shadow trader. United States and United Kingdom law approach the same problem from the same place, through fiduciary duty. So going forward, rather than continually redrafting the list of prohibited information, Indian regulators would do better to expand slightly the category of securities thereby tainted. Fixing

¹ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 2(1)(n) (defining ‘s unpublished price sensitive information’s).

shadow trading requires not a longer list of banned information but a doctrinally modest expansion of fiduciary principle.”

INTRODUCTION

Shadow trading is the kind of trading you know is wrong as soon as you hear about it, but which the law has trouble capturing. Assume a senior executive at a pharmaceutical firm learns through the course of her work that the company will soon be acquired at a substantial premium. She knows better than to trade in her own company’s shares; that would be insider trading, plain and simple, and she is too clever to fall into that trap. Instead, she purchases shares in one of her company’s closest competitors, reasoning (correctly) that news of the acquisition in the sector will buy up the rival’s share price when the market revalue the industry as a whole.² She has used non, public corporate information to secure a certain profit at the market’s expense. But she has not, strictly speaking and on current Indian authority, committed insider trading. The PIT Regulations, 2015 prohibit trading in securities while in possession of unpublished price sensitive information relating to those securities or their issuer. Both variables have to line up. The information about her own employer was price sensitive, and it was unpublished, but she did not trade in her employer’s securities.

Analysed through the doctrinal filters Indian law has created for detecting market abuses, she’s barely broken the law at all. She has committed shadow trading, which lies in the eye’s blind spot formed by the intersection of those filters. That blind spot is not the product of drafting accident, it is the inevitable result of how the law was drafted. Current Indian law treats insider trading and front, running as two separate and mostly self, contained prohibitions. Insider trading is covered by the PIT Regulations 2015, which attach liability to the act of dealing while in possession of unpublished price sensitive information about those securities or its issuer. Front, running is covered separately by the PFUTP Regulations 2003 as an example of market manipulation. Neither approach is wrong (though each misses this particular case); both simply focus on policing a distinct informational boundary. Insider trading rules guard against the misuse of information specific to a listed issuer. Market, manipulation rules, like those that target front, running specifically, guard against the abuse of advance knowledge of market transactions yet to occur.

² Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 4

Shadow trading is none of these. It is the misuse of information about Issuer A to trade in Issuer B's securities, and it does not (necessarily) involve taking advantage of any client order. It falls through the cracks formed by two regulatory regimes built around lines it does not cross.³

The instinct will be to treat this paper's opening anecdote as the signal outlier that can be cured with minor definition, checking, broaden the definition of unpublished price sensitive information just enough to cover shadow trading, logic dictates, or extend the PIT Regulations 2015. List of securities to include those held by connected persons and the gaps closes. That solution is understandable but ultimately unconvincing, and deconstructing why illustrates the point better than any amount of abstract argument can. Insider trading, in Indian law as elsewhere, is misdescribed by reference to the price, sensitive nature of the information used. The officers conducts no different in kind from her statutory insider trading partner. Both betray a position of corporate trust for private gain, and both use information they learned only by virtue of that trust to make a securities trading profit. For the Indian regulations to reach her, the information simply happens to have also borne on the price of her own company's shares. Regulating securities rather than the breach that trading on inside information represents, and the regulations will always be one amended definition behind the conduct they seek to prohibit.

That brings us, however, to the suite of legal duties the market abuse regime tends to ignore at its peril. Indian company law includes, scrawled in big block letters across section 166 of the Companies Act 2013, a restatement of directors' fiduciary duties. That section commands every director to act in good faith in the manner a person connected with the affairs of a company ought to act in order to promote its objects and benefit its members; to exercise independent judgment; and avoid conflicts of interest. Most relevantly for present purposes, it expressly forbids a director from achieving or attempting to achieve an undue advantage for himself or any other person. Shadow trading strikes straight to the heart of that last clause. Reading section 166 alongside the market abuse regime exposes the shadow trader as seeking to achieve an undue advantage (a private trading profit) by misusing his position as a director (or senior officer). More than that, the argument developed over the following pages is that fiduciary duty as currently understood by

³ Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003.

Indian courts already prohibits the very conduct Indian securities law will not reach, and that the doctrinally sound approach is to build bridges between the two instead of continuously redrafting the definitions that belong to the latter alone.

There is method to the comparative madness. This paper is predominantly India, focused. References to American and British law are to jurisdictional lenses instead of legislative templates. Still, the United States misappropriation theory⁴ of insider trading liability, famously adopted in *United States Vs. O's Hagan*⁵, captures liability for trading on a confidence fraudulently breached and ties it not to any relationship with the company whose securities are traded, but to the undisclosed source of the information. If proven, shadow trading in India appears to violate a fiduciary duty very similar to that which O's Hagan would have owed his employer. Across the channel, the United Kingdom understands and defines insider dealing as an offence quite differently, in terms that may or may not stretch far enough to cover shadow trading. Both examples illustrate decisions Indian regulators can make but have, thus far, largely avoided through inattention: whether to conceptualise trading abuses in terms of the information used or the breach effected by using it. This paper holds Indian law accountable for drifting toward the former and makes the case for moving toward the latter.

THE ARCHITECTURE OF THE EXISTING REGIME

To understand why shadow trading escapes Indian regulation, one must first understand exactly how the two relevant regimes are built because this gap is produced by their internal architecture, not by any absence of enforcement will. The argument of this chapter is that each regime is built around a boundary line – the relevant security, in the case of insider trading; the order, in the case of front, running – and that shadow trading is the type of trading that respects both boundaries but that still captures the underlying wrongful conduct. Take insider trading first.⁶ The prohibition

⁴ Securities Exchange Act of 1934, 15 USC § 78j(b); Rule 10b-5, 17 CFR § 240.10b-5.

⁵ 521 US 642 (1997).

⁶ reg 2(1)(g) ('insider' means any person who is a connected person or in possession of or having access to unpublished price sensitive information).

hinges on three defined terms that link arm, in, arm, and the whole contraption turns on the first link in that chain. Unpublished price sensitive information's means information that relates to a company or its securities, is not generally available, and is likely to materially affect the price of those securities once it becomes generally available. Its synonyms include financial results, dividends, changes in capital structure, mergers and acquisitions, and so on. Two things about this definition do the heavy lifting. First, the information must relate to a company or its securities. Second, the materiality is the materiality of that information to that company's securities price. Call it issuer, specific. It contemplates a closed informational loop that runs from the information, to the company to which it relates, to the securities of that company.⁷ Next is the definition of an insider's, which includes any person who is a connected person⁸ or who otherwise comes into possession of or has access to unpublished price sensitive information. Finally, a connected person is anyone with a relationship to the company that would reasonably be expected to give that person access to unpublished price sensitive information: directors officers employees and various professional advisers and contactants. Each of these terms, save for one exception noted below, loops back to that same issuer. The prohibition that brings them together forbids an insider from trading in securities if at that time he possesses unpublished price sensitive information relating to those securities, subject to specified exceptions. All of which adds up to regulatory elegance. The entire architecture is built around a single issuer: the information must relate to a company; the insider must be connected to that company; and the trading must be trading in that company's securities. That elegance is also the trap. Every term that carries any weight in the insider, trading prohibition links back to a single issuer. The information must relate to a company; the insider must be connected to that company; and the prohibited trading must be trading in that company's securities. Shadow trading breaks that final link in the causal chain. When the executive trades in her competitor's shares, she is in possession of information that relates to her own employer, but not to the company whose shares she buys. That information may be price sensitive, but as a matter of regulatory definition it is not unpublished price sensitive information relating to the competitor's shares because the competitor is not the company to which that information relates⁹. Regulatory doctrine, in other words simply has no language to describe a remote issuer whose securities are

⁷ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 2(1)(n).

⁸ reg 2(1)(d) ('connected person').

⁹ reg 4(1) (prohibition on trading in securities when in possession of unpublished price sensitive information).

traded by an insider possessing information about a different, proximate issuer. The trade falls outside of the prohibition, not because of any exception or exemption but because the basic building blocks of the prohibition were never meant to stretch this far. One might object that the information still relates to the competitor in the real (economic) sense, since it will have an effect on the competitor's share price. But accepting that argument would upend the issuer, specificity of the regime's entire framework. It would, moreover, go too far, since on that reasoning almost any material corporate development – a product launch by Competitor Z, say – would relate to every other company in that industry. It would certainly reach shadow trading. But so too would almost everything else that happens in the market, which cannot be right. Point is that the regime as currently drafted simply cannot cover the scenario.

Which leaves open the question whether front, running law can. If we cannot use insider trading laws to target shadow trading, should we not be using front, running laws instead? After all, shadow trading is often described by securities regulators, including SEBI, as a form of anticipatory front, running. The prohibition on front, running exists in a separate regulation, the PFUTP Regulations, and targets fraudulent and unfair trade practices vis, à, vis securities markets. Classic front, running – namely broker who learns his client is about to place a market moving order and trades ahead of it for his own account, fits inside that definition as dealing in securities while in possession of information relating to a substantial impending transaction. The theory of the wrong is access to advance knowledge of order flow, and the person wronged is, in the first instance, the client whose order is being exploited.

The Supreme Court gave this regime a broad reading in *SEBI v Shri Kanaiyalal Baldevbhai Patel*¹⁰ by allowing a claim of front, running to be brought against a person who was not himself an intermediary, on the logic that this regime targets fraudulent and unfair trade practices against the market rather than fraudulent and unfair practices by the market's intermediaries.¹¹ The decision is important because it untethered the front, running prohibition from its original moorings in the broker, client relationship and reframed front, running as a species of market, wide fraud or deception. If front, running is concerned with frauds on the market, one might think that shadow

¹⁰ (2017) 15 SCC 1

¹¹ Securities and Exchange Board of India Act 1992, s 12A

trading would fit neatly inside that prohibition. It does not, however, and the reason reveals again why this gap exists.

Recall that front, running however expansively interpreted still depends on the existence of a known impending transaction or order whose execution will move the market, and upon the front, runner's advance knowledge of that specific transaction. Shadow trading has no such transaction at its core. When the executive trades in the competitors' shares, she is not anticipating any specific order; she is misusing information about sector, wide conditions. There is no impending transaction in those securities for her to front, run. True, the trading is anticipatory in the colloquial sense of the word: she knows about that order before it occurs. But it lacks the causal object (viz. the impending order) that the statutory prohibition was designed to reach.

Shadow trading falls outside the front, running prohibition for the same reason that it falls outside the insider, trading prohibition: each is built around a boundary line that the paradigmatic shadow trade does not cross. So why describe shadow trading as a loophole? A loophole implies a gap in a law whose purpose would be furthered by closing that gap. But insider trading on non, public information does not frustrate the purposes of the securities laws; it respects them too perfectly. That suggests not that the law should be revised to cover the gap but that the law might be built around the wrong landmarks.

THE SHADOW TRADE

The question motivating earlier part of the paper was whether shadow trading really escapes liability under the securities laws, extant as they are. The conclusion of that Part was that it does: neither the law on insider trading nor the law on front, running reaches shadow trades committed by insiders.

NEXT QUESTION: WHY SHOULD WE CARE?

One reason is that shadow trading is not inevitably slight. Regulators elsewhere have exposed shadow trades involving billions of dollars of shareholder wealth; SEC Chair Clayton has called it illegal and unethical. When an insider trades on information that she knows is non, public, she misuses her informational advantage either way.¹² Another reason to care about shadow trading stems from the fact that Indian securities laws would prohibit an identical trade if the insider had disclosed her information to a friend and let him trade directly in her stead. Lets call that conduct pure tipping. The regulated transaction is the same in a shadow trade and a pure tip: both insiders buy or sell the same security on the same day at the same price. If that trade is wrongful when prefaced by a disclosure of information, why would it be any less wrongful when prefaced by its concealment?

¹² *ibid*; on the April 2024 jury verdict in favour of the Securities and Exchange Commission, see the SEC litigation release.

There is an objection to comparing shadow trades to tips, which is that in the former but not the latter case the corporation whose stock is traded has no notice of the wrongdoing. Unlike a pure tippee, the shareholder traded away does not know her stock is being traded on non, public information and so cannot take action to replace the selling insider. Does that matter? At a minimum, the corporate shareholder is no better off when its insiders trade shadow than when they tip pure; at worst the shareholder is harmed by the shadow trade itself. If Raj discloses information to Ranjit and lets Ranjit trade, the company has no cause of action against either; if Raj trades herself on the same information, the company has no cause of action against her either but does suffer the mischief of the trade.

The third reason to care about shadow trading, and this reason is normatively powerful, is that shadow trades effectively nullify the prohibition on trading on non, public information in many cases. As Ashwani Bhushan has observed, trading profits are relational: they depend not just on an insiders ability to trade early (relative to when the public receives the information) but also on who else happens to be trading at the same time. So long as the market is populated by perfectly informed traders – that is, so long as everyone else is trading on public information – an insider can expect to earn roughly half of the full insider trading profit, with the remainder being split amongst the informed traders. Give that insider the opportunity to trade against one of those informed traders and her profits nearly double. Which informed trader should she tip? Why, the one who plans on buying (or selling) the same stock at the same time.

To see why let's assume that an insider learns some information that will increase the price of company ABC's stock from \$100 to \$120. Also assume that there is another buyer in the market who is willing to pay up to \$119 for that stock. If the insider trades directly, she and the other buyer split the \$20 tippee profit evenly; but if she tips her information to the other buyer and lets him trade himself, the insider keeps the entire \$20. This opportunity to trade away the other buyer's profits gives the insider a powerful reason to enable shadow trades. If insider trading were allowed but tipping were forbidden, insiders would have an incentive to allow those to whom they disclosed information to trade shadow. To prevent this result, prohibitions on insider trading should extend to shadow trades as well.

The bottom line. This Part began by asking why we should care about shadow trading. The apparent answer was that it is not prohibited by Indian securities laws. But that statute, free space has taught us two further lessons. First, that space is not empty: insider trading in connected securities happens, and regulators everywhere care about it. Second, Indian law regards trades that would be illegal were they prefaced by a disclosure of information as perfectly legal if instead prefaced by its concealment. So why not care about shadow trading?

THE ANATOMY OF SHADOW TRADING AND THE INFORMATIONAL, ASYMMETRY PROBLEM

We can now offer a reasonably precise definition of shadow trading. It is trading by a corporate insider, on the basis of material non, public information about company A, in the securities of another company B, where B is economically linked to A but where the information is not known to affect the price of B's securities (and so does not, in the regulatory sense, relate to them). The crucial aspect of this definition is the sideways jump: the trader gains his informational advantage through a position of trust with respect to company A, but uses it to trade in company B. Every element of what makes this conduct unacceptable is present, the position of trust, the confidential information, the private gain made at the expense of an otherwise ignorant market, but one element that Indian law insists upon, the fact that the information relates to the securities traded.

The practice first got its name and its most egregious example, in the United States enforcement action *SEC v Panuwat*.¹³ Panuwat was an executive at a pharmaceutical company. He learned that his company was about to be acquired. Rather than trading in his own company's securities (at least directly, he purchased call options), he traded in the securities of another pharmaceutical company whose fortunes he anticipated would rise when the acquisition news was announced, as they did. The SEC sued him under the general antifraud provision of the US federal securities laws, and secured a ruling from the federal court allowing that theory to go to a jury, which ultimately convicted Panuwat. Two features of American law made the case possible. One is that Panuwat was accused of violating not a bespoke shadow, trading rule (the US has none), but the

¹³ *Securities and Exchange Commission v. Matthew Panuwat*, 4:21-cv-06322 (N.D. Cal. filed Aug. 17, 2021)

federal securities laws' sweeping antifraud provision. Behind that provision lies a theory of liability that asks not whether the information relates to the securities traded, but something else.

What lies behind that provision is the misappropriation theory, and it merits emphasis because it is precisely the analytical step that Indian law has declined to take. Under US federal law, trading by a person who possesses material non, public information is unlawful when done “in connection with” the purchase or sale of a security. Trading on inside information is connected to the purchase or sale when that trading is a deceptive device used to induce the purchase or sale. In *United States v O's Hagan*¹⁴, however, the Supreme Court interpreted “in connection with” to reach someone who misappropriated confidential information for securities trading in breach of a duty owed to the source of that information, even though he owes no duty to the market counterparties with whom he trades or to the issuer of the securities traded. That is, the defendant's liability arose from deceiving his employer by abusing a position of trust, not by deceiving the market. The reason the misappropriation theory applies so easily to the shadow trade is that the defendant in Panuwat similarly breached a duty to his employer when he traded on his employer's confidential information—indeed, violated several duties—but traded in his employer's competitor's shares instead of his own employer's. What securities were traded was immaterial to the violation he committed. Academic commentary on the Panuwat case has observed that it represents insider trading law's “migration away from strict adherence to fiduciary, owed, to, counterparty” towards a broader idea of informational betrayal.

Section 166 of the Companies Act 2013

If betraying a source of information by trading on it is the wrong that shadow trading commits, then securities fraud laws draw the line in the wrong place; they focus on the purchase or sale and the security rather than on the deception of the source of the information. If that proposition is accepted, then Indian law already contains a well, developed set of principles designed to police just this sort of disloyalty; the constructive task becomes explaining how those principles reach shadow trading. The principles in question are those of fiduciary obligation, specifically as imposed on corporate directors by section 166 of the Companies Act 2013. This chapter will argue

¹⁴ 521 US 642 (1997) 652–653 (articulating the misappropriation theory)

that shadow trading by definition breaches section 166. Shadow trading is, at heart, a breach of fiduciary duty. Section 166 contains the conceptual home that SEC Rule 10b, 5 cannot provide.

The statutory text is helpful. Section 166(2) states that a director shall discharge his duties in good faith towards the company, in order to promote its objects and for the benefit of its members as a whole and in the best interests of the company.¹⁵ Section 166(4) states that in discharging his duties, a director shall not seek to “gain an undue advantage” for himself, his relatives, his partners, or his associates. And section 166(5)¹⁶ says that anyone who does gain an undue advantage “shall be liable to account” to the company for that gain. Step through these provisions, and you see how they map neatly onto the facts of shadow trading. A shadow trader is, by definition, a corporate insider who abuses a position of trust to gain an undue advantage. Whether he trades in his own company’s securities or not is irrelevant to the violation committed: he has used his position to benefit personally from information that came to him because of that position. Section 166(4) does not require that the undue advantage be attained at the company’s expense (though it may well be); it merely states that it shall not be attained through use of the position, full stop.¹⁷ The shadow trade trades on information attained through that very position. Given section 166’s language, the breach is hard to see.

It is simply a correct application of fiduciary law to the shadow trade. Under the common law that Congress section 166 by reference to, fiduciaries may not use their position (or the information or opportunity obtained through that position) to make a private profit. *Regal (Hastings) Ltd v Gulliver*¹⁸ established liability to account for profits made in violation of this principle even where the fiduciary acted in good faith and did not harm the beneficiary, and *Boardman v Phipps*¹⁹ applied it equally to fiduciaries who used information obtained and opportunities created through their positions of trust. The logic of *Regal* and *Boardman* speaks directly to shadow trading: what information obtained through a corporate insider’s position is more the paradigm of information

¹⁵ 166(2) (duty to act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment).

¹⁶ 166(5) (if a director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company).

¹⁷ 166(4) (a director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates).

¹⁸ [1967] 2 AC 134 (HL)

¹⁹ [1967] 2 AC 46 (HL)

obtained through that position than material non, public information about the company? And what profit is more the paradigm of profit that cannot be retained than a trading profit made by betraying the source of the information?

If there is an objection to all of the above, it comes in the next sentence and the strength of this chapter's argument depends on squarely addressing it rather than deftly side, stepping it. That objection is that the fiduciary duties imposed by section 166 are owed to the company and its members, not to the investors in the market who suffer loss because of shadow trading. Fiduciary duties are not owed to the victims of the shadow trade. The accepted view (due to *Percival v Wright*²⁰) has been that fiduciary duties run to the company as an entity (which has nominal standing to bring them but cannot be said to suffer loss) and not to shareholders, individual or institutional. If that is correct, then fiduciary obligations cannot reach shadow trading because the only victim is the market counterparties to whom no fiduciary duty is owed, and the company to whom the duty is owed suffers nothing at all if its own shares are not traded. Shadow trading wrongs the wrong people for fiduciary duties to apply.

The objection has force. But it rests on a conflation between the person harmed by the fiduciary's breach and the beneficiary of the fiduciary duty. Disentangling those two concepts largely removes the force from the objection. Fiduciary law has never required that beneficiary be the person who incurs the economic harm when duties are violated. To the contrary, the reason Boardman and Regal impose liability to account even where the company suffered no loss is that they impose liability notwithstanding the company's lack of loss. The point of fiduciary law's rules—including the rule that fiduciaries may not put themselves in a position where their duty and interest conflict—is to prevent conflicts of interest from arising in the first place. Fiduciaries who breach their duties are liable to account not to compensate a victim but to strip them of any profit made through their position. The loss to market counterparties is why society prohibits shadow trading, but the fiduciary wrong that triggers directors' liability is the disloyal use of their position. Society prohibits shadow trading and Indian law enforces that prohibition through fiduciary duties because

²⁰ [1902] 2 Ch 421 (Ch)

the breach is against the company that owns the information used, whether or not that company can point to a loss.

Put differently, this is exactly the structure that US misappropriation liability adopts. O's Hagan grounded liability for trading on confidential information in violation of a duty to the source of that information, the employer, not the market counterparties. Indian fiduciary law works the same way. The fiduciary duty is to the company. Market counterparties are the victims only in the colloquial sense; the legally cognizable wrong is committed against the company. When a shadow trader breaches his fiduciary duty to his company by using information obtained through that position, he must account to that company for profits made as a result of that breach. The objection that fiduciary duties target the wrong victim therefore proves, on examination, to support the exact opposite conclusion. Fiduciary duties are the only doctrine that locates the breach where it actually occurred: in the betrayal of trust. The securities regulation approach, with its emphasis on price, sensitive information, mistakes the downstream effects for the essence of the wrong.

Two points of caution are necessary to prevent my argument from becoming overbroad. The first is that section 166 only applies to directors (and officers in default and the small class of senior employees governed by the Companies Act 2013's chapter on officers); tippees and employees lower in the corporate hierarchy are not directors and do not owe fiduciary duties under section 166. Secured creditors or any other arm's length market participants who receive a tip do not owe fiduciary duties to the company under the Companies Act. This limitation is significant, and the fiduciary path is not a complete solution. The second limitation is one of remedy. Section 166(5) sends the undue gain to the company, which solves the problem of disgorgement but does nothing by itself for market counterparties and does not by itself create the enforcement regime—investigation, penalty, and disqualification—that viable deterrence requires. These are important limitations, and the proposal in the penultimate chapter is designed to address them. But they are limitations on how broadly the fiduciary solution can apply, not problems with the solution itself. Directors who abuse their positions betray the company that entrusted them with those positions, and within the category of senior insiders section 166 of the Companies Act 2013 already condemns shadow trading. Indian law has just not realized that yet.

The previous subsection helps situate this argument in the longstanding theoretical debate about what kind of thing inside information is. Scholarship has long been divided between viewing inside information as a property right held by the company and viewing trading on inside information as a form of fraud on the market. Which view one takes matters. If inside information is property belonging to the company, then trading on it in any company's securities—your own or a competitor's—is a form of misappropriation of that property. If trading on inside information is a fraud on the market in the securities traded, then the information must relate to the securities traded, and shadow trading is avoided because the non, public information does not relate to the competitor's shares. By not defining "inside information" in section 2(1)(g), Indian law has implicitly adopted the latter view and built its regulations around fraud on the market in particular securities. Under the fiduciary framework exemplified by section 166, by contrast, inside information is property: it belongs to the company, and when a director misappropriates it for personal gain he betrays the company that owns that information. The securities in which he trades to personal gain is irrelevant. The shadow, trading gap exists because Indian securities regulation is built around an implicit, but unstated theoretical choice. Applying fiduciary principles to bridge that gap is not solving the problem through workaround rules; it is the better of the two theoretical choices.

Equally importantly, the property conception is consistent with the well, established Indian and common, law treatment of the corporate opportunity . The corporate opportunity is the closest analogue to shadow trading that existing doctrine recognizes. A director who diverts to himself a business opportunity that came to him through his office must account for the resulting profit whether or not the company would or could have pursued the opportunity. Shadow trading, by contrast, is the diversion of an informational opportunity. The director takes for himself the trading profit made possible by confidential information: an opportunity that arose only in virtue of his fiduciary position. If diverting a concrete business opportunity is a breach of fiduciary duty, it is difficult to see why diverting an informational trading opportunity should not be as well. The corporate, opportunity doctrine therefore provides a ready bridge from established fiduciary principles to this novel case. And it does so without necessitating any broadening of the securities, law definitions that I have argued are the root of the problem.

COMPARATIVE LENSES: THE UNITED STATES AND THE UNITED KINGDOM

For that reason, the comparative material in this chapter is offered not as a menu of rules to be imported but as illumination for the single design choice that this paper has argued India has inadvertently made. That choice is between anchoring liability in the relationship of the information to the securities traded (or to the issuer of those securities) and anchoring liability in the nature of the breach (did the trader abuse a relationship of trust with the source of the information?). The United States and United Kingdom have answered that question in instructively different ways, and the contrast highlights India's s unconsidered position.²¹

The United States is the more interesting of the two because it reaches shadow trading without any rule expressly aimed at the problem. American insider, trading law is not erected on a comprehensive statutory prohibition; it is a judicial gloss on a general antifraud provision of the federal securities laws that prohibits the use of any “manipulative or deceptive device” in connection with the purchase or sale of a security. Within that capacious language, the courts have developed two theories of liability. One is the classical theory, forged in *Chiarella v United States*,²² which treats trading on inside information as fraudulent only where the trader owes a duty of disclosure to his counterparty under a relationship of trust and confidence – typically, the duty that a corporate insider owes to the shareholders of his own company. That theory, by itself, would not reach the shadow trade, for the same reason that India does not: there is no relevant duty to the shareholders of the unconnected company in whose stock the trader traded. But something else comes into play.

Enter the second theory, known as misappropriation, approved by the Supreme Court in *United States v O's Hagan*. That decision explains that a person commits securities fraud when he misappropriates confidential information for trading purposes in breach of a duty owed to the source of the information, whether or not he owes any duty to the issuer or to the person with whom he trades. It matters only that he owe a duty – and breach it – to the source, the employer, the principal, the client from whom the information was obtained. Because that duty is breached

²¹ Paul L Davies and Sarah Worthington, *Gower: Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) ch 16.

²² 445 US 222 (1980) 228–230

when (and only when) the insider trades on the information for his own purposes, O's Hagan's theory is completely indifferent to which securities are traded. That was what allowed the Securities and Exchange Commission to charge SEC v Panuwat and a jury to convict even though the defendant traded in one company but misappropriated information about another. To be sure, India should not adopt Rule 10b, 5; its open texture sits oddly with India's codified tradition. But America's lesson for India is that a liability regime anchored in the breach of a duty to the source of information will swallow up shadow trading as a matter of course; a liability regime anchored in the information's relationship to the traded security never will.²³

Tipper–tippee doctrine in American law tends the same point: liability stems from breach of the insider's duty rather than from any relationship of the tippee to any issuer.²⁴ Put differently, the misappropriation theory also tells us something about this paper's fiduciary argument in the previous chapter, because the duty to the source that matters in O's Hagan is, in essence, a fiduciary duty. America caught shadow traders by running its securities law through a fiduciary concept. This paper has suggested that India reach the same result by running the problem through its existing codified fiduciary duties directly, instead of distorting its issuer, specific securities definitions to try to achieve the same endpoint indirectly. American law gives that suggestion analytical support by showing how the destination can be reached within a securities, fraud framework, but only because America lacks India's codified directors' duties.

By contrast, the United Kingdom provides the foil to America's approach, and it is the more cautionary example. The criminal law conceals market abuse in two overlapping regimes. There is first the offence of insider dealing, found in Part V of the Criminal Justice Act 1993, which prohibits an individual who has information as an insider from dealing in price, affected securities on the basis of that information. The key definition is that of 'inside information's'. That concept the statute defines as information as to price, sensitive developments that is specific or precise, relates to particular securities or to a particular issuer of securities, and is likely to have a significant effect on the price of those securities if it were made public. Structurally, that is identical to the Indian definition for the shadow, trading problem: it is issuer, specific and (implicitly) security,

²³ Securities Exchange Act of 1934, 15 USC § 78j(b); Rule 10b-5, 17 CFR § 240.10b-5.

²⁴ *Dirks v SEC* 463 US 646 (1983) (tipper–tippee liability turns on breach of the tipper's fiduciary duty for personal benefit).

specific, and on its face applies to inside information about ABC Company whether or not the insider trades ABC's shares. So long as he trades the shares of another company, the British criminal regime does not reach the shadow trader. Short.

The civil regime might be wider still, but what is said of it comes with several caveats. For many years, the United Kingdom simply applied the European Union's Market Abuse Regulation, which defines inside information and prohibits insider dealing in terms that replicate the criminal offence but go wider in a few important respects. Following the United Kingdom's exit from the European Union, that Regulation was converted into domestic law with amendments, and has since been subject to further amendment and development under domestic financial, services legislation. So the precise scope of the regulation (as amended) that currently applies in the United Kingdom, and in particular whether its definition of inside information has been construed or amended in any way that would allow it to reach trading in economically connected securities, is a question that this author must leave to the reader to verify against the regime in force at the time of reading rather than declare on the basis of any snapshot. Even so, it is clear that the core definition of inside information in MAR – like the offence under its criminal, law cousin – revolves around information about an issuer or its financial instruments. Nothing in MAR's basic structure is geared to the phenomenon of shadow trading.²⁵

The lesson that the United Kingdom offers is thus the opposite of America's.²⁶ There can be a sophisticated, twin, track regime for market abuse that nonetheless leaves shadow trading entirely untouched if both lines of liability are anchored to the relationship of information to a given issuer. Congress could have imported the British regime in its entirety just as easily as it imported MAR as domestic law. India could do the same today. The point is not that Congress or the U.K. legislature got the design choice wrong but that the choice itself has left, on consequences for India.

United Kingdom and United States do together frame India's choice with some clarity. The United Kingdom shows that you can have an elaborate, securities, specific regime that still misses

²⁵ Deborah A DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' (1988) Duke LJ 879.

²⁶ 17 CFR § 240.10b5-2 (circumstances giving rise to a duty of trust or confidence for purposes of the misappropriation theory).

shadow trading if you organise the regime around the issuer to which the information relates. More regulations do not fix the problem if the conceptual anchor is wrong. The United States shows that the hole is patched as soon as liability comes to be based instead on breach of a duty to the source of the information. India has something close to the latter as part of its codified domestic law. It does not need to travel to America to learn the lesson; it needs only to apply its own law in light of it.²⁷

RECOMMENDATIONS

This paper has argued that shadow trading is currently unregulated due to doctrinal blind spot in Indian securities law. Indian securities regulation does not adequately address shadow trading, not because the rules prohibit the wrong type of trading activity, but because they have been constructed around issuer, identified informational relationships. Any solution must therefore reckon with the fact that appropriately tailored regulations cannot consist simply of adding additional issuers onto an infinite laundry list of banned information.

The first step towards closing this gap is simply recognition by SEBI that shadow trading can amount to market abuse. In light of the PIT Regulations's silence on economically linked securities, there is a pressing need for SEBI to clarify that information relating to one issuer could potentially restrict trades in securities issued by another economically linked issuer. Such recognition need not come in the form of immediate regulatory change, but could take the form of guidance provided by SEBI that explicitly alerts insiders, compliance personnel and listed companies to the reality of shadow trading.

Second, India may consider adding "economically connected securities" to the PIT Regulations. Any such amendment must be careful not to prohibit trading based on industry, wide information. Ideally, the new provision will simply identify situations where there is a clear economic connection between the source and traded company. The existence of a competitor, supplier, partner, target company, or fellow industry player within an oligopolistic sector could form useful,

²⁷ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015, reg 2(1)(n).

objective metrics for determining what counts as “economically connected.” Done correctly, this amendment would neither be overbroad, nor would it capture all forms of shadow trading.

Third, regulators can improve enforcement by bridging the gap between securities regulation and fiduciary liability. This paper centres on the notion that shadow trading violations are, at their core, fiduciary wrongs rather than securities, law wrongs. To that end, SEBI and the Ministry of Corporate Affairs should develop shadow trading into a category of market abuse that can be simultaneously considered misuse of unpublished information (as regulated by securities law) and breach of fiduciary duty (as prohibited by section 166 of the Companies Act).

Fourth, Indian courts should interpret section 166 of the Companies Act to include confidential information as a “property of the company.” Section 166 already does a decent job of encompassing confidential information within its definition of “property of the company” by virtue of prohibiting the acquisition of “any undue gain or advantage.” However, statutory language that expressly identifies confidential information as a protected form of company property would provide greater clarity.

Fifth, companies should develop insider, trading policies that cover shadow, trading behaviour. While insider, trading policies usually prohibit the trading of securities issued by the very same company, companies should expand restrictions to cover peer companies, competing entities, predicted takeover targets, suppliers, etc. during the restricted period. Trading windows should be adjusted accordingly, as should disclosure requirements and internal pre, clearance policies. Such changes can be made at the corporate level, without having to wait for regulatory action.

Sixth, regulators should place greater emphasis on disgorgement. While securities laws often impose punitive sanctions, fiduciary liability is centrally concerned with preventing unjust enrichment. The profit earned by the shadow trader is due to his or her misuse of confidential information obtained from a position of trust within a company. Disgorging those profits and directing them back to the company whose information was misused would speak directly to the fiduciary nature of the violation.

Finally, regulators must avoid over, inclusiveness. Regulating shadow trading should not give rise to situations where any trade made in connection with a company in the same industry is suspect.

Over, inclusive regulations chill investment, decrease market efficiency, and impose undue compliance obligations. The goal of regulating shadow trading should not be to eliminate informational advantages across the board, but to prevent insiders from using confidential corporate information obtained from a position of trust and converting that information into private gain. A regulatory framework that combines securities regulation with fiduciary liability and corporate, governance solutions would be a positive step in that direction.

CONCLUSION

Shadow trading exposes critical limitations in the ways that securities law understands both market abuse and insider trading. Rather than represent an arcane loophole that only pertains to a narrow class of trades, shadow trading underscores the fact that securities regulation (both in India and abroad) have come to define liability through the information, security nexus. Regulators have attempted to tackle insider trading and its various derivatives by focusing directly on the trading of securities for which an insider possesses price sensitive information. In India, regulators have responded to this reality through a series of detailed prohibitions outlining when and what corporate insiders may trade. While these regimes have been successful in regulating traditional forms of insider trading and front, running, shadow trading threatens to expose the limits of these tools. After all, if the trade is made in securities issued by a company with whom the insider does not appear to have a relationship, how does Indian securities law prevent abuse?

Instead of a technical lacuna in Indian securities law, shadow trading exposes a conceptual blind spot. The reason Indian securities laws fail to account for shadow trading is not because Indian regulators have not dedicated enough attention to the drafting of securities regulations. Rather, Indian securities laws fail to account for shadow trading because they have been constructed around the incorrect organising principle. Price sensitive information, in Indian securities law at least, has been treated as though its defining characteristic is the relationship between that information and the particular security to which it applies. Shadow trading poses a threat to this conceptual paradigm. By demonstrating that identical trading advantages can be secured through abuse of information that is not, on its face, price sensitive to the traded security, shadow trading calls into question the efficacy of securities regulations that are built around this boundary. But why should Indian law care about shadow trading? If the abuse takes place through information

obtained from Company A, but the trade is made in securities issued by Company B, how is India harmed?

Shadow trading matters because it highlights the misplaced conceptual focus of current securities regulations. The breach committed by the shadow trader may occur in connection with Company B's securities, but that fact does nothing to change the nature of the breach. Whether or not the trade is made in Company A or Company B's securities, the shadow trader has exploited information obtained from a position of trust for personal gain. Indian securities laws may not care about shadow trading, but Indian fiduciary laws certainly should.