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SEBI revamps insider trading regulations

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Introduction

Insider trading refers to use of certain unpublished information related to a public listed company by a person for the purpose of transacting the securities of the company. Insider trading is not only a civil wrong but also a criminal offence in India. Until now, insider trading norms were governed by the two decade old SEBI (Prohibition of Insider Trading) Regulations, 1992. In order to provide a better regulatory policy on this subject which is in line with international standards, Securities and Exchange Board of India ("SEBI") has framed a new set of regulations ("New Regulations")^[1]. The new regulations restructure the existing legal regime that prohibits insider trading on one hand and protect the interests of insiders in legitimate transactions on the other hand. The New Regulations are based on the report prepared by Justice Sodhi's Committee ("Report")^[2].

Salient Features of the Regulations

The salient features of the regulations are as under:

1. Definition of Insider and Connected Person – Defining the term 'insider' is one of the most crucial aspects of any effective insider trading laws. Whether the insider should be connected with the company or whether there is any obligation on the part of the person not to use of the information for personal purposes are bone of contentions while defining the term. The new Regulation makes the definition very clear and provides that any person who is in possession of Unpublished Price Sensitive Information ("UPSI") will be considered as an insider. The prosecution only has to provide that person was in possession of UPSI at the time of trading. Thereafter, the burden will shift to the person to prove that he has not traded using the information or his trade falls under the defenses provided in the New Regulation.

Definition of insider also includes a 'connected person' The earlier definition of 'connected person' was based on position. Connected person included director, officers, employee, persons having a professional or a business relationship etc.

In the new regulations, the distinction between 'connected persons' and 'persons deemed to be connected' no longer exists. "connected person", as per the new regulations, would include persons connected on the basis of any contractual, fiduciary or employment relationship that allows such person access to UPSI. The new definition of connected person includes within its ambit persons who are in regular contacts with officers of the company, government servant who by virtue of their position or relation ha access to UPSI. Moreover, the new definition of connected persons has been widened to include immediate relatives. Although, such persons were indirectly brought under the purview of "deemed to be connected persons" under the old regulation, the new definition of insider is much more specific in its approach.

2. Unpublished Price Sensitive Information and generally available information – UPSI has been defined to mean information that is not generally available, which can impact the price of securities if it is available in public domain. The new regulation strengthens the definition of UPSI by laying down the principles to ascertain whether information is generally available. Information that is accessible to the public on a non-discriminatory basis would be considered generally available information. This would include information such as research report which are available on a non-discriminatory basis, etc. The test of non-discriminatory access has been discussed in detail in the Report. In order to ascertain whether some information is available on a non-discriminatory basis, the standard of a reasonable man would be adopted. For instance, a research report that is priced for purchase and is made available to all clients of a stock broker would be considered non- discriminatory when it is reasonably priced and any client of the broker or any class of clients of a broker may acquire that research report. However, if the pricing of the report is not in line with market practice, intended to provide benefit to only some identified persons, it would not be non-discriminatory. Hence, it would be considered as UPSI. Information that is capable of being accessed by any person without breach of any law would also be considered generally available information.

The earlier definition of price sensitive information only covered information which is related securities of the company. The new definition covers all securities. Therefore, a security such as a derivative instrument which is not issued by the company but represent an interest in company would be covered under the new regulations. Similarly, securities issued by mutual fund, collective investment scheme, etc. also will fall under the ambit of new regulations.

3. Third party connected persons – The New Regulations requires third-party connected persons to disclose their trading and holdings in securities of the company. This would mean that the disclosure requirements have to be complied with, even by external consultants and any third party who has a contractual or fiduciary relationship with the company.

4. *Prohibited Communication of UPSI* – As per the new regulations mere communication of UPSI is strictly proscribed. In the earlier regulations, to constitute an offence, a person in possession of UPSI should have traded with the securities or communicated to another person who traded in the company's securities. Hence, this provision would give more teeth to SEBI by bringing persons who have communicated UPSI under its scrutiny, whether there was any trading in pursuance of UPSI or not.

5. *Permitted Communication of UPSI* – Communication of UPSI is permitted as an exception in the following cases:

- For legitimate purposes
- For performance of duties or
- For discharge of legal obligations

In the case of permitted communication of UPSI, advance disclosure of UPSI must be mandatorily made at least 2 days prior to trading. This regulation has been introduced in order to protect every investor's interest in securities market. Disclosure of UPSI in public domain has been made mandatory before trading, so as to rule out asymmetry of information in the market, as prevalent in other jurisdictions.

The exceptions for communication of UPSI have been provided to provide such information on a "need to know" basis. UPSI must be disclosed only to those persons who need the information to discharge their duties and whose possession of such information will not give rise to conflict of interest or misuse of information.

Permitted communication of UPSI would have a positive impact in the exercise of 'due diligence' on the company prior to making investment transactions.

6. *Prohibition on derivative trading* – The New Regulations prohibit derivative trading by directors and Key Managerial Persons ("KMP") on securities of the company. This regulation is in consonance with section 194 of the Companies Act, 2013 ("Act of 2013") which prohibits forward dealings in securities by directors and KMPs. Hence, directors and KMPs cannot deal with future, options and swap transactions in shares and debentures.

7. *Trading Plans* – Insiders who are liable to possess UPSI all round the year will now have an option to formulate pre-scheduled trading plans. There are certain persons such as promoters of the company, persons in senior management, etc who may perpetually be in possession of some UPSI or the other. Prohibition on insider trading renders such persons incapable of trading in securities throughout the year. Hence the concept of Trading Plans has been introduced as a novel experiment in India based on US practices[3]. This provision would enable compliant trading by insiders.

There were certain reservations in introduction of trading plans based on empirical evidence that suggested abuse of trading plans in several jurisdictions. In order to curb such malpractices, certain safeguards have been provided. Trading plans will be permitted only for bona fide transactions and advance disclosure of such plans has to be made mandatorily on a stock exchange platform.

8. *Disclosure based on prescribed Codes* – Every company whose securities are listed or proposed to be listed is required to formulate and publish a code of fair disclosure. This provision intends to require every listed company to formulate a framework that could impact price discovery for its securities in the market. Principles regarding equality of access to information, publication of policies such as those on dividend, inorganic growth pursuits, calls and meetings with analysts, publication of transcripts of such calls and meetings, etc shall be covered in the code.

9. *Removal of repeated disclosures* – In terms of regulation 13 of the previous regulations, any person holding more than 5% shares or voting rights was required to make initial disclosure of his holding. Such a person was also required to make continuous disclosure about number of shares or voting rights held and any change therein from the last disclosure, if such change exceeded 2% of total shareholding or voting rights in the company. This disclosure was required to be made within two working days of receipt of intimation of allotment of shares or acquisition or sale of shares or voting rights.

The above requirement of repeated disclosures has been removed. The new regulation acknowledges the redundant practice of repeated disclosures, when a compliance mechanism has already been provided in regulation 29 of the Takeover Code[4].

Conclusion

The Regulation has widened the applicability of the insider trading norms to various classes of persons by broadening the definition of insider and connected persons. The regulations have also tightened the noose around offenders by placing the onus of establishing their innocence on them. The regulations provide more teeth to SEBI by making mere communication of UPSI an offence. The earlier law only condemned actual trading of securities when the person was in possession of UPSI.

The regulations have balanced the increase in powers of SEBI along with certain legitimate exceptions to what constitutes the offence of insider trading. Permitted communication of UPSI in the process of due diligence would benefit merger and acquisition transactions. The introduction of trading plans, inspired by international practices, can provide a level playing field to the compliant insiders along with other traders in the securities market.

The regulations have been aligned with the Takeover Code by removing repeated disclosures and with Act of 2013 by prohibiting derivative trading. However, the new regulations are inconsistent with section 195 of the Act of 2013 which deals with insider trading. Section 195 of the Companies Act, 2013 prohibits insider trading by director, KMP, or any other officer of company. This section is inconsistent with the new regulations which also prohibit insider trading by immediate relatives. Similarly, the definition of price sensitive information as mentioned under section 195 of the Act of 2013 is restricted to information related to company in contrast with the definition provided under the new regulations which extends to information related to securities as well. As far the listed companies are concerned, SEBI is within its power to prescribe more stringent requirement. However, it is better to avoid regulatory uncertainties.

[1] *The regulations were approved by the SEBI Board in its meeting held on November 19, 2014*

[2] *An 18 member committee under the chairmanship of Justice N.K. Sodhi, Former Chief Justice of the High Courts of Kerala and Karnataka and a Former Presiding Officer of the Securities Appellate Tribunal was formed to review SEBI (Prohibition of Insider Trading) Regulations, 1992. The Committee finalized its comprehensive report on December 7, 2013*

[3] *The concept of “pre-arranged trading plans” was first introduced in the United States in the form of Rule 10b5-1 of the Securities Exchange Act, 1934 in 2000.*

[4] *SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011*