Insider Trading: Emerging Regulatory Challenges

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Introduction

It is generally accepted that regulation of market conduct has direct linkages to the level of confidence investors have in a given market. India has gained significant ground as a thriving emerging market within a comparatively shorter span of time amongst its peers. One of contributing factors for investor confidence in the Indian market has been the constant dynamism with which our market regulation and regulators have evolved and adapted to the needs of a growing and increasing global economy with a keen focus on investor protection. It therefore not surprising that insider trading was one of the first issues that the securities market regulator, viz., Securities Exchange Board of India (**"SEBI"**) legislated,[1] in 1992 – the same year that SEBI was established.

Since then, the 1992 Regulations have been revised a few times, often the need for a change arising from the regulator's learning of actual market situations. The most recent overhaul took place in 2015. With the local markets and market participants getting increasing more connected, the underlying objective of the revamp was to align the Indian insider trading laws with the changing regulatory environment on insider trading globally. It is noteworthy, that the Indian legal regime on insider trading has always been more principle based than prescriptive. However, overtime, recognising the evidentiary challenges of establishing an insider trading charge (and proving malafide intent), the law has incorporated a more strict liability type approach which seeks to penalise insider who trade whilst in possession of unpublished price sensitive information (**"UPSI"**) or material non-public information as is commonly known in other jurisdictions.

Before the amendments were carried out and implemented, SEBI constituted a committee in 2013 led by Justice N. K. Sodhi (the "Committee") to review and recommend changes to help align regulatory framework with commercial market needs while strengthening governance. The Committee finalised its recommendations in 2013 itself, which were then distilled into the SEBI (Prohibition of Insider Trading) Regulations, 2015 (**"2015 Regulations"**). The 2015 Regulations have been effective since May, 2015. This article seeks to analyse the key changes that were introduced in terms of the 2015 Regulations and the implications of that on market participants and transactions.

Who is an insider?

In terms of Regulation 2(h) of the 2015 Regulations, an insider means any person who is:

i. a connected person; or
ii. in possession of or having access to unpublished price sensitive information in relation to a listed or to be listed company in India.

The definition of 'connected person' under the 2015 Regulations is wider in scope as it includes any person associated with the company in any capacity, including by reason of frequent communication with its officers, in a fiduciary, employment or contractual capacity, in the six month period prior to the concerned trade. The concept of "frequent communications" as an ingredient to establish connection between with the officers of a listed company (which can go beyond corporate insiders) is quite open ended and likely to get interpreted on a case by case basis. These changes are in some ways sweeping as there could be several day to day interactions that could get caught in the web of "frequent communications".

For instance, in a recent *ex-parte order*,[2] SEBI relied on the social media accounts to draw connection between two persons for establishing charge of insider trading and held two persons to be 'connected' on the basis of them being 'mutual friends on Facebook'. While this *ex parte* order is yet to be tested in appeal and was in fact dealt with under the 1992 Regulations which didn't have a specific reference to "frequency of communication", it is an indication of the extent to which the regulator may go to establish connection between an insider and an outsider in the coming days.

The 2015 Regulations also shifts the burden of proof to demonstrate that the connected person was not in possession of unpublished price sensitive information **("UPSI")**[3] on such person, since effectively, all connected persons would be considered to be insiders.

One aspect that has remained unchanged from the erstwhile regulatory regime is the second limb of the 'insider' definition which is effectively a residual catch-all provision. This is an unqualified category and there is no carve out for persons who may receive UPSI in an unsolicited or inadvertent manner. The underlying purpose of this catch all provision was to include such persons who brings within its every person (irrespective of their connection or lack thereof, with a company) who has received or access to UPSI as an insider.

UPSI – Not generally available?

Another key change introduced through the 2015 Regulations is in relation to the concept of UPSI which now excludes from its ambit 'generally available information'. The phrase generally available information[4] has been defined to mean information that is accessible to the public on a non-discriminatory basis. An explanatory note to this definition of UPSI states that information published on the stock exchanges' websites will ordinarily be considered as generally available information. However, no other instances of what would constitute generally available information has been provided.

Interestingly, prior to 2002, 'unpublished price sensitive information' was defined in the 1992 Regulations as *'any information which relates to…a company, and is not generally known or published by such company for general information...'*. This definition was relied upon, in the case of HLL v. SEBI[4], by the Appellate Authority to observe that for information to be 'generally known' it was not required for such information to be authenticated or confirmed by the company. Subsequently, the term 'unpublished' was amended in the 1992 Regulations to mean *'information which is not published by the company or its agents and is not specific in nature'*, therefore, creating a nexus between the information and publication of such information by the company itself. Hence the 2015 Regulations have now reverted to the pre-2002 position by creating a carve-out for generally available information.

Whilst this is likely to make it possible to argue that certain information that is publicly available (but not originating from the company) should not be considered to be USPI, the new definition is likely to raise questions the extent to which such information should be disseminated in the public domain, for it to be considered as available on a 'non-discriminatory' basis. Given the lack of regulatory prescription on what 'non – discriminatory' means, coupled with the rapid expansion of digital communication and social media, it will be interesting to see how the lines around the scope of UPSI are drawn.

The 2015 Regulations also do not spell out the thresholds of 'materiality' and 'price sensitivity' of information in relation to UPSI. However, illustrative guidance in relation to events that are likely to be considered UPSI has been provided and includes (i) financial results; (ii) dividends; (iii) change in capital structure; (iv) mergers, de-mergers, acquisitions, de-listings, disposals and expansion of business and such other transactions; (v) changes in key managerial personnel; and (vi) material events in accordance with the listing agreement. As such, other than the illustrative circumstances set out above,, which are deemed to be "material" and "price sensitive", for all other situations, the assessment of whether any particular information is material or price sensitive, will depend on the facts and circumstances of the case.

It has however been recognised through case law, that the nature of the information does not have to be absolutely certain for it to be considered as being UPSI.[5]

Another change is that UPSI can now relate to the listed/to be listed company or its securities. While this may seem like a minor tweak in the 2015 Regulations, its implications are quite significant to the extent that even where the company has no knowledge about specific information (for instance an impending secondary block) would be considered as UPSI.

Communication for legitimate purposes

Insiders are prohibited from communicating, providing or allowing access to UPSI unless required for legitimate purposes, performance of duties or discharge of legal obligations in terms of the 2015 Regulations. In addition to the direct communication of UPSI, procurement of UPSI and inducement to share UPSI which is not in furtherance of ones legitimate duties and discharge of obligations would also result in a contravention.[6] This is a standalone requirement which if not complied with could lead to a contravention, even in scenarios where there is no evidence/ confirmation of actual trading taking place pursuant to such communication. The explanatory note to definition of UPSI provides that the purpose of the provision is to ensure that organisations develop practices based on 'need to know' principle for treatment of information in their possession. However, SEBI has not set out any guidelines to determine the manner in which the corporate entities are to implement the Chinese walls.

Communication in relation to PIPE transactions

In terms of Regulation 3(3) of the Insider Trading Regulations 2015, sharing of UPSI is permitted in relation to:

- any transaction that would entail making an open offer under the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011, provided that the board of the company is satisfied that the transaction is in the 'best interests' of the company; and
- otherwise, for transactions where the board of the company is satisfied that the transaction is in the 'best interests' of the company and the UPSI is made generally available two trading days prior to the trade.

An obligation is cast on the board of directors of the listed company to ensure that confidentiality and non-disclosure contracts are duly executed between the parties and that such parties keep information received confidential and not otherwise trade in securities of the company when in possession of UPSI. This exception has been created specifically for PIPE deals (i.e., private investment in public enterprises) and to create a process for conduct of pre-investment diligence by the investor. However, given that any UPSI made available to the incoming investor as part of the diligence is now required to be ultimately published, parties will have to weigh the necessity of sharing UPSI with more care.

Further, the requirement to obtain a board approval at the initial stages of the transaction where the board would need to satisfy itself that that a potential transaction in the best interest of the company is likely to be a case by case assessment for the board each time the situation arises.

Inclusion of specific notes as an interpretation aid

Yet, another the introduction of specific 'notes' following some of the provisions, which set out the legislative intent and rationale behind the formulation of a particular legal requirement. Whilst this is a useful aid in interpreting such provisions, the interpretive value of such notes especially when it is used to give wider meaning to the provisions is yet to be tested in appeal.

Safe Harbours

Interestingly, under the new regime, SEBI has provided a broad defence mechanism which includes:

- Off market transactions inter-se between promoters, who were in possession of same UPSI.
- In case of non-individuals where trading decisions were not taken by persons in possession of UPSI and arrangements were in place to ensure that no UPSI was provided to the person making trading decisions.
- Trades undertaken pursuant to a trading plan.

While the Sodhi Committee had recommended that this be a valid defence available generally, as per the 2015 Regulations the parity of information defence is only available for inter-se transfers between promoters off the exchange.

SEBI has also left out some of the other defences suggested by the Sodhi Committee, such as trades being contrary to the manner in which advantage may be taken of UPSI or trades being undertaken by another person without the knowledge of the insider (such as wealth managers or discretionary portfolio managers). Having said that, as the list of defences set out in the 2015 Regulations is inclusive, the possibility of a 'blue sky defence', i.e., defending a charge of insider trading on certain other grounds may be possible. This could also potentially result in a dilution of the strict liability approach that been in place till date.

Trading Plan as a defence

Taking a cue from jurisdictions such as the US and UK, the 2015 Regulations also adopts the concept of trading plans as a defence to insider trading and prescribes the following requirements, inter alia:

- trading may not commence earlier than 6 months from public disclosure of such plan and should be for a period of at least 12 months;
- the trading plan must be specific and set out details of value or quantum of trades along with the nature of trades, and the interval or dates of trades;
- the trading plan would be irrevocable and any deviation could potentially result in a contravention of the 2015 Regulations; and
- the trading plan shall not commence unless the UPSI in possession of the insider at the time of formulation of the trading plan becomes generally available.

While trading plans were intended to be used a viable route for trading by perpetual insiders (such as promoters), given that under the present construct, trading plans (i) needs to publicly disclosed; (ii) are irrecovable; (iii) subject to a six month cool off period, they may not actually be as user friendly as one would have hoped for.

Code of fair conduct and disclosure

Unlike the 1992 Regulations, which prescribed separate model codes of conduct for listed companies and market intermediaries, the 2015 Regulations only prescribe principles based on which every person who is required to handle UPSI in the course of business operations is required to formulate a code of conduct to regulate, monitor and report trading by employees. As such, a strict reading of the regulations would require unlisted securities market intermediaries to also comply with the trading window requirement (in addition to maintaining a pre-clearance mechanism).

Further, the 2015 Regulations also stipulate a six month holding period for securities which is considerably longer than the previously prescribed holding period of 30 days. The 2015 Regulations also empower listed companies/ intermediaries to make their codes of conduct applicable to such persons as they identify based on their role and function in the organisation.

Conclusion

The 2015 Regulations in the Indian securities market has been a much needed overhaul was undertaken to replace the old insider trading regime by adopting a transparent and consultative approach. However, there certain issues which need to be ironed out and may gain further clarity when applied to actual cases. The 2015 Regulations have also introduced certain new concepts (defences to insider trading, generally available information, etc.) which may require careful analysis by the SEBI as well the Securities Appellate Tribunal to clearly demarcate the scope of ambit of the regulatory framework. There are however, quite a few changes that tighten the erstwhile regime and require listed companies and market participants to implement stronger controls and monitor the exchange of UPSI more carefully. It is also relevant to note that any regulatory investigation/ proceeding involving an allegation of insider trading cannot be ordinarily settled through the settlement mechanism[7] and hence would necessarily would have to dealt with through the adversarial process. While typically, an offence of insider trading is punishable with the payment of a monetary fine, SEBI does have the ability to initiate criminal action against the offender, though this power is

rarely exercised. In cases which are of an emergent situation requiring remedial action to be taken by SEBI, orders suspending the offender from accessing the market, etc., may also be passed by SEBI.

In parallel, SEBI has also recently been granted greater enforcement powers to tackle offences of market manipulations, including the powers to attach property, bank accounts, etc. Therefore, the regulator maybe expected to crackdown on insider trading more heavily in the times ahead.

Therefore, while the introduction of the Insider Trading Regulations 2015 is certainly a positive development, it needs to be coupled with more enforcement and constructive interpretation both by SEBI and the appellate bodies in the times ahead, to further evolve the regulatory regime and lend dynamism to the way the regulations are interpreted to best serve public interest.

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[1] To introduce the SEBI (Prohibition of Insider Trading) Regulations, 1992 (herein after referred to as the 1992 Regulations)

[2] SEBI Whole Time Member Order dated February 4, 2016 in respect of Palred Technologies Ltd. However decisions like these are indicative of the nature of

[3] Regulation 2 (1) (e) of the Insider Trading Regulations 2015

[4] (1998) 18 SCL 311 MOF

[5] In the matter of DSQ Biotech, SEBI Chairman Order dated February 27, 2003.

[6] Regulation 3(2) of the 2015 Regulations

[7] SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 which lays out the framework for the Indian equivalent of a plea bargaining process.