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Insider Trading Regulations, 2014 – An Overview

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The malfeasance of insider trading has attracted the attention of regulators from jurisdictions across the world, especially in the light of discovery of massive frauds, both in the Indian and international capital markets. The lacunae in the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 (the "existing regulations") has had a detrimental impact on the rights of public shareholders, corporate governance norms and dented confidence in financial markets overall. Securities Exchange Board of India (SEBI), has sought to usher in a new regime to close the prevailing loopholes and curtail the malpractices prevalent in the securities market and in its meeting held on 19th November, 2014 ("meeting"), approved amendments that cover norms related to insider trading, delisting and enforceability of the listing agreement among others. It is to be noted that presently, SEBI has issued a press release bearing PR No. 130/2014, which only describes the important measures in principle and its complete implications can only be ascertained on release of the detailed amendment regulations.

Justice N.K Sodhi Committee Report

SEBI constituted an eighteen (18) member committee under the chairmanship of Justice N.K Sodhi ("Committee"), to review the existing regulations and its report has endeavoured to align the existing regulations with international practices, and adapting the same to Indian conditions and practices. The report has drawn heavily on literature pertaining to International Organization of Securities Commissions ("IOSCO"). It has made suggestions to address specific regulatory concerns balancing the needs of the Indian market as well as its investors. The report was submitted by the Committee on 7 December, 2013 ("Committee Report") and discussed in the meeting in which SEBI approved the SEBI (Prohibition of Insider Trading) Regulations, 2014 ("proposed regulations"). Certain key features of the proposed regulations are discussed in the following paragraphs.

Definition of "Insider"

The definition of "*insider*" has been broadened to include "*persons connected on the basis of being in any contractual, fiduciary or employment relationship that allows such person access to unpublished price sensitive information*". SEBI has made an effort to provide clarity to the definition by disintegrating it, into two parts, (i) Connected persons (ii) Unpublished Price Sensitive Information ("UPSI")

The proposed regulations have enhanced the scope of a "*connected person*". The criteria is not only limited to persons that occupy responsible positions in the company or those having professional/business relations with the company (which is the case currently) but extends to persons who are associated with a company in any manner, who have or are reasonably expected to have access to UPSI. The proposed regulations state that "*immediate relatives*" shall be presumed to be "*connected persons*" albeit

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with a right to rebut the presumption. Regulation 2(h) of the existing regulations enlists certain categories of persons who are deemed to be connected. It has been observed in several SAT cases, that the deeming provisions cannot be construed as exhaustive in nature. The proposed regulations build upon the principle laid down by judicial precedents over the years. However, it is to be seen, whether the proposed regulations do away with the deeming provisions completely as suggested in the Committee Report or retain the definition as provided in Regulation 2(h).

The Committee has rightly observed in its report, that whether a person is a *"connected person"* or not shall always necessarily be a mixed question of fact and law, which has to be decided on a case to case basis. It is in the background of this premise that the concept of UPSI has been clarified, and has been made more principle based. Principally, any information not *generally available,* and which may impact the price of a security shall be treated as UPSI. The phrase *"Generally available information"* has been defined so as to include, dissemination of information on a non-discriminatory platform, such as the stock exchange. Further, the Committee Report attempts to clarify the definition by using various illustrations, which seeks to establish that any information that is available on a non-discriminatory basis, and which is capable of being assessed by any person without any breach of law shall be considered as *"Generally available"*.

The Committee Report seeks to cast liability on public servants holding statutory positions that provides them with an opportunity to be in possession of UPSI. However, SEBI has not adopted such a liberal view in the Press Note.

Communication of UPSI

Under the existing regulations, it is not clear as to whether the offence of *"insider trading"* takes place only when one trades on unpublished information or whether the offence is committed immediately upon receipt of the information. The proposed regulations categorically prohibit disclosing and procuring UPSI as well as trading on receipt of such UPSI. Therefore, it could be the case that a mere disclosure of UPSI in itself constitutes an offence under the proposed regulations whether or not the recipient has utilised the UPSI to gain an undue advantage. However the most significant point to be noted here is that, the Committee Report as well as the Press Note issued by SEBI, employ the use of the word "trading" in place of "dealing". In case the above-mentioned change is reflected in the charging provisions of the official regulations, it will serve the purpose of restricting the scope of the Insider Trading Regulations to capture only the market abuse of insider trading.

However the proposed regulations provide sufficient leeway for communication of UPSI, in the event of discharge of legal obligations, performance of duties or communication in furtherance of legitimate purposes such as due diligence for private equity investments which so far, was prohibited under the existing regime.

Valid defences

In order to provide clarity to the charging provisions of the proposed regulations, provisions enlisting valid defences to be taken against allegations of insider trading have been

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introduced. It is to be noted that SAT has, in its order in the case of *Rakesh Agrawal* v. *SEBI*, [(2004) 1 CompLJ 193 SAT = 2004 49 SCL 351 SAT], emphasized on the element of *mens rea*, to be taken cognizance of, before setting out a charge of insider trading. The Committee report provides for these defenses only with respect to an offence of trading with UPSI and not an offence relating to communicating or receiving the UPSI. In light of the suggestions made by the report, it will be interesting to observe the approach adopted by the SEBI/SAT in the final regulations.

Trading plans

The concept of *"Trading Plans"* on the lines of Rule 10b5-1 of the Exchange Act, 1934, United States shall be adopted in the proposed regulations. Typically, *"pre-arranged trading plans"* allow officers and directors of public companies to trade in a pre-determined number of shares at a pre-determined time. A *"trading plan"* can be used as an affirmative defense against allegations of insider trading. It is understood that SEBI shall provide necessary safeguards, to ensure that the plans ascribe only to *bona fide* transactions.

Disclosure requirements

The proposed regulations prescribe mandatory disclosure of UPSI before trading, to avoid asymmetry of information in the market. The proposed amendment is in line, with Section 194 of the Companies Act 2013, which prohibits derivative trading by directors and Key Managerial Personnel on securities of the company.

Further SEBI has sought to relax the burden of repeated disclosures, by doing away with Regulation 13(3), which mandates disclosure of any change of 2% in the shareholding structure of the company, for persons holding more than 5% shares or voting rights. The rationale behind eliminating this regulation is to avoid repetition of disclosures as such a provision already exists in the Takeover Code.

Code of Fair Disclosures and Code of Conduct

The proposed regulations prescribe for a principle based Code of Fair Disclosures, which shall be published on the company's official website. The Code of Fair Disclosures shall govern the disclosure of events and circumstances that would impact the price discovery of its securities. Further, the board of directors of every company and market intermediary registered with SEBI would be required to formulate a Code of Conduct to regulate, monitor and report trading by its employees and other connected persons.

Conclusion

A brief perusal of the proposed regulations will lead us to believe that SEBI has indeed adopted a more principle based approach to deter insider trading in the securities market. This is evident from the tests laid down to understand and determine concepts such as UPSI, *"Connected persons"* or even *"Generally available information"*. The existing regulations, instead of defining these terms in clear and unambiguous language, have provided deeming provisions that haves misled both the regulator as well as the investor so far. The proposed regulations purport a wider definition, and have

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annotated each provision with legislative notes as an aid to interpretation. Another significant development is the exception carved out for due-diligence process, in case of merger & acquisition transactions, which clearly reflects upon the mindset of the regulator to facilitate rather than impede businesses. On the other hand, by shifting the *"burden of proof"* to the alleged offender, SEBI has strengthened its enforcement mechanism that has proven to be a major lacuna in the existing regime. Theoretically speaking, the reforms proposed shall serve good purpose in reducing rampant violation of insider trading norms, however until case-law develops it will be difficult to assess the practical implications of the proposed regulations.

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Notifications & Circulars

Appointment of Cost Auditor - Return filing: Companies who have filed Form 23C for appointment of Cost Auditor for financial year 2014-15 need not file Form CRA-2 afresh for the said financial year. General Circular No. 42/2014, dated 12-11-2014 issued by Ministry of Corporate Affairs also extends the date of filing of Form CRA-2 till 31-1-2015, considering the delay in availability of said form on the MCA website.

FDI in defence sector: The Department of Industrial Policy and Promotion (DIPP) has provided a list of defence items as finalised by Department of Defence Production, Ministry of Defence and has clarified that items not in the list, and dual use items i.e. items having military as well as civilian applications, would not require industrial license for defence purposes. Further, according to RBI Circular No. 46 dated 8-12-2014, listed investee company engaged in defence sector, shall immediately allocate limits for portfolio investment for RFPI (including QFI and FII), NRI (not exceeding 10%) and FVCI within the default portfolio investment limit of 24% permitted now, and approach RBI so that allocated limits can be monitored.

Issue of FCCBs and FCBs - Provisions of Chapter III of Companies Act, 2013 not applicable: Ministry of Corporate Affairs has clarified by way of General Circular 43/2014 dated 13-11-2014 that unless otherwise provided in the scheme or the directions/regulations issued by Reserve Bank of India, provisions of Chapter III of the Companies Act, 2013 shall not apply to an issue of Foreign Currency Convertible Bonds (FCCBs) or Foreign Currency Bonds (FCBs) made exclusively to persons resident outside India in accordance with the said regulations. It may be noted that provisions of Chapter III of the Companies Act provide for prospectus and allotment of securities including power of SEBI to regulate issue and transfer of securities.

Overseas investments by AIF allowed: Indian Alternative Investment Funds (AIF), registered with SEBI, have now been allowed to invest overseas as per Foreign Exchange Management (Transfer or Issue of any Foreign Security) (Amendment) Regulations, 2004

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and A.P. (DIR Series) Circulars No. 49 and 50, dated 30 April, 2007 and 4 May, 2007 respectively. Through these circulars, the Reserve Bank of India, had permitted Indian Venture Capital Funds registered with SEBI, to invest in equity and equity-linked instruments of off-shore venture capital undertakings, subject to an overall limit and SEBI regulations issued in this regard. According to RBI A.P.(DIR Series) Circular No. 48, dated 9-12-2014, the new provisions in respect of AIFs are applicable from 21-11-2014.

Pre-paid Payment Instruments (PPIs) - Issuance and Operation: The limit of Pre-paid Payment Instruments (PPIs) that can be issued, after carrying out customer due diligence, has now been enhanced from Rs. 50,000 to Rs. 1,00,000. RBI's Notification dated 3-12-2014 issued in this regard also states that the balance in the PPI should not exceed Rs. 1,00,000 at any point of time. Further, maximum validity of the gift cards has been enhanced from one year to three years. Banks have also been permitted to issue open system rupee denominated non-reloadable (a) PPIs to NRIs and foreign nationals visiting India & (b) PPIs co-branded with exchange houses/money transmitters (approved by RBI) to NRIs and foreign nationals visiting India, subject to certain conditions.

Credit facilities to minority communities - Inclusion of Jain community: Ministry of Minority Affairs, Government of India, had notified the Jain Community as a minority community, vide Notification No. S.O. 267(E), dated 27-1-2014. RBI Notification dated 3-12-2014 now states that the Master Circular dated 1-7-2013 relating to credit facilities to minority communities would also be applicable to Jain community. According to the notification, this is in addition to five communities already notified as minority communities, viz. Sikhs, Muslims, Christians, Zoroastrians and Buddhists.

Ratio Decidendi

BIFR does not automatically lose jurisdiction once company gets revived: The Supreme Court of India has held that after a reference is registered by the Board for Industrial and Financial Reconstruction (BIFR), all throughout the subsequent stages, BIFR has complete supervisory control over the affairs of such company till it is revived or the decision to wind up such company is taken. The Apex Court rejected the plea that since the net worth of the company had become positive, the BIFR had lost jurisdiction over the company. It was held that the ambit of such control includes determination of measures to achieve revival of the sick company; to check whether by such measures revival is being achieved; and the power to decide at any stage subsequent to registration of reference under Section 16 of Sick Industrial Companies (Special Provisions) Act 1985 (SICA) whether such company has ceased to be sick company. It was held that cessation of the status as a sick company can be under Section 17(1) of SICA or as a result of scheme for revival and that

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determination of such issue, is in the exclusive domain of BIFR.

The Supreme Court further observed that any submission or assertion by anyone including the company that by certain developments the company has revived itself and/or that its net worth since the stage of registration having become positive no such scheme for revival needs to be undertaken, can only be dealt with by the BIFR. It was also held that only upon the satisfaction of BIFR that a sick company is no longer sick, such company could be said to have ceased to be amenable to its supervisory control under SICA. [*Ghanshyam Sarda* v. *Shiv Shankar Trading Company* - 2014 (12) SCALE 732 (SC)]

Land Developer Scheme linking returns to land value appreciation is a 'Collective Investment Scheme': SEBI has held that fund mobilizing activity of a company under the garb of real estate business for sale/purchase, development and maintenance of agricultural land is covered within the parameters of 'collective investment scheme' as defined in Section 11AA of the SEBI Act, 1992. The company in this case was running a scheme whereby it collected deposits from public in lump-sum or in installments. As per the scheme, deposits were invested in purchase, development and maintenance of agricultural land. Return of 15-20% on investment was advertised. Noting that the scheme satisfied various conditions stipulated under Section 11AA(2)(i), (ii), (iii) and (iv) of the SEBI Act, the SEBI held that such a scheme is to be considered a 'Collective Investment Scheme' under SEBI (Collective Investment Schemes) Regulations, 1999, and hence the company cannot initiate such a scheme without obtaining prior registration from SEBI under the said regulations. An interim order barring the company from diverting any funds collected from the public has been issued by SEBI. The company has also been asked to provide a full inventory of its assets to SEBI. [SEBI Order in respect of *M/s KMJ Land Developers India Ltd. and its Directors* - WTM/ SR/ CIS/ WRO/109/12/2014 dated 9-12-2014]

Penalty for non-compliance of CCI Order: Delhi High Court has set aside penalties imposed by the Competition Commission of India for non-compliance of its earlier order directing the petitioner to file an undertaking to cease and desist from anti-competitive conduct, within the specified time period. Noting that such penalties are to be considered in the light of several factors including the nature of non-complied directions, effect of such non-compliance, intention of the parties accused of non-compliance, benefit derived by offending parties, and causes for non-compliance, the court held that the direction to file such undertaking was only to ensure compliance of the 'cease and desist' direction as contained in the earlier order, and was not a part of the substantive measures taken by CCI.

The court in this regard also held that CCI in its order imposing such penalty ignored the

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fact that substantive direction to cease and desist from anti-competitive conduct was not violated, and hence there was no element of public interest in imposing such penalty. The court also took cognizance of the fact that the petitioner had not derived any benefit from such non-compliance and that COMPAT had stayed the deposit of penalties imposed by CCI in its earlier order to the extent of 95% on the ground of petitioner-factory being a small scale industry. [*Rajkumar Dyeing & Printing Works Private Limited* v. *Competition Commission of India* - W.P.(C) 5947/2014 & CM 14538/2014, decided on 19-11-2014, Delhi High Court]

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