Consumer Unity and Trust Society

Suggestions on SEBI (Prohibition of Insider Trading) Regulations, 1992

Background

In April 2013, the Securities and Exchange Board of India (SEBI) constituted a high level committee (Committee) to review the SEBI (Prohibition of Insider Trading) Regulations, 1992 (PIT Regulations). As a part of review process, the Committee has sought inputs and suggestions from public on any aspect of PIT Regulations.

As an active member of the civil society tirelessly working for rights of consumers including investors in securities market, Consumer Unity and Trust Society (CUTS) is pleased to provide its suggestions on PIT Regulations.

International experience

Internationally, insider trading is prosecuted on the basis of two well settled principles. An insider (e.g. director) breaches *fiduciary duty* it owes to a company's shareholders when it deals in its shares on the basis of unpublished price sensitive information (UPSI). Absent a fiduciary duty, the *misappropriation theory* is invoked when a relationship of *trust or confidence* is breached by a person (e.g. market intermediary) dealing in shares of a company on the basis of UPSI, in its possession on account of a relationship of trust or confidence.

Insider trading does not have identifiable victims, and thus the aforesaid principles focus on ante-insider trading actions rather than post-insider trading results. The casualty of insider trading is the company to which the information belongs or the source from which the information is misappropriated upon breach of trust. This approach has both advantages as well as disadvantages. Regulators face practical problems in proving that dealing in securities was 'on the basis of' UPSI and collusion between an insider and outsider might escape the misappropriation theory (as the relationship of trust is not breached). The greater the number of hands the UPSI has passed through, the difficult it is to prove insider trading. However, the advantages consist of absence of outright ban on trading in securities. Markets participants are in a position to efficiently function in financial markets without any burden to ensure that they are not merely 'in possession' of UPSI, if they are not using such information to make investment decisions.

Countries have modified the interpretation of above principles and have adopted them to suit their domestic requirements. For instance, United States deals with insider trading under the broad spectrum of anti-fraud provisions (Section 10(b) of the Securities Exchange Act, 1934 and, specifically, rule 10b-5 promulgated by the Securities Exchange Commission), the recently constituted Financial Conduct Authority in the United Kingdom deals with insider trading under

the ambit of market abuse provisions (Section 118 of the Financial Services and Markets Act, 2000).

Indian position

SEBI was constituted with the objective of protecting interests of investors and promote development of securities markets, including prohibiting direct and indirect engagement in insider trading (Section 12A(d) of the SEBI Act, 1992). In fact, as recently as in April 2013, in the matter of *N. Narayanan* v. *Adjudicating Officer, SEBI* (decision dated 26.4.2013 – MANU/SC/0426/2013) the Supreme Court observed, "SEBI, the market regulator, has to deal sternly with companies and their directors indulging in manipulative and deceptive devices, insider trading etc. or else they will be failing in their duty to promote orderly and healthy growth of the securities market. Economic offence, people of this country should know, is a serious crime which, if not properly dealt with, as it should be, will affect not only country's economic growth, but also slow the inflow of foreign investment by genuine investors and also casts a slur on India's securities market. Message should go that our country will not tolerate "market abuse" and that we are governed by the "Rule of Law". Fraud, deceit, artificiality, SEBI should ensure, have no place in the securities market of this country and 'market security' is our motto. People with power and money and in management of the companies, unfortunately often command more respect in our society than the subscribers and investors in their companies. Companies are thriving with investors' contributions but they are a divided lot. SEBI has, therefore, a duty to protect investors, individual and collective, against opportunistic behaviour of directors and insiders of the listed companies so as to safeguard market's integrity."

Consequently, in addition to the international experience, the goals of investor protection and development of securities market, have been guiding light for SEBI to deal with insider trading. SEBI has embraced a modify-and-adopt approach with respect to international experience on insider trading in form of PIT Regulations. The PIT Regulations have been amended from time to time to suit the regulatory requirements. Unfortunately, failure to constantly examine its understanding of investor protection, periodically review its actions, and half-hearted adoption of international principles has resulted in complex regulatory regime in relation to insider trading that, on one hand has resulted in failure to continuously prosecute insiders, and on the other, has the potential to result in several unintended consequences.

For instance, SEBI has attempted to tackle the problem of insider trading by banning dealing in securities while 'in possession' of UPSI (Reg 3(1) of PIT Regulations). A duty to promote orderly and healthy growth of the securities market encompasses the duty to guarantee investor confidence by regulating insider trading. However, growth of securities markets should not be stifled by measures like outright ban on dealing in securities in certain circumstances. The approach of SEBI has following fundamental problems:

- Persons in possession of UPSI might not deal in securities on the basis of such information. Regulatory inability to identify and prosecute dealing on the basis of UPSI has led to complete prohibition on dealing in securities, even if no benefit is intended from such information.

- Capital markets provide an efficient avenue to investors to intelligently manage risks and uncertainties. Inability of managing risks in emergency circumstances by dealing in securities, for reasons of possessing UPSI alone, makes capital markets inefficient and hinder use of capital markets as a risk management tool.
- A person in possession of UPSI might not be aware that such information is UPSI. Placing of unnecessary additional burden on market participants to ensure that information in their possession is not UPSI increases transaction costs leads to differential treatment amongst market participants.

The solution

There is an urgent need to develop clarity in regulatory objectives and formulate high level guiding principles on insider trading. These principles need to be guided by objectives of SEBI, and must be investor – focused.

A person who deals in securities on the basis of UPSI is at a higher pedestal than the person with whom the financial contract is entered into. In contractual terms, the *consensus ad idem* is missing as one of the parties to the contract has better understanding of risks or benefits of the transaction which the other party is in no position to gather.

Neither the international approach of prosecuting insider trading on the 'basis of UPSI' nor the current Indian approach of prohibition of dealing while 'in possession of UPSI' may prove helpful in Indian context.

A principle of avoiding dealing in securities on knowledge of possession of UPSI may be adopted in Indian scenario. A person should not generally be allowed to trade in securities if in possession of UPSI and has knowledge or is reasonably expected to know that such information is UPSI. This would assist unsuspecting investors (deemed insiders) to function in securities market without unnecessary burden. In addition, SEBI may prescribe some acceptable exceptions (such as trading in emergency circumstances) from the above mentioned principle, in order to maintain efficiency and utility of securities markets. (SEE Rajiv B. Gandhi v. SEBI, SAT order dated 9.5.2008)

Further, if a company insider deals in its securities while in possession of UPSI and having knowledge (including deemed knowledge) that such information is UPSI, the burden of proof to establish absence of insider trading may be shifted on such person. This principle may not be enshrined in the regulations but may be developed by judicial interpretation of revised PIT Regulations. (SEE Chandrakala v. SEBI, SAT order dated 31.1.2012)

This would also help in leveling the playing field between persons in possession of UPSI and other investors in the market, while allowing market participants to freely deal in securities.

In addition to the above suggestions, the following part of this paper sets out some specific observations and suggestions of CUTS International on the PIT Regulations.

Specific observations and suggestions

S. no.	Issue	Suggestion	Rationale
1.	Reg 2(c) - Definition of "connected person" and Reg 2(h) – definition of "deemed to be a connected person"	A. Revised draft of Reg 2 (c) – "connected person means any person who – (i) is a director, as defined in section 2(13) of the Companies Act, 1956 (1 of 1956), of a company, or is deemed to be a director of that company by virtue of section 307(10) of that Act (already covered in Reg 2(c)(i)); (ii) occupies the position as an officer or an employee of the company (already covered in Reg 2(c)(ii)); (iii) holds a position involving a professional or business relationship with the company (already covered in Reg 2(c)(ii)); (iv) holds a relationship of trust or confidence with the company. Thus, two principal changes are suggested in the definition of connected person - (i) addition of an additional requirement of "relationship of trust or confidence with the company" (ii) deletion of words "and who may reasonably be expected	The definition of connected person is included in the PIT Regulations for the purposes of determining an insider. Internationally, a person is considered to be an insider if: (i) such person has received unpublished price sensitive information or a person; or (ii) such person: (a) has a fiduciary duty or a relationship of trust or confidence towards the source of the information; and (b) is reasonably expected to have access to unpublished price sensitive information in respect of a company. Condition (i) mentioned above is covered in Reg 2(e)(ii) at present and condition (ii) is covered in Reg 2(c) and Reg 2(h). On a closer scrutiny of Reg 2(c) and Reg 2(e), following three conditions are required to be fulfilled to prove that a connected person, other than a director, is an insider: 1. Officer/employee of company/person holding professional or business relationship with company; (reg 2(c)(ii) – part one) and 2. Reasonable expectation that such person has access to unpublished price sensitive <u>information about that company</u>; (reg 2(c)(ii) – part two) and 3. Reasonable expectation that such person has access to unpublished price sensitive <u>information in respect of securities of a company.</u> (reg 2(e)(i) – part two). Such language creates confusion for following reasons – 1. Fulfillment of either of the conditions

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		to have an access to unpublished price sensitive information of the company" from existing Reg 2(c)(ii). B. Deletion of Reg 2(h) that sets out definition of "deemed to be a connected person." The suggested deletion is consequent to the addition of requirement (iv) mentioned above to Reg 2(c).	(2) and (3), will in majority of cases, fulfill the other condition also - stating same condition twice is not good drafting. 2. However, in some cases, the companies under (2) and (3) might be different (SEE V.K. Kaul v. SEBI, SAT order dated 8.10.2012), and thus a person satisfying requirement (3) but not requirement (2) might not be considered an insider. Accordingly, deletion of condition (2) above would lead to a situation wherein an officer/employee/professional having access to unpublished price sensitive information of any company, as a result of such employment, would be considered an insider. This should ideally be the objective of PIT Regulations. In addition, Reg 2(h) is not a principal based definition and considers various entities to be deemed insiders even if such entities may not have any existing relationship with the source company. The addition suggested to Reg 2(c) introduces a principal based requirement and any entity that has a relationship of trust or confidence (this is expected to cover most of the entities covered in Reg 2(h)) would be considered as connected persons. Consequently, Reg 2(h) needs to be deleted.
2.	Explanation to Reg 2(c)(ii) – connected person shall mean any person who is a connected person six months prior to	Inserting words "initiation of" prior to the words "an act"	Confusion might arise on what constitutes an act of insider trading? Will an 'incomplete action' constitute an act (such as attempted insider trading)? Or an 'in progress' action constitute an act (such as an ongoing insider trading)? Or a series of 'partly completed actions' constitute an act (such as a chain of tipping and dealing in securities)?

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	an act of insider trading.		By inserting "initiation of" prior to "an act", the position will be clarified and it might also help in prevention of insider trading by bringing attempted insider trading within the ambit of insider trading.
3.	Reg 2(d) – Definition of "dealing in securities"	Modify the definition to "dealing in connection with the securities" to mean – directly or indirectly, either as principal or as agent, either on its own behalf or on behalf of any other person,: (a) subscribing, buying, selling, or agreeing to subscribe, buy or sell securities (already covered in reg 2(d)), or; (b) communicate, counsel or procure any unpublished price sensitive information to any person (covered in reg 3(ii)).	The structure of PIT Regulations is such that transacting in securities as well as unauthorized communication of unpublished price sensitive information is prohibited in certain circumstances (Reg 3). Currently, Reg 3(ii) provides that a tippee (outsider to whom unpublished price sensitive information is communicated) cannot deal in securities. However, dealing in securities is currently limited to transaction in securities i.e.; subscribing, buying, selling securities and does not cover communication of unpublished price sensitive information. Consequently, a tippee acting as a conduit and merely passing on unpublished price sensitive information is not caught by the current language of PIT Regulations. Replacing dealing in securities in reg 2(d) with as suggested "dealing in connection with securities" that covers communication of unpublished price sensitive information and making consequent modifications in PIT Regulations including in Reg 3 would prevent a tippee from further selectively passing on unpublished price sensitive information.
4.	Reg 2(e)(i) – Definition of "insider"	Delete words "of securities" after the words "in respect of"	Currently, Reg 2(c)(ii) requires expectation of access to unpublished price sensitive information about a

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			company, by a connected person. However, Reg 2(e)(ii) requires expectation of access to unpublished price sensitive information in respect of securities of a company, by an insider. Price sensitive information, by its inherent nature, can only be information that has the potential to affect price of securities of a company. Addition of the words "securities of" and use of inconsistent language (between reg 2(c)(ii) and reg 2(e)(ii)) may create confusion and unintended consequences.
5.	Reg 2(e)(i) – Definition of "insider"	Replace "," with ";" after the words "a company" Addition of explanation to Reg 2(e) – conditions (i) and (ii) above are mutually exclusive to each other.	Reg 2(e)(i) and Reg 2(e)(ii) are mutually exclusive and independent of each other and any person who has received or accessed unpublished price sensitive information must be considered an insider, irrespective of position of such person vis-à-vis the company to which such information relates. (SEE V.K. Kaul v. SEBI, SAT order dated 8.10.2012, Rajiv. B. Gandhi and others v. SEBI, SAT order dated 9.5.2008.) However, in certain cases, Reg 2(e)(ii) has been unintentionally clubbed with Reg 2(e)(i). (SEE, in the matter of Manoj H. Modi and Smita M. Modi, SEBI order dated 10.4.2013, in the matter of Reliance Petroinvestments Limited, SEBI order dated 2.5.2013) In order to avoid such an interpretation, it is necessary to clearly bring out exclusivity of both the conditions.
6.	Reg 2(g) – Definition of "officer of a company"	Deletion of the words "an auditor of the company" after the words "of the Companies Act"	A combined reading of Reg 2(g) and Reg 2(c)(ii) might lead to an interpretation that the terms "professional relationship" in Reg 2(c)(ii) is limited to "auditors" (as only auditor has been categorically included in Reg 2(g)) and consequently

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			would exclude legal advisors and other professionals capable of having relationship with a company.
7.	Reg 2(ha) – Explanation to definition of price sensitive information	Replace the words "the following shall be deemed to be price sensitive information" with "price sensitive information will include but not be limited to the following:"	It has been argued previously that price sensitive information is limited to the instances provided under explanation to Reg 2(ha). (SEE arguments in Manoj Gaur v. SEBI, SAT decision dated 3.10.2012) To clarify the position that the explanation to Reg 2(ha) is illustrative in nature and does not list all the possible cases of unpublished price sensitive information, the change in language is required.
8.	Reg 3 – Prohibition on insider trading	Revised formulation is as follows: "No insider shall, when in possession of unpublished price sensitive information and having knowledge, or is reasonably expected to know, that such information is unpublished price sensitive, deal in connection with securities listed on any stock exchange."	As discussed earlier, to avoid unintended consequences of strict regulation of insider trading, it is proposed that a person who has the knowledge that the information such person possesses is unpublished and price sensitive, could be prohibited from dealing in connection with securities (as noted above, this would include dealing as well as communication of inside information). As tippees would expressly be included in the definition of insider, such persons also would be prohibited from dealing in connection with securities, should they be aware that the information in their possession in unpublished price sensitive information.
9.	Reg 3A	Delete Reg 3A. Consequent modifications in the PIT Regulations to remove references to Reg 3A will need to be made.	At present, Reg 3A prohibits a company to deal in securities of an associate company while in possession of unpublished price sensitive information. Such a blanket prohibition is unwarranted, and reduces efficiency of capital markets.

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			If a company and its associates are in a business or any other relationship as a result of which the associate comes in possession of some unpublished price sensitive information, such associate would be covered in the revised definition of connected person (by virtue of other relationship of trust or confidence), and if such associate knows, or is reasonably expected to know, that such information is unpublished price sensitive, it will be prohibited from dealing in connection with company's securities. Thus, the need to separately state the prohibition on associate company does not arise.
10.	Reg 4	Replace the words "deals in securities" after the words "insider who" with the words "deals in connection with securities." Add explanation to Reg 4 – "Any person who abets an insider to deal in connection with securities in contravention of Reg 3 or Reg 3A shall be guilty of insider trading."	This is to ensure consistency with the proposed revised language in relation to dealing in connection with securities. In addition, a person abetting insider trading must also be prosecuted similar to an insider under the PIT Regulations.
11.	Reg 7(3)	Add the word "officer" after the word "employee".	This is to ensure consistency with Reg 7(4).
12.	Reg 7(4)	Add the word "member" after the word "employee."	This is to ensure consistency with Reg 7(3).
13.	Reg 8	Provide specific time limit, for instance 60 days.	This is to ensure accountability of investigation officer and prevent undue harassment of a market participant.

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14.	Schedule I, Part A, paragraph 3.2.1	Add the words "existence of unpublished price sensitive information, including" before the words "during the time"	Currently, paragraph 3.2.1 may be interpreted to mean that trading window is closed only when information referred in paragraph 3.2.3 is unpublished, and consequently need not be closed if any other price sensitive information is unpublished. (SEE Hindustan Dorr Oliver Limited v. SEBI, SAT order dated 19.10.2011). However, the intention should be to close trading window when any unpublished price sensitive information is in existence. Closing the trading window only in cases when certain specific price sensitive information is unpublished, and allowing insiders to trade in other situations, defies the logic of prohibiting insider trading. Such intention is clear from para 3.3.3 (b) of part A in schedule I. Thus, the change is required.
15.	Schedule I, Part A, paragraph 3.2.6	Addition of words "or conversion of convertible securities" after the words "of ESOPs"	Necessary exemption is required in cases where convertible securities are eligible for conversion during the period when trading window is closed. The situation is similar to exercise of options in case of ESOPs, as no third party (seller) is involved in conversion of securities.
16.	Schedule I, Part A, paragraph 4.2	The thirty day lock in requirement is not provided in SEBI (Issue of Capital and Disclosure Requirement) Regulations (ICDR Regulations), it should be provided in ICDR Regulations also.	In order to bring consistency between ICDR Regulations and the PIT Regulations, the same requirement may be replicated in the ICDR Regulations.
17.	Schedule I, Part B, paragraph 4.2	Add the words "or its material associate" after the words "listed company."	Often there are situations when the listed company is a shell/non-operating holding company and its shares derive value from

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			operations of a material operating associate. Thus, if any assignment for an entity which is material associate of a listed company is being undertaken, the organization undertaking such assignment, must not be able to deal in securities of the listed associate while in possession of unpublished price sensitive information and if reasonably expected to know that such information is unpublished price sensitive.

In addition, certain global comments consist of replacing "organization/ firm" in Part B of Schedule I with "entity" and defining entity as "person, other than individual". Further, it is suggested that use of gender neutral language be adopted and use of archaic words (such as shall) be avoided (and words such as must, could be used.)

About CUTS

Consumer Unity and Trust Society (www.cuts-international.org), established in 1984, is a research based advocacy and capacity building organization with its headquarters in Jaipur (India), and working on various elements of regulatory policy, competition, consumer protection (including investor protection) and international trade. CUTS has a long experience of working in the area of financial consumer protection (http://cuts-international.org/cart/financial_consumer_protection.htm), and also has completed a project on India's investment environment (http://www.cuts-ccier.org/India_Investment_Environment.htm). CUTS is also registered as an investor association with SEBI.