

## Salient Features of the Regulations

### I. Definitions

#### i. 'Insider'<sup>i</sup>

Instrumental to the functioning of an insider trading regulation is the definition of an 'insider'. Under the Regulations, an 'insider' has been defined to mean any person who is (i) a connected person; or (ii) **in possession of or having access** to unpublished price sensitive information ("UPS"). Every connected person is an 'insider' under the Regulations. An outsider i.e. a person who is not a 'connected person' would qualify as an 'insider' if such person was 'in possession of' or 'having access to' UPS.

The Regulations, whilst not deviating drastically from the definition under the 1992 Regulations, have strengthened the definition of who an 'insider' is by expanding the definition of 'connected person'.

#### ii. 'Connected Person'<sup>ii</sup>

Every 'connected person' under the Regulations is an insider. The qualifying test of whether or not a person would fall within the definition of a 'connected person' is if a person who is or has during the *six months* prior to the concerned act been associated with the company, *directly or indirectly*, in any capacity including:-

- by reason of frequent communication with its officers; or
- by being in a contractual, fiduciary or employment relationship; or
- by being a director, officer or an employee of the company; or
- holds any position including a professional or business relationship between himself and the company whether temporary or permanent that allows such person, directly or indirectly, access to UPS or is reasonably expected to allow such access.

The definition, therefore, covers any person who has a connection with the company that is expected to put him in possession of UPS. Persons who do not seemingly occupy any position in a company but are in regular touch with the company will be covered within this definition. The Committee had recommended express inclusion of public servants/persons holding statutory positions that have or reasonably expected to have access to UPS. However it is not to say that such individuals are not captured within the definition of connected persons if such persons are in frequent communication with the company's officers in the course of their activities. Also, the Committee had recommended doing away with the concept of 'deemed connected persons'. However, those recommendations have not been incorporated in the Regulations.

In the US, outsiders such as investment bankers, advisors and others who often receive confidential information while providing services to the issuer acquire the direct fiduciary duties of the true insider are popularly termed as 'constructive insiders'<sup>iii</sup>. As per the misappropriation theory, an outsider commits insider trading when he obtains material confidential information and uses it in securities transactions in breach of fiduciary duty or similar relationship of confidence to the source of information<sup>iv</sup>. In this context, it is interesting to note that the verdict in *SEC vs. Cuban*<sup>v</sup> suggests that outside of fiduciary or fiduciary-like context, a confidentiality agreement is sufficient to create liability under the misappropriation theory only if the agreement involves both obligation to preserve confidentiality of the information and obligation not to trade on the basis of the information or otherwise use it for personal advantage. However, given the paucity of jurisprudence, it remains to

be seen as to how a duty of trust and confidence is created for the purpose of misappropriation theory.

iii. **Unpublished Price Sensitive Information<sup>vi</sup> & Generally Available Information<sup>vii</sup>**

The Regulations make clearer what constitutes UPSI by defining it to mean any information relating to a company *or its securities*, directly or indirectly, that is not generally available which upon becoming available is likely to materially affect the price of the securities and shall include: financial results; dividends; change in capital structure; mergers, demergers, acquisitions, delistings, disposals and expansion of business and such other transactions; changes in key managerial personnel; and material events in accordance with the Listing Agreement.

The Regulations further define the term 'generally available' to mean information that is accessible to the public on a non-discriminatory basis.

Under the 1992 Regulations, price sensitive information would remain 'unpublished' if the information was not published by the company or its agents. However, that concept has been done away with in these Regulations. Therefore, the criteria to determine what constitutes UPSI is whether the information is 'generally available' or not under the Regulations. Another key change lies in the definition of price sensitive information in 1992 Regulations which earlier had reference to a company only. The definition of UPSI shall now extend to both a company and securities.

iv. **Trading<sup>viii</sup>**

Trading under the Regulations has been defined to mean and include '*subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, deal in any securities*'. Although the Committee had recommended streamlining of the definition of 'trading' to only include transacting in securities by way of acquisition and disposal of the securities. The Regulation has been kept wide so as to include 'dealing' in securities keeping in mind the principal legislation i.e. SEBI Act, 1992 which prohibits 'dealing' in securities on the basis of material non-public information, amongst other things. Therefore, even transactions such as creation of security interest or pledging would come within the scope of 'trading' for the purpose of this Regulation.

v. **Other definitions**

- a. The definition of 'securities'<sup>ix</sup> has been borrowed from the Securities Contracts (Regulation) Act, 1956. However, for the purpose of this Regulation, 'units of a mutual fund' shall not qualify as 'securities'. Therefore, apart from the plain vanilla securities, more sophisticated instruments including derivatives, security receipts, any rights or interest in securities, hybrid instruments will be covered under the definition of 'securities' for the purpose of this Regulation. It may be worthwhile to note that leaving out 'units of mutual funds' may lead to the issue of fund arbitrage.
- b. The Regulations have introduced a definition for a 'compliance officer'<sup>x</sup> of the company who shall be financially literate and is capable of appreciating requirements for legal and regulatory compliance under these Regulations. The compliance officer shall directly report to the Board of the Company or the head of the organization as the case may be.

II. **Charging Provisions<sup>xi</sup>**

Prohibition on insider trading consists of the following key components: (i) prohibition on communicating UPSI by an insider (ii) prohibition on other persons on procurement of UPSI and (iii) prohibition on trading by an insider while in possession of UPSI.

As stated above, at stark variation with the 1992 Regulations, the Regulations restricts communication by insiders and procurement by outsiders of UPSI of a *company or its securities listed or proposed to be listed*. The charge of insider trading will not get attracted in case such

communication or procurement is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

Drawing a comparison to foreign jurisprudence, in assessing the extent of ‘tipper – tippee’ liability (in light of what is more commonly known as the misappropriation theory in the US) the United States Court of Appeals for the Second Circuit in the case of [United States vs. Newman](#), made the conditions for attributing liability to a ‘tippee’ extremely stringent i.e. only if the tippee is aware of the tipper’s breach of fiduciary duty due to disclosure of the information as well as the fact that the tipper divulged it for personal benefit.<sup>xii</sup>

As regards the charge under ‘trading while in possession of UPSI’, the Regulations have provided certain circumstances in which an insider may prove his innocence:-

<b>General</b>	An off-market transaction between promoters who – were in possession of the same UPSI (without being in breach of Regulation 3) <b>and</b> – both counterparties made a conscious and informed trade decision.
<b>Specifically for non-individual insiders</b>	– Individuals who executed the trade were different from individuals in possession of UPSI and were not in possession of such UPSI; or – Chinese wall arrangements were in place and there was no leakage of information and the Regulations were not violated; or – Trades were made pursuant a trading plan.

Interestingly, there were a variety of valid defences which had been proposed to be incorporated in the Regulations by the Committee, which have not been finally incorporated in the Regulations.

The legislative notes further define the spirit of the Regulations to move closer to a strict liability test by stating that the trades of an insider will be presumed to be motivated by the knowledge and awareness of the UPSI that he is possession of. The legislative notes further state that reasons for which such a person trades or the purposes to which he applies the proceeds of the transactions are not intended to be relevant for determining whether a person has violated the regulation. We may note in this respect that Section 15 G of the SEBI Act, 1992 prohibits dealing ‘on the basis of’ UPSI which may now lead to a certain ambiguity as to whether the charge of insider trading will be attracted if the insider trades while he is ‘in possession of UPSI’ or would it apply only if he trades ‘on the basis of’ UPSI. This debate has plagued the insider trading norms for quite some time now. 1992 Regulations suggested that the prohibition against insider trading was only attracted if the insider traded ‘on the basis of’ UPSI. However, the same was later amended by SEBI so as to include dealing while ‘in possession of’ UPSI, which was later sufficiently negated by the Securities Appellate Tribunal Ruling of [Chandrakala vs. SEBI](#).

### Due Diligence<sup>xiii</sup>

The Regulations contain a specific carve-out for communication and procurement of information, for instance for the purpose of conduct of due-diligence in connection with substantial transactions including mergers and acquisitions. Therefore, based on whether or not a transaction entails making an open offer under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (“**Takeover Code**”), information may be communicated, provided, allowed access to or procured on the following conditions:

<b>Open Offer Obligation under Takeover Code</b>	Where the board of directors of the company is of the informed opinion that the <i>proposed transaction</i> is in the best interest of the company.
<b>No Open Offer Obligation under Takeover Code</b>	Where the board of directors of the company is of the informed opinion that the <i>proposed transaction</i>

	<p>is in the best interest of the company.</p> <p style="text-align: center;">+</p> <p>Information that constitutes UPSI is disseminated to be made generally available at least 2 trading days prior to the proposed transaction being effected in such form as the board of directors may determine.</p>
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Therefore, as long as the board is of the informed opinion that the transaction is in the best interest of the company, due –diligence may be lawfully conducted. In case, a particular transaction does not entail making an open offer to the public shareholders, the board of directors would be required to cause public disclosures of the UPSI prior to the proposed transaction to rule out any information asymmetry in the market. Additionally, a duty has been cast on the board of the company to cause the parties to execute confidentiality and non-disclosure agreements for the purpose of this provision.

Although, due-diligence was not specifically prohibited under the 1992 Regulations, there was an ambiguity on whether as a part of the diligence a company was permitted to disclose unpublished price sensitive information. Therefore, introduction of this provision under the Regulations has amply clarified that the communication or procurement of UPSI for the purpose of due-diligence shall be permitted, subject to the conditions set out in the Regulations.

SEBI has left it to the board of the company to determine the form and manner of disclosure of such UPSI prior to the proposed transaction. However, there still remains a level of uncertainty regarding the market reaction and consequences of causing such public disclosures prior to the proposed transaction, in cases where an open offer obligation is not triggered under the Takeover Code.

### III. Trading Plans<sup>xiv</sup>

To facilitate compliant trading by insiders constantly in possession of UPSI, the Regulations have introduced the concept of ‘trading plans’ (similar to Rule 10b5-1 plans in the U.S.) whereby every insider is entitled to execute trades in pursuance of pre-determined trading plan which has been approved by the compliance officer and has been publically disclosed six months prior to commencement of such trading. Some of the key features of the trading plans are:-

- Trading plans shall not entail trading for a reasonable period around declaration of financial results;
- Trading plan shall not entail trading for at least 12 months since the date of decision to trade;
- There shall not be any overlap with another trading plan already in existence;
- Trading plan that entail trading in securities for market abuse is prohibited;
- Trading plans must set out nature of trade, value of securities or the number of securities to be invested or divested, specific dates and time etc.;
- The compliance officer is entitled to review the trading plan and seek express undertakings that may be necessary for such assessment/monitoring and notify the stock exchanges on which the securities are listed, once the trading plans are approved;
- Once approved trading plans shall be irrevocable and the insider shall mandatorily implement the plan within the scope of the trading plan, without any deviation;
- Commencement of the trading plan will be required to be deferred in a situation where the insider is in possession of UPSI at the time of formulation of the plan has not become generally available at the time of commencement of the plan.

Given that once approved the trading plan becomes irrevocable, long term trading plans may not be commercially viable.



#### IV. Disclosure Obligations<sup>xv</sup>

The chart below sets out the initial and continual disclosures to be made by certain categories of persons in a company whose securities are listed on a stock exchange along with the public disclosure requirements for the company:

Disclosure	Categories required to make disclosures	Particulars	Time Period
<b>Initial Disclosure to the Company (Internal)</b>	<ul style="list-style-type: none"> <li>- Promoter</li> <li>- Key Managerial Personnel</li> <li>- Director</li> </ul>	Holding of securities of the company as on date of the Regulations taking effect.	Within <b>30 days</b> of Regulations taking effect.
<b>Initial Disclosure to the Company (Internal)</b>	Upon appointment as:- <ul style="list-style-type: none"> <li>- Promoter</li> <li>- Key Managerial Personnel</li> <li>- Director</li> </ul>	Holding of securities of the company as on date of appointment.	Within <b>7 days</b> of appointment
<b>Continual Disclosure to be made to the Company (Internal)</b>	<ul style="list-style-type: none"> <li>- Promoter</li> <li>- Employee</li> <li>- Director</li> </ul>	Number of securities acquired or disposed of in case the value of securities traded, whether in one day or a series of transactions over a calendar quarter, aggregates to a traded value <b>in excess of one million rupees</b> or such other value as may be specified.	Within <b>2 trading days</b> of such transaction.
<b>Disclosure to be made by the Company (Public)</b>	Company required to notify the stock exchange	<ul style="list-style-type: none"> <li>- in case the value of securities traded by a promoter, employee or director, whether in one day or a series of transactions over a calendar quarter, aggregates to a traded value <b>in excess of one million rupees</b> or such other value as may be specified.</li> <li>- incremental transaction after the above disclosure to be made when the transactions effected after the prior disclosure crosses the monetary threshold of <b>one million rupees</b> or such other value as may be specified</li> </ul>	Within <b>2 trading days</b> of receipt of the disclosure or from becoming aware of such information.

A key change introduced by the Regulations is that the provision relating to initial and continual disclosures for persons holding more than 5% shares or voting rights has been done away with. It is intended that the disclosure to be made by any persons shall also include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions (regardless of whether the person has title to the trades is in such possession or not).

#### V. Code of Fair Disclosure and Conduct<sup>xvi</sup>

The Board of every listed company is required to formulate and publish a code of practices and procedures to be followed for fair disclosure of UPSI in accordance with the principles set out in

Schedule A to the Regulations. Schedule A of the Regulations sets out certain minimum standards such as 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.

Further, the board of directors of *every listed company* and *market intermediary* shall formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons in accordance with Schedule B to the Regulations. The Regulations further provide every other person who is required to handle UPSI in the course of business operations such as auditors, accountancy firms, law firms, analysts, consultants, other capital market participants etc. are also required to formulate such a code of conduct. Therefore, even entities that normally operate outside the capital market may be required to formulate such a code depending on their exposure to UPSI. Also, every such person formulating a code of conduct is required to identify and designate a compliance officer to administer the same.

#### *Trading Windows*

Another important development is in relation to notional trading windows which are used as an instrument to monitor compliant trading by designated persons within a company. The concept of notional trading windows has also been made applicable to external agencies having contractual or fiduciary relation with the company such as law firms, accountancy firms etc. The time-frame for such re-opening of trading windows has been set to 48 hours (which was 24 hours under 1992 Regulations) after the UPSI becomes generally available.

#### *Sanctions*

Certain disciplinary actions such as wage freeze, suspension etc. may be imposed by the person required to maintain a code of conduct as well.

### **Analysis**

With a view to do away with the lacunae and inadequacies of the 1992 Regulations, SEBI has revamped the entire framework governing insider trading in India. With the introduction of the Regulations, the scope of who an 'insider' or a 'connected person' is, will stand significantly widened. Therefore, any person, whether or not related to the company, may come within the purview of the Regulations if he is expected to have access or possess UPSI. Applicability of the Regulations shall extend to UPSI in relation to a company as well as securities listed or proposed to be listed on a stock exchange.

For the purpose of legitimate business transactions, access to UPSI, for instance of due – diligence, with appropriate safeguards has been explicitly provided for which shall avert the risk of any regulatory scrutiny in relation to such transactions. It is of merit to consider that certain changes proposed by the Committee such as introduction of definition of a 'company'; inclusion of public servants or persons occupying statutory positions within the definition of 'connected persons and certain valid defences have not been incorporated in the Regulations. A unique feature of the Regulations i.e. legislative notes interspersed within provisions will be an effective tool for interpretation of these Regulations going forward. The Regulations shall come into force on the 120<sup>th</sup> day of their notification i.e. May 15, 2015. Therefore, all companies as well as the promoters, employees, directors and external agencies in a contractual or fiduciary relationship with such companies and officers will be required to ensure due compliance with the Regulations within the stipulated time period.

SEBI has overhauled the entire framework for regulation of insider trading, which is seen to be a deep rooted<sup>xvii</sup> problem in India, with a view to ensure a level-playing field in the securities market and to safeguard the interest of the investors. This move by SEBI will provide a much-needed filip to Indian capital market and facilitate further economic buoyancy.

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- <sup>i</sup> Regulation 2(g)  
<sup>ii</sup> Regulation 2(d)  
<sup>iii</sup> Dirks v. SEC, 463 US 646 (1983)  
<sup>iv</sup> SEC v. Texas Gulf Sulphur (1968, CA2 NY, U.S. vs. O'Hagan, 521, U.S. 642 (1997); U.S. v. Carpenter, 484, U.S. 19 (1987);  
<sup>v</sup> SEC v. Cuban, 634 F Supp 2d 713, 725 (N.D. Texas 2009). SEC Rule 10b5-2  
<sup>vi</sup> Regulation 2(n)  
<sup>vii</sup> Regulation 2 (e)  
<sup>viii</sup> Regulation 2(l)  
<sup>ix</sup> Regulation 2(i)  
<sup>x</sup> Regulation 2©  
<sup>xi</sup> Regulation 3& 4  
<sup>xii</sup> On December 20, 2014, United States Court of Appeals for the Second Circuit in United States v. Newman, after considering landmark decisions by the U.S. Supreme Court, in the case of Dirks v. S.E.C., 463 U.S. 646 (1983) and Chiarella v. United States, 445 U.S. 222 (1980), narrowed down the scope of insider trading liability for tippees.  
<sup>xiii</sup> Regulation 3(3)  
<sup>xiv</sup> Regulation 5  
<sup>xv</sup> Regulation 6 & 7  
<sup>xvi</sup> Regulation 8 & 9 read with Schedule A & B  
<sup>xvii</sup> Article published in Wall Street Journal points out certain inadequacies as regards insider trading framework in India. Available on <http://blogs.wsj.com/indiarealtime/2014/04/21/why-is-it-tough-to-catch-insider-trading-in-india/>.