Consultative Paper on amendments to SEBI (Prohibition of Insider Trading) Regulations 1992

1. On 1st January 2008, SEBI came out with a consultative paper to introduce "short swing profit" regulations by amendment to the SEBI (Prohibition of Insider Trading) Regulations 1992 and sought public comments on the same. In addition to the proposal of 1st January, public comment is being sought on several other proposed amendments to the regulations.

2. Amendments were carried out in 2002 to the SEBI (Prohibition of Insider Trading) Regulations 1992 (**the regulations**) to introduce a wide range of prophylactics and corporate governance norms.

3. Over the course of the past few years since the amendment, there have been some new learnings in terms of the way the regulations have played out in the market. The key amendments brought in processes which would reduce the possibilities of insider trading by means of an institutionalized methodology e.g. pre-clearance of trades, black-out windows of trading, disclosure of buy/sell by certain insiders, appointment of compliance officer and a catena of other provisions.

4. There have been several instances of persons of high integrity committing unintended violations of these provisions. Thus, we need to be sensitive to the

fact that perhaps the norms have been set so high that even experts are unable to keep track and be in compliance with these standards. This is an important issue as criminal jeopardy is attached to such corporate governance violations. In addition, there is a need to move towards a more principle based approach to regulations rather than a rule based approach, particularly in matters of corporate governance.

5. In addition, some regulations are also proposed to be introduced.

Background

6. The 2002 amendments to the Regulations provide extensive suggestions and regulations. Most of the good governance provisions are provided for as mandatory provisions. Briefly, the good governance regulations provide for:

    a) Officer, director and substantial shareholder to disclose their holding on certain events or at certain intervals.

    b) Appointment of a compliance officer.

    c) Setting forth policies and procedure to restrict the possibility of abuse of insider trading.

    d) Monitoring and pre-clearance of trades by the designated persons.

    e) Restrict trading by such insiders within a certain period of time i.e. before corporate announcements, buybacks etc. are made.

    f) The company has to convey all the significant insider activity and corporate disclosure in a uniform publicly accessible means to the public – and to the stock exchange.

    g) Chinese walls within a firm to prevent one part of the firm which deals in sensitive information from going to other parts of the firm which have an inherent conflict of interest with such other parts.

    h) Minimum holding period of securities by insiders.

    i) No selective disclosure to analysts. Wide dissemination of information.

7. Provided below is an analysis of some of the provisions of good governance regulations and proposals for amendments.

Officer, director and substantial shareholder to disclose their holding on certain events or at certain intervals.

8. There should be some coordination between the requirements of acquisition/sale of shares reported in these regulations with the requirements of the takeover regulations. In fact the takeover reporting is broader since it mandates reporting by any person over certain thresholds and also requires reporting by a group – a concept not introduced in these Regulations. However, the insider trading Regulations provide for disclosure of smaller amounts and provides for disclosure on selling shares (something which the takeover code does not mandate).

   Proposal: It is suggested that a purchase disclosure made under either regulations (with the same or higher level of disclosure) should be deemed to be good disclosure under the other. It is also proposed to increase the harmonization between the two in terms of threshold limits set.

   Regulatory Impact Assessment: As there is a proposal to harmonise the two regulations, there is expected to be neither a substantial change in the burden on insiders nor will there be a dilution of the rights of investors. To the extent of deemed disclosure, there will be a reduction in cost without any reduction in benefit to investors.

Restriction on trading by insiders within a certain period of time i.e. before corporate announcements, buybacks etc. are made.

9. The wordings of the regulations may freeze trading in sometimes rather large windows. The Regulations should not asphyxiate legitimate trading by insiders. As trading by insiders and employees aligns their interests with those of the company and should be encouraged if there is no improper behaviour. Provided below are the relevant clauses pertaining to the trading window:

3.2 Trading window

3.2.1 The company shall specify a trading period, to be called "Trading Window", for trading in the company's securities. The trading window shall be closed during the time the information referred to in para 3.2.3 is unpublished.

3.2.2 When the trading window is closed, the employees / directors shall not trade in the company's securities in such period.

3.2.3 The trading window shall be, inter alia, closed at the time of:-

(a) Declaration of Financial results (quarterly, half-yearly and annual)

(b) Declaration of dividends (interim and final)

(c) Issue of securities by way of public/ rights/bonus etc.

(d) Any major expansion plans or execution of new projects

(e) Amalgamation, mergers, takeovers and buy-back

(f) Disposal of whole or substantially whole of the undertaking

(g) Any changes in policies, plans or operations of the company

10. Issuance of (non cash) bonus/rights shares may have no real effect on the price of the security and therefore there is no need to have an automatically restricted window for that purpose. Since the list given in clause 3.2.3 is inclusive, where the management believes that such issue will be in fact price sensitive, they would be free to create an appropriate window freeze. In addition sub-clauses (d) to (g) above appear broad and could cause unnecessary problems. To give an example, a company which makes a large gas find, in one grid, does not want to disclose that fact so that it can buy the neighbouring grids at a bargain price. It therefore, for a valid business purpose keeps the find a secret for six months. Even though the directors who know about the find would be expressly prohibited from trading in the securities under the substantive provisions of the regulations,

all employees (who do not know) too would be barred from trading for six months in the shares of the company. An auto company comes out with secretive plans for introducing ‘new age’ models almost every month. Such companies would never allow employees to trade in their shares because there is a closed window for any ‘execution of new projects’. This does not in any way effect the substantive provisions which restrict insider trading – which will of course continue to be strictly prohibited.

Proposal: It is proposed that the phraseology of the above clauses be tightened so that harmless transactions are no implicated in the prohibitions imposed. In addition, issue of bonus shares being a book entry, may have no impact on the price (there is correlation rather than causal connection if any), reference to bonus issue and rights issues may be removed from the list. Management of a company would in any case create such window freeze, where it believes that such freeze would be necessary. This would be in line with a principles based approach rather than a rule based approach.

Regulatory Impact Assessment: Presently, the regulations appear rigid and broad and thus restrict harmless acts of a class broader than classic insiders. Also certain non-price sensitive information invokes trading window bans. In both cases the costs outweigh any regulatory benefits and are proposed to be rationalized and made more principle based.

Pre clearance of trades

11. Certain provisions are made for clearing of trades if certain officers/employees engage in trading of shares of their own company. To cite from Schedule I, Part A.

> “3.3.1 All directors/officers/designated employees of the company who intend to deal in the securities of the company (above a minimum threshold limit to be decided by the company) should pre-clear the transactions as per the pre-dealing procedure as described hereunder.

3.3.2 An application may be made in such form as the company may notify in this regard, to the Compliance officer indicating the estimated number of securities that the designated employee/ officer/ director intends to deal in, the details as to the depository with which he has a security account, the details as to the securities in such depository mode and such other details as may be required by any rule made by the company in this behalf.

4.1 All directors/officers /designated employees shall execute their order in respect of securities of the company <u>within one week after the approval</u> of pre-clearance is given. If the order is not executed within one week after the approval is given the employee/ director must pre clear the transaction again.

4.2 All directors/officers /designated employees shall hold their investments in securities for a minimum period of 30 days in order to be considered as being held for investment purposes. The holding period shall also apply to subscription in the primary market (IPOs). In the case of IPOs, the holding period would commence when the securities are actually allotted.

12. Once securities are pre-cleared, there is no necessity of prescribing just one week for the trades to occur. This would expose the employees / officers to unnecessary market timing risk. Experience from the market seems to suggest that it is not uncommon in large institutions for officers to get their approval for trading after several weeks or even months from the date of application. Given a one week window to execute their orders would penalize employees with market timing risk while trading in their own company's stock.

Proposal: The company should be free to determine their own methodology within an outer time frame. The window permitting execution of trades may be changed to 4 weeks or such shorter period as may be prescribed by the company through internal policy.

Regulatory Impact Assessment: Presently, the regulations appear restrictive and thus impose a risk on employees to transact within a short window after approval is received from the company. This exposes the employee to sell at possibly inopportune times or restart the long process of obtaining another permission. It is proposed to rationalize the trading window to reduce this market risk which may be decided by a company with an outer limit. Thus where companies are smaller and more responsive they may choose to retain a shorter window, while slower/larger companies may choose to retain a longer duration window for employees.

Designated or qualified brokers.

13. To facilitate compliance with the new reporting of transactions, issuers should either designate a single broker through whom all transactions in issuer stock by insiders must be completed or require insiders to use only brokers who will agree to the procedures set out by the company. A designated broker can help ensure compliance with the company's pre-clearance procedures and reporting obligations by monitoring all transactions and reporting them promptly to the issuer. If designating a single broker is not feasible, issuers should require insiders to obtain a certification from their broker that the broker will:

    - Verify with the issuer that each transaction entered on behalf of the insider was precleared; and
    - Report immediately to the issuer the details of each of the insider's transactions in the issuer's securities.

Proposal: It is proposed that the regulations be amended to introduce either designated brokers' empanelment or building a reporting system between a company and specified brokers. Public comments may address the desirability of such introduction as also which method may be specified.

Regulatory Impact Assessment: While imposing either standard proposed is likely to impose some additional costs in terms of flexibility to execute trades by insiders, the benefits of a closer connection between the executing broker and the company would likely exceed such costs.

Derivatives amendments

14. Parts of the regulations refer to 'shares' instead of 'securities' for the purpose of disclosures. For instance, one could, using derivatives, economically buy/sell the shares without physically trading in those shares. Similarly, one can easily create synthetic securities with the same (or higher) economic impact as an equity share of a company often with a high leverage. By reclassifying shares into securities for the purpose of disclosure, one can eliminate the problem because securities are defined to include equity, quasi-equity, derivatives and any combination of the three. Pure debt instruments can be excluded specifically from the disclosure regulations, while they would continue to be included in the substantive violation provisions of Regulations 3 and 4. Thus an insider holding debt, and while aware of a problem in the solvency/rating of the company, sells such debt securities would continue to be liable under the prohibition.

Proposal: It is proposed that the regulations be amended to broaden the class of securities beyond shares as the present regulations leave out disclosure of a key means of taking an exposure to the economic interest in shares and that too on a leveraged basis (i.e. higher exposure).

Regulatory Impact Assessment: The drafting appears to miss the disclosure of derivatives positions by insiders as exchange based derivatives trading began only in June of 2000. The proposal corrects this important shortcoming in the securities market regulation where the regulation.

Tippee liability

15. The regulations prohibit persons from tipping people about inside information by insiders i.e. the tipper. However, there seems to be no liability for a person who improperly receives a tip i.e. a tippee from trading. There is a vague prohibition

against 'procurement' of information. However, it does not clearly prohibit a tippee from trading.

Proposal: It is proposed that the language of the regulation may be improved by way of clarification to specifically penalize a tippee of information from trading.

The penal clause

16. Regulation 14 creates a substantive violation under S. 24 of the Act so that one can in theory go to jail for 10 years for violating simple or process oriented provisions.

Proposal: Presently, the corporate governance standards contained in Regulations 12 and 13 is made a violation of not only S. 11 but also of S. 24 viz. criminal prosecution. It is recommended that such a harsh consequence for process based violations is inappropriate. It is proposed that criminal penalties attached to corporate governance measures may be deleted while the other powers of monetary penalties and directions are continued. In addition it is proposed to let companies make a standardized disclosure in their annual report as to how much of the Schedule they are not in compliance with. This will allow the markets to decide whether to economically penalise companies which do not have these process oriented safeguards in place and will take us a step forward towards the Efficient Capital Markets Hypothesis. It goes without saying that criminality will continue to attach to substantive violation of insider trading prohibitions.

Regulatory Impact Assessment: The costs of criminal sanction on lack of proper processes and corporate governance employed appears excessive and disproportionate to the violation and the proposal will rationalize the proportionality attached to violations by restricting them to monetary penalties and directions instead of criminal sanction.

Disclosure - key means of enforcement of process

17. Standards of corporate governance should be left at the helm of the managers of the company. What should be mandated should be a statement in the annual report of the degree of compliance with the standards set forth in the Schedule. Thus companies which do not follow corporate governance guidelines in substance would be penalized by its shareholders.

    Proposal: There should be a disclosure standard on which areas of the norms set in the schedule have not been implemented by the company in its annual report. This may be provided by amending Clause 49 (VI) of the listing agreement to provide for such disclosure.

    Regulatory Impact Assessment: As regulations move towards an increasingly disclosure based and principle based regime where investors assess and value companies based on good corporate governance and in view of the proposal to negate criminality from good governance measures, the proposal to introduce fair disclosure of non-compliance will likely positively impact investor information while imposing a burden by means of market price on non-compliant companies and their management.

Comments are invited from the public on the above proposals. The comments may be sent by e-mail upto 27th March 2008 to the following addresses –

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Comments may also be sent physically to the following address, so as to reach latest by 27th March 2008 –

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