

## Corpsec Hotline

March 13, 2012

### RBI WELCOMES FIIS TO PRIMARY BOND ISSUANCES!

"The prohibition contained in Regulation 3 of the regulations apply when an insider trades or deals in securities 'on the basis' of any unpublished price sensitive information and not otherwise. It means that the trades executed should be motivated by the information in the possession of the insider."– Securities Appellate Tribunal (emphasis applied)

The Securities Appellate Tribunal ("SAT"), in its recent order in the matter of Mrs. Chandrakala vs. The Adjudicating Officer, Securities and Exchange Board of India ("SEBI"), has stirred up the deliberation regarding interpretation and application of Regulation 3 of the SEBI (Prohibition of Insider Trading) Regulations, 1992 ("Insider Trading Regulations") by setting aside an order passed by the Adjudicating Officer of SEBI ("SEBI Order") vide which a penalty of INR 0.8 million was imposed on Mrs. Chandrakala ("Appellant") for the violation of Regulations 3(i), 3(ii)<sup>1</sup> and 4<sup>2</sup> of the Insider Trading Regulations.

### FACTS

SEBI conducted an investigation into the affairs of M/s. Rasi Electrodes Limited ("Company"), listed on the Bombay Stock Exchange, upon noticing a sudden rise in the price and volume of its scrip between the period June 8, 2007 to July 20, 2007. The investigation revealed the following pertinent facts:

1. The agenda for the board meeting of the Company to be held on June 30, 2007 concerning the rate of dividend, was discussed between Mr. B. Popatlal Kothari (chairman and managing director of the Company) and Mr. G. Mahavirchand Kochar (whole time director of the Company). This agenda was finalised between the period June 19, 2007 to June 30, 2007, during which period the information about the financial results and dividend was considered to be 'unpublished price sensitive information'<sup>3</sup>.
2. Similarly, between July 15, 2007 and July 17, 2007, the agenda for the board meeting of the Company to be held on July 25, 2007 concerning the issue of bonus shares was discussed between the directors of the Company. This was subsequently published on July 17, 2007. Hence, the bonus share issuance by the Company remained unpublished price sensitive information for a period between July 15, 2007 and July 17, 2007.

SEBI associated the aforesaid set of events with the trading details of the Company and observed that the Appellant was trading in the scrip of the Company during the impugned period and that she is the wife of Mr. Uttam Kumar Kothari (being the promoter of the Company and also the brother of Mr. B. Popatlal Kothari, chairman and managing director of the Company).

On account of the relationship between the Appellant and the directors of the Company (who were in possession of unpublished financial results and aware of dividend and bonus issuances concerning the Company), SEBI alleged that the Appellant is an 'insider'<sup>4</sup> and a 'connected person'<sup>5</sup>, and traded in the scrips of the Company based on unpublished price sensitive information. Based on this, SEBI issued a show cause notice to the Appellant for alleged violation of Regulation 3(i), (ii) and 4 of the Insider Trading Regulations and ultimately levied a penalty of INR 0.8 million on the Appellant.

It is against this SEBI Order that the Appellant referred an appeal to the SAT.

### ARGUMENTS ON BEHALF OF THE PARTIES

SEBI argued that the Appellant, who stayed with her husband at the same address as that of the chairman and managing director of the Company, was deemed to be a 'connected person' with the Company and being an 'insider', privy to the unpublished price sensitive information, had traded on the basis of possession of such information.

On the other hand, counsel on behalf of the Appellant contended that the Appellant's husband had given up his interest in the Company as promoter with effect from March 31, 2005 and was a mere shareholder of the Company during the impugned trading period and consequently had no information about the day-to-day affairs of the Company. Moreover, it was submitted that the Appellant together with her husband resided in an apartment different from the one (though built on the same plot of land) in which the chairman and managing director of the Company resided. The Appellant vehemently opposed the allegation that her trades were motivated by the unpublished financial results of the Company and submitted that her trading activity was independent of and unrelated to the corporate announcements of the Company. The Appellant's contention was also supported by the fact that she was not only involved in buying of shares, but had also sold shares of the Company both prior to, during and post the corporate announcements.

### JUDGMENT

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Though it was not disputed by the Appellant that it can be treated as a person 'deemed to be a connected person' with the Company and that the information in question qualified as 'price sensitive information', the Appellant stressed on the fact that, as required under Regulation 3 of the Insider Trading Regulations, there was no material brought on record by SEBI to prove that the Appellant traded on the basis of price sensitive information.

SAT agreed with the Appellant that she did not trade on the basis of the impugned unpublished price sensitive information and instead her trades were genuine transactions carried out in the ordinary course of business. SAT further surged on the fact that the Appellant had bought the shares of the Company as well as sold them in multiple transactions not only during the said period when the price sensitive information was unpublished but also prior to and after the information was made public. SAT interestingly observed that, unlike in the present case, in case any insider is motivated by the unpublished price sensitive information, such person will usually tend to purchase shares and not sell shares prior to the unpublished information becoming public.

Based on the aforesaid observation, SAT allowed the appeal and set aside the SEBI Order.

It is noteworthy that in facts of the instant case, SAT came to the conclusion that the Appellant did not trade 'on the basis of' unpublished price sensitive information. SAT while interpreting Regulation 3 of the Insider Trading Regulations, expounded that the prohibition contained in Regulation 3 applies only when an insider trades or deals in securities 'on the basis of' any unpublished price sensitive information and not otherwise. SAT further clarified that trades executed should be motivated by the information in the possession of the insider.

## ANALYSIS

Through this order, SAT has tried to endorse the legal position which existed prior to 2002 in relation to Regulation 3 whereby the then existing Insider Trading Regulations provided that no insider shall deal in securities of a company listed on any stock exchange 'on the basis of' any unpublished price sensitive information. Vide the amendment in 2002, the phrase 'on the basis of' was replaced with 'when in possession'. By this order, SAT has laid down stringent criteria for triggering the applicability of the Insider Trading Regulations and the onus of proving whether trading by an insider was induced by the unpublished price sensitive information would now lie on SEBI.

SAT establishes that the purpose of Regulation 3 of the Insider Trading Regulations is not to prohibit an insider from trading altogether but to restrain him from trading based on the unpublished price sensitive information that may be in its possession. If an insider trades or deals in securities of a listed company, the presumption is that he / she has traded on the basis of unpublished price sensitive information and the burden of proof lies on the insider to establish the divergent view. This order gives an elaborate explanation on the doctrines relating to Regulation 3 of the Insider Trading Regulations, which is the epicenter of the Insider Trading Regulations.

– Harshita Srivastava, Sambhav Ranka & Vyapak Desai

You can direct your queries or comments to the authors

<sup>1</sup> Regulation 3 (i) and (ii) of the Insider Trading Regulations states: 'No insider shall: (i) either on his own behalf or on behalf of any other person deal in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information; or (ii) communicate or counsel or procure directly or indirectly any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information shall not deal in securities. Provided that nothing contained above, shall be applicable to any communication required in the ordinary course of business or profession or employment or under any law.'

<sup>2</sup> Regulation 4 of the Insider Trading Regulations states that any insider who deals in securities in contravention of the provisions of the Regulation 3 or 3A shall be guilty of insider trading.

<sup>3</sup> Regulation 2 (k) defines the term 'unpublished' to mean information which is not published by the company or its agents and is not specific in nature. Regulation (ha) of the Insider Trading Regulations defines the term 'Price Sensitive Information' to mean any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company.

<sup>4</sup> Regulation 2 (e) of the Insider Trading Regulations defines the term 'insider' to mean any person who: (i) is or was connected with the company or is deemed to have been connected with the company and is reasonably expected to have access to unpublished price sensitive information in respect of securities of company, or (ii) has received or has had access to such unpublished price sensitive information.

<sup>5</sup> Regulation 2 (c) of the Insider Trading Regulations defines the term 'connected person' to mean: (i) is a director as defined in Section 2 of the Companies Act, 1956 of a company or as is deemed to be director of the company by virtue of sub-clause (10) of Section 307 of the Act; or (ii) occupies the position of an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company with a temporary or permanent and who may reasonably be expected to have a access to unpublished price sensitive information in relation to that company.

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