FINSEC
Law Advisors

SECURITIES AND INVESTMENT REGULATIONS

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Newsletter

DRAFT INSIDER TRADING REGULATIONS

The Justice Sodhi Committee report which was released on 7 December, 2013, purports to restructure the existing legal regime on insider trading in India (**"Draft Regulations"**). The following table highlights some of the significant provisions in the Draft Regulations *vis-à-vis* the SEBI (Prohibition of Insider Trading) Regulations, 1992,(**"1992 Regulations"**) and contains a brief analysis of the proposed changes.

1992 Regulations	Draft Regulations
Definition of 'connected person' broadened	
No provision specifically included public servants or persons who frequently communicate with officials. Separate definition of 'connected person' and 'person deemed to be a connected person'.	Persons who frequently communicate with company officials and public servants having access to UPSI included in the definition of 'connected persons'. No separate definition of 'person deemed to be a connected person'.
Overbroad definition of 'connected person' may lead to uncertainty in scope and create overlaps with other regulations relating to fraud.	
Communication of UPSI	
Prohibition on insider from communicating UPSI to any person who is prohibited from dealing in securities while in possession of such UPSI.	Mere communication of UPSI is an offence, even in absence of any trading in securities. Communication only permissible when in furtherance of legitimate purposes.
Insider trading must involve actual trading of securities when in possession of UPSI. Prohibiting mere communication in absence of any trade would be improper.	
Due Diligence	
Permissibility of conducting due diligence prior to investment unclear.	Due diligence permissible if board believes it is in best interest of the company. In cases where open offer is not triggered by proposed trading, additional obligation to disclose all UPSI two trading days prior to transaction.
The due diligence exception should also be provided for private placement of securities by qualified institutional placement, rights issue and follow-on public offering.	
Dealing vs. Trading	
Regulations governed all dealing in securities, including subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in securities.	By using the term 'trading', regulations more focused on transacting in securities whether by way of acquisition or disposal.
Necessary change, as it narrows applicability and excludes situations such as pledging of shares.	
Trading Plan	
Concept of trading plan not provided.	Trades by insider pursuant to an approved trading plan and disclosed to the public.
Will make trading by insiders more clear and enable them to engage in regular investments in relation to the company without attracting the prohibition against insider trading.	

1992 Regulations	Draft Regulations
'UPSI'	
Definition of 'unpublished price sensitive information' included all information that was not published by company or its agents.	Shift to reliance on 'generally available information' threshold which includes information that is accessible to the public on a non-discriminatory basis. Any information that is not 'generally available information' is defined as UPSI.
Unclear whether unconfirmed information that is generally available would be seen as UPSI.	
Disclosure by Employees	
Promoters, officers and directors required to make disclosures. Only designated employees were covered.	Apart from promoters, officers and directors, obligations of making disclosures on all employees.
Such mechanical disclosures would simply result in increased compliance costs and accumulation of irrelevant data. Financial threshold for transaction by employees should be provided.	
Trades by Relatives	
No provision requiring disclosure of trades carried out by dependents or relatives.	Persons who are required to make disclosures must also disclose trades executed by immediate relatives and dependent persons.
Obligation may be unreasonably onerous in cases where access to trading details of immediate relatives is limited.	
Defences	
The regulations provide defences to dealing in securities of one company by another company while in possession of UPSI in certain situations.	Any insider who has traded while in possession of UPSI may adopt certain defences.
This is a good move since defences have been made available for all transactions covered under the Draft Regulations.	
Code of Conduct	
Code of Conduct restricts directors/officers/designated employees from executing trades that are opposite to a prior trade executed by them for 6 months from the earlier trade.	Provision along these lines absent.
Any profit made during the short term of 6 months should flow back to the company and there should not be a blanket ban on such trades.	

Shelf Prospectus

A shelf prospectus filed during the first offer of securities enables the company filing it, to make a subsequent offer of such securities within one year from the date of opening of the first offer, without issuing another prospectus. Under Section 60A of the Companies Act, 1956, only public financial institutions, public sector banks or scheduled banks whose main object was financing could file a shelf prospectus. However, Section 31 of the Companies Act, 2013 has left it to the discretion of SEBI to determine the class of companies which may file shelf prospectus. Accordingly, SEBI issued the draft 'Proposals for Allowing Certain Class of Companies to File Shelf Prospectus for Public Issuance of Non-Convertible Debt Securities' on 26 November, 2013 and subsequently approved the same at its Board Meeting held on 24 December, 2013.

The draft proposes that the following class of companies may file shelf prospectus: (i) public financial institutions and scheduled banks;(ii) issuers authorized by the notification of CBDT to make public issue of tax free secured bonds with respect to such tax free bond issuances;(iii) Infrastructure Debt Funds Non Banking Financial Companies (IDF-NBFC) regulated by RBI. NBFCs registered with RBI, Housing Finance Companies registered with National Housing Bank and other entities, whose equities or debt securities have been listed on a stock exchange for the last three years, having net worth of at least Rs. 500 crores and a credit rating of not less than 'AA' from a recognized credit rating agency, may, subject to certain conditions, issue a shelf prospectus for raising funds through public issuances of non-convertible debt securities.

While Section 31 of the Companies Act, 2013 permits the issuance of all types of securities under a shelf prospectus, SEBI has allowed only non-convertible debentures to be issued under shelf prospectus. It is time that the capital markets regulator allowed companies to file shelf prospectus for public issuance of equity shares. Not only will it facilitate in reducing the time and costs involved in raising funds from public, it will also help spur the waning equity capital markets in India.

Research Analysts

The Draft SEBI (Research Analyst) Regulations, 2013 was issued on 29 November, 2013. Before the draft regulations, research analysts have been subject to disclosure requirements under the SEBI (Prohibition of Insider Trading) Regulations, 1992 and The Code of Corporate Disclosure Practices for Prevention of Insider Trading.

The draft regulations provide for registration and regulation of independent research analysts, intermediaries that employ research analysts or issue research reports and research analysts that give recommendations in the public media. Investment advisers, asset management companies, proxy advisory service providers and fund managers of Alternative Investment Funds need not be registered as research analysts. However these entities need to fulfil conflict avoidance and disclosure obligations prescribed under Chapter III if, they, their employees or directors make public appearances or appear in public media to give recommendations on securities or public offers.

The avoidance of conflict of interest measures contained in the draft regulations are primarily restrictions on trading or dealing in securities on which research analysts make recommendations to the public. For instance, provisions to ensure that the recommendations are not influenced by investment banking or brokerage transactions of entities.

Research analysts and intermediaries are required to make several disclosures, including the valuation methods used to determine the price target, the financial interest of any close relative, whether they receive any compensation for investment banking or any other services from the company. All these disclosures are to be made in research reports and while making public appearances.

The draft regulations are a welcome step to ensure the neutrality and quality of research reports. However a few issues need attention. The draft regulations do not contain sufficient and specific provisions for prevention of potential conflicts and malpractices by research analysts. Further, it may be difficult to enforce provisions which impose the obligations under Chapter III on entities other than research analysts.

Foreign-based research analysts providing reports to foreign clients on Indian listed securities should be specifically excluded from the purview of these regulations as it would not protect Indian investors and would impose a severe restriction on the operation of foreign research entities providing their analysis to foreign investors. The capital adequacy requirements under Regulation 7 should be eliminated as research analysis does not need capital.

A Self-Regulatory Organization should be set up under Regulation 13 at an early date. It can function as a regulator of first instance at the industry level and prescribe industry-wide conflict mitigation and disclosure standards. Moreover it will act as a link between SEBI and the research analyst.

Penalties Imposed for Siphoning off IPO Proceeds

SEBI has recently imposed a penalty of more than Rs. 53 crores (530 million) against 16 entities and 9 of their directors for their involvement in siphoning IPO proceeds off Brooks Laboratories Ltd. SEBI found the entities, acting along with the directors of Brooks Labs, guilty of diverting the IPO proceeds for the repayment of certain fraudulently created Inter-Corporate Deposits (ICDs) which had detrimentally affected other investors. This is perhaps the largest penalty imposed by the regulator.

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