AMENDING THE Insider Trading Regulations

EXPANDING THE SCOPE OF STRICT LIABILITY

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Every action has an equal and opposite reaction. Since its formulation over three centuries ago, Sir Issac Newton's third law of motion – one of the foundational principles of classical mechanics – has helped us understand the physical world. Newton's third law may have eventually faltered at the quantum level, but there is one field where it continues to hold true: regulatory rule-making. The November 24, 2022 amendment to the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations) to extend its application to mutual funds units, is the latest instance of this axiom shaping securities market regulations in India.

This amendment comes in the wake of a Consultation Paper released by the market regulator in July last year, which had mooted the idea of insider trading laws being extended to mutual funds. The events ('action' in Newton-speak), which triggered the formulation of the Consultation Paper and the subsequent amendment to the PIT Regulations (the regulatory 'reaction'), are no mystery. The Consultation Paper talked about the need to "initiate serious enforcement

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actions" against those who misused sensitive, non-public information related to mutual fund schemes. To underpin this point, it refered to a couple of incidents where entities and individuals with access to non-public information about mutual fund schemes, had redeemed their holdings in those schemes.

By introducing the amendment to the PIT Regulations, SEBI has now sought to prohibit trading in mutual funds by insiders who possess any information that is not generally available and could have a material impact on the net asset value of a scheme or interest of unitholders. Consequently, once the amendment is notified and becomes effective, entities will need to monitor trades in mutual funds by their designated persons which could increase their compliance burden. Moreover, the wide-ranging definition of 'connected persons' (who are deemed to be 'insiders' under the law) could forestall a host of market players from investing in mutual funds.

Interestingly, the proposed amendment is a reversal of SEBI's earlier stand on this issue. Prior to the introduction of the PIT Regulations in 2015, SEBI had constituted a committee (under the Chairmanship of Justice N.K. Sodhi) to recommend changes to the extant regulatory regime dealing with insider trading.

As the SEBI order in the FTMF matter awaits appellate scrutiny, the amendment to the PIT Regulations is intended to introduce deeming provisions – the made-to-measure manacles – that can apply to future instances of trading in mutual fund units.

One of the recommendations made by the committee was to include mutual funds within the scope of insider trading laws. However, at that time, SEBI had rejected this recommendation in view of the strict and transparent norms of NAV calculations and observed – somewhat fatefully – that the offence of 'front running' was covered under the SEBI (Prohibition of Fraudulent and Unfair trade Practices relating to Securities Market) Regulations, 2003 (PFUTP Regulations).Thus, when the PIT Regulations were introduced in 2015, mutual fund units were specifically excluded from its ambit.

Several years on, the regulator's decision to modify its view is understandable. The enforcement of market conduct laws is an unenviable task and, in most cases, direct evidence of wrongdoing is nearly impossible to find. To overcome this handicap, the regulator relies on a variety of jurisprudential and legislative tools; a key one being the 'deeming provisions' in the PIT and PFUTP Regulations. Simply stated, the 'deeming provisions' invert the traditional rule of the prosecutor having to prove that the accused has committed an offence. These provisions allow SEBI to presume that an offence has been committed, as soon as a particular set of conditions set out in the rulebook is satisfied. The burden of proof then shifts to the accused who needs to refute the allegations. And yet, even tools as potent as 'deeming provisions' can sometimes prove ineffective.

In June 2021, a SEBI Whole Time Member (WTM) passed an order dealing with a unique situation: a key executive of Franklin Templeton Mutual Fund (FTMF) was alleged to have redeemed the units he (and his family) held in certain schemes of the mutual fund, while possessing non-public information about those schemes. SEBI contended that the redemption had allowed the executive and his family to avoid losses suffered by other unitholders, and alleged a contravention of the PFUTP Regulations. However, when the WTM parsed the regulatory provisions to determine whether a violation had occurred, he faced a few challenges.

Firstly, while the misuse of material, non-public information would generally be examined under the lens of insider trading, the PIT Regulations were inapplicable in this case as it pertained to mutual fund units. Secondly, the charge of fraudulent conduct met with the stumbling block of inducement. Under the PFUTP Regulations, a 'fraudulent' act must induce others to deal in securities. The WTM correctly observed that if redemption does not induce other market participants to deal in securities, the allegation of fraud cannot stand. And lastly, the redemption could not be categorised as front-running – an act that is 'deemed' to be an offence– as the PFUTP Regulations make knowledge of a "substantial impending transaction" a pre-condition to front-running. In this case, no such knowledge had been alleged by SEBI.

At this juncture, it is worth noting that this was not the first – and will not be the last – time that the regulator faced a fact-pattern that did not neatly fit the charging provision in the rulebook. In 2011, SEBI had held certain individuals liable for front-running and this conviction was overturned by the Securities Appellate Tribunal on the grounds that the provision which deemed front-running as an offence under the PFUTP Regulations applied only to intermediaries, i.e., non-individuals.

Eventually, the Supreme Court was called upon to determine whether the limited applicability of a deeming provision could shackle the regulator's ability to prosecute market offences by wielding the broader, principle-based charging provisions, namely, Regulation 3 and 4(1) of the PFUTP Regulations. In its order in SEBI v. Kanaiyalal Baldevbhai Patel &Ors., the Supreme Court vindicated

SEBI's decision to hold the individuals liable for front-running and noted that Regulation 3 and 4(1) were "couched in general terms to cover diverse situations and possibilities."

In the FTMF matter as well, when the deeming provisions proved inapplicable, the WTM could rely on the prohibition on 'unfair trade practices' in Regulation 4(1) of the PFUTP Regulations. The phrase 'unfair trade practices' is not defined but has been described by the Supreme Court (in SEBI v. Rakhi Trading) in expansive terms: as "a practice which does not conform to the fair and transparent principles of trades in the stock market". This broad formulation allowed the WTM to invoke this provision to assail the redemption of mutual fund units by individuals allegedly in possession of non-public, sensitive information.

As the SEBI order in the FTMF matter awaits appellate scrutiny, the amendment to the PIT Regulations is intended to introduce deeming provisions – the made-to-measure manacles –that can apply to future instances of trading in mutual fund units. However, there will always arise circumstances which cannot be pre-emptively envisioned and tackled by the existing clauses in the rulebook. Indeed, the Supreme Court has itself noted (in SEBI v. Kanaiyalal) that even when "amendments are made to the regulation, yet such amendments sometimes fail to live up to human ingenuity and growth of technology."

The Kanaiyalal matter is a classic example of SEBI successfully using the principle-based charging provisions at its disposal, when faced with novel situations. This precedent – and its affirmation by the apex court – should embolden the regulator to reduce its reliance on deeming provisions and make optimal use of the catch-all prohibitions that are already available in the law.

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