FINSEC
Law Advisors

SECURITIES AND INVESTMENT REGULATIONS

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We successfully hosted the inaugural edition of Finsec Dialogue on Insider Trading Regulations, 2015 on February 16, 2016. Finsec Dialogue is a monthly event which will discuss, over a telephonic conference call, topical issues in the field of financial regulation, including securities and investment laws. At Finsec Dialogue we will discuss contemporary issues of financial law and policy. These sessions will focus on practical issues faced by market participants on account of financial regulations and highlight legal ambiguities, gaps and overlaps.

For more information please visit the events page on our website.

Facebook friends as Insider Trading Evidence

The Whole Time Member, SEBI recently issued an order in relation to the violation of the provisions under the erstwhile SEBI (Prohibition of Insider Trading) Regulations, 1992. Pursuant to its investigations, SEBI observed that certain insiders traded in the scrip of the company while in possession of unpublished price sensitive information regarding the slump sale of the software division and declaration of interim dividend. SEBI observed that 15 individuals had violated the provisions under the PIT Regulations, 1992 and ordered impounding of the alleged gains made by such persons.

What is interesting in this matter is that SEBI has, for the first time, used Facebook accounts as evidence for insider trading. The WTM held that a certain person was an insider based on various factors, including that he was connected to a certain other person *"through mutual friends on Facebook"*. While SEBI has been examining social media accounts of suspected persons during its investigation, it had until now, not actually presented it as evidence.

Social media accounts, by their very nature and usage, cannot provide strong, cogent and conclusive evidence, especially as regards establishing a connection between suspected individuals indulging in an insider trading case. Under the PIT Regulations, 1992 a connected person was one who held a position involving business or professional relationship with a company and who may reasonably have been expected to have access to UPSI in relation to that company. Merely befriending a company's official or having common friends with such official does not satisfy the aforesaid requirements. Such connectedness over social media does not imply that a person can reasonably be expected to have access to UPSI.

PIT Regulations not applicable to ESOP Trusts

SEBI, in its recent no-action letter issued to KPIT Technologies Limited, considered the applicability of the trading restrictions under the SEBI (Prohibition of Insider Trading) Regulations, 2015, to trusts created to facilitate stock option schemes. In the case at hand, for meeting the needs of exercised stock options, the trust either applies to the company for issuance of shares or acquires shares through secondary market purchases.

Trading restrictions under the PIT Regulations, 2015 are not applicable to an employee either at the time of exercise of stock options or at the time of sale of the shares so acquired. However, as the trust is deemed to be an insider and is to be treated similarly to a promoter, trading restrictions are ordinarily applicable when the trust acquires shares. SEBI, in the no-action letter, has observed that the trust is not undertaking the trades in its own capacity but is acting solely on behalf of the employees to give effect to the exercise of stock options. Therefore, it is now clarified that acquisition of shares by the trust to give effect to exercise of stock options are not subject to the trading restrictions under the PIT Regulations.

As the clarification is in the form of a no-action letter, the same is not binding on SEBI and its decisions in the future. However, it provides an insight into SEBI's outlook on the treatment of stock option trusts and is another step in the right direction in making stock options a viable means of aligning employee interests with those of the company.

Dividing Line between PFUTP Regulations and Code of Conduct Violations

In *SEBI* v. *Kishore R. Ajmera*, the Supreme Court recently passed an order on several appeals involving a common question of law i.e. what is the degree of proof required to hold brokers/ sub-brokers liable for fraudulent/ manipulative practices under SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 2003 and/ or liable for negligence under the Code of Conduct as specified under SEBI (Stock Broker and Sub-Broker) Regulations, 1992.

The court stated that it is a cardinal rule of law that proof of an allegation levelled against a person may be in the form of direct evidence or circumstantial evidence. In relation to the violations committed by the brokers/sub-brokers, the court stated that the evidence has to be gathered from various circumstances such as the volume of the trade effected; the period of persistence in trading in the particular scrip; the particulars of the buy and sell orders; the proximity of time between the two etc.

The court held that there is a dividing line between negligence and deliberate intention. The difference between Code of Conduct violations and PFUTP Regulations violations depends on the extent of the persistence on the part of the broker/sub-broker. Upto an extent, where the brokers/sub-brokers failed to alert themselves, violations can be attributed to negligence and lack of due care and caution. However, persistent trading either over a long period of time or in respect of huge volumes would show deliberate intention to play the market. The court further added that the said dividing line has to be drawn on the basis of the volume of the transactions and the period of time that the broker/sub-broker indulged in the conduct.

This is a landmark decision by the Supreme Court which has shed some clarity on the determination of liability either for violations of the provisions under PFUTP Regulations or for the violation of the provisions under the Code of Conduct, though the question of broker/sub-broker complicity will always be a fact centric issue.

RBI lends a hand for Start-up India

In line with the government's Start-up India initiative, RBI, on February 2, 2016, announced various regulatory relaxations proposed to be made, in consultation with the government, to ease doing business and contribute to an ecosystem that facilitates growth of start-ups. The focus has been on relaxing norms for overseas investors in order to make it easier for them to transfer their holdings in Indian start-ups. Easier exit norms are intended to encourage other foreign investors to invest in Indian start-ups. The two key changes are:

(i) ***Foreign venture capital investment:*** Start-ups would be allowed to receive foreign venture capital investment irrespective of the sector they are in; Foreign Venture Capital Investors (FVCIs) would be explicitly allowed to transfer shares to residents or non-residents. Currently, only Venture Capital Funds and Indian Venture Capital Undertakings are eligible to raise foreign venture capital investments and automatic approval is available to FVCIs to invest only in 9 specific sectors.

(ii) ***Transfer of ownership of start-ups:*** It would be permissible to receive the consideration amount on a deferred basis, and have escrow or indemnity arrangements up to 18 months.

Additional proposals are being considered in order to (i) permit start-ups to access rupee loans under the External Commercial Borrowing framework with relaxations in respect of eligible lenders; and (ii) facilitate the issuance of innovative FDI instruments like convertible notes by start-ups. Clarifications have also been issued by RBI regarding issuance of sweat equity. Indian companies are permitted to issue equity shares against funds payable by an investee company (e.g. payments for import of goods, consultancy fees), which can be remitted without prior permission of the government or RBI, subject to the FDI policy and applicable tax laws.

These measures are intended to create an enabling framework whereby start-ups can raise capital at low cost and without excess dilution of equity, have access to foreign loans, structure deals in a flexible manner, and improve investor participation. Although these changes have been welcomed by entrepreneurs as well as investors, certain changes such as relaxations in capital gains tax on start-up investments may be a huge booster. The changes proposed by RBI definitely address some of the issues faced by Indian start-ups; however, these alone would not be sufficient to bring the disruptive change that one would like to see.

Unregistered CIS allowed to Register

The Securities Appellate Tribunal, in the matter of *Citrus Check Inns Limited* v. *SEBI*, recently considered the validity of SEBI's order finding Citrus to be running an unregistered Collective Investment Scheme. Citrus is in the holiday timeshare business and its schemes are largely similar to those of other unregulated timeshare companies. SAT observed that Citrus may be distinguished from other timeshare companies as some of its schemes allow customers to obtain a refund along with promised returns. Thereby, SAT was convinced that certain schemes of Citrus satisfied the ingredients of a CIS.

While deciding the course of action to be resorted to, SAT observed that the fundamental legislative purpose in entrusting SEBI with the affairs of CIS companies is to register and regulate them under the CIS regulations so that the interests of gullible investors are duly protected. It noted that only one entity is registered as a CIS and other entities that are found to be acting as unregistered CISs are directed to wind up. In this light, SAT observed that it is high time for SEBI to take corrective measures and permit a company operating a CIS to register. Thereby, SAT directed SEBI to grant Citrus an opportunity to register as a CIS.

The final directions issued by SAT makes this case a landmark judgement. Ordinarily, when SEBI determines that a company is running an unregistered CIS, it directs the company to wind up, refund all monies collected along with promised returns, and imposes several restrictions on its promoters and directors. These directions are issued by SEBI irrespective of submissions made by these companies seeking permission to register under the CIS Regulations. However, this is unfair to certain businesses which may not clearly fall within the definition of a CIS and this may be ascertained only after SEBI finds them to be a CIS. It is imperative that such businesses are provided an opportunity to register and become compliant with the CIS Regulations when SEBI finds them to be a CIS. Apart from allowing a CIS to continue operations, this will allow SEBI to keep a watchful eye on these entities and ensure investor protection.

About Us

Finsec Law Advisors is a financial sector law firm which provides regulatory advice and assistance focusing on the securities, investments and banking industry.

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