

SECURITIES LAWS/SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992

SEBI'S ATTEMPT TO PLUG SHORT SWING PROFITS LACKS CLARITY

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This article gives an overview of the short swing profit rule that has been recently introduced in India by SEBI through an amendment in the SEBI (Prohibition of Insider Trading) Regulations, 1992. The author opines that the SEBI's move is laudable since it will curb the rampant malpractice of insider trading in the stock market for short-term profits but the amendment is full of controversial issues. However, as the amendment lacks clarity on several fronts, it would be appropriate if SEBI issues necessary clarification in this respect to settle the controversial issues.

INTRODUCTION

1. The Securities and Exchange Board of India (SEBI) had framed the SEBI (Insider Trading) Regulations, 1992 which were substantially amended with effect from February 20, 2002 and were renamed as the SEBI (Prohibition of Insider Trading) Regulations, 1992 ('the Regulations'). These Regulations cast certain obligations on the insiders while dealing in the equity shares of their own company. Over the past few years, it was felt by SEBI that these Regulations need to be further strengthened. With this objective in mind, the following consultative papers were issued by SEBI in January 2008:—

- ◆ Consultative Paper titled, 'Introduction of Short Swing Profit Regulations in India'.
- ◆ Consultative Paper titled, 'Amendments to SEBI (Prohibition of Insider Trading) Regulations, 1992'.

On the basis of these consultative papers, SEBI has amended the SEBI (Prohibition of Insider Trading) Regulations, through a Gazette Notification issued on November 19, 2008. It is worthwhile to note here that clause 173 of the Companies Bill, 2008 which was introduced in Lok Sabha on October 23, 2008 also proposes to make insider trading a criminal offence. Clause 173(2) of the Bill provides as under :—

'If any director or key management personnel contravenes the provision of this section he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to one crore rupees, or with both'.

Thus, the Government has taken a serious view of the problem of insider trading and

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wants to take stern action against the offenders, which is a very welcome move.

MEANING OF SHORT SWING PROFITS

2. The problem of insider trading occurs due to the deep gap between the insiders and the public at large as the insiders by virtue of their relationship with the company have access to unpublished price-sensitive information. They can very easily trade in their company's shares and make short-term profits on the basis of critical information that is not available in the public domain. Thus, it is necessary to prevent the insiders from reaping profits on the basis of such information at the cost of ordinary investors.

In US, the law relating to 'short swing profits' is primarily contained in section 16(b) of the Securities Exchange Act, 1934. The short swing profit rule requires that company's insiders should disgorge to the company any profit made by them from the purchase and sale of company's stock if both the transactions occur within the period of six months. A company insider, as determined by the rule, is any officer, director or holder of more than 10 per cent of the company's shares. The rule was implemented to prevent insiders, who have greater access to company's material information and who takes the unnecessary advantage of such information for the purpose of making short-term profits. It was felt by the US Congress that it would be difficult, if not impossible, to prove that insiders misused inside material information. Therefore, this section imposes a strict liability to take the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.

OVERVIEW OF SEBI'S LATEST AMENDMENT

3. In order to protect the interest of the ordinary investors, the SEBI *vide* its notification dated November 19, 2008 has, *inter alia*, amended the Schedule I to the said Regulations which contains the Model Code of Conduct for Prohibition of Insider Trading. The said Model Code of Conduct was introduced in the Regulations through an amendment notified on February 20, 2002. The November 19, 2008 amendment has amended clause 4.2 of the said Model Code of Conduct so as to introduce and implement the 'short swing profits' rule in India.

Before the amendment, clause 4.2 was as under :—

"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."

After the amendment made on November 19, 2008 clause 4.2 is as under :—

"4.2 All directors/officers/designated employees who buy or sell any number of shares of the company shall not enter into an opposite transaction, *i.e.*, sell or buy any number of shares during the next six months following the prior

transaction. All directors/officers/designated employees shall also not take positions in derivative transactions in the shares of the company at any time.

In the case of subscription in the primary market (initial public offers), the abovementioned entities shall hold their investments for a minimum period of 30 days. The holding period would commence when the securities are actually allotted."

The rationale behind the amendment, as stated in the consultative paper on the introduction of 'short swing profits', is to check the insiders who have greater access to price-sensitive information from taking advantage of such information for the purpose of making short-term profits (short swing profits). It is assumed that the insiders have a long-term investment in the company and are not expected to make rapid buy/sell transactions, which are apparently based on at least some level of superior access to information, whether material or not. It seems that another objective of the introduction of 'short swing profits' rule is to align the long-term objectives of the company insiders with the company shareholders.

CONSEQUENCES OF SEBI'S AMENDMENT

4. The aforesaid amendment made by SEBI by substitution of clause 4.2 of the Model Code of Conduct lacks clarity and is likely to create problems for the directors and designated employees while trading in their company's shares. Some of these problems have been highlighted below :—

- (a) *Fresh purchase of shares can block the sale of earlier shareholding* - The wording used in the amended clause 4.2 is "shall not enter into an opposite transaction, i.e., sell or buy any number of shares during the next six months following the prior transaction". Thus, if a person makes fresh purchase of shares, then he will be debarred from selling his previous shareholding for a period of six months from the date of purchase transaction. Suppose Mr. X, a director of the company is holding 1,00,000 equity shares of his company since July 2001 and he purchases 1,000 shares on January 1, 2009, then the effect of this purchase is that he can't enter into an opposite transaction during the next six months. Accordingly, he can't sell any share till June 30, 2009 even from the block of 1,00,000 shares that he is holding since July 2001. This provision is unfair and some relaxation is desired.
- (b) *FIFO method not prescribed for sale transactions* - It would have been appropriate if the amendment had specified that the shares bought in tranches during any period of six months could be sold as per the 'First In First Out' (FIFO) method. We can take the following example Mr. A, a designated employee, buys 1,000 shares of his company in the following manner :—

| <i>Date of Purchase</i> | <i>No. of shares</i> |
|-------------------------|----------------------|
| 1-1-2009 | 200 |
| 31-3-2009 | 300 |
| 30-5-2009 | 500 |

As per the amended clause 4.2, Mr. A can't sell even a single share before December 1, 2009, *i.e.*, May 30, 2009 (date of last purchase transaction) *plus* six months, whereas if FIFO method had been applied, he could have sold 200 shares on July 1, 2009; 300 shares on October 1, 2009 and 500 shares on December 1, 2009. The consultative paper had suggested adoption of 'Last In First Out' (LIFO) method for determining the six month period between trades but the November 19, 2008 amendment is silent on this matter. Thus, most probably LIFO method is applicable, however, it would be appropriate if SEBI clarifies the matter.

- (c) *Restriction on subsequent purchase of shares after concluding sale transaction* - Subsequent purchase transaction after a sale transaction is also not allowed before expiry of six months. Therefore, if a director or designated employee had sold his earlier holding, he can't make fresh purchases for a period of six months from the date of such sale transaction. This will have the effect of limiting the total number of transactions that can be carried out during any period of twelve months. For example, if a person buys 1,000 shares on January 1, 2009, then he can sell those shares on or after July 1, 2009 and he can make fresh purchase of shares only on or after January 1, 2010.
- (d) *No method prescribed for calculation of short swing profits* - There is no method prescribed under the Regulations as to how short swing profits would be calculated. For example, if Mr. X buys 7,000 shares of his employer company in the following manner :—

| <i>Date of Purchase</i> | <i>No. of Shares</i> | <i>Purchase Price</i> |
|-------------------------|----------------------|-----------------------|
| 1-1-2009 | 2,000 | Rs. 20 |
| 15-1-2009 | 3,000 | Rs. 22 |
| 30-1-2009 | 2,000 | Rs. 25 |

and out of these 7,000 shares if he sells 2,500 shares at a price of Rs. 30 per share on February 25, 2009, then it is a clear-cut case of violation of short swing profit rule as the shares have not been held for six months from the date of purchase. However, we don't know how much short swing profit has been made by Mr. X. In the present case, the profit can be determined by FIFO method, LIFO method as well as by considering the weighted average cost of shares.

- (i) Profit as per FIFO method would be Rs. 24,000 which has been computed as under :—
 $(Rs. 30 \times 2,500) - [(Rs. 20 \times 2,000) + (Rs. 22 \times 500)]$
- (ii) Profit as per LIFO method would be Rs. 14,000 which has been computed as under :—
 $(Rs. 30 \times 2,500) - [(Rs. 25 \times 2,000) + (Rs. 22 \times 500)]$.

- (iii) Profit as per weighted average cost method would be Rs. 19,275 which has been computed as under :—

$$(Rs. 30 \times 2,500) - \{[(Rs. 20 \times 2,000) + (Rs. 22 \times 3,000) + (Rs. 25 \times 2,000)] / 7,000\} \times 2,500$$

It is necessary to determine the exact quantum of short swing profit as the same should be disgorged by the person, who has violated the norms.

- (e) *Where would profits go ?* - In US, the person who violates the provisions of section 16(b) has to disgorge the short swing profits to the company. The consultative paper introduced by SEBI also suggested the same treatment. However, disgorgement/surrender of profits in favour of the company is not appropriate since it would tantamount to unjust enrichment of the company whose director/designated employee has violated the Regulations. Moreover, it is not the company which has suffered any monetary or non-monetary loss but the ordinary shareholder(s) who were involved in buying/selling the shares from/to the concerned director or the designated employee of the company.

The amended Regulations are completely silent on the issue of disgorgement of profits and what is to be done with the short swing profits is a big question.

- (f) *Exemption to certain transactions* - The consultative paper had proposed to exempt certain transactions from amounting to transactions resulting in short swing profits such as transactions approved by a regulatory authority, employee benefit plans, *bona fide* gifts and inheritances, mergers, acquisitions, etc. However, once again the amendment is silent on the critical issue of such exemptions. Thus, companies, directors and the designated employees may be compelled to file exemption applications with SEBI for the purpose of seeking exemption/relaxation from the applicability of the short swing profit rule in the abovementioned situations.

Moreover, the Managing Director or the Compliance Officer of the concerned company should have the authority to exempt certain deserving transactions, say, an employee wants to sell the shares during a valid trading window but before six months from the date of purchase in order to meet the requirement of funds like hospitalisation expenses for himself or any of his dependants.

- (g) *Whether ESOP shares are exempt from applicability of short swing profit rule ?* - The consultative paper had specifically stated that shares allotted on exercise of options granted pursuant to Employee Stock Option Plans (ESOPs) would be exempted from the applicability of short swing profit rule but surprisingly the amended regulations are silent on this issue also. Therefore, the employees who will be allotted shares pursuant to ESOP would be under confusion

whether they have to necessarily hold these shares for at least six months from the date of allotment. In order to find an answer to this question one should have a look at the provisions of the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

Clause 9.2 of the aforesaid SEBI Guidelines gives freedom to the companies to decide the lock-in period for the shares that are allotted pursuant to ESOP. Since clause 9.2 of the SEBI ESOS Guidelines specifically provides that there shall not be any lock-in period for the shares allotted pursuant to ESOS, until the Scheme framed by the company provides for the same, we can safely conclude that ESOS shares are not subject to any lock-in period despite the amendment made in the SEBI (Prohibition of Insider Trading) Regulations, with effect from November 19, 2008. In other words, the amended provisions of SEBI (Prohibition of Insider Trading) Regulations, are applicable to directors/designated employees who purchase the company's shares from the stock exchanges. In such cases, they would be bound to keep those shares as investment for at least six months, before entering into a sale transaction and further wait for another six months before entering into next purchase transaction.

This argument can be further substantiated by the fact that shares are acquired under a stock option scheme by means of 'subscription' and not by way of 'purchase', which is hit by the amended clause 4.2 of the Model Code of Conduct. Moreover, as far as the subscription of the shares is concerned, second paragraph of the amended clause 4.2 specifies that shares allotted on subscription to Primary Market Offerings (IPOs) cannot be sold for a period of 30 days from the date of allotment. Thus, it seems that the other modes of subscription to shares like Rights Issue, Preferential Allotment and Employee Stock Option Schemes are exempt from the applicability of the short swing profit rule. However, it would be appropriate if SEBI clarifies this issue.

- (h) *No dilution is permitted in company's Code of Conduct* - Till now regulation 12(1) of the SEBI (Prohibition of Insider Trading) Regulations, provided that all the listed companies and organizations associated with securities markets shall frame a Code of Internal Procedures and Conduct as near thereto the Model Code specified in Schedule I of the Regulations. Thus, the words "*as near thereto the Model Code*" provided some flexibility to the companies to make some adaptations in the Model Code before adopting the same, so as to suit their special needs. However, the November 19, 2008 amendment has amended the regulation 12(1) by inserting the words, "*without diluting it in any manner and ensure compliance of the same*".

The effect of this amendment is that all the listed companies and the organizations associated with securities markets are under the obligation to ensure that the short swing profit rule is incorporated in their Code of Conduct for Prohibition of Insider Trading with immediate effect and that too without any exemption clauses.

- (i) *Harsh Punishment*- The short swing profit rule will get automatically attracted as soon as two things are established. First is the fact of being a director/designated employee of the company. And second, the fact that the same securities were bought and sold within six months of each other. In other words, it will be the nature of the transaction and not the intent of the person that will be material. For example, if a person by mistake sells the shares after 5 months and 28 days from the date of purchase, does not earn any profit in the transaction and moreover had no knowledge of any sort of unpublished price-sensitive information at the time of purchase as well as sale of shares, then also he would be deemed to have violated the short swing profit rule and appropriate action could be taken against him by SEBI.

Thus, there is a possibility that even the persons with high integrity can commit unintentional violation of short swing profit rule since at times they may not be able to keep track of their purchase and sale transactions. This is a serious issue since small mistakes can also lead to criminal prosecution and penalty. It is worthwhile to take note of new regulation 14 which is as under :—

"14. *Action in case of default*.— Without prejudice to the directions under regulation 11, if any person violates provisions of these regulations, he shall be liable for appropriate action under sections 11, 11B, 11D, Chapter VI-A and section 24 of the Act."

Section 24 of the SEBI Act, 1992 is really draconian as it provides that any person who contravenes any provision of the SEBI Act or any Rules/Regulations framed thereunder can be punished with imprisonment for a term which may extend up to ten years or with fine which may extend to Rs. 25 crores or with both. Thus, it is imperative that the directors and the designated employees would need to exercise utmost care and caution in order to prevent violation of the 'short swing profit' rule.

CONCLUSION

5. SEBI's attempt to plug short swing profits of the corporate insiders by amendment of the SEBI (Prohibition of Insider Trading) Regulations, is laudable since it will instill confidence and feeling of security among the investors. However, as the amendment lacks clarity on several fronts, it would be appropriate if SEBI issues necessary clarification in this respect to settle the controversial issues.

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