Note

Insider trading in unlisted companies: Understanding the operation of Section 195

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Note

There are many sections under the new Companies Act, 2013 ('Act') whose intent many be novel, but the proper implementation of which is in doubt due to their inadaptability in certain types of companies. One of such section that we are going to discuss in this article is the section with the highest penal action *viz.* section 195 of the Act, 2013.

At the outset, we lament the fact that a section providing for the highest penal consequence under the Act must be as unclear in its scope as section 195. If the section was intended to be applied to listed companies, it is unnecessary as the SEBI (Prohibition of Insider Trading) Regulations, 1992 already provides for the same offence, with the same penalties. If the section is to apply it to unlisted companies, the very meaning of unlisted price sensitive information ('UPSI') and what is "public information" is buried in doubt.

The Section 195

Section 195 of the Act prohibits any person, including directors and key managerial personnel of a company from carrying on insider trading activities *i.e.* an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities on the basis of any non-public price sensitive information or act of counselling about procuring or communicating directly or indirectly such non-public price-sensitive information to any person.

Price sensitive information has been defined as *any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.*

Having said this, the applicability of the section can be understood for listed companies whose shares are regularly traded on a stock exchange and there is a price discovery mechanism of such securities which provides for a scope of speculative trading.

However unlisted companies, whose securities are not dynamically traded in, resulting in valuation difficulties of the price of securities, the provision may not become applicable in the true letter and spirit of the section. Such unlisted companies do not provide a platform to traders for creating speculative opportunities for themselves on the basis of such price sensitive information.

Note

Intent behind introducing the Section

Para 12.108 of the Standing Parliamentary Committee Report on Companies Bill, 2009[1] provides an interesting clue as to the true scope of section 195 (which was section 173 in the Bill of 2009). This para reproduces written representation received from the MCA as to why this section, already enacted by SEBI, came into the statute:

> *"During preparation of the Bill it was observed that at present the offence of insider trading has not been defined in any statute. Though this term has been referred and prohibited in SEBI Act, 1992, the definition and other detailed requirements for 'insider trading' have been provided in relevant regulations framed by SEBI. Since regulation of insider trading is an important matter for good corporate governance, the provisions in this regard in context of prohibitions for directors and KMPs have been provided in the Bill without referring to any regulatory provisions framed by SEBI. It is not the intention to modify the existing regulatory structure formulated by SEBI on this matter, which may continue as it is.*
>
> *"(b) In view of above, keeping in view the need and appropriateness for enabling provisions on offence relating to insider trading to be provided in the principal legislation for corporate entities, the provisions may not be considered to be deleted from the Bill. However, any suggestion to improve the drafting of this clause to bring more clarity on the matter may be considered."*

Further Para12.113 of the Report, in this regard, provided that:

> *"The Committee, while appreciating the fact that enabling provisions are required to prohibit forward dealings and insider trading in securities of company by a KMP or a director, would like to point out that the provisions proposed in Clauses 172 and 173 for this purpose should remain in consonance with SEBI regulations on the subject. These clauses may therefore be modified accordingly so as to bring greater clarity to the legislative intent on the issue. It is also necessary in this regard that "insider trading" is also suitably defined in the Bill."*

It is thus clear that the section was inserted in the statute book only due to the "appropriateness of enabling provision" on the offence of insider trading in the principal statute dealing with companies. The idea was not to duplicate the provisions. The idea was not to step into the domain of SEBI (which becomes clear from section 458 of the Act, discussed below).

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[1] http://www.icsi.edu/webmodules/linksofweeks/21_Report_Companies_Bill.pdf

Note

Critically Analysing

Looking at the clear language of Section 195 of the Act, one cannot presume that the section is not applicable to unlisted companies, both private and public.

The applicability of the section to private companies is not understood given the fact that its shares are not freely transferable. Private companies are closely held companies in which the relevance of insider trading based on UPSI becomes irrelevant. Ironically, the exemption notification for private companies placed before the Parliament does not grant any exemption even to private companies from section 195. Also looking at the provisions of section 458 (1) of the Act, powers to deal with insider trading in case of listed companies has been delegated to SEBI, making it thus evident that there is a potential scope for insider trading in case of unlisted companies too.

In case of unlisted public companies, one cannot take the view that there is no public trading in shares of such companies, as the shares of all public companies are freely transferable. While the trading is public, the question is – is such trading based on public information?

In our view, there are no rules for transmission of information about performance of unlisted companies other than by publication of their annual results. Neither are periodical results disseminated, nor is there any need to intimate any significant developments about the company to the public. Hence, everyone other than the "insiders" are all the time unaware of price sensitive information, since the information gets published only on publication of the annual results.

Applicability of the section on unlisted companies

In the absence of any clarifications in this regard, it becomes difficult for such unlisted companies to ascertain whether a trading of its securities was based on UPSI or not. On the face of it, if there is any purchase or sale of the securities of an unlisted company by "insiders", there is rebuttable presumption that there in non-level information between the trading parties. Also, if there is any transmission of non-public price sensitive information about such companies, other than in normal course of one's duties, there is an offence of the section.

We are of the view that the following general principles apply:

- If the buyer and seller are both insiders, there cannot be any allegation about availability of UPSI.

Note

- If only one of the parties is an insider, we strongly recommend that the insider party should allow access/right to access to at least quarterly performance and any material developments thereafter before any trade.

- If trades are done based on fair valuation, allegation of a trade being based on UPSI becomes diffused.

Is there a need for a separate insider trading code to be framed?

The SEBI Insider Trading Regulations requires listed companies to frame a Code of Conduct for Prevention of Insider Trading for its directors and designated employees which lay down appropriate mechanisms to check and prevent insider trading of securities in such companies based on UPSI.

The Code adopted by listed companies lay down the periods during which the trading window would be opened and closed for the purpose of trading in the securities of the company; the reason being the existence and dissemination of UPSI to the public by such listed companies during the trading window periods.

However, the requirement of such a Code by unlisted companies is not justified since they do not dissipate their information to the public and every insider has information of the existence of such UPSI. Practically the volume of trading in securities of such unlisted public companies would not be large enough and it would be relatively easier for such companies to ascertain insider trading of securities based on the abovementioned three conditions.