

SEBI's Informal Guidance on short swing trade falls short of its intent!

Pammy Jaiswal | Corporate Law Division
corplaw@vinodkothari.com
Vinod Kothari and Company
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Background

The concept of insiders under the insider trading regulations across the globe acknowledges the fact that they are privy to unpublished price sensitive information (UPSI). Possession of UPSI gives them the edge over the other market participants and by using the same they can make profits to the detriment of the other investors.

As the name for the instant discussion is 'contra-trade' or 'short swing trades' - popularly known in the United States, the same means profits made by certain specified insiders who trade (purchase and sale / sale and purchase) within a short time period usually within a period of six months.

While the Indian legislation on prevention of Insider Trading (SEBI Prohibition of Insider Trading Regulations, 2015 / SEBI PIT Regulations) casts the restriction on designated person for not entering into contra-trade. The US legislation (section 16 (b) of the Securities Exchange Act, 1934¹ ['SEC Act']) covers directors, officers and beneficial owners of companies for the purpose of recovery of profits made through short swing trades.

The point of analyses in this write-up is to see whether the trading by such person will only be taken under the purview of contra-trade restrictions or will it also cover those trades where the trading decision has presumably been taken by such restricted persons.

Guidance by SEBI in the matter of Arvind Limited

Recently, on November 25, 2019, SEBI through its informal guidance² in the matter of Arvind Limited clarified that once the designated persons are determined, the contra-trade restrictions will be applicable irrespective of the capacity in which the shares are held.

However, it is interesting to also note that in the case of Arvind Limited, while the contra-trade restrictions was guided to be applicable on all the cases where shares were held under

the PAN of one of the promoters (designated as one of the DPs) (shares held under different capacities), for one of the trust shareholders even though the said DP was a co-trustee, it has been clarified by SEBI that such restriction will not be applicable since shares were not held under his PAN but under the PAN of the other trustee (not designated as DP).

Contra-trade restriction applicable on:

**Designated Person (DP), irrespective of the capacity
in which the shares are held by such DP**

¹ <https://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20of%201934.pdf>

² Click [here](#) to view the informal guidance

The malice of insider trading is dependent on the decision making of such person who is designated as a DP and not the different PANs held by different person even though the decision maker behind such person is the same DP.

Critical Comment:

The informal guidance in the matter of Arvind Limited interestingly gives pre-dominance to shares held by DPs through their PAN for determining the applicability of contra-trade restrictions instead of mulling over the fact of who took the trading decision.

Global Scenario in case of short-swing trades

I. United States

Section 16 (b) of the SEC Act deals with prohibition on short-swing trades by specified beneficial owners, directors and officers of the companies. The extract of the section is reproduced for quick reference:

“For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.”

Key takeaways from the aforesaid restriction and its uniqueness from Indian legislation

Point of discussion	SEC Act	SEBI PIT Regulations
Applies to	Shareholders holding shares to the extent of 10% or more (beneficial owners), directors and officers of the company.	Designated persons.

Point of discussion	SEC Act	SEBI PIT Regulations
Period of restriction	Trade executed within 6 months.	Same period.
Profit treatment	Can be recovered by the company.	Disgorgement of the profit to Investor Protections and Education Fund (IPEF).
Institution of suit / proceedings	<ul style="list-style-type: none"> Suit can be filed by the company itself or on the request of any shareholder; or Any other shareholder in case the company refuses to institute the suit. 	Proceedings can be initiated by the company itself or on receipt of information by any informant under Chapter IIIA any person under chapter or the SEBI itself.
Time bar	Suit to be instituted within 2 years of realisation of profit.	No time bar under the Regulations.
Exempted trades	<ul style="list-style-type: none"> Shares held in an investment account; Employee compensation and benefit plans in certain circumstances³; Foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section. 	<ul style="list-style-type: none"> Pursuant to exercise of options under ESOP; Pursuant to trading plan (except for pledge of shares); Buy-back, open offer, right issues and FPOs.⁴

US Case Laws on short-swing trades⁵

(i) In the matter of *Diamond v. Oreamuno*⁶, 24 N.Y.2d 494, it was held that:

“It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.”

³ <https://www.securitieslawyer101.com/wp-content/uploads/2014/12/Short-Swing-Profits-Q-A.pdf>

⁴ [Guidance](#) on exemption in case of contra-trade restrictions

⁵ <https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=4594&context=flr>

⁶ <https://casetext.com/case/diamond-v-oreamuno#p915>

(ii) Further, in the matter of **Kern County Land Co. v. Occidental Petr. Corp.**⁷, 411 U.S. 582 (1973), it dealt with the applicability of section 16(b) on the a person who acquired shares under a tender offer and became a shareholder holding 10% shares and then sold the same in its effort to exit the company being a minor shareholder.

"The option agreement was not of itself a "sale"; the option was grounded on the mutual advantages to respondent as a minority stockholder that wanted to terminate an investment it had not chosen to make and Tenneco, whose management did not want a potentially troublesome minority stockholder; and the option was not a source of potential speculative abuse, since respondent had no inside information about Tenneco or its new stock."

(iii) Also, the question of relatives trading in the scrip of companies was clarified in the matter of **Whiting v. Dow Chemical Co**⁸, 523 F.2d 680 (2d Cir. 1975). It was discussed –

"Although the discussion below relates to the reporting of beneficial ownership of securities under Section 16(a) of the Securities Exchange Act of 1934 (Exchange Act), it should be noted that generally the same principles apply to disclosing beneficial ownership in registration statements, annual reports, proxy statements, applications for registration as a broker-dealer or as an investment adviser, and statements of eligibility and qualification to act as indenture trustee under the securities acts where such disclosure is required."

II. Japan

Article 164 of the Financial Instruments and Exchange Act⁹ draws out similar provisions for short-term trades as in case of United States. The text of the law uses the term 'Officer or Major Shareholder' for applying the restriction of contra-trade.

While countries like USA and Japan have clear cut prohibition on making profits through short swing trades on similar lines as that of India, countries like United Kingdom, Canada, Russia and Switzerland do not have such restriction explicitly in their insider trading laws.

⁷ <http://cdn.loc.gov/service/ll/usrep/usrep411/usrep411582/usrep411582.pdf>

⁸ <https://openjurist.org/523/f2d/680/whiting-v-dow-chemical-company>

⁹ <https://www.fsa.go.jp/common/law/fie01.pdf>

Conclusion

The intent of the insider trading laws is to prevent the insiders from engaging themselves in short-term trades of the company's stocks where they are insiders. A short term reversal indicates a trade trying to cash on a short term opportunity.

With the presumptive possession of inside information, these trades are commonly indicate of exploitation of insider information. While tracking the contra-trade violations, the Board should be guided by the fact on who is taking the decision for the trade instead of simply tracking the PAN of the shareholders. If the decision-maker is the same person, then short swing trade restriction should certainly be applicable.

Having said so, it is important to note that while in our view, trades with the same decision maker should be restricted under contra-trade (DP is the decision maker, irrespective of whether the shares are held under the PAN of such DP), the informal guidance given by SEBI in the matter of Arvind Limited narrates a different story altogether.

- To read our FAQs on Prohibition of Insider Trading Regulations (PIT), please click [here](#)
- To read our other resources on PIT Regulations, please click [here](#)
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