

NAVIGATING THE MAZE OF MARKET MANIPULATION - CREATING EFFECTIVE INSIDER TRADING PLANS

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Abstract

The mechanism of insider trading plans was introduced in India via the 2015 Prohibition on Insider Trading regulations as a means to allow corporate insiders the freedom to legitimately trade in company stock owned by them. The lack of popularity of this mechanism amongst insiders coupled with growing issues of insider trading violations have attracted the attention of the SEBI which has proposed an array of recommendations to restructure the mechanism to make it an attractive option to insiders. The authors of this blog provide an appraisal of the current mechanism of trading plans, followed by details on the shortcomings of the mechanism, a cross jurisdictional analysis of the use of trading plans, and finally suggestions to make trading plans a more attractive choice for insiders.

Keywords: Insider Trading; Trading Plans; Range-Specific Determinations; Prohibition of Insider Trading Regulations (PIT); Shareholder Interests;

I. INTRODUCTION

Regulatory studies have long focused on capital markets and the regulations thereof from two angles- one, concerning protecting the rights of stakeholders that are involved in transactions that take place in these markets and two, to the effect one's action within the confines of the market, has on every other stakeholder so involved.¹ In this blog, the authors explore insider trading regulations in India with a special focus on a cross-jurisdictional analysis of the recent consultation paper (henceforth, 'the Consultation Paper') released by SEBI pertaining to the relaxation of the existing regulatory framework.²

I. AN APPRAISAL OF THE CURRENT STATE OF INSIDERS' INFLUENCE ON MARKET BEHAVIOUR

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¹ Shantanu Dey, 'Insider Trading Regime in India: Learning Lessons from the US and UK Regulatory Experience' (2016) 37 Business Law Review <<https://kluwerlawonline.com/journalarticle/Business+Law+Review/37.1/BULA2016004>> accessed 13 December 2023.

² 'SEBI | Consultation Paper on Providing Flexibility in Provisions Relating to "Trading Plans" under the SEBI (Prohibition of Insider Trading) Regulations, 2015' <https://www.sebi.gov.in/reports-and-statistics/reports/nov-2023/consultation-paper-on-providing-flexibility-in-provisions-relating-to-trading-plans-under-the-sebi-prohibition-of-insider-trading-regulations-2015_79317.html> accessed 15 December 2023.

The key piece of regulation concerning insider trading in India is the Prohibition of Insider Trading (“PIT”) Regulations of 2015.³ Alongside countries such as the US and the UK that have implemented the concept of ‘trading plans’ – India too accommodates such a practice under Regulation 5 of the PIT⁴. However, trading plans have not been well received by insiders in India. A meagre average of about thirty trading plans⁵ have been adopted every year in the past five years- a number which is indicative of two things - one, regulatory burden⁶ of complying with the strict conditions that these trading plans come with, and two, circumvention of insider trading regulations by way of trading in peer stocks.⁷ Now, it follows a logical trail to assume that a policy that is too hard on the people is bound to fail or worse, yet, have people circumvent it.⁸ The authors recognise that preserving market integrity and protecting the general public from volatility and adverse selection are vital objectives of these regulations, yet, a circumvention of the same by spurious means such as informed trading in peer stocks by way of the Unpublished Price Sensitive Information (“UPSI”) being fungible⁹ ultimately brings about the defeat of this objective.¹⁰ This only underscores the importance of regulations that are not only workable on paper but cognizant of implementational constraints and are made in such a way as to incentivise compliance.¹¹

Trading plans, by the strict conditions imposed, may hamper the legitimate dealing of securities by corporate insiders to meet exigencies. In the current framework,¹² trading plans are subject to a slew of regulatory requisites such as twelve months of the minimum coverage period, months of cool-off period, a mandatory blackout period and exemption from the general contra trade restrictions applicable on trade in securities. It is well-acknowledged that the framework is suffocative¹³ of insider’s interests- a realisation that prompted SEBI to release the Consultation Paper. Now, the authors of this blog argue that the Consultation Paper itself is not comprehensive in remedying the flaws of Prohibition of Insider Trading Regulations.

II. CROSS JURISDICTIONAL COMPARISON OF THE PROHIBITION OF INSIDER TRADING REGULATIONS

³ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 5.

⁴ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 5.

⁵ Guest, ‘Flexible Trading Plans: SEBI’s Consultation Paper on Insider Trading Regulations’ (*IndiaCorpLaw*, 28 November 2023) <<https://indiacorplaw.in/2023/11/flexible-trading-plans-sebis-consultation-paper-on-insider-trading-regulations.html>> accessed 15 December 2023.

⁶ Donald C Langevoort, ‘Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited’ (1992) 140 *University of Pennsylvania Law Review* 851.

⁷ Prachi Deuskar, Aditi Khatri and Jayanthi Sunder, ‘Insider Trading Restrictions and Informed Trading in Peer Stocks’ (20 June 2023) <<https://papers.ssrn.com/abstract=4210203>> accessed 13 December 2023.

⁸ Langevoort (n 5).

⁹ Deuskar, Khatri and Sunder (n 6).

¹⁰ Langevoort (n 6).

¹¹ Park (n 1).

¹² ‘SEBI | Consultation Paper on Providing Flexibility in Provisions Relating to “Trading Plans” under the SEBI (Prohibition of Insider Trading) Regulations, 2015’ (n 3).

¹³ Taxmann, ‘[Analysis] Insider Trading Reforms | Balancing Regulations with Operational Realities for Effective Implementation’ (*Taxmann Blog*, 27 November 2023) <<https://www.taxmann.com/post/blog/analysis-insider-trading-reforms-balancing-regulations-with-operational-realities-for-effective-implementation/>> accessed 14 December 2023.

Laws prevailing in the US

In the United States, insider trading regulations permit the exception of trading plans under Rule 10b5-1.¹⁴ These plans give corporate insiders an “affirmative defence to insider trading” by allowing them to carry out trades under trading plans made in advance whilst not in possession of “material non-public information.”¹⁵ The defence has been included to strike a balance between restricting injustices on account of information asymmetry and retaining a securities market that is free. Unlike in the Indian context, trading plans have been popular amongst insiders in the USA with the Securities Exchange Commission’s 2021 report stating that around 5,800 executives and board members from 1,600 firms engaged in trading activities governed by Rule 10b5-1 plans. Pfizer CEO Albert Bourla previously had his trading plan altered (making for a very profitable transaction for him) a day before positive news of his company’s development of the COVID-19 mRNA vaccine was declared.¹⁶ The trade was deemed suspicious on account of its timing. This is an example of how allowing excessive flexibility in trading plans defeats the very purpose of its formulation.

The 2023 amendments to Rule 10b5-1 plans were brought in to correct individual excesses on the part of corporate insiders who had been utilising this mechanism to amass personal gains at the cost of the integrity of the stock market and shareholders’ interests.¹⁷ This must be contrasted with the SEBI’s intent on amending Regulation 5¹⁸ to encourage trading plan formulation, adoption, and implementation to benefit corporate insiders by removing the excesses of the current regulations – particularly the length of the minimum coverage period of the trading plan, the six months long cooling off period, and the existence of blackout periods. While the US and India may have implemented trading plans as a concept, the legislative intent is fundamentally different between the two;¹⁹ and is reflective of the larger differences in the economic ideology of the two countries. Advocating for a single trading plan mandate, and limits on the quantum of securities are measures that would face stark opposition in the US but were readily accepted in the Indian context.²⁰

¹⁴ Securities Exchange Act of 1934 § 10(b)5-1, 15 U.S.C. § 78j (2000).

¹⁵ Stephen L Lenkey, ‘Cancellable Insider Trading Plans: An Analysis of SEC Rule 10b5-1’ (2019) 32 *The Review of Financial Studies* 4947.

¹⁶ ‘Pfizer CEO Sold Millions in Stock After Coronavirus Vaccine News, Raising Questions’ (11 November 2020) <<https://www.wbur.org/npr/933957580/pfizer-ceo-sold-millions-in-stock-after-coronavirus-vaccine-news-raising-questio>> accessed 15 December 2023.

¹⁷ C. Alex Bahn, Alan J. Wilson, ‘SEC Adopts Amendments to Rule 10b5-1’ (*WilmerHale*, 15 December 2022) <<https://www.wilmerhale.com/en/insights/blogs/focus-on-audit-committees-accounting-and-the-law/20221215-sec-adopts-amendments-to-rule-10b5-1>> accessed 13 December 2023.

¹⁸ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 5.

¹⁹ Pranav Saraswat, ‘Elements of Effective Insider Trading Regulations: A Comparative Analysis of India and USA’ (2020) 10 *Nirma ULJ* 81.

²⁰ Dey (n 2).

Insider trading in China

China, on the other hand, takes an iron-hand approach²¹ concerning insider trading by absolutely restricting directors and senior management personnel²² from selling their shareholding in the company whilst they continue to have such office.²³ Although this provision may have the effect of encouraging long-term growth prioritisation and helping in the alignment of managerial interests with that of shareholders' interests, there is no doubt that this provision is highly restrictive and counts as regulatory overreach.

III. BRINGING IN REFORMS: A CRITIQUE ON SEBI'S CONSULTATION PAPER

The SEBI's Consultation Paper²⁴ is a good place to begin a discourse on the regulatory framework of insider trading in India. The following section pinpoints the points of reforms as suggested by the SEBI and attempts to understand the rationale behind these pointers.

1. Evaluating the Jurisprudence behind Reducing the Cool-off Period

The basis of a cooling-off period in insider trading regulations across the globe is quite simple- the rationale behind the outlawing of insider trading is to protect the general public from adverse selection in the market- now, such adverse selection ceases to exist upon the UPSI becoming publicly available. In essence, the cooling-off period foresees the release of such UPSI to the general public within this statutory window to level the playing field for the general public vis-à-vis the insider. It is unclear as to how a four-month window as opposed to a six-month window would serve better in allowing for public disclosures. Perhaps, the regulator has intended to favour insiders' right to trade in securities. Such a recommendation is welcome as the cooling-off period may symbolically exist to provide an opportunity for the publicization of the UPSI but in essence, the very deferral of the trading plan's implementation serves the purpose of lessening its impact on market dynamics and simultaneously being considerate of the insider's position.

2. Altering Durations of Trading Plans to Suit Insiders' Interests

The minimum coverage period, that is, the duration in which the trading plan is to be fully implemented is currently twelve months under the PIT Regulations. The Consultation Paper²⁵ rightly acknowledges that twelve months as a window of disbursement of funds to the insider is rather stretched and recommends the watering down of this period to four months. This is in light of remedying the insider of the otherwise inflexible nature of the insider trading plan under the

²¹ Company Law, Art 147.

²² NPC, 'Company Law of the People's Republic of China' (NPC) <http://www.npc.gov.cn/zgrdw/english-npc/Law/2007-12/12/content_1383787.htm> accessed 15 December 2023.

²³ (Robin) Hui Huang, 'The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform' (9 July 2005) <<https://papers.ssrn.com/abstract=753745>> accessed 15 December 2023.

²⁴ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 5.

²⁵ 'SEBI | Consultation Paper on Providing Flexibility in Provisions Relating to "Trading Plans" under the SEBI (Prohibition of Insider Trading) Regulations, 2015' (n 3).

Regulation that disallows any alteration, modification or complete novation of the trading plan. In essence, making the trading plan an irrevocable commitment- but such reduction of the minimum coverage period does bring the insider much-needed respite as to the immediacy of funds disbursement from the plan.

IV. SUGGESTIONS FOR POLICY CHANGES TO INSIDER TRADING REGULATIONS IN INDIA

Let us suppose that the recommendations of the Consultation Paper are implemented, for example, a corporate insider may make a plan with a cool-off period of four months. However, soon after she makes the plan, she may become aware of her son's sudden critical illness – requiring urgent funds to pay off his medical bills. High-level executives are, by convention, paid heavily by transfer of stock options- and she is no exception. She may sell these securities to fund her son's medical treatment but the trading plan would not only restrict her from making immediate sales to finance such an exigency but also the quantum of shares that she may be able to sell – since she would only be allowed to sell the quantum as disclosed in the trading plan. Such instances leave much to be pondered about the position of the insider concerning these trading plans not improving by much even if the Consultation Paper's recommendations are implemented in toto.

1. Allowing for Selective Trading Plan alterations in Emergency Situations

It is in the authors' opinion, that this situation be remedied by allowing for emergency alterations of trading plans in the interest of justice – upon an application by the insider to the compliance officer and a subsequent inspection and approval. The compliance officer has been endowed with judicial discretion concerning matters related to insider trading throughout the PIT Regulations.²⁶ The authors suggest that the same office be used to streamline such applications by those in such levels of the corporation that receive a sizable proportion of their income by way of securities. Upon the approval of the same, the application may be forwarded to the stock exchange akin to the disclosure under Regulation 5- after which, the necessary changes are made and the insider is allowed to disburse funds from his shares for his emergency.

2. Implementing Volume-Specific Application of Trading Plans

A possible course of action to make trading plans more effective could be the establishment of threshold limits on the total size of shareholding of the insiders for the application of trading plans. For example, only eighty per cent (80%) of insiders' quantum of shareholding be subject to the application of trading plans. This would ensure that a certain sum be allowed to be freely traded as per changing market requirements – making the trading plan more attractive to insiders while simultaneously ensuring that market integrity is not sacrificed by an infliction of adverse selection. Such a proportion is to be worked out considering the level at which the insider is in within the organisation, shares distributed to him as against his cost-to-company

²⁶ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 5.

salary and a macroeconomic analysis of the impact of his activity of buying or selling the permissible quantum of shares.

3. Allow for Range-specific determinations of the Quantum of Shares to be traded in Trading Plans

Much like the recommendation 4.4 of the SEBI Consultation Paper²⁷ allowing for a price limit to protect insiders from significant adverse price fluctuation, another possible addition to make the trading plan option more attractive is to allow for the creation of trading plans with estimated volume ranges for trades as opposed to specific monetary figures. For example, the trading plan would mention that trades of shares between 40,000 and 50,000 shares would be made on 1st August 2024, followed by a trade of 20,000 to 30,000 shares on 15th September 2024. This would allow a greater deal of flexibility to insiders in their formulation of trading plans.

V. THE WAY FORWARD

Insider trading regulations in India necessitate an approach that is not top-heavy to burden the insider with lofty rules that negate his right to trade in securities but at the same time must cater to the general public's principle right to not be subjected to adverse selection by way of such insiders exploiting their access to UPSI. Unlike the US, the Indian economic set-up cannot be expected to give the insiders complete free rein over their alterations and revocability of insider trading plans as such an approach would endanger shareholder interests. Similarly, the Chinese approach of complete suppression of the insiders' right to trade in securities granted to them is not workable in the Indian context where stock options have become popular. The way forward necessitates a mix of the two and innovations in terms of accommodating these competing interests by way of evolving regulations that fit the Indian context.

²⁷ 'SEBI | Consultation Paper on Providing Flexibility in Provisions Relating to "Trading Plans" under the SEBI (Prohibition of Insider Trading) Regulations, 2015' (n 3).