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Mutual fund managers, FIIs qualify as insiders

N Mahalakshmi / Mumbai April 08,2004

Sebi ruling on Samir Arora case has far-reaching implications

The mutual fund industry and foreign institutional investors are perturbed by the Securities and Exchange Board of India's (Sebi's) interpretation of the term"insider."

Fund managers at 30-odd domestic mutual funds, 500-odd foreign institutional investors, over 100 banks, numerous brokers and large stakeholders could henceforth qualify as "insiders" to various companies if Sebi's interpretation of the term "insider", as defined in the Samir Arora case, were to be applied across the board.

The regulator used Sections 2(e) and 2(h) of the Insider Trading Regulations to nail the former chief investment officer and head of Asian emerging markets of Alliance Capital in a case relating to Digital GlobalSoft.

On March 31, 2004, Sebi's wholetime director T M Nagarajan passed final orders banning Arora from dealing in securities on Indian bourses for five years on three key charges: thwarting Alliance Capital's plans to sell its India operations, making inadequate disclosure and violation of insider trading regulations.

A Sebi spokesperson declined to comment on the issue, pointing out that "the order is a judicial document which has gone through the legal process and, hence, no further clarification can be provided".

Section 2 (e) defines an insider as any person who is (or was) connected with a company, or is deemed to have been connected with the company and is reasonably expected to have access to unpublished price-sensitive information about the company.

The enumeration of persons deemed to be connected with the company, as given in Section 2 (h), includes intermediaries, investment companies, trustee and asset management companies or employees of stock exchanges and clearing corporations. This clearly means that mutual funds and their executives are indeed covered by the definition.
However, till recently it was assumed that the wider ambit of the definition of "insider" would be applied less in practice, with the focus being on direct insiders — those who work for the company in various capacities, and their relatives.

The Arora case is the first instance of a fund manager being hauled up for insider trading violations despite not having a board seat or any direct official connection with its management.

If Samir Arora or Alliance Capital did indeed have access to any inside information on Digital GlobalSoft, it was not because of any official position in the company.

Normally, if insider trading has to be proved, Sebi would have had to prove how Arora got price-sensitive information, and how his use of it was mala fide.

But an amendment made to the insider trading regulations in February 2002 dropped some crucial words in Section 2(e).

Earlier, an “insider” not only had to be connected or deemed to be connected with a company, but also had to have access to price-sensitive information “by virtue of such connection”. The dropping of the words “by virtue of such connection” makes it easier for Sebi to level charges without a higher degree of proof.

Observes Siddharth Shah, senior associate, M&A and funds practice, Nishith Desai Associates: "Legally, all persons mentioned in Sebi regulations 2 (e) and 2 (h) qualify as insiders and Sebi can charge them with violation of insider trading regulations in case they leverage unpublished price-sensitive information. The burden of proof, in such cases, would rest with the fund managers or any other affected party."

Para 9.15 of Sebi's final order in the Arora case says as much. "It is not material whether Shri Arora was providing any service to DGL (Digital GlobalSoft). The factual position was that the entities managed by Shri Arora, at some time or other, held as much as 10 per cent of the paid-up capital of the equity capital of DGL which was next only to that of the controlling holder, viz. Compaq. He and his analysts were maintaining contact and close interaction with the management of DGL. I find that Arora was indeed an insider within the meaning of insider trading regulations."

And further, clause 9.17 of the final order, says: "The requirement for Sebi to show that any other insider has shared unpublished price-sensitive information with Shri Arora does not arise."

Industry players, academics and some lawyers believe that Sebi's logic may be flawed. "This is a way to circumvent the idea of having to prove violation of insider trading because it is difficult to prove," says Jayant S Varma, a former Sebi executive director and professor at the Indian Institute of Management, Ahmedabad.

An official of a leading law firm in the country, who preferred anonymity, said that Sebi's definition of 'insider' was not in consonance with regulations in some foreign countries.

A representation to Sebi regarding this was made a year-and-a-half ago, but no alterations were made in this respect, the official added.

The interpretation of Section 2 (e) and 2 (h) may have far-reaching implications for institutional investors and large individual shareholders, who tend to have frequent interactions with company managements.

Even prudent buy or sell decisions based on judgements could be termed insider trading, if they happened to be timed before a material event. "This could even hamper FII flows into the country," a fund manager pointed out.

Packing a punch

- According to Section 2(h) of the Insider Trading Regulations, “intermediaries, investment companies, trustee and asset management companies or employees of stock exchanges and clearing corporations” are insiders
- An amendment made to Section 2(e), in February 2002, shift burden of proof from the regulator to the accused