

# INNOCENT TIPPEE: A NOVEL DEFENSE IN INSIDER TRADING REGULATIONS OF INDIA

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## ABSTRACT

The liability of tipper and tippee forms a crucial aspect in the regime of insider trading and securities fraud, across the world. However, in India, the liability of the tippee in insider trading has traditionally been untested and no coherent framework or guidelines exist around it. Interestingly enough, SEBI recently dealt with this unexplored periphery of the insider trading norms by introducing a novel defense of ‘innocent tippee/recipient’, and started India’s journey on the development of jurisprudence on tippee liability.

With the foregoing at this backdrop, this article dwells upon the extant legal position of a tippee and an innocent tippee as envisaged in the SEBI (Prohibition of Insider Trading) Regulations 2015, whilst focusing on the legal trajectory and evolving doctrines through various reports. The article also discusses and critically analyzes the key observations rendered by SEBI. The author appreciates the SEBI’s Adjudication Order as it adopts a doctrinal novelty, however, criticizes it on two major grounds. Firstly, it is difficult to square defence of ‘innocent tippee’ with the underlying equal access doctrine adopted in India; and secondly, as the Adjudication Order introduces an element of subjectivity to predicate liability, it will be practically very arduous to inflict liability on tippees. Lastly, the article concludes drawing a succinct comparison with the USA’s practice on tipper-tippee liability, and how the defence extended by SEBI is reminiscent of the practice espoused in the insider trading jurisprudence on tippee liability in the USA.

**Keywords:** Tippee Liability, Insider Trading, Innocent Tippee, Sodhi Report. Mannapuram Finance Limited Case

## INTRODUCTION

The ‘Tipper-Tippee liability’ remains a topical issue in the securities market, especially in the regime of insider trading. The person who receives the information is referred to as the ‘tippee’, and the person from whom the tippee receives the information, the ‘tipper.’<sup>i</sup>

Interestingly, the Securities and Exchange Board of India (hereinafter, ‘SEBI’) extended a novel defense of ‘innocent tippee’, *vide* its recent Adjudication Order<sup>ii</sup> dated 13 April 2020 in the matters of AMC Limited, SBI Mutual Fund and Kotak Mahindra Life Insurance Company (hereinafter, ‘Notices’) relating to investigation of alleged selective disclosure of sensitive information by Mannapuram Finance Limited (hereinafter, ‘MFL’). Here, SEBI moved beyond the statutory defences enumerated in Regulation 4(1) of the SEBI (Prohibition of Insider Trading) Regulations, 2015 (hereinafter, ‘Insider Trading Regulations’)<sup>iii</sup>, by granting an alibi wherein the tippee can concede a leeway to be innocent i.e. the tippee traded under an assumption that it is publicly available information or symmetric information. Hence, the Adjudication Order of SEBI has introduced and dealt with an unexplored periphery of the insider trading norms.

In this context, the article dwells upon the legal position of a tippee and an innocent tippee in the regime of insider trading in India, whilst discussing the key observations rendered by SEBI. The article also seeks to critically analyze SEBI’s Adjudication order by drawing a succinct comparison with the USA’s practice on tipper-tippee liability.

## BACKGROUND

Insider trading occurs when an insider accesses material, non-public information, then uses that information to buy or sell a security, where the information provides a certain profit.<sup>iv</sup> Notably, the insider trading violations include the ‘*tipping*’ of such information.<sup>v</sup> Thereby, the conundrum to ascertain the liability of tipper and tippee forms a crucial aspect in the realm of insider trading, across the world, including India. To put in place a coherent framework for prohibition of insider trading in securities and to strengthen the legal framework,<sup>vi</sup> SEBI enacted the Insider Trading Regulations. Essentially, by nature, they are prohibitive regulations as to ensure a level-playing field in terms of access to material information.

To ensure strict compliance, Explanation to Regulation 4(1) of the Insider Trading Regulations prescribes a '*deeming legal fiction*' to affix the strict liability on insiders. It provides that when a person in possession of unpublished price sensitive information (hereinafter, '**UPSI**')<sup>vii</sup> trades in securities, his trades would be '*presumed*' to have been motivated by the knowledge/awareness of such information in his possession.<sup>viii</sup> As the Insider Trading Regulations vests the onus of proof on the insider, it also provides an opportunity to the insider to prove his innocence under the statutory defences illustrated in proviso to Regulation 4(1). Proviso to Regulation 4(1) postulates defences where the charge of insider trading will not get attracted, for instance, the transaction was carried out pursuant to a statutory or regulatory obligation to carry out a bona fide transaction.<sup>ix</sup>

## **LEGAL POSITION OF TIPPEE AND INNOCENT TIPPEE IN INDIA**

The appropriate starting point of this discussion is the 'Report on the Regulation of the Stock Market in India (1948)', authored by P. J. Thomas (hereinafter, '**Thomas Report**')<sup>x</sup> to appreciate the doctrines underlying the insider trading prohibitions. The Thomas Report suggested that framework of insider trading is predicated on the '*special relationship doctrine*'<sup>xi</sup> of Cady, Roberts<sup>xii</sup>. As per the doctrine, the liability of insider trading is invariably correlative to the person's special relationship with the company i.e. person shall be '*connected*' or '*deemed to be connected*' with the company. Imbibing the doctrine, both the Sachar Report (1979) and Patel Report (1994) also implicitly advocated the continuance of the special relationship.<sup>xiii</sup> Thus, by virtue of the special relational doctrine, despite tippee being privy to the price sensitive information, no liability could be inflicted.

Thereafter, departing radically from the established doctrine of special relationship, India adopted a framework of '*absolute tippee liability*'. Presently, the liability on tippee is predicated as an '*insider*' defined under Regulation 2(g) the Insider Trading Regulations. Regulation 2(g) envisages two kinds of insiders; the first kind consists of persons who are connected<sup>xiv</sup> with the company and; the other kind consists of persons who have actually received or had access to UPSI. Therefore, any person who is in possession of UPSI falls under the definition of '*insider*'<sup>xv</sup>. Further, the Regulation 3 of the Insider Trading Regulations prohibits insider trading by all '*insiders*' in general.<sup>xvi</sup> Thus in the current regime, the liability

of tippee is predicated from their superior access to UPSI<sup>xvii</sup> on the acid test of ‘absolute liability’, without paying any consideration to the innocence of the tippee.

The concept of ‘Innocent tippee recipient’ as a defence was first proposed in 2013 by the High Level Committee constituted under the chairmanship of N. K. Sodhi, Former Chief Justice of the High Courts of Kerala and Karnataka, to review the SEBI (Prohibition of Insider Trading) Regulations, 1992 (hereinafter, ‘**the Sodhi Report**’)<sup>xviii</sup>. The Sodhi Report *inter alia* suggested inclusion of a defense in Regulation 4 (3)(i) wherein ‘*the insider being an innocent recipient of UPSI or placed reliance on information not believed to be UPSI*’.<sup>xix</sup>

The relevant extract reads as follows:

*It is possible that an insider may have received information from someone who is not a connected person and he did not have reason to believe that the person providing the information violated any law or confidentiality obligation owed by that person. Any person who receives UPSI would be immediately placed in the shoes of an ‘insider’ in view of the definition of the term. Therefore, if a person were to receive information about a company from someone who is not a connected person, but such person had procured the information illegally, the recipient would be innocent if unaware of the tipper’s violation. Therefore where a person trades on the basis of contents of a research report which later turns out to have contained UPSI illegally procured by the research analyst, the fact that a bona fide recipient of that report traded when in possession of that report should not be visited with the charge of insider trading.*<sup>xx</sup>

Unfortunately, SEBI, based on the *comments* solicited from the *public and various stakeholders*, *rejected* the suggestion by the Sodhi Report since it introduced a subjective criterion for determining insider trading. It was argued that the defence of innocent recipient of UPSI must be without any further qualification as the determination of, *inter alia* a) whether there was reason to believe, b) whether diligence was exercised, c) what constitutes the diligence of a reasonable man, etc. as it leads to a lot of interpretative uncertainty in the hands of SEBI.<sup>xxi</sup> Thereby, the proposed defence of ‘innocent recipient’ did not find its way into the final form of the Insider Trading Regulations.

In essence, due to the absence of statutory recognition to the defence of ‘innocent tippee’, mere possession and communication of UPSI is sufficient to fasten the liability on a tippee under the Insider Trading Regulations. In other words, the tippee’s liability is independent and not an extension of the tipper's liability.<sup>xxii</sup>

## SEBI ADJUDICATION ORDER

Before adverting to the legal issue, it’s imperative to understand the background of the case. In 2013, MFL anticipating negative financial results; referred the information to the board and subsequently, the board approached a research analyst, Ambit, to seek market guidance. On March 19, 2013, Ambit released research reports to more than 2000 persons, disclosing the information about negative financial results. On March 19, 2013, MFL held a conference call to inform investors about the financial results. However, AMCs had sold their shares in MFL, after receiving the research reports. In this regard, show-cause notices were issued to these AMCs for trading while in possession of UPSI. The responses by the Noticees were subsequently filed wherein it was pleaded that they relied on the research report which was public information since it was made available to more than 2500 persons and had no reason to suspect that it was based on UPSI.<sup>xxiii</sup>

SEBI adjudicated on the pertinent issue of whether AMCs can claim the defence of innocent tippee. SEBI taking into consideration the facts in a holistic manner, held that the Noticees were not in a position to know that the information that was distributed in the research report or discussed in the conference call or being covered by media is UPSI<sup>xxiv</sup> since the research report issued by Ambit came with a disclaimer that it was based on publicly available information.

Interestingly enough, this legal aspect has been addressed and determined by SEBI for the first time. The author argues that SEBI’s Adjudication Orders will have wide-ranging ramifications in the insider trading jurisprudence of India as it concedes a doctrinal novelty. However, following two glaring flaws cannot be overlooked.

- a. **Breach of equal access doctrine:** The insider trading framework in India is formed on the bedrock of ‘equal access doctrine’ i.e. parity of information rule (fairness)<sup>xxv</sup> as endorsed by the Sodhi Report. The equal access doctrine is essentially premised on the principle that all parties have an equal chance to obtain information,<sup>xxvi</sup> and the liability was to be affixed solely by the virtue of unequal access of nonpublic information. In the regard of this doctrine, the tippee’s liability not to trade on such information is independent of any breach of duty by the tipper.<sup>xxvii</sup> Hence, it is difficult to square this untested defence extended by SEBI with the underlying equal access doctrine.<sup>xxviii</sup>
- b. **Introduces an element of subjectivity:** The use of term ‘innocence’ implies absence of mens rea/intention to commit the offence<sup>xxix</sup> and thus, imposes a duty on SEBI to establish absence of mens rea. From a practical standpoint, it will be difficult to establish whether the tippee had cognizance about the tipper’s fraudulent disclosure for personal gain. Furthermore, based on regulatory experience of enforcing insider trading cases, such a defense may not be required to be listed in the regulations as it contains subjective criteria which may make a case impossible to establish.<sup>xxx</sup>

## INTERNATIONAL PERSPECTIVE

The defence extended by SEBI is reminiscent of the practice espoused in the insider trading jurisprudence on tippee liability in the USA. The US Court of Appeals for the Second Circuit in the case of *United States vs. Newman*<sup>xxxi</sup>, categorically laid down the conditions for attributing liability to a ‘tippee’ extremely stringent i.e. only if the tippee is aware of the tipper’s breach of fiduciary duty due to disclosure of the information as well as the fact that the tipper divulged it for personal benefit.<sup>xxxii</sup> Therefore, in the USA regime, the tippee’s duty is derivative,<sup>xxxiii</sup> and not an independent duty.

In essence, SEBI in tune with the wisdom of the US judicial courts on tipper-tippee liability has implicitly opined that the tippee liability is a derivative of that of the tipper’s breach of duty and can be proved innocent. However, the defence has to be implemented with caution because the regulatory approach in the US is based on ‘fiduciary duties’, which are vastly different from the approach in India based on ‘parity of information’.

## CONCLUSION

As in India, tippee liability has historically been untested and no detailed principles exist on the same, it is heartening to see jurisprudence coming of age and embarking on a journey to impart uniformity. However, the judicially innovated ‘innocent recipient defence’ may throw up several teething problems before the adjudicatory authorities which will need resolution over time. The SEBI Adjudication Order will henceforth act as a precedent and invariably provide an opportunity to tippees’ to take a shelter as an innocent tippee and thus, requiring SEBI to adjudicate mindfully and holistically. Nevertheless, the real impact and anomalies of the defence would be discernible only after they are put to test in the near future.

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