

Why rewarding whistleblowers is key to tackling insider trading

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A promising alternative mechanism to the existing regulatory framework for reporting insider trading concerns by whistleblowers took effect on December 26, 2019, when the provisions of Securities and Exchange Board of India (Prohibition of Insider Trading) (Third Amendment) Regulations, 2019, came into force.

With this, a whistleblower would have an option to report insider trading concerns directly to the Indian securities market regulator, the Securities and Exchange Board of India (Sebi), instead of approaching the listed company.

Prior to this amendment, to tackle insider trading activities, listed companies were required to put in place a vigil mechanism as contemplated by the Companies Act 2013, the Sebi (Listing Obligations and Disclosure Requirements) Regulations 2015, and the Sebi (Prohibition of Insider Trading) Regulations, 2015. Any suspected violation had to be internally received and dealt with. This process was required to be overseen by the company's audit committee which is required to have a minimum of three directors with independent directors forming a majority. While some amount of checks and balances did exist to prevent muffling of genuine concerns highlighted by whistleblowers (such as the composition of a relatively independent audit committee), reporting and resolution did present challenges that are discussed below.

Market's integrity

Detection and prosecution of insider trading activities remain a challenge due their clandestine nature. In this context, whistleblowers are invaluable in revealing information that is critical to take steps for holding accountable those indulging in such malpractices and market manipulation. Timely detection and redressal are essential for preserving the integrity of the securities market.

The key driver for encouraging whistleblowing is the need for sustaining a healthy ecosystem where investors would be at a level playing field in terms of information. Increase in transparency and a secure environment will instil confidence in the investors leading to greater participation in the capital markets.

Who could be a whistleblower?

An informant can be at any level of hierarchy – senior management/ board of directors, mid-level executives or junior employees (who could be executing instructions of senior management or be part of the IT/ secretarial task force).

Similarly, the hierarchy of those violating the insider trading regulations cannot be pre-determined.

Malignancy in the existing mechanism

Historically, owing to the higher degree of promoter shareholding, affairs of Indian companies (as opposed to their western counterparts) have often typically either been promoter controlled or influenced (at the very least).

Such an ecosystem coupled with an internal reporting and investigation of complaints would be a significant deterrent for a whistleblower who seeks to report serious concerns such as insider trading. The situation would clearly be exacerbated if the alleged wrongdoer was a promoter or its ally. There would definitely be considerable scepticism surrounding the likelihood of (a) an unbiased investigation, and (b) protection to the whistle-blower, from disclosure of its identity and from victimisation.

Generally, any person having legitimate access to unpublished sensitive price information (UPSI) and illegitimately benefitting from such UPSI, would wield substantial power and/ or be a person of significant influence. Therefore, a whistle-blower undertakes great personal risk in divulging grave concerns such as insider trading, given the limited expectation of an impartial probe as well as protection from backlash/ adverse repercussions.

Allegations have also been made against companies for brushing such wrongdoings under the carpet, for protecting the company's image from getting tarnished and/ or for avoiding the risk of any 'negative impact' on the share price.

The above circumstances have indeed posed a significant hurdle for people to come forward and report genuine concerns, and the amendment to the insider trading regulations addresses these lacunae.

The new innings

The reworked legislative framework presents informants with a direct channel to approach Sebi and report insider trading concerns. It provides for setting up of an office of informant protection (OIP) by the Sebi which would, *inter alia*, (a) receive complaints through a voluntary information disclosure form (VIDF), (b) maintain a hotline for assisting potential informants, (c) act as a communication interface between Sebi and the informant, and (d) recommend monetary rewards for the informant.

Secrecy

It stipulates safeguards for ensuring that confidentiality of the whistleblower's identity is maintained throughout. Disclosure of information reported as well as the informant's identity are exempted from disclosure under the Right to Information Act, 2005.

Additionally, every listed company is required to put in place adequate safeguards to protect the informant against any retaliation and victimization.

Monetary reward

Amongst the several conditionalities to become eligible for receiving the monetary reward, a key pre-requisite is that the informant must have furnished 'original information'. Also, such a person must not be obligated to report such information to Sebi (under law or otherwise). Additionally, the penalty imposed by Sebi for the wrongdoing must be at least Rs 50 million.

The rewards are pegged against successful recovery of penalty from those who are sanctioned by Sebi for the wrongdoing. The reward is to be determined by Sebi (as recommended by the Informant Information Committee in consultation with the OIP) and is capped at the lower of Rs 10 million or 10 percent of the monetary penalty recovered by Sebi. This is to be sourced from the Investor Education and Protection Fund. In case of joint informants, this amount is to be equally divided.

That said, there is no legal obligation on an informant to report any insider trading activities which come to the informant's notice. Therefore, a person who becomes aware of any unlawful insider trading activities may seek to settle with the offender for a negotiated amount instead of reporting it to Sebi. It is recommended that the legal framework be amended to build-in sanctions for attempting or agreeing to receive monetary benefits for not reporting such information. While it may be tough to enforce in practice, nevertheless, it may instil some further fear and maybe a deterrent for those looking to negotiate such arrangements for quick money.

No amnesty

Being an informant does not automatically grant immunity for any past

wrongdoings by such person including violations of securities law. Nevertheless, such an informant can opt for settlement of its violations in a confidential manner as prescribed under the Sebi (Settlement) Regulations, 2018. Notably, in determining any penalty/ sanction against an informant, Sebi has been given the leeway to consider cooperation rendered by the informant.

Any action taken by Sebi against an informant would not disqualify such a person from receiving the monetary reward.

Malicious whistleblowing

Frivolous and unscrupulous complaints can affect shareholder confidence and lead to significant negative impact on the share prices of the company. Therefore, some protection has been provided against this risk with the informant being required to provide an undertaking that the information does not contain any false, frivolous, fictitious or fraudulent statement.

Sebi's investigation will also be conducted confidentially to ensure that this mechanism doesn't result in becoming a tool for market manipulation with malicious complaints or for settling personal scores with the promoters / management of a listed company.

Conclusion

The mechanism to report concerns directly with Sebi is a step in the right direction and is the beginning of a fresh innings to tackle insider trading. It appears to be a well-thought-out tweak in the legal regime for spurring reporting of insider trading activities. It is hoped that Sebi will effectively implement these provisions to safeguard whistle-blowers and maintain requisite incentives for them to keep coming forward.

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