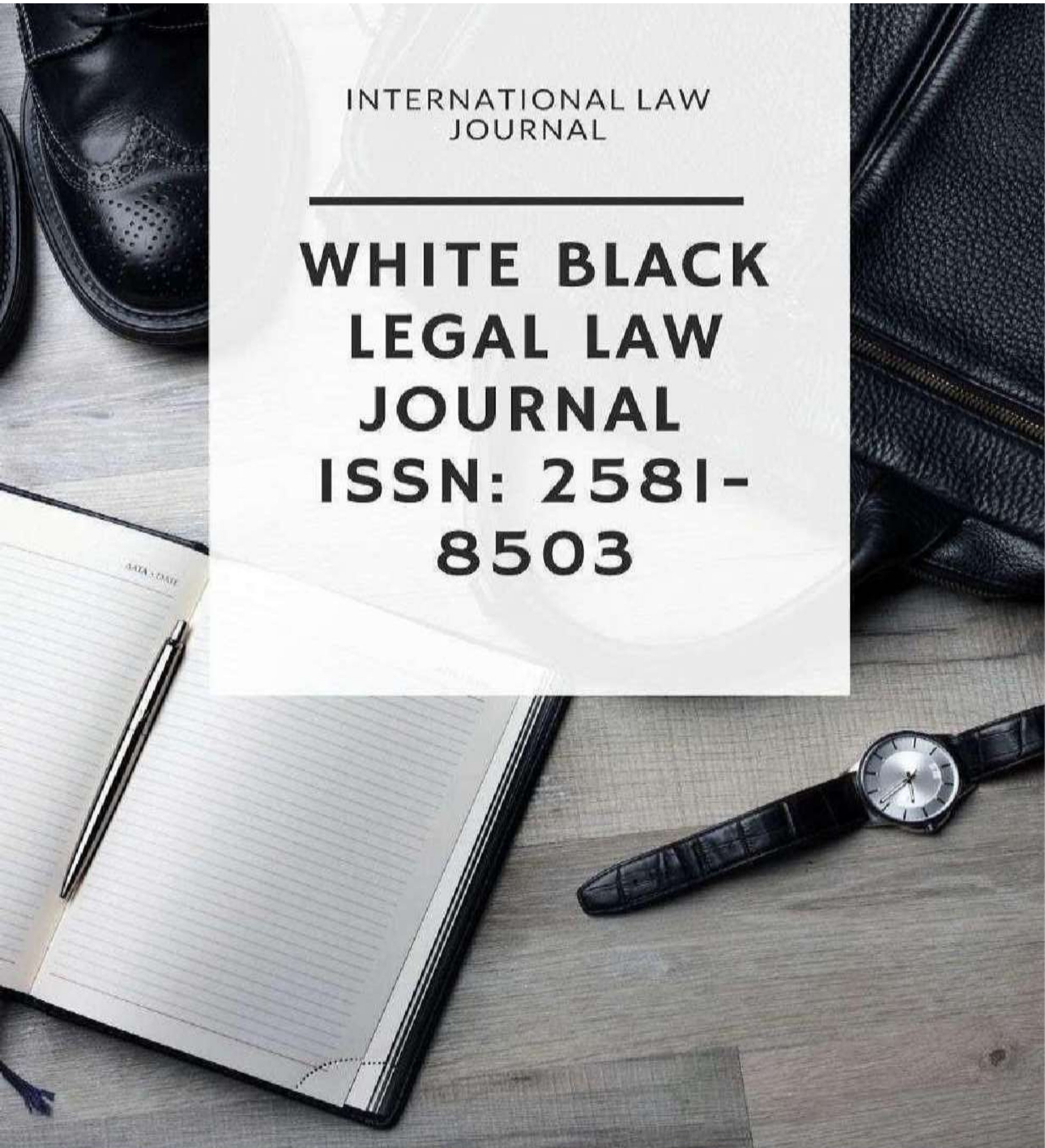

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ABOUT US

WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

REPERCUSSIONS OF INSIDER TRADING IN THE CONTEXT OF MERGERS AND ACQUISITIONS

AUTHORED BY - AISHWARYA GUPTA[1]

Abstract

Within the domain of mergers and acquisitions (M&A), the phenomenon of insider trading has been a subject of considerable scrutiny, primarily because of its capacity to disrupt market dynamics and undermine the integrity of these transactions. This extended abstract explores the intricate ramifications of insider trading in the context of M&A deals.

Mergers and acquisitions represent crucial events in the corporate world, involving the consolidation of companies, reallocation of assets, and often, significant changes in market dynamics. These transactions have far-reaching economic implications, making them a focal point for investors, regulators, and corporate insiders. Regrettably, insider trading, the illicit act of trading securities on the basis of undisclosed, material information, presents a substantial threat to the integrity of M&A transactions. At its core, insider trading undermines the principles of fairness and transparency that should underpin M&A deals. Furthermore, it erodes trust in financial markets, deterring investment and diminishing overall market efficiency.

To address these issues, regulatory bodies have implemented stringent laws and regulations to combat insider trading. These rules aim to provide a level playing field for all market participants, safeguarding the integrity of M&A transactions. Nevertheless, enforcement remains a challenge, as insider trading often occurs covertly, requiring vigilance and cooperation from market actors and authorities. This abstract also investigates the ethical dimensions of insider trading in M&A transactions, where corporate insiders are faced with moral dilemmas and conflicts of interest.

In conclusion, the repercussions of insider trading in the context of mergers and acquisitions are far-reaching, affecting the fairness, transparency, and trust in financial markets. This abstract provides insights into the regulatory efforts to combat insider trading, the ethical considerations for corporate insiders, and real-world examples that highlight the consequences of this illegal

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practice.

Introduction

Inextricably linked to the high-stakes realm of mergers and acquisitions (M&A) are the complex intricacies of insider trading, a practice that holds the capacity to cast a cloud over the equity and integrity of these transactions. The interplay between these two domains is of significant interest to stakeholders ranging from investors and regulatory bodies to corporate insiders and legal experts.

When the stock market experiences a sudden shift or observes a consistent trading pattern for a particular security, it often signals an underlying reason. This cause, on occasion, can be linked to insider trading, which entails the trading of a public company's stock or other securities by an individual possessing non-public, material information about the company.[2] Such information is highly sensitive and must remain concealed; otherwise, it could have detrimental consequences for the trader who possesses it. Consequently, in order to safeguard investor interests and investments, SEBI (Securities and Exchange Board of India) has classified insider trading as illegal.

Mergers and Acquisitions (M&A) can be described as the process of consolidating companies. The underlying principle of M&A is rooted in the belief that when two separate companies join forces, they have the potential to generate greater value than they could individually. With a primary goal of maximizing wealth, businesses continually assess various prospects for growth through mergers and acquisitions.[3]

In the context of M&A (Mergers and Acquisitions) transactions, the due diligence process holds a paramount position. Within this transaction, the acquirer often holds privileged information that is not available to other investors. This information, whether it pertains to share acquisition or asset purchase, carries an inherent capacity for value enhancement. The ripple effects of these transactions extend well beyond boardrooms, influencing the financial markets and economies at

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[2] Akhilesh Ganti, What Is Insider Trading?, What is Insider Trading and When Is It legal?, Investopedia, (8:45 PM, 11 Oct. 2023), https://www.investopedia.com/terms/i/insidertrading.asp

[3] Natika, Regulatory Framework Regarding Insider Trading, A Study on Mergers and Acquisition in India and Its Impact on Operating Efficiency of Indian Acquiring Company, (Scientific Research), (7:30 PM, 12 Oct. 2023), https://www.scirp.org/journal/paperinformation.aspx?paperid=91980#:~:text=Mergers%20and%20Acquisitions%20(M%20%26%20A,taken%20over%20by%20the%20other.

large. Hence, it is imperative that details regarding M&A transactions remain confidential, not only to protect investors but also to preserve the equilibrium necessary for facilitating the due diligence process in M&A activities.

Intricately interwoven with the fabric of corporate finance, the repercussions of insider trading in M&A transactions are profound and far-reaching. Through this exploration, we aim to shed light on the intricate issues surrounding this phenomenon.

Regulatory Framework for Insider Trading in M&A Transactions

The Securities and Exchange Board of India, abbreviated as SEBI, plays a pivotal role in overseeing and facilitating India's secondary securities market. One of its key responsibilities is to establish the necessary regulations for the prevention and control of insider trading offenses.

1. As per Regulation 3 of the SEBI (Prohibition of Insider Trading) Regulation, 20154, the act of conveying undisclosed price-sensitive information (UPSI) is considered a violation. Unpublished price-sensitive information encompasses any data pertaining to a company or its securities, whether directly or indirectly, that is not widely accessible and, once it becomes public knowledge, is likely to have a significant impact on the securities' price.[5]
2. However, within the realm of due diligence in an M&A transaction, a distinctive challenge emerges, necessitating the sharing of specific information with pertinent stakeholders. Nonetheless, regulation 3(3)6 permits such communication to take place when a company or its representatives are involved in the due diligence process as part of a merger and acquisition (M&A) transaction.

Within these regulations, sub-clause (i) and sub-clause (ii) specify the circumstances under which such communication is permissible:

a) Sub-clause (i) pertains to acquisitions that fulfill the criteria mandating an open offer, as stipulated in compliance with the SEBI (Substantial Acquisition of Shares and Takeovers)

[4] (“PIT, 2015”)

[5] Admin, What are the disclosure requirements by certain persons under the SEBI (Prohibition of Insider Trading) Regulations, 2015?,Overview of SEBI’s Prohibition of Insider Trading Regulations (PIT Regulations), (9:32 PM, 13 Oct. 2023), https://www.taxmann.com/post/blog/overview-of-sebis-prohibition-of-insider-trading-regulations/

Regulations, 2011.

b) Sub-clause (ii) applies to acquisitions falling below these thresholds.

This provision has garnered approval from various industry professionals and corporations as it streamlines the due diligence process in M&A transactions. This is because the provision enables the acquiring company to access necessary information about the target company, even if such information remains undisclosed. As per the requirement, the shared UPSI must be both valid and in the company's best interests.

Furthermore, the regulation[7] stipulates the necessity for the 'board's opinion.' This implies that in the context of an M&A transaction, where undisclosed price-sensitive information (UPSI) is shared during due diligence (rather than reverse due diligence), it is a legal requirement for only the board of the target company to offer their perspective that the proposed transaction serves the best interests of their company. The acquirer company's board is not under a legal obligation to provide such an opinion for the exception to apply.

The regulation mandates that any UPSI regarding a transaction must be publicly disclosed at least two days before the transaction's occurrence. An important point to emphasize is that in both scenarios, this disclosure must be made to the general public and not to a selective group. This requirement ensures that every individual has an equal opportunity to access and utilize such information, thereby eliminating the potential for a select few to gain an unfair advantage. Consequently, this aligns with the regulation's core objective of preventing illicit gains by a privileged few.

As a result, this functions as a safeguard against the potential misuse of the exception granted in Regulation 3. Therefore, in scenarios where an M&A transaction, involving the sharing of undisclosed price-sensitive information (UPSI) during its negotiation phase, does not come to fruition, the prerequisite of prior approval from the board could categorize the earlier disclosure of UPSI under Regulation 3(3) as a communication made for 'legitimate purposes,' as outlined in Regulations 3(1) and 3(2). Consequently, even in cases of unsuccessful M&A transactions, the conveyance of UPSI would maintain its legal standing under the Prohibition of Insider Trading (PIT) Regulations, 2015.

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[7] Regulation 3(3), SEBI (Prohibition of Insider Trading) Regulation, 2015

This stipulation, which mandates securing the board's consent for sharing UPSI, deviates somewhat from the recommendations outlined in the Sodhi Committee Report[8]. In the report, it was recommended that, in order for the board to approve the sharing of undisclosed price-sensitive information (UPSI) during due diligence, two conditions should be satisfied: firstly, the M&A transaction under consideration must be in the best interests of the acquired company, and secondly, the due diligence process should be carried out in a manner consistent with this objective. However, under the Prohibition of Insider Trading (PIT) Regulations, 2015, only the proposed transaction itself needs to align with the best interests of the relevant company.

Ambiguities under Regulation 3

1. Uncertainty of the phrase "propose to be listed"

The Prohibition of Insider Trading (PIT) Regulations, 2015, has imposed restrictions on individuals who have access to undisclosed price-sensitive information (UPSI), affecting both the communication and trading of securities while in possession of UPSI. These prohibitions, as outlined in regulations 3 and 4, apply not only to currently listed companies but also to those that are "proposed" for listing. However, neither the PIT, 2015, nor the Sodhi Committee's Report offers a specific definition for the term "proposed to be listed." This lack of a clear definition creates uncertainties surrounding the scope and extent of this provision. Adding to the ambiguity is the fact that in the draft regulations presented in the Report, regulation 2(1)(c) defines a company as an entity whose securities are either listed or "intended" to be listed on a stock exchange. The terms "proposed" and "intended" with regard to the listing of securities are not necessarily synonymous.

This ambiguity becomes particularly significant in the context of an M&A transaction. This is because in such a scenario, a company may be acquired with the "intention" of eventually having either of the participating companies in the M&A deal listed. For example, situations like reverse takeovers involve the "intention" of facilitating the listing of the acquiring company as a result of the M&A transaction. Consequently, in M&A deals where either of the participating companies is not yet listed at the time of the deal but harbors the "intention" to attain listing after the transaction, the unlisted participant company may face some uncertainty regarding its compliance

[8] Ibid.

with PIT, 2015, during the course of the deal.

2. Uncertainty regarding the meaning of the phrase ‘legitimate purposes’

Firstly, there exists ambiguity concerning whether the term 'communication in furtherance of legitimate purposes' is restricted to communication made to fulfill an existing legal obligation, or if it encompasses a broader scope. Additionally, it remains unclear whether this phrase exclusively pertains to communication made for professional 'legitimate purposes' or if it extends to the sharing of undisclosed price-sensitive information (UPSI) related to personal 'legitimate' objectives.

For instance, while the sharing of UPSI by a company with a law firm providing counsel to the company might qualify as a business-related 'legitimate purpose,' the act of an employee disclosing the company's UPSI to their spouse could be regarded as a personal 'legitimate' objective.

The inherent uncertainties within the Prohibition of Insider Trading (PIT) Regulations of 2015 have the potential to cast a detrimental impact on the sharing of undisclosed price-sensitive information (UPSI) within M&A transactions and the M&A deals as a whole. Furthermore, these ambiguities could lead to unintended consequences in the broader realm of insider trading. This is mainly because M&A transactions often create favorable conditions for insider trading activities and may tempt individuals to seek out loopholes or develop methods to circumvent insider trading regulations. M&A transactions are pivotal moments in the corporate world, with significant implications for businesses and markets. A deep understanding of the repercussions of insider trading in this context is vital for investors, regulatory bodies, and industry participants.

Steps To Be Taken To Disregard Insider Trading During M&A

Companies and relevant authorities can take proactive measures to mitigate the risks associated with insider trading during M&A transactions. These steps include:

1. Raising Awareness: Directors and officers should be informed early about the potential prohibition of trading in the company's securities during the initial stages of M&A activities. This awareness should be established well before the company is obligated to disclose any information about a potential transaction.

2. Continuous Evaluation: Issuers, especially when faced with unsolicited expressions of interest or when planning for anticipated M&A activities, must assess the facts and circumstances at each stage of the process. It is crucial to determine whether these circumstances qualify as a "material fact" that warrants imposing a trading blackout on insiders and other employees.
3. Early Materiality Assessment: During the early stages of M&A discussions, companies should evaluate whether the potential transaction constitutes a "material fact." This assessment should consider various factors, including the nature of the counterparty, their genuine interest in the transaction, and the company's suitability and interest level in the deal. This evaluation helps in determining whether trading restrictions should be imposed even before the specifics of the transaction are finalized.
4. Restricted Information Access: Implementing procedures to limit access to information about early-stage or unsolicited M&A activities to a select core team of management, directors, and advisors is essential. This restricted access helps in controlling the flow of information while the materiality of the situation is being evaluated. This measure also prevents inadvertent trading offenses by ensuring that sensitive information remains confidential.

By adhering to these guidelines, companies can minimize the risk of insider trading violations and maintain the integrity of the M&A process. These proactive steps not only safeguard against legal repercussions but also uphold the trust and fairness essential to the functioning of financial markets.

CASE LAW – Samir Arora v. SEBI by the Securities Appellate Tribunal (SAT)

Facts:

The case in question pertains to allegations of insider trading against Samir Arora, a prominent fund manager in the late 1990s. He had faced allegations of divulging certain UPSI related to a merger and subsequently profiting from it. Approximately a decade ago, SEBI imposed a five-year ban on Samir Arora, who had previously served as a fund manager at Alliance Capital Management. However, this order was swiftly overturned by the Securities Appellate Tribunal (SAT) within a few months. Subsequently, in 2004, SEBI took the matter to the Supreme Court, challenging SAT's decision.

Senior counsel CA Sundaram, representing Arora had informed the court that the SEBI order had not been enforced for all these years, and Arora had since relocated his business operations to Singapore. Given these circumstances, there was no compelling reason to adjudicate the appeal on its merits.

Issue:

Whether Shri Samir C. Arora is guilty of violating the provisions of Regulation 3 of SEBI (Prohibition of Insider Trading) Regulations, 1992?

Decision of SAT:

Regarding the allegation of insider trading, it was determined that the appellant had accessed purportedly price-sensitive information (UPSI), which, as it turned out, did not align with reality because the merger was not announced on May 12, 2003. Information that ultimately proves to be inaccurate or, at the very least, uncertain, cannot be rightfully categorized as information held by the Securities Appellate Tribunal (SAT).

Supreme Court:

On April 2, in its final verdict, the Supreme Court rejected SEBI's appeal on the basis that Arora had abstained from trading during the period he was barred from participating in the Indian stock market. SAT's ruling clarified that since the information was found to be inaccurate, the prohibition on non-disclosure would not apply. To qualify as undisclosed price-sensitive information (UPSI) and warrant charges of insider trading, information must be accurate and substantiated.

Conclusion

In summary, the implications of insider trading within the context of mergers and acquisitions (M&A) are both complex and significant. Insider trading, which involves trading securities based on non-public, material information, has the potential to disrupt the fairness, transparency, and efficiency of M&A transactions.

Insider trading significantly impacts the securities exchange market, and SEBI's actions are geared towards safeguarding investors and stakeholders' interests. However, the current regulations regarding insider trading and their implications on mergers and acquisitions lack clarity and proper guidance. Moreover, the regulatory landscape governing insider trading, particularly in the M&A context, highlights the importance of precision and clarity in legal frameworks.

Ambiguities surrounding concepts like 'legitimate purposes' and 'intended' listings create uncertainty and can affect the sharing of UPSI during M&A deals, potentially leading to unintended consequences. The existing formulations create confusion rather than providing the necessary clarity and direction. These ambiguities within the SEBI (Prohibition of Insider Trading) Regulation, 2015 can adversely affect the sharing of unpublished price sensitive information during M&A transactions and within the deals themselves. Real-world examples serve as potent reminders of the grave repercussions of insider trading. High-profile cases have shaken the financial world, leading to legal battles, tarnished reputations, and substantial financial penalties. These instances underscore the pressing need for stringent enforcement measures and robust ethical guidelines to safeguard the integrity of M&A transactions.

Mergers and acquisitions, being inherently value-enhancing, require stringent protection of sensitive information to maintain market parity. Furthermore, M&A transactions offer a fertile ground for insider traders, making it imperative to have clear regulations and restrictions. The current state of insider trading regulations calls for substantial development to ensure positive impacts on the market. Clearer guidelines and laws are essential to curb insider trading and foster a fair and transparent market environment.[9] As we move forward, it becomes crucial to establish clear and precise regulations, robust enforcement mechanisms, and a commitment to ethical behaviour to ensure that the realm of M&A maintains its integrity and fairness for all stakeholders. The current state of insider trading regulations calls for substantial development to ensure positive impacts on the market. Balancing these elements is an ongoing journey to foster trust, protect investor interests, and uphold the core principles of equity and transparency within the world of mergers and acquisitions.

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[9] Akhilesh Ganti, What Is Insider Trading?, What is Insider Trading and When Is It legal?, Investopedia, (8:45 PM, 11 Oct. 2023), https://www.investopedia.com/terms/i/insidertrading.asp