

Market gauging in listed company capital markets transactions in India—analysis of the SEBI order in Factorial



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I. Introduction and Background

Listed company transactions in India are subject to a strict disclosure regime under securities laws, particularly the laws governing insider trading. These regulations impact multiple facets of listed company transactions, ranging from preliminary due-diligence to the relatively routine post transaction compliances. The larger policy objective of these laws, as emphasized by the Sodhi Committee in its 2013 Report¹, is to ensure the integrity of price discovery and to maintain a level-playing field for trading in the securities market.

The erstwhile Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 (“**1992 Regulations**”),

which was the regulation governing the insider trading regime in India for more than two decades primarily centered around three substantive classes of requirements: (a) prohibiting communication of, and trading while in possession of unpublished price sensitive information (“**UPSI**”); (b) mandating disclosure of trading by insiders; and (c) prescribing a model code of conduct for disclosure by listed companies and intermediaries. The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (“**2015 Regulations**”) which replaced the 1992 Regulations, substantively overhauled the insider trading regime in India and in the process, clarified some of the longstanding ambiguities under the old regulations, including around due-diligence by acquirers in listed companies.

In capital markets transactions, merchant bankers routinely conduct ‘market gauging’, with an objective to assess potential demand for the securities they have been mandated to place with investors. There is no specific guidance in Indian law on the nature of conversations they can engage in with prospective investors while conducting such market gauging. Neither the 1992 Regulations nor the 2015 Regulations expressly cover the aspects relating to such exercise. Both the laws contain a standard exemption for communications made in ordinary course of business, the scope of which was largely untested until recently. Late last year, on December 8, 2016, SEBI’s whole time member passed its final order against Factorial Master Fund (“**Factorial**”) for dealing in the securities of L&T Financial Holding Limited (“**LTFH**”) while in possession of UPSI in violation of the 1992 Regulations and observed, for the first time, that merchant bankers are entitled to the benefit of the ‘ordinary course of business’ exception to the prohibition on communication of UPSI, while discussing deal-related information with potential investors during market gauging.

II. The SEBI Order in Factorial

A. Facts

Upon noticing fluctuations in the share price of LTFH for the period from March 10, 2014 to March 14, 2014, SEBI had conducted an investigation into the trading of LTFH. It was observed that Factorial had engaged in aggressive trading of the scrip of LTFH ahead of the announcement of an offer for sale by L&T of shares of LTFH (“**OFS**”). In October 2014, SEBI had passed an interim order restraining Factorial from accessing the securities market and prohibiting it from buying, selling or dealing in securities on grounds of alleged insider trading. In the order, SEBI alleged that Factorial had taken a short position on the futures and options segment of the LTFH scrip on the basis of UPSI of the likely floor price in the OFS.

Subsequently, Factorial challenged the interim order before the Securities Appellate Tribunal (“**SAT**”) which dismissed the interim order, leaving the option open to SEBI to issue a show cause, if any new facts adverse to Factorial came to the knowledge of SEBI.

Upon completion of its investigation, SEBI issued a show cause notice in December, 2015 against Factorial alleging violation of the 1992 Regulations.

The timeline of events taken into consideration by SEBI was as follows:

Date	Activity
March 10, 2014	L&T sought exemption from SEBI from the cooling-off period from its last disposal of shares of LTFH and stating therein that it was considering sale of shares of LTFH through an OFS in the next 2-3 days.
March 10, 2014	The merchant banker appointed on the OFS conducted market gauging for shares of LTFH to ascertain potential investor interest and price at which the investors would be willing to purchase the shares of LTFH in the OFS. Factorial participated in this exercise along with around 70 other potential investors. In the exercise, negative sentiment in respect of the shares of LTFH was expressed and that investors would seek deep discount to buy shares of LTFH.
March 13, 2014 (9:20 AM)	A Bloomberg chat message was sent by one member of the equity team of the merchant banker to another stating that shares of LTFH are “likely to come in at a steep discount about 70 types”.
March 13, 2014	Factorial entered into derivative contracts of LTFH equivalent to selling shares of LTFH at a price of Rs. 80.94. It is to be noted that Factorial in its submissions before SAT argued that it had anticipated the shares of LTFH would be sold at a deep discount.
March 13, 2014 (after market close)	L&T received exemption from SEBI from the cooling-off period
March 13, 2014 (after market close)	L&T intimated to the stock exchanges that it would launch the OFS on the next day at a floor price of Rs. 70 per share.
March 14, 2014	Factorial purchased shares of LTFH in the OFS at an average price of Rs. 71.50.

B. Decision

In its final order passed on December 8, 2016 (the “**Order**”), SEBI held that Factorial had dealt in the securities of LTFH, while in possession of UPSI, in violation of the 1992 Regulations. SEBI’s decision rested on the following key aspects:

- (i) *Identification of UPSI*– SEBI held that (a) the decision to undertake an OFS; and (b) the floor price for such OFS, each qualified as UPSI;
- (ii) *Communication of UPSI*– While SEBI could not find specific evidence of communication of UPSI, it found, on the basis of circumstantial evidence that UPSI was communicated to Factorial. The circumstantial evidence relied upon by SEBI was the following:
 - a. the merchant banker to the OFS and Factorial had communicated on multiple occasions during the UPSI existence period;
 - b. Factorial had met with senior management of LTFH two days before the launch of the OFS; and
 - c. proximity of events and trading pattern of Factorial, as per which, it did not appear to have had any position on the scrip of LTFH prior to the trades in question coupled with the fact that the research reports cited by Factorial did not support the sudden aggressive trading it carried out.

The Order directed Factorial to disgorge the entire profit unlawfully gained by them i.e. the difference between the sell price and the buy price of the LTFH scrip, along with interest.

Additionally, SEBI observed that even though the finding implied communication of UPSI between the merchant banker and Factorial, such communication was in the ordinary course of business or employment, having been made as part of a market gauging exercise prior to the launching of the OFS. Accordingly, it justified not having initiated any action against the merchant banker.

C. Analysis

While the Order does not expressly state so, it appears to classify the communication between the merchant banker and Factorial in two categories:

- (a) *The discussion which actually took place between the merchant banker and Factorial and was admitted by the parties:*

This was on the lines of a prepared script which discussed the regulatory requirements for shareholding of promoters in listed companies, the fact of L&T’s existing holding in LTFH being higher than the regulatory threshold, thereby indicating the possibility of a sell-down, and sought to obtain an indicative demand and price from Factorial. The script also referred to the fact that L&T had conducted an OFS of shares of LTFH in the past. However, the script, by itself, was not considered UPSI by SEBI.

(b) *A presumed communication of UPSI based on circumstantial evidence:*

As per SEBI, the UPSI was (i) the decision of L&T to undertake an OFS in the shares of LTFH; and (ii) floor price for the OFS. SEBI presumed, on the basis of circumstantial evidence noted above, that such communication must have taken place.

Consistent with the course charted by this dispute prior to the Order, Factorial appears to have appealed to SAT against the Order and the matter was last listed on July 13, 2017. It would be interesting to know the views of SAT, specifically in relation to the 'existence of the transaction' being UPSI as opposed to, say, the timing of the transaction being considered so. The Order is unclear on this point since while on one hand it states that the decision to undertake an OFS was UPSI, it did not expressly find the 'script' (which referred to the previous OFS conducted by L&T) to be containing UPSI.

Further, the impact of regulatory requirements around dilution of promoter shareholding in listed companies on the apparent 'white-listing' of the script in the Order is also not clear. For instance, it remains to be seen whether a script on the lines above in case of a more 'strategic' capital raising decision (such as a QIP) would also pass the test of not being UPSI.

Lastly, it may be noted that the Order was passed under the 1992 Regulations, which have subsequently been replaced by the 2015 Regulations. The 2015 Regulations also provide for an exemption to communications which are made 'in furtherance of legitimate purposes, performance of duties or discharge of legal obligations' from constituting a violation of the prohibition on communication of UPSI. However, while the exemption under the 2015 Regulations appear to be wider than the one in the 1992 Regulations, the Order does not make a pronouncement on the current regulations.

III. Implications of the Factorial Order

While we hope that SAT (if and when approached), and future orders from SEBI, would give a more detailed analysis on the matter clarifying some of the nuances above, the Order now provides some basis for a more informed evaluation of existing practices on market gauging:

- A discussion on the lines of the script described above may not per se constitute UPSI and thus, preliminary market gauging following a similar script centered around regulatory requirements may be permissible. However, as noted above, the script would need to be assessed in light of the nature of the transaction proposed. In any case, details relating to the existence of a transaction, as well as specific details on timing or pricing would be considered UPSI.
- Merchant bankers by themselves may not be liable for communication of UPSI as part of market gauging, since SEBI found such communications to be in their 'ordinary course of business or employment'. Further, SEBI noted that the merchant banker was verbally mandated for the OFS and hence, the benefit of this exemption would not be restricted to instances where a written engagement letter is signed.
- It may be advisable for merchant bankers to enter into a confidentiality and 'standstill' arrangement with any investor with whom they propose to discuss any information related to the transaction which could be considered to be UPSI. As per the Order, this would definitely include any discussion on the existence of the transaction, its timing and pricing.
- SEBI, in the Order, presumed communication of UPSI to Factorial based on circumstantial evidence, including meetings held between Factorial and the management of L&T. If Factorial was able to rebut this presumption with any specific proof, agenda or material used for these meetings, it may have been able to avoid liability or at least shift the evidentiary balance in its favour. Accordingly, adequate safeguards should be taken by merchant bankers and the issuer in the event any additional meetings or communications are proposed to be made with potential investors after an initial market gauging exercise such that they are better placed to rebut presumptions, if any, drawn by the regulator on a post-facto reconstruction of events.

¹ Report of the High Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992, dated December 7, 2013.