

## Corpsec Hotline

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### NEW 'FRONT RUNNING' BY PERSON OTHER THAN INTERMEDIARY IS NOT PROHIBITED: SAT

In a recent ruling of Mr. Dipak Patel vs. Securities and Exchange Board of India<sup>1</sup> ("Order"), the Securities Appellate Tribunal<sup>1</sup> ("SAT") while adjudicating on legality of 'front running' by a person, other than an intermediary, under Regulation 3 of Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 ("FUTP Regulations") has held that a person engaging in front running may be committing a fraud against his employer, but in the absence of any specific provision, he cannot be held guilty under Regulation 3 of the FUTP Regulations.

**Front running** means buying or selling of securities ahead of a large order so as to benefit from the subsequent price move. This denotes persons dealing in the market, knowing that a large transaction will take place in the near future and that parties are likely to move in their favour.<sup>2</sup>

**Intermediary** means a stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deeds, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser, depository, participant, custodian or securities, credit rating agency and such other intermediaries as the Securities and Exchange Board of India ("SEBI") may specify and includes asset management company in relation to the SEBI (Mutual Funds) Regulations, 1996, clearing member of a clearing corporation or clearing house and a trading member of a derivative segment or currency derivatives segment of a stock exchange but does not include foreign institutional investor, foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund.<sup>3</sup>

### FACTUAL BACKGROUND

SEBI conducted investigations into the trading activity by Mr. Kanaiyalal Baldevbhai Patel ("KBP"), an individual trader, and a foreign institutional investor ("FI"), registered with SEBI, for the period between January, 2007 and March, 2009. It was noted that KBP had placed and executed orders before the orders of the FI and consequently squared off his position when the orders of the FI were placed for trading.

Mr. Dipak Patel ("Dipak") was the portfolio manager of the FI and is also related to KBP and Mr. Anandkumar Baldevbhai Patel ("ABP"). SEBI noted that Dipak provided information to KBP and ABP regarding forthcoming trading activity of the FI. Taking advantage of the same KBP indulged in 'front running' i.e. he placed and executed orders before the order of the FI and consequently squared off the position when the orders of the FI were placed for trading. It was noted by SEBI that trades were executed using telephone number registered in the name of ABP at the common residential address of KBP and ABP. Thus, ABP allegedly aided and abetted KBP and Dipak in these transactions. By adopting this method KBP earned a total profit of INR 1,56,32,364 (approximately USD 285,000) from the alleged trades.

### DECISION OF SEBI

The Adjudicating Officer of SEBI found Dipak, KBP and ABP guilty of violating the provisions of Regulation 3(a), 3(b), 3(c) and 3(d) of the FUTP regulations and imposed monetary penalty under Section 15HA of the SEBI Act, 1992 of INR 5,00,00,000 (approximately USD 910,000) each on Dipak and KBP, and INR 1,00,00,000 (approximately USD 182,000) on ABP.

### QUESTION BEFORE SAT

Aggrieved by the order of SEBI, the appellants filed an appeal to SAT. The moot question before SAT was whether trading done in the securities market by a person who is not an intermediary, on the basis of information about forthcoming orders of another trader in the market, is violative of Regulation 3 of the FUTP Regulations?

### ARGUMENTS OF THE APPELLANTS

The appellants primary contention was that all the trades executed by KBP were in the normal course, were screen based, at the prevalent market price and hence there was no market manipulation, and that the transactions had not affected the market in any way. The appellants contended that if at all there is any wrongdoing, it may be between the FI and Dipak, who was the portfolio manager of the FI, and it is for the FI to take action, if any, against Dipak and that there is no violation of the FUTP Regulations. It was reported that the FI has, in fact, terminated services of Dipak for violation of the FI's policies.

Further, the communication through telephone among cousins is in no way unnatural or unusual; KBP has been dealing in the stock market since long and communication between him and Dipak was regular for a long time. There is no finding that either Dipak or ABP had dealt in the securities market or earned profit or shared profit.

It was further argued by the appellants that according to impugned SEBI order the transactions in question amount to front running but there was no such charge in the show cause notice.

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The appellants drew SAT's attention to Regulation 4(2)(q) of the FUTP Regulations which prohibit front running by intermediaries. Since, the appellants are not intermediaries, SEBI did not consciously charge them for violating Regulation 4(2)(q) of the FUTP Regulations. The appellants then argued that prior to coming into force of the FUTP Regulations of 2003, SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995 ("**FUTP Regulations 1995**") were in force and under those regulations, the prohibition on front running was not confined to intermediaries alone but was applicable to 'any person' trading in the securities market. Appellants contended that the FUTP Regulations of 2003 make a clear departure from the earlier position and now front running is prohibited only by the intermediaries and not by other entities trading in the securities market.

### ARGUMENTS OF SEBI

SEBI argued that Dipak was handling sensitive affairs of a foreign investor and he was supposed to maintain highest standards of integrity. It is because of information provided by Dipak that KBP could make huge profits. SEBI argued that this amounts to fraud against the market and against the employer of Dipak and has misled the investors as well.

SEBI also drew SAT's attention to the order passed by SAT in the case of M/s. Jayant Amaerchand Kalidas<sup>4</sup>, wherein SAT had observed that front running is an irregular practice of a stock broker executing orders on behalf of its clients in a security while taking advantage of advance knowledge of pending orders from its other clients. This is something akin to insider trading and is not permitted in the market.

SEBI argued that the charge in the show-cause notice and charge in the impugned order is the same. SEBI contended that, in the present case, the fact that the term 'front running' was not used in the show cause notice and was used in the impugned order will not amount to change or shifting of stand.

### SAT ORDER

SAT allowed the appeals of the respective appellants and held that SEBI has erred in holding the appellants guilty of violation of Regulation 3 of the FUTP Regulations. The reasons and arguments noted by SAT while giving the above order are as follows:

**Charge in show case notice and SAT order is same** : SAT refused the argument of the appellants that SEBI had not taken up the charge of front running in the impugned order. Simply because the term 'front running' is not used in the show cause notice does not mean that the charge has been given up. The conduct of the appellants as described in the show cause notice and as finally attributed to them in the impugned order is the same.

**Activities of KBP tantamounts to front running** : Though, the term 'front running' is not defined in the FUTP Regulations, but relying on the various definitions quoted by SEBI from Major Law Lexicon by P Ramanatha Aiyar (4th Edition 2010), and Black's Law Dictionary (Ninth Edition), SAT stated that if a person trades in stocks or other investments having knowledge of the upcoming transaction by a third party which is likely to affect the market price of the investment, the person can be said to be doing front running. As examined in the above perspective, SAT stated it is clear that the appellants were doing front running in relation to the trades of the FII.

**Front running by person other than intermediary not banned** : SAT noted that it is an admitted position on both sides that Regulation 4(2)(q) of the FUTP Regulations, which prohibits 'front running' applies only to intermediaries and not to other persons trading in the securities market. SAT also referred to the earlier FUTP Regulations 1995, wherein Regulation 6 prohibited front running by any person. SAT concurred with the contentions of the appellants that the FUTP Regulation 1995 prohibited front running by any person (other than intermediaries) dealing in the securities market and a departure has been made in the FUTP Regulations of 2003 whereby front running has been limited only by intermediaries.

**No violation of Regulation 3 of the FUTP Regulations** : SAT went through Regulation 3<sup>5</sup> of the FUTP Regulations which prohibits a person directly or indirectly to buy, sell or otherwise deal in securities in a fraudulent manner. In order to understand the abovementioned Regulation 3 better, SAT also looked at the definition of 'fraud' provided in Regulation 2(c)<sup>6</sup> of the FUTP Regulations. SAT stated that as the title of the FUTP Regulations itself suggests, these regulations are for prohibition of fraudulent and unfair trade practices relating to securities market. SAT ruled that it is, therefore, necessary to bring on record as to how the fraud perpetrated by the appellants has affected the securities market.

SAT stated that there is no denying the fact that when the appellants placed their trading orders, these were screen based and at the prevalent market price. Admittedly, the FII was the major counter party for trading in the market and was placing huge orders and hence possibility of order of traders placing orders for smaller quantities matching with orders of the FII cannot be ruled out. Therefore, it cannot be said that they have manipulated the market. The alleged fraud on the part of Dipak may be a fraud against its employer for which the employer has taken necessary action. SAT held that in absence of any specific provision in law, it cannot be concluded that a fraud has been played on the market or market has been manipulated by the appellants when all transactions were screen based at the prevalent market price.

### ANALYSIS

While SEBI has the option to appeal the SAT order in the Supreme Court of India, this case does highlight a possible serious lacuna in the regulatory framework. Mere replacement of the word 'person' with 'intermediary', while moving from the erstwhile FUTP Regulations 1995 to the current FUTP Regulations seems to have excluded a person other than intermediary from the liability of front running, which understanding doesn't seem to be intended. Further, it also leaves the door open for a lot of other advisors who may not be registered with SEBI as an intermediary.

Considering that the SEBI Act, 1992 and the regulations framed thereunder have the objective of protecting the interests of investors in the securities market, the view adopted by SAT in the Order while interpreting the provisions of the FUTP Regulations, seems to have been restricted and narrow.

In fact, Mr. U. K. Sinha, Chairman of SEBI, very recently stated that "On this particular aspect of front running, we will have to look at our regulations to see if it needs more improvement and strengthening."<sup>7</sup> It will be interesting to see, whether SEBI will amend the FUTP Regulations to extend them to even non-intermediaries. However, in the interim, if SEBI appeals against the decision of SAT, it will need to be seen how the Supreme Court of India reads into the FUTP Regulations to direct on this issue.

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<sup>1</sup> Appeal No. 216 of 2011; Date of Decision – November 9, 2012. Appeal nos. 74 and 78 of 2012 also combined.

<sup>2</sup> As per Major Law Lexicon by P Ramanatha Aiyar (4th Edition 2010).

<sup>3</sup> As defined under Regulation 2(g) of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

<sup>4</sup> Appeal no. 123 of 2010 decided on October 14, 2010

<sup>5</sup> Prohibition of certain dealings in securities: No person shall directly or indirectly-

(a) buy, sell or otherwise deal in securities in a fraudulent manner; (b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made thereunder; (c) employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange; (d) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange in contravention of the provisions of the Act or the rules and the regulations made thereunder.

<sup>6</sup> "fraud" includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include-

(1) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment; (2) a suggestion as to a fact which is not true by one who does not believe it to be true; (3) an active concealment of a fact by a person having knowledge or belief of the fact; (4) a promise made without any intention of performing it; (5) a representation made in a reckless and careless manner whether it be true or false; (6) any such act or omission as any other law specifically declares to be fraudulent; (7) deceptive behavior by a person depriving another of informed consent or full participation; (8) a false statement made without reasonable ground for believing it to be true; (9) the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price; and "fraudulent" shall be construed accordingly.

<sup>7</sup> [http://www.nishithdesai.com/New\\_Hotline/Other/Retail%20Alert\\_Sep2512.htm](http://www.nishithdesai.com/New_Hotline/Other/Retail%20Alert_Sep2512.htm) last visited on December 5, 2012

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