

## Funds Hotline

September 19, 2013

### SAT EXTENDS PROHIBITION OF 'FRONT RUNNING' TO PERSONS OTHER THAN INTERMEDIARIES (COPY 1)

- SAT now holds that front running even by a person, in addition to an intermediary, is illegal.
- SAT adopts liberal interpretation of FUTP Regulations and departs from its earlier ruling in Dipak Patel.
- SEBI introduces new amendment to the FUTP Regulations to clarify that acts or omissions are prohibited if they fall under the purview of Regulation 3 regardless of the category of persons committing such acts or omissions.

In a departure from its earlier ruling in the case of *Dipak Patel v Securities and Exchange Board of India*<sup>1</sup>, the Securities Appellate Tribunal ("SAT") recently ruled in the case of *Vibha Sharma & Anr. v Securities and Exchange Board of India*<sup>2</sup> ("Order"), that 'front running'<sup>3</sup> even by a person other than an intermediary is illegal. Interestingly, in 2012, in the case of Dipak Patel, SAT had specifically held that the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Markets) Regulations, 2003 ("FUTP Regulations") only bars front running by intermediaries and not by any other persons. Please refer to our Hotline titled "" dated December 7, 2012 for an analysis of the case of *Dipak Patel*.

In this hotline, we will briefly discuss the facts, arguments made by the parties and the reasons identified by SAT for forming its conclusions in the Order.

#### FACTUAL BACKGROUND

Jitender Sharma is the husband of Vibha Sharma and at the relevant time, was an equity dealer with Central Bank of India ("CBI"). Vibha Sharma had a trading account with the broker, Eureka Stock & Share Broking Services Limited. Following a report from the National Stock Exchange, the Securities and Exchange Board of India ("SEBI") conducted an investigation into the trading activities of certain persons including of Vibha Sharma during the period between December 1, 2009 and March 31, 2010.

The investigation revealed that for a period of 16 days during the investigation, trades were executed in the account of Vibha Sharma in such a way that the net quantity at the end of each day was zero. In other words, she would buy a certain number of shares and sell the same number of shares during the course of the trading day. Further, on 14 out of the 40 days during which Vibha Sharma's trading activities were being investigated, there was a complete match between the sell trades of Vibha Sharma and the buy trades of CBI. The investigation concluded that Vibha Sharma had purchased shares and placed sell orders on those shares to match the buy orders of CBI.

#### DECISION OF SEBI

SEBI appointed an Adjudicating Officer under section 15-I of the SEBI Act, 1992 to enquire into and adjudicate upon alleged violations of the FUTP Regulations. The Adjudicating Officer ruled that Vibha Sharma and Jitender Sharma had violated clauses (a), (b), (c) and (d) of Regulations 34 and 4(1)<sup>5</sup> of the FUTP Regulations and proceeded to levy a penalty of INR 2,500,000.

#### QUESTION BEFORE SAT

Aggrieved by the order of the Adjudicating Officer, Vibha Sharma and Jitender Sharma appealed to SAT. The issue that arose for SAT's consideration was similar to the issue that arose in the previous case of *Dipak Patel: Whether trading done in the securities market by a person other than an intermediary, on the basis of information about forthcoming orders of another trader in the market, is in violation of the FUTP Regulations?*

#### ARGUMENTS OF THE APPELLANTS

The Appellants, Vibha Sharma and Jitender Sharma, submitted that Vibha Sharma's trades were based on research reports received from various stock brokers / analysts as well as newspaper articles and other publicly available information. In fact, they contended that Vibha Sharma has been trading long before her husband's appointment as an equity dealer with CBI and her trading strategy was akin to any day trader who seeks to square off all positions before the close of the market. On this basis, the Appellants argued that Vibha Sharma's trades were in the normal course of business and any matching of trades was purely coincidental.

Further, the Appellants argued that Vibha Sharma's trades and the trades of CBI matched only for 14 days out of the total investigation period of 40 days and that this was an inadequate sample size to arrive at conclusive results. The Appellants submitted that SEBI should have suitably extended the period under investigation and established matching trades during such extended period to prove the charge under the FUTP Regulations conclusively.

Finally, the Appellants also relied on SAT's earlier ruling in *Dipak Patel v SEBI* and contended that only intermediaries are subject to the FUTP Regulations. Accordingly, Vibha Sharma, an individual investor, could not be

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## ARGUMENTS OF SEBI

SEBI argued that Vibha Sharma was in possession of information of purchases to be made by CBI through her husband, Jitender Sharma. For 14 days, Vibha Sharma only purchased one scrip such that her sale orders matched with the purchase orders of CBI. These sale and purchase orders were more or less synchronized in terms of price and time of the orders.

SEBI also submitted that for those 14 days, when there was a 100% matching of trades between Vibha Sharma's sale orders and CBI's purchase orders, Vibha Sharma would purchase a scrip at the last traded price ("**LTP**") and offer the same for sale at a price matching the price at which CBI was to buy the scrip. This price would normally be considerably higher than the LTP. Thus, it was clear that Vibha Sharma had made undue gains by relying on information to which she had access but which was not available to other investors.

## SAT ORDER

SAT dismissed the appeal of Vibha Sharma and Jitender Sharma and held that they had violated the provisions of Regulations 3(a), 3(b), 3(c), 3(d) and 4(1) of the FUTP Regulations. In arriving at this conclusion, SAT made the following observations:

**Liberal Interpretation of concept of front running:** SAT observed that the Dipak Patel case makes it evident that front running is always considered detrimental irrespective of whether it is done by an individual or an intermediary. In light of this, SAT was of the opinion that the definition of front running cannot be put to a strait-jacket formula and a liberal interpretation must be applied to the concept of front running.

**Exchange of information:** SAT held that Jitender Sharma, an equity dealer in securities with CBI and Vibha Sharma, a day trader were related as husband and wife. There was exchange of information relating to future trades by CBI and Vibha Sharma traded in the securities market on the basis of this information. In the process, she realized undue gains.

**Not mere coincidence:** SAT held that the trades made by Vibha Sharma cannot be explained in terms of mere coincidence, since there was a 100% matching of trades between Vibha Sharma's sale orders and CBI's purchase orders at a price significantly higher than LTP on 14 days. Further, SAT held that the matching in trades on 14 out of 40 days of investigation is statistically significant and hence an extended period of investigation was unnecessary.

## ANALYSIS

This ruling appears to have filled a serious lacuna in the regulatory framework. In the earlier cases, SAT had proceeded on the basis that the erstwhile FUTP Regulations of 1995 had prohibited all persons from indulging in front running while the current FUTP Regulations only prohibited intermediaries from indulging in front running. SAT has adopted a liberal construction of the concept of front running this time around.

One could make the argument that since the provision of 'front-running' in Regulation 4(2)(q)<sup>6</sup> is only illustrative and inclusive, the act of 'front-running' itself tantamounts to 'fraud'<sup>7</sup>, in which case the person committing it, whether an 'intermediary' or not, should be irrelevant. The question which would then arise is whether instances where intermediaries are specifically prohibited from indulging in certain acts should also apply to all persons and not just intermediaries. It may be noted that Regulation 4(2) of the FUTP Regulations makes specific reference to an "intermediary" in certain clauses.

Sometime back, Mr. U.K. Sinha, Chairman of SEBI, had proposed to re-examine the FUTP Regulations in the context of front running to decide whether the aspects relating to front running would require further strengthening or improvement. Subsequently, in a SEBI Board Meeting on August 12, 2013, a proposal was approved to introduce an amendment to the FUTP Regulations in order to clarify that the list under Regulation 4(2) is not exhaustive and the general provisions of Regulation 3 of the FUTP Regulations will override.<sup>8</sup>

On September 6, 2013, an amendment to the FUTP Regulations was notified. The amending regulation inserted an Explanation to Regulation 4(2) of the FUTP Regulations which reads as follows:

*"For the purposes of this sub-regulation, for the removal of doubts, it is clarified that the acts or omissions listed in this sub-regulation are not exhaustive and that an act or omission is prohibited if it falls within the purview of regulation 3, notwithstanding that it is not included in this sub-regulation or is described as being committed only by a certain category of persons in this sub-regulation."*

This amendment and the Order seem to settle the position for the time being with respect to the applicability of the FUTP Regulations to persons other than intermediaries, at least in the case of 'front running'. It will now be interesting to see the future application of the FUTP Regulations to persons other than intermediaries in other instances as mentioned above.

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<sup>1</sup> [2013] 112 CLA 97 (SAT).

<sup>2</sup> Appeal No. 27 of 2013. Decided on 04.09.2013.

<sup>3</sup> **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. As per Major Law Lexicon by P Ramanatha Aiyar (4th Edition 2010).

<sup>4</sup> Regulation 3 of the FUTP Regulations prohibits certain dealings in securities. It reads as under:

"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 there under;

(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>5</sup> Regulation 4(1) reads as follows:  
"Without prejudice to the provisions of regulation 3, no person shall indulge in a fraudulent or an unfair trade practice in securities".

<sup>6</sup> Regulation 4(2)(q) of the FUTP Regulations reads as follows:  
"Dealing in securities shall be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following, namely:  
(q) an intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract."

<sup>7</sup> Regulation 2(1)(c) of the FUTP Regulations defines "fraud" as follows:  
"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 ..."

<sup>8</sup> SEBI Board Meeting. PR No. 73/2013 [http://www.sebi.gov.in/sebiweb/home/document\\_detail.jsp?link=http://www.sebi.gov.in/cms/sebi\\_data/docfiles/26230\\_t.html](http://www.sebi.gov.in/sebiweb/home/document_detail.jsp?link=http://www.sebi.gov.in/cms/sebi_data/docfiles/26230_t.html), last visited on September 11, 2013

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