

De Jure

November 30, 2012

Success for Rajani at the Securities Appellate Tribunal on Front Running

Order dated November 9, 2012 passed by SAT



Landmark ruling by SAT on Front Running by Individuals

Mr. Dipak Patel (DP), Mr. Kanaiyalal Patel (KP) and Mr. Anand Patel (AP) ("Appellants") V/s the Securities and Exchange Board of India ("SEBI")

Mr. Dipak Patel (DP), Mr. Kanaiyalal Patel (KB) and Mr. Anand Patel (AB) filed an appeal against an Order passed by SEBI imposing monetary penalty against the Appellants aggregating to Rs.11.00 Crores in relation to what is known as "front running" in the stock markets i.e. trading in securities on the basis of before-hand information about forthcoming trades by Passport India Investment (Mauritius) Limited, an FII based in US.

The question was whether such trading activity was violative of Regulation 3 of the SEBI (Prohibition of Fraudulent and Unfair Practices relation to Securities Market) Regulation, 2003, as amended (the "**SEBI (FUTP) Regulations**").

SAT by its order dated November 9, 2012 overruled the SEBI order that barred DP, KB and AB from dealing in securities and had imposed a monetary penalty against DP and KB.

According to SEBI, they allegedly made a profit of Rs.1.56 crore from 557 synchronized trades on the National Stock Exchange and 50 on BSE between January 2007 and March 2009.

A SEBI investigation found that KB and AB, two (2) traders, traded on information about forthcoming orders from their cousin, DP, a former portfolio manager at Passport India Investment (Mauritius) Limited, based in the US about forthcoming trading activity of the FII. Further, taking advantage of such information, KB placed and executed orders ahead of the FII's order to make a profit from the price move.

"Ambiguity in the Regulations leads to individual investor allegedly engaged in front running to escape punishment"

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SEBI, further could conclude from its investigations that the trades were executed using a phone number which was registered in the name of AB and hence AB aided and abetted the 'front running'.

The aforementioned order of SEBI was set aside by SAT on the grounds that the existing regulations i.e. SEBI (FUTP) Regulations, 2003, in relation to Prohibition of Fraudulent and Unfair Trade Practices do not clearly define the term 'front running'.

It further adds to say that while the SEBI (FUTP) Regulations, 1995 categorically prohibited front running by 'any person', the existing SEBI (FUTP) Regulations prohibit front running 'only by intermediaries'. Therefore, even if a particular fraudulent transaction would come within the purview of Regulation 3 and 4 and is construed as 'front running', it applies **only to market intermediaries and not individuals**. Hence, even the penalties imposed by SEBI were set aside.

SAT was further of the view that the alleged fraud on the part of the DP could at best be considered as a fraud against its employer (FII) for which the employer had already taken necessary action and not against the market.

"SAT says SEBI (FUTP) Regulations apply only to market intermediaries and not to individuals"

Fraud on Market

One of the allegations by SEBI in the aforementioned case against the Appellants was also in relation to the "fraud played on the securities market". Regulation 2(1)(c) of the SEBI (FUTP) Regulations defines fraud as "*any act, expression, omission or concealment..... in order to induce another person or his agent to deal in securities...* ".

In the present case, the trades carried out by the Appellants have been construed by SEBI as "fraud played on the securities market". However, it was argued that knowledge based trading can never be alleged to be fraud on the market since practically it would not be possible for all traders to have same knowledge at the same time. Further, traders base their trades on several types of tips, information, rumours, SMS's, TV shows, etc..

It was also argued that on a screen based market trading, a trader or an investor is neither bound to nor is he required to disclose the information or the reasons for his trading. In this regard a statutory illustration (d) to Section 17 (*wherein "fraud" has been defined*) of the Indian Contract Act, 1872

was relied upon which states that "*A and B, being traders enter upon a contract. A has a private information of a change in prices which would affect B's willingness to proceed with contract. A is not bound to inform B.*"

Therefore, in the present case as the transactions were undertaken on the screen based platform of the stock exchange and at the prevailing market price such activity had not affected the market.

Therefore SAT is of the view that the alleged fraud on the part of DP may be a fraud against its employer and cannot be construed as a fraud played on the market or there was any market manipulation.

Further, apart from Regulation 4(2)(q) of the SEBI (FUTP) Regulations, the only other Regulation which restricts trading while a person is in the possession of private information, is the Prohibition of the Insider Trading Regulations, 1992 which apparently does not apply to the facts of the present case.

"Fraud on Market difficult when all transactions are screen based and at the prevailing market price"

Our View

The SAT while considering the matter and the charges levied by SEBI on the Appellants on the basis of SEBI (FUTP) Regulations found two pertinent aspects mentioned in the impugned SEBI Order missing in the SEBI (FUTP) Regulations i.e. (i) the term "front running" and (ii) the fact that the existing SEBI (FUTP) Regulations did not specifically mention or prohibit front running by 'any person' and prohibited front running only 'by intermediaries'.

As we understand SAT in this case followed one of the golden rules for interpretation of statutes known as Literal Interpretation or Litera Legis, but in a different manner. Courts/Judicial Authorities are expected to deduce the legislature's intention (*in this case SEBI*) from the language through which it has expressed itself, especially in case of laws containing strict and stringent provisions. In view of the absence of specific provisions on "front running" in the SEBI (FUTP) Regulations, SAT allowed the Appeals and set aside the impugned orders passed by SEBI.

This SAT Order is likely to make SEBI re-consider and re-look the existing SEBI (FUTP) Regulations on an immediate basis which in its present form prohibit "front running" only by intermediaries. Specific provision and definitions relating to "front running" may be incorporated to plug out the loop-hole in the existing Regulations. In addition, SEBI may also appeal to the Hon'ble Supreme Court challenging the Order passed by the SAT.

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