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Analysis of front running under SEBI regulations, 2003

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Abstract
Front running happens when a broker or investors join a trade because they have foreknowledge of large confidential deal which may potentially impact the stock price; this process is also known as forward trading or tailgating. In this paper the researcher has tries to look into various perspective of front running and its impact on investors. This paper begins with the meaning of front running and moving ahead it also focuses on recent debate on front running and tries to find out the probable solution for the same.

Keywords: SEBI regulations, tailgating

Introduction

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003 (hereinafter 'SEBI Regulations') prohibits several fraudulent practices. One of these prohibited fraudulent practices is front running. Front running has been the center of controversy in the past year with respect to the scope of the offence. It has been defined as *"A broker's or analyst's use of non-public information to acquire securities or enter into options or future contracts for his or her own benefit, knowing that when the information becomes public, the price of the securities will change in a predictable manner."* [1]. Front running has been defined in a SEBI Circular [2] as

> "*means usage of non-public information to directly or indirectly, buy or sell securities or enter into options or futures contracts, in advance of a substantial order, on an impending transaction, in the same or related securities or futures or options contracts, in anticipation that when the information becomes public; the price of such securities or contracts may change"* [3].

Provision of front running under sebi regulations

Front running has been specifically declared to be an offence under the Regulation 4(2) (q) of the SEBI Regulations. It states as follows:

> *"Dealing in securities shall be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include-*
> *(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 futuresor options contract."*.

Regulation 3 of the SEBI Regulations is a more general provision that deals with a wide range of fraudulent [4] activities and includes front running within its scope.

Front Running in the securities market: The unethical practice of when a broker trades equity based on information received from the analyst department even before his/her clients are provided with the information [5]. The Securities Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995 (hereinafter '1995 Regulations' sought to regulate front running in India for the first time. The term 'front running' however, was not used by these regulations. Regulation 6(b) of the 1995 Regulations stated,

> "*no person shall on his own behalf or on behalf of any person knowingly buy, sell or otherwise deal with securities pending execution of any order of his client relating to the same security for purchase, sale or other dealings in respect of securities*." [6]

However, since the provision stated the words "*pending execution of any order of his client"* it was clear that the provision was only with respect to front running by brokers only even though the beginning of the paragraph stated "*no person shall"* which indicated that person other than brokers were also prohibited from front running.

The Securities Exchange Board of India (Mutual Funds) Regulations, 1996 (hereinafter "Mutual Funds Regulations") first made a direct reference to front running under Regulation 18(23). The regulation stated that trustees would have to submit a half yearly certificate to the Securities Exchange Board of India (SEBI) that stated that the trustees were satisfied that there was no instance of front running by either the trustees or the directors or any of the key personnel of the asset management company [7]. Thus, what can be inferred from these Mutual Fund Regulations is that SEBI's understanding of front running was not limited to activities of only brokers but then again, there was no front running case that SEBI dealt with under the 1995 Regulations.

The Securities Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (hereinafter "2003 Regulations") repealed and replaced the 1995 Regulations. Even the 2003 Regulations do not directly use the words 'front running' [8]. However, Regulation 3 and Regulation 4 of the 2003 Regulations have a very wide wording and prohibit dealing in securities in a fraudulent way or dealing in securities in

such a way so as to be indulging in unfair trade practice. It is specifically provided under Regulation 4(2) (q) of the 2003 Regulations that if an intermediary buys or sells securities before a substantial client order or in case a futures or option position is taken about an impending transaction in either the same or related futures or option contract, it shall be deemed to be an unfair or fraudulent trade practice [9]. Whether or not SEBI intended to exhaustively regulate and cover all cases of front-running under only this provision itself is a question that arises.
With this background, in 2012, the Securities Appellate Tribunal (hereinafter "SAT") held that front running is prohibited under the 2003 Regulations. This gave rise to a lot of debate and controversy.

Front Running: The Definition Conundrum
In order to fully and completely understand the concept of front running and context of the same holistically as well as the consequences of the SAT decision on the Securities world, it is important to examine the definitions of both front running and intermediary, as it is around these two words that the controversial questions of law arise.
Originally,

> *"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 favor."* [10]

Intermediary means a stockbroker, share transfer agent, sub-broker, trustee of trust deeds, banker to an issue, merchant banker, portfolio manager, registrar to an issue, underwriter, depository, investment adviser, participant, credit rating agency, custodian of securities and any other intermediaries that SEBI specifies and also includes an asset management company as under the Mutual Fund Regulations, trading member of a derivative segment or currency derivative segment of a stock exchange and a clearing member of a clearing house or a clearing corporation but does not include a foreign venture capital investor, a mutual fund, a foreign institutional investor, a venture capital fund and a collective investment scheme [11].
The SAT, recently, in *Dipak Patel v. Securities and Exchange Board of India* [12] was faced with the issue as to what exactly constituted front running and whether any person other than an intermediary could be charged with front running under Regulation 3 of the 2003 Regulations. The SAT held that in the absence of any other specific provision, a person other than an intermediary cannot be held guilty of front running and punished for the same even if he engages in front running activities.

The Recent Debates
Dipak Patel vs. SEBI, [13] in 2012, was the first to raise the issue about front running in the SAT. It was contended that the case of Dipak Patel did not fall within the ambit of the provision of front-running as Regulation 4(2) (q), which prohibited the activity of front-running, was restricted to intermediaries only and therefore Dipak Patel was not liable to any penalty [14]. The Tribunal applied literal interpretation to the provision and accepted the contention of Dipak Patel as it found that scope pf the relevant provisions was limited to "intermediaries" and does not apply to any other person,

> "*In the absence of any specific provision in the Act, rules or regulations prohibiting front running by a person other than an intermediary"*.

Surjit Karkera v. SEBI [15], reaffirmed this decision of the Tribunal as it was in one mind with the reasoning that the application of the provision is restricted to "intermediaries" only as Regulation 4 (2) (q) clearly states so in explicit language [16].

The Debates Resolved
Finally, in *Vibha Sharma v. SEBI* [17], the SATreversed the decision of the Tribunal in *Dipak Patel.* It stated that the no straight jacket formula should be applied to the provision and liberal interpretation should be applied keeping in mind the harmful nature of the activity of front running [18]. Therefore, any individual connected to the capital markets and guilty of the offence of front running will face the consequences of violating the provision.
Additionally, in September 2013, SEBI issued a clarification under Regulation 4(2)(q) which sated that,

> *"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."* [19].

As a result of this clarification, front running is now applicable to "any person" and not only to "intermediaries" and thereby can be interpreted to come under the general provision of Regulation 3.
The SAT made an observation about the Dipak Patel case saying that the case has made it clear that front running always causes detriment irrespective of whether an individual or an intermediary is an offender. Therefore, the SAT opined that the definition of front-running should receive a liberal interpretation and the concept should not be put in a Straight-jacket formula.
The SAT also held that that Vibha Sharma and Jitender Sharma who were a day trader and an equity dealer in securities with CBI were related to each other in the capacity of husband and wife. Exchange of information took place between them regarding future trades by the CBI and Vibha Sharma used this information to trade in the securities market, thereby making undue profits in the process.
The SAT held the profits collected by Vibha Sharma cannot be termed as a mere coincidence, as the trades made by Vibha Sharma matched 100 per cent with that of CBI's purchase order over a period of two weeks. This decision by the SAT seems to have filled a loophole in the regulatory framework. In earlier decisions, the SAT has ruled on the perception that the erstwhile Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 1995 had prohibited every person from committing the offence of front running, while the present Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003 only prohibit intermediaries from committing the offence of

front running. However, this time around, SAT decided to lend a liberal interpretation to the concept of front running.

It can be argued that the provision of front-running under Regulation 4(2) (q) [20] is inclusive and serves as an illustration only and, whereas the very act of front-running would amount to fraud [21], and therefore the fact that a person or an intermediary is committing it should be irrelevant. Therefore, the question that arises is whether circumstances which specifically prohibit intermediaries from committing such an offence should apply to everyone and not just to intermediaries. It is important to note that Regulation 4(2) of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003 specifically refers to an "intermediary" in certain provisions [22].

Vibha Sharma decision and the Clarification issued by SEBI also partly resolves the issue of including Collective Investment Schemes, which are unregistered, within the ambit of front running. The Security Law Ordinance, 2013, resolved the left over issue of bringing unregistered schemes under the category of SEBI *(*Collective Investment Schemes*)* Regulations, 1999. The Ordinance amended Section 11A by adding, "any pooling of funds under any scheme or arrangement" involving a corpus of Rs. 100 crores, as a Collective Investment Scheme [23].

The American Perspective

The United States recently decided to expand their front-running policy and therefore approved a plan from the Financial Industry Regulatory Authority (FINRA) [24]. Their former front-running policy applied till the knowledge about the transaction has been made public. The FINRA plan, while retaining the 'publicly available information' rule, devised a new standard when the information becomes 'stale or obsolete' [25]. Therefore, if either of these two standards are met, i.e., if the information become 'publicly available' or 'stale or obsolete', then the restrictions on front-running will no longer apply. Both of these standards rest on facts and circumstances of each case including a number of factors like amount of time lapsed post the transaction, radical change in market conditions, knowledge of such transaction among the members etc.

The suggested expansion of the definition is aimed to apply to,

> *"all securities and financial instruments and contracts (in addition to the existing options and security futures) that overlay the security that is the subject of an imminent block transaction and that have a value that is materially related to, or otherwise acts as a substitute for, the underlying security."* [26]

Such an expansive and broad definition is required to prevent fraud at the time making open and free market conditions accessible to all. However, unlike the Indian SAT, the United States S.E.C does not classify the kinds of people to which these front-running restrictions apply.

Conclusion

It is necessary to interpret provisions dealing with fraudulent practices such a front-running as these are serious crimes which have far reaching consequences. They not only affect the confidence of existing investors but also affect the confidence of prospective investors as such practices lead to marked fall in faith in the securities market. As it was observed in *Surjit Karkera*, that

> "*It is of utmost importance that a sense of fair play be maintained in the market so that innocent investors do not find themselves at the receiving end of irregular conduct by entities in the market.".*

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18. *SAT Extends Prohibition of 'Front Running' To Persons Other Than Intermediaries*, Adhithya Srinivasan, available at http://www.mondaq.com/india/x/264962/Securities/SAT+Extends+Prohibition+Of+Front+Running+To+Persons+Other+Than+Intermediaries (Last seen on 26th March, 2014)
19. *Ibid.*
20. 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."

21. 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 ..."*
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