

**FRONTRUNNING”BATTLE BETWEEN SAT AND SEBI TAKES A NEW TWIST: SEBI
INVOKES ITS LEGISLATIVE POWERS TO HAVE ITS WAY**

The clarification issued by Securities Exchange Board of India (“**SEBI**”) by way of a press release on August 12, 2013, whereby SEBI has approved a proposal to amend the SEBI (Prohibition of Fraudulent and Unfair Trade Practice relating to the Securities Market) Regulations, 2003 (“**PFUTP Regulations**”) to clarify that the list under Regulation 4(2) of the PFUTP Regulations is not exhaustive and that the general provisions of Regulation 3 will override, may possibly set at rest the controversy over whether front running by non-intermediaries is covered at all by the PFUTP Regulations.

Genesis of Ambiguity

The primary question was whether front running activities, if carried on by persons who are not intermediaries are prohibited under the PFUTP Regulations. Front running broadly refers to “buying or selling of securities ahead of an anticipated larger order, which is not known to the market, with a view to benefit from the subsequent price rise”.¹ It is also defined as “a broker’s or analyst’s use of non-public information to acquire securities or enter into options or futures 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”². Regulations 3 and 4 of the PFUTP Regulations were worded very broadly to prohibit dealings in securities in a fraudulent manner or by indulging in unfair trade practices. However, Regulation 4(2)(q) of the PFUTP Regulations (“**Regulation 4(2)(q)**”) specifically provides that 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 option contract shall be deemed to be a fraudulent or an unfair trade practice. The question was whether SEBI intended to exhaustively cover and regulate all cases of front running (by intermediaries as well as non-intermediaries) under the aforementioned provision alone. SEBI was initially of the view that Regulation 4(2)(q) was only illustrative and therefore the broader provisions contained in Regulation 3 covered front running by non-intermediaries as well.

¹ Major Law Lexicon by P Ramanatha Aiyar (4th Edition 2010)

² Black’s Law Dictionary (Ninth Edition)

Securities Appellate Tribunal (SAT)³, in its recent decision had held that front running only by an intermediary is prohibited under the PFUTP Regulations, thereby brushing aside earlier decisions of SEBI whereby SEBI held that front running by non-intermediaries was also covered under the said regulations⁴. In that case, DP who was the portfolio manager of a financial institutional investor (registered with SEBI) Passport India Investment (Mauritius) Ltd (hereinafter referred to as the “**Company**”) provided non-public information with regard to the upcoming trades of the Company to KB and AB, who are cousins of DP. This information was acted upon by KB, who traded ahead of the trades of the Company and made gains from such trades.

The Adjudicating Officer (“**AO**”) held that KB and AB, had knowledge of the trades of the Company, through DP, and DP had indulged in front running and all of them were thus guilty under Regulations 3 (a), (b), (c), (d) and 4 (1) of the 2003 Regulations. On appeal the SAT reversed the order of the AO stating that the PFUTP Regulations explicitly prohibited front running activities only by “intermediaries” under Regulation 4 (2) (q).

The crux of the debate between the two authorities lies in the interpretation of the purpose and intent of the PFUTP Regulations and its wording. While SEBI has been upholding that the intent of law is to admonish “any person” involved in front running activities, SAT has ruled otherwise and restricted penalties only to “intermediaries”. It has now been made clear by SEBI by way of the press release that the PFUTP Regulations are intended to be broader in scope. SEBI has proposed to amend the Regulations to clarify that Regulation 4 is only illustrative and will not cut down the broader scope of Regulation 3 which seeks to prohibit all kinds of fraudulent activities. This would imply that even though Regulation 4(2) (q) prohibits front running only by intermediaries, it would not have the effect of permitting front running by other entities, as this would be covered by the broader Regulation 3.

IndusLaw Quick View:

While the clarification does not say that this is specifically issued to address the issue of front running by non-beneficiaries, this seems to be the implication especially considering the background of conflict between the views of SEBI and SAT on front running, stemming from the differing interpretation of the PFUTP Regulations. This clarification and the proposed amendment may aid in plugging the deficiency in the language of the statute, thereby possibly bringing closure to the dual approaches of SEBI and SAT. While this press release by SEBI will broaden the scope of the PFUTP Regulations, it is interesting to note how SEBI has used its legislative powers to override SAT, which otherwise sits in judgement over SEBI decisions. However, it is a well settled principle that legislative powers can be used to overturn judicial decisions by taking away the very basis or the reason for the judicial decision by amending/clarifying the provisions relied on for rendering the judicial decisions. The same principle would be applicable for subordinate legislative powers to be exercised so as to take away the effect or basis for decisions by tribunals. The exact language of the amendment remains to be seen which will determine whether any scope for re-interpretation by SAT is possible. An argument could be made that front running, which is akin to insider trading, may

³ Shri Dipak Patel v. The Adjudicating Officer, Securities and Exchange Board of India Appeals no. 216 of 2011

⁴ Shri Sujit Karkera, Shri Purushottam Karkera and Smt Shilpa Kotak and Trading Activity of Sujit Karkera and Group (Adjudication Order No. BM/AO-31 to 33 /2012)

not amount to a fraudulent activity since no representation may be made to any person or nobody may be induced or deceived into trading, but that it merely involves a person taking advantage of his position where he happens to have advance information so as to gain over others. The focus and coverage of Regulations 3 and 4 are not entirely similar, though in quite a few cases there may be an overlap. While the former is aimed at fraudulent and deceitful trading, the latter also deals with unfair trading. While all fraudulent trading could be termed unfair, all that is unfair need not be fraudulent or involve deceit. Therefore a mere clarification that Regulation 3, mainly aimed at fraudulent activity, is not restricted to, or by, the illustrations listed in Regulation 4(2) of the PFUTP Regulations may not really solve the problem, rather a clarification that the instances set out in Regulation 4(2) of the PFUTP Regulations are only illustrative and not exhaustive of what is unfair trading and that unfair trading need not involve fraud, would have helped and been more appropriate.



BANGALORE
101, I Floor, "Embassy
Classic" # 11, Vittal
Mallya Road,
Bangalore -560001,
India
Tel: +91 80 4072 6600
Fax: +91 80 4072 6666
bangalore@induslaw.com

DELHI
A-4, Sector 26
Noida -201301
NCR of Delhi, India
Tel: +91 120 472 8100
Fax: +91 120 472 8114
delhi@induslaw.com

MUMBAI
1002A, 10th Floor,
Tower 2
Indiabulls Finance Centre
Senapati Bapat Marg,
Elphinstone Road,
Mumbai 400 013
mumbai@induslaw.com

HYDERABAD
204, Ashoka Capitol,
Road No. 2, Banjara Hills,
Hyderabad 500 034,
India
Tel : +91 40 4026 4624
Fax: +91 40 4004 0979
hyderabad@induslaw.com