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A CRITICAL ANALYSIS ON FRONT RUNNING IN INDIA

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ABSTRACT

Due to its potential to jeopardize market integrity and weaken investor trust, front-running, a dishonest behavior in financial markets, has drawn a lot of attention recently. The Prohibition of Fraudulent and Unfair Trade Practices (PFUTP) regulations are highlighted specifically in this abstract's thorough review of front-running laws in India. The Securities and Exchange Board of India's (SEBI) enforcement of the PFUTP regulations provides an essential legal foundation for preventing unfair and fraudulent conduct in the Indian securities market. These rules are intended to safeguard investors' interests and guarantee honest and open trading.

This study looks at the development of front-running laws in India and evaluates how well the PFUTP laws work to stop front-running practices. The paper includes a summary of the front-running-related legal laws, including their definition. The paper also covers the history of front-running and its types and a comparative analysis with USA is also analyzed with India. The research emphasizes the effects of front-running on market integrity, investor trust, and overall market efficiency by referencing pertinent case studies.

Keywords: *front-running, PFUTP regulations, Securities and Exchange Board of India (SEBI), market integrity, investor protection.*

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INTRODUCTION

As said by Gregory Scopino (Special Counsel, CFTC; Professor of Law): “*The quickest predators on the planet swim in oceans of data, move through interconnected computer networks associated with electronic trading platforms, and can place bids and offers for future contracts faster than a human can blink, all the while looking for large trades to pick off.*”²

The Capital Markets in India are regulated and supervised by the Ministry of Finance, the Reserve Bank of India and the Securities and Exchange Board of India (hereinafter referred to as ‘SEBI’). The Ministry of Finance regulates through the Department of Economic Affairs i.e., through its Capital Markets Division. The division is in charge of creating policies for the expansion and development of the securities markets and protection of investor’s interests. The Capital Markets Division also administers laws and rules enacted under the Depositories Act, 1996, the Securities Contract (Regulation) Act, 1956 and Securities and Exchange Board of India Act, 1992.

The capital market had remarkable expansion in the 1980s due to increased public engagement. However, this also resulted in malpractices like price rigging, unofficial premiums on new issues, violation of rules and regulations of stock exchange and listing requirements, etc. by brokers, investment consultants, merchant bankers, companies involved in stock market. Following this there were many investor grievances. This necessitated establishment of a separate statutory regulatory body known as Securities and Exchange Board of India (SEBI). SEBI was officially appointed as the authority for regulating the capital markets in India. However, it was only in 1992, that SEBI was declared an autonomous body with legislative powers.

SEBI oversees and regulates the securities market and protects the interest of investors by enforcing specific laws and regulations. SEBI has issued several guidelines, regulations, and adopted stringent observation, investigation, inspection, and implementation procedures throughout the last 30 years to ensure a fair market, market integrity, interest of investors. SEBI investigates and punishes those who engage in manipulative, unlawful, fraudulent, or unfair trade practices in the securities market, such as *front running*.

² Gregory Scopino, *The Legality of High-Speed ‘pinging’ and ‘Front Running’ in the Futures Markets*, 47 Connecticut Law Review, 608 (2005).

Even though not clearly defined or particularly mentioned in the latest SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 2003 (PFUTP Regulation), *Front running* is the unethical and illegal practice of buying or selling securities ahead of a large client order to profit from the subsequent predictable price movement after the execution of such client's purchase order. This allows the broker to book profits from the undisclosed information in a predictable manner. For e.g., a broker receives client order to purchase 5,00,000 shares of XYZ Co. He holds it until he executes the purchase of a smaller order of same stock in his own account. After which he will execute client's large order, this will drive up the share price. The broker will then sell his share, hence making profit based on client's order.³ This will be an example of *front-running*.

Further, to curb the above-mentioned illegal and fraudulent trade practices like *front running* and the SEBI in exercise of its quasi-legislative power, had framed the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulation, 1995 to address market manipulation and market abuse. However, the 1995 Regulation were replaced with SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) Regulations, 2003 (PFUTP Regulation). Both the 1995 and 2003 regulations address and give provisions for front running. However, the terms *front running* is nowhere explicitly used in either of these regulations.

In the present paper, the author aims to analyze the existing laws and regulations of SEBI which deals with *front running*. The paper will start out by explaining the concept of front running in brief, followed by penal provisions for those intermediaries and non-intermediaries who practice front running in India. The paper will also discuss in brief some important case laws on *front running* which has shaped the concept of front running in India. Lastly, for the purpose of comparative analysis, the author will discuss *front running* laws in the United States.

³ Gaddam Naresh Reddy, *Fraudulent Financial Practices and Investor Protection in the Indian Capital Market Role of SEBI*, OSMANIA.

BRIEF HISTORY

The concept of *front running* was vigorously debated in the aftermath of what the professionals in the finance world referred to as the epochal 'Black Monday', when on October 19, 1987, considered as one of the worst days in the history of U.S equity markets. The first instance of front running is said to have appeared in the Chicago Board Operations Exchange (CBOE), considered as world's largest and first organized stock exchange, when liquidity and institutional participation increased significantly as volume exploded in the 1970's, resulting in a number of abuses with regard to listed options trading, including 'front-running' as identified by the US Securities Exchange Commission in 1977.⁴

SEBI vide its Consultative Paper dated March 16, 1995, recognized and grouped *front running* as an undesirable manipulative practice, it stated that⁵: "*However, SEBI Act does not prescribe or specify as to which practice would be considered to be fraudulent and unfair trade practices..... The draft defines fraudulent and unfair trade practices. These regulations seek to cover market manipulation on the stock exchanges also. Practices like wash sales, front-running, price rigging, artificial increasing or decreasing the prices of the securities are brought within the ambit of the regulations.*" After which SEBI incorporated it into the erstwhile SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) Regulations, 1995 (**1995 PFUTP Regulations**) under **Regulation 6 (b) which is now repealed.**

WHAT IS FRONT RUNNING?

In *Major Law Lexicon* by P. Ramanatha Aiyer, front running is defined as "*buying or selling securities ahead of a large order so as to benefit from the subsequent price move.*"⁶ It is the illegal private trading by broker or any other intermediary who is aware of a large price movement that is about to occur.

Whereas, the *Black's Law Dictionary* defines it 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.*"

⁴ Archana Iyer, *Back stabbing by Frontrunning: An Indian Perspective*, Vol. I, 2 (2015),

⁵ Consultative Paper issued by SEBI, pursuant to a Press release No. 34/95

⁶ P. Ramanatha Aiyer, *Major Law Lexicon*, 4th (2010).

TYPES OF FRONT RUNNING

The Supreme Court of India in the case of *SEBI v. Shri Kanaiyalal Baldevbhai Patel and Ors.*⁷ highlighted 3 types of front-running in Para 19 of the judgement. The Supreme Court while explaining *front running* held that, in reality front running is much more complicated than the definition under Regulation 4 (2) (q) of the PFUTP Regulations, 2003. The three types of front running laid down are:

1. Trading by third parties who have received information/tip about an impending block trade. (tippee trading)
2. Transactions wherein the owner or the purchaser of the block trade himself engages in the offsetting futures or options transaction to hedge against price movements caused by block trade. (Self-front running)
3. Transactions wherein an intermediary, who has knowledge about an impending customer block order, trades ahead of that order for the intermediary's own profit. (Trading ahead)

EXISTING LAWS AND REGULATIONS IN INDIA GUIDING FRONT RUNNING

Front running in India is currently governed by SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) Regulations, 2003 (**PFUTP Regulations, 2003**). The PFUTP Regulations, 2003 replaces the former 1995 PFUTP Regulation.

Regulation 4 of the PFUTP Regulations, 2003 prohibits *manipulative, fraudulent and unfair trade practices*. Front running provision can also be found in Regulation 4 (2). **Regulation 4 (2) (q)** of the PFUTP Regulations, 2003 states that “*Dealing in securities shall be deemed to be a manipulative, fraudulent or an unfair trade practice if it involves: any order in securities placed by a person, while directly or indirectly in possession of information that is not publicly available, regarding a substantial impending transaction in those securities, its underlying securities or its derivative.*”⁸ Hence, even though the words front running are not specifically used, the aforementioned regulation clearly describes what front running is and who can be classified as a front-runner.

⁷ (Civil Appeal No. 2595 of 2013)

⁸ Regulation 4 (2) (q), SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) Regulations, 2003

CHANGES IN FRONT RUNNING PROVISION PRE AND POST AMENDMENT

Previously the provision for front-running in Regulation 4 (2) (q) of the PFUTP Regulations, 2003 only dealt with *intermediaries*. Prior to the amendment, the provision read as follows: “*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*”. However, this prevented SEBI and the Securities Appellate Tribunal (SAT) from booking several offenders for front running just because they did not fall within the purview of ‘*intermediaries*.’

In *Shri Dipak Patel v. SEBI*⁹, the SAT ruled that the PFUTP Regulations, 2003 only prohibited front running by intermediaries and would not apply to anyone else. The order also implied that front-running by non-intermediaries would not constitute market manipulation.

This left no option to the SAT or SEBI as they had to go with literal/strict interpretation of the language as laid down in the regulations. However, Regulation 4 (2) (q) was substituted with the word “*person*” vide SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2018 w.e.f February 01, 2019.¹⁰ This amendment was made possibly in the aftermath of the landmark *Kanhaiyalal* decision in 2017, after which Regulation 4 (2) (q) was made neutral to include both intermediaries and non-intermediaries as well as individuals. In a subsequent chapter, the author will go into greater detail about this case law.

If only intermediaries are held responsible for front running, then the manipulators will get the leeway to engage in iniquitous activities through name lending or by masking their identity. However, as decided in the matter of *Manish Chaturvedi & Ors.*¹¹, name lending is a serious offence and one cannot be absolved of the liability simply by claiming obliviousness. If these activities remain uncontrolled, then those who aid and abet such unfair practices will also detrimentally affect the interest of investors. When the accounts are rented out to third parties, they become the custodians of those securities or funds. Although the account holder still remains as the technical owner, the non-intermediary or third party employs its own resources which may be utilized for illegal purposes. The account holder may also receive direct or indirect gratification in return for the same. This deceitful practice helps the third parties to carry out fraudulent activities while concealing their identity.

⁹ (*Appeal No. 189 of 2018*)

¹⁰ Regulation 4 (2) (q), SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) (Amendment) Regulations, 2018.

¹¹ Order/SBM/VS/2022-23/16857-16859

FRONT RUNNING V/S INSIDER TRADING – IS THERE A DIFFERENCE?

There is a fine line between insider trading and front running, but conceptually, they are not particularly different. Front running and insider trading are both examples of market abuse based on a person or entity having access to non-public price sensitive information that could influence the stock prices. Even though jurisdictions such as the United States and Singapore have traditionally defined front running and insider trading as distinct offences, the lines can become blurred. A Singapore Court in 2019 convicted three people for insider trading after they engaged in front running. Front running was prosecuted as an insider trading offence for the first time in Singapore. Given that India's insider trading statute considers anyone with access to "unpublished price sensitive information" to be an insider, the link to front running is even more apparent. However, the SEBI has chosen not to confuse the two offences, and has instead prosecuted front-running cases under the PFUTP Regulations of 2003.¹²

Irrespective of this, post the decision of *SEBI vs. Shri Kanaiyalal Baldevbhai Patel and Ors. dated September 20, 2017*, the Supreme Court has clearly held in Para 19 that “*It is important to note that trading ahead has been explicitly recognized under regulation 4(2) (q) of FUTP 2003*”. Therefore, the position being clear that front-running cases should be decided through PFUTP Regulation only, even though there exists a thin line of difference between insider trading and front-running.

COMPARATIVE ANALYSIS – FRONT RUNNING IN U.S.A

In the United States (U.S), the capital market is highly regulated and the laws are very stringent. Similar to India, even in the U.S the market is flooded by fraudulent people who run illegal schemes such as front-running, price rigging, etc. Therefore, to curb these manipulative and unfair trade practices, the Congress passed the Securities Act, 1933 and the Securities Exchange Act, 1934. This was originally done in the aftermath of the Great Depression and the Wall Street Crash of 1929.

The Securities Exchange Act of 1934 provides for establishment of Securities and Exchange Commission (SEC). The SEC is given broad control and authority over the securities business, including the ability to register, regulate, and supervise brokerage companies, clearing agencies. The SEC's primary responsibility is to enforce the laws that govern the securities markets in the United States. The SEC is responsible for enforcing three major pieces of

¹² Khyati G, *what is front running? – A Q&A Piece in light of the SEBI Order against dealers of Reliance Securities Ltd.*

legislations viz., *Securities Act, 1933, Securities Exchange Act, 1934 and Investment Advisors Act, 1940*. Apart from the SEC, there is also a Financial Industry Regulatory Authority (FINRA), the erstwhile National Association of Securities Dealers (NASD). FINRA is the United States' largest independent regulator of all brokers and brokerage firms involved in the securities markets. The government has given it authority to safeguard investors by ensuring that intermediaries operate in a fair and honest manner.¹³

In the U.S, the FINRA Rules specifically talks about *front-running*, whereas the laws governed by the SEC including *Securities Exchange Act, 1934 and Investment Advisors Act, 1940* provides provisions for front-running. However, similar to security laws in India, neither the Securities Exchange Act, 1934 nor the Investment Advisors Act, 1940 explicitly mentions the term *front-running*. The U.S SEC had approved a proposal from the FINRA to expand the front-running policy. Therefore, now it applies to all securities and other financial instruments and contracts (in addition to the existing options and security futures) that cover the security which is the subject of an imminent block transaction. **The various provisions in the above laws/rules which prohibits and prevents *front-running* and other fraudulent and manipulative acts are:**

Rule 5270 (a) (*Front Running of Block Transaction*) of the FINRA Rules: Rule 5270 (a) of the FINRA Rules states that“ no member/person associated with a member shall execute an order to buy or sell a security or a related financial instrument when such member/person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in that security, a related financial instrument (option, derivative, security based swap) or an underlying security prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete.”

Section 10b of the Securities Exchange Act, 1934: It shall be unlawful for any person directly/indirectly to use or employ, in connection with purchase or sale of any security registered on a national securities exchange or any security not so registered any manipulative or deceptive device or contrivance in contravention of rules and regulations as the SEC may prescribe or appropriate in the public interest or for the protection of investors whether by use of any means or instrumentality interstate commerce or mails or facility of national securities exchange.

¹³ Team, *Who Regulates US Stock Markets?* ,Groww

Section 206 of the Investment Advisors Act, 1940: It shall be unlawful for any investment advisors whether directly or indirectly by use of mails or any means or instrumentality of interstate commerce:

1. To employ any device, scheme or artifice which is likely to defraud any client or prospective client or and it will also be unlawful to engage in any transaction, practice, or business course that is intended to deceive or defraud any client or prospective client.
2. To knowingly act as a principal for his own account, to sell any security to or purchase any security from a client, or act as broker for a person other than such client, knowingly to affect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.
3. To engage in any practice, act or business course which is fraudulent, deceptive or manipulative. The SEC shall for this purpose define and prescribe means to prevent such acts by including preventive provisions in rules and regulations.

CONCLUSION

From the above analysis of the topic, it is certain that front running in India is currently governed by SEBI (Prohibition of Fraudulent and Unfair Trade Practices in the Securities Market) Regulations, 2003, more specifically Regulation 4 (2) (q) which states that “*Dealing in securities shall be deemed to be a manipulative, fraudulent or an unfair trade practice if it involves: any order in securities placed by a person, while directly or indirectly in possession of information that is not publicly available, regarding a substantial impending transaction in those securities, its underlying securities or its derivative.*” Therefore, even though the word *front-running* is nowhere mentioned in the PFUTP Regulation, 2003, in *SEBI vs. Shri Kanaiyalal Baldevbhai Patel and Ors.* dated September 20, 2017, the Supreme Court has clearly held in Para 19 that “*It is important to note that trading ahead has been explicitly recognized under regulation 4(2) (q) of FUTP 2003*”. Also, for better interpretation and lack of confusion, Regulation 4 (2) (q) was amended vide 2018 amendment to replace the word *intermediary* with *person* to include non-intermediaries within the scope of Regulation 4 (2) (q). Furthermore, the author has also made efforts to explain the whether there is any difference between insider trading and front running. The historic judgement of *SEBI vs. Shri Kanaiyalal Baldevbhai Patel and Ors* which changed the landscape of front running and Regulation 4 (2) (q) to include non-intermediaries. The Supreme Court in this case analyzed various issues which were much required to be addressed to protect the investors from such fraudulent and unfair trade practices.

If found guilty of *front running* under Regulation 4 (2) (q), Section 15HA of the SEBI Act, 1992, will be attracted wherein, if anyone who engages in fraudulent or unfair trading practices faces a penalty of minimum Rs. 5 lakhs which may go up to Rs. 25 Crores, or three times the profits gained as a result of the practices, whichever is greater. Furthermore, under the SEBI (Intermediaries) Regulations, 2008, and Section 11 and 11B of the SEBI Act, SEBI has the authority to launch parallel civil enforcement proceedings based on the same set of facts.

In India the securities market is regulated by SEBI, whereas in the U.S, the securities market is regulated by SEC along with certain other self-regulatory organizations (SRO) which are registered and governed by the SEC like the FINRA which also has ability to enforce regulations set by the SEC and levy penalties for manipulative and unfair trade practices like *front running* under Rule 5270 (a) of the FINRA Rules.

Surveillance mechanisms of stock exchanges are most useful to uncover instances of front-running. Surveillance software that tracks real-time trades in the market is well-equipped to spot similar trading patterns between big investors and individuals, which forms the basis for front-running investigations by the regulator.

Therefore, rooting out such cases calls for a stringent examination of surveillance data by the exchanges and the quick escalation of any suspicious trades to SEBI. Putting in place clear whistleblower policies with anonymity for the informer at the exchanges, big institutions, and brokers trading in the markets can help flag a nexus between market players at an early stage.

SEBI will also need to consider more stringent punishments for information carriers and front-runners when investigations find hard evidence of wrongdoing. Soft measures such as barring the entities from securities markets for a temporary period, levying a low-key fine or settling with the accused without admitting to the offence, may not suffice.