

M&A Hotline

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THE FAST AND THE UNFAIR: FRONT-RUNNING'S GRIP ON INDIA'S CAPITAL MARKET

- Front-running is an unfair trading practice where traders exploit non-public information to place trades ahead of large orders, affecting market integrity.
- The Securities and Exchange Board of India (SEBI) prohibits front running under the Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market (PFUTP) Regulations, 2003, imposing heavy penalties and potential criminal action.
- While both involve misuse of non-public information, insider trading is based on confidential company information, whereas front-running is based on knowledge of impending market transactions.
- SEBI actively investigates and penalizes front-running cases to maintain transparency and protect investor interests.

INTRODUCTION

'Front running' is the practice of exploiting non-public information to gain an unfair advantage in executing trades ahead of other market participants.¹ A person who is in possession of non-public information about a large order in respect of a security (that is likely to affect a stock's price), utilizes such non-public information to gain an advantage by executing certain trade(s) ahead of those (proposed) orders, thereby benefitting from the resulting price movement. This practice undermines market integrity and fairness by exploiting information asymmetry for personal gain.

Large investors or institutional investors often place sizable orders that can influence stock prices. Insiders or brokers who are aware of these trades may buy scrips before executing the client's order. When the client's order causes the stock price to move, the insider sells their shares at a profit, exploiting their privileged position.

In a circular issued by the Securities and Exchange Board of India ("SEBI") dated May 25, 2012², SEBI has defined "front running as 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," which has also been used in several orders issued by SEBI.

The erstwhile SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 also laid down an identical explanation for the term front running as defined under the SEBI circular dated May 25, 2012³

In addition, the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003⁴ ("PFUTP Regulations"), similar to the aforementioned definition, prohibit various fraudulent and unfair practices, including market manipulation, insider trading, and deceptive transactions through Regulation 4(2)(q) — "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 that securities, its underlying securities or its derivative;"

According to SEBI, the below three ingredients for a front running case are⁵:

- (a) The alleged frontrunner possesses material non-public information;
- (b) Such information pertains to a substantial transaction; and
- (c) The order is executed in advance of the consummation of said substantial transaction.

An intriguing question that often comes up is "how is front running different from insider trading?" While both front-running and insider trading relate to the use of non-public information for personal gains, they differ in their nature and the relationships involved.

DIFFERENCES AND OVERLAPS BETWEEN INSIDER TRADING AND FRONT RUNNING

The main difference between front running and insider trading lies in information source. A classic example of front running is when a broker or trader uses their knowledge of pending client orders to trade ahead of those orders, thereby taking advantage of the client. The key aspect of front-running is the breach of fiduciary duty, where the broker, acting in a fiduciary capacity, prioritizes their own interests over their client's. This malpractice exploits the trust placed by the client in the broker to act in their best interests.

On the other hand, insider trading involves trading based on material, non-public information about a company. This

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typically involves individuals who have privileged access to confidential information, such as company insiders, executives, or consultants, i.e., 'Connected Person'⁶. The primary distinction here is the misuse of insider information of the company that is not available to the public, rather than an information relating to a substantial order relating to a security.

Any person, whether (a) an insider exploiting 'unpublished price sensitive information'⁷ ("UPSI"); or (b) a person undertaking the activity of 'front running' by exploiting information that is not publicly available, both challenge market integrity and exploit information asymmetry but differ in the source and details of the concerned information.

Despite the demarcation between insider trading and front running and due to a lack of clear legal provisions identifying front running, there exists an overlap in some instances. When the source of the UPSI stems from a company insider's actions, leading to an external entity front-running a large order that is based on such UPSI. This could cause price fluctuations and generate profits for the outside entity, such cases can be recognized as involving both front-running and insider trading.

For instance, an employee of a publicly traded company becomes aware of an upcoming acquisition by such publicly traded company of another company, which is expected to increase the publicly traded company's share price upon announcement, this information is inherently price sensitive in nature and would constitute as confidential insider information. In a case where such employee shares this insider information with family members, who then purchase shares of the company before the acquisition is publicly announced, it would be constituted as insider trading, as they are trading based on the unpublished price sensitive information, i.e., the insider information. At the same time, the employee also communicates the insider information to a large institutional client who agrees to place a substantial order for the company's stock. The client, in turn, colludes with another market participant who front runs the client's trade, anticipating a price increase once the large client order is executed. This scenario illustrates how insider trading and front running can occur simultaneously.

RELEVANT JURISPRUDENCE

SEBI has tested this definition in certain scenarios of front running in the recent years. In the *SEBI vs. Kanaiyalal Baldevbhai Patel*⁸ case, the Hon'ble Supreme Court of India delivered a landmark judgment that expanded the interpretation of fraudulent activities in the securities market, focusing on front-running. The Court emphasized a broad interpretation of "fraud" under the PFUTP Regulations, recognizing front-running as a fraudulent practice under Regulation 4(2)(q). It identified various forms, including trading based on non-public information about impending transactions and intermediaries trading ahead of client orders. The judgment clarified that SEBI's proceedings require proof based on a preponderance of probability rather than beyond a reasonable doubt, allowing inferences from circumstantial evidence and trading patterns. As per this order, it was held that inferential conclusion from the proved and admitted facts shall be permitted and legally justified so long as the same are reasonable and can be legitimately arrived at on a consideration of the totality of the materials. This decision reinforced SEBI's authority to curb manipulative practices and protect market integrity.

The next question that arose with respect to the applicability of Regulation 4(2)(q) was with respect to the determining threshold of the term "substantial". In this regard, SEBI observed that there cannot be a straitjacket formula to ascertain whether an order is substantial in nature or not. There will need to be a metric to take into account several factors, as may be applicable to each subjective order, such as liquidity in the stock, prevalent economic conditions as well as general trends in the stock market at that point.⁹ Subsequently, in February 2023, SEBI applied the "reasonable person" test to determine the interpretation of the term "substantial" wherein the judgement of a reasonable person related to the volatility and impact on the stock would likely ascertain the final decision¹⁰.

Another interesting interpretation taken by SEBI for the term "substantial" was in a case where the impending order was said to be considerable when it comprised of at least 3% (Three Percent) of the total traded stock of such scrip and if the order size was equal to or greater than 4,000 (Four Thousand) shares¹¹.

The SEBI (Prohibition of Insider Trading) Regulations, 2015¹², which contain SEBI's insider trading regulations, are also relevant. Trading based on price-sensitive information that is not released is expressly prohibited under these restrictions. Leveraging such information for high frequency trading (HFT) front-running purposes could violate these rules and result in SEBI enforcement action.¹³

The applicable penalty in case of front running may be found under Section 15-HA along with Section 24 of the SEBI Act which provide for a penalty not less than INR 5,00,000 (Indian Rupees Five Lakhs) (approximately USD 5,734) which may extend up to INR 25,00,00,000 (Indian Rupees Twenty-Five Crores) (approximately USD 28,67,000), or 3 (three) times the amount of profits made out of such practices, whichever is higher. Section 24 specifically allows for a criminal proceeding to be initiated in case of a contravention, along with the imposition of a penalty. The jurisprudential nature of such cases allows for a civil and criminal penalty to be invoked together.¹⁴

Invocation of a criminal proceeding under Section 24 of the SEBI Act was clarified in the case of *Prakash Gupta vs. SEBI*¹⁵ where it was stated that the provision is an omnibus provision and can be used against "most banal of offences, to the most egregious of market disruptions and frauds". This provides a clarification that the provision can be used in case of front running cases as well.

Recently, SEBI uncovered a front-running scheme involving former stockbroker Ketan Parekh and 21 (twenty-one) associates. The scheme involved using non-public information about large trades planned by a significant client managing USD 2.7 trillion in assets. SEBI uncovered this scheme through meticulous analysis of communication data, including mobile phone records. Notably, a mobile number registered to Ketan Parekh's wife played a crucial role in linking him to the fraudulent activities.¹⁶ SEBI's investigation, covering the period from January 1, 2021, to June 20, 2023, *prima facie* indicated that Ketan Parekh and his associates employed complex trading strategies to exploit their prior knowledge of the client's impending trades. As a result, SEBI issued an interim order barring Ketan Parekh and two others from dealing in securities for an unspecified period and initiated proceedings to recover the illicit gains¹⁷.

RISK MITIGATION

Regulatory bodies in India, such as the SEBI, have regulations and measures in place to prevent and penalize front running activities to maintain transparency and trust in the securities markets. Front-running gives a select few an unfair advantage, manipulates stock prices, and impairs trust in financial markets. Recently, on April 30, 2024, SEBI has proposed amendments¹⁸ to the SEBI (Mutual Funds) Regulations, 1996¹⁹ in order to establish an institutional mechanism which would aid in preventing front running as well as other activities in such regard ("**2024 Amendment**"). SEBI stated that the mechanism shall consist of enhanced surveillance systems, internal control procedures and escalation processes to identify, monitor and address specific types of misconduct including front running, insider trading and misuse of sensitive information.²⁰

In the present-day mechanism, the trustees of the mutual funds are required to provide a declaration through the periodical reports to SEBI that the mutual fund has not witnessed any instances of self-dealing or front running by the directors, key managerial personnel as well as the employees. Further, under the Code of Conduct for Asset Management Companies and Fund Managers and Dealers²¹ ("**FMDs**"), practices such as circular trading, artificial inflation of trading volumes, simultaneous buying and selling of the same securities at off market prices in order to create false or misleading signals, manipulation of prices of infrequently traded securities etc. have been expressly prohibited. While this mechanism imposes several restrictions and checks on the mutual funds, there is no specific requirement under it to establish a structural and institutional framework / committee for prevention and strict prohibition on market manipulation, including front running. There is also no requirement to have in place a whistleblower policy or a vigil mechanism.

Accordingly, SEBI proposes to make amendments to SEBI (Mutual Funds) Regulations, 1996 keeping in mind the gaps in the existing framework to prevent market malpractices, including front running. These amendments, although yet to be notified, include the requirement to put in place an institutional mechanism which is structured in order to identify and prevent any market abuse, enhancing the responsibilities of the asset management companies in cases of market abuse, setting up of a whistleblower policy for risk mitigation as well as a relaxation of the erstwhile norms which required the FMDs to record all communications during market hours.

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You can direct your queries or comments to the relevant member.

¹ Available at <https://dictionary.cambridge.org/dictionary/english/front-running>

² Available at https://www.sebi.gov.in/legal/circulars/may-2012/amendment-to-the-consent-circular-dated-20th-april-2007_22808.html

³ SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 Reg 5(2)

⁴ Available at https://www.sebi.gov.in/legal/regulations/jun-2024/sebi-prohibition-of-fraudulent-and-unfair-trade-practices-relating-to-securities-market-regulations-2003-last-amended-on-june-28-2024_84781.html

⁵ SEBI Order in the matter of Front Running by Mr. Mandar Ulhas Bhatkar, January 29, 2025, available at <https://www.msei.in/SX-Content/Circulars/2025/January/Circular-16683.pdf>

⁶ Regulation 2(1)(d) of SEBI (Prohibition of Insider Trading) Regulations, 2015

⁷ Regulation 2(1)(n) of SEBI (Prohibition of Insider Trading) Regulations, 2015

⁸ SEBI vs. Kanaiyalal Baldevbhai Patel, (2018) 207 Comp Cas 416 (SC)

⁹ In the matter of Front Running Trading activity of Dealers of Reliance Securities Ltd. and other connected entities, available at https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/jan-2023/1675081215253_1.pdf

¹⁰ In the matter of front running of orders of Quest Investment Advisors Private Limited by Ketan Bhupendra Parekh and Bhupendra Jasvantra Parekh, available at https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/feb-2023/1676031603443_1.pdf

¹¹ In the matter of Front Running by Banhem Securities Pvt. Ltd. and Ninja Securities Pvt. Ltd., available at https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/mar-2023/1680004209712_6.pdf

¹² Available at https://www.sebi.gov.in/legal/regulations/nov-2022/securities-and-exchange-board-of-india-prohibition-of-insider-trading-regulations-2015-last-amended-on-november-24-2022_65864.html

¹³ SEBI (Prohibition of Insider Trading) Regulations, 2015, Reg. 3(1), "*No insider shall communicate, provide, or allow access to any unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, to any person including other insiders except where such communication is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.*"

¹⁴ Securities and Exchange Board of India vs. Cabot International Capital Corporation, 2004 SCC OnLine Bom 180.

¹⁵ Prakash Gupta vs. Securities and Exchange Board of India, 2021 SCC OnLine SC 485.

¹⁶ Available at <https://economictimes.indiatimes.com/news/india/how-ketan-parekhs-wifes-phone-helped-sebi-uncover-a-rs-65-crore-front-running-scam/articleshow/116920346.cms>

¹⁷ In The Matter of Extended Front Running by Rohit Salgaocar, Ketan Parekh and Others, available at https://www.sebi.gov.in/sebi_data/attachdocs/dec-2024/Front_Running_Order_Big_Client.pdf

¹⁸ Available at https://www.sebi.gov.in/sebi_data/meetingfiles/may-2024/1715144023897_1.pdf

¹⁹ Available at https://www.sebi.gov.in/legal/regulations/aug-2023/securities-and-exchange-board-of-india-mutual-funds-regulations-1996-last-amended-on-august-18-2023_76333.html

²⁰ Available at <https://www.thehindu.com/business/sebi-board-approves-amendment-to-mf-rules/article68125619.ece>

²¹ Available at https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2020/1602839577069_1.pdf

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