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QUANT MUTUAL FUND FIASCO - AN EXPLORATION OF FRONT RUNNING IN INDIA

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ABSTRACT

*The Quant Mutual Fund scandal has brought the issue of front-running in India's securities market to the forefront. This article examines the regulatory system surrounding front running in India, especially in the wake of the Securities and Exchange Board of India's ("**SEBI**") investigation into the fastest-growing mutual fund in the country. Despite existing regulations under the SEBI Act, the framework for preventing market manipulation like front-running remains inadequate, characterised by vague prohibitions and minimal whistleblower protections. This analysis delves into the intricacies of front running, drawing parallels with the United States' ("**U.S.**") and Singaporean regulations, and highlights the significant gaps in India's current approach. The article also explores recent amendments to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (Mutual Fund Regulations) aimed at curbing front running and suggests critical enhancements to ensure more robust enforcement. The proposed changes include clearer definitions of key terms, expanded liability for those*

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involved, and stronger protections for whistleblowers. By adopting these recommendations, SEBI can significantly strengthen the regulatory framework, safeguard market integrity, and enhance investor confidence in India's capital markets.

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I. INTRODUCTION

The issue of front-running has gained significant attention recently, particularly in light of the recent Quant Mutual Fund investigation. This fund, the fastest-growing in the country, was scrutinized by SEBI earlier this year following allegations of front running. In the aftermath, clients have withdrawn thousands of crores from the fund. The question that arises is: What is the regulatory regime for front running in India and is it comprehensive enough to deal with such market manipulation tactics?

While the SEBI Act and related regulations mention front-running, the regulatory coverage is minimal, offering only a vague prohibition without defining its scope. The majority of the current understanding is traced to SEBI's regulatory investigations and penalties.

The legal understanding of front-running can be traced back to the misappropriation theory of insider trading, a form of market manipulation or abuse. Misappropriation theory expands on classical insider trading by holding individuals accountable for trading on material nonpublic information ("**MNPI**") acquired through a breach of fiduciary duty, even if they are unaffiliated with the company involved. For instance, if an attorney at a law firm purchases stock options in a company based on MNPI, obtained through firm discussions, they may be held liable under United States Securities and Exchange Commission Rule 10b-5,[1] despite not owing a direct fiduciary duty to the company itself. The fiduciary duty here pertains to not misusing confidential information that one has no right

[1] 15 U.S.C. § 78j (2006) (U.S).

to use. This activity was likened to embezzlement, which refers to the theft or misappropriation of funds placed with one under trust, by the U.S. Supreme Court in a 1997 case.[2] This theory has since been codified in the U.S. insider trading jurisprudence, expanding the earlier understanding of the insider trading provisions.

Particularly, front-running similarly involves a breach of fiduciary duty—specifically, the duty not to use confidential information that one has no right to use. Asset managers and intermediaries in stock trades are typically implicated in this activity, as opposed to individuals connected to a particular company in any other capacity, which is the case with insider trading. However, both deal with one crucial aspect: the unauthorized usage of confidential and sensitive information.

The current regulatory environment has major gaps, particularly in the scope of coverage and whistleblower protections. Although SEBI has recently amended the Mutual Fund Regulations to strengthen the regulations against front running, we argue that more substantial changes are needed to address these issues effectively. In this article, we conduct an examination of the current regulations and recommend changes. We attempt to firstly, explore the Indian regulations as well as the U.S. and Singaporean regulations related to front-running, secondly, delve into the newly introduced compliance and accountability requirements for mutual funds concerning front running, and thirdly, analyze the definition of the

[2] United States v. O'Hagan, 521 U.S. 642 (1997).

offence, its new patterns and suggest changes to fill the regulatory gaps that we identify from the discussion.

II. REGULATIONS IN INDIA

Front-running is considered a 'fraudulent practice' under the Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations, 2003 ("**PFUTP regulations**").[3] The PFUTP regulations define fraud to mean such 'act', 'omission', 'expression' undertaken by a party or his agent with his permission, to 'induce' any other individual to trade in securities, which may or may not lead to wrongful profit or prevent wrongful loss.[4]

Regulation 4(1)(q), which specifically deals with front running, states that "*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*".[5]

III. REGULATIONS IN SINGAPORE

Regulation 44 of the Securities and Futures (Licensing and Conduct of Business) Regulations regulate the offence of front running in Singapore.[6] The essential ingredients for attracting this offence under this provision are three-fold. At the outset, the person should act "*on his own*

[3] Securities & Exch. Bd. of India (Prohibition of Fraudulent & Unfair Trade Practices Relating to Securities Mkt.) Regulations, 2003 (India).
[4] *Id.* reg. 2(1)(c).
[5] *Id.* reg. 4(2)(q).
[6] Securities and Futures (Licensing and Conduct of Business) Regulations (Cap. 289, RG 10) Reg. 44 (*Sing.*).

account" or on "*behalf*" of another person. Subsequently, while acting in such a capacity, a certain purchase or sale of securities has to be done. Lastly, at the time of such a trade, the person should be acting under instructions from his customer or of the entity he represents to enter into a trade of that same security, and he must have failed to comply with those instructions.

IV. **REGULATIONS IN THE UNITED STATES**

Front-running is defined as a form of market manipulation, which refers to artificially affecting the supply or demand of security by spreading false or misleading information and engaging in transactions to manipulate how the security is traded.[7] It generally refers to "*practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity*".[8] This activity affects fair execution of trades in the securities marketplace and allows parties with sensitive information about upcoming trades to manipulate the market for personal gain, thereby violating their fiduciary duty to their clients.

FINRA Rule 5270 classifies front-running as an illegal act when based on material, non-public market information, concerning an imminent block transaction in a particular security.[9] Information shall be considered publicly available when it has been disseminated via a last sale report system or high-speed communications or by a third-party news wire service. It does not debar transactions that can be demonstrated to be unrelated to material,

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[7] Kohn, Kohn & Colapinto, *what-is-market-manipulation*, KKC (Nov. 2, 2023) https://kkc.com/frequently-asked-questions/what-is-market-manipulation/.
[8] Santa Fe Industries v. Green, 430 U.S. 462 (1977).
[9] FINRA Rule 5270, 77 Fed. Reg. 20452 (Apr. 4, 2012).

non-public market information received in connection with the customer order. It also does not preclude transactions undertaken to fulfil, or facilitate the execution of, the customer block order. US Securities and Exchange Commission's ("**SEC**") Thrivent Code of Ethics deems it illegal and prohibits front running.[10] Commodity Futures Trading Commission deems front-running as an abusive trading practice.[11]

The United States Whistleblower Program is based on a complaint-award model, a reward system, and offers various protections against arbitrary action against whistleblowers under the Dodd-Frank Act.[12] Those with information regarding illegal front-running may file a whistleblower tip or claim to the SEC. SEC offers 10 to 30% of the fines collected to the whistleblower if it exceeds the threshold of $1,000,000, an amount which is paid from the investor protection fund, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

SEC has imposed hefty penalties on individuals found guilty of front running.[13] In one landmark instance, the defendants used confidential information by a company and engaged in front-running. They bought Sterling in advance of a large currency exchange transaction that the company was planning, which caused the price of sterling to spike and

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[10] SEC, THRIVENT CODE OF ETHICS, https://www.sec.gov/Archives/edgar/data/811869/000119312517059407/d328614dex99p1.htm

[11] Final Rules on Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. (2013).

[12] SEC, WHISTLEBLOWER PROGRAM, https://www.sec.gov/enforcement-litigation/whistleblower-program

[13] *SEC Enforces Second-Highest Year for Penalties*, QUEST CE (Nov. 15, 2023) https://www.questce.com/blog-sec-enforces-second-highest-year-for-penalties/.

caused the defendants to profit. Thereafter, false representations were made to the company to hide these activities.[14]

Another relevant concept in the U.S. context is 'flashing'. A flash order refers to the flashing of order information to certain parties prior to the information being made widely available in the marketplace.[15] This, in the era of modern technology, gave access to certain high paying customers to view such information. These practices are likely to facilitate front running and other forms of market manipulation. SEC allowed flashing in 1978. Apart from a few restrictions, flash orders are still legal in the U.S.

V. MUTUAL FUNDS: INCREASED REQUIREMENT FOR ASSET MANAGEMENT COMPANIES

Upon consultation with the industry stakeholders, after the number of front running and insider trading cases went up, SEBI issued amendments to the Mutual Fund Regulations, 1996 (amended regulations)[16] to introduce an institutional mechanism for Asset Management Companies ("**AMCs**"). The primary objective of introducing such a deterrence framework is to ensure that the AMCs implement strict vigil for any unfair market practices and that suspected instances of such activities are reported and flagged faster.[17]

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[14] United States v. Johnson, 945 F.3d 606 (2d Cir. 2019).

[15] *SEC Moving on Flash Trading, High Frequency Trading*, MTLR Blog, https://mttlr.org/2009/11/sec-moving-on-flash-trading-high-frequency-trading/ .

[16] Securities and Exchange Board of India (Mutual Funds) (Second Amendment) Regulations, 2024.

[17] Securities and Exchange Board of India, Institutional mechanism by Asset Management Companies for identification and deterrence of potential market abuse including front-

Earlier, the only requirement incumbent upon the AMCs was the responsibility of its Board of Directors to ensure that any transactions entered by it were in line with the regulations. However, after the amendment, if an AMC fails to put in place the institutional mechanism, then it would lead to the imposition of personal liability upon the Chief Executive Officer or Managing Director of the AMC.[18]

Such a mechanism would undoubtedly allow for an enhanced detection of front running activities and deterrence, subject to the fulfillment of certain criteria. Primarily, the entire framework needs to have specific accountability mandates. As per regulation 25(27) of the new amendment,[19] it appears that accountability only exists till the implementation of such a mechanism. There is a lack of clarity with regard to whether such accountability would continue after the mechanism has started to function. On the other hand, even if it is presumed that liability would continue to exist, its effectiveness is negated as it is only limited to a specific individual and not the board in general.

The need to increase the ambit of liability to the board of AMCs becomes apparent once we look into the nature of the offence of front running. The non-public information regarding the substantial order to be placed by the AMC would only be available to those who are involved in the day-to-day business of the company.[20] This could also be extended to

running and fraudulent transactions in securities, SEBI/HO/IMD/IMD-I POD1/P/CIR/2024/107 (Issued on August 5, 2024).

[18] *Supra* note 16, Reg. 25(28).

[19] *Id.* Reg. 25(27).

[20] SEBI v. Shri Kanaiyalal Baldevbhai Patel, (2017) 15 SCC 1.

mean that the board or certain directors would have such information. Despite the same, if there is a lapse on their part to report suspicious trades as per the manner provided in the institutional mechanism, then they should be personally held liable. This would prevent board members from neglecting the mechanisms and compel them to take action against trading activity that is flagged by surveillance.

In order to further strengthen the institutional mechanism, the role of independent directors could be further expanded by having them oversee the functioning of the institutional mechanism after its implementation. Independent directors are non-executive directors who cannot be held liable,[21] but a reporting system could be put in place wherein they have to make periodical disclosures to the regulator regarding the operations of the mechanism. This would go a long way in boosting accountability.

VI. **DEFINITION: AMBIT EXTENDED TO INCLUDE NON-INTERMEDIARIES**

According to the judgment of the Supreme Court in *SEBI v. Kanaiyalal Patel*,[22] which held that even non-intermediaries can be guilty of front running, SEBI overhauled the entire definition while swapping the phrase 'intermediaries' with 'persons' in its 2019 amendment of the

[21] M. P. Ram Mohan, Urmil Shah, *Tracing Director Liability Framework during Borderline Insolvency & Corporate Failure in India*, IIMA W. P. No. 2021-08-02 (Indian Inst. of Mgmt. Ahmedabad, Aug. 2021) https://www.iima.ac.in/sites/default/files/rnpfiles/812680252021-08-02.pdf .
[22] *Supra* note 20.

regulations.[23] Herein, we evaluate the definition.[24] We discuss three aspects: the term 'person', the nature of 'information' and the criteria for a 'substantial' transaction.

A. AMBIT OF THE TERM 'PERSON'

The term 'person' has not been defined in the PFUTP Regulations or even under the SEBI Act, 1992.[25] Reliance has always been placed upon the judicial pronouncements for the purpose of deciding who comes under the ambit of a 'person'.[26] It is also relevant to peruse the definition of an 'insider' under the SEBI Prohibition of Insider Trading Regulations, 2015 for comparison.[27]

An insider, defined as a connected person (which includes family up to a certain degree) or anyone in possession of 'sensitive information', covers multiple individuals, which allows the regulator to specifically determine whom to prosecute.[28] This was even witnessed in the matter of Front-Running of the Trades of Axis Mutual Fund wherein SEBI barred a fund manager who was operating through entities associated with him for placing front running trades through other accounts.[29] In the instant case, there was indeed no straight jacketed formula to define a person for the

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[23] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2018.
[24] *Supra* note 3, Reg. 4(2)(q).
[25] Securities and Exchange Board of India Act, 1992, No. 10, Acts of Parliament 1992 (India).
[26] *Supra* note 20.
[27] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.
[28] *Id.* Reg. 2(d).
[29] Interim Order-cum-Show Cause Notice in the matter of Front Running of the Trades of Axis Mutual Fund, WTM/SM/ISD/ISD-SEC-3/24180/2022-23.

purposes of front running, as rightly enunciated by the Supreme Court.[30] Despite that, the abrupt shift from narrow to broad by replacing 'intermediary' to 'any person' under the PFUTP regulations may lead to implementation challenges. To illustrate, a third party, X, who already owns shares of an entity decides to place a limit order on them one day before obtaining the information about the large client order and, in turn, makes a greater than usual profit without any malafide intent. Under the amended regulations, he would also be considered a front runner since he falls within the ambit of 'any person'.

In Canada, only a 'participant', as defined under the Universal Market Integrity Rules ("**UMIR**"),[31] can be held liable for front running. Regulation 1.1 defines a participant as two categories:[32] *firstly*, a dealer who has a valid registration from exchange, and *secondly*, persons (defined in Regulation 1.2)[33] which includes 'corporations', and 'incorporated associations' who actively undertake activity in the market. Regulation 4.1,[34] which deals with front-running, explicitly bars three practices: frontrunning by the participant itself, soliciting any third party to partake in the same, and information pertaining to the big client in order to reach any other person. The third part of the provision may explicitly only bar the informational flow but its implied intent is to prevent any other entity from being able to access such information and act upon it.

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[30] *Supra* note 20.
[31] Universal Market Integrity Rules, 2002 (Can.).
[32] *Id.* Reg. 1.1
[33] *Id.* Reg. 1.2.
[34] *Id.* Reg. 4.1.

From our aforementioned discussion, two things become clear. *Firstly*, it is essential to clearly demarcate who would be the subject of the application of a specific law rather than opting for a generic definition. *Secondly*, it is equally crucial to expand the application of law as and when the type of fraudulent conduct shifts. This trend was even reflected in the Supreme Court's verdict where it abstained itself from relying on the pigeon-hole theory for ascertaining conduct to be guilty or not.[35]

B. SUBSTANTIAL TRANSACTION

Another crucial aspect of the statutory definition is that the transaction in the securities as per the client order has to be 'substantial'. Since the regulation does not define this term, its meaning may be expounded through case laws. SEBI in Front Running Trading Activity of Dealers of Reliance Securities took a broad approach by holding that the criteria of determining a substantial order vary for each entity and it depends on factors including the liquidity of that security and major announcements by the company.[36]

Contrarily, SEBI adopted a narrower interpretation in the matter of Front Running by Banhem Securities by outlining more specific criteria on the basis of the volume of the trade to determine what is 'substantial'.[37] It held that if the volume of the client order is equal to or more than 3% of the amount of the same stock traded on that specific day and it is at least

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[35] *Supra* note 20.
[36] Final Order in the matter of Front Running Trading activity of Dealers of Reliance Securities Ltd. and other connected entities, 2023 SCC OnLine SEBI 56.
[37] In the matter of Front Running by Banhem Securities Pvt. Ltd. and Ninja Securities Pvt. Ltd, SCC OnLine SEBI 87.

4000 shares in number, then such an order would be considered substantial. The order was silent on the aspect of the price of the security.

It is submitted that while both volume and price of the security ought to be relevant in ascertaining a 'substantial order', price should be given priority over volume as a criterion. The reason for the same is that any change in price by virtue of the order would showcase how much of a profit the front runner has made. While profit may not be a statutory essential to attract the liability, it is generally the motive behind it.[38] Thus, the change in price dictates how much of an impact a certain order would have. The volume criteria as envisaged by the court in Banhem could be used as a corroborative factor to ensure that the price change was not influenced by any other cause.[39]

C. **INFORMATION**

In the Regulations, SEBI only mentions 'information not publicly available'. It fails to specify the nature of such information as to whether it has to be specific or could it be general in nature. In the case of the latter, it would be possible for SEBI to prosecute a larger pool of entities who may or may not be directly involved in it. For instance, if a market rumour circulates among a few non-intermediaries about an impending order and they act on it, would they be considered equally liable? This question arises in light of the fact that they received such information in the form of a rumour and not through any direct channel.

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[38] Tom C.W. Lin, The New Market Manipulation, 66 EMORY L. J., 1253 (2017).
[39] *Supra* note 37.

Herein, reference could also be drawn from the Canadian framework which requires the knowledge of the order to be specific. It means that anyone acting on such information needs to have acquired it from a direct channel with particular details about the order that would be placed. Further, it categorically bars any trades executed based on information arising out of a market rumour from coming under the ambit of front running.

It is concluded that while the earlier amendment as mentioned above in this discussion is a step in the right direction, amending or altering these terms would further increase the clarity in enforcement of the regulations.

VII. THE EMERGENCE OF A NEW FRONT RUNNING PATTERN – 'BSB'

The practice of front running is divided into three trades out of which two are made by the front-runner and the one which is made before the big order forms the basis for constituting it. Generally, the execution of such trades takes place in a 'Buy Buy Sell' pattern ("**BBS**") or in a 'Sell Sell Buy' pattern ("**SSB**").[40] In the first scenario, the front runner purchases the security prior to its purchase by the large client and then sells it, while in the second, the security is sold before the large order and is then bought at a lower price.

[40] Riya R Alex, *SEBI crackdown on Quant MF: What is front-running? All you need to know*, LIVEMINT (June 24, 2024), https://www.livemint.com/companies/sebi-crackdown-on-quant-mf-what-is-front-running-all-you-need-to-know-11719202556510.html .

In *Kajal Savla*,[41] SEBI had attempted to include different patterns of a front-running apart from the aforementioned ones, especially in light of newer mechanisms that allow the scheduling of trades on the happening of a certain event. To determine whether a trade is a case of front-running or not, the court decided that the relevant factor is whether it was put in place before the purchase or sell order of the client. The second part of the trade allows the front runner to make an unlawful gain, but it does not compulsorily have to be after the client's order due to two reasons. *Firstly*, they may intentionally place it to make it appear as a genuine trade to evade detection, and *secondly*, they may rely on limit order mechanisms to place such orders at a prior date.

Such limit order mechanisms also form the foundation for the new "*'Buy Sell Buy' pattern* ("**BSB**") *by the client*", as discussed by SEBI in its order.[42] In such a trade, the second leg (buy at a minimum X price point or sell at Y price point) is placed in advance of the client order yet executed only before the last tranche of the client order. Thus, while such a leg may appear to be placed before the clients impending trade, in reality, it is executed after the price of the stock has been altered. The reasoning of the order can be extended to another front-running scenario which is the "*'Buy by the client' Buy Sell*" pattern. It would involve placing the first leg of the front running trade after the first tranche of the client. This also indicates that the front runner possesses specific information as to which tranche of the client's order is significant. Thus, even though the first leg of the trade

[41] In the matter of Front Running by Kajal Savla and Others, 2022 SCC OnLine SEBI 1782.
[42] *Id.*

takes place after the client order, the fact that it is placed prior to the substantial or last tranche satisfies the statutory definition.

However, it is stated that the determination of more patterns of this activity depends upon the facts of each conduct and would vary on a case-to-case basis. To further reduce ambiguity, it is suggested that a suitable explanation be added to Regulation 4(2)(q)[43] that the date of execution of the order should be the relevant date for determining the offence. Lastly, the flow of non-public information between such accused individuals needs to be compulsorily established to ensure that no one is falsely punished or genuine trades are penalised as front-run ones.

VIII. INDIA'S WHISTLEBLOWER POLICY

Aside from the Whistle Blowers Protection Act, 2014 ("**WBPA**"),[44] and some provisions in the Companies Act, India lacks a proper whistleblower protection mechanism. Notably, WBPA is only applicable on public servants and public sector undertakings. Section 177 of the Companies Act, 2013, along with Clause 49 of the Listing Agreement, mandates the adoption of a whistleblower policy on listed companies.[45] While private sector companies are increasingly moving towards voluntary adoption of whistleblower policies, it is insufficient unless proper rules are made in this regard. The US, as discussed above, has a proper reward system for whistleblowers, which may act as an incentive for reporting such

[43] *Supra* note 24.
[44] The Whistle Blowers Protection Act, 2014, No. 17, Acts of Parliament, 2014, (India)
[45] The Companies Act, 2013, §177, No. 18, Acts of Parliament, 2013, (India)

activities to the SEC. Moreover, the protection system for whistleblowers is strong. Such mechanisms, if adopted in India, will act as protective measures for whistleblowers.

SEBI, in a Circular titled 'Measures to instill confidence in securities market - Brokers' institutional mechanism for prevention and detection of fraud or market abuse', directed stock brokers to establish and implement whistleblower policy providing for a confidential channel for employees and other stakeholders to raise concerns regarding suspected fraudulent and unfair market practices.[46] Such policies shall also ensure adequate protection for whistleblowers. We observe that this is a step in the right direction. However, proper regulations by SEBI in relation to whistleblowers reporting market abuse instances would go a long way in preventing inconsistencies.

IX. **CONCLUSION**

The issue of front running remains a significant challenge in the Indian securities market. While recent amendments by SEBI, particularly in the Mutual Fund Regulations, have introduced measures aimed at curbing this practice, they fall short of addressing the broader systemic issues. The comparative analysis with U.S. and Singaporean regulations displays the need for a more well-defined approach in India, especially regarding the

[46] SECURITIES AND EXCHANGE BOARD OF INDIA, MEASURES TO INSTIL CONFIDENCE IN SECURITIES MARKET – BROKERS' INSTITUTIONAL MECHANISM FOR PREVENTION AND DETECTION OF FRAUD OR MARKET ABUSE (JULY 4, 2024), <https://www.sebi.gov.in/legal/circulars/jul-2024/measures-to-instil-confidence-in-securities-market-brokers-institutional-mechanism-for-prevention-and-detection-of-fraud-or-market-abuse_84588.html>

scope of liability, the nature of the information involved, and the criteria for substantial transactions. Additionally, the lack of robust whistleblower protections is another problem, deterring potential informants from coming forward with crucial information on market abuses.

Therefore, it is imperative for SEBI to refine the existing regulations by providing clear definitions and expanding the ambit of accountability. Incorporating lessons from international practices, such as the U.S. whistleblower reward system, could also significantly enhance the detection and prevention of front running. Moreover, the introduction of specific accountability mechanisms, particularly for board members and independent directors of AMCs, is essential to ensure that the institutional mechanisms are not merely procedural but lead to tangible deterrents against market manipulation.

The proposed changes to the regulatory framework, including clarifications on the definition of a 'person', the criteria for a 'substantial' transaction, and the nature of the 'information' involved, would enhance the effectiveness of enforcement actions against front running. By addressing these gaps, SEBI can bolster market integrity and protect investors from the detrimental effects of market manipulation.