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COMMERCIAL/CORPORATE

SEBI v. Kishore R Ajmera: Voluminous trading in illiquid scrips

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PUBLISHED 10 March 2016

Introduction

The instant case involves five appeals filed by the Securities and Exchange Board of India ("**SEBI"**) against brokers and sub-brokers who have indulged in trading of illiquid scrips and artificially creating a high volume of trading which had resulted in unnatural inflation of the price of the script.

SEBI v. Kishore R. Ajmera[1]

In this case, two clients, through the Respondent-broker and a sub-broker indulged in matching trades which resulted in creation of artificial volumes in the scrip of one Malvica Engineering Ltd ("**MEL**").

The scrip in question was an illiquid scrip where the volume of trading is normally minimal. A note of caution had also been struck by the Bombay Stock Exchange by circulating an advice requiring brokers to be aware of any unnatural trading in such illiquid scrips. Despite the note of caution being issued, the sub-broker acting through the terminal of the Respondent broker allegedly indulged in creating artificial volumes of illiquid scrip. It is on the said facts that charges of negligence, lack of due care and caution were leveled against the sub-broker and the Respondent-broker.

It was also found that the two clients were related to each other and they were beneficiaries of the allotment of the shares made directly by the parent company i.e. MEL. The said allotment incidentally was made out of the shares that were forfeited on account of failure to pay call money by the allottees, following a public offer.

Due enquiry was held against the sub-broker and the Respondent-broker under the provisions of Securities and Exchange Board of India Act, 1992 ("**SEBI Act**"), SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 ("**Conduct Regulations**") and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Market) Regulations, 2003 ("**FUTP Regulations**") and the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 (" **Enquiry Regulations**").

Inferentially, the Whole Time Member of SEBI levied a penalty of suspension of registration of the Respondent as a broker for a period of four months. Aggrieved, the Respondent filed an appeal before the Securities Appellate Tribunal ("**SAT**"). SAT held that in the absence of any direct proof or evidence showing the involvement of the sub-broker in allegedly matching the trades and thereby creating artificial volumes of trading, the charges are not substantiated. The penalty imposed was accordingly interfered with. It is against the said order that the SEBI has filed the present appeal before the Supreme Court.

SEBI v. Ess Ess Intermediaries Pvt. Ltd.[2], *SEBI v. M/s. Rajendra Jayantilal Shah*[3], *SEBI v. M/s. Rajesh N. Jhaveri*[4]

The scrip involved in these appeals was one of M/s. Adani Export Ltd. (AEL). The Respondents were all sub brokers who were alleged to have synchronized trades in respect of a huge number of shares for their clients. The volume of shares traded was very high. It was also observed that the time gap between buy and sell orders was minimum, between 0-60 seconds.

The Respondents were held to be liable under the FUTP Regulations and the Conduct Regulations. In appeal, the SAT had taken the view that the allegations of fraud under the FUTP Regulations can be established only on the basis of clear, unambiguous and unimpeachable evidence which is not available in the instant case. Consequently, SAT disposed off these appeals.

SEBI v. Networth Stock Broking Ltd.[5]

In the present case, the allegation against the Respondent was that alongwith three other brokers, the Respondent had indulged in circular trading of the scrip on behalf of one client. The *modus operandi* of the circular trading involved commencement of trading on a particular day by a sale made by one broker to a second and continuation of such sale in a circular manner until at the end of the day the same or substantially the same number of shares would come back to the first broker who had initiated the sale. The time difference between buy and sell orders was 0 to 60 seconds in most cases. The circular trading resulted in huge and voluminous trading in the illiquid shares thereby artificially raising its price in the market.

The Respondents were held to be liable under the FUTP Regulations and the Conduct Regulations by the Whole Time Member of SEBI. However, the order was reversed by SAT, giving rise to the instant appeal before the Supreme Court.

Reasoning of the Supreme Court

The Court observed that the SEBI Act and the Regulations framed thereunder are intended to protect the interests of investors in the capital/securities market thereby boosting their confidence in the regulatory mechanism. This would also include measures that are intended to preempt manipulative trading and check all kinds of impermissible conduct in the capital market.

The Court observed that there are parallel provisions contained in the SEBI Act and the Regulations in the context of the power of imposition of penalty on determination of liability either for manipulative or fraudulent practices or for violation of the Conduct Regulations by the brokers. The different Regulations including Enquiry Regulations and the successor Regulation i.e. SEBI (Intermediaries) Regulations 2008 contain identical and parallel provisions with regard to imposition of penalty resulting in myriad provisions dealing with the same situation. The Court held that a comprehensive legislation can bring about more clarity and certainty on the norms governing the security/capital market and, therefore, would best serve the interest of strengthening and securing the capital market.

In the above appeals, the Court held that, in the absence of direct evidences, it would be their judicial duty to take note of the immediate and proximate facts and circumstances surrounding the events on which the charges/allegations were founded to reach to a reasonable conclusion.

The Court held that circular and synchronized trading *per se* is not prohibited and in fact is regulated by the SEBI regulations in force. In the above appeals, the scrips in which trading had been done were illiquid scrips meaning thereby that such scrips were not listed in the Bombay Stock Exchange and, therefore, were not a matter of everyday buy and sell transactions. Although trading in illiquid scrips is not prohibited, voluminous trading over a period of time in such scrips is a fact that should attract the attention of a vigilant trader engaged/engaging in such trades. The same was notified by the Bombay Stock Exchange in the form of a notice/memorandum alerting its members with regard to the necessity of exercising care and caution in case of high volume of trading in illiquid scrips.

In the present appeals it was clear from all the surrounding facts and circumstances that there had been transgressions by the brokers beyond the permissible dividing line between negligence and deliberate intention. The failure of the brokers/sub-brokers to alert themselves to this minimum requirement and their persistence in trading in the particular scrip either over a long period of time or in respect of huge volumes thereof, disclosed a deliberate intention on the part of the brokers to indulge in trading beyond the forbidden limits.

The Court noted that a common view taken by SAT in all the above appeals was that trading was based on onscreen trading. In an on screen based trading it is not possible for the broker to know who the counter party is at the time the trade is being executed. Hence, there is no direct material to show that the Respondents were aware of the identity of the clients on whose behalf the transactions were being carried out.

The Court held that while the screen based trading system keeps the identity of the parties anonymous, the conclusions cannot be formed by solely relying on this fact. There could be a possibility of meeting of minds elsewhere. The conclusion, therefore, has to be gathered from various circumstances like:

- volume of the trade effected;
- the period of persistence in trading in the particular scrip;
- the particulars of the buy and sell orders, namely, the volume thereof;
- the proximity of time between the two and such other relevant factors.
- The fact that the broker himself has initiated the sale of a particular quantity of the scrip on any particular day and at the end of the day approximately equal number of the same scrip has come back to him;
- that trading has gone on without settlement of accounts i.e. without any payment and the volume of trading in the illiquid scrips,
- all, should raise a serious doubt in a reasonable man as to whether the trades are genuine.

Decision of the Supreme Court in the above appeals

In ***SEBI v Kishore R. Ajmera***, the Supreme Court noted that the only proven facts were as follows:

- Both the clients are known to each other and were related entities.
- This fact was also known to the sub-broker and the respondent – broker.
- The clients through the sub-broker had engaged in mutual buy and sell trades in the scrip in question, volume of which trade was significant, keeping in mind that the scrip was an illiquid scrip.

Apart from the above there is no other material to hold either lack of vigilance or *bona fides* on the part of the sub-broker. The above facts are not sufficient to hold the respondent-broker liable under the Code of Conduct Regulations.

Hence, the Supreme Court dismissed the said appeal and affirmed the order passed by the SAT.

In ***SEBI v. Ess Ess Intermediaries Pvt. Ltd.), SEBI v. M/s. Rajendra Jayantilal Shah, and SEBI v. M/s. Rajesh N. Jhaveri***, the volume of trading in the illiquid scrips were huge coupled with the fact that buy and sell orders in respect of the transactions

were made within a span of 0 to 60 seconds. While the proximity of time between the buy and sell orders by itself may not be conclusive in an isolated case, such an event in a situation where there is a huge volume of trading can reasonably point to some kind of a fraudulent or manipulative exercise with prior meeting of minds.

The Court also distinguished the trades in question with “negotiated trades”. A negotiated trade involves consensual bargaining involving synchronizing of buy and sell orders which will result in matching thereof but only as per permissible parameters which are programmed accordingly. However, the trades in question were in violation of the terms of the notice stuck by Bombay Stock Exchange. Hence, the brokers were held to be liable.

In ***SEBI v. Networth Stock Broking Ltd.,*** SAT had held that the principles of natural justice had been violated on account of the fact that the entire trade log and the statements made by the client were not furnished to the Respondent which caused prejudice to the Respondent. The client had been regularly trading in the same fashion in as many as 25 different scrips and since inception, the client’s trading pattern was primarily by way of day trading whereby she bought and sold equal quantities in respective scrips in the course of the day. All payments were made from her bank account and even for her delivery based trades, deliveries were made from her demat account.

However, the Supreme Court rejected the plea of violation of principles of natural justice. The Court held that the fact that on behalf of the client, similar transactions were entered into in respect of other illiquid scrips which did not disclose any irregularities cannot be a ground to overlook what has happened in case of the scrip involved in which the Respondent broker had indulged in. Hence, the broker was held to be liable.

[1] *Civil Appeal No.2818 of 2008*

[2] *Civil Appeal No.6719 of 2013*

[3] *Civil Appeal No.252 of 2014*

[4] *Civil Appeal No.282 of 2014*

[5] *Civil Appeal No. 8769 of 2012*