

**BEFORE THE SECURITIES APPELLATE TRIBUNAL
MUMBAI**

Appeal No.51 of 2009

Date of decision: 26.10.2010

Indiabulls Securities Limited
F-60, 2nd Floor, Malhotra Building,
New Delhi – 110 001.

..... Appellant

Versus

Securities and Exchange Board of India
SEBI Bhavan, Plot No. C-4A,
G Block, Bandra Kurla Complex,
Bandra (East), Mumbai – 400 051.

.....Respondent

Mr. P.N. Modi, Advocate with Ms. Preeti Salaskar, Advocate for the Appellant.

Mr. Kumar Desai, Advocate with Mr. Nikhil Pai, Advocate for the Respondent.

CORAM : Justice N.K. Sodhi, Presiding Officer
Samar Ray, Member

Per : Samar Ray, Member

This order will dispose of four Appeals no. 51, 57, 168 and 214 of 2009 as they raise identical questions of law and fact and originate from the same investigations and the consequent ad interim ex-parte order passed by the Securities and Exchange Board of India (for short the Board). We shall take the main facts from Appeal no. 51 of 2009 and refer to the other appeals thereafter. The appellants in Appeal numbers 51, 168 and 214 are stock brokers and the appellant in Appeal no. 57 is a market trader.

2. Whether the appellants had aided and abetted their clients in executing non genuine transactions in collusion with counter party clients and brokers in the Futures and Options (F & O) segment of the National Stock Exchange of India Limited (NSE) and misused the stock exchange mechanism in violation of Regulations 3(a), 3(b), 3(c), 4(1), 4(2)(a) and 4(2)(b) of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 2003 (FUTP Regulations) and Regulations 7A(1), (2), (3) and (4) of the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations 1992 (Stock brokers Regulations) is the short question that arises for our consideration in the appeals filed by the stock brokers.

3. (F&O) contracts are traded in the derivative segment of the Indian Capital Market. Derivatives are actually financial instruments whose values are derived from the other, more

basic, underlying variables like the share price of a particular scrip in the cash segment of the market or the stock index of a portfolio of stocks. Derivative trade is governed by section 18A of the Securities Contracts Regulation Act, 1956 which was recently inserted with effect from February 22, 2000 and is legal only when such contracts are traded on a recognized stock exchange and settled through the clearing house of that exchange. Futures contract is a contract that obligates the holder to buy or sell an asset at a predetermined delivery price during a specified time period. An options contract, on the other hand is a derivative contract between a buyer and a seller where the seller gives a right but not an obligation to buy from or sell to the seller the underlying asset on or before a specific date at an agreed price. We have discussed the nature of an options contract in detail in the case of Rakhi Trading Private Limited vs. Securities and Exchange Board of India, Appeal no.70 of 2009 decided on October 11, 2010. Since the present appeal deals mostly with futures contracts, let us notice the parameters of such contracts before coming to the facts and issues involved in this case.

4. A futures contract is standardized by the stock exchange. All the terms of a futures contract like the stock/index to be traded in F & O segment, the expiry date of the futures contract, the contract size etc are determined by the stock exchange where the contracts are traded. The only constituent of the contract which is determined by the trading parties is the price of the contract. Unlike the options contract where the buyer has the right and not the obligation and the seller is under the obligation to fulfill the contract, in futures contracts both the buyer and the seller are under an obligation to fulfill the contract. If two investors agree to trade an asset in futures for a certain price there are obvious risks. One of the investors may regret and try to back out. Alternatively, the investor simply may not have the financial resources to honour the agreement. One of the key roles of the exchange is to organize trading so that contract defaults are avoided. Both the buyer and seller of the futures contracts are protected against counter party risk by an entity called the Clearing Corporation. The Clearing Corporation provides this guarantee to ensure that the buyer or the seller of futures contracts does not suffer as a result of the counter party defaulting of its obligation. To be able to guarantee the fulfillment of the obligation under the contract, the Clearing Corporation holds an amount as a security from both the parties. This amount is called the margin money and can be in the form of cash or other financial assets. NSE collects margins from the brokers which are recalculated six times a day on the basis of the

value of the underlying in the cash segment and the same or the differential is directly debited/credited to the broker's account. This margin has to be collected by the broker from the concerned client. The brokers are exposed to regulatory action if they fail to ensure adequate margins from their constituents. Unlike an options contract, both the buyer and the seller have potential to make unlimited gains or losses. The parties in the futures contract have the flexibility of closing out the contract prior to its maturity by squaring off the transaction in the market by closing the contract. Alternatively, a reverse position can also be taken i.e. a buyer can take a sale contract for the same scrip/contract for the same quantity, in which case, his obligation is squared off and he will only get the difference between the buy and sell price. It must be remembered that in F & O segment, only a contract is traded without involving any delivery of the underlying asset or change of beneficial ownership of the asset and all trades are settled in cash through the exchange mechanism.

5. The Board had been watching the nature of transactions occurring in derivative segment of capital market and a perusal of trading data of the F & O segment in NSE for the period January to March, 2007 revealed that the brokers were buying and selling almost equal quantities of contracts within the day and such buy/sell was synchronized in nature. The Board got alarmed. After preliminary examination into the trading in F & O contracts, the Board identified that certain entities including the appellant operating in the derivative segment had executed irregular and non-genuine trades and by an ad-interim ex-parte order dated June 18, 2007, the whole time member of the Board, directed under Sec 11D of the Securities and Exchange Board of India Act, 1992 (for short the Act) these entities including the appellant to cease and desist from indulging in the violations as noticed by the Board till further orders. The appellants were asked to file their objections, if any, within 15 days from the date of the order. Attention was also drawn to NSE's circular issued in March 2005 to brokers specifically advising them to desist from entering such transactions as detailed in the ad interim ex-parte order. The appellant filed a detailed reply to the ad interim ex-parte order on July 3, 2007 denying all the allegations and submitted that as a broker it had always exercised due care and diligence in its transactions carried out on behalf of its clients. It was pointed out that during the period of investigation, the appellant had undertaken 1,69,71,078 trades for 1,21,306 clients having a turnover of Rs. 1,11,659 crores out of which only 23 trades on behalf of 15 clients with a total close out difference (COD) of Rs. 35.44 lacs

(positive) had been called into question. The appellant also pleaded that in these 23 trades, 12 trades had a COD of less than Rs. 1 lac and in 5 trades the same was less than Rs. 2 lacs. While the ad-interim ex-parte order was pending finalisation, the Board issued another show cause notice to the appellant on October 5, 2007 under Rule 4 of Securities and Exchange Board of India (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 1995 charging it with violation of Regulations 3 and 4 of the FUTP Regulations and code of conduct prescribed under the Stock brokers Regulations for the same transactions mentioned in the ad interim ex-parte order. The appellant was asked to show cause why an enquiry should not be held against it and why monetary penalty, if any, be not imposed on it under sections 15-HA and 15-HB of the Act. The appellant again submitted a detailed reply denying its involvement in any manipulative trade in the F & O segment and detailing the steps it had taken to check suspicious trades in that segment including issuing necessary instructions to its employees to detect certain specified red alerts and sanitise the system against them and also to the clients cautioning them to desist from raising such alerts. The adjudicating officer, after considering the facts and circumstances of the case and the submissions advanced by the appellant and the material available on record, held the appellant guilty of aiding and abetting its clients in executing synchronized/matched/reverse trades in the F & O segment in violation of the provisions of FUTP Regulations and Stock brokers Regulations and by his order dated February 25, 2009, a monetary penalty of Rs.15,00,000/- was imposed on the appellant. The present appeal is directed against this order as also the ad interim ex-parte order dated June 18, 2007 qua the appellant.

6. Shri P.N Modi, the learned counsel for the appellant and Shri Kumar Desai, the learned counsel for the Board took us extensively through the records of the case in particular and trading patterns in F&O segment in general. We find that the appellant has been held guilty for executing 23 non-genuine and reverse trades on behalf of 15 clients in 21 futures and two options contracts on 22 different underlying scrips and one Banknifty futures. Of the 15 clients, 9 did only one trade each, 2 did 2 trades each and 3 did 3 trades each. The sum total of the COD in these 23 transactions has been only Rs. 35.44 lacs. Further, out of these 23 transactions, 17 have been carried out on-line by the clients through Internet and six transactions were executed at the broker's terminal on the instructions of the clients. For executing these transactions, the appellant has been held guilty of violating

Regulations 3 and 4 of the FUTP Regulations. Regulation 3 prohibits a person from buying, selling or otherwise dealing in securities in a fraudulent manner or using or employing in connection with purchase or sale of any security any manipulative or deceptive device in contravention of the Act, Rules or Regulations. Similarly, Regulation 4 prohibits a person from indulging in fraudulent or any unfair trade practices in securities which include creation of false or misleading appearance of trading in the securities market or dealing in a security not intended to effect transfer of beneficial ownership. Going by the nature of the transactions, we are unable to discern any whisper of evidence that the appellant had “aided and abetted” its clients in executing any manipulative trade or adopting any devious device to manipulate the market either in the derivative segment or in the cash segment. It is the Board’s case that trades had been reversed in many cases in a matter of minutes/seconds with significant difference between the buy and sell prices and the change took place without any significant change in the price of the underlying in the cash segment. This allegation proceeds on the assumption that the prices in the F & O segment must necessarily move in tandem with the prices/values of the underlying in the cash segment. Besides, according to the Board, in such reverse transactions one party had always booked profits and the other party had always booked losses and, therefore, the transactions were manipulative. We do not agree with the Board. The question whether the prices in the F & O market should necessarily move in tandem with the prices/values of the underlying in the cash segment came up for our consideration in Rakhi Trading’s case (supra) and we held that they need not necessarily move in consonance with each other. For the reasons recorded in Rakhi Trading’s case we hold that the trades impugned in this case cannot be described as manipulative on this ground. Again, the question of reversal of trades where one party continuously books profits and the other continuous losses came up for our consideration in Rakhi Trading’s case (supra) and we have held that such trades were executed for the purpose of tax planning and do not violate any rule of the game nor do they affect the market much less manipulate it. The gravamen of the charge(s) levelled against the appellant in paragraph 2 of the show cause notice dated October 5, 2007 read with Annexure A thereto is as under:-

“SEBI conducted an examination into the dealings in the futures and options segment of NSE, during the period from January to March 2007. It is alleged on the basis of the findings of the examination report that during the said period, you had executed non genuine transactions in collusion with certain clients and brokers in the futures and options segment of NSE. In this regard, it is alleged that you bought and sold almost equal quantity of contracts

within the day and such buy/sale was synchronized in nature. By executing the said trades, the original trades were closed out during the day at a price which was significantly above or below the price at which the first / original transaction was executed without significant variations in the traded price of the underlying security. It is alleged that synchronized/matched/close out transactions were executed in respect of various contracts with different underlying securities wherein one party had booked profit and the other party had booked loss as per the prior understanding between them. The above stated actions amount to non genuine trades and misuse of the stock exchange mechanism and are in violation of Regulations 3a, 3b, 3c, 4(1), 4(2)(a) and 4(2)(b) of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.”

Identical charge(s) was/were levelled against the appellant in Rakhi Trading’s case (supra) and for the detailed reasons recorded in our order of October 11, 2010 we hold that the aforesaid charge(s) against the appellant herein is/are not established.

7. The appellant before us which is a stock broker must also succeed for two additional reasons as well. The appellant is said to have executed 23 trades on behalf of its clients which were reversed between the same parties. Assuming that these trades were manipulative and had been executed by the clients with a premeditated plan, the fact still remains that the appellant only acted as a broker and carried out the directions of its clients which it ought to. Could the appellant be held liable merely because it acted as a broker? This question has come up for the consideration of this Tribunal time and again and this is what was held in *Kasat Securities Pvt. Ltd. vs. Securities and Exchange Board of India*, Appeal No. 27 of 2006 decided on June 20, 2006 wherein this Tribunal observed as under:-

“The trades, on the face of it, appear to be fictitious and we shall proceed on that assumption. It is obvious that these trades were executed by the clients and the appellant acted only as a broker. If the appellant knew that the trades were fictitious then there would be no hesitation in upholding the finding of the Board that it aided and abetted the parties to execute fraudulent transactions. Having heard the learned counsel for the parties and after going through the record we are satisfied that this link is missing. There is no material on record to show that the appellant as a broker knew that the trades were fictitious or that the buyer and the seller were the same persons. Trading was through the exchange mechanism and was online where the code number of the broker alone is known and the learned counsel for the parties are agreed that it is not possible for anyone to ascertain from the screen as to who the clients were. This is really a unique feature of the stock exchange where, unlike other moveable properties, securities are bought and sold between the unknowns through the exchange mechanism without the buyer or the seller ever getting to meet. Therefore it was not possible for the broker to know who the parties were. Merely because the appellant acted as a broker cannot lead us to the conclusion that it must have known about the nature of the transaction. There has to be some other material on the record to prove this fact. The Board could have examined someone from KIL to find out whether the appellant knew about the nature of the transactions but it did not do so. As a broker, the appellant would welcome any person who comes to buy or sell shares. The Board in the impugned order while drawing an inference that the appellant must have known about the nature of the transactions has observed that the appellant failed to enquire from its clients as to why they were wanting to sell

the securities. We do not think that any broker would ask such a question from its clients when he is getting business nor is such a question relevant unless, of course, he suspects some wrong doing for which there has to be some material on the record.”

In *Kishor R. Ajmera vs. Securities and Exchange Board of India*, Appeal No. 13 of 2007 decided on February 5, 2008 this Tribunal again observed as under:-

“Merely because two clients have executed matched trades, it does not follow that their brokers were necessarily a party to the game plan. On a screen based trading through the price order matching mechanism of the exchange, it is not possible for either of the brokers (or sub-brokers) to know who the counter party or his broker (or sub broker) is and when the trade is executed, their names or codes do not appear on the screen. A unique feature of the stock exchange is that, unlike other moveable properties, securities are bought and sold among the unknowns who never get to meet and they are traded at prices determined by the forces of demand and supply. If the Board is to hold the broker (or the sub-broker) responsible for a matching trade, it has to allege and establish that the broker (or the sub-broker) was aware of the counter party or his broker at the time when the trade was executed. There is no such allegation in this case.”

The aforesaid observations apply with full force to the facts of the present case because the trading system is the same, both in the cash segment as well as in the F&O segment. As already observed, even if we assume that the appellant’s clients had executed reverse trades with the same counter party for some mischief, we cannot impute knowledge of the same to the appellant when the anonymity of the trading system does not allow a broker to know who the counter party or counter party broker is. The screen based trading system provides complete anonymity and the trades are executed through the price order matching mechanism. In the instant case, no link other than broker client relationship between the appellant and its clients has been established, let alone any relation with the counter parties or the counter party brokers. Moreover, the appellant executed only 23 trades on behalf of 15 clients with a total close out difference of Rs. 35.44 lacs (positive) which have been called in question. Having regard to the fact that the appellant had executed 1,69,71,078 trades for 1,21,306 clients with a turnover of Rs. 1,11,659 crores during the investigation period we are of the view that in terms of materiality and substance this miniscule number of trades done on behalf of 15 clients were not likely to raise any alarm for the appellant with a client base of over 4,70,000 clients. In these circumstances, we cannot hold the appellant liable for the impugned trades.

8. The other additional reason for which we cannot hold the appellant liable is that out of the 23 impugned trades that it executed on behalf of its clients, 17 were executed directly

by the clients through the Internet. NSE by its circular of August 24, 2000 has set detailed guidelines on Internet based trading through order routing system which route client orders to the exchange trading system and the software for this service has to be in compliance with the parameters set by the Board. The appellant as a broker has very little direct control over such trades though it is recorded as a broker in those trades. Having regard to the total volume of trades executed by the appellant and the wide client base that it has, the learned counsel for the appellant was right in contending that the appellant could not be expected to put every single trade under its scanner on a continuous basis particularly those executed by the clients through the Internet and that the impugned trades being so miniscule, there was no occasion for the appellant to get a red alert. It is a fact that the clients had sufficient margins with the appellant with no credit defaults at any stage and that all the trades were settled in cash through the clearing system of the exchange. In this background, we find no evidence of lack of due diligence on the part of the appellant while executing the impugned transactions which could make him guilty of violating the code of conduct prescribed for the stock brokers. The charge must, therefore, fail.

9. Reference has been made in the impugned order to the circular of March 10, 2005 issued by NSE to its members the violation of which has been pressed as a charge against the appellant in the show cause notice and upheld in the impugned order. We have discussed the import of this circular in the case of Rakhi Trading Pvt. Ltd. (supra) and for the reasons stated therein we find no merit in citing this circular to establish the charge against the appellant. What we have observed in the case of Rakhi Trading Pvt. Ltd. holds good here as well. In this view of the matter the charge against the appellant must necessarily fail.

Appeal No. 214 of 2009

10. Prashant Jayantilal Patel, the appellant in this appeal is a member of NSE and registered as a stock broker with the Board. He is alleged to have undertaken 19 non-genuine reverse trades in options contracts for several clients including Rakhi Trading Pvt. Ltd. with a COD of Rs. 1,18,58,795. The adjudicating officer by his impugned order dated August 31, 2009 has imposed a monetary penalty of Rs. 22 lacs on the appellant for violating FUTP Regulations and the code of conduct prescribed for stock brokers. We have already examined the transactions of Rakhi Trading Pvt. Ltd. in Appeal no. 70 of 2009 decided on October 11, 2010 and held that the trades in options contracts executed by the appellant therein were not manipulative or fictitious as alleged. For the detailed reasons

recorded in our order of October 11, 2010 the charge against the appellant who was the broker in these transactions must also fail. The transactions undertaken by the appellant on behalf of other clients are squarely covered by the facts and circumstances in the case of Indiabulls Securities Ltd., the appellant in Appeal no. 51 of 2009. Whatever has been said hereinabove in Appeal no. 51 of 2009 equally applies to the case of the appellant in this appeal. We, therefore, hold that the appellant committed no market irregularity and the charges levelled against him as a broker for executing the impugned trades in the F&O segment cannot be sustained.

Appeal no. 168 of 2009

11. The appellant herein is another broker who is alleged to have executed 56 non-genuine reverse transactions with an aggregate COD of Rs. 33.6 lacs in 43 stock options in collusion with certain clients and brokers. The adjudicating officer by his impugned order dated May 22, 2009 has imposed a monetary penalty of Rs. 3 lacs for violating FUTP Regulations and the code of conduct prescribed for the stock brokers. Whatever has been said in the case of Indiabulls Securities Ltd., Appeal no. 51 of 2009 equally applies to the appellant herein.

12. For the reasons recorded above, the question posed in para 2 of this order is answered in the negative and we hold that the three aforesaid appellants have not aided and abetted their clients while executing the impugned trades on behalf of their clients in the F & O segment.

Appeal no. 57 of 2009

13. TLB Securities Pvt. Ltd. is the appellant in this appeal which is a market trader. It is alleged to have executed 10 reverse trades in futures contracts in respect of 10 different underlying scrips with different counter party clients. The trades are said to have been executed through a broker who was also a broker of the counter parties. The transactions took place during January – February 2007 and the COD in these trades was Rs. 38,69,650 (negative) with a total loss of Rs. 38.69 lacs. It is alleged that the appellant executed the reverse trades in a matter of minutes incurring a loss without any significant change in the value of the underlying security. The adjudicating officer has found the appellant guilty of violating the FUTP Regulations and by his order of March 16, 2009 imposed a monetary penalty of Rs. 10 lacs on the appellant. It is Board's case that the impugned transactions executed in the F&O segment by first determining the amount of loss that is sought to be

written off and then entering into trades and reversal of trades at prices that would give the desired loss is an abuse or misuse of stock exchange mechanism. The trades in this case were executed in similar circumstances as noticed by us in Rakhi Trading's case (supra) and for the detailed reasons recorded in our order of October 11, 2010 we hold that the trades in this case were only for tax planning and do not manipulate the market and nor are they fictitious or non-genuine. In this view of the matter, the charge against the appellant of violating Regulations 3 and 4 of the FUTP Regulations cannot be sustained.

In the result, all the appeals are allowed and the impugned orders set aside with no order as to costs.

Sd/-
Justice N.K.Sodhi
Presiding Officer

Sd/-
Samar Ray
Member

26.10.2010

Prepared and compared by
RHN/MSB