Regulatory Digest

May 03, 2023

'SYNC' OR SWIM: NAVIGATING THE LEGAL WATERS OF 'SYNC'HRONIZED TRADES IN INDIA

INTRODUCTION

The price discovery mechanism is the cornerstone of a modern stock exchange. The price of securities and assets at large, not only facilitate efficient trade but also act as a barometer of the economy. This price discovery mechanism of stock exchanges works on the blind trading characteristic of a stock exchange wherein the buyers and sellers generally do not have any direct interaction and the exchange acts as a market maker. The trade matching system on a price-time priority basis of stock exchanges ensures that a security cannot be sold / bought from any specifically identified person on the exchange, therefore enabling price discovery.

However, there have been instances of collusion between parties wherein such parties place identical buy/sell trades at identical times with their broker, thereby causing a disruption of the price discovery mechanism. This, at times, leads to artificial inflation in the trade volume of the security and a drastic change in the price of the security (increase/decrease depending on the intention of the parties involved). Furthermore, in case such trades are executed between group entities, there is in fact no transfer of beneficial ownership of the traded securities.

Unfortunately, synchronized trades time and again show their faces in the financial markets. In such a trade, two or more traders coordinate their buying and selling activities to take advantage of and influence the market conditions. Simply put, synchronized trades, also globally known as wash trades, are transactions wherein the buyer and seller (often related parties / group entities) repeatedly execute trades between themselves for a particular scrip(s) at the same / similar quantity and price with the intent of artificially boosting the price / volume of the scrip traded.

This issue of the regulatory digest aims to cover the basics of synchronized trades, including the factors to consider when identifying them (which has been debated among regulators, market participants, and legal experts) and the evolving legal framework in India.

FORMS OF SYNCHRONIZED TRADES

Commercially, synchronized trades may be undertaken in various manners, including:

1. Reversal trades: Areversal trade entails a transaction wherein an entity reverses its buy / sell position with the same counter party on the same day, thus, creating an illusion of trading, and artificially boosting trading volumes so as to attract genuine investors to buy into and exit positions where the securities have a high trading volume. Such trades are typically observed in highly illiquid markets, where a small party may influence the price / volume of securities.
2. Circular trading:Occurs when two or more persons collude to trade a particular stock in a circular manner, such that the ultimate beneficial ownership of the stock rests with the person who initiated the trades.
3. Cross deals:Cross deals occur when two parties, a buyer and a seller, have a common third-party trading member (usually the same broker) executing their trades. Collusion between all three parties can cause synchronized trades if the orders are executed at similar prices, quantities, and times. These cross deals may also involve more than one buyer and one seller, provided that the same broker is used for all parties involved.

INDIAN LEGAL FRAMEWORK

Securities and Exchange Board of India ("**SEBI**") has been accorded wide powers under the SEBI Act, 1992 ("**SEBI Act**")[1] to ensure the fair functioning of the securities markets in the country. As the watchdog of the nation's bourses, SEBI takes enforcement action against those who violate the integrity of the market by indulging in synchronized trades with the intent of price / volume manipulation.

Although India currently does not have specific legislations governing synchronized trades, the SEBI Act read with the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 ("**PFUTP Regulations**" or the "**Regulations**")[2] govern and restrict fraudulent, manipulative and unfair trade practices in India, including instances of synchronized trades. The SEBI Act prohibits persons from engaging in manipulative and deceptive devices while dealing with any securities listed or proposed to be listed on a recognized stock exchange[3].

PFUTP Regulations

The PFUTP Regulations provide the primary legal framework governing synchronized trading in India. The PFUTP Regulations prohibit persons from directly or indirectly dealing in securities in a fraudulent manner, using any manipulative or deceptive device that compromises market integrity, utilizing any device, scheme or artifice in the listed market with the intent to defraud, or undertaking any activity that may fall under the umbrella of fraud or deceit

Research Papers

Compendium of Research Papers
January 11, 2025

FAQs on Setting Up of Offices in India
December 13, 2024

FAQs on Downstream Investment
December 13, 2024

Research Articles

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals
January 15, 2025

Key changes to Model Concession Agreements in the Road Sector
January 03, 2025

The Revolution Realized: Bitcoin's Triumph
December 05, 2024

Audio

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice
December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps
November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I
August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FII8 event in Riyadh
October 31, 2024

Analysing SEBI's Consultation Paper

in relation to a listed security[4].

Further, the Regulations also prohibit manipulative, fraudulent, and unfair trade practices in the securities market,[5] with specific provisions prohibiting transactions undertaken, inter alia, (a) to create a false or misleading appearance of trading in the market, (b) without the intention to change a security's beneficial ownership, with the sole purpose of inflating, depressing, or causing fluctuations in the price of the security for wrongful gain or avoidance of loss, (c) without the intention of performing such a transaction or changing the ownership of the security, or (d) circular transactions of a security between parties to artificially create a false impression of trading or manipulate the security's price.[6]

In addition to the above, the PFUTP Regulations empower SEBI to investigate cases where there are reasonable grounds to believe that transactions in securities may be detrimental to investors or the securities market and are in violation of the PFUTP Regulations, or where any intermediary or person associated with the securities market has violated the provisions of the SEBI Act, rules, or regulations.[7]

Penalty for synchronized trade

Given that India does not have a specific regulation governing synchronized trades, penalties for such trades are derived from provisions under the SEBI Act which levy penalties for fraudulent and unfair trade practices. The SEBI Act stipulates a minimum penalty of five lakh rupees and a maximum penalty of the higher of twenty-five crore rupees or three times the amount of profits made from such practices.[8]

Evolution of Jurisprudence

Owing to the lack of clear statutory provisions governing the issue, the jurisprudence related to synchronized trading has continuously evolved over the past two decades.

Until 2017, there was significant discrepancy as to the principles to be followed when assessing alleged instances of synchronized trades. There were conflicting judicial decisions, and it was up to the discretion of the adjudicating officers and the courts to determine whether a breach under Section 12A of the SEBI Act read with Regulation 4(2) of the PFUTP Regulations had occurred. After significant debate and intervention from the Government of India, SEBI approved a policy on May 16, 2017[9] ("**EAP**") that set out the principle to determine when synchronized trading would be illegal. The principle has been referred to in various SEBI / Securities Appellate Tribunal ("**SAT**") orders and states that synchronized trades, where done with the intent to manipulate or defraud the market, would be illegal under the applicable laws. Under the EAP, the adjudicating body had to, inter alia, look into various factors, including the intent of the parties undertaking the trade so as to determine whether the same was carried out with a mala fide intent, classifying such non-genuine trades as illegal. The EAP, on the examination of provisions applicable to self-trades i.e. 4(2)(a), (b) and (g) of PFUTP Regulations, 2003, concluded that "intention is a sine qua non for establishing manipulation in case of self-trades and accidental/unintentional self-trades are not covered under the said regulations." Thus, the EAP causes the concerned adjudicating body to undertake an assessment of the matter based on the intent and in consideration of supporting evidence.

The Indian judicial and quasi-judicial bodies have also, over the years, evolved the principle that the volume /frequency / value of the transactions, whether the transactions involve circular trading; what are the prevailing market conditions; and whether there is any real change in the beneficial ownership of the traded securities; should be factored in to determine the genuineness of any transaction. The courts have further noted that such factors are indicative, and an exhaustive list cannot be set out[10]. Thus, it should not be incorrect to say that an inadvertent synchronized trade, with no malafide intention and not affecting the price or volume of the scrip, would not be deemed to be a prohibited wash-trade[11] in India. However, it should be noted that the adjudicating officers and the courts have also passed conflicting orders in this respect.

Synchronized trades in the Future and Option Segment

The Future and Option Market ("**F&O Market**") is one wherein the derivative instruments are traded in lots.

In the matter of synchronized trading in the F&O Market, the case of SEBI v. Rakhi Trading (P) Ltd.,[12] provides a holistic overview on the same. In this case, it was observed that there was a reversal of trades in the Nifty futures segment between three parties in a synchronized manner at a price that wasn't in line with the market. Such repeated wash trades caused the issuance of show cause notices to the concerned trades and their brokers. SEBI, while adjudicating the case, opined that such wash trades were non-genuine and were undertaken with the sole intention of tax planning, thereby, levying penalty on all the parties.

The SAT reversed the SEBI decision on appeal and observed that as the parties were trading Nifty futures, which is an index of the largest Indian companies by market capitalization, the same could not be manipulated or influenced. Thus, in the absence of market manipulation, the traders and the broker could not be held liable under the PFUTP Regulations. It is also to be noted that SAT accepted two additional contentions of the broker, viz. (i) clients of the brokers matching trades does not ipso facto entail that the broker has colluded in the alleged non-genuine transaction(s); and (ii) the broker was not actively involved in the transaction as the majority of them were conducted over the internet.

Ultimately, the Hon'ble Supreme Court overruled the SAT decision and held that the respondents were engaged in non-genuine transactions creating an appearance of trading. It was observed that SEBI's role as the market regulator was to maintain market integrity and not limited to preventing market manipulation – the former awards SEBI a much wider scope and a more active role as the regulator of the India's securities markets. Relying on the judgement of SEBI v. Kishore R Ajmera,[13] the Apex Court observed that the market integrity could be comprised by direct and indirect factors, thus, bringing the F&O Markets into the fold. Further that the trades were purposefully conducted at a loss by the three traders were at odds with the concept of market integrity and affect genuine traders in the F&O Market; it was stated that the market manipulation was not a sine qua non for wash trades to be considered illegal.

The Apex court dismissed the SEBI allegation against the brokers as SEBI was unable to evidence any connivance on the part of the brokers and also remarked that a mere facilitation of such trades by brokers does not taint them with

on Simplification of registration for FPIs
September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996
September 22, 2024

the guilt of illegal trading.

Synchronized trades in algorithmic trading

SEBI defines algorithmic trading ("**algo trading**") as "any type of automated rule-based trading where decision making is delegated to a computer model."[14] Algo trading significantly increases the possibilities of unintentional or genuine self-trades due to the absence of human intervention. The algo trading model executes buy / sell transaction on the basis of pre-fed algorithm/s, generally, at high frequencies. It is pertinent to note that both the BSE and SEBI's Secondary Market Advisory Committee have stipulated that wash / self-trades could be possible in a scenario wherein multiple algo orders of the same broker get matched without any intent of self-execution or creation of artificial volume or manipulation, i.e. a case of genuine transaction.[15]

The interplay of algo trading and wash trades has been considered by the SEBI and discussed in its order in the matter of Crosseas Capital Services Pvt. Ltd., 26.07.2018, where the trading entity viz. Crosseas was also acting as its own broker. The entity had executed certain trades using algo trading strategy, which had matched, resulting in occurrence of synchronized trades. The entity in this case contended that the self-trades in question were purely accidental, resulting from ultra-high frequency intended arbitrage trading (simultaneous buying and selling of securities) which was done through approved algo trading software. It also contended that internal matching had happened on account of the latency factor in the system of algo trading whereunder the system places orders at 'Ultra High Frequency' and there is latency on account of lease line distance as well as drop of packets in the leased lines, due to which some of the trades may have rarely and accidentally matched internally in an automatic way.

Accepting this contention, the adjudicating authority observed that the instances of self-trades alleged in the case were merely an occurrence resulting from genuine trading strategies in the liquid and volatile scrip at the relevant time. The 'self-trade' in question was, thus, held to be purely accidental/incidental in the ordinary course of business.

The order delves deep into the nature of algo trading and sets out certain crucial yardstick to determine instances of wash trades in this context, being: a) whether self-trades result in creation of artificial volumes in terms of higher contribution to either total volumes or substantial volume for the days traded?; b) whether the buy and sell orders for the alleged self-trades have been placed from same terminal or different terminal in case self-trades are executed through same brokers?; c) whether the buy and sell orders for the alleged self-trades were also structured in terms of time, order quantity and price when self-trades were executed through different brokers?; and d) whether the self-trades have resulted in new high price and thereby contributed to price manipulation? Thus, these factors should thus play operative role when instances of synchronized trades from algo trading emerge.

Broker liability

In line with the Hon'ble Supreme Court's rulings in Rakhi Trading[16] and Kishore Ajmera[17], there have been other cases as well which provide higher threshold for brokers than mere knowledge of such trades for the purposes of ascertaining a broker's liability. In the matter of Kasat Securities (P.) Ltd. v. SEBI[18], it was observed that although the broker had knowledge of the alleged fictitious trades, the broker was not in a position (nor was SEBI to evidence that) he had knowledge of the lack of change in the beneficial ownership due to trades or that such trades were non-genuine.

Thus, it may be inferred that, in order to hold a stock broker liable for facilitating non-genuine trades, it must be evidenced that (i) the broker was in knowledge that the transaction was non-genuine, and (ii) the broker facilitated such transactions. Further, additional evidence underscoring the broker making a monetary gain, i.e. the broker being compensated for facilitating the non-genuine trades could substantially strengthen a plea to hold brokers liable in such cases.

GLOBAL OUTLOOK

The risk of fraudulent wash trades exists in exchanges around the world. In order to identify global best practices, it is important to understand the legal framework governing synchronized trades in other relevant jurisdictions. Thus, below is a brief overview of the regulatory framework in the United States ("**US**") and United Kingdom ("**UK**")

US

In the US, wash trading has been defined as, "purchases and sales of securities that match each other in price, volume and time of execution, and involve no change in beneficial ownership."[19]

The Securities Exchange Act of 1934 prohibits practices of market manipulation undertaken, inter alia, including (a) transactions involving no change in the beneficial ownership of the security, or (b) entering purchase order(s) for a security with a prior knowledge that substantially similar order(s) has / have been or will be entered by or for the same or different parties, or (C) entering sale order(s) for a security with the knowledge that substantially similar purchase order(s) has / have been or will be entered by or for the same or different parties. Further, transactions in securities creating an actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others has also been prohibited.

The Commodity Exchange Act, 1936 ("**CEA**") also prohibits wash trades in commodity futures and option markets[20] under Section 4c(a) of the CEA, which prohibits trading practices that are disruptive to fair and equitable trading. Additionally, the Commodity Futures Trading Commission ("**CFTC**") has issued rules specifically prohibiting wash sales,[21] and other forms of noncompetitive trading[22] in the futures markets.

UK

In the UK, the Financial Conduct Authority ("**FCA**") regulates financial markets and has rules in place to prohibit wash trading. The relevant legal provisions governing wash trading in the UK are contained in the Market Abuse Regulation ("**MAR**") and the Financial Services and Markets Act 2000 ("**FSMA**").

Wash trades have been considered to be manipulating transactions which amount to market abuse and false or misleading impressions. MAR defines the concept of wash trading as, "a sale or purchase of a qualifying investment where there is no change in beneficial interest or market risk, or where the transfer of beneficial interest or market risk is only between parties acting in concert or collusion, other than for legitimate reasons."[23] Notably, market manipulation is a criminal offence in the UK and is punishable by imprisonment or a fine.[24]

In addition to MAR, the FCA also has rules on wash trading under the FSMA. The FSMA prohibits market manipulation, including wash trading, and gives the FCA the power to take enforcement action against those who engage in such practices. The FCA can impose fines and other sanctions, including banning individuals from working in the financial industry.

CONCLUSION

The current position of law does not make synchronized trade per se illegal in India. However, as discussed, there are multiple factors that need to be taken into account by an adjudicating authority to determine the legality, or lack thereof, of a synchronized trade. Presently, the foremost factor the regulators investigate, prior to determining whether an act of trading is unlawful, is the intent of such trades. Further, there are multiple systems put in place with the objective of preventing any ill-intentioned transactions in the stock market. For example, the National Stock Exchange of Indian Limited[25] ("**NSE**") and the Bombay Stock Exchange[26] ("**BSE**") have implemented self-trade prevention check mechanisms in furtherance of their duties as first level regulators. Such prevention mechanisms that are built into the stock exchanges tend to provide requisite comfort to the genuine investors.

Nonetheless, the critique that remains in this regard is the unwarranted NSE / BSE / SEBI enforcement action/s for alleged self-trades against the trading members engaged in algo or high frequency trading, especially in light of the fact that various judgments / orders have envisaged that in cases of bona fide trades, the allegation of wash / self-trades should not hold water under the PFUTP Regulations or the SEBI Act.[27]

– Ritul Sarraf & Prakhar Dua

You can direct your queries or comments to the authors

We acknowledge and thank Athul Kumar, Student, Symbiosis Law School, Pune for his assistance on this digest.

---

[1]Available at https://www.sebi.gov.in/legal/acts/jan-1992/securities-and-exchange-board-of-india-act-1992-as-amended-by-the-finance-act-2021-13-of-2021-w-e-f-april-1-2021-_3.html

[2]Available at https://www.sebi.gov.in/legal/regulations/jan-2022/securities-and-exchange-board-of-india-prohibition-of-fraudulent-and-unfair-trade-practices-relating-to-securities-market-regulations-2003-last-amended-on-january-25-2022-_55604.html

[3]Section 12A of the SEBI Act

[4]Regulation 3 of PFUTP Regulations

[5]Regulation 4(1) of PFUTP Regulations

[6]Regulation 4(2) of PFUTP Regulations

[7]Regulation 5 of PFUTP Regulations

[8]Section 15 HA of SEBI Act

[9]Enforcement Action Policy, Approved Policy Number EFD/DRA3/ON332/2017), May 16, 2017. At the time of publication of this article, the authors have been unable to find the EAP in the public domain.

[10]Ketan Parekh v SEBI, SCC Online SAT 221

[11]SEBI order in Manasvi Consultancy Pvt. Ltd. In the matter of The Byke Hospitality Limited, 26.02.2018

[12]SEBI v. Rakhi Trading (P) Ltd., (2018) 13 SCC 753.

[13]SEBI v. Kishore R Ajmera, 2016 SCC OnLine SC 179

[14]Measures for Strengthening Algorithmic Trading Framework, SEBI

https://www.sebi.gov.in/sebi_data/meetingfiles/apr-2018/1524113320566_1.pdf

[15]In the matter of Shilpi Cable Technologies Ltd and Another, 2020 SCC OnLine SEBI 650.

[16]ibid.

[18]ibid

[19]Kasat Securities (P.) Ltd. v. SEBI, [2008] 87 SCL 275 (SAT - Mum.).

[20]In the Matter of Carole L. Haynes, Administrative Proceeding File No. 3-8512, Available at: https://www.sec.gov/litigation/aljdec/id78grl.txt

[21]Section 4c(a) of the Commodity Exchange Act

[22]17 CFR § 1.38 - Execution of transactions

[23]17 CFR § 1.41 - Designation of hedging accounts

[24]MAR 1.6.2

[25]Financial Services Act, 2012

[26]Prevention of Self-trade, NSE circular no. NSE/CMTR/30879, NSE/CMTR/30879

[27]Self-trade Prevention Check for Equity Derivatives & Currency Derivatives segments – FAQs, BSE Notice No. 20150127-30, January 27, 2015.

[28]Order in respect of AKG Securities and Consultancy Ltd. and Adroit Financial Services Pvt Ltd in the matter of Bharatiya Global Infomedia Ltd., WTM/SKM//EFD1-DRAIII/09/2019-20