



Discussion on proposed regulations on prohibition of unexplained suspicious trading activities in the securities market

Background

- Contraventions of securities laws undermine market integrity (manipulation, fraud, unfair trade practices, insider trading, front running, pump and dump).
- SEBI's main role is protecting investor interests through effective enforcement of securities laws.
- Market participants increasingly use new-age technology and novel methods to commit fraud while hiding their identities and relationships.
- SEBI's surveillance detects insider trading and front running, but innovative, encrypted communication and complex funding arrangements make establishing probability challenging.
- SEBI follows the "preponderance of probability" principle to hold violators accountable.
- Gathering conclusive evidence and proving fraudulent activities becomes difficult



Concept of Preponderance of Probability (POP)

What is Preponderance?

- Preponderance is the degree of cogency required to discharge a burden in a civil case - *Denning, J., in Miller v. Minister of Pensions, (1947) – House of Lords*
- “**Preponderance**”, literally interpreted, means nothing more than an outweighing in the process of balancing however slight may be the tilt of the balance or the preponderance - *Beg J. in of Rishi Kesh Singh and Ors. vs The State – Allahabad High Court - 18 October, 1968 – 9 Judge Bench*



Concept of Preponderance of Probability (POP)

- **Charles R. Cooper v. F.W. Slade [(1857-59) 6 HLC 746] House of Lords** - “preponderance of probability” means is “more preponderance probable and rational view of the case”.
- **Section 3, Indian Evidence Act, 1862** – “Proved”: – A fact is said to be proved when, after considering the matters before it, the Court either believes it to exist, or considers its existence so probable that a prudent man ought, under the circumstances of the particular case, to act upon the supposition that it exists.
- **Rishi Kesh Singh and Ors. vs The State (Supra) –**
 - ✓ Proved
 - ✓ Disproved – Non-Existence of circumstances as proved until disapproved
 - ✓ Not Proved – Neither Proved nor disproved



Concept of Preponderance of Probability (POP)

■ Narayan Ganesh Dastane vs Sucheta Narayan Dastane

When the court either believes it to exist or considers its existence so probable that a prudent man ought, under the circumstances of the particular case, to act upon the supposition that it exists. ***Hon'ble Supreme Court of India, 19.03.1975, Civil Appeal No. 2224 of 1970***

■ As per Black's Law Dictionary

“The greater weight of the evidence, not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other. This is the burden of proof in most civil trials, in which the jury is instructed to find for the party that, on the whole, has the stronger evidence, however slight the edge may be. — Also termed preponderance of proof; balance of probability.”



Preponderance of Probability (POP) – Securities Law

- **SEBI vs. Kanaiyalal Baldevbhai Patel & Ors, SC, 20.09.2017**—The Supreme Court in Kanhaiyalal Patel (supra) held that an inferential conclusion from proved and admitted facts would be permissible and legally justified so long as the same is reasonable.
- **Hanumant vs. State of Madhya Pradesh [AIR 1952 Supreme Court 343]** : The Supreme Court has held that In dealing with circumstantial evidence the rules specially applicable to such evidence must be borne in mind. In such cases there is always the danger that conjecture or suspicion may take the place of legal proof. It is well to remember that in cases where the evidence is of a circumstantial nature, the circumstances from which the conclusion of guilt is to be drawn should in the first instance be fully established, and all the facts so established should be consistent only with the hypothesis of the guilt of the accused. Again, the circumstances should be of a conclusive nature and pendency and they should be such as to exclude every hypothesis but the one proposed to be proved. In other words, there must be a chain of evidence so far complete as not to leave any reasonable ground for a conclusion consistent with the innocence of the accused and it must be such as to show that within all human probability the act must have been done by the accused.



Preponderance of Probability (POP) – Securities Law

- **Sterlite Industries (India) Ltd. v. SEBI (2001) 34 SCL 485 (SAT)** - Evidence merely probabalising and endeavoring to prove the fact on the basis of preponderance of probability is not sufficient to establish such a serious offence of market manipulation. When such a serious offence is investigated and the charge is established, the fall out of the same is multifarious.
- **Chintalapati Srinivasa Raju vs Securities and Exchange Board of India [(2018) 7 SCC 443]** – The Supreme Court has held that a reasonable expectation to be in the know of things can only be based on reasonable inferences drawn from foundational facts.



EXAMPLES CITED BY SEBI

- **Suspected front-running case:** Technology used to destroy evidence, conceal identities, and avoid detection. Encrypted messaging apps erased wrongdoing evidence. Unrecorded calls hindered establishing connections. SEBI struggled to gather evidence for front-running despite seizing devices.
- **Suspected entities built long positions in listed company prior to the announcement** of financial results, resulting in significant profits. Indirect connections to an insider were observed, but concrete evidence of communication of undisclosed price-sensitive information (UPSI) was lacking. It was difficult to establish violations of regulatory frameworks.
- **Prior to the financial results, two suspected entities built long positions in a scrip.** After the results, they closed their positions, earning significant profits. The trading pattern indicates possible insider trading, but establishing concrete evidence of communication and bank transfers was challenging.



DIFFICULTIES FACED BY SEBI IN DETECTING FRAUDS

- Lack of evidence and difficulty in establishing communication of material non-public information or connections between suspected entities hinders legal scrutiny. (Para 2.8, Page 13)
- In 2022, SEBI's new alert generation models produced around 5,000 alerts involving 3,588 unique entities. (Para 2.9, Page 13)
- Only 97 entities appeared repeatedly in 5 or more alerts, indicating suspicious trading patterns. (Para 2.9, Page 13)
- Most entities identified in alerts couldn't be acted upon due to the inability to establish connections/communications. (Para 2.9 and 2.10, Page 13)
- Approximately 60% of detailed investigation cases couldn't proceed due to insufficient evidence of information communication. (Para 2.9, Page 14)
- Even in the remaining 40% of cases, establishing communication of material non-public information proves challenging due to varying evidentiary requirements. (Para 2.9, Page 14)
- Probability of executing repetitive fraudulent trades is very low considering the large number of daily trades (1.5 - 2 crore) in the equity market. (Para 2.10, Page 14)



RELIANCE PLACED ON LEGAL PROVISIONS – DOMESTIC AND INTERNATIONAL

Deeming provisions and presumptions

Section 68 of the Income Tax Act, 1961, provides a presumption as to the income of an assessee, if the assessee offers no explanation about the source and nature of the cash credits found in the books of the assessee or the explanation offered by the assessee, in the opinion of the Assessing Officer, is not found satisfactory.

Section 11 of the Securities Act 1933 of the United States of America imposes liability upon the parties involved in securities offering if the registration statement contains a materially false statement or there is material omission.



OUTLINE OF THE PROPOSED REGULATORY FRAMEWORK:

Unexplained Suspicious Trading Pattern

repetitive abnormal gainful dealings in a security or a set of securities, around the presence of Material Non-Public Information, would be deemed to be violating the securities laws, unless they are able to effectively rebut the said presumption.

Unusual Trading Pattern (UTP) –

- shall mean and include such repetitive pattern of trading activity by a person or a group of connected persons:
- which involves a substantial change in risk taken in one or more securities over short periods of time;
- which consequently delivered abnormal profits or averted abnormal losses.

Deemed UTP –

- Instances exist where the trading pattern of a single person or a group of persons, which may appear normal in isolation, exhibit unusual trading patterns (UTP) when analyzed holistically. Such trading activity is also considered Deemed UTP.



OUTLINE OF THE PROPOSED REGULATORY FRAMEWORK:

Material Non-Public Information (MNPI) –

- Information about a company or security, which was generally not available, and upon becoming generally available had reasonable impact on the price of the securities of the company; or information about any impending order in a security, which when executed reasonably impacted the price of that security.
- Information about an impending recommendation, advice by name, etc., in a security, by an influencer, to the public/ followers/ subscribers, etc., and which when became generally available to the public / followers / subscribers, reasonably impacted the price of that security.

Suspicious Trading Activity (STA) –

- A person or a group of connected persons, if found to be exhibiting UTP, in a security or a group of securities, where such UTP coincides with Material Non-Public Information in relation to that security or group of securities, such UTP will be deemed to be Suspicious Trading Activity (STA).

STA = UTP + Existence of MNPI



OUTLINE OF THE PROPOSED REGULATORY FRAMEWORK:

Rebuttal by the persons charged under the Regulations –

The persons may rebut the allegations by demonstrating that the trading activities were not suspicious.

Such rebuttal may include, but not be restricted to, any of the following,

1. Information doesn't meet the test of MNPI;
 - Trades were not based on information that was material;
 - Trades were not based on information that was not available in the public domain prior to / in the vicinity of trading activity undertaken
2. Trading pattern was not repetitive;
3. Trading pattern does not exhibit substantial change in risk taken;
4. Period for which trading was undertaken, cannot be categorized as a short period of time;
5. Trading activity did not deliver abnormal profits or avert abnormal losses;



OUTLINE OF THE PROPOSED REGULATORY FRAMEWORK:

Unexplained Suspicious Trading Activity (USTA)

- A person or group of connected persons, being called upon to explain the STA exhibited by them, are not able to effectively rebut or provide explanation, then such trading activity will deem to be an Unexplained Suspicious Trading Activity (USTA).

USTA = STA + (Absence of effective rebuttal /
explanation)





Discussion on Consultation Paper on Foreign Portfolio Investments (FPI)

What are Foreign Portfolio Investor's?



➤ Foreign Portfolio Investment (FPI) refers to the purchase and holding of a wide array of foreign financial assets by investors seeking to invest in a country outside their own.

➤ Foreign portfolio holders have access to a range of investment instruments such as stocks, bonds, mutual funds, derivatives, fixed deposits, etc.

➤ In India, FPI is regulated by the Securities and Exchange Board of India (SEBI).



Classification of FPIs- Current Scenario

FPIs are currently classified into 2 categories-

Category-I includes-

1. Eligible investors: government-related entities, pension funds, university funds, and regulated financial entities.
2. Appropriately regulated entities such as insurance or reinsurance entities, banks, AMCs, investment managers, investment advisors etc.
3. Entities from FATF member countries with registered managers are allowed.

Category-II includes-

1. Appropriately regulated funds not eligible as Category-I foreign portfolio investor;
2. Endowments and foundations
3. Charitable organizations
4. Corporate Bodies
5. Family Offices
6. Individuals
7. Unregulated funds in the form of limited partnerships and trusts



What are Designated Depository Participants and their Role?

Custodian of
securities registered with SEBI

Empowered to register and certify
foreign portfolio investors on behalf of
SEBI

Ensure that only registered foreign portfolio
investors are allowed to invest in the securities
market

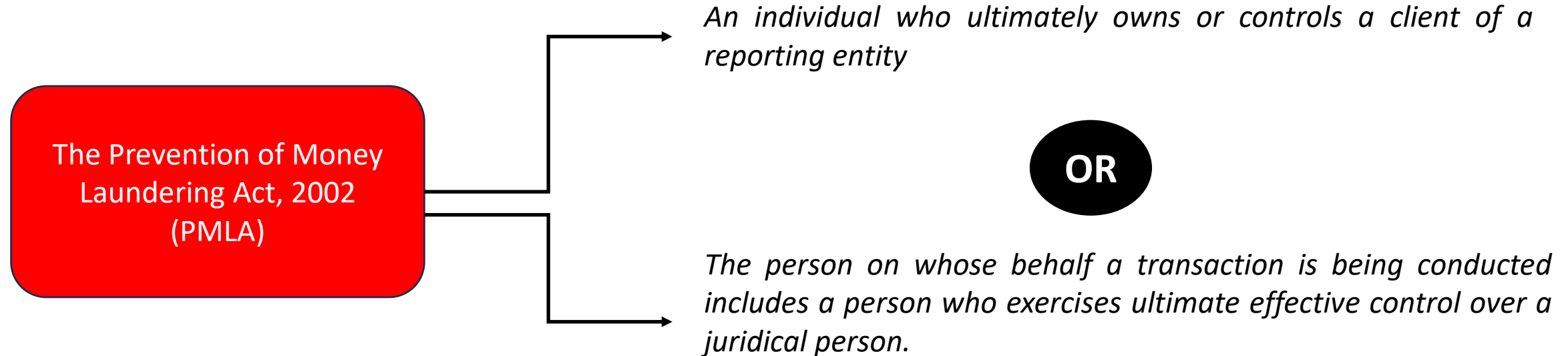
Shall perform KYC due diligence
for each of the joint holders;

One of the KYC requirements is to Identify and Verify Beneficial Owners of the FPI

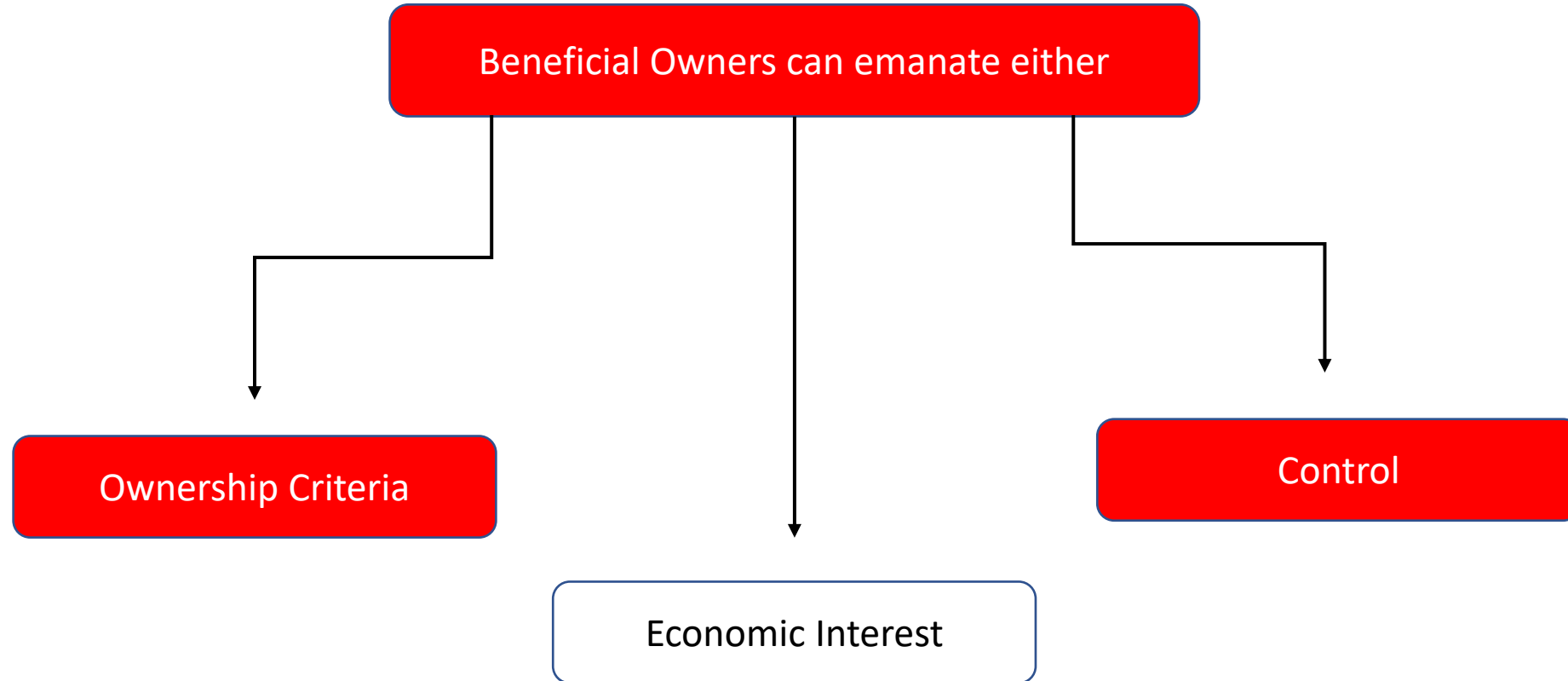


"Existing Regulations on Disclosure of FPI's BO

In India, the Prevention of Money Laundering Act, 2002 ('PMLA') and the Prevention of Money Laundering (Maintenance of Records Rules), 2005 (PML Rules) provide the framework for identifying the Beneficial Owners (BO) of legal entities:



Existing Regulations on Disclosure of FPI's BO



"Existing Regulations on Disclosure of FPI Ownership, Economic Interest, and Control"

Under the PML Rules, the Procedure to identify the BO are discussed below-

1st Stage

The materiality Threshold is first applied in the FPI Level.



2nd Stage

If entities exceed the materiality threshold at the FPI Level then FPI leads to the identification of BO on a look-through basis until reaching natural person BO at the end of the chain.



When, no natural person is identified, then BO is the relevant natural person who holds the position of Senior Managing Officer (SMO)

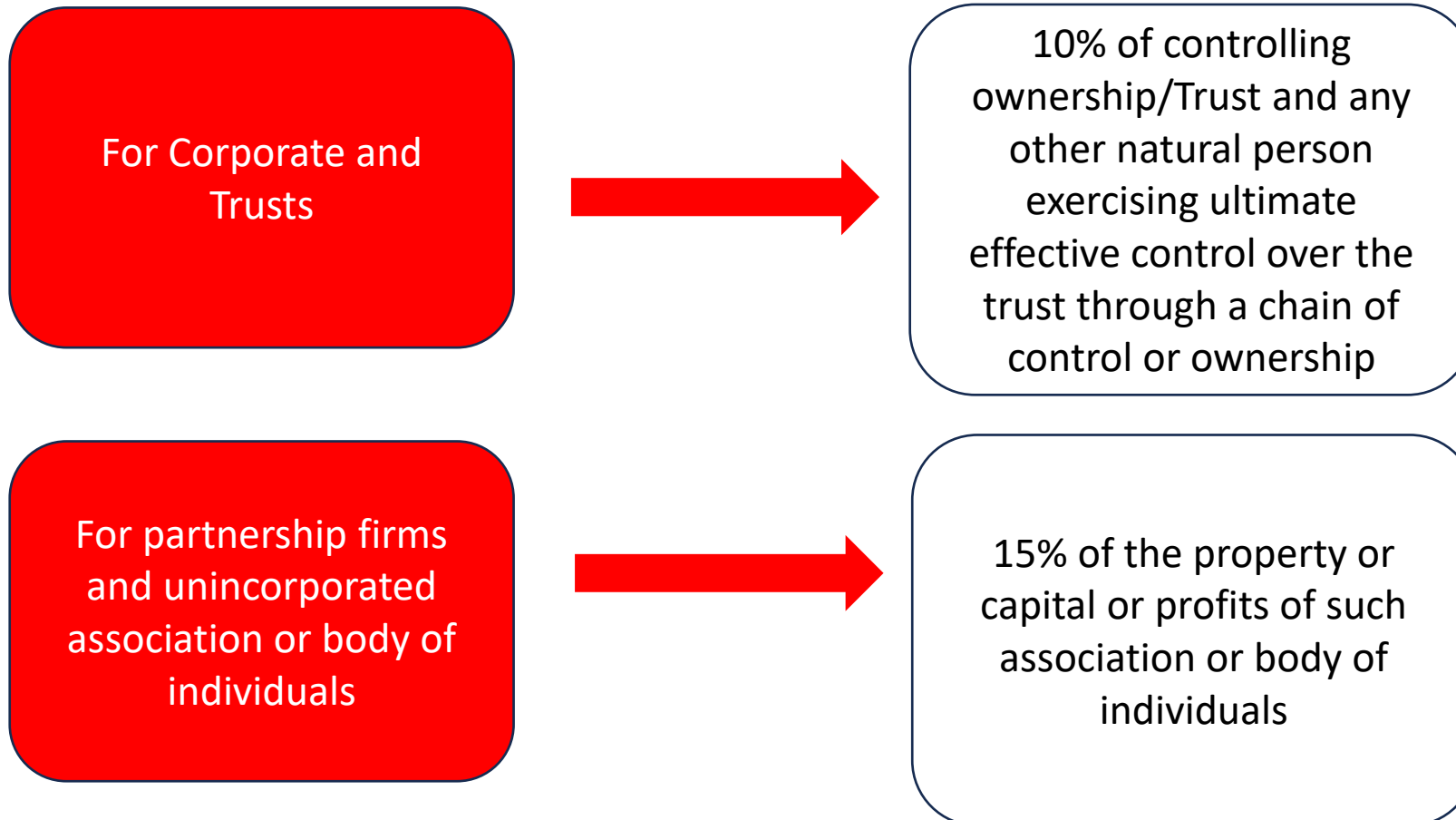


Any changes occurring during the whole procedure will have to be informed to the Designated Depository Participants (DDPs) by the FPIs.



Existing Regulations on Disclosure of FPI's BO

Thresholds for identifying beneficial owners (BOs) of legal entities based on ownership or entitlement to capital or profits are specified in Rule 9(3) of the PML Rules*



Potential Issues flagged by SEBI

Circumventing MPS Norms.

1. Disclosure of beneficial ownership should not be limited by any materiality thresholds, particularly in the case of high-risk Foreign Portfolio Investments (FPIs).
2. The same natural person holds an aggregate economic interest in the FPI through various investment entities, none of which individually exceed the materiality threshold for identification of BO.

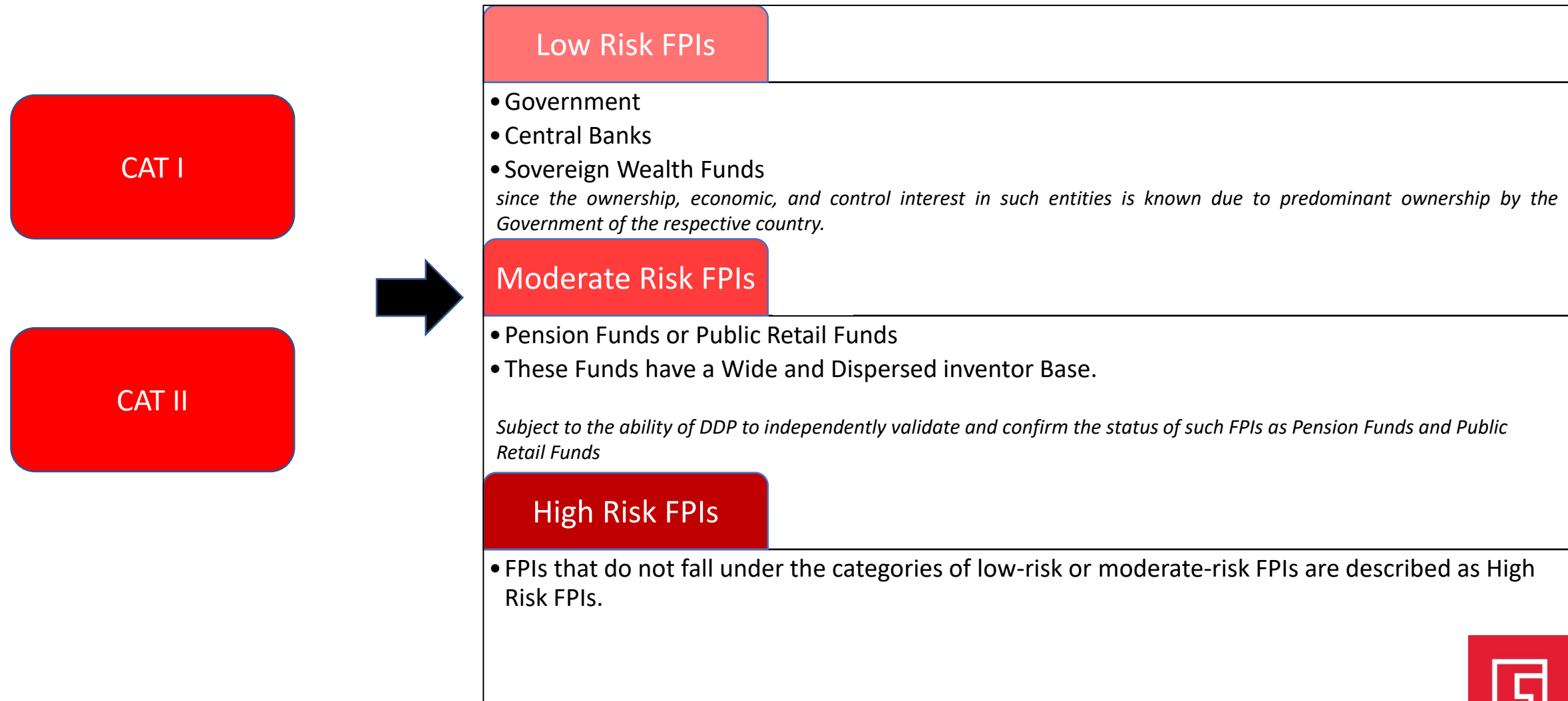
Press Note 3

1. Press Note 3 mandates that FDI from neighboring countries sharing a land border with India, or where the beneficial owner is a resident of a country sharing a land border with India, must invest only through the government route, regardless of the original entry route.
2. Press Note 3 was initially introduced as a measure to prevent opportunistic takeovers of stressed and strategic assets or entities in response to the impact of the COVID pandemic.



Classification of FPIs- Proposed Changes

After the classification of FPIs under 2 categories, there has been a further sub-classification into 3 parts:



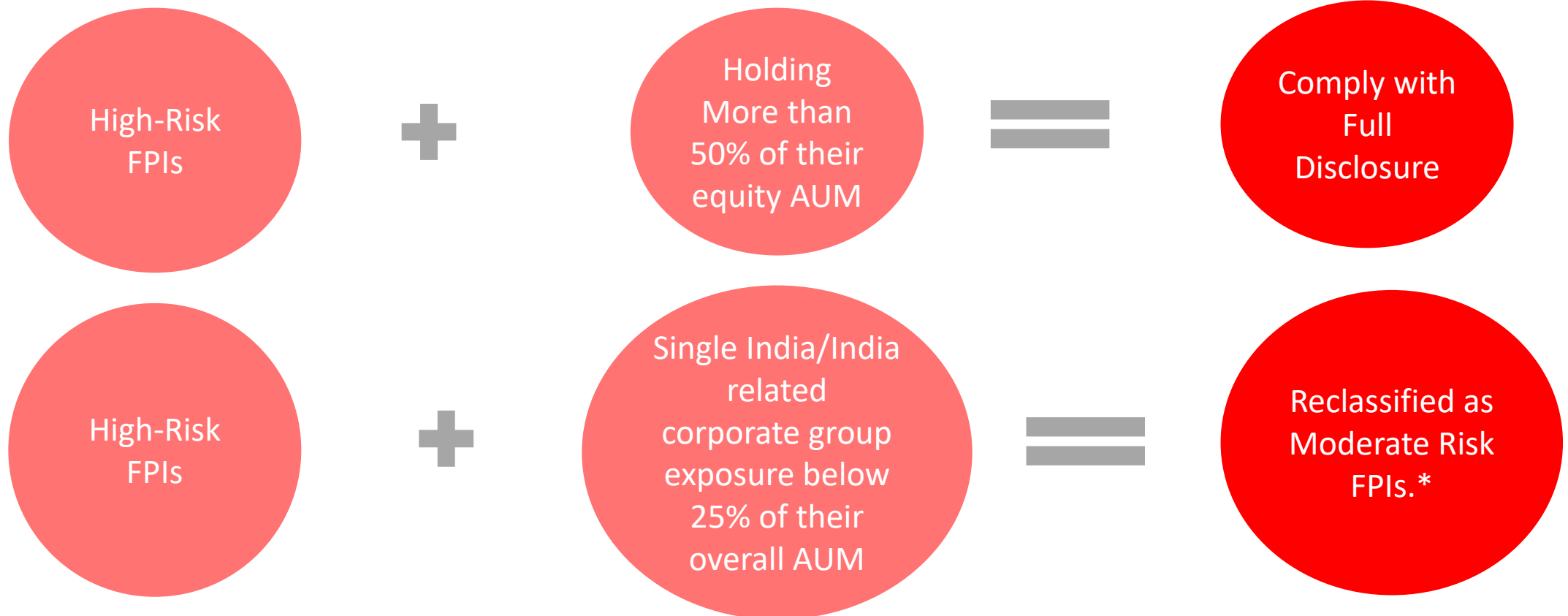
Prevention of Circumvention of MPS/Press Note 3:

The above risk classes will be coupled with either:

the quantum of concentrated investments by FPIs in a single corporate group.

OR

the size of the overall equity Asset Under Management (AUM).



- The additional Disclosure requirements won't impact Moderate and Low Risk FPIs.

*It is applicable in both cases i.e. Prevention of Circumvention of MPS and Prevention of Misuse of the FPI route for circumvention of Press Note 3



Prevention of Circumvention of MPS:

Prevention of misuse of the FPI route for circumvention of Press Note 3:

New FPIs

- Allowed to **cross 50% group concentration up to 6 months** without the need for additional disclosure.
- Beyond **6 months, additional disclosure** will be triggered if the Group Concentration is above 50%

No such provision

Winding Up FPIs

- Temporarily **breach the 50% investment threshold** in a single corporate group does not need for an additional disclosure.
- Provided that the portfolio should be **wounded up within 6 months.**

No such provision



Existing High Risk FPIs

- More than **50% concentration threshold** in a single corporate group will be **provided a time period of 6 months** to bring down the exposure.
- High Risk FPIs with an **overall holding in Indian markets of Rs. 25000 Cr.** Shall also be required to comply with **additional disclosure within 6 months.**

Ongoing High Risk FPIs

- FPIs that **breach the 50%** group concentration investment threshold will be provided a **window of 10 days** to bring down the concentration.
- High Risk FPIs that **crosses the Rs. 25000 Cr. AUM threshold** in the future will be required to comply with additional disclosure requirements **within 3 months.**



Miscellaneous Pointers

- Estimated as of March 31, 2023, around Rs. 2.6 lakh crore of FPI assets (6% of total FPI equity AUM) may be categorized as high-risk FPIs, meeting the 50% group concentration or Rs. 25,000 crore fund size thresholds.
- High-risk FPIs must submit an undertaking at registration, waiving privacy rights in favor of SEBI. Existing high-risk FPIs have 6 months to submit the undertaking.
- FPIs monitor thresholds, but it is duty of the DDPs to notify breaches and take necessary actions.



THANK YOU

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