BEFORE THE SECURITIES APPELLATE TRIBUNAL MUMBAI

Appeal No.70 of 2009

Date of decision: 11.10.2010

M/s. Rakhi Trading Pvt. Ltd.
61/62, 4th Floor,
109, Gaya Building,
Y.M. Road, Masjid Bunder,
Mumbai – 400 009. ….. 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. Iqbal Chagla, Senior Advocate with Mr. P.N. Modi, Mr. Riyaz Chagla, Mr. R.R. Bhosale and Mr. Pramod Y. Kevi, Advocates for the Appellant.

Mr. Kumar Desai, Advocate with Mr. Kersi Dastoor, Advocate for the Respondent.

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

Per: Samar Ray, Member

Whether the transactions executed by the appellant in the derivatives segment of the securities market violated Regulations 3 (a), (b) and (c) and 4 (2)(a) and (b) of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (hereinafter referred to as the Regulations) is the short question that arises in this appeal. The adjudicating officer by his order of March 26, 2009 found the appellant guilty and imposed a penalty of Rs.1,08,00,000/- on it for executing synchronized matched/reverse trades in the Futures and Options segment (F & O) of the National Stock Exchange of India Ltd. (NSE) and thereby violated the Regulations. It is this order which is under challenge before us.

Before noticing the facts and analysing the issues involved, let us understand to the extent necessary for this case what the derivative market is all about.

2. Derivative segment is a comparatively new area of operation for trading activity in the Indian capital market. Derivative trading is governed by Section 18-A 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 recognised stock exchange and settled through the clearing house of that exchange. Derivates are actually a form of financial instruments which are traded in the securities market and whose values are derived from the values of 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. Futures and options are the two common derivatives traded on the stock exchanges. A futures contract is an agreement between two parties to buy or sell an asset at a certain date in the future at a certain price agreed upon on the date of the contract. An options contract, on the other hand, is a derivative contract between a buyer and a seller where the seller gives to the buyer the right but not the obligation to buy from or sell to the seller the underlying asset on or before a specific date at an agreed price. Since we are concerned in this appeal with options contracts in Nifty, the stock index of NSE, we shall discuss these contracts a little. The seller in an options contract sells a right to the buyer and since nothing can be sold without a cost, the former charges an amount from the latter which is called the premium. It is this premium which is the only negotiable element in an options contract that is negotiated on the trading screen of the stock exchange. At the beginning of every trading cycle which is fixed by the concerned stock exchange, it (stock exchange) prescribes in the case of stock options a series of strike rates based upon the prevailing market price of particular shares that are allowed to be traded in the F & O segment. In the case of index options, the strike rates are determined with reference to the index value in the cash segment. These strike rates are based on the general market perception both bullish and bearish. Equal number of strike rates both upwards and downwards of the prevailing market price/index value are fixed by the stock exchange. The stock exchange also fixes the size of the contracts that are traded in lots. When an investor choses to trade in the options contracts, he has to choose a scrip or the Nifty, then assess whether the same will go up or down on the next

settlement date and by how much. That is his gamble. Accordingly, he will select a strike rate which is the exercise price. He can then buy or sell a “Call Option” or a “Put Option”. A Call Option is an option to “buy”, that is, the contract is to buy the shares on a settlement date at the selected strike rate. A Put Option is an option to sell, that is, the contract is to sell the shares on the settlement date at the selected strike rate. In case the price of the underlying or the value of the index in the cash segment goes below the selected strike rate/exercise price, the buyer will have no attraction to exercise his option under the contract and will allow the contract to lapse and thereby lose whatever premium was paid by him. Premium amount is the maximum that the buyer can lose in case the market moves contrary to his perception. In case the price of the underlying or the index value in the cash segment were to go beyond the selected strike rate/exercise price, the buyer would certainly exercise his option under the contract depending upon how high the price or the stock index has gone after adjusting the premium amount. These are some of the motivating factors which weigh with the investors in the options contracts. It is a one sided contract where the loss suffered, if any, by the buyer is limited only to the premium amount whereas the loss which could be suffered by the writer of the contract (seller) is limitless. If during the period of the contract the market perception of the seller (writer) changes or the market starts moving contrary to his expectations, he may, in his anxiety to cap his losses, take a reverse position. He would then put in an offer or accept an offer of a higher premium for the same option and this in effect would result in his repurchasing the contract at a higher rate/premium to avoid greater losses. This could even happen on the same day and if the options contract is illiquid, the parties in the reverse trade could be the same. It is pertinent to mention that what is traded in the F & O segment are the contracts and not the underlying assets which are separately traded in the cash segment of the exchange except a stock index. The contracts in this segment are settled at the end of the settlement period in cash and there is no physical delivery of the underlying asset. Unlike in the cash segment where trading is done by making the entire payment upfront, trading in the F & O segment is carried on with a relatively small amount which provides the possibility of greater profits and/or losses.

3. The Board had been watching the nature of transactions occurring in the derivative segment of the capital market and a perusal of the trading data of the F and O segment on the NSE for the period January to March, 2007 revealed that brokers were buying and selling almost equal quantities of contracts within the day and such buy/sell orders were synchronized. These observations raised some concerns with the Board. After preliminary examination into the trading of 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 exercising his powers under Sec 11D of the Securities and Exchange Board of India Act, 1992 (for short the Act), directed these entities including the appellant to cease and desist from executing such trades till further orders. The noticees were asked to file their objections, if any, within 15 days from the date of the order. Reference was made to NSE's circular issued in March 2005 to brokers specifically advising them to desist from entering into such transactions as detailed in the ad interim ex-parte order. While the ad-interim ex-parte order was pending for confirmation, the Board issued a show cause notice to the appellant on October 5, 2007 enclosing extracts from the preliminary examination report covering 14 options contracts executed by it in the F & O segment between March 21 and March 30, 2007 with a total close out difference (COD) of Rs.1,15,79,312.15 (positive) showing a net profit of Rs.115.79 lacs. It was alleged that these were fictitious transactions involving synchronized and reverse trades resulting in the creation of misleading appearance of trading in these options. All the 14 transactions except one pertained to Nifty, the stock index of NSE. It was observed that the appellant in these transactions had operated through Prashant Jayantilal Patel as its broker and the counter party was Kasam Holding Pvt. Ltd. which executed these transactions through Vibrant Securities Pvt. Ltd. as its broker. One single transaction carried out on a different underlying variable with a different counter party broker (Spark Securities Pvt. Ltd.) trading in its proprietary account was not pressed against the appellant. There were certain generic observations on the transactions of all the entities mentioned in the extract of the examination report the thrust of which was that reverse/close out transactions were executed at prices with significant variation within a short period though no major variation in the underlying

price during that period was observed and hence the trades were prima facie non-genuine. It was alleged that the synchronized transactions had a definite objective of enabling one party to book profits and the other party to book losses in the close out difference. While diagnosing the transactions, the whole time member in his ad interim ex-parte order had observed that "The range and scope with which such transactions have been carried out seems to suggest that there is a thriving market for such transfer of profits/losses providing the opportunity to avail of favourable tax assessments". The appellant was asked to show cause why an enquiry should not be held against it and penalty, if any, be not imposed under section 15HA of the Act. The appellant in its reply dated January 23, 2009 emphatically denied the charge of manipulative trading in the F & O segment and explained the motivating forces of operation in the derivative segment of the market stating that speculative trading in the options market is a normal trading phenomenon which the appellant as an investment company had indulged in. The appellant further stated that options which have been purchased/sold may get reversed at different rates on the same day. Such reverse trades are only to avoid greater potential losses on the one side and book profits on the other side. It denied that there was any instruction to the broker for synchronization of trades. The appellant also rebutted the charge that it's swift reversals were suspicious because the underlying variable did not move correspondingly by stating that the F & O segment movement need not correspond with the movement in the cash segment as the former moves on its own anticipation and perception. The adjudicating officer considered the reply and after affording an opportunity of personal hearing to the appellant found that Nifty was the most active in the options contracts traded on the exchange and that it had contributed to 92.21 percent of the contracts traded in the options segment during March 2007. In such a scenario the appellant's counter party trader always being the same entity clearly indicate that the trades were pre-arranged, synchronized and matched. The adjudicating officer, therefore, found the appellant guilty of violating Regulations 3 and 4 of the Regulations and imposed a penalty of Rs.1,08,00,000 on the appellant through his order dated March 26, 2009. Hence this appeal.

4. Learned counsel for both the parties took us extensively through the records and the nuances of the trading patterns in the derivative segment. We take note of the fact that

investors trade in derivatives for three broad purposes: hedging, speculation and arbitrage. Hedgers use derivatives to reduce the risk that they face from potential future movements in a market variable in the cash segment. For example, if an investor owns a number of shares of a particular company but anticipates a possible fall of the share price in the cash segment, he takes an opposite position in the options contract by entering a contract at a lower strike rate below the market price which may offset the loss suffered by him in the cash market. Speculators use the derivatives to bet on the future direction of a market variable and arbitrageurs take offsetting positions in two or more instruments to lock in a profit. Before we examine whether the appellant has assumed any of these positions in its trades in the options contracts and whether those transactions have violated any rule of the game, it is necessary to discuss the anatomy of index option as distinct from stock option where the price of the underlying stock physically traded in the cash market impacts the value of the futures and options contracts. This is because the allegations in the present appeal pertain to manipulated and structured trades in one index option viz. Nifty.

5. Index in a capital market is a statistical indicator of how the market is functioning and acts as a barometer for market behaviour. It is not a product but a measure expressed in numbers and a benchmark against which financial or economic performance is evaluated. Unlike stocks in the cash segment, it is not traded as such though investors speculate on market behaviour using index as the underlying in the F & O segment. Nifty, the stock index of NSE, is computed using market capitalization weighted method (share price x number of outstanding shares) of fifty stocks being traded in the cash segment of NSE. It is a well diversified stock index covering 22 different sectors of the Indian economy. The eligibility of a particular stock for being selected for Nifty index depends on the liquidity of the stock as well as the floating stock of the company. Nifty, therefore, is a very dynamic index which is not constant but evolves continuously. Obviously, to manipulate such a diverse and changing portfolio of stocks in the cash segment is extremely difficult, if not impossible by trading in the in F & O segment. It is also NSE's stated position on its website that "stock index is difficult to manipulate as compared to stock prices, more so in India and the possibility of cornering is reduced. This is partly because an individual stock has a limited supply which can be cornered". It

is obvious that when Nifty is traded in options contracts, the movement of prices in that segment cannot have any impact on the price discovery system in the cash segment which is one of the allegations brought out in the ad-interim ex-parte order and the show cause notice. The charge against the appellant in the show cause notice is that by executing trades in Nifty options in the F & O segment "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". The insinuation is that by executing manipulative trades in the F & O segment, Nifty index was sought to be tampered with. This charge proceeds on the assumption that the movement of Nifty options in the F & O segment should be in harmony with the movement of Nifty index in the cash segment. This assumption is fallacious and we cannot agree. Movement of index in the cash segment does influence the index options in the F & O segment because the strike rate is directly linked with the index value in the cash segment. However, the converse is not always true. While transactions in the cash market are based on the current market price of the underlying derived by the principle of demand and supply and in the case of an index, the value depends on the performance of the stocks that constitute it, the pricing in the F & O segment is based on future expected events which may or may not happen. Anticipated future events may not have a discernible effect on the cash segment today where delivery of shares is given/taken immediately. Such events may have a great impact on perceptions in the F & O market where the investor holds an open position and a continuous liability during the currency of the contract which is generally for one to three months with anticipation of future events which are always pregnant with all sorts of possibilities. Again, volatility and potential for greater losses may trigger movements in the F & O market without any equivalent cash market movements. Further, the cash market may move up today but the prediction for the F & O market could be that at the end of a month, two months or three months the market may move down. Only short term investors like speculators trade in the F & O market whereas in the cash market long terms investors also trade. We are, therefore, satisfied that the movement in the two segments need not be in tandem. In the instant case the appellant executed Nifty option contracts and it must be remembered that Nifty index is determined by fifty highly liquid

scrips which also vary from time to time and the index moves on the basis of their performance in the cash segment. These movements cannot be in tandem with the movement of the price of Nifty options in the F & O segment because Nifty as an index is not capable of being traded in the cash segment. What is traded in the cash segment are the fifty stocks which constitute Nifty. To say that some manipulative trades in Nifty options in the F & O segment could influence the Nifty index is too farfetched to be accepted. The only way Nifty index could be influenced is through manipulation of the prices of all or majority of the scrips in the cash segment that constitute Nifty. This is extremely difficult, if not impossible. It is common case of the parties that the appellant traded only 13 Nifty option contracts in the F & O segment. Assuming these trades were manipulative, could these ever influence the Nifty index. As already observed, Nifty index is a very large well diversified portfolio of stocks which is not capable of being influenced much less manipulated by the movement of prices in the F & O segment particularly by the handful of trades executed by the appellant. In this view of the matter, we have no hesitation to hold that the 13 trades in Nifty options executed by the appellant had no impact on the market or affected the investors in any way nor did these influence the Nifty index in any manner. The charge in this regard must fail.

6. Another charge against the appellant is that its trades in Nifty options were fictitious transactions which were synchronized and reversed resulting in the creation of misleading appearance of trading in those options. Derivative segment is highly volatile and involves a complexed form of trading with high risks and the players in this segment do not follow the herd mentality as is often noticed in the cash segment but take decisions based on their own perception of the market. The number of persons trading in this segment is comparatively much less than those in the cash segment. The Board has found that only 14 contracts executed by the appellant in the options segment constituted 30 to 50 per cent of the market gross in that segment though nifty is the most active of the options contracts traded on the exchange and contributed 92.21 per cent of the trades during March, 2007. This is indicative of the fact that the number of players in the options segment is very less. Artificial/fictitious trades in the cash segment do give a false appearance of active trading in a particular scrip by increasing volumes which tend to lure the lay investors to invest in that scrip. The impression given to the investors is

that the scrip is highly liquid and much in demand and this interferes with the price discovery mechanism of the exchange and it is for this reason that such trades are held illegal in the cash segment. This, however, cannot be the case in the F & O segment. Since all the trades are executed through the stock exchange and settled in cash through its mechanism they cannot be said to be artificial trades creating a misleading appearance of trading in the options. The charge is misconceived.

7. This brings us to the issue of synchronization of the buy and sell orders in the Nifty option contracts executed by the appellant where the counter party in the 13 impugned transactions was the same entity. Impugned order records that Nifty contracts which are the most active contracts in the options segment cannot be traded in the way the appellant has traded matching its orders to seconds with the counter party client. This, according to the adjudicating officer, was a pre-planned arrangement between the appellant and its counter party and their intention was to create a false and misleading appearance in the market and a manipulative device was used for synchronizing the trades. The learned senior counsel appearing for the appellant did not dispute the fact that the trades had been synchronized and reversed but he argued that these did not manipulate the market and that only the synchronized trades which manipulate the market are prohibited. He placed reliance on a judgment of this Tribunal in Ketan Parekh vs. Securities and Exchange Board of India, Appeal No.2 of 2004 decided on 14.7.2006. He also referred to the order passed by the Board in the case of ICICI Brokerage Services Ltd. wherein a similar view had been taken and strenuously argued that since the synchronized trades of the appellant did not manipulate the market, the impugned order deserves to be set aside. We find merit in this contention. The fact that the trades executed by the appellant had been synchronized with the counter party is not really in dispute before us. We have already held that the 13 trades in Nifty options executed by the appellant had no impact on the market or affected the investors or the Nifty index in any manner. In Ketan Parekh's case (supra) this Tribunal had observed that synchronized trades per se are not illegal but only those which manipulate the market in any manner are the ones that are prohibited and violate the Regulations. Relying upon the observations made by this Tribunal in Nirmal Bang Securities Pvt. Ltd. vs. Securities and Exchange

Board of India [2004] 49 SCL 421, the then chairman of the Board while dealing with the synchronized trades executed by the appellant therein observed as under:-

> "For the above reason, although it cannot be said that synchronized deals are pre se illegal, for the same reason, it cannot be said that all synchronized transactions are legal and permitted. All synchronized transactions which have the effect of manipulating the market are against fair market practices and hence undesirable and prohibited."

We have reproduced the observations from the order of the Board only to highlight that the Board also understands that the law is that only such synchronized trades violate the Regulations which manipulate the market. Since the impugned trades of the appellant in the F & O segment had no impact on the market, we hold that they did not violate the Regulations. Shri Kumar Desai learned counsel for the respondent was equally emphatic in arguing that the appellant had not only executed synchronized trades but had also reversed them during the course of the trading with the same counter party and, therefore, the trades were fictitious and non-genuine and that the adjudicating officer was justified in holding so and imposing the monetary penalty for violating the Regulations. He placed strong reliance on the observations of the Tribunal in Ketan Parekh's case (supra) wherein it has been held that reversal of trades between the same parties results in fictitious trades and they are illegal. We are unable to agree with him. The observations in Ketan Parekh's case were made with reference to the trades that were executed in the cash segment and we are clearly of the view that all those observations cannot apply to the trades executed in the F & O segment. Reverse trades in the cash segment have been held to be illegal and violate the Regulations because there is no "change of beneficial ownership" in the traded scrip. Moreover, in the cash segment the scrip is actually traded entailing not only "change of beneficial ownership" but also physical delivery/movement of the traded scrip. When this does not happen in the cash segment, the trade is described as a fictitious trade creating false volumes which manipulates the market. The scenario in the F & O segment, particularly in the options contracts with which we are concerned in the present case, is altogether different from that of the cash segment. In the F & O segment there is no concept of "change of beneficial ownership" since what is traded in this segment are contracts and not the underlying stock or index and it is only through cash settlement that the trade is concluded and no physical delivery of any asset is involved. In this view of the matter, synchronized and reversed trades in Nifty options in

the F & O segment can never manipulate the market which, in the present context, means the value of the Nifty index in the cash segment. To repeat, we may again observe that it is almost impossible to manipulate the Nifty index which consists of fifty well diversified highly liquid stocks in the cash segment. Since the trades of the appellant were settled in cash through the stock exchange mechanism, they were genuine and these could not create a false or misleading appearance of trading in the F & O segment. It is the Board's own case that the appellant made profits in all these transactions and the counter party suffered losses.

8. When we analyse the nature of the trades executed by the appellant, we find that it played in the derivative market neither as a hedger nor as a speculator and not even as an arbitrageur. The question that now arises is why did the appellant execute such trades with the counter party in which it continuously made profits and the other party booked continuous losses. All these trades were transacted in March 2007 at the end of the financial year 2006-07. It is obvious and, this fact was not seriously disputed by the learned senior counsel appearing for the appellant, that the impugned trades were executed for the purpose of tax planning. The arrangement between the parties was that profits and losses would be booked by each of them for effective tax planning to ease the burden of tax liability and it is for this reason that they synchronized the trades and reversed them. They have played in the market without violating any rule of the game. This Tribunal in Viram Investment Pvt. Ltd. vs. Securities and Exchange Board of India, Appeal no.160 of 2004 decided on February 11, 2005 while dealing with a contention as to whether trades could be executed through the stock exchange for tax planning, made the following observations which are relevant for our purpose:-

> "Even if we consider transactions undertaken for tax planning as being non genuine trades, such trades in order to be held objectionable, must result in influencing the market one way or the other. We do not find any evidence of that either in the investigation conducted by the Bombay Stock Exchange, copy of which has been annexed to the memorandum of appeal or in the impugned order that there was any manipulation. …… Trading in securities can take place for any number of reasons and the authorities enquire into such transactions which artificially influence the market and induce the investors to buy or sell on the basis of such artificial transactions."

The observations even though made in the context of the cash segment are equally applicable to the F & O segment. We are in agreement with the aforesaid observations

and relying thereon we hold that the impugned transactions in the case before us do not become illegal merely because they were executed for tax planning as they did not influence the market. The learned counsel for the respondent Board drew our attention to Regulation 3(a), (b) & (c) and Regulation 4(1) and 4(2)(a) & (b) of the Regulations to contend that the trades of the appellant were in violation of these provisions. We cannot agree with him. Regulation 3 of the Regulations 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 persons 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. Having carefully considered these provisions, we are of the view that market manipulation of whatever kind, must be in evidence before any charge of violating these Regulations could be upheld. We see no trace of any such evidence in the instant case. We have, therefore, no hesitation in holding that the charge against the appellant for violating Regulations 3 and 4 must also fail.

9. Before concluding, we may notice the circular dated 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 the impugned order. In the said circular it had been mentioned by NSE that some transactions in illiquid securities/contracts had come to its notice where the same set of members/clients had executed “reversing transactions”, both buy and sell, at abnormal price differences in the premium in the case of options that had no relevance to the movement of prices in underlying securities at that point of time. The members were advised to desist from entering such orders which prima facie appeared to it to be non-genuine. We are of the view that this advisory has no legal binding as it has not cited violation of any rule or regulation and is tentative in nature without bringing out any specifics regarding the suspicious transactions. Moreover, the advisory was issued to the member brokers and is not enforceable against the appellant or other players in the market. It is also interesting to note that while NSE had issued such an advisory to its members, the other most important stock exchange viz.

The Bombay Stock Exchange Ltd. Mumbai (BSE) where F&O segment is also in operation did not issue any such advisory to its members. Does it mean that such trades in options contracts are allowed on BSE but not on NSE? Obviously, such an absurdity cannot be anybody's case. Besides, if the Board as the market regulator was concerned with such transactions in the derivative segment, it should have issued suitable directions on the issue in whatever form. It is only the Board that has the statutory authority to regulate the market as a whole. In the absence of any direction from the Board, we find no merit in citing the NSE circular to establish the charge against the appellant.

For the reasons recorded above, we answer the question posed in the opening part of this order in the negative and hold that the transactions executed by the appellant did not violate the Regulations. In the result, the appeal is allowed and the impugned order set aside with no order as to costs.

Sd/-
Justice N.K.Sodhi
Presiding Officer

Sd/-
Samar Ray
Member

11.10.2010
Prepared and compared by
RHN