Amendments to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, with regard to instituting a formal mechanism by Asset Management Companies for identification and deterrence of potential market abuse including front-running and fraudulent transactions in securities, and consequent relaxation to the requirement of recording of all communication

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1. Objective

1.1. This memorandum seeks the approval of the Board for amendments to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (hereinafter referred to as 'MF Regulations'), inter alia, to provide relaxation to the requirement of recording of all communication by Fund Managers and Dealers (hereinafter referred to as 'FMDs') during market hours, as requested by the Mutual Fund industry. In order to facilitate such relaxation, this memorandum proposes to enhance the existing surveillance systems, internal control procedures and escalation processes as a compensatory risk mitigation mechanism at the end of Asset Management Companies (hereinafter referred to as 'AMCs').

1.2. Accordingly, the following are proposed to be enshrined in the MF Regulations for instituting a compensatory risk mitigation mechanism:

a) putting in place a structured institutional mechanism for identification and deterrence of potential market abuse including front-running and fraudulent transactions in securities

b) enhancing responsibility and accountability of management of AMC for such an institutional mechanism

c) fostering transparency through a whistle blower policy

2. Background

2.1. In order to deter market abuse and front-running activities while dealing in securities, SEBI, in the year 2020, mandated that the Fund Managers and Dealers shall conduct all communication during market hours through recorded modes and channels only.

2.2. This requirement mandated FMDs to conduct all communication during market hours only through recorded modes and channels, including their personal communication.

Therefore, the industry had requested that such stringent requirement may be relaxed.

2.3. It is also important to note that SEBI, in recent past, has passed orders on instances of front-running including instances wherein broker-dealers, employees and connected entities of AMCs were found to have front-run the trades of the AMCs.

2.4. Considering these instances and to facilitate the relaxation of requirement of recording of all communication by FMDs, it was felt necessary to have a compensatory mechanism at the end of AMCs for mitigating risk of market abuse including front-running and fraudulent transactions by employees of the AMCs.

2.5. Accordingly, a proposal to put in place a compensatory risk mitigation mechanism at the end of AMCs, was discussed with industry participants and Association of Mutual Funds in India (hereinafter referred to as 'AMFI'). The proposal was also placed before the Mutual Fund Advisory Committee (hereinafter referred to as 'MFAC'). Based on above mentioned discussions, a consultation paper on the proposed institutional mechanism for deterrence and detection of market abuse by AMCs was issued on May 20, 2023, inviting public comments on the proposed framework.

2.6. Subsequently, a proposal to cast an institutional responsibility on AMCs to deter potential market abuse and fraudulent transactions was placed before the SEBI Board in its meeting held on June 28, 2023 (relevant Board Memorandum along with its minutes is enclosed as **Annexure A1**) and March 15, 2024 (relevant Board Memorandum is enclosed as **Annexure A2)**. In this regard, while SEBI Board agreed in principle with the proposals contained in the abovementioned memorandums, in its meeting held on March 15, 2024, the Board advised that a revised proposal highlighting the contours of the proposed institutional mechanism, including the guiding principles, the broad framework as well as detailed implementation standards proposed by AMFI be placed before the Board. The approved minutes of the said agenda item placed in the board meeting held on March 15, 2024 are reproduced below:

(This has been excised for reasons of confidentiality.)

2.7. In light of the feedback received from the Board, the guiding principles of the institutional mechanism are proposed to be enshrined in the MF Regulations through an amendment. Pursuant to the amendment to the MF Regulations, the broad framework of the institutional mechanism may be prescribed by way of a SEBI circular (draft circular is enclosed as **Annexure A3**). It is also proposed that while SEBI may specify the broad framework for the institutional mechanism, the industry body i.e. AMFI, may formulate detailed standards for implementation of such an institutional mechanism by the AMCs. The draft implementation standards proposed by AMFI are enclosed as **Annexure A4**.

3. Current Regulatory Framework

3.1. The existing regulatory framework governing Mutual Funds in India centers on the principles of integrity, transparency and accountability. As part of the existing regulatory framework, trustees, in their periodical reports to SEBI, are required to confirm that there have been no instances of self-dealing or front-running activities by any of the trustees, directors and key personnel of the asset management company. Additionally, Trustees and AMCs are required to exercise due diligence in empaneling the brokers, monitoring securities transactions with brokers and avoid undue concentration of business with any broker.

3.2. The regulatory framework has also laid down various provisions under Code of Conduct for Asset Management Companies and FMDs. The framework, inter alia, requires the FMDs to act with integrity, to strive for highest ethical and professional standards, to act honestly in dealings with other market participants, and to conduct all communication during market hours through recorded modes and channels only. FMDs are also prohibited from indulging in any unethical business activities or professional misconduct involving dishonesty, fraud or deceit or committing any act that could damage the reputation of their organization or the Mutual Fund industry.

3.3. The code of conduct for FMDs, also prohibit activities such as circular trading, artificial inflation of trading volumes, simultaneous buying and selling of the same securities at off market prices in order to create false or misleading signals, manipulation of prices of infrequently traded securities etc.

3.4. While the existing regulatory framework has in place various restrictions, risk management measures and general guidelines for prevention of market abuse including front-running, there is no specific requirement under the MF Regulations for AMCs to put in place a structured institutional mechanism for identification and deterrence of potential market abuse including front-running. The existing framework also does not require the AMCs to put in place a whistle blower policy / vigil mechanism. Thus, under the existing regulatory framework, the market abuse tends to get attributed only to the actions of 'rogue employees', without requiring AMCs to have adequate mechanisms and systems in place for identification and deterrence of such market abuse including front-running.

3.5. Therefore, the proposals in this Board Memorandum aim to fill this gap in the existing regulatory framework to address concerns relating to market abuse including front-running and fraudulent transactions in securities.

3.6. Incidentally, an institutional mechanism for prevention of fraud or market abuse is already in place for Market Infrastructure Institutions and Qualified Stock Brokers ('QSBs').

4. Global Examples

4.1. The global regulatory framework for detection and deterrence of market abuse and misconduct involves a combination of principles and regulations aimed at maintaining market integrity and investor confidence.

4.2. In the European Union, the Market Abuse Regulation (hereinafter referred to as 'MAR') mandates market operators and investment firms to establish and maintain effective arrangements, systems and procedures aimed at preventing and detecting insider dealing, market manipulation etc. MAR also requires entities to have in place appropriate internal procedures for employees to report potential misconduct.

4.3. Monetary Authority of Singapore (hereinafter referred to as 'MAS') has laid down detailed institutional framework for brokers. This framework requires brokers to establish and maintain automated surveillance systems and structured processes to detect potential market misconduct, and have senior management oversight on such systems and processes.

5. Proposed Amendments

5.1. Putting in place a structured institutional mechanism for identification and

deterrence of potential market abuse including front-running and fraudulent transactions in securities

i) Considering the recent instances of market abuse involving AMCs, there is a need for a structured institutional mechanism at the end of AMCs, which can proactively identify and prevent such instances of market abuse including front-running.

ii) This mechanism shall consist of enhanced surveillance systems, internal control procedures, and escalation processes such that the overall mechanism is able to identify, monitor and address specific types of misconduct, including front running, insider trading, misuse of sensitive information etc. By having an institutionalized framework, AMCs can be expected to effectively detect unusual trading patterns, identify potential instances of market abuse including front-running and fraudulent transactions in securities, and promptly take corrective actions.

iii) In line with SEBI's industry standard setting approach, while the principle-based requirements shall be specified in the regulations, AMFI, in consultation with SEBI, shall specify detailed standards for the institutional mechanism.

A. Proposal:

1) In view of the above, it is proposed that the MF Regulations may be amended to insert an enabling clause for enhancing the existing regulatory framework by requiring AMCs to put in place a structured institutional mechanism for identification and deterrence of potential market abuse including front-running and fraudulent transactions in securities. The proposed amendment to the MF Regulations is provided below:

   This has been excised for reasons of confidentiality. Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified.

2) Additionally, for better clarity, it is also proposed that the MF Regulations may be amended to include a definition of the term 'market abuse'. The proposed definition is in line with the definition of 'market abuse' as approved by the Board in the context of institutional mechanism for stock brokers.

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Funds) Regulations, 1996 shall be notified.

5.2. Enhancing responsibility and accountability of management of AMC for the Institutional Mechanism

The active involvement and oversight of senior management is essential in order to ensure that the implementation and functioning of any institutional mechanism is consistent and effective. Making the senior management accountable for implementation of the institutional mechanism, shall foster compliance and accountability that influences the entire AMC. Thus, the proposed institutional mechanism aims to cast specific responsibility on Chief Executive Officer or Managing Director and Chief Compliance Officer of AMCs to ensure the setting up and effective functioning of the institutional mechanism.

A. Proposal:

In view of the above, the MF Regulations may be suitably amended to make the Chief Executive Officer or Managing Director or such other person of equivalent or analogous rank and Chief Compliance Officer of the AMC, responsible and accountable for implementation of the institutional mechanism. The proposed amendment to the MF Regulations is provided below:

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5.3. Whistle blower policy

Implementation of a whistle blower policy or vigil mechanism within the AMCs, would enable employees and stakeholders to report genuine concerns about unethical practices or potential market abuse within the organization. Additionally, confidentiality of identity and protection of whistle blower would promote a safe and anonymous reporting environment, which would enable AMCs to detect potential issues relating to unethical practices or market abuse and to take corrective actions.

A. Proposal:

In view of the above, the MF Regulations may be suitably amended to require AMCs to put in place whistle blower policy. The proposed amendment to the MF Regulations is provided below:

This has been excised for reasons of confidentiality. Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified.

5.4. <u>Relaxation of requirement of recording of all communication by FMDs</u>

i) The existing code of conduct for FMDs under the MF regulations, inter-alia, outlines specific requirements related to communication, disclosures and transparency. As per these provisions, while FMDs are required to conduct all communication during market hours through recorded modes and channels only, they are also mandated to adhere to certain other provisions such as:

a. FMDs shall communicate in unambiguous, transparent, accurate and professional manner to promote effective communication that supports transparent market.

b. FMDs on their discretion may share views on market colour, general state of market or trends without disclosing confidential information.

c. FMDs shall not intentionally disseminate false or misleading information with respect to price or market for a security.

d. FMDs shall not disclose any material non-public information that could affect the value of an investment to external parties and to not act or cause others to act on such information.

ii) In addition to the above, the SEBI Master Circular on Mutual Funds dated May 19, 2023 prescribes various provisions related to the dealing room, wherein, inter alia, it has been mandated that all conversations of the dealer shall be only through dedicated recorded telephone lines. Also, mobile phones or any other communication devices, other than recorded telephone lines, are prohibited inside the dealing room.

iii) With regard to the requirement of recording of communication, it has been represented by the industry participants, that FMDs are often required to interact with third parties during investor meets, conferences etc., where recording of conversations becomes challenging. Thus, the industry participants have requested that the requirement related to recording of communication by FMDs during market hours, may be relaxed.

iv) The regulatory framework provide certain checks on communication by FMDs as highlighted at para 5.4.(i) & 5.4.(ii), which cast responsibilities on FMDs to ensure adequacy and appropriateness of communication at all times. In view of the guardrails prescribed in the regulatory framework as well the implementation of the proposed institutional mechanism for AMCs, a relaxation to the requirement of recording of all communication by FMDs merits consideration.

v) Accordingly, it is proposed to provide exemption to the present requirement of recording all communication of FMDs during market hours, so as to allow face to face conversations, including out-of-office interactions without recording.

(This has been excised for reasons of confidentiality.)

vi) Thus, it is important to highlight that while all communication through mobile phones, telephone lines etc. by FMDs will continue to be required to be recorded during market hours, only face-to-face conversations, including out-of-office interactions as outlined in para 5.4.(v), will be exempt from the current requirement of recording.

vii) In order to facilitate such relaxation, there is a need to have a compensatory risk mitigation mechanism at the end of AMCs for identification and deterrence of potential market abuse including front-running and fraudulent transactions in the securities.

viii) The proposed institutional mechanism casts responsibilities on the AMCs to identify and deter market abuse by employees of AMCs. Upon implementation of the proposed institutional mechanism, the requirement of mandatory recording of all communication by FMDs during market hours, having similar objective of deterring market abuse, may be relaxed.

ix) Thus, once the institutional mechanism is in place, relaxation of requirement of recording of all communication by FMDs, may be considered, and the same may be facilitated by amending the relevant provision in the MF Regulations.

A. **Proposal:**

In view of the above, the MF Regulations may be suitably amended to relax the provision related to recording of all communication by FMDs. The proposed amendment to the MF Regulations is provided below:

This has been excised for reasons of confidentiality. Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified.

6. Proposal for consideration and approval of the Board

6.1. The Board may consider and approve the proposals at paragraphs 5.1.A, 5.2.A, 5.3.A. and 5.4.A. Draft amendments to the SEBI (Mutual Funds) Regulations, 1996 and the draft notification for the proposed amendment are placed at **Annexure B1** and **Annexure B2** respectively.

6.2. It is proposed to provide six months' time for implementation of proposals at paragraphs 5.1.A, 5.2.A and 5.3.A, so as to facilitate stakeholders to have required systems in place.

6.3. It is also proposed that the relaxation suggested at paragraph 5.4.A may be made effective after six months of implementation of the institutional mechanism by AMCs.

6.4. The Board may authorize the Chairperson to make consequential and incidental changes and take necessary steps to give effect to the decisions of the Board.

Annexure A1

This has been excised for reasons of confidentiality.

Annexure A2

This has been excised for reasons of confidentiality.

Annexure A3

This has been excised for reasons of confidentiality.

Annexure A4

This has been excised for reasons of confidentiality.

Annexure B1

Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified after following the due process.

Annexure B2

Amendment to SEBI (Mutual Funds) Regulations, 1996 shall be notified after following the due process.