SC's Ruling on Synchronised Trading

Why in news?

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The Supreme Court has recently upheld an adjudication order by SEBI and set aside a SAT order on synchronised trading.

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What is synchronised trading?

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- A ‘synchronised’ trade is a pre-negotiated trade.
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- **How** - Here, the buyers and sellers enter the quantity and price of shares on the screen they wish to transact at nearly the same time.
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- The buy and sale transaction at the same day for the same quantity between the same set of broker/clients is called reversal of trade.
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- Except the parties who have pre-fixed the price, nobody has the position to participate in the trade.
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- This is done with the support of the brokers.
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- Through circular trading between related entities of the company promoter, the price of the stock would be inflated.
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- A year later the investor would sell the shares to promoter entities at the inflated price.
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- The profit gained would then be shown as long term capital gains (used to be tax free till the recent Budget made it taxable).
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- **Purpose** - The ‘profit’ would be returned to the promoter in either cash or through another set of fake transactions.
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- These transactions may not necessarily happen through the stock exchange

platform.
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- It thus serves as a means of converting black money to legitimate income.
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- Market is also manipulated to book artificial losses for tax purposes.
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- **Effect** - Synchronised trading may at times distort price discovery and affect other investors also.
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- SEBI had no way of proving these offline cash transactions.
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- It found it hard to raise charges of tax evasion and stock manipulation.
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What is the present case?

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- SEBI had imposed a penalty of Rs.1.8 crore on Rakhi Trading.
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- This was for indulging in synchronised trading through the ‘reversal of trade’ route in March 2009.
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- Notably, the price did not reflect the value of the underlying in synchronized and reverse transactions.
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- SEBI considered this a violation of the Prohibition of Fraudulent and Unfair Trade Practices Regulations.
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What was SAT's order?

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- The case went for appeal before the Securities Appellate Tribunal (SAT).
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- SEBI’s order was struck down by SAT in 2011.
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- SAT admitted that the trades were synchronised.

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- But it held that the trades had no impact on the market and neither induced the investors.
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- As, SAT held that the derivative trades could not influence the market (Nifty index).
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- SEBI however alleged that the fictitious trades created false liquidity in the Nifty options contract, manipulating the market.
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- SEBI then appealed the SAT ruling in the Supreme Court.
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What is the SC's ruling?

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- The Supreme Court has now set aside the SAT order.
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- The Court observed that the stock market is not a platform for any fraudulent or unfair trade practice.
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- SC has not mentioned the tax evasion angle in its judgement.
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- However it had made it clear that the synchronized trades did affect market integrity.
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- It held that orchestrated trades, whether in the cash or derivatives segment, are a misuse of the market mechanism.
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- Moreover, protection of interest of investors as per SEBI Act, 1992 necessarily includes prevention of misuse of the market.
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- The bench reiterated the need for a more comprehensive legal framework governing the securities market.
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- It stressed the need for SEBI to keep pace with changing times and develop principles for good governance in the stock market.
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What is the significance?

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- SC’s ruling on synchronised trading strengthens SEBI in prosecuting cases of price manipulation in future.
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- It empowers SEBI to impose severe penalty even on the smallest manipulations in the derivative segment.
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Source: Live Law, Business Line

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