

Capital markets regulator needs to proactively keep tab of abnormal trading activities

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Synopsis

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When both the options, prevention and cure, are available, the former is preferred to the latter because it nips the trouble in the bud. The latter option, however, is not practically available in securities markets as it is not often possible to either undo the damage to the market integrity or indemnify the loss of the victims arising from abnormal activities of miscreants.

This leaves the regulator and the exchanges with the Hobson's choice of prevention. They have accordingly set up potent surveillance systems to keep close watch on transactions in the market and activities of the participants and to raise alarm in time when they notice something abnormal to enable all concerned to take precautionary measures to contain the damage or loss.

This is easier said than done. The surveillance system usually throws up various alerts, which need to be examined manually and often with reference to the laws and the facts on the ground to filter the indisputable abnormal activities. While the examination usually happens in-camera, the abnormal activity continues unabated.

On conclusion of the examination, if warranted, a show cause notice is issued to the miscreant(s) seeking explanation, and is penalised if no satisfactory explanation is received. This approach neither prevents nor remedies the abnormal activities except to the extent that the penalty imposed on the miscreant(s) may serve as deterrent for potential

miscreants.

Take the case of the alleged front-running where a client was placing orders ahead of the orders of a sub-account of an FII. Although this was noted by surveillance of the exchange, the activity continued for 27 months probably because no definite view could be taken of the activity. Pending investigation, an interim order was issued with various directions, and on completion of the investigation, enforcement action was initiated.

Under this approach to surveillance, the participants do not get an alert about the abnormal activity while it is on, at times for years, and, therefore, fail to take a precautionary measure. Being emboldened by inaction of the authorities, the miscreants carry on the abnormal activity on a larger scale. The activity soon becomes a practice and acquires legitimacy if it continues for long with the knowledge of surveillance.

The market and participants continue to suffer from the abnormal activity till the authorities issue any kind of advice or direction, or the miscreants discontinue the activity on their own. The follow-up enforcement actions never make good the damage to the market and/or loss to the victims.

The abnormal activity is usually carried out through an intermediary who may not have an idea about the design of the miscreants. It may not have any idea, for example, if two miscreants are matching their orders by design with a view to create artificial markets or prices. Being duty-bound, it faithfully passes on the orders received from a client to the trading platform.

Subsequently, the authorities find these orders to be abnormal and initiate enforcement actions against the intermediary for its failure to exercise due care and diligence, not realising that it is a victim of the miscreants, and the authorities, who have in possession the matching details, never alerted it in time.

Bereft with the options to indemnify the loss or damage, surveillance has two, though not strictly mutually-exclusive, options to promote market integrity. First, it can prevent or minimise damage or loss by alerting the market in time that it has come across some abnormal activity. The miscreants would discontinue the abnormal activity when they become aware that they and their actions are under the radar of the authorities. The innocent intermediaries and investors would keep themselves away from the abnormal activity.

After all, the goal of surveillance is to spot abnormal activities in the market and take preventive measures to avoid disruption. Second, it may allow the miscreants a long rope so that it can build clinching evidence, and penalise them following the due process of law to serve as deterrent for potential miscreants. This is subject to many ifs and buts given the kind of evidence required to nail the miscreants. Obviously, the first option is more effective and less costly, and promotes confidence of investors in the market.

The authorities have increased the focus on the first option by their recent decision that the exchanges would issue observation or caution letters where they observe prima facie unusual or abnormal activities, with a view to alert the brokers and clients at an early stage. Kudos to the exchanges and Sebi for this bold, but investor- and market-friendly, decision. This casts much higher responsibility on the exchanges in the sense that they must correctly spot the abnormal activity and issue alerts well in time. They must scrupulously avoid false alerts as well as panic, and not damage the reputation of any participant at the stage of alert.

Sebi, whose jurisdiction extends over the entire securities market unlike that of an exchange, could consider similar dissemination as and when it finds anything abnormal. This approach to surveillance would not only promote market integrity but also save many innocent participants. Notwithstanding the success of this option, the second option must result, on conviction, in exemplary punishment of the guilty and, wherever possible, compensation to the victims.

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