

**CONSULTATION PAPER ON INSTITUTIONAL MECHANISM FOR ASSET MANAGEMENT COMPANIES
FOR DETERRENCE OF POSSIBLE MARKET ABUSE AND FRAUDULENT TRANSACTIONS**

1. Objective

1.1. To solicit public comments/ views on the following:

- Proposal of setting up of adequate surveillance and internal control systems (collectively referred as 'Institutional Mechanism') by Asset Management Companies ('AMCs') for deterrence of possible market abuse and fraudulent transactions in securities related to the AMCs' transactions, and ensuring appropriate escalation and reporting mechanism.
- Proposal on accountability of the AMCs and their senior management personnel on implementation of the Institutional Mechanism to deter possible market abuse and fraudulent transactions in securities related to the AMCs' transactions, and to ensure monitoring and compliance on an ongoing basis.

2. Background

- 2.1. A committee on Fair Market Conduct was constituted in 2017 to address issues related to market manipulation and fraud, insider trading, surveillance etc. The legal framework relating to surveillance, investigation & enforcement was amended to incorporate various recommendations of the aforesaid committee.
- 2.2. One of the recommendations of the committee was that intermediaries and fiduciaries should have a mechanism to prevent market abuse and fraudulent transactions in securities by their employees, Key Managerial Personnel ('KMP') etc.
- 2.3. The Institutional Mechanism for prevention of fraud or market abuse is in place for Market Infrastructure Institutions. Additionally, Institutional Mechanism putting enhanced obligations and responsibilities has been brought in for Qualified Stock Brokers ('QSBs').
- 2.4. In the past, orders on two instances of front-running have been passed wherein broker-dealers, certain employees and connected entities were found to have front-run the trades of the AMCs. In another instance, an employee of a listed insurance company was observed to be front-running the trades of the company. In yet another instance, an employee of a Foreign Portfolio Investor ('FPI') was found to be front-running the trades of the FPI.
- 2.5. In view of the above, it is considered important to have an institutional mechanism in AMCs for deterrence of possible market abuse or fraudulent transactions in securities related to AMCs' transactions.

3. Need for Institutional Mechanism

- 3.1. Presently the regulatory framework for AMCs includes provisions relating to code of conduct for AMCs, fund managers & dealers, and various other disclosure and reporting requirements. As an additional deterrence, the framework also requires the fund managers and dealers to conduct all communication during market hours through recorded modes and channels only.
- 3.2. In this regard, during the course of discussions with the industry, AMCs have expressed challenges in compliance with certain requirements relating to recording of all communication of fund managers and dealers. Further in such discussion, it was noted that there are no specific regulatory provisions that cast responsibility on the AMCs or their senior management personnel to put in place systems for deterrence, detection or reporting of market abuse or fraudulent transactions.
- 3.3. The list of possible instances/ indicators of market abuse or fraudulent transactions in securities related to AMCs' transactions for Mutual Fund schemes (hereinafter collectively referred as 'misconduct') which the AMCs' system shall be equipped to monitor, at a minimum, are as follows:
- Front running
 - Insider trading
 - Misselling of products
 - Misuse of information by the AMC, its employees, distributors, broker-dealers etc.
 - Delay in execution of orders of the AMCs by their broker-dealers
- 3.4. Instances of market abuse or fraudulent transactions in securities distort transparency, imperil market integrity and undermine the confidence of investors in the capital market.
- 3.5. In view of the above, there is a need for an institutional mechanism for AMCs to ensure that systems are in place for deterrence, detection and reporting of possible misconduct.

4. Proposed Regulatory Framework

- 4.1. In view of the same, detailed discussions were held with various AMCs and Association of Mutual Funds in India ('AMFI'), wherein existing best practices in various AMCs were discussed. After detailed deliberations, the following proposals are being made:

Setting up of surveillance systems and internal control procedures:

- 4.1.1 **For deterrence of possible misconduct:** The AMCs shall put in place robust surveillance systems and internal control procedures, to deter possible misconduct by employees or

such other entities which may have information relating to fund management and/or investments of Mutual Fund schemes.

4.1.2 For detection of possible misconduct: The AMCs shall customize their surveillance systems and internal control procedures including alert types, parameters and thresholds based on back testing of historical data to ensure their effectiveness.

4.1.3 For processing of alerts relating to possible misconduct:

- a) In order to determine the likelihood of misconduct, AMCs shall process system driven alerts in conjunction with soft alerts such as lifestyle checks, recording of communication (such as recorded emails, chats), CCTV footage etc.
- b) If the AMCs detect any alert, suspicion or exceptions relating to possible misconduct, such instances shall be adequately investigated. For the purpose of such investigation AMCs shall examine all information including recorded communication, trading activity, lifestyle etc.
- c) In order to enable the AMCs to further investigate alerts mentioned at paragraph 4.1.3.b), the stock exchanges may provide relevant data to the AMCs.
- d) The Standard Operation Procedure ('SOP') for processing alerts shall also determine likelihood of wrongdoing and appropriate classification of alerts as actionable/ non-actionable.

4.1.4 For taking action in case of possible misconduct:

- a) The AMCs shall have a documented policy on types of actions to be taken based on likelihood of wrongdoing and other relevant factors. Further, the terms of employment/ contract shall also clearly specify the actions that may be taken by the AMCs in the likelihood of possible misconduct by the employees of AMCs and connected entities.
- b) AMCs shall take appropriate action against entities connected to the AMCs (including their employees), who appear to be directly or indirectly involved in possible misconduct.

Reporting and Escalation mechanism:

4.1.5 AMCs shall submit Action Taken Report, on actionable alerts at the level of AMCs, to the Board of Directors of AMCs, Trustees of Mutual Funds and SEBI on a periodic basis.

- 4.1.6 Escalation processes shall be documented in the SOP and appropriately implemented so as to keep Board of Directors of AMCs and Trustees of Mutual Funds apprised of status of compliance with the proposed framework.

Review and updation of systems and procedures:

- 4.1.7 The Audit Committee and Board of Directors of AMCs, shall review the compliance with the provisions of this framework at least on half-yearly basis and shall verify that systems in place for deterrence and reporting of possible misconduct, are adequate and operating effectively.
- 4.1.8 The Board of Directors of AMCs shall review and update the systems, processes, and control procedures on a regular basis (at least once a year) to keep pace with market developments and regulatory changes.

Sharing of resources/ systems/ infrastructure may be permitted:

- 4.1.9 In order to keep the costs low, AMCs may be permitted to share resources/ systems/ infrastructure. Further, mechanisms for sharing of such resources/ systems/ infrastructure may be suggested by AMFI, in consultation with SEBI.

Whistle blower policy:

- 4.1.10 All AMCs who are listed on recognized stock exchanges are required to have a vigil mechanism/ whistle blower policy as per SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. In view of the same, all AMCs irrespective of being listed or not, shall adopt a similar vigil mechanism/ whistle blower policy as applicable to listed AMCs, which specifically addresses market abuse practices.
- 4.1.11 Additionally, the whistle blower policy of AMCs shall also establish procedures to ensure adequate protection of the whistle blowers.

Responsibility and accountability:

- 4.1.12 The Chief Executive Office ('CEO'), Managing Director ('MD'), Compliance Officer ('CO') or other such analogous person of the AMCs shall be responsible to ensure that an institutional mechanism is put in place to deter, detect and report possible misconduct by its employees, dealers, stock brokers or any other connected entities. The CEO, MD, CO or other such analogous person of the AMCs shall also be held accountable for non-

compliance and/or negligence in implementing appropriate surveillance and internal control systems.

Relaxation in certain provisions:

4.1.13 As the proposals at paragraphs 4.1.1 to 4.1.12 seek to cast responsibility and accountability on the AMCs and their senior management for deterrence, detection and reporting of possible misconduct, certain extant provisions that have been considered onerous for compliance by the industry such as recording of all communication by fund managers and dealers as mentioned at paragraph 3.1 above may be subsequently relaxed, after implementation of the proposals herein.

5. Consultation

5.1. Keeping in mind the interest of unit holders and to deter, detect and report instances of possible misconduct at the level of AMCs, comments are sought on the following:

- a) Comments on the proposed framework at paragraph 4 above
- b) Any other suggestions/ comments

Public Comments on this Consultation Paper

1. Considering the implications of the said matter on the market participants, public comments are invited on the proposal. The comments/ suggestions may be provided as per the format given below:

Name of the person/entity proposing comments:			
Name of the organization (if applicable):			
Email Id:			
Contact details:			
Category: whether market intermediary/ participant/ AMC (mention type/ category) or public (investor, academican etc.)			
Sr. No.	Paragraph no. in the consultation paper	Issues (with page/paragraph nos., if applicable)	Comments

Kindly mention the subject of the communication as, “Consultation Paper on Institutional Mechanism for Asset Management Companies for deterrence of possible market abuse and fraudulent transactions”.

Comments as per aforesaid format may be sent by email to Ms. Manaswini Mahapatra, General Manager (manaswinim@sebi.gov.in), Mr. Peter Mardi, Deputy General Manager (peterm@sebi.gov.in) and Mr. Rushikesh Bhopatrao, Assistant Manager (rushikeshb@sebi.gov.in) latest by June 03, 2023. While sending the email, kindly mention the subject as “Consultation Paper on Institutional Mechanism for Asset Management Companies for deterrence of possible market abuse and fraudulent transactions”.

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(End of Consultation Paper)