<u>Front-Running in Mutual Funds: Cases, Recovery, and Investor Takeaways</u>

Due to SEBI's investigation into potential frontrunning at Quant Mutual Fund, many investors are concerned about how this might impact the fund's performance, with some considering exiting. However, understanding what frontrunning is and its potential fallout is crucial before making any decisions.

What is Front-Running?

Front-running is an unethical and illegal practice where a broker or a dealer trade on advance knowledge of pending orders from their clients. In mutual funds, it involves someone with insider information about large upcoming trades executing personal trades beforehand, capitalizing on the expected market movement caused by the fund's order.

How is Front-Running Done?

Front-running typically involves:

1. **Insider Access:** A broker or dealer learns about large trades the mutual fund plans to execute.
2. **Early Execution:** This individual trades in his personal account or for another client, buying or selling shares before the mutual fund's trade.
3. **Market Movement:** Once the mutual fund's large trade is executed, the stock price moves as expected.
4. **Profit Realization:** The front-runner closes their position at a profit, leveraging the price movement initiated by the fund's trade.

Impact of Front-Running

Front-running can severely impact:

- **Mutual Funds:** The fund buys stocks at a higher price or sells at a lower price than it would have, leading to reduced returns.
- **Investors:** Investors in the mutual fund suffer diminished returns on their investments.
- **Market Integrity:** It undermines market integrity, reducing trust among investors and damaging the reputation of financial institutions involved.

Cases of Front-Running in Indian Mutual Funds

Some high-profile frontrunning cases in the past include:

- **Aditya Birla Mutual Fund:** In April 2024, SEBI settled front-running allegations, with four entities paying ₹3 crore and facing a six-month debarment.
- **Axis Mutual Fund:** In March 2023, SEBI barred Viresh Joshi and 20 others from capital markets, seizing ₹30.5 crore in ill-gotten gains.
- **Deutsche Mutual Fund (DHFL Pramerica Mutual Fund):** In December 2021, Akash Singhania and his parents settled their case by paying ₹5 crore.
- **HDFC AMC**: SEBI slapped fine on 4 entities in July 2020 with the investigation by SEBI starting in 2006.

Recovery post-scandal

Mutual funds facing front-running scandals often recover over time:

- **HDFC Mutual Fund:** After implementing stronger compliance measures and improving transparency, the affected schemes recovered within a year, aligning performance with benchmarks. Some schemes underperformed benchmarks by 1-2% in subsequent quarters but recovered within a year.
- **Axis Mutual Fund:** Post-reforms and personnel changes, Axis Mutual Fund stabilized within six months, with performance gradually improving as investor confidence returned. Certain schemes underperformed benchmarks by 2-3% over subsequent months, showing improvement within six months as new strategies were implemented.

Impact on Mutual Fund Returns

Returns of mutual funds involved in front-running scandals are impacted but often show resilience:

- If top-level management is implicated, the impact is more severe, potentially leading to significant changes, investor withdrawals, and a longer recovery period.
- If only brokers or dealers are involved without management knowledge, the impact might be less severe. Prompt actions to replace involved parties and reinforce compliance measures can lead to quicker recovery.

Statistics and Facts

- In the Axis Mutual Fund case, accused fund managers allegedly made over INR 50 crore in illegal profits.
- SEBI's investigations have led to fines and penalties, including banning involved individuals from the securities market.
- Despite these incidents, the Indian mutual fund industry has grown, with assets under management (AUM) reaching INR 58.91 lakh crore by May 2024.

Conclusion

Front-running is a serious violation that can erode investor trust and may impact fund performance adversely.

However, history shows that with proper measures and better internal controls, mutual funds can recover and continue delivering value to investors. While regulatory bodies like SEBI are vigilant, investors must stay informed and cautious. By understanding the risks and being proactive, investors can better safeguard their investments in the Indian mutual fund landscape.