Capital Market Frauds : Reasons and Avoidances.

A Dissertation submitted in Partial Fulfillment of Requirement of the Degree

Of

LLM [Business Law]

Submitted by

Anjali Singh

ID NO 309

Under Guidance of Prof Dr. N.L.Mitra

MAY 2010

To,

The Chairman,

Post Graduate Council,

NLSIU Bangalore.

Subject: Permission to submit the dissertation.

Dear Sir,

This is with reference to submission of dissertation in partial fulfilment of LLM (Business Law) Degree at the NLSIU , Bangalore.

I have completed my dissertation titled "**Capital Market Frauds : Reasons and Avoidances**" in accordance with the requirements , verifications and suggestions of my guide Prof Dr N.L.Mitra. Pursuant to that I would like to request you to allow me to submit the same.

Thanking you,

Anjali Singh

ID NO 309

NLSIU Bangalore.

Endorsed by

Prof Dr N.L.Mitra

Signature

Chairman , PG Council

Declaration

I hereby declare that this dissertation entitled " **Capital Market Frauds : Reasons and Avoidances** " is the outcome of research conducted by me under the guidance of **Dr.N.L.Mitra , Former Director , National Law School of India University , Bangalore.**

I also declare that this is original except for such help taken from such authorities as has been acknowledged at the appropriate places .

I further declare that this work has not been submitted for any degree in any university.

Bangalore.

Date: 11/5/2010

ANJALI SINGH

Certificate

This is to certify that this dissertation " Capital Market Frauds : Reasons and Avoidances " submitted by Anjali Singh (ID NO 309) for the Degree of Masters of Laws of the National Law School of India University , is the product of bonafied research carried out under my guidance and supervision . This dissertation or any part thereof has not been submitted elsewhere for any other degree.

DATE: 11|5|2010

PLACE: NLSIU, BANGALORE.

(Prof Dr .N.L.Mitra)

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Date: 12/5/2010

Place: Bangalore

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Contents

Capital Market Frauds:

Reasons and Avoidances

Introduction:

It was in the year 1992 when Indian government was trying to implement the liberalization policy in India at that time came the first press report appeared indicating that there was a shortfall in the Government Securities held by the State Bank of India. In a little over a month, investigations revealed that this was just the tip of an iceberg which came to be called the *securities scam,* involving misappropriation of funds to the tune of over Rs. 3500 crores (about $ 1.2 billion). In an ever expanding ambit, the scam has engulfed top executives of large nationalized banks, foreign banks and financial institutions, brokers, bureaucrats and politicians. The functioning of the money market and the stock market has been thrown in disarray[1]. The scam has generated such immense public interest that it has become a permanent feature on the front pages of newspapers and even after many years of this event still the position of Indian Stock Market is same there are no significant change in the situation. A large number of agencies, namely, the Reserve Bank of India (RBI), the Central Bureau of Investigation (CBI), the Income Tax Department, the Directorate of Enforcement and the Joint Parliamentary Committee (JPC) are currently investigating various aspects of the scam.

In an attempt to expedite legal processes, the government responded to the scam with promulgation of an ordinance[2] and setting up of a special court to try those accused in the scam. The ordinance ordered attachment of property of all the accused and voided all transactions done by the accused brokers and their firms after April 1, 1991. These extraordinary measures were so harsh that even the purchases made by genuine investors were invalidated, if the shares at some stage had been routed through the accused brokers. This led to the creation of

[1] Bhole. L.M "Financial Institutions and Market: Structure, Growth and Innovation, Tata Mc Graw Hill. New-Delhi.
[2] Chandra Prasanna "Indian Capital market: pathways of development" Journal of management Vol.20 PP.No 2-3.

what came to be known as "tainted" shares. The tainted shares were worthless in the market as they could not be sold. The scam also had an impact on the liberalization policies being pursued by the government with several reform measures being put on hold.

As is to be expected, everyone is trying to disown the responsibility for the scam. The RBI[3] has blamed the commercial banks, charging them with negligence and extensive violation of banking regulations. The commercial banks were in turn blaming the RBI for inefficient functioning and ineffective supervision. The brokers are being accused by all of downright fraud. The government has chosen the ubiquitous term "systems failure" to describe the reason for the scam. All this has left a lay reader thoroughly confused. The daunting nature of the task of understanding the scam is clear from the arcane terms and acronyms used to describe the scam: ready forward, double ready forward, SGL, PDO, BR, PMS etc. Comprehending these terms however is essential for understanding the ramifications of the scam[4]. In this work it is tried to first present a plausible reconstruction of how the scam originated and how it was perpetrated. Then discuss the aftermath of the scam, and critically examine the government's response to the scam, before suggesting policy initiatives required to clean up the financial system. The work is essentially expository in nature and is based on our analysis of the available published material on then scam as well as our discussions held at various platform in the securities markets.

[3] BSE 2002 "BSE investor awareness Hand book for NSDL Depository operation module.

[4] Gupta L.C (1992) "stock exchange trading in India: Agenda for Reform, Society for capital market R& D, New-Delhi PP. 123.

Research Methodology

Abstract:

The term "Capital Market Frauds" refers to a diversion of funds from the banking system to various stockbrokers in a series of transactions. The scam has from several years become a permanent feature of the front pages of the newspapers and a matter of great concern. Despite the massive media coverage of the scam, most readers found it hard to understand it particularly when they were confronted with arcane terms and acronyms like ready forward, double ready forward. Nevertheless an understanding of the scam is a prerequisite for any meaningful analysis of policy alternatives to improve the functioning of the financial system. This work presents a plausible reconstruction of how the scam originated, how it was perpetrated, and what would be its aftermath. The paper is expository in nature and the authors make no claims to omniscience.

The work goes on to discuss the response of the government to the scam in terms of

1) discovering and punishing the guilty,

2) recovering the money, and

3) reforming the system.

While agreeing with the importance of discovering and punishing the guilty, the work argues that the attempt of the government to recover the money by such measures as the tainted shares law which cause severe and unjustified hardship to genuine

and innocent investors is misguided. Turning to the arena of reforms of the financial system, the paper argues that the origins of the scam lie in overregulation of our markets. It recommends that normal transactions must be allowed to be done openly and transparently, and the role of brokers as market makers must be recognized. The second lesson from the scam is that artificial insulation of closely related markets from each other is counterproductive in the long run. Artificial barriers between the money market and the capital market, between the market for corporate securities and the market for government securities and between the formal money market and the informalone must be eliminated.

Scope and Limitation:

The scope of this work is to analyze the concept of Capital Market Frauds as it has been a matter of discussion since from a very long time and also in what manner this is committed that all the laws and other regulatory bodies are not able t o trace that what is going on in the market. The researcher has tried to rely on the law in this regard in the form of Acts, Regulations and Circulars etc.

Research Questions:

- To study the investors protection mechanism prescribed by the SEBI.
- To study SEBI Regulations with respect to stock market frauds.
- To study the instruments available to SEBI to protect safety and integrity of the stock market.

- The scams remain under investigation with no concrete steps taken against default companies.

Hypothesis:

- Modus operandi for committing Capital Market Frauds.
- Laws for investor's protection are not efficient enough to curb the menace.
- SEBI as regulator is not a good boss to regulate its affairs.

Mode of Writing:

The researcher has primarily adopted the descriptive method of writing. The analytical and comparative approach has also been used where ever found necessary.

Mode if Citation:

A uniform mode of citation has been adopted and followed consistently throughout this work.

Chapter 1

Indian Capital Market: At a glance.

The financial system of every economy consists of various constituents such as:

1. Financial institutions.
2. Financial companies.
3. Financial markets.
4. Financial instrument.
5. Financial services.
6. Financial regulations.

The major concern here is the regulation of the financial services in India. There are a number of Acts , legislations, guidelines, rules, regulations and notifications issued by concerned ministries or regulating bodies. Financial services in India are governed and regulated by SEBI through a set of various rules and regulations notified by SEBI . Individual professionals registered by SEBI as market intermediary are regulated by SEBI otherwise they are bound by their respective regulations and code of conducts of institutes of which they are member like ICSI, ICAI, ICWAI and ICFAI. No stock-broker, sub- broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with

securities market shall buy, sell or deal in securities except under, and in accordance with, the conditions of a certificate of registration obtained from the Board in accordance with the [regulations] made under this Act. An intermediary cannot commence acting as such without obtaining certificate from SEBI.

All capital market intermediaries will be subject to supervision and control of SEBI and SEBI also give time to time regulations on Insider Trading and unfair trade practices. The Indian Capital Market in recent past has witnessed a very significant growth. Liberalization measures introduced in the Indian Economy by Government through devaluation , deregulation , delicencing , globalization and free pricing have further increased the interest in stock market. A number of new investors and significant new funds have been inducted into the market.

The recent growth of capital market has exhibited some undesirable trends and has also raised several issues which need to be analysed and resolved so that their full benfit could be achieved for long term growth[5]. There are issues such as factor causing movement in share prices , investors protection , integrity of stock exchange members , the need for high standards of disclosures , capital adequacy norms , greater transparency in operations , inadequacy of existing regulatory framework and the need of the stock market to perform their monitoring and self regulatory functions in a better way .

SEBI emerged as The Securities and Exchange Board of India came into being through an administrative order- Resolution of Government of India, Department of Economic Affairs No. 1(44) SE/86 dated April 12, 1988. It started functioning under the over-all administrative control of Ministry of Finance till it got an independent statutory status in 1992. Infact the resolution creating SEBI itself had envisaged that

[5] Agrawal Sanjeev , Manual of Indian Capital Market , Bharat Law House, edition 1997, page 13.

it was an interim body pending enactment of a comprehensive legislation to create the proposed statutory board. The statutory status was conferred though an ordinance passed on January 30, 1992. The Act was passed in the same year in April. As per the Statement of Objects and Reasons (stated in SEBI Bill of 1992), SEBI was being vested with statutory powers required to deal effectively with all matters relating to the capital market, with the ultimate objective of investor protection in view. However, the Act gave only a limited autonomy to SEBI as the Board was bound by the directions of the Central Government on questions of policy (Section 16) and the Central Government could supersede the Board in certain situations (Section 17). The Board also had the obligation to furnish returns and reports to the Central Government in relation to its activities (Section 18). Under the SEBI Act of 1992, SEBI was given the authority to levy fees and other charges for carrying out its purposes under Section 11, which is indicative of some autonomy that it had. As far as its enforcement powers are concerned it only had the power to impose penalty of suspension and cancellation of a certificate of registration of an intermediary for any violation of the Act / Rules/Regulations. SEBI had to obtain prior sanction of Central Government for making a complaint to the Court of any offence punishable under the Act or rules/regulations thereunder[6].

However SEBI Act of 1992 did not give adequate powers to SEBI to protect the interest of investors. SEBI had no power over companies who were the issuers of securities and governed by Companies Act of 1956[7], especially when it came to questions of corporate governance. In 1993, promoters of certain MNCs started the trend of allotting shares to themselves on a preferential basis after obtaining general body clearances, at a substantial discount compared to the market price, which meant a large loss to minority

[6] "Special issues on Indian Capital Market" Indian journal of Commerce Vol. 57 Oct-Dec-2004.
[7] Gupta Ramesh "Retail Investors" The Chartered Accountant, February 1999. PP No. 12-18.

shareholders. SEBI issued new guidelines in 1994 on preferential allotment that prohibited preferential allotments at a price lower than the average market price during the last six months. The MNCs protested against this as an assault on "shareholder democracy".

Chapter 2

Powers of Security Exchange Board of India:

For a Regulator to function effectively it is important that the powers that it can exercise either as a preventive or a remedial measure and the eventualities in which they can be exercised are clearly and definitely provided for- the very object of conferring it with statutory powers. In SEBI's case the conditions for exercise of functions and powers under Sections 11 & 11B were laid down in broad terms such as to protect the interests of investors in securities, promote orderly development of securities market, etc. though Section 11(2) did enumerate the specific measures which SEBI could take to achieve its objective under the SEBI Act. Similarly the power to issue directions was broadly termed as no specific directions that could be issued were provided for. In such a situation, there was ample opportunity for the Courts, to which the party aggrieved by the Regulator's measure appealed, to interpret the scope of the Regulator's powers[8].

SEBI being the creation of a statute- SEBI Act, 1992 was to be guided in its functioning by the objectives set out in the statute. The Act entrusted SEBI with the functions of protecting the interest of investors, promoting the development of securities market and regulating it. The functions of market development and market regulation can often be in

[8] Pandy V.H "SEBI: it's Role, powers, functions and activities" chartered secretary. Vol 22, PP. 9.

conflict with each other[9]. Thus either of the two functions would take a back seat according to the need of the situation.

In 1992 when SEBI came into being, the focus was on growth of the market and a liberal regime of free pricing of public issues was put in place by the policy-makers. However, when this approach resulted in irresponsible and irrational pricing by the issuers, SEBI had to concentrate more on its regulatory role by bringing about improvements in the disclosure norms for offer documents. SEBI from time to time issued clarifications to the Guidelines for Disclosure and Investor Protection since they were issued in 1992, through DIP series circulars (for disclosure and investor protection) and GI series circulars (for General Instructions to merchant bankers). Significant changes were introduced in the standard of disclosure in offer documents based on recommendations of Malegam Committee appointed in March 1995, which included extending the applicability of guidelines to unlisted companies proposing to make a public issue and to finance companies (eligibility condition for a public issue by them); making the offer document submitted to SEBI for vetting, a public document; additional requirements to those mentioned Schedule II of Companies Act to be stated in the prospectus to be submitted to SEBI for vetting, introduction of book building system for IPOs, etc. In 2000 SEBI issued SEBI (Disclosure and Investor Protection) Guidelines by consolidating all the DIP and GI series guidelines. These provide for free pricing subject to the basis for issue price being disclosed and justified on the basis of certain criteria mentioned

[9] "NSDL" An investor's guide ton depositors.

The functioning of SEBI is also to be seen in the light of the multiple regulators for the capital market. SEBI had to share its regulatory responsibility with the Department of Economic Affairs, Department of Company Affairs and RBI.

The Capital Market Division of Department of Economic Affairs is entrusted with policy formulation for development of Capital market in consultation with inter alia SEBI, RBI and other agencies. SEBI's primary responsibility can be seen as day to day regulation or monitoring of the capital markets.

After the Securities Scam of 1992, the Government (Ministry of Finance) set up a High Level Committee on Capital Market (HLCCM)[10] to ensure better coordination among the multiple regulators. However it is quite evident that regulatory coordination amongst various regulators has been practically nil. On the contrary there was a relationship of hostility between the DCA and SEBI, each of them vying for more regulatory powers, but putting the blame on the other when things went wrong (Vanishing Companies case).

When it came to taking action against the manipulators, SEBI often complained of lack of powers (especially in respect of companies). However there were instances when SEBI failed to take action in time inspite of having the powers. For example in the case of price rigging of BPL, Videocon and Sterlite shares in 1998, even after completing its investigation SEBI took action

[10] HLCCM consists of-
Governor RBI, who is the Chairman of the Committee
Secretary, Economic Affairs
Chairman of SEBI
Chairman of IRDA

against the companies and the manipulator – Harshad Mehta, after three years , in 2001 after yet another scam had taken place.

Despite the frequency of scams and market manipulations in the period between 1992 and 2000, SEBI certainly evolved as a Regulator, though the process was not smooth. Although it took a scam or a major market manipulation for the Government to realize that greater powers need to be given to the Regulator, SEBI got some significant powers during this period in respect of all intermediaries, mutual funds, collective investment schemes and finally the companies.

The year 2000 was quite important for SEBI in so far as its attained legitimate regulatory powers over companies, under the provisions of Companies Act, 1956. It was delegated[11] the prosecution powers under various provisions of Companies Act which were earlier exercised by the Department of Company Affairs. Thus SEBI got the power to impose penalty for issue of prospectus in contravention of Section 57 (which requires expert to be unconnected with the formation and management of company) & Section 58 (which requires expert's written consent to issue of prospectus containing statement by him)[12]; the power to prosecute (for criminal liability) for mis-statements in prospectus[13]; the power to impose penalty for fraudulently inducing persons to invest money[14]; the power to prosecute for non-return of application money where permission of stock exchange to list securities is not granted[15]; the

[11] Vide Notification No. GSR 727(E), dated, 18-9-2000

[12] Section 59, Companies Act, 1956
[13] Section 63, Companies Act, 1956
[14] Section 68, Companies Act, 1956
[15] Section 73(2), Companies Act, 1956

power to impose penalty for default in re-paying excess of application money[16]; the power to impose penalty for failure to distribute dividends within thirty days after declaration[17].

A significant addition to SEBI's regulatory armoury in respect of companies raising capital through a public issue was the insertion of Section 55A by Companies (Amendment) Act of 2000. It gave certain powers to SEBI in relation to prospectus, allotment and other matters relating to issue of shares and debentures in respect of listed public companies and public companies which intend to get their securities listed on a recognised stock exchange in India. Another power conferred by the Amendment Act, which was to come handy in checking the utilization of funds raised through public issue, was to inspect the books of account and other books and papers of a company in respect of matters covered under sections referred to in Section 55 A.[18]

Another significance of year 2000 was that SEBI in exercise of it powers under Section 11 enacted detailed guidelines[19] to be followed by a company raising capital through a public issue, giving it the power to enforce these guidelines [Clause 17.1of SEBI (DIP) Guideline, 2000] as well. This was a step towards ensuring that SEBI closely monitors each step of a public issue by a company for a greater protection of the interest of investors.

[16] Section 73(2B), Companies Act, 1956
[17] Section 207, Companies Act, 1956
[18] Section 209(1) (iii), Companies Act, 1956
[19] SEBI (Disclosure & Investor) Protection Guidelines, 2000

Chapter 3

Investors Protection Law in India:

SEBI has been working targetting the securities and is attending to the fulfillment of its objectives with commendable zeal and dexterity. The improvements in the securities markets like capitalization requirements, margining, establishment of clearing corporations etc. reduced the risk of credit and also reduced the market[20].SEBI has introduced the comprehensive regulatory measures, prescribed registration norms, the eligibility criteria, the code of obligations and the code of conduct for different intermediaries like, bankers to issue, merchant bankers, brokers and sub-brokers, registrars, portfolio managers, credit rating agencies, underwriters and others. It has framed bye-laws, risk identification and risk management systems for Clearing houses of stock exchanges , surveillance system etc. which has made dealing in securities both safe and transparent to the end investor. Another significant event is the approval of trading in stock indices (like S&P CNX Nifty & Sensex) in 2000.

The basic objectives of the Board were identified as:

* to protect the interests of investors in securities;
* to promote the development of Securities Market;
* to regulate the securities market and
* for matters connected therewith or incidental thereto.

[20] Dr. D.M.Madari "Capital Market Reforms: Some Issues"

A market Index is a convenient and effective product because of the following reasons:

- It acts as a barometer for market behavior;
- It is used to benchmark portfolio performance;
- It is used in derivative instruments like index futures and index options;
- It can be used for passive fund management as in case of Index Funds.

Two broad approaches of SEBI is to integrate the securities market at the national level, and also to diversify the trading products, so that there is an increase in number of traders including banks, financial institutions, insurance companies, mutual funds, primary dealers etc. to transact through the Exchanges. In this context the introduction of derivatives trading through Indian Stock Exchanges permitted by SEBI in 2000 AD is a real landmark.

SEBI appointed the **L. C. Gupta Committee** in 1998 to recommend the regulatory framework for derivatives trading and suggest bye-laws for Regulation and Control of Trading and Settlement of Derivatives Contracts. The Board of SEBI in its meeting held on May 11, 1998 accepted the recommendations of the committee and approved the phased introduction of derivatives trading in India beginning with Stock Index Futures. The Board also approved the "Suggestive Bye-laws" as recommended by the Dr LC Gupta Committee for Regulation and Control of Trading and Settlement of Derivatives Contracts.

SEBI then appointed the **J. R. Verma Committee** to recommend Risk Containment Measures

(RCM) in the Indian Stock Index Futures Market. The report was submitted in november 1998.

However the Securities Contracts (Regulation) Act, 1956 (SCRA) required amendment to include "derivatives" in the definition of securities to enable SEBI to introduce trading in derivatives. The necessary amendment was then carried out by the Government in 1999. The Securities Laws (Amendment) Bill, 1999 was introduced. In December 1999 the new framework was approved.

Derivatives have been accorded the status of `Securities'[21]. The ban imposed on trading in derivatives in 1969 under a notification issued by the Central Government was revoked. Thereafter SEBI formulated the necessary regulations/bye-laws and intimated the Stock Exchanges in the year 2000. The derivative trading started in India at NSE in 2000 and BSE started trading in the year 2001.

Securities Exchange Board of India Act 1992[22], is the basic and primary piece of legislation which mainly focuses on the investors protection who trade in securities, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. Regulating the business in stock exchanges and any other securities markets; registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets

[21] R. Subramaniam, 1995. "Corporate finance in developing countries: new evidence for India", CRIEFF Discussion Paper No. 9512.

[22] Vikas Gupta " A need for research to amend SEBI Act"; SEBI and Corporate Laws Magazine; Volume 92; 2009, page 89

in any manner; registering and regulating the working of the depositories, [participants,] custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the Board may, by notification, specify in this behalf; registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds; promoting and regulating self-regulatory organisations; prohibiting fraudulent and unfair trade practices relating to securities markets; promoting investors' education and training of intermediaries of securities markets; prohibiting insider trading in securities; regulating substantial acquisition of shares and take-over of companies; calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self- regulatory organisations in the securities market; calling for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which is under investigation or inquiry by the Board. Board may take measures to undertake inspection of any book, or register, or other document or record of any listed public company or a public company (not being intermediaries referred to in (section 12) which intends to get its securities listed on any recognised stock exchange where the Board has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to securities market. Board shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908),while trying a suit, in respect of the following matters, namely :

(i) the discovery and production of books of account and other documents, at such place and such time as may be specified by the Board;

(ii) summoning and enforcing the attendance of persons and examining them on oath;

(iii) inspection of any books, registers and other documents of any person referred to in section 12, at any place;

(iv) inspection of any book, or register, or other document or record of the company referred to in sub-section (2A);

(v) issuing commissions for the examination of witnesses or documents.]

(4) Without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) and section 11B, the Board may, by an order, for reasons to be recorded in writing, in the interests of investors or securities market, take any of the following measures, either pending investigation or inquiry or on completion of such investigation or inquiry, namely:-

(a) suspend the trading of any security in a recognised stock exchange;

(b) restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;

(c) suspend any office-bearer of any stock exchange or self- regulatory organisation from holding such position;

(d) impound and retain the proceeds or securities in respect of any transaction which is under investigation;

(e) attach, after passing of an order on an application made for approval by the Judicial Magistrate of thefirst class having jurisdiction, for a period not exceeding one month, one or more bank account or accounts of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act, or the rules or the regulations made and provided that only the bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the

provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached; direct any intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of any transaction which is under investigation provided that the Board may, without prejudice to the provisions contained in subsection (2) or sub-section (2A), take any of the measures specified in clause (d) or clause (e) or clause (f), in respect of any listed public company or a public company (not being intermediaries referred to in section 12) which intends to get its securities listed on any recognised stock exchange where the Board has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to securities market provided further that the Board shall, either before or after passing such orders, give an opportunity of hearing to such intermediaries or persons concerned. Board can conduct investigation if it has reason to believe the transactions in securities are being dealt with in a manner detrimental to the investors or the securities market; or any intermediary or any person associated with the securities market has violated any of the provisions of this Act or the rules or the regulations made or directions issued by the Board thereunder, It may, at any time by order in writing, direct any person (hereafter in this section referred to as the Investigating Authority) specified in the order to investigate the affairs of such intermediary or persons associated with the securities market and to report thereon to the Board. Without prejudice to the provisions of sections 235 to 241 of the Companies Act, 1956(1 of 1956), it shall be the duty of every manager, managing director, officer and other employee of the company and every intermediary referred to in section 12 or every person associated with the securities market to preserve and to produce to the Investigating Authority or any person authorised by it in this behalf, all the books,

registers, other documents and record of, or relating to, the company or, as the case may be, of or relating to, the intermediary or such person, which are in their custody or power.

The Investigating Authority may require any intermediary or any person associated with securities market in any manner to furnish such information to, or produce such books, or registers, or other documents, or record before it or any person authorised by it in this behalf as it may consider necessary if the furnishing of such information or the production of such books, or registers, or other documents, or record is relevant or necessary for the purposes of its investigation. The Investigating Authority may keep in its custody any books, registers, other documents and record produced under sub-section (2) or sub-section (3) for six months and thereafter shall return the same to any intermediary or any person associated with securities market by whom or on whose behalf the books, registers, other documents and record are produced.

The Board has to play role in prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities or control. No one shall use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made or shall employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock Exchange nor shall engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made thereunder, engage in insider trading,

deal in securities while in possession of material or non-public information or communicate such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules or the regulations made thereunder; acquire control of any company or securities more than the percentage of equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange in contravention of the regulations made under this Act.

The Board [23]has the power to adjudicate into the matters related to the fraudulent practices Board shall appoint any of its officers not below the rank of a Division Chief to be an adjudicating officer for holding an inquiry in the prescribed manner after giving any person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty. While holding an inquiry, the adjudicating officer shall have power to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or to produce any document which in the opinion of the adjudicating officer, may be useful for or relevant to the subject matter of the inquiry and if, on such inquiry, he is satisfied that the person has failed to comply with the provisions of any of the sections specified in, he may impose such penalty as he thinks fit in accordance with the provisions of any of those sections.

While adjudging quantum of penalty under section 15 I, the adjudicating officer shall have due regard to the following factors, namely:

(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to an investor or group of investors as a result of the default;

(c) the repetitive nature of the default.

[23] Prashant Abhilekh " Future in Share Market" SEBI and Corporate Laws Magazine; Volume 92; 2009; page 117

Under Section 388B of the Companies Act, the Central Government is permitted to petition the CLB if there are circumstances suggesting, *inter alia*, that the persons conducting the management and affairs of a company are guilty of fraud, misfeasance, persistent negligence or default in carrying out their business or breach of trust, or the business of the company has not been conducted by such persons with sound business principles or prudent commercial practice. Section 388C of the Companies Act permits the CLB, if it is in the public interest, to issue interim orders and direct a person not to discharge his or her duties and appoint a suitable person in lieu thereof. Under Section 388C, the replacement person shall be deemed a "public servant" for purposes of the Indian Penal Code.

Section 408 of the Companies Act permits the Central Government to take action against a company when there is an act of oppression against the minority shareholders under Section 397 of the Companies Act or an action of mismanagement of the company under Section 398 of the Companies Act. Section 403 permits the CLB to issue interim orders for any proceeding under Sections 397 or 398. Accordingly, the CLB invoked these provisions of the Companies Act to suspend the Satyam board and appoint new directors proposed by the Central Government. Under the Indian Penal Code, any person who is a party to a criminal conspiracy, commits a criminal breach of trust, is guilty of cheating, falsifies accounts or forges documents is liable to a fine or imprisonment that may extend to 10 years or both. Sections 120-B (punishment for conspiracy) read with Sections 409 (criminal breach of trust), 420 (cheating), 467 and 468 (forgery), 471 (use of forged documents) and 477A (falsification of accounts) of the Indian Penal Code.

Section 372 A Company Law, [24]Section 372A of the Companies Act, 1956 (The Act) deals with intercorporate Loan, Investment, Guarantee and Securities in connection with loan. All the four transactions are frequently taken place in any company and henceforth the section becomes more important and therefore it requires to special heed by virtue of strict penal provisions and because of no much space to play.In this section an amendment is proposed as this is an easy way out to facilitate scams as it was used in Satyam Fiasco. According to the proposed amendment Central Government may prescribe for certain class of companies like stock brokers or any other intermediary, the limits upto which they may receive inter corporate loans or deposits or extent to which they may make loans or inter corporate deposits or inter corporate investment. A sub-section (9A) to Section 372A is proposed to be inserted wherein a company can make investments only through one investment company.

The proposed restriction is only where funds are sought to be placed at the disposal of investment company whose principal business is acquisition of shares or debentures or other securities. There will not be any restriction on a company directly subscribing, purchasing or acquiring securities of other bodies corporate which are not investment companies. There is also no restriction on a company forming subsidiaries which are not investment companies. The proposal is essentially to facilitate monitoring of funds and to identify diversion of funds through the route of Investment Company.

[24] K.K.Jhanwar" Section 372-A of the Companies Act – a recipe of Fraud" SEBI and Corporate Law Magazine; volume 91; 2009 ; page 125.

Chapter 4

Mechanism of Frauds:

The Ready Forward Deal,

the crucial mechanism through which the scam was effected was the ready forward (RF) deal. The RF is in essence a secured short term (typically 15 day) loan from one bank to another bank. The lending is done against government securities, exactly the way a pawnbroker lends against jewellery or other valuables.

In form, however, the RF is not a loan at all. The borrowing bank (Bank 2) actually *sells* the securities to the lending bank (Bank 1) and buys them back at the end of the period of the loan at (typically) a slightly higher price. The price difference represents the interest on the loan[25].

The RF is what in other countries is known as repo or repurchase agreement. It is a very safe and secure form of lending and is very common throughout the world. The US repo market, for example, is about a hundred times larger than the Indian RF market.

The RF in India serves two main purposes:

Like repo markets around the world the RF deals provide much needed liquidity to the government securities markets. The RF deals are an important tool in the hands of the banks to manage their Statutory Liquidity Ratio (SLR) requirements. Banks in India were required to maintain 38.5% of their demand and time

[25] D.W., 1991. "Monitoring and reputation: the choice between bank loans and directly placed debt", *Journal of Political Economy*, 99(4): 689-721.

liabilities (DTL) in government securities and certain approved securities which are collectively known as SLR securities. RF helps in managing this requirement in two ways: ¾ A bank which has a temporary surge in DTL may not want to buy SLR securities outright and then sell them when the DTL comes back to normal. Instead it can do an RF deal whereby it effectively borrows the securities from a bank which has surplus SLR securities. An RF in SLR securities can thus be seen either as lending of money or as borrowing of securities.

¾ An RF deal is not legally a loan. The amount borrowed by a bank under RF is not regarded as a part of the bank's liabilities[26]. Therefore it is not a part of its DTL, and does not attract the SLR requirement. Had the bank borrowed outright, it would have had to maintain 38.5% of the borrowing in SLR securities.

The Mechanics of the Scam ,as explained above, a ready forward deal is, in substance, a secured loan from one bank to another. To make the scam possible, the RF had to undergo a complete metamorphosis: it had to become an unsecured loan to a broker. How was this transformation brought about?

The three crucial steps to effect the metamorphosis were:

The settlement process in the government securities market became broker intermediated, that is, delivery and payments started getting routed through a broker instead of being made directly between the transacting banks.

[26] "The Theory of Capital Structure", *Journal of Finance*, XLVI(1): 297-355.

The broker through whom the payment passed on its way from one bank to another found a way of crediting the money into his account though the account payee cheque was drawn in favour of a bank.

While the above two steps transformed an RF deal from a loan to a bank into a loan to a broker, it would still be a secured loan[27]. However, the brokers soon found a way of persuading the lending bank to dispense with security for the loan or to accept worthless security.

We shall now elaborate on each of these steps, in order to clearly understand the modus operandi used in the scam.

Settlement Process:

The normal settlement process in government securities is that the transacting banks make payments and deliver the securities directly to each other. The broker's only function is to bring the buyer and seller together and help them negotiate the terms, for which he earns a commission from both the parties. He does not handle either the cash or the securities. During the scam, however, the banks or at least some banks adopted an alternative settlement process which was similar to the process used for settling transactions in the stock market. In this settlement process, deliveries of securities and payments are made through the broker. That is, the seller hands over the securities to the broker who passes them on to the buyer, while the buyer gives the cheque to the broker who then makes the payment to the seller.

[27] Khanna, T. and K. Palepu, 1999. "Emerging market business groups, foreign investors and corporate governance", NBER Working Paper No. 6955.

In this settlement process[28], the buyer and the seller may not even know whom they have traded with, both being known only to the broker.

There were two important reasons why the broker intermediated settlement began to be used in the government securities markets:

The brokers instead of merely bringing buyers and sellers together started taking positions in the market. In other words, they started trading on their own account, and in a sense became market makers in some securities thereby imparting greater liquidity to the markets.

When a bank wanted to conceal the fact that it was doing an RF deal, the broker came in handy. The broker provided contract notes for this purpose with fictitious counterparties, but arranged for the actual settlement to take place with the correct counterparty.

Account Payee Cheques:

A broker intermediated settlement allowed the broker to lay his hands on the cheque as it went from one bank to another through him. The hurdle now was to find a way of crediting the cheque to his account though it was drawn in favour of a bank and was crossed account payee. As it happens, it is purely a matter of banking custom, that an account payee cheque is paid only to the payee mentioned on the cheque. In fact, exceptions were being made to this norm, well before the scam came to light. Privileged (corporate) customers were routinely allowed to credit account payee cheques in favour of a bank into their

[28] Myers, S.. "Determinants of corporate borrowing", *Journal of Financial Economics*, 5 1977: 147-175.

own accounts to avoid clearing delays, thereby reducing the interest lost on the amount. Normally, if a customer obtains a cheque in his own favour and deposits it into his own account, it may take a day or two for the cheque to be cleared and for the funds to become available to the customer. At 15% interest, the interest loss on a clearing delay of two days for a Rs. 100 crore cheque is about Rs. 8 lacs. On the other hand, when banks make payments to each other by writing cheques on their account with the RBI, these cheques are cleared on the same day. The practice which thus emerged was that a customer would obtain a cheque drawn on the RBI favouring not himself but his bank.The bank would get the money and credit his account the same day. This was the practice which the brokers in the money market exploited to their benefit[29].

Dispensing with the Security:

The brokers thus found a way of getting hold of the cheques as they went from one bank to another and crediting the amounts to their accounts. This effectively transformed an RF into a loan to a broker rather than to a bank. But this, by itself, would not have led to the scam because the RF after all is a secured loan, and a secured loan to a broker is still secured.

What was necessary now was to find a way of eliminating the security itself. Three routes adopted for this purpose were:

Some banks (or rather their officials) were persuaded to part with cheques without actually receiving securities in return. A simple explanation of this is that the officials concerned were

[29] Sarkar, J. and S. Sarkar, 2000. "Liberalization, financing pattern, and corporate performance in India"

bribed and/or negligent. A more intriguing possibility is that the banks' senior/top management were aware of this and turned a Nelson's eye to it to benefit from higher returns the brokers could offer by diverting the funds to the stock market. One must recognize that as long as the scam lasted, the banks benefited from such an arrangement. The management of banks might have been sorely tempted to adopt this route to higher profitability.

The second route was to replace the actual securities by a worthless piece of paper – a fake Bank Receipt (BR). This is discussed in greater detail in the next section.

The third method was simply to forge the securities themselves. In many cases, PSU bonds were represented only by allotment letters rather than certificates on security paper. And it is easier to forge an allotment letter for Rs. 100 crores worth of securities than it is to forge a 100 rupee note! Outright forgery of this kind however accounted for only a very small part of the total funds misappropriated.

Bank Receipt:

In an RF deal, as we have discussed it so far, the borrowing bank delivers the actual securities to the lender and takes them back on repayment of the loan. In practice, however, this is not usually done. Instead, the borrower gives a Bank Receipt (BR) which serves three functions:

The BR confirms the sale of securities.

It acts as a receipt for the money received by the selling bank. Hence the name – bank receipt.

It promises to deliver the securities to the buyer. It also states that in the meantime the seller holds the securities in trust for the buyer.

In short, a BR is something like an IOU (I owe you securities!), and the use of the BR de facto converts an RF deal into an unsecured loan. The lending bank no longer has the securities; it has only the borrower's assurance that the borrower has the securities which can/will be delivered if/when the need arises.

Control Systems:

The scam was made possible by a complete breakdown of the control system both within the commercial banks as well as the control system of the RBI itself. We shall examine these control systems to understand how these failed to function effectively and what lessons can be learnt to prevent failure of control systems in the future.

The internal control system of the commercial banks involves the following features:

Separation of Functions: The different aspects of securities transactions of a bank, namely dealing, custody and accounting are carried out by different persons. Dealing refers to the decision about which transactions are to be entered into with which parties. Custody involves receiving and delivering securities/substitute instruments and cheques for the transactions done[30]. Accounting involves maintenance of the investment account of the bank and its reconciliation with the SGL account of the bank maintained by the PDO of the RBI. Closely related to separation of functions is the notion of double custody. Just as the currency chests in the banks are under double custody where two people have to collaborate to open it, the securities too are usually under double custody. The assumption underlying double custody is that two individuals

[30] Shleifer, A. and R. Vishny, 1987. "A survey of corporate governance', *Journal of Finance*, 52: 737-783.

are unlikely to have a criminal intent at the same time! In many banks like the National Housing Bank, these controls did not exist. In others, such as the State Bank of India, they existed but broke down partially or wholly because of the negligence of one or more of the functionaries.

Counterparty Limits: The moment an RF deal is done on the basis of a BR rather than actual securities, the lending bank has to contend with the possibility that the BR received may not be backed by any/adequate securities. In effect, therefore, it may be making an unsecured loan, and it must do the RF only if it is prepared to make an unsecured loan. This requires assessing the creditworthiness of the borrower and assigning him a "credit limit" up to which the bank is prepared to lend. Technically, this is known as a counterparty limit. Strictly, a counterparty limit is required even if an RF is done against actual securities because the securities may decline in value and the RF may end up becoming only partly secured though it was fully secured to begin with. Most of the foreign banks with the exception of the Standard Chartered Bank had very strict counterparty limits and were thus protected from lending too much against fake BRs. For a bank like the Bank of Karad, a reasonable counterparty limit may have been Rs. 50 *lacs* so that an RF for several hundred crores would be flatly refused. The Standard Chartered Bank either did not have or did not adhere to such limits and agreed to do these RFs.

The control system of the RBI should ideally involve the following:

The PDO keeps track of the aggregate of each type of government security claimed by all the banks and ensures that the figures tally with the aggregate value of the securities at the end of

each day. If all BRs are backed by securities, the seller's investment account would decrease and the buyer's account would increase by the transaction amount, leaving the aggregate unchanged.

A reconciliation of the SGL securities claimed by each bank through mandatory periodic statements with the total holding as recorded in the SGL account (of the bank) at the PDO, would help in pin-pointing the banks whose accounts need to be investigated.

These simple control mechanisms were not being operated by the PDO. What is more surprising is that even when discrepancies were discovered, such as when some SGL forms sent to the PDO bounced because of inadequate inventory of securities in the seller's account, the intimation regarding the inadequacy of securities was communicated to the buyer leisurely, may be through a letter by ordinary post, which could take days to reach. In the mean time, if the buyer sells the same securities on the strength of the SGL sent to the PDO, it could start an ever expanding chain of bounced SGLs It appears that the PDO was not particularly perturbed by such possibilities[31]. The RBI is expected to carry out site inspections and other audits of the investment accounts and procedures of the banks. These were not quite comprehensive and even when some irregularities were detected, the RBI did not act decisively against the erring banks. There are several aspects of the scam which are closely related to the securities markets, but which are different from the operational aspect of the markets. These pertain to information that can cause significant changes in the prices of securities as well as the information supplied by the commercial banks on their financial

[31] Shirai, S., 2002. "Assessment of India's banking sector reforms from the perspective of the governance of the banking system", in Economic and Social Commission for Asia and the Pacific and Asian Development Bank (ed.), *Rejuvenating Bank Finance for Development in Asia and the Pacific.*

performance. We need to understand these to appreciate the motivation for certain kinds of transactions that are entered into in the market.

Coupon Changes and Insider Trading:

During the period from September 1991 to June 1992, the government raised the interest (coupon) rate on its fresh borrowing three times. On each occasion the coupon rate was increased by 1/2%, thereby raising the coupon rate from 11.5% to 13% during this ten month period. The major implication of raising interest rate on new borrowings is that it would trigger a fall in the market prices of the old loans which are pegged at the old (lower) interest rates. The price of the 11.5% Government Loan 2010 dropped by 3% to 5% with each coupon rate hike. If anyone has advance information about these changes in the coupon rates, he could make enormous amounts of riskless profit by shortselling the old securities just before the announcement of rate hike and buying back (covering his position) after the prices have fallen. Somebody who took a short position of Rs. 500 crores before the coupon hike of September 1991 could have made a profit of Rs. 15 crores, practically overnight! Since several persons in the Finance Ministry and the RBI are likely to be aware of the impending hike in the coupon rate, the chance of leakage of this all important information is always there. There have been several allegations in this regard. However, it will probably be very difficult to prove with any degree of certainty that there was insider trading based on information about coupon rate changes, because of the size of the market. With a daily trading volume of Rs. 3000 - 4000 crores, it would have been very easy for anyone to take a position (based on inside information) of Rs. 500 or even Rs. 1000 crores without anyone suspecting anything untoward.

Window Dressing Bank Balance Sheets:

Most banks carry investments in their books at their cost of acquisition and do not mark it down to market. This creates serious distortions during a period when, as shown in the preceding section, the prices of securities are falling. If one assumes that prices of government securities fell by about 5% over the last year, then on an aggregate holding of these securities by the banking system of Rs. 70,000 crores, the paper loss of the banks would be Rs. 3,500 crores. A 10% fall in the prices of PSU bonds would imply a further paper loss of about Rs. 800 crores to the banks (based on the assessment that banks hold about Rs. 8000 crores worth of PSU bonds). Under the current system of accounting, these losses are recognized only when the securities are sold. This means that a bank would be reluctant to sell these securities and show the loss in its books. It was in this context that the banks and the brokers resorted to innovative methods of window dressing the bank balance sheet.

The basic idea is as follows:

a) The bank sells the securities trading at a discount to a broker at face value or at a price which is much higher than the prevailing market prices. The broker incurs a huge loss in this transaction as he will have to resell the securities to some other bank at market prices.

b) The bank then buys some other securities from the same broker at prices well above market prices. The broker therefore makes a huge profit in the second transaction which compensates him for the loss incurred in transaction (a).

Thus, the net result of the two transactions is that neither the bank nor the broker make any profit or loss. Then why would these transactions be done? The reason is that while the profit earned through transaction (a) would improve the

bottom line (profit) for the bank, the loss suffered by the bank in transaction (b) would not be reflected in its profit and loss account at all[32]. The securities bought would simply appear in the bank's balance sheet at inflated values! It is a most ingenious way of creating paper profits. As far the broker is concerned, the price in transaction (a) can be as high as the bank wants so long as he gets a correspondingly higher price in transaction (b). What the scam investigations have revealed is that window dressing of this kind was rampant. Instances have been recorded of the same broker selling the same security on the same day to different banks at vastly different prices. This makes it very difficult to fathom the motives for a single transaction in isolation from other transactions done by a bank. Unless one can put together the entire series of transactions, it is impossible to know whether the banks or the brokers have been the net gainers through all the manipulative transactions. It is conceivable that some brokers were willing to absorb a part of the losses as a quid pro quo for other "services" which the banks provided them.

It is interesting to note that even the pure RF deal involves an element of window dressing. The lending bank shows the interest received as an income in its profit and loss account. But the borrowing bank does not show the interest paid as an expense, because it simply carries the investment in its books at the higher repurchase price. It is, in fact, quite likely that the enormous increases in the profits that some of the banks reported in 1992 over the previous year, can at least in part be explained by use of such "creative" accounting practices.

Policy Responses Required:

It is clear that the government, the RBI and the commercial banks are as much accountable as the brokers for the scam. The brokers were encouraged and abetted

[32] Barua, S. K. and Varma, J. R. (1993b), "MNCs Must be Subjected to SEBI Acquisition Code", *Economic Times*, November 17, 1993.

by the banks to divert funds from the banking system to the stock market[33]. The RBI too stands indicted because despite knowledge about banks over-stepping the boundaries demarcating their arena of operations, it failed to reign them in. The looting was done with active connivance and sometimes full knowledge of the very individuals who were supposed to guard against such a possibility. What has been the response of the government so far and what needs to be done to ensure that such scams do not recur in the future? The response of any government to a scam of this kind would have three main facets:

1. Discover and punish the guilty. This task has been entrusted to the Central Bureau of Investigation (CBI) and to the Joint Parliamentary Committee (JPC). A special court has also been set up to facilitate speedy trial.

2. Recover the money. The draconian provisions of the Ordinance for attachment of property and voiding of transactions with the consequent creation of "tainted" shares were attempts in this direction.

3. Reform the system. The government's response so far has consisted of measures like banning of RF deals and going slow on liberalization. There cannot be two opinions on the need for identifying and punishing the guilty. The principal objective behind punishing the offenders is more to deter future offenders.

However, the government must ensure that not only the obviously guilty (the brokers) but also the not so obviously guilty (the bank executives, the bureaucrats and perhaps the politicians) are identified and brought to book. Investigations of this

[33] Cadbury, A., Chairman, (1992), *Report on the Financial Aspects of Corporate Governance.*

kind are necessarily time consuming and expensive, but they have to be gone through so that the credibility of the system is restored. A rule of thumb which is often quoted throughout the world is that investigation of any fraud will cost as much as the magnitude of the fraud itself. One can, therefore, expect the real costs of the scam investigation to be of the order of a couple of thousand crores at least.[34] While recovery of the money swindled from the banks is important, the method employed by the government to do that is extremely ham handed and unfair. While governments have, at all times, claimed special powers to recover dues like land revenue and taxes, the same principle cannot be extended to recovery of amounts which the government owned organizations (or for that matter, the foreign banks) have lost by their own negligence and complicity. There can be no justification for such measures as the "tainted" shares law which harass genuine innocent investors irrespective of the magnitude of the loss incurred. The most constructive response to the scam would be in the arena of reforms of the financial system. In our view, the origins of the scam lie in over-regulation of our markets. The regulations in the money markets were such that thoroughly legitimate and essential transactions could not be put through openly, but had to be disguised and camouflaged. The role of the brokers and of some of the banks as market makers was not recognized and they could perform these important and useful functions only by subterfuge. The payment and clearance system was so antiquated and cumbersome that totally indefensible methods had to be adopted to achieve speedy funds transfers. The net result of all these was a total lack of transparency in the operations in the money market. Irregularities of all kinds were so common that no suspicions were aroused even by highly irregular transactions. The situation was an ideal environment for a scam to germinate and grow to alarming proportions. We would even argue that some of the control systems in the banks broke down because they had been deliberately allowed to weaken by both the commercial

[34] King, M. E., Chairman, (1997), *Report on Insider Trading*

banks as well as the RBI in order to facilitate normal transactions in violation of the RBI guidelines.

The other lesson from the scam is that artificial insulation of closely related markets from each other is counterproductive in the long run. Just as water finds its own level, money also seeks out the highest levels of return after due adjustments for risk and liquidity. Even after ten years of progressive liberalization of our financial markets, artificial barriers exist between the money market and the stock market, between the market for corporate securities and the market for government securities and between the formal money market and the informal one. Integration of these markets with the attendant equalization of returns in these markets, in our view, is a matter which should be accorded the highest priority in the agenda for financial reforms. This integration will allow a coherent yield curve to emerge covering the entire financial markets.

In this context, the policy responses of the government in the direction of further regulation and controls, typified by the ban on RF deals appears to be quite misguided. Notwithstanding the repeated statements by the Prime Minister and the Finance Minister to the contrary, there are signs that the pace of liberalization has slowed down. This would be most unfortunate as the surest way of preventing scams of this type in the future would be to quickly bring the liberalization process to its logical conclusion by integrating the various financial markets. In this connection, the recommendations of the Nadkarni Committee, set up in the wake of the scam, to examine the functioning of the money market, that RF deals be permitted and that the entire settlement and clearing system be streamlined and computerized are to be welcomed.

Chapter 5

Big Scams in India:

1.Ramalinga Raju: The biggest corporate scam in India has come from one of the most respected businessmen.Satyam founder Byrraju Ramalinga Raju resigned as its chairman after admitting to cooking up the account books. His efforts to fill the "fictitious assets with real ones" through Maytas acquisition failed, after which he decided to confess the crime. With a fraud involving about Rs 8,000 crore (Rs 80 billion), Satyam is heading for more trouble in the days ahead. On Wednesday, India's fourth largest IT company lost a staggering Rs 10,000 crore (Rs 100 billion) in market capitalisation as investors reacted sharply and dumped shares, pushing down the scrip by 78 per cent to Rs 39.95 on the Bombay Stock Exchange. The NYSE-listed firm could also face regulator action in the US. "I am now prepared to subject myself to the laws of the land and face consequences thereof," Raju said in a letter to SEBI and the Board of Directors, while giving details of how the profits were inflated over the years and his failed attempts to "fill the fictitious assets with real ones." Raju said the company's balance sheet as of September 30 carries "inflated (non-existent) cash and bank balances of Rs 5,040 crore (Rs 50.40 billion) as against Rs 5,361 crore (Rs 53.61 billion) reflected in the books."

2.Harshad Mehta : He was known as the 'Big Bull'. However, his bull run did not last too long. He triggered a rise in the Bombay Stock Exchange in the year 1992 by trading in shares at

a premium across segments.Taking advantages of the loopholes in the banking system, Harshad and his associates triggered a securities scam diverting funds to the tune of Rs 4000 crore (Rs 40 billion) from the banks to stockbrokers between April 1991 to May 1992. Harshad Mehta worked with the New India Assurance Company before he moved ahead to try his luck in the stock markets. Mehta soon mastered the tricks of the trade and set out on dangerous game plan. Mehta has siphoned off huge sums of money from several banks and millions of investors were conned in the process. His scam was exposed, the markets crashed and he was arrested and banned for life from trading in the stock markets.
He was later charged with 72 criminal offences. A Special Court also sentenced Sudhir Mehta, Harshad Mehta's brother, and six others, including four bank officials, to rigorous imprisonment (RI) ranging from 1 year to 10 years on the charge of duping State Bank of India to the tune of Rs 600 crore (Rs 6 billion) in connection with the securities scam that rocked the financial markets in 1992. He died in 2002 with many litigations still pending against him.

3 .Ketan Parekh: Ketan Parekh followed Harshad Mehta's footsteps to swindle crores of rupees from banks. A chartered accountant he used to run a family business, NH Securities. Ketan however had bigger plans in mind. He targetted smaller exchanges like the Allahabad Stock Exchange and the Calcutta Stock Exchange, and bought shares in fictitious names. His dealings revolved around shares of ten companies like Himachal Futuristic, Global Tele-Systems, SSI Ltd, DSQ Software, Zee Telefilms, Silverline, Pentamedia Graphics and Satyam Computer (K-10 scrips).
Ketan borrowed Rs 250 crore from Global Trust Bank to fuel his ambitions. Ketan alongwith his associates also managed to get Rs 1,000 crore from the Madhavpura Mercantile Co-operative

Bank. According to RBI regulations, a broker is allowed a loan of only Rs 15 crore (Rs 150 million). There was evidence of price rigging in the scrips of Global Trust Bank, Zee Telefilms, HFCL, Lupin Laboratories, Aftek Infosys and Padmini Polymer.

4. C R Bhansali : The Bhansali scam resulted in a loss of over Rs 1,200 crore (Rs 12 billion). He first launched the finance company CRB Capital Markets, followed by CRB Mutual Fund and CRB Share Custodial Services. He ruled like a financial wizard 1992 to 1996 collecting money from the public through fixed deposits, bonds and debentures. The money was transferred to companies that never existed. CRB Capital Markets raised a whopping Rs 176 crore in three years. In 1994 CRB Mutual Funds raised Rs 230 crore and Rs 180 crore came via fixed deposits. Bhansali also succeeded to to raise about Rs 900 crore from the markets. However, his good days did not last long, after 1995 he received several jolts. Bhansali tried borrowing more money from the market. This led to a financial crisis. It became difficult for Bhansali to sustain himself. The Reserve Bank of India (RBI) refused banking status to CRB and he was in the dock. SBI was one of the banks to be hit by his huge defaults.

5.Cobbler scam : Sohin Daya, son of a former Sheriff of Mumbai, was the main accused in the multi-crore shoes scam. Daya of Dawood Shoes, Rafique Tejani of Metro Shoes, and Kishore Signapurkar of Milano Shoes were arrested for creating several leather co-operative societies which did not exist. They availed loans of crores of rupees on behalf of these fictitious societies. The scam was exposed in 1995. The accused created a fictitious cooperative society of cobblers to take advantage of government loans through various schemes. Officials of the Maharashtra

State Finance Corporation, Citibank, Bank of Oman, Dena Bank, Development Credit Bank, Saraswat Co-operative Bank, and Bank of Bahrain and Kuwait were also charge sheeted.

6.Dinesh Dalmia : Dinesh Dalmia was the managing director of DSQ Software Limited when the Central Bureau of Investigation arrested him for his involvement in a stocks scam of Rs 595 crore (Rs 5.95 billion). Dalmia's group included DSQ Holdings Ltd, Hulda Properties and Trades Ltd, and Powerflow Holding and Trading Pvt Ltd. Dalmia resorted to illegal ways to make money through the partly paid shares of DSQ Software Ltd, in the name of New Vision Investment Ltd, UK, and unallotted shares in the name of Dinesh Dalmia Technology Trust. Investigation showed that 1.30 crore (13 million) shares of DSQ Software Ltd had not been listed on any stock exchange.

7.Abdul Karim Telgi : He paid for his own education at Sarvodaya Vidyalaya by selling fruits and vegetables on trains. He is today famous (or infamous) for being he man behind one of the Telgi case is another big scam that rocked India. The fake stamp racket involving Abdul Karim Telgi was exposed in 2000. The loss is estimated to be Rs 171.33 crore (Rs 1.71 billion), it was initially pegged to be Rs 30,000 crore (Rs 300 bilion), which was later clarified by the CBI as an exaggerated figure. In 1994, Abdul Karim Telgi acquired a stamp paper license from the Indian government and began printing fake stamp papers.Telgi bribed to get into the government security press in Nashik and bought special machines to print fake stamp papers. Telgi's networked spread across 13 states involving 176 offices, 1,000 employees and 123 bank accounts in 18 cities.

8.Virendra Rastogi : Virendra Rastogi chief executive of RBG Resources was charged with for deceiving banks worldwide of an estimated $1 billion.He was also involved in the duty-drawback scam to the tune of Rs 43 crore (Rs 430 milion) in India. The CBI said that five companies, whose directors were the four Rastogi brothers -- Subash, Virender, Ravinde and Narinder -- exported bicycle parts during 1995-96 to Russia and Hong Kong by heavily over invoicing the value of goods for claiming excess duty draw back from customs.

9.The UTI Scam : Former UTI chairman P S Subramanyam and two executive directors -- M M Kapur and S K Basu -- and a stockbroker Rakesh G Mehta, were arrested in connection with the 'UTI scam'. UTI had purchased 40,000 shares of Cyberspace between September 25, 2000, and September 25, 2000 for about Rs 3.33 crore (Rs 33.3 million) from Rakesh Mehta when there were no buyers for the scrip. The market price was around Rs 830. The CBI said it was the conspiracy of these four people which resulted in the loss of Rs 32 crore (Rs 320 million).Subramanyam, Kapur and Basu had changed their stance on an investment advice of the equities research cell of UTI. The promoter of Cyberspace Infosys, Arvind Johari was arrested in connection with the case. The officals were paid Rs 50 lakh (Rs 5 million) by Cyberspace to promote its shares.He also received Rs 1.18 crore (Rs 11.8 million) from the company through a circuitous route for possible rigging the Cyberspace counter.

10.Uday Goyal: Uday Goyal, managing director of Arrow Global Agrotech Ltd, was yet another fraudster who cheated investors promising high returns through plantations. Goyal conned investors to the tune of over Rs 210 crore (Rs 2.10 billion). He was finally arrested.The plantation scam was exposed when two investors filed a complaint when they failed

to get the promised returns.Over 43,300 persons had fallen into Goyal's trap. Several criminal complaints were filed with the Economic Offences Wing. The company's directors and their relatives had misused the investors' money to buy properties. The High Court asked the company to sell its properties and repay its investors.

11.Sanjay Agarwal : Home Trade had created waves with celebrity endorsements. But Sanjay Agarwal's finance portal was just a veil to cover up his shady deals. He swindled a whopping Rs 600 crore (Rs 6 billion) from more than 25 cooperative banks. The government securities (gilt) scam of 2001 was exposed when the Reserve Bank of India checked the acounts of some cooperative banks following unusual activities in the gilt market. Co-operative banks and brokers acted in collusion in abid to make easy money at the cost of the hard earned savings of millions of Indians. In this case, even the Public Provident Fund (PPF) was affected.A sum of about Rs 92 crore (Rs 920 million) was missing from the Seamen's Provident Fund. Sanjay Agarwal, Ketan Sheth (a broker), Nandkishore Trivedi and Baluchan Rai (a Hong Kong-based Non-Resident Indian) were behind the Home Trade scam.

Chapter 6

Investor Protection in Other Countries:

United States of America:

In USA The **Sarbanes–Oxley Act of 2002** (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House) and commonly called **Sarbanes–Oxley**, **Sarbox** or **SOX**, is a United States federal law enacted on July 30, 2002. It is named after sponsors U.S. Senator Paul Sarbanes (D-MD) and U.S. Representative Michael G. Oxley (R-OH)[35].

The bill was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the nation's securities markets. Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the new law. It created a new, quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. The act also covers issues such as

[35] www.truthaboutlloyds.com

auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. Section 302 of the Act mandates a set of internal procedures designed to ensure accurate financial disclosure. The signing officers must certify that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared." 15 U.S.C. § 7241(a)(4). The officers must "have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report" and "have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date."

The SEC interpreted the intention of Sec. 302 in Final Rule 33–8124. In it, the SEC defines the new term "disclosure controls and procedures", which are distinct from "internal controls over financial reporting". Under both Section 302 and Section 404, Congress directed the SEC to promulgate regulations enforcing these provisions.

External auditors are required to issue an opinion on whether effective internal control over financial reporting was maintained in all material respects by management. This is in addition to the financial statement opinion regarding the accuracy of the financial statements. The requirement to issue a third opinion regarding management's assessment was removed in 2007. Sarbanes-Oxley required the disclosure of all material off-balance sheet items. It also required an SEC study and report to better understand the extent of usage of such instruments and whether accounting principles adequately addressed these instruments; The most contentious aspect of SOX is Section 404, which requires management and the external auditor to report on the

adequacy of the company's internal control over financial reporting (ICFR). This is the most costly aspect of the legislation for companies to implement, as documenting and testing important financial manual and automated controls requires enormous effort.

Under Section 404 of the Act, management is required to produce an "internal control report" as part of each annual Exchange Act report. Under 15 U.S.C. § 7262. The report must affirm "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." 15 U.S.C. § 7262(a). The report must also "contain an assessment, as of the end of the most recent fiscal year of the Company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." To do this, managers are generally adopting an internal control framework such as that described in COSO.

To help alleviate the high costs of compliance, guidance and practice have continued to evolve. The Public Company Accounting Oversight Board (PCAOB)[36] approved Auditing Standard No. 5 for public accounting firms on July 25, 2007. This standard superseded Auditing Standard No. 2, the initial guidance provided in 2004. The SEC also released its interpretive guidance on June 27, 2007. It is generally consistent with the PCAOB's guidance, but intended to provide guidance for management. Both management and the external auditor are responsible for performing their assessment in the context of a top-down risk assessment, which requires management to base both the scope of its assessment and evidence gathered on risk. This gives management wider discretion in its assessment approach. These two standards together require management to:

[36] www.iassa.co.za

- Assess both the design and operating effectiveness of selected internal controls related to significant accounts and relevant assertions, in the context of material misstatement risks;
- Understand the flow of transactions, including IT aspects, sufficient enough to identify points at which a misstatement could arise;
- Evaluate company-level (entity-level) controls, which correspond to the components of the COSO framework;
- Perform a fraud risk assessment;
- Evaluate controls designed to prevent or detect fraud, including management override of controls;
- Evaluate controls over the period-end financial reporting process;
- Scale the assessment based on the size and complexity of the company;
- Rely on management's work based on factors such as competency, objectivity, and risk;
- Conclude on the adequacy of internal control over financial reporting.

SOX 404 compliance costs represent a tax on inefficiency, encouraging companies to centralize and automate their financial reporting systems. This is apparent in the comparative costs of companies with decentralized operations and systems, versus those with centralized, more efficient systems. For example, the 2007 FEI survey indicated average compliance costs for decentralized companies were $1.9 million, while centralized company costs were $1.3 million. Costs of evaluating manual control procedures are dramatically reduced through automation.
Sarbanes–Oxley Section 802: Criminal penalties for violation of SOX

Section 802(a) of the SOX, 18 U.S.C. § 1519 states:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

Sarbanes–Oxley Section 1107: Criminal penalties for retaliation against whistleblowers

Section 1107 of the SOX 18 U.S.C. § 1513(e) states:

Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, shall be fined under this title, imprisoned not more than 10 years, or both.

United Kingdom:

The Financial Services and Markets Act 2000 (FSMA 2000) is an Act of the Parliament of the United Kingdom that created the Financial Services Authority (FSA) [37]as a regulator for insurance, investment business and banking.

[37] www.cps.gov.uk

Some of the key sections of this act are:

- Section 2 outlines the regulatory objectives of the FSA: (a) market confidence; (b) public awareness; (c) the protection of consumers; and (d) the reduction of financial crime.
- Section 19 requires firms to be authorised to conduct regulated activities.
- Section 21 makes it a criminal offence to issue a financial promotion in the United Kingdom unless it is issued or approved by an authorised firm or exempt via the Financial Promotions Order.
- Section 59 states that a person can not carry out certain controlling functions in a firm without approval by the FSA.
- Section 71 allows private persons to sue a firm for damages if a person performing a controlled function is not approved.
- Section 118 concerns market abuse.
- Section 132 establishes the Financial Services and Markets Tribunal.
- Section 138 grants the FSA rule-making power.
- Section 150 allows private persons to sue for damages if an authorised firm has breached certain rules.
- Section 165 gives the FSA power to require certain information.
- Section 397 makes it a criminal offence to mislead a market or investors.

The **Financial Services Authority ("FSA")** [38]is an independent non-governmental body, quasi-judicial body and a company limited by guarantee that regulates the financial services industry in the United Kingdom. Its board is appointed by the Treasury· Its main office is based in Canary Wharf, London, with another office in Edinburgh. When acting as the competent authority for listing of shares on a stock exchange, it is referred to as the **UK Listing Authority (UKLA)**, and maintains the Official list.

Japan:

The Bill to amend the old Securities and Exchange Law was approved in the Diet in June 2006. As a result, the title of the law was changed to the Financial Instruments and Exchange Law[39], and it became fully effective as of end-September last year. The law aims to enhance investor protection, fairness and transparency of the market and thereby to increase the attractiveness of the Japanese capital market. Contents of the amendment are very comprehensive and include various technical aspects.

First, the new law has established a cross-sectional framework for a wide range of financial instruments and services. With the advancement of financial techniques, we have seen the emergence of various types of financial products, notably various types of investment funds which solicit investment from the general public. In some cases, these funds were not covered by the old Securities and Exchange Law or other laws, and

[38] www.lse.ac.uk

[39] www.farrer.co.uk

their failure in the past has caused serious financial damage to their investors. Also the new law has expanded the scope of "securities" which are subject to various regulations for investor protection, such as regulations on advertisement or obligations to deliver written documents before and at the time of contract.

For example, investors' rights in a "collective investment scheme", which is a broad concept to include various types of funds, are now regarded as "securities" under the new law. Also, the new law has expanded the scope of "derivative transactions" to include, for example, currency and interest rate swaps or weather derivatives, which were not covered by the old law. It has also broadened the scope of financial instruments firms to include different types of investment related firms, including securities firms, investment advisory firms and financial futures trading firms, and made them subject in principle to the same regulations.

Second, the new law has enhanced disclosure requirements. This change was made after some cases which related to unlawful or inappropriate disclosure practices came to light in Japan several years ago. The new law has introduced a statutory quarterly reporting system for listed companies as a result, and this new system will start from the current quarter of April to June 2008 for most companies. It has also enhanced internal control over financial reporting. Listed companies must submit "internal control reports" which provide an evaluation of the validity of internal control of financial reporting, and make them subject to audit by certified public accountants or other auditing firms. Listed companies must also submit "certification" by management stating that descriptions in financial statements are appropriate and in compliance with laws and regulations. These new

regulations, which are sometimes called "J-SOX", following the US SOX or Sarbanes-Oxley Act, will start at the end of this current fiscal year (in March 2009 for many companies).

Third, the new law has increased the maximum criminal penalties against various market frauds to strengthen investor protection; for example, the maximum prison sentences have been raised for unfair trading, spreading of false rumours, market manipulation and the submission of false annual reports (from five to ten years), whilst that for insider trading has been increased from three to five years. The maximum fines for various fraudulent activities have also been increased.

Fourth, the new law has provided organisational structures for self-regulatory functions for exchanges; as a result, for example, the Tokyo Stock Exchange Regulation was created last year as a self-regulatory regime under the umbrella of TSE Inc.

These are the highlights of the new Financial Instruments and Exchange Law. If we go further, we will come to know this new law is once again expected to be amended in the current Diet session which started at the beginning of this year.

Last December, the Japanese Government adopted its "Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets", after a broad consultation with the private sector and with academics. Basic philosophies of the plan are summarized as "Four Pillars", i.e.

(I) bolstering the confidence and vigour of the markets,

(II) encouraging a business environment that vitalizes the financial services industry and promotes competition,

(III) Improving the regulatory environment (i.e. better regulation) and

(IV) improving the broader environment surrounding the markets.

Under these pillars, the government put forward various measures to strengthen the markets and improve regulations. The government also submitted a Bill to amend the Financial Instruments and Exchange Law and related laws to the Diet in March of this year. First, under the heading of "1. Diversification of products tradeable at exchanges" "(i) Diversification of exchange-traded funds (ETFs)", it is proposed that the regulations on ETFs be amended to make it possible to invest in a wide range of products, including financial and commodity derivatives. ETFs are mutual funds or investment trusts which are traded in exchanges and their values are often linked to market indexes.

With such features as low cost and the availability of continuous pricing, the number of ETFs listed on the world's major stock exchanges has increased remarkably in recent years, and their coverage is being broadened to include not only stock indexes but also indexes of bonds and commodity futures. In Japan, ETFs currently traded in exchanges are largely confined to stock indexes, but the Bill, once approved, will enable ETFs to be linked to bond indexes or commodities, such as gold, and commodity futures. This represents an example of further diversification of financial products in Japan.

Moreover, as the next explanation is for, the plan envisages "(ii) Alliance between financial and commodity exchanges", so that these exchanges as a group will be able to offer a full line of products from equities, bonds, financial derivatives to commodity derivatives in the future. Fostering vibrant transactions among professionals". Here it is proposed to amend "the current legal framework to further broaden the scope of the framework for markets among professionals". In other words, the Government is preparing for

the creation of markets for professional investors. This proposes to establish markets with a high degree of freedom, notably with an exemption for professional investors, from the current disclosure regulations, following examples abroad, such as the US market based on Rule 144A made by the Securities and Exchange Commission.

The new markets are expected to enhance financing opportunities for foreign companies such as those from Asia and start-up companies in Japan, and promoting financial innovation through competition among professional investors. Last year, the Tokyo Stock Exchange and the London Stock Exchange announced their intention to establish a new market for emerging companies both from abroad and in Japan, building on the successful experience of the AIM. The TSE and LSE are now working on designing this new market for professional investors.

"Relaxing the firewall regulation among banking, securities, and insurance businesses". Here, focus will be on the relation between banking and securities businesses, which is one of the frequently debated topics in Japan's system of financial regulation. In Japan, the Financial Instrument and Exchange Law provides for the separation of banking and securities businesses, like the Glass Steagal Act of the United States. However, this regulation has been gradually relaxed in line with the developments abroad; in 1993, Japanese banks and securities firms were allowed to enter into each other's business areas through subsidiaries, while the laws and regulations have maintained firewalls between the two businesses in certain areas.

Today there remain views from domestic as well as foreign financial institutions that compliance with current Japanese firewalls is costly. Notably, the ban on interlocking or concurrent posts in banking and securities affiliates within

the same financial group and the restrictions on the sharing of undisclosed customer information are often cited as examples of costly regulations. The United States has already effectively repealed these restrictions during the last ten years.

Then, after the deliberations within the Government and consultations with the private sector, the Government has decided to amend the law and related regulations so that the ban on concurrent posts within the same financial group is to be lifted, and the restriction on the sharing of corporate customer information is to be relaxed, while requiring the financial groups themselves to establish an internal system for managing conflicts of interest between their banking, securities and insurance arms.

Improving the regulatory environment" or "better regulation". A better legal framework must, of course, be accompanied by a better regulation by the regulatory authorities. The Japanese FSA is trying to improve its regulation following the practice of UK FSA in many respects. Here various changes are proposed for implementation, such as "Enhanced dialogue with the industry", "Optimal combination of rules-based and principles-based supervisory approaches".

On the issue of the rules-based vis-à-vis principles-based approach, in the past, the Japanese FSA's emphasis has been on rules-based regulation, as this enhances predictability and avoids the discretionary applications of laws. The rules-based approach is still important in certain areas, notably in enforcement. However, there are other areas that are better left to the judgment and internal control of financial institutions themselves, for example in the case of handling new financial products and techniques. In this way, the

Japanese FSA has been seeking to achieve an optimal combination of both the rules-based and principles-based approaches.

Last but not least, a competitive financial market cannot be realised only by the improvement in financial legal and regulatory framework, but it also has to be approached within a broader context. The Government is therefore promoting "Developing and accumulating internationally competitive human resources specialising in finance, law, and accounting", and "Enhancing urban functions as an international financial centre".

This last point of "Enhancing urban functions as an international financial centre" takes Canary Wharf as one of the main models in its design. Of course, the FSA does not itself have expertise on urban development and, therefore, another office under the Cabinet Secretariat is now working on developing this approach.

China:

China's economy has changed from a centrally planned economy (CPE)[40], which was introduced in 1949, to a more market orientated economy since 1978 and is currently a significant participant in the global economy. There were some inherent shortcomings of the CPE, like the defective functioning of the planning mechanism, the monopolistic, non-contestable position of the State Owned Enterprises (SOE's), the lack of financial sanctions, the

[40] www.chinaorbit.com

lack of adequate incentives, the macro-economic, suboptimal allocation of resources, the autarchic isolation and Mao's disastrous initiatives. This led to the reforms in the late 1970's, which started with the de-collectivisation of agriculture, the gradual liberalization of prices, a diversified banking system, more autonomy for SOE's, decentralisation of the fiscal system, development of the stock markets, the growth of the non-state sector and the opening to foreign trade and investment.

In Mainland China, the stock market reappeared in the 1980's and has experienced a lot of growth ever since. The number of companies listed, increased from a dozen in 1991 to more than 600 in 1997. At the same time, the market capitalisation increased from less than 10 billion to more than 1300 billion RMB. The Chinese market has a number of unique features, like different shares issued to enterprises, state, individual share holders, who have different purchasing costs and circulation regulation. Other characteristics are strictly segmented markets for domestic investors and foreign investors, high transfer rates, high P/E ratios and high system risks. The Chinese government has formulated four principles of stock market development, namely: the legal system, standardization to normalize its stock market, supervision and self-discipline. One of the reforms that China gradually has implemented were the refinements in foreign exchange and bond markets and the sale of equity of China's largest state banks to foreign investors in 2005.

Recently, the stock prices have been increasing caused by recoverable growth. Therefore, market-oriented adjustments are needed. China's stock market went from a sustained slump to a stable development, but now, it has reached a major turning point. It is expected that the Chinese people should cherish this hard-won situation and use the

opportunity to maintain the development of the stock market. China's capital market has been stagnant since June 2001, which is not quite normal. It is claimed that there are multiple reasons explaining this situation. One is a misunderstanding of the capital market's development caused by flawed thinking. This type of thinking has had a negative impact on the capital market because people generally rejected China's capital market and have been arguing and advocating a "new start".

Efforts to improve and expand reforms resulted in the major shift and changes that occurred in 2006. It was emphasized that China must cherish the situation they now have. Five factors can be distinguished that contributed to the turning point of 2006.

1. Firstly, the CPC Central Committee as well as the State Council have to consider the development of the capital market as one of their priorities. They also made important strategic plans and policy decisions.

2. Secondly, China has solved some of its major problems, by completing equity division reforms. This will have a long term impact on the healthy development of the capital market. In addition, shareholders no longer have the possibility to hold tradable shares as well as non-tradable shares at the same time or share the same equity property in order to strengthen the basic mechanism.

3. Thirdly, another factor conductive for the development of the capital market is the improved legal environment.

4. Fourthly, a favourable external environment for the capital market was created by the sustained and rapid development of the national economy. It is said that money market was more

liquid, which helped to ease the shortage of funds in the capital market. This has been a problem for the past two years. In the meantime, the objective requirements for the development of China's capital market have been raised by the growing demands of investors.

5. Finally, improving the regulation and supervision of China's capital market and the quality and efficiency of the companies listed, are factors that also contributed to the recovery of the stock market.

Earlier this year, the Shanghai and Shenzhen Stock Index set a record, when the largest single-day decline in the market occurred, which resulted in a nationwide debate. Some people were claiming that there was a serious bubble in the stock market. Authorities reacted on that by stating that this incorrect conclusion was caused by a biased analysis of the stock market. It was claimed that the decline was just an internal market rebound. Furthermore, he pointed out that as virtual capital, it is normal for stock prices to fluctuate. Moreover, certain bubbles are normal to occur in the capital market. There is no threat as long as the bubbles are small and do not form a risk to the healthy development of the market. Although the decline was an inevitable rebound, anxiety and rumours regarding "the existence of serious bubbles" in the Chinese stock market, further aggravated the fall. According to authoirty, the rise of the stock prices of last year were actually recoverable growth. Nevertheless, the stock index did increased rather quickly in the period of December 2006 to January 2007. However, suppressing excessive growth by implementing administrative changes and regulations is not desirable. Instead, economic mechanisms and market-orientated adjustments should be used to address the problem.

In general, the development of China's stock market is healthy. It is not moving too slow, which would be an enormous risk to the entire economy and financial system on the long run. The

turning point quickened the speed of the capital market development. Naturally, there is always some instability in sustainable development, which is determined by the market mechanisms. China has to understand this and be prepared for it.

It is stated that China has to promote the development of a multi-layer capital market system. In addition, it should expand the size and proportion of direct financing, speed up developments of the bond market, steadily develop the stock -and futures market and strengthen the infrastructure of the market, improve the listed companies' quality, increase supervision of the market and promote the market-oriented reform of the stock and bond issuing system. It is emphasized that supervision is particularly critical during periods of rapid growth. Fraud, inside knowledge and black market banking should be severely punished.

If you compare the Chinese securities market with mature markets, you will notice that China's market is still in its "childhood". The quality of investors is not yet high enough and the regulatory system not mature enough. Therefore it is emphasized that new investors should have an adequate risk education in order to give them a clear understanding of the risks that are lying ahead. Furthermore, China should give more priority to developing a multi-level market system and should attempt to increase direct financing and to speed up the development of the bond market. The desirable result would be that the process of bond issuance should be open, market-orientated and transparent. China will be able to maintain the sustained and healthy development of the capital market during this 11th Five Year Plan period, trough cooperation, implementing the right policies and governing the stock market according to the legal system.

Chapter 7

Effective Method to Avoid Frauds in India:

Explicitly review and approve the appointment of auditors and the audit plans for adequacy of scope coverage and performance. Proactively monitor major financial independent, choice of accounting and compensation policies including coordination with other Committee and board committees. Conduct 'in camera' executive sessions with internal and external auditors separately without the management being present. Review and approve anti fraud programs and controls. Scrutinise related-party and transactions closely including seeking independent advice experts[41]. Establish an effective anti-fraud program.Putting in place a formal program for identification, assessment and monitoring of fraud risk areas. Review of the internal and external audit assurance plans to assess how they address fraud risk areas. Review the organisation's tools and techniques to combat fraud (data analytics, key performance indicators, segregation of duties). Review the organisation's approach to investigate fraud and suspected instances of fraud including the adequacy of the reporting process[42]. Establish an objective and independent internal audit function. Establish reporting lines of the Chief Internal Auditor to the Audit Committee and not management. Help ensure that internal audit teams undertake process reviews of key strategic projects / new operations to identify control weaknesses / fraud risks.Help ensure that as far as practicable financial/ operational and IT audits are seamlessly combined so as to help ensure that the IT implications

[41] www.merinews.com

of operational controls are appropriately assessed. Help ensure that internal audit undertakes ethical audits to assess the importance given to ethics and how ethical violations are dealt with. Review the skill sets present within internal audit to effectively audit fraud risk areas (knowledge of the business, forensic skill sets, seniority within the organization and ability to leverage technology). organizations do not have a formal Fraud risk management framework. Perhaps because of the buoyant regional economies, management of fraud risk was not hitherto at the top of the agenda. The increase in frauds and adverse reputation consequences that come in its wake makes it imperative that organisations adopt a proactive approach to fraud risk management. Corruption is a serious offence, often not appropriately recognised by many organisations. The World Bank has estimated that, globally, bribes paid each year amount to over USD 1 trillion. Bribery and Corruption is on the risk radar of Governments, regulators, law enforcement agencies and businesses worldwide. With the increase in public scrutiny of multinational organisations, it is pertinent for companies to adopt essential controls to mitigate the risk of corruption. Lack of effective regulatory framework, specifically weak law enforcement, as a facilitator of corruption. Companies in India are increasingly expected to adhere to Indian - Prevention of Corruption Act, 1988. Primarily these laws suggest effective policies and governance as a key measure to prevent bribery and corruption. However, compliance with these regulations is scarcely monitored. Corruption and bribery need to be addressed at the entity level by the board and senior management. Companies should develop and promote unequivocal policies that curb bribery and encourage disclosure of facilitation payments[43]. The way in which organisations operate with their external stakeholders (e.g. vendors, customers, regulators, tax

[43] Barua S K & Varma J R (1993), "Securities Scam: Genesis, Mechanics and Impact", *Vikalpa*, Vol. 18, No. 1 (Jan-Mar), p. 3-12.

authorities and minority shareholders) often has a tremendous bearing on how the senior management and the board are perceived internally by employee. In today's knowledge intensive economy where innovation and technology are viewed as key differentiators, it is not surprising to witness a dramatic increase in intangible assets, especially Intellectual Property, as a proportion of the total assets. As the significance of Intellectual Property increases, the accompanying risks, especially fraud risk, also dramatically increase. Maximum number of respondents identified counterfeiting and parallel supply chain as the most prevalent form of IP fraud. Companies in consumer market segment and IT space suffer severely on this account and lose a large amount of revenue on this account every year. While, on one hand, technology tools assist companies in enhancing productivity and efficiency, on the other it increases their vulnerability to sophisticated cyber crime attacks. Electronic crimes weaken the organisation's IT backbone. For instance, theft of customer information from a company's computer system could not only expose the company to litigation risks but also to reputation risks that could cripple the company's business. Today's globalised and intertwined markets have vastly contributed to increased business complexities, especially in the area of supply chain. The risk of supply chain extends from primary sourcing of the raw material to the distribution of the finished products.

SECURITIES AND EXCHANGE BOARD OF INDIA (PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO SECURITIES MARKET) REGULATIONS, 2003[44]; give a detailed mechanism to avoid frauds at Indian Stock Market its says that a fraud is any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his

[44] www.sebi.gov

agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also bring within it a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment; a suggestion as to a fact which is not true by one who does not believe it to be true; an active concealment of a fact by a person having knowledge or belief of the fact; a representation made in a reckless and careless manner whether it be true or false.

The SFIO[45] is a multi-disciplinary organization under Ministry of Corporate Affairs, consisting of experts in the filed of accountancy, forensic auditing, law, information technology,investigation, company law, capital market and taxation for detecting and prosecuting or recommending for prosecution white-collar crimes/frauds. The SFIO will normally take up for investigation only such cases, which are characterized by

- complexity and having inter-departmental and multi-disciplinary ramifications ;
- substantial involvement of public interest to be judged by size, either in terms of monetary misappropriation or in terms of persons affected, and;
- the possibility of investigation leading to or contributing towards a clear improvement in systems, laws or procedures. The SFIO shall investigate serious cases of fraud received from Department of company Affairs.

a) detecting and prosecuting or recommending for prosecution white collar crimes/corporate frauds.

b) SFIO will normally take up investigation of only such cases which are characterized by:-

i. complexity and having inter-departmental and multi-disciplinary ramifications'

[45] www.mca.gov

ii. substantial involvement of public interest to be judged by size, either in terms of monetary misappropriation or in terms of persons affected and

iii. the possibility of investigation leading to or contributing towards a clear improvement in systems, laws and procedures.

SFIO takes up investigation of cases referred by the Government under section 235 to 239 of the Companies Act,1956. SFIO, at present, does not initiate investigation on its own. The Serious Fraud Investigation Office (SFIO) was set up in July, 2003 and is fully functional now. Till date, 26 cases have been referred to it by the Central Government for investigation under Sections 235/237 of the Companies Act, 1956. Investigations in respect of four cases have been completed and the reports submitted to the Government.

Conclusion:

Stock market fraud is rampant throughout history and widespread today. There is no magic bullet to avoid becoming a victim of stock market fraud, because frauds are committed by the "brand name" investment banks and "prestigious" public companies. A number of the most-recognizable names on Stock Exchanges are crooked to the core. Some of the most prominent businessmen in India have committed outright fraud, been slapped on the wrist, and continued their previous ways while sprinkling out funds to worthy causes to polish up their public image[46]. The name-brand auditing firms regularly have audit failures where the sheer magnitude of the fraud defies explanation except that the auditors simply failed to examine the records to verify the claims of management and failed to obtain confirmation with third-parties.

That said, the vast majority of stock frauds are committed by small-time crooks in small-time companies in the micro-cap market. With few exceptions, principally small local banks, each and every stock traded on the stock exchange is a worthless company being promoted by crooks and

[46] Agarwal P C(1992), "Suggestions on Scripless Trading", *Chartered Secretary*, Vol. 22, No. 10 (Oct), p. 888.

a manipulated stock. The auditors are small-time no-name accountants who are literally in on the fraud and act as the auditors for every fraud by the same promoters and boiler rooms[47].

Public investors must be on their guard buse the stock market is often a crooked craps game. The following tips are not perfect protection against stock market frauds, but, in my experience, filter out the vast majority of stock frauds.

1. Stop and think. Be skeptical. Why are you being solicited to invest your money in this stock or deal by this promoter or broker-dealer? Because you're special? Lucky? They like you? Is that why they're letting you in on the ground floor of this remarkable opportunity and not keeping it to themselves? Remember that big companies isn't calling you to share the gains in his proprietary ideas; to the contrary, they has been granted by the SEBI a special exemption from the reporting requirements applicable to everyone else in the case of making disclosures.

2. Never accept or reply to cold calls or unsolicited mail. These are callers from boiler-rooms, many run by organized crime, and the person calling you about the Next Great Opportunity will, after the shift, commute home by public transit if he or she has carfare home.

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[47] Avadhani V A(1992), *Investment & Securities Markets in India: Investment Management,* Himalaya Publishing, Bombay. p 426.

3. Never open an account with a no-name broker-dealer. Pay special attention to names similar to a brand name or names that sound wasphy.

4. Never buy stock in an issuer being promoted by a no-name broker-dealer.

5. Never buy a stock traded on the exchange without registration.

6. Never invest with people or firms with a history of wrongful conduct. Check each and every name of the people and firms involved .

7. Never buy stock in an issuer using a no-name auditor. The difference between arithmetic and accounting is that, in accounting, the result can be any number you want.

8. Never buy stock of a foreign issuer, even if listed on BSE.

9. Stick to public companies which are actively traded on the NSE and BSE, have meaningful revenues and earnings, significant institutional shareholders, and analyst buy recommendations by several brand-name brokerage firms.

The SEBI[48] cannot fully protect you. You have to protect yourself in Stock Exchnage Jungle. In summary, the fallout from fraud and misconduct can be significant,

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[48] Barua S K & Srinivasan G (1982), "Experiment on Individual Investment Decision Making Process", Working Paper No. 423, (Apr-June), Indian Institute of Management, Ahmedabad.

including punitive damages, tarnished corporate and brand image, lost revenue, plummeting shareholder value and inability to attract and retain human capital. To combat frauds effectively, organisations need to adopt a holistic approach that takes cognizance of fraud risks emanating from the organisation's strategy and the adequacy of mitigating measures at multiple levels i.e. entity level, process level and functional level controls.

Despite the apparent awareness of the risks posed by a multitude of fraud types as indicated by this survey, organisations tend to focus more on the adequacy of controls mitigating financial frauds and there is a considerably lesser focus on anti-fraud programs and controls to mitigate non-financial fraud risks[49]. At the organisational level (senior management and the Board), it is important to have a comprehensive approach to fraud risk management which also considers the organisation's preparedness in terms of skills, tools and technology to implement the desired control mechanisms. In other words, implementation and intent need to go hand in hand to combat fraud effectively.

An analysis of the scams reveals a common script – greed, corruption, unscrupulous brokers, colluding bankers, irresponsible authorities and hapless investors, who refuse to learn their lessons. But then, these are the essential ingredients of a worthy financial scam. In India, barring a few honourable exceptions, organisations which profess that they protect the interests of investors / shareholders, exist only on paper or serve the personal interests of promoters. Today, even politicians have entered this arena and their participation should be taken not with a pinch but with a large spoon of salt. Politicians are only

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[49] Barua S K & Raghunathan V (1987), "Inefficiency and Speculation in the Indian Capital Market", *Vikalpa*, Vol. 12, No. 3,(Jul-Sept), p. 53-58.

interested in furthering their own agenda. Investors should be wary of such organisations and should not believe that these organisations will solve all their problems.

There can be no denying the fact that our country has become a country of scams. Every two / three years there is a major scam involving crores of rupees and thousands of small investors. Apart from the lax regulators, one of the major reasons for such recurring scams is the extremely poor implementation of the penal laws. As a result, manipulators and scamsters have no fear of the law and are smug in the belief that, even if caught, they will be back in business in no time. Even after nine years, Harshad Mehta's case has reached nowhere. Such cases only encourage others to commit more of such crimes.

Hence, unless the enforcement of laws is strengthened and special courts are created for dispensing speedy justice and scamsters are made to forfeit all their gains, nothing much will change. This requires a strong political will among the powers-that-be.

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Annexure:

SECURITIES AND EXCHANGE BOARD OF INDIA

NOTIFICATION

Mumbai, the 17th of July, 2003

SECURITIES AND EXCHANGE BOARD OF INDIA (PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO SECURITIES MARKET) REGULATIONS, 2003

S.O. 816 (E) In exercise of the powers conferred by section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board hereby makes the following regulations, namely:-

CHAPTER I

PRELIMINARY

Short title and commencement

1. (1) These regulations may be called the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003.

(2) They shall come into force on the date of their publication in the Official Gazette.

Definitions

2. (1) In these regulations, unless the context otherwise requires,-

(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(b) "dealing in securities" includes an act of buying, selling or subscribing pursuant to any issue of any security or agreeing to buy, sell or subscribe to any issue of any security or otherwise transacting in any way in any security by any person as principal, agent or intermediary referred to in section 12 of the Act.

(c) "fraud" includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include-

(1) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;

(2) a suggestion as to a fact which is not true by one who does not believe it to be true;

(3) an active concealment of a fact by a person having knowledge or belief of the fact;

(4) a promise made without any intention of performing it;

(5) a representation made in a reckless and careless manner whether it be true or false;

(6) any such act or omission as any other law specifically declares to be fraudulent,

(7) deceptive behaviour by a person depriving another of informed consent or full participation,

(8) a false statement made without reasonable ground for believing it to be true.

(9) The act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled eventhough they did not rely on the statement itself or anything derived from it other than the market price.

And "fraudulent" shall be construed accordingly;

Nothing contained in this clause shall apply to any general comments made in good faith in regard to –

(a) the economic policy of the government

(b) the economic situation of the country

(c) trends in the securities market or

(d) any other matter of a like nature

whether such comments are made in public or in private.

(d) "Investigating Authority" means any officer of the Board not below the rank of Division Chief, authorized by the Board to undertake investigation under Section 11C of the Act;

(e) "securities" means securities as defined in section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956).

(2) Words and expressions used and not defined in these regulations, but defined in the Act or in the rules or regulations made thereunder, shall

have the meanings respectively assigned to them in the Act or rules or regulations made thereunder, as the case may be.

CHAPTER II

PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO THE SECURITIES MARKET

3. Prohibition of certain dealings in securities

No person shall directly or indirectly-

(a) buy, sell or otherwise deal in securities in a fraudulent manner;

(b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made there under;

(c) employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange;

(d) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange in contravention of the

provisions of the Act or the rules and the regulations made there under.

4. Prohibition of manipulative, fraudulent and unfair trade practices

(1) Without prejudice to the provisions of regulation 3, no person shall indulge in a fraudulent or an unfair trade practice in securities.

(2) Dealing in securities shall be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following, namely:-

(a) indulging in an act which creates false or misleading appearance of trading in the securities market;

(b) dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;

(c) advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;

(d) paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security;

(e) any act or omission amounting to manipulation of the price of a security;

(f) publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities;

(g) entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security;

(h) selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form;

(i) an intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in

the price of such security and retaining the difference in prices as profit for himself;

(j) an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security;

(k) an advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors;

(l) an intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage;

(m) an intermediary not disclosing to his client transactions entered into on his behalf including taking an option position;

(n) circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security;

(o) encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.

(p) an intermediary predating or otherwise falsifying records such as contract notes.

(q) an intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract.

(r) planting false or misleading news which may induce sale or purchase of securities.

CHAPTER III

INVESTIGATION

Power of the Board to order investigation

5. Where the Board, the Chairman, the member or the Executive Director (hereinafter referred to as "appointing authority") has reasonable ground to believe that -

(a) the transactions in securities are being dealt with in a manner detrimental to the investors or the securities market in violation of these regulations;

(b) any intermediary or any person associated with the securities market has violated any of the provisions of the Act or the rules or the regulations,

it may, at any time by order in writing, direct any officer not below the rank of Division Chief (hereinafter referred to as the "Investigating Authority") specified in the order to investigate the affairs of such intermediary or persons associated with the securities market or any other person and to report thereon to the Board in the manner provided in section 11C of the Act.

Powers of Investigating Authority

6. Without prejudice to the powers conferred under the Act, the Investigating Authority shall have the following powers for the conduct of investigation, namely:-

(1) to call for information or records from any person specified in section 11(2)(i) of the Act;

(2) to undertake inspection of any book, or register, or other document or record of any listed public company or a public company (not being intermediaries referred to in section 12 of the Act) which intends to get its securities listed on any recognized stock exchange where the Investigating Authority has reasonable grounds to believe that such company has been conducting in violation of these regulations;

(3) to require any intermediary or any person associated with securities market in any manner to furnish such information to, or produce such books, or registers, or other documents, or record before him or any person authorized by him in this behalf as he may consider necessary if the furnishing of such information or the production of such books, or registers, or other documents, or record is relevant or necessary for the purposes of the investigation;

(4) to keep in his custody any books, registers, other documents and record produced under this regulation for a maximum period of one month which may be extended upto a period of six months by the Board:

Provided that the Investigating Authority may call for any book, register, other document or record if the same is needed again:

Provided further that if the person on whose behalf the books, registers, other documents and record are produced requires certified copies of the books, registers, other documents and record produced before the Investigating Authority, he shall give certified copies of such books,

registers, other documents and record to such person or on whose behalf the books, registers, other documents and record were produced;

(5) to examine orally and to record the statement of the person concerned or any director, partner, member or employee of such person and to take notes of such oral examination to be used as an evidence against such person:

Provided that the said notes shall be read over to, or by, and signed by, the person so examined;

(6) to examine on oath any manager, managing director, officer or other employee of any intermediary or any person associated with securities market in any manner in relation to the affairs of his business and may administer an oath accordingly and for that purpose may require any of those persons to appear before him personally.

Power of the Investigating Authority to be exercised with prior approval

7. The Investigating Authority may, after obtaining specific approval from the Chairman or Member also exercise all or any of the following powers, namely:-

(a) to call for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which are under investigation;

(b) to make an application to the Judicial Magistrate of the first class having jurisdiction for an order for the seizure of any books, registers, other documents and record, if in the course of investigation, the Investigating Authority has reasonable ground to believe that such books, registers, other documents and record of, or relating to, any intermediary or any person associated with securities market in any manner may be destroyed, mutilated, altered, falsified or secreted;

(c) to keep in his custody the books, registers, other documents and record seized under these regulations for such period not later than the conclusion of the investigation as he considers necessary and thereafter to return the same to the person, the company or the other body corporate, or, as the case may be, to the managing director or the manager or any other person from whose custody or power they were seized:

Provided that the Investigating Authority may, before returning such books, registers, other documents and record as aforesaid, place identification marks on them or any part thereof ;

(d) Save as otherwise provided in this regulation, every search or seizure made under this regulation shall be carried out in accordance with the

provisions of the Code of Criminal Procedure, 1973 (2 of 1974) relating to searches or seizures made under that Code.

Duty to co-operate, etc.

8. (1) It shall be the duty of every person in respect of whom an investigation has been ordered under regulation 7-

(a) to produce to the Investigating Authority or any person authorized by him such books, accounts and other documents and record in his custody or control and to furnish such statements and information as the Investigation Authority or the person so authorized by him may reasonably require for the purposes of the investigation;

(b) to appear before the Investigation Authority personally when required to do so by him under regulation 6 or regulation 7 to answer any question which is put to him by the Investigation Authority in pursuance of the powers under the said regulations.

(2) Without prejudice to the provisions of sections 235 to 241 of the Companies Act, 1956 (1 of 1956), it shall be the duty of every manager, managing director, officer and other employee of the company and every intermediary referred to in section 12 of the Act or every person associated

with the securities market to preserve and to produce to the Investigating Authority or any person authorized by him in this behalf, all the books, registers, other documents and record of, or relating to, the company or, as the case may be, of or relating to, the intermediary or such person, which are in their custody or power.

(3) Without prejudice to the generality of the provisions of sub-regulations (1) and (2), such person shall -

(a) allow the Investigating Authority to have access to the premises occupied by such person at all reasonable times for the purpose of investigation;

(b) extend to the Investigating Authority reasonable facilities for examining any books, accounts and other documents in his custody or control (whether kept manually or in computer or in any other form) reasonably required for the purposes of the investigation;

(c) provide to such Investigating Authority any such books, accounts and records which, in the opinion of the Investigating Authority, are relevant to the investigation or, as the case may be, allow him to take out computer out-prints thereof.

Submission of report to the Board

9. The Investigating Authority shall, on completion of investigation, after taking into account all relevant facts, submit a report to the appointing authority:

Provided that the Investigating Authority may submit an interim report pending completion of investigations if he considers necessary in the interest of investors and the securities market or as directed by the appointing authority.

Enforcement by the Board

10. The Board may, after consideration of the report referred to in regulation 9, if satisfied that there is a violation of these regulations and after giving a reasonable opportunity of hearing to the persons concerned, issue such directions or take such action as mentioned in regulation 11and regulation 12:

Provided that the Board may, in the interest of investors and the securities market, pending the receipt of the report of the investigating authority referred to in regulation 9, issue directions under regulation 11:

Provided further that the Board may, in the interest of investors and securities market, dispense with the opportunity of pre-decisional hearing by recording reasons in writing and shall give an opportunity of post-decisional hearing to the persons concerned as expeditiously as possible.

11. (1) The Board may, without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) of section 11 and section 11B of the Act, by an order, for reasons to be recorded in writing, in the interests of investors and securities market, issue or take any of the following actions or directions, either pending investigation or enquiry or on completion of such investigation or enquiry, namely:-

(a) suspend the trading of the security found to be or *prima-facie* found to be involved in fraudulent and unfair trade practice in a recognized stock exchange;

(b) restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;

(c) suspend any office-bearer of any stock exchange or self-regulatory organization from holding such position;

(d) impound and retain the proceeds or securities in respect of any transaction which is in violation or *prima facie* in violation of these regulations;

(e) direct any intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of a fraudulent and unfair transaction:

(f) require the person concerned to call upon any of its officers, other employees or representatives to refrain from dealing in securities in any particular manner;

(g) prohibit the person concerned from disposing of any of the securities acquired in contravention of these regulations;

(h) direct the person concerned to dispose of any such securities acquired in contravention of these regulations, in such manner as the Board may deem fit, for restoring the *status-quo ante*;

(2) The Board shall issue a press release in respect of any final order passed under sub-regulation (1) in atleast two newspapers of which one shall have nationwide circulation and shall also put the order on the website of the Board.

Suspension or cancellation of registration

12. (1) The Board may, without prejudice to the provisions contained in sub-sections (1), (2), (2A) and (3) of section 11 and section 11B of the Act, by an order, for reasons to be recorded in writing, in the interests of investors and securities market take the following action against an intermediary:

(a) Issue a warning or censure

(b) suspend the registration of the intermediary; or

(c) cancel of the registration of the intermediary

Provided that no final order of suspension or cancellation of an intermediary for violation of these regulations shall be passed unless the procedure specified in the regulations applicable to such intermediary under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 is complied with.

Repeal and savings

13. (1) The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995 is hereby repealed.

(2) Notwithstanding repeal of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995, any violation of regulations 3, 4, 5 and 6 of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995 shall be investigated and

proceeded against in accordance with the procedure laid down in these regulations.

(3) Notwithstanding repeal of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995, any investigation pending, at the commencement of these regulations shall be continued and disposed of in accordance with the procedure laid down in these regulations.