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Evaluation of the Malpractices of Intermediaries in the Secondary Securities Market

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Abstract

A major issue encountered by investors as well as regulators in the securities market is the malpractices of intermediaries. Small investors invest their hard-earned money in securities in anticipation of better returns. Market malpractices not only disturb the orderly functioning of securities markets but also cause financial loss to investors. The volatile nature of the securities market coupled with the malpractices of the intermediaries creates uncertainty and drives away investors from the market. In this paper, the author discusses the malpractices of intermediaries in the secondary securities market in general and specific, as well as highlights the methodologies carried out by them to cheat innocent investors. The category of the market intermediaries may differ but their objective is the same to cheat the investors in the market.

Keywords: Intermediaries, malpractices, market, secondary, securities

INTRODUCTION

The legal and regulatory regime stipulates to carry out of buying and selling activities in the securities market through registered market intermediaries, and in addition to that, the complex nature of the securities market necessitates investors to seek the specialized services of market intermediaries especially, investment advice, selection of securities, buying and selling, portfolio management, depository, etc. They charge fees/commissions, for rendering professional services to the investors. Fraudulent persons and unregistered intermediaries are also engaged in malpractices in the market to cheat investors. A rationally ignorant investor does not have the requisite expertise to evolve the services of market intermediaries and as a consequence, they are facing many issues such as adverse selection, moral hazard, asymmetric information, etc. An investment in the right securities requires a proper valuation for a better return. Securities provide returns in the form of dividends on profits and rights to assets in liquidation. It will be difficult for investors to value a particular security in terms of its expected return and risk based on the available information about the nature of the intangible rights and the issuer's underlying business due to a lack of expertise and skills. The centralized securities market architecture supports the buying and selling of securities through registered intermediaries and in addition to that most of the investors are interested in converting their savings into an investment with less time, which imperatively seeks the support of the intermediaries. Securities professionals act as facilitators of investors' participation in the financial exchange and supply investors with "participation services," in that they bridge the gap between the investors' lack of knowledge and the expertise required to get the most out of increasingly sophisticated financial markets [Allen, Santomero, 1996], [1].

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MALPRACTICES OF INTERMEDIARIES

Manipulation is almost as old as the earliest stock market. In modern financial markets, manipulations are often taken in hidden ways that cannot be easily detected. [Mei et al 2004] [2]. Malpractices of market intermediaries differ from intermediary to intermediary by the services rendered by them. Securities market intermediaries may be registered or unregistered/fraudulent persons. Malpractices are carried out by both registered and unregistered market intermediaries of which the malpractices of the latter pose a big threat to the market and investors. The common motive of all intermediaries carrying out malpractices is to make an undue profit at the cost of investors.

Intermediaries are carrying out market malpractices in any one or more of the following manners:

- Market manipulation is a deliberate attempt to intervene in the free and fair operation of the market which can create artificial, false, or misleading appearances concerning the price of a security, [Lin in 2017], [3].
- Action-based manipulation is possible when the informed manipulator first trades in the wrong direction of their information, [Chakraborty and Yilmaz, 2004], [4].
- Stock manipulation is the buying or selling of security to increase or depress its market price, [Yadin O, 2001] [5].
- Profitable manipulation is possible if the manipulator can corner the market. The manipulator can achieve a positive profit if he can establish a price trend and trade against it, [Jarrow, 1992] [6].

Stock market manipulators use a variety of means, such as releasing false information about a company into the market and employing trading strategies that impede the price formation process, such as naked shorting, wash sales, matched trades, and painting the tape, all of which inject misleading trading information into the market, to move market prices in the direction that benefits the manipulator. Illegal short selling, such as naked shorting, can distort market prices by creating artificial supply-demand imbalances, [Thel 1994], [7].

Manipulators are trading shares at the closing of the trading day to influence the closing price to be published to affect the valuation of the portfolio, to dispense with margin calls, etc.

Churning is another issue encountered by investors. An intermediary increases the commission by executing buying and selling orders, at the same price to show increased activity in a client's account to attract other investors for driving up the price.

High-Frequency Traders often use the tactics of pinging, to know the large orders through small orders. It is done on a large scale, over a sustained period, and it can cost investors and the marketplace significant sums of capital, [Scopino, 2015] [8].

Intermediaries lend money to investors to pursue their investment motives, but the motive of the intermediaries is the expeditious recovery of the money lent, contrary to the motive of investors.

Conflict of interest is an inherent nature in the services offered by intermediaries. It is a common practice of an intermediary who provides multiple services or a group of intermediaries providing multiple services to the same investor.

Some of the intermediaries solicit the clients of other intermediaries to increase their business and profit in an unethical manner.

The lack of expertise of market intermediaries aggravates the risks associated with the complex and hybrid products on the market.

BROKERS AND THEIR MALPRACTICES

Brokers act as a conduit between buyers and sellers in the secondary securities market. Investors “trust” them on a perceived level of honesty, good faith, judgment, and responsibility in looking after

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the money entrusted to them. Investors confer authority on them to trade on their behalf. Some of them take undue advantage of their positions to commit malpractice. They are expected to act for and on behalf of clients; contrary to that, they act against the interests of the clients.

Manipulation

Brokers are manipulating the price of the securities to make a profit. They often rig the prices of securities through pump-and-dump schemes in collaboration with promoters. Some secondary market sub-brokers are engaging in unfair trade practices, manipulating transactions with the intent to deceive clients.

A stockbroker attempts to short-sell security to bring down the price, allowing it to be bought back at a lower price and thereby make a profit on the difference. Contrary to this practice cornering the market involves buying enough stock to gain effective control of the supply to set the price.

A broker must get the best available price for the order placed with them and is expected to put the client’s interest ahead of their own. In contrast, they place orders for their account, with advanced knowledge of their client's orders. When a customer places orders with them, they execute these orders at a higher price.

A broker manipulates the closing price of a stock to give a better impression of their executions to their customers, [Hillion, Suominen, 2004], [9].

Misappropriation

Brokers are maintaining the clients’ accounts. Clients have to properly check the accounts regularly to ensure their correctness, but in practice, many of them are not interested in checking due to the trust reposed with them besides lack of time, laziness, etc. Brokers are taking advantage of this opportunity to misappropriate funds out of the trading account using sophisticated techniques which are difficult to detect.

Unauthorized Trading

A broker is expected to carry out a purchase or sale transaction with the prior approval or instruction of the client. They operate discretionary trading accounts through an agreement with the client to carry out specified trading transactions as per the pre-instructions given by the client without requiring their authorization for every transaction. Brokers gradually misuse this facility for their benefit without the knowledge of their clients. In a non-discretionary trading account, a broker is legally prohibited from entering into any transaction without first getting the express approval of the client for the particular trade.

Misrepresentation of Facts

The Brokers must make an investment recommendation with full disclosure of material facts about sales-related compensation, risks, liquidity, and other material facts associated with a degree of risk relating to the purchase or sale of securities. They deliberately make a partial or inadequate disclosure, omission, or withholding of material facts to mislead their clients.

Excessive Trading

Controlling the client account helps Brokers, to engage in excessive trading, to earn more commission at the risk and cost of their clients.

Lack of Diversification

This type of malpractice arises when a broker fails to properly structure the client's portfolio. Overconcentration of investments in a particular sector or segment is risky and may lead to heavy losses. A well-diversified portfolio for a client may minimize exposure and risk. A broker should diversify the investments, consistent with the client's investment objectives and risk tolerance to protect them but many of them advise their clients to concentrate on a particular stock for their benefit.

Unsuitability

This is a common type of securities fraud. It is the broker's responsibility to recommend securities that are appropriate for their clients, but many of them disregard their clients' investment objectives, financial standings, and risk tolerance and recommend unsuitable securities.

Conflict of interest

Stockbrokers owe a fiduciary duty to their clients. They are legally required to disclose their interest in the transaction to their clients to make an informed decision, as part of their duty. However, failure to disclose their interests amounts to fraud. The conflict-of-interest is not uncommon in the securities market. The conflict-of-interest situation often arises in the case of brokers offering multiple services.

Breakpoints

Brokers often look out for their commissions at the expense of their clients by encouraging clients to break up transactions, which makes their clients miss out on discounts at key break points.

Misuse of Clients’ Money

Clients’ money for the purchase of shares is deposited into a cash account. Brokers use this money as collateral for an equal amount, thereby doubling investment potential. Instead of charging brokerage fees on the actual amount invested, they charge their fee on the double-margin account balance.

Pledge of clients' securities.

Brokers often pledge clients' securities without the clients' knowledge for their benefit.

Guaranteed Returns

The fluctuations in the price of securities are inherent to the nature of the securities market, and there is no guarantee for better returns; however, brokers often assure guaranteed returns on their fraudulent investment schemes to cheat their clients.

PORTFOLIO MANAGERS AND THEIR MALPRACTICES

Significant changes have taken place in the investment climate in the securities market in the past decade. One of the main reasons for the major growth of portfolio management in India is the emergence of financial institutions, mutual funds, and other agencies that are undertaking the task of investing the money of investors in the market. They understand the client’s financial needs, consider the client's ability to undertake risk, suggest the best investment policy for them with the minimum risks involved, and thereby increase the chances of making a profit. They provide customized investment solutions to clients as per their requirements, besides overseeing and reviewing the portfolio's performance to ensure conformance to expectations regularly. Portfolio managers provide investment management solutions to clients, which may be discretionary, non-discretionary, or advisory, by taking increased market volatility and the risk and return parameters of financial assets into account. In India, the majority of PMS providers offer discretionary services.

Investors honestly believe that a portfolio manager is a professional expert who carries out investment activities and takes investment-related decisions on behalf of the investors or any institution, and who legitimately discharges their duties. Contrary to their expectations, portfolio managers engaged in malpractice.

Portfolio Management Services Schemes

The most popular malpractice under this category is the Portfolio Management Services (PMS) scheme: General PMSs, which are directed to an exclusive client, and pool PMSs, which are structured products for a specific group of investors with similar investment preferences, are mostly involved with brokers. Investors look for different avenues to cover the loss incurred in the market on account of the volatility and market crash. Portfolio management service (PMS) schemes are floated in the market by brokers to exploit the opportunity to make money in the market at the expense of small investors.

No Demat Account

Small investors who do not have time to spare but desire to invest judiciously in the market to get a better return on their investment are attracted by these kinds of schemes available in the market. The specialty of the scheme is that investors who do not have Demat accounts can also invest in pool PMS by signing a general PMS agreement and entrusting the brokers to manage their investments.

Excessive Fees

Common malpractices prevailing among portfolio managers include charging excessive fees and other charges to investors for managing their portfolios. Lack of clarity in the agreement helps them to charge excess fees.

Conflicts of Interest

Conflicts of interest arise when a fund, trustee, fund manager, and intermediaries route a client deal through related entities that form part of one corporate group. Portfolio managers may overlook exorbitant fees or commissions charged by a related-party trader, broker, or advisor who is part of the related group or engaged in creating markets for the fund managers. Investors are unaware of transactions between related entities that amount to reduce their return.

Performance Reports

The periodic performance report or statement, which depicts the status of the assets along with the client's securities transaction details, is an indicator of the fund's performance. Portfolio managers are deliberately not disclosing the actual performance of the fund to investors to dispense with the danger of a withdrawal of the funds**.** They are intentionally making false or misleading disclosures in documents to protect their interests.

Valuation of Portfolio

The right valuation of a portfolio assists investors to know the actual value of their portfolio. Overvaluation or undervaluation adversely affects them. Portfolio managers are using cumbersome techniques to inflate the value of portfolios to cheat investors. Investors also find it difficult to detect the inflated value. Portfolio revisions are deliberately made to charge excess fees, which has an adverse impact on the portfolios of investors in terms of high costs and low returns.

Misuse of Client's Funds

Clients are not aware of the actual use of the funds when portfolio managers have discretionary control over client funds. Portfolio managers often use the funds for their gains. This misuse of funds deprives the investors of the actual benefit of the funds.

Unauthorized Investments

Clients authorize portfolio managers to invest the funds in specific securities to control the actual use of the funds. Portfolio managers, on the other hand, make unauthorized investments for their gain or to cover up losses.

Manipulation

Portfolio managers often come across information in advance about the large orders to be placed with them by their big clients or in the market. They misuse this advanced information by engaging themselves in price manipulation, front-running, etc. at the expense of investors.

Boiler Room Frauds

Investors believe that their money is invested in the right investments for a better return, but in practice, portfolio managers, sell worthless, overpriced, or even nonexistent stocks and shares to the fund through boiler rooms.

Ponzi Investment Schemes

Ponzi investment schemes are deceptive investment schemes that promise high returns to investors. Under these schemes, funds are collected from one set of investors, and the return is paid to them out of the funds collected from the subsequent investors, and so on until the targeted money is collected from the investors, after which the funds vanish from the market.

Guaranteed Return on Investments

Banks are offering a fixed return on the deposits made, but there is no such concept of a fixed return in the securities market due to price fluctuations. Investors are not sure of the return on their investment in securities. If there is any certainty in the return on the investment, which would immensely benefit them. Portfolio managers are taking advantage of the mindset of investors to assure them of a fixed return on their fraudulent investment schemes to cheat them.

Bogus funds

Professional portfolio managers establish a good reputation in the market through a track record of consistent payment of returns over some time. Fraudsters set up bogus funds with a similar or deceptively similar name to that of genuine funds, to cheat the investors.

Fake Portfolio Managers

Fake portfolio managers use attractive techniques such as well-established offices, well-designed websites, frequent cold calls, and promising higher returns, to project themselves as genuine portfolio managers to win over the confidence of investors, to siphon their money.

INVESTMENT ADVISERS AND THEIR MALPRACTICES

Small investors have been satisfied with bank deposits and treasury bonds as safe harbors for a long time. The development of the securities market with sophisticated financial products induced their interest in securities, mutual funds, and other financial products. It is a difficult task for investors to identify the right investment that is appropriate for their investment objective and risk appetite among multiple choices placed before them in the market. Investment advisers provide consulting services to investors, mutual funds, etc. to identify suitable securities to ensure optimal returns for their investments.

Malpractices are committed not only by investment advisors but also by fraudulent individuals.

Conflict of Interest

Sponsors are paying fees, commissions, etc., to the investment advisors to recommend their investment schemes to the investors, which may not be in the best interest of investors. Investment advisors recommend the investment schemes of their sponsors to investors without disclosing the fee or commissions they receive.

Violation of Fiduciary Duty

The position of the investment advisors in the market carries with it a fiduciary duty to their clients, by putting the interests of their clients above their own. The common practice of investment advisers is to execute a single block trade at a uniform price and allocate the proceeds on a pro-rata basis to the participating clients. In contrast to this practice, a few of them favorably allocate to some clients at the expense of other clients.

Improper Allocation of Expenses

Investment advisors often allocate their consulting, legal, and compliance-related expenses in the course of registering as an investment adviser or other unconnected expenses to the fund without disclosing the nature of the allocated expenses or their relevance. Investors are also not aware of the basis of charges to the fund, and as a consequence, clients have to bear higher costs.

Misrepresentation

Investment advisors must disclose all material facts of the proposed investment to the investors. Some of them are deliberately not disclosing vital financial information, such as historical performance, the presence of risks, fees to be charged, etc. To misrepresent the facts, they make partial disclosure instead of full disclosure.

Guaranteed Return

Investment advisors assure a guaranteed return on their fraudulent investment schemes to attract investors to siphon their money. The guaranteed return will never be paid to the investors.

Fake Performance

Fake investment advisors claim fake performance or other firms' performance through the technique of misleading advertisements, to attract investors for their fraudulent schemes.

Front-Running

Front-running is an unethical trading practice. An investment advisor, places an order for their account, well in advance, based on the advance information about the specific order to be placed with them by their client or in the market to sell at a higher price.

Pump-and-Dump Scheme

Some investment advisers, buy large quantities of volatile micro-cap stocks to inflate the price and later sell them off to make more profit at the expense of innocent investors.

Churning/Excessive Trading

Investment advisors earn more fees/commissions and engage in excessive trading that lowers the returns to the investors.

Unsuitable Advice

Investors differ in their age, education, wealth, investment objectives, risk appetite, etc. An investment advisor must understand their client's financial background and risk appetite, before recommending a suitable financial product to them. Some of them deliberately recommend unsuitable products to cheat investors.

THE DEPOSITORY AND THEIR MALPRACTICES

A well-developed depository system improves market efficiency and transparency, resulting in stable economic growth. It facilitates faster transactions with enhanced liquidity, development, and integration of the market. It made the work of stock exchanges, clearing houses, broking firms, issuers, and share transfer agents, easier and faster, using paperless trading. It also removed many of the hurdles faced by the market participants.

One of the malpractices encountered by investors is, the transfer of securities from the beneficial owner (BO) accounts without their authorization.

- Fraudulent debits in the depository account became a common practice in the depository system.
- High-value portfolios and dormant accounts are more vulnerable to fraud.
- Misuse of Power of Attorneys (POA) and Depository instruction slips (DIS).

CONCLUSION

The expertise knowledge and skills of the intermediaries and their predominant position make their presence indispensable in the modern securities market. The lack of knowledge and skills of the investors and their eagerness to get a better return in the market enhance the role of the market intermediaries and their malpractices. An inevitable ingredient of financial insecurity is market practices, [Zigrand, 2006], [10]. The Investors encounter the malpractices of registered / unregistered intermediaries along with fraudulent market intermediaries. Registered intermediaries are coming under the purview of the regulators and are subject to regulatory action. However, the growing concern of the market participants is the malpractices of fraudulent persons/unregistered market intermediaries who often escape from the purview of the market regulators and actively engage in malpractices. Unregistered/fraudulent intermediaries use a lot of techniques to project themselves as genuine ones. Many times, investors are not able to distinguish between genuine and fraudulent intermediaries. The presence of fraudulent persons in the market reduces the volume of the business of the genuine intermediaries and also acts as a big threat to the market. The malpractices carried out by registered or unregistered market intermediaries are harmful to the market in terms of erosion of the confidence of the investors and discouraging them to enter the market. It is the regulators' responsibility to identify and prevent market malpractice. The rationale behind the prohibition of market malpractices is to protect market participants, especially small investors from being harmed by fraudulent entities. Regulatory action has been initiated by the Securities and Exchange Board of India against the registered as well as unregistered/fraudulent intermediaries to eradicate the malpractices in the market. SEBI is initiating efforts to identify the unregistered intermediaries engaged in malpractice in the market to eliminate them to ensure the orderly conduct of the market.

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