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Study on the Regulatory Response to Malpractices of Secondary Market Intermediaries

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Abstract

An investor perceives that the investment in securities is subject to inherent market risk which may be combated with the assistance of market intermediaries. He trusts the integrity of the securities market and relies on the information placed before him to be authentic and reliable. He is confident of the expertise of market intermediaries and honestly expects that they are rendering professional services diligently without any malpractices. He strongly believes appropriate regulations are in place to prevent malpractices and that securities market regulators have adequate powers to combat malpractices and discharge their duties and responsibilities efficiently and effectively to protect their interests. In this paper, the author discusses how the Securities and Exchange Board of India (SEBI) encounters the issue of secondary market malpractices of intermediaries through its regulations in general as well as specific to each category of market intermediaries.

Keywords: Intermediaries, market, regulations, response, Securities and Exchange Board of India, securities

INTRODUCTION

Securities markets have a long history in the world and so also market malpractices. The securities market gave birth to malpractices and nurture them for a long time without any hindrance. Even though the market malpractices are as old as the securities market, the need for regulating the securities market was not realized for a long time in many jurisdictions. Lack of awareness, minimal malpractices, and trust of investors facilitate the securities market development without any regulation or government intervention and securities market regulators. The rationale behind legal intervention in the securities market is to ensure the smooth functioning of the market and the preservation of market efficiency. However regular occurrence of malpractices not only disturbs the market but also questions the credibility of regulators and their intervention in the market. Many intermediaries participating in the securities market are exposed to systemic risk because cascading effect of the collapse of any of them in the market may be led to the collapse of other participants too. Effective regulation of market intermediaries is essential for the protection of investors as well as the orderly functioning of the secondary securities market.

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REGULATORY RESPONSE TO MALPRACTICES OF MARKET INTERMEDIARIES

The securities market witnessed the malpractices, manipulations, frauds, mushroom growth of unofficial private placements, price rigging of shares, etc. in addition to the exploitation of the opportunities placed before them by self-styled unofficial merchant bankers, especially between the years the 1980s and 1990s.

The Securities and Exchange Board of India (SEBI) Act 1992

The Government of India and Stock exchanges, the regulators of the market could not effectively control the malpractices of market participants/intermediaries and fraudulent persons/entities due to a lack of proper penal provisions in the existing legislation. In the absence of an effective legal regime in place, investors' grievances mounted up and their confidence was eroded. The growth of the securities market and malpractices created a need for a separate regulator for the securities market. The Government of India by a notification dated April 12, 1988, constituted "The Securities and Exchange Board of India" (SEBI), as an administrative body, to ensure the orderly function of the securities market, protect the interest of the investors, and for the healthy growth of the market.

The development of the securities market with mega scams/malpractices called for a strong regulator for better regulations and monitoring of market participants/market intermediaries. The change in market condition mandates proper response to the issues of the market then and there, to ensure fair market practices and demand for a statutory agency. Considering the exigencies of the situation, The Government enacted *"The Securities and Exchange Board of India Act, 1992"*. SEBI became a statutory body and quasi-judicial body. To regulate the market, it framed rules and regulations under the SEBI Act for the registration and regulation of all market intermediaries, and the prevention of unfair trade practices, insider trading, etc. It also issues notifications, guidelines, and circulars which are also required to be complied with.

The Securities Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003

SEBI being a regulator of the securities market, must maintain the integrity of the market and ensure that the market is free from unfair, manipulative, and fraudulent activities to win over the confidence of investors. To respond to these issues effectively, SEBI has brought out a separate regulation, viz., The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [1] to deal with manipulative, fraudulent, and unfair trade practices and facilitates SEBI to investigate cases of market manipulation and fraudulent and unfair trade practices. The advent of new techniques in fraudulent and manipulative activities drive SEBI to bring amendments to the Regulations during 2012 and 2013.

SEBI considered the current regulations are not sufficient to effectively prohibit market malpractices and to respond to these issues in a better manner, formed a committee under the Chairmanship of Mr. T.K. Viswanathan, (Committee). The committee reviewed the existing legal framework with reference to, the surveillance, investigation, and enforcement mechanisms being undertaken by SEBI. It made recommendations to SEBI. Accordingly, SEBI brought amendments to vide the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2018, and brought into force on February 01, 2019.

Prohibition of fraudulent and unfair trade practices relating to securities markets is one of the functions of the SEBI. It discharges its function through Regulation 4. It prohibits, indulging in a manipulative, fraudulent, or unfair trade practice in securities markets (Regulation 4 (1)). It lists out the activities which are deemed to be manipulative fraudulent or unfair trade practices (Regulation 4(2)). It also describes what are the activities to be included in the fraud and fraudulent shall be construed accordingly.

SEBI has been conferred with the power to order an inspection in case of transactions in securities are being dealt with in a manner detrimental to the interest of investors or contravention of any of the provisions of the Act or the rules or the regulations, in accordance with Regulation 5. SEBI in accordance with regulation 11, respond to manipulative and fraudulent activities by means of suspending the trading of the security, prohibiting any person associated with the securities market to buy, sell or deal in securities, etc. SEBI, to protect the interests of investors and the securities market, can issue a warning or censure; suspend the registration of the intermediary, or cancel the registration of the intermediary (Regulation 12).

Category-Wise Intermediary Regulations

Investors especially small investors are not rational and fully informed. They lack, the information and expertise to assess the credibility of a specific market intermediary and are exposed to risk and vulnerable to malpractices of the market intermediaries. Realizing the significance of the regulation of market intermediaries, SEBI has notified regulations for each category of market intermediaries viz., [2].

- The SEBI (Stock Brokers) Regulations, 1992;
- The SEBI (Portfolio Managers) Regulations, 1993;
- The SEBI (Depositories and Participants) Regulations, 1996; and,
- The SEBI (Investment Advisors) Regulations 2013.

The SEBI (Intermediaries) Regulations, 2008

SEBI considered it expedient to bring all market intermediaries under one umbrella, and brought out a separate and comprehensive regulation viz., “The Securities and Exchange Board of India (Intermediaries) Regulations, 2008” in response to the market malpractices [3], in addition to the existing regulations.

Almost all intermediaries in the primary and secondary markets have been brought under the SEBI’s regulatory purview.

REGULATION OF MARKET INTERMEDIARIES

SEBI addresses the issues of the market intermediaries through “The Securities and Exchange Board of India (Intermediaries) Regulations, 2008” in response to the market malpractices of the market intermediaries [4].

Definition of Market Intermediaries

It is pertinent to define market intermediaries to bring them into the ambit of the regulations without any ambiguity. Accordingly, Regulation 2 (1) (g) defines “intermediary” as a person mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the Act and includes an asset management company in relation to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, a clearing member of a clearing corporation or clearing house, foreign portfolio investors and a trading member of a derivative segment or currency derivatives segment of the stock exchange but does not include foreign venture capital investor, mutual fund, collective investment scheme, and venture capital fund.

Registration of Market Intermediaries

Market intermediaries interact with investors in the secondary market for rendering their professional services. Identification of market intermediaries and requiring them to be registered with the regulatory authority should be the first step because it would be impossible to regulate their activities without identifying their role and controlling them in the market. The registration of all market intermediaries helps SEBI, to exercise better control over them and monitor their activities to ensure better protection of the interest of investors. Regulation 3 to 7 of SEBI (Intermediaries) Regulations 2008, stipulates regulations for application for the grant of certificate, details the disclosure requirements, furnishing of information and clarifications, verification of information, and consideration of application respectively.

SEBI follows stringent norms for the registration of an intermediary. The intermediary applicant shall route their application through their sponsors, to SEBI. The sponsors scrutinize the eligibility of applicants and forward it to SEBI. SEBI, based on the fulfillment of the eligibility criteria considers the application for registration (Regulation 3(2)). It shall grant a certificate of registration to the intermediary subject to the conditions to be complied with. It may also impose additional conditions in the interest of investors/orderly development of the securities market (Regulation 9(1). The certificate granted to an intermediary shall be permanent unless surrendered by the intermediary or suspended or cancelled by SEBI.

An intermediary shall cease to act as an intermediary if SEBI refuses to grant the certificate or after the expiry of the certificate. An intermediary who is under debarment, suspension, or cancellation of a certificate shall cease to carry on any activity in respect of which the certificate had been granted. Also, an intermediary shall not undertake any new assignment or contract or launch any new scheme during the period of debarment or suspension.

An intermediary may carry on more than one activity only if it obtains a separate certificate to carry on each such activity (Regulation 3(6)).

General Obligations of Market Intermediaries

The regulatory regime-imposed obligations on registered market intermediaries for the protection of the interest of investors. An intermediary shall appoint a compliance officer for monitoring the compliance of Acts, Rules, Regulations, etc. The compliance officer shall report to the intermediary or its board of directors, in writing, of any material non-compliance by the intermediary. In addition to that, an intermediary is mandated to file with SEBI, a certificate of its compliance officer each year, certifying the compliance of all the obligations, responsibilities, and the fulfillment of the eligibility criteria on a continuous basis (Regulation 12(1)).

To ensure transparency in the transactions, it is obligatory on the part of the intermediary to maintain books, accounts, and records. SEBI stipulates that the intermediary shall redress investor grievances promptly. It also imposes an obligation to maintain records regarding investor grievances received by it and redressal of such grievances besides uploading quarterly information on the status of the investors' grievances on the website specified by SEBI. It prohibits an intermediary or its insiders from rendering investment advice on any security in the publicly accessible media, unless disclosure of its interest, in the said security has been made, while rendering such advice. It also mandates an intermediary and its directors, officers, employees, and key management personnel to abide by the Code of Conduct (Regulation 16).

Supervision of Market Intermediaries

SEBI performs a supervisory role over market intermediaries for the effective discharge of its duties. It has been conferred with the power to appoint one or more persons or a qualified auditor as inspecting authority to undertake the inspection of the books, accounts, and records including telephone records, electronic records, and documents of an intermediary, and submit a report to it. The inspecting authority enjoys substantial power including the power to examine directors; partners etc. of the intermediary or record their statements. The intermediary and its officers are duty-bound to help the inspecting authority in the discharge of its duties. The inspecting authority shall submit an inspection report to the SEBI (Regulation 21).

Surveillance Mechanism

An effective surveillance mechanism is one of the key requirements of a well-functioning securities market. The stock exchanges are the first-level regulators who have been entrusted with the primary responsibility of maintaining the integrity of the market and ensuring the performance of the market in accordance with the stipulated norms and practices. To enhance the efficacy of the surveillance function, SEBI has put in place a comprehensive Integrated Market Surveillance System (IMSS), which generates alerts arising out of unusual market movements. SEBI also keeps a continuous vigil on the activities of the stock exchanges and inspects surveillance departments of major stock exchanges [5].

Action in Case of Default of Market Intermediaries

Regulatory actions taken against market intermediaries in case of default are crucial in the protection of the interest of investors and restoring their confidence in the market. SEBI can initiate the following actions against a market intermediary, in case of default in accordance with Regulation 26:

a. Suspending certificate of registration;
b. Cancelling certificate of registration;
c. Prohibiting taking up any new assignment;
d. Debarring a principal officer from being employed or associated with any registered intermediary or another registered person;
e. Debarring a branch or an office from carrying out activities; and,
f. Warning the intermediary.

Considerable reduction in the incidence of default depends on the effectiveness of the regulatory action initiated against defaulters.

Suspension or Cancellation of Registration

The threat of removal of the license ensures intermediaries and intermediary firms comply with statutory requirements in a better manner. SEBI can initiate an action against an intermediary for suspension or cancellation of registration of an intermediary holding a certificate of registration, in the circumstances specified in regulation 11 of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations 2003 and without prejudice to its power under regulation 12.

SEBI has been vested with the power to suspend or cancel the registration of intermediaries for their a) failure to comply with any conditions subject to which a certificate of registration has been granted and (b) contravenes any of the provisions of the securities laws in accordance with Regulation 23 of SEBI (Intermediary) Regulation 2008.

Any person aggrieved by an order under SEBI (Intermediary) Regulation 2008 can appeal to SAT in accordance with Sec 15T of the Act (Regulation 33).

SEBI can order an investigation of the affairs of an intermediary or persons associated with the securities market, if it has reasonable ground to believe that the transaction in securities is being dealt with in a manner detrimental to the investor or an intermediary has violated the rules and regulations under the Act. SEBI can initiate action for suspension or cancellation of registration of an intermediary after giving a reasonable opportunity of being heard, based on the report of the investigating officer [6]. The effect of debarment, suspension, cancellation, or surrender of the certificate of registration is a serious one, leading to serious consequences and repercussions. In Sharedeal Financial Consultants V. Chairman, SEBI [7], SEBI passed an order for cancellation of the certificate of registration for nine months for the involvement of the appellant in market manipulation/irregularities in trade and failure to exercise due care and skill as per Clause A (2) of Schedule II of the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992. On appeal, SAT sustained the order of SEBI.

Penalties

Potential penal sanctions may discourage conflicts of interest. The contravention or attempts to contravene or abets the contravention of the provisions of this Act or any regulations or byelaws made thereunder shall be punishable with imprisonment for a term which may extend to five years, or with a fine, or with both. Section 15I of the SEBI Act 1992 empowers SEBI to appoint adjudicating officers to adjudicate a wide range of violations and impose monetary penalties [8]. However, the penalties for fraudulent and unfair practices, introduced by the SEBI through the Securities Laws (Amendment) Act, 1995, were quite insignificant in amount to act as a disincentive for offenses. In the SEBI (Amendment) Act, 2002, penalties have again revised substantially, from around Rs. 5 lakhs for certain offenses, to a maximum of Rs. 25 crores [9].

REGULATORY RESPONSE TO MALPRACTICES OF BROKERS

Stock brokers being key players in the secondary market are expected to be fair, efficient, and transparent. They act as an agent for dealing with securities on behalf of their client [11] and offer value management or services [12]. They are shouldered with the responsibility to act in the interest of their clients. SEBI facilitates better market access to investors by approving Direct Marketing access (DMA) [13] and giving necessary guidelines for providing DMA facility through various connectivity modes permitting the trading members of INDIAINX to provide direct trading terminals to their DMA clients [14].

Legal Framework

Brokers being the prime intermediary in the market act as a vital link between stock exchanges and investors. To regulate and in response to the malpractices of the Brokers, SEBI has brought out an exclusive regulation viz., The Securities and Exchange Board of India (Stock Brokers) Regulations, 1992, in addition to the Securities Contract Regulation Act 1956, SEBI Act 1992; Securities and Exchange Board of India (Intermediaries) Regulations, 2008; and by-laws of stock exchanges. It is an important landmark in the journey of SEBI.

Regulatory Response

SEBI mandates the registration of stock brokers, to exercise better control over them, and to identify and eliminate unregistered stock brokers in the market. Regulation 3 stipulates a certificate of registration to act as a broker. It prescribes conditions (Regulation 9) for the grant of registration (Regulation 6). Regulators mandate the brokers to pay fees (Regulation 8 and in accordance with Schedule III/ Schedule V). It framed code conduct for the brokers to address the issues of the brokers and their malpractices. It prescribes the duties of brokers to investors as well as Stock Brokers vis-a-vis Other Stock Brokers to ensure fairness in their dealing. It also stipulates the general obligations and responsibilities of the Stock Brokers (Chapter IV). Compliance with Acts and Regulations is very important for better enforcement. Liability for contravention of the Act, rules, or regulations is laid down in Regulation 25. A stock broker shall be liable for prosecution U/s 24 of the Act (Regulation 28).

REGULATORY RESPONSE TO MALPRACTICES OF PORTFOLIO MANAGERS

Investors with the intention to get a better return on their investments, invest their money in the securities market and seek the assistance of portfolio managers for the construction of portfolios and better allocation of resources. The major concern of the investors is the malpractices of the portfolio managers. Portfolio Management Services lead to malpractices in the market which are detrimental to the interest of investors. In addition to that they are encountering the issue of selection of right portfolio managers.

Legal Framework

Regulators to address the concerns of the investors, prohibit the malpractices of the portfolio managers, and regulate them, brought out an exclusive regulation viz Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 in addition to SEBI Act 1992, Securities and Exchange Board of India (Intermediaries) Regulations, 2008 and the Securities Contracts (Regulation) Act, 1956.

Regulatory Response

The first step towards regulating portfolio managers is to define a portfolio, as ‘the total holdings of securities and goods belonging to any person’ (Regulation 2(1)(n)) for better clarity and enforcement. The regulatory regime mandates portfolio managers to obtain a certificate of registration to act as a Portfolio Manager in accordance with Regulation 3 and formalities to be complied with for getting registration through Regulations 3 to 12. It also laid down conditions for the grant of registration under Regulation 11.

Chapter IV of the regulations imposes general obligations and responsibilities to portfolio managers. It framed a code of conduct that addresses many of the issues investors encounter with Portfolio managers. Management of clients' portfolios is spelled out under Regulation 24. It also mandates the portfolio manager to submit a periodic report to the client to update them on the status of their portfolio. Portfolio managers are making a false promise for an assured/guaranteed return, to their clients with the intention to cheat them. The regulatory regime restricts the portfolio managers not to offer/promise indicative or guaranteed returns to clients, to respond to these types of malpractices.

REGULATORY RESPONSE TO MALPRACTICES OF INVESTMENT ADVISORS

Growing awareness of the securities market encourages a greater number of investors to take part in the securities market. However modern automated securities market and the products available in the market are complex which necessitates small investors to seek investment advisors' assistance to stabilize themselves in the market. Services of an investment advisor are based on the trust of their clients and their survival depends on the maintenance of trust and viz. A common malpractice in the market is the circulation of unsolicited investment advice through the print media or bulk SMS messages, without any contract or consideration [15]. This advice is made not in the interest of the investors but for the benefit of individuals and their sponsors. Regulators caution investors to be careful with these vested interest investment advisors.

Legal Framework

The legal regime to address the issues of the investment advisor brought out an exclusive regulation namely SEBI (Investment Advisors) Regulations 2013 in addition to The SEBI Act 1992, and the Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020.

Regulatory Response

Investors find it difficult to identify the right investment advisors due to the wide range of job titles used by them for their operations in the market which may lead to confusion in the minds of investors, about who does or does not assume a fiduciary role. The question of "what constitutes investment advice? has been addressed through regulation 2(1)(m) by defining an investment advisor. To prevent undesirable persons to perform the role of investment advisor and to regulate the investment advisors in the market, the legal regime stipulates investment advisors register in accordance with Regulation (3) to (13) to act as investment advisors.

The main criticism leveled against investment advisors is that many of them are not qualified to act as investment advisors. This issue has been addressed through Regulation 7 by prescribing the qualifications and experience of an investment advisor. The regulators prescribe net worth requirements to ensure that Investment Advisors have adequate financial resources and protect the interest of the investors from the risk of bankruptcy of the investment advisors and prevent undesirably persons from handling the money/securities of the investors.

Regulators prescribe obligations and responsibilities of an investment advisor with regard to fees, risk profiling, suitability and responsibility for disclosure, maintenance of records including copies of agreements with clients, etc. They also mandate investment advisors to act in a fiduciary capacity towards their clients and to disclose all conflicts of interest involved in their service (Regulation 15: General obligations).

The main criticism leveled against investment advisors is, charging exorbitant fees to clients. This issue has been responded to through Regulation 15A.

Many investment advisors are not doing a proper risk assessment of their clients before giving investment advice. The legal regime addressed this issue through regulation 16 by casting responsibilities on investment advisors to collect information from the clients to give investment advice and periodically update the same. Many investment advisors are not making suitable recommendations to the client. SEBI addresses this suitability issue through Regulation 17. The regulatory regime responds problem of no disclosure or inadequate disclosure issues through Regulation 18 by prescribing disclosure requirements. Investment advisors carry out both advisory and distribution services and there is no segregation for a long time. This issue has been responded to through Regulation 22 which mandates client-level segregation of activities to prevent conflicts of interest besides barring advisors from offering investment advice and product distribution services to the same client.

REGULATORY RESPONSE TO MALPRACTICES OF DEPOSITORY & DEPOSITORY PARTICIPANTS

Advanced securities markets successfully implemented a depository system to ensure efficient transfer and settlement of securities.

Legal Framework

In response to the Dematerialisation of securities, capital market reforms, and participation of foreign institutional investors (FIIs) in the securities market necessitates, a legal regime to bring out The Depositories Act, 1996, in addition to The SEBI Act 1992, Securities Contracts (Regulation) Act, 1956, The Companies Act, 2013, the SEBI (Intermediaries) Regulations, 2008, the SEBI (Depositories and Participants) Regulations, 1996 and 2018. The Depository Byelaws are also governing the Depository and Participant.

Regulatory Response

A depository shall be established and registered in accordance with Regulations 3 to 10 of the Depositories Regulations 2020 and in addition to that a depository must get a certificate of commencement of business to act as a depository (Sec 3). A depository is restricted to carry on any activity involving the deployment of funds (Regulation 7(c)).

The legal regime ensures that for any loss caused to the beneficial owner on account of the negligence of the depository or the participant, the depository shall indemnify such beneficial owner (Sec 16(1)). It also considers the delay in indemnifying investors' mandates, where the loss due to the negligence of the participant is indemnified by the depository, and the depository shall have the right to recover the same from such participant (Sec 16(2)). It imposes a penalty for failure to redress the grievances of the investors (Sec 19 C) with the intention to protect the interest of the investors.

The depository shall establish and maintain an Investor Protection Fund for the protection of the interest of beneficial owners (Regulation 73(1)):

Special Courts shall be established to provide speedy trial of offenses under this Act, in accordance with Sec 22©.

The legal regime mandates depositories to abide by the Code of Conduct through Regulation 17 and Part D of the Third Schedule and the Code of Conduct for directors and key management personnel through Regulation 27.

Separate accounts shall be opened by every participant in the name of each of the beneficial owners and the securities of each beneficial owner shall be segregated and shall not be mixed up with the securities of other beneficial owners or with the participant's securities (Regulation 59. (1)).

Every participant shall provide statements of account to the beneficial owner as provided in the agreement with the beneficial owner (Regulation 60). A depository and a participant shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules, and regulations (Regulation 81).

CONCLUSION

Malpractices of market intermediaries are a big threat to market integrity and efficiency. They are not only corroding the confidence of investors but also driving them away from the market. Issues of market malpractice have been a concern of the securities market. Domestic and international investors are keenly watching the regulatory response to combat malpractices in the market to ensure its integrity. The presence of regulators and too many regulations are also in place, but many investors are still reluctant to take an active part in the market due to a lack of confidence in the market and market intermediaries. Regulatory system, market participants/intermediaries failed to instill confidence in the minds of investors. Investors in the United States of America and the United Kingdom are reaping the benefits of the securities market through their active participation in the securities market and contributing to the growth of the economy. Indian population is the second largest population in the world but only a few investors are active in the Indian securities market, because contrary to the expectations of investors, market intermediaries abuse the trust reposed on them and explore every opportunity to exploit them. Regulators and market intermediaries must ensure the smooth functioning of the market to encourage more investors to take active participation in the securities market to avail the benefits of the securities market through effective securities regulations.

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