



# An Analysis of Securities Market Frauds in India

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## Abstract

Securities market fraud have been rising in the past as financial markets have expanded, it has been an easy target. It can be exploited easily as compared to other markets. This paper discusses about the securities market frauds, types of securities fraud and to what extent it is prevalent in India. It also discusses the legal regulatory regime associated with securities with securities markets to detect the crime and prevent is further. It is concluded that to prevent such crimes there is need for stringent legislations and proper cooperate governance at the fundamental level.

## INTRODUCTION

Securities involve financial instruments which represents the rights of investor like income, voting rights and other benefits arising from that financial instruments. Securities also involve stocks, treasury stocks, bonds and notes. Unlike cash or tangible property, securities do not have any intrinsic value. The value of securities is based on certain factors like market conditions, representation made by the issuer and other extrinsic factors. Section 2(h) of the Securities Contract (Regulation) Act, 1956 define Securities as-

(h) securities include –

(i) shares, scrips, stock, bonds, debentures, debentures stock or other marketable securities of a like nature in or any of incorporated company or other body corporate;

(ia) derivative;

(ib) unites or any other instruments issued by any collective investment scheme to the investors in such schemes;

(ic) security receipts as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

- (id) units or any other such instruments issued to the investors under any mutual fund scheme;
- (ii) Government securities;
- (iia) such other instruments as may be declared by the Central Government to be securities; and
- (iii) rights or interest in securities.

One of the essential duty of company is to maintain interest of investors and shareholders and when a company fails to perform this duty then it will result into securities market frauds. The company can perform this duty by having a prohibition on insider duty, by fulfilling requirements of substantial acquisition of shares, by following public disclosure requirements and by avoiding fraudulent practices and market manipulation in securities. The number of securities market scams like Harshad Mehta, Ketan Parekh, Satyam and Sahara Scam draws attention towards inefficiency of law. There are number of securities market frauds in the market. All these types of securities frauds fall under white – collar crimes. These crimes are only committed by those who are having financial knowledge.

There is no strict definition of Fraud but it is usually associated with deception by which one takes an advantage from other. Securities fraud are those are deceptive or fraudulent activities which involve stocks or commodities market. Security frauds are like other frauds offenses. which are typically. Which? Perpetrated. Through one or more schemes. To induce to others. To invest their money. Or other valuable things. In a present era. Securities market fraud is not limited to any particular nation. Rather, it become a global phenomenon. Corporation are facing a crisis of confidence. Due to failure of the basic structure of capitalist system like stock market, financial analyst and accountants and investment banks. In India, certain regulations and statutes probed securities fraud. The number of securities regulations are implemented with the object to bring Full disclosure to eliminate fraud and to improve trading system so that interest of investors could be protected by ensuring fair, efficient and transparent market which would reduce systematic risk. Every misstatement or omission of information by the company to its shareholder and investors does not commit securities fraud. It is only committed when such MIS stated information or omitted information is material. The essential ingredient for Commission of securities fraud is dead. Investors should have noticed the change in fax and its impacts.

## 2. TYPES OF SECURITIES FRAUDS

There is no exhaustive list of securities market frauds and one can see invention of new types of frauds by people from time to time. Some of the specialised forms of securities market frauds include insider trading, misrepresentation in fulfilling requirements of substantial acquisition of shares, fraudulent practices and market manipulation in securities market and stock frauds like technology fraud, accounting fraud. Securities market fraud generally involve huge quantum of money in comparison to ordinary frauds. The different types of securities market frauds emerging out of securities transactions are as follows.

## **a Common law fraud**

This type of frauds are covered more specifically in the domain of tort or tortious law. A basic principle guarantees that “every wrong shall have a remedy.” Common fraud is useful to interpret the securities market fraud in two ways. First one is that it give some peculiarities of the securities markets, the requirements of common law principles may be modified for the securities market. The second point of departure from the common law definition would be where an element of common law fraud is clearly over ruled by the elements of statutory fraud. In such cases, the common law principles would stand negated. The SEBI definition of fraud is somewhat vague and over broad which makes reliance on common law definition not only important but also critical in understanding securities fraud. In securities market fraud the courts will impose a higher burden of proof on someone alleging fraud in comparison to cases in tortious actions. The essential ingredients of common law fraud are (i) mens rea or intention; (ii) materiality; (iii) misrepresentation of fact; (iv) transaction causation and reliance on the fraud; (v) loss causation; (vi) actual damages

Negligence will typically not show intent to defraud and usually a negligent act will not result in action for fraud. The use of words like manipulative, device and contrivance clearly shows that it was intended to proscribe a type of conduct which is quite different from negligence. It has been provided by section 26 of the Companies Act, 2013 and Clause 41 of the listing agreement that a company should not remain silent about any fact which shall be disclosed and if they not disclose the information that would lead to misrepresentation. A fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor. For a test of materiality the usual common law test of reasonable person is replaced by a test of the reasonable investor. To prevail an action for fraud, investors must demonstrate that the defendant’s deceptive conduct caused them an economic loss.

## **b. Insider Trading**

People closely connected with a company also known as insider have easy access to certain confidential information which is not known to outsiders. Confidential information is about profits of a company, proposed dividends, bonus shares proposed by a company, rights issue of shares, expansion plans of a company like merger, acquisition, amalgamation, disinvestment etc., and insider have access of this confidential information before it is made public. This information is ‘Material Information’ as it is not accessible to general public. Material information can be misused by insider for his personal benefit. Such act of insider is harmful in the interest of investors and capital market. Black’s Law Dictionary defines insider trading as, “*the use of material, non-public information in trading the shares of a company by a corporate insider or other person who owes a fiduciary duty to the company.*” A person is insider when he has a non-public information of a company. Insider must not use non-public information for buying or selling of shares of a company and also not advice others to buy or sell shares of that company till the time such information is disclosed to the public.

The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 it is one of the governing regulation which is used to detect and control the insider trading. It also prohibits insider trading, govern the conduct of insiders, connected persons and such persons who are deemed to be connected

with matters of insider trading. This regulation defines insider as any person who is a connected person or who is in possession or have access to unpublished price sensitive information. Price Sensitive Information is such information which has direct connection with companies running affairs and it is directly or indirectly related to the company working and management. If such information is published than it could affect the price of the securities of the company. It includes information related to periodical financial results of the company, intended declaration of dividends, change in capital structure of a company, corporate restructuring of a company through merger, acquisition, amalgamation, takeovers or disinvestment, changes in key managerial personnel etc., can be considered as price sensitive information. Further, Clause 36 of the Listing Agreement casts a duty on all listed companies to immediately inform Stock exchange(s) in respect of some events which are considered to be price sensitive. Such events occur due to change in general character or nature of business, if operations of a company are disrupted due to natural calamity, litigation or dispute took place which have material impact, any developments in respect to pricing or realisation arising out due to in the regulatory framework and any other information having bearing on the operation or performance of the listed company as well as price sensitive information. The disclosures requirement on listed companies are mandatory for avoiding the establishment of false market by a company on its securities which can protect interest of the shareholders.

This regulation prohibits the use of unpublished information. Connected person includes any person who is or has during the six months prior to an act of insider trading is either directly or indirectly associated with a company, in any capacity including frequent communication with officers of the company or being in any contractual, fiduciary, employment relationship or being a director, officer, an employee of the company, holding of any position including both professional or business relationship between himself and company and the company allows such person access to unpublished price sensitive information whether directly or indirectly or is reasonably expected to allow such access. There are certain persons which are presumed to be connected person but such presumption is rebuttable. A person is deemed to be connected person if such person is an immediate relative, holding or associate or subsidiary company, officials of stock exchange, a concern firm or trust, Hindu Undivided Family, a company or association of persons wherein a director of a company or his immediate relative or banker of the company has more than ten percent of the holding or interest, an intermediary, a merchant banker, an employee, a member of Board of Directors, an official, an employee of a self-regulatory organization recognised by SEBI, relative of connected person or persons mentioned, a banker of the company

#### Restriction on an Insider

An insider is not permitted to deal with the securities, to subscribe to primary issue till the time he is in possession of unpublished price sensitive information. He shall not be allowed to communicate, provide, or allow access either directly or indirectly about any unpublished price sensitive information to any other including other insiders also. The only exception to disclosure of unpublished price sensitive information is when insider is under a legal duty to communicate such information. The giving of advice by an insider to

any person in respect to deal in securities of the company on a basis of unpublished information is also prohibited. A company is also not permitted to deal in securities of another company if it is in possession of any unpublished price sensitive information. There are exceptions when a company is allowed to deal in above transactions. A company is allowed to deal in securities of another listed company if a person making a decision to enter into such transaction does not have the possession of unpublished price sensitive information even though such unpublished information may be in possession of any other officer or employee of the company. Another exception is when a company acquired shares of a listed company in accordance with the provisions of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

### **c. Substantial acquisition of shares**

A company acquiring shares of another company in violation of SEBI Substantial Acquisition of Shares and Takeover (SAST) Regulations, 2011 constitutes a fraud. Acquisition of shares by one company of another without following provision of the Regulation is prohibited as the Regulations focuses on proper fixation of price of the shares.

#### **Disclosure Requirement under the Regulation**

Any person who by himself or in concert of other persons holds shares or voting rights which if aggregating to five percent or more of the shares or voting rights in a target company then such person is under a legal obligation to disclose their aggregate number of shares or voting rights held and change in shareholding or voting rights even if such change results in shareholding falling below five percent if there has been change in such holdings from the last disclosure made and such change exceeds two percent of total shareholding or voting rights in the target company. If any such circumstances occur then acquirer shall disclose the number of shares or voting rights acquired and also to disclose the change if occurred. The acquirer must also give same information to all the stock exchange on which the shares of the company are listed and to a registered office of the target company.

#### **Public Offer Requirements under the Regulations**

The Regulation casts a duty on an acquirer to make a public offer when an acquirer by himself or in concert of other persons acquire shares or voting rights aggregating to twenty-five percent or more in a target company. Public offer is also to be made when acquisition and holding of shares or voting rights in a target company entitling to exercise twenty-five percent or more of the voting rights in the target company but less than the maximum permissible non-public shareholding within any financial or more than five-percent of the voting rights.<sup>13</sup> Irrespective of any percentage of acquisition of shares or voting rights in a target company, if acquisition either directly or indirectly results in control over the target company then acquirer is under a duty to make a public offer. If any direct or indirect acquisition of shares or voting or change in control in a target company attracts the obligation on an acquirer to make a public offer under the Regulation then acquirer shall make a public offer. The exemptions of public offer requirements are provided under Regulation 10 which are general exemption and under Regulation 11 which includes exemption granted by SEBI. Only those

acquisition which is pursuant to inter se transfer of shares amongst qualifying persons is covered under general exemption.

#### **d. Market Manipulations and Unfair Trade Practices in Securities Market**

Market manipulation means any practices which is interfering with the sanctity of the securities market and its operation. Manipulation is nowhere defined. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 2003 is a governing law which prohibits market manipulation and unfair trade practices in securities market. The Regulation defines fraud as any act, expression, omission or concealment committed which may or may not be in a deceitful manner by a person or by any other person with his connivance or by an agent of any such person while dealing in securities in order to induce another person or an agent of that person to deal in securities, no matter whether there is any wrongful gain or avoidance of any loss. Fraud also include –

1. A knowing misrepresentation of the truth or concealment of material fact made to another person so that that person may act to his detriment;
2. A suggestion made by a person as to a fact which is not true who himself does not believe that fact to be true;
3. An active concealment of a fact by a person who has knowledge or belief of that fact;
4. A promise made without having any intention to perform that promise;
5. A representation made in a reckless and careless manner no matter whether that representation is true or false;
6. All those act and omission which are specifically declared as fraudulent by any other law;
7. Deceptive behaviour by a person depriving another of informed consent or full participation;
8. Making of a false statement without having reasonable ground for believing that statement 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 even though they did not rely on the statement itself or anything derived from it other than the market price.

The Regulations prohibits those dealings in securities which would amount to manipulation of the price of a security. Certain acts or omissions are prohibited-

1. Publishing or causing to publish or reporting or causing to report of such information which is not true made by a person who himself does not believe it to true prior to or in the course of dealing in securities;
2. Entering into a transaction in securities without having an intention to perform that transaction or without having any intention of changing an ownership of such security;
3. Selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form;

4. A promise made by an intermediary about a certain price in respect of buying and selling of a security to a client and waiting till a difference arises regarding price of such securities and retaining the difference in prices as profits for himself;
5. Providing of such information relating to security by an intermediary to his clients which cannot be verified by the clients before their dealing in such security;
6. Misleading advertisement or that advertisement that contains information in a distorted manner which could result influencing of a decision of the investor;
7. An intermediary reporting trading transactions to his clients entered on their behalf in an inflated manner in order to increase his commission and brokerage;
8. Transactions entered by an intermediary on behalf of their client without disclosing them;
9. 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;
10. Encouragement made by an intermediary to their clients to deal in securities with sole object of intermediary to raise their brokerage or commission;
11. Falsification of records such as contract notes by an intermediary
12. Buying or selling of securities by an intermediary in advance of a substantial client order; 13. Giving of false or misleading news which may induce sale or purchase of securities.

### **3. REGULATORY FRAMEWORK IN INDIA:**

In order to ensure that such crimes do not take place, a mechanism has to be in place that prevents the same. The legislations that are made in this regard are mainly for the purposes of regulating the stock markets in an efficient and fair manner and for the general good of the public since the burden of these scams is borne upon the investors at large. The regulatory bodies like NCLT, The Reserve Bank of India (RBI) which is primarily responsible, inter alia, for the supervision of banks and money markets, Department of Economic Affairs (DEA) which is responsible for the economic management of the country and is the arm of the government that is concerned with the orderly functioning of the financial markets as a whole, Ministry of Corporate Affairs (MCA) which is at the apex of a three tier structure that has responsibility for the registration and oversight of incorporated entities which fall under the regulatory purview of the Companies Act., etc. keeps checks and balances. The Companies Act, 1956 was specially amended to include sections that dealt with the issues arising due to the securities frauds in the corporate sector including the Satyam Scam. Sections 74 and 75 of the Companies Act, 2013 have been incorporated in order to keep in mind the public who suffers at the cost of such frauds. They provide for “repayment of deposits and other such investments that were accepted by the companies before the commencement of the Act in case any default so occurs.” There also exists

provisions for fraud investigation offices under section 211 which looks towards the payment of compensation and damages. As per section 447, companies act mentions that if any person who will commit fraud and will be found guilty, shall be punished with 6 months imprisonment which might extend upto 10 years. They will also be liable to pay fine which should not be less than the amount involved in the fraud and thrice the amount of fraud. If fraud is committed against the public interest, minimum imprisonment that will be given will be not less than three years. Section 448 of companies act mentions that if any person makes any false representation with regards to any report, certificate, or any related document for the business purpose will be punished under Section 447 of the Companies Act, 2013

### **The Security Exchange Board of India Act, 1992**

The SEBI looks after the administration and smooth working of the securities market and ensures investor protection. Its functions include (a) it protects the interests of investors in securities, (b) it promotes development of the securities market, and (c) it regulates securities market. In *Sterlite Industries Vs. Union of India* It was held that SEBI has been given wide powers which it can use upon its own discretion to regulate the securities market and protect the interest of investors.<sup>19</sup> In order to ensure that strict actions are taken against the defaulters, the Act provides for the establishment of a Securities Appellate Tribunal under Section 10. The powers have been provided under section 15 of the Act which includes :

- summon and enforce attendance of any person on oath.
- discovery and production of documents and asking them to produce it.
- Asking for evidence on affidavits.
- Forming commission and board for the examination of witnesses or documents.
- Changing of decision, if there is any error
- Dismissal of an application if it is not correct or not in its purview, declaring it ex-parte.
- It can also set aside any order which is given in previous point, i.e. dismissal of any application and declare it ex- parte.
- Matters related to any other circumstances which might arise.
- Recently, the SEBI (prohibition of fraudulent and unfair trade practices relating to securities market) regulations, 2003 have come into existence which provide for rules that look into fraudulent activities and provides for an investigating agency which can look into them and find means in which compensation may be provided to those who have suffered including the shareholders of the company.



Also, according to Regulation 3 of the SEBI regulations, 1996, it mentions that any person who has price sensitive information with them, will be considered as an insider of the company, they would not be allowed to deal in securities of the company until they are in possession of such unpublished price sensitive information.

### **Powers of SEBI**

The powers of SEBI can be divided into quasi legislative, quasi executive and quasi judicial. Most of the powers of SEBI are broad and remedial and should be interpreted, where there is ambiguity in favour of the investor and to protect the integrity of the markets. Strict interpretation as in case of tax statutes is not to be followed, instead SEBI is empowered to remedy the damages cause.<sup>20</sup> SEBI can also penalise anyone who commits a breach of any statute or any of the regulations, with penalties upto ₹ 25 crores or with suspensions and bars from acting in the securities market as an intermediary or investor or even with prosecution. The three forms of remedies for securities fraud can be enforced by SEBI (i) Administrative enforcement action by SEBI; (ii) Criminal prosecution; (iii) Civil law remedies.

#### **(i) Administrative Enforcement Action by SEBI**

Enforcement is a process of putting in execution or imposing a course of conduct or making a person to perform his legal obligation. The enforcement policy must be targeted towards integrity, speed, efficiency, effectiveness, fairness, accountability and objectivity. The detection of a violation and forming of a probable cause of action by the process of enforcement can start from these five sources

1. Electronic surveillance employed by SEBI or the exchanges.
2. Complaints from investors or any person from the marketing including exchanges.
3. Inspection of intermediaries by SEBI or inspection by the exchanges or Self-regulatory Organisations (SROs).
4. Investigation whether formal or informal.
5. Media reports.

Before an enforcement action is taken there is often a need to establish facts. Facts could be established by an investigation and SEBI Act has created a formal process of investigation.

Inspection is carried out only with reference to registered intermediaries like brokers or merchant brokers. Inspection could be both routine inspection or could be based on special facts that come to the notice of the regulator, the scope and extent of inspection is usually more intrusive and complete. These wide power are given to regulator to keep the securities markets in order. As the entire purpose of registering intermediaries is to license them and hold them accountable as gatekeepers of the securities markets, they must be held to higher standards than other participants in the market. In *Religare Securities Ltd. v SEBI*, it was held that “the purpose of carrying out inspection is not punitive and the object is to make the intermediary comply with the procedural requirements in regard to maintain of records.”

The following categories of actions can be passed by SEBI. Cease and desist order under Section 11D of the SEBI Act, 1992;

2. Suspension or debarment of person registered as an intermediary with SEBI

3. Imposition of administrative

4. Remedial directions whether interim or final

#### (ii) Criminal Prosecution

The Board has the power to criminally prosecute persons who violate the securities law by filing a criminal complaint in a court of session's judge. Prosecution can be filed under Section 24 of the SEBI Act. If there is any sort of violation of SEBI rules and regulation, or in accordance with Section 11(6) of the SEBI Act. Similarly, violations of the SCRA, 1956, Depositories Act, 1996 or certain provisions of the Companies Act, 2013 could attract prosecution by SEBI. In a criminal prosecution mens rea or intention is an important ingredient for final conviction. As per Section 26(1) of SEBI Act, 1992 "No Court shall take cognizance of any offence punishable under this Act or any rules or regulations made thereunder, save on a complaint made by the Board". SEBI has multiple remedies under both civil and criminal laws. Usually, one remedy does not preclude usage of other remedies.<sup>22</sup> Thus, SEBI could impose a monetary penalty, pass remedial directions and also criminal prosecution arising out of the same cause of action. This does not fall within the prohibition of the double jeopardy clause of the Indian Constitution.

Merely because a civil or administrative proceedings is ongoing does not prevent criminal prosecution. Under constitution double jeopardy will not be violated.

#### (iii) Civil Proceedings

The Board also has authority to go to court to obtain relief against alleged securities law violators. As administrative remedies are restricted by certain limitations, a civil action does not suffer from any fetter as a court has very broad and creative ways of remedying a wrong done. Such remedies also have the benefit of injecting objectivity into a proceeding as SEBI would do the investigation while the courts would carry out the judicial function. SEBI in its own discretion can file a case on behalf of the investors or shareholders, as protecting the public interest, if there has been any unfair trade reported. It is SEBI's responsibility to protect investors right. The only thing is it should not be contrary to the law present thereof.

#### 4. CONCLUSION:

Securities fraud arises from many cause of actions which represents fraud. It is a form of misrepresentation. It has been contended that in a business corporate frauds are unavoidable. It is due to lack of corporate governance, CEO and the CFO of the companies are mainly responsible for committing it. This implies that top management of the organisations next to the Board of Directors is responsible for committing frauds, although, in practice, the compliance certificates for various purposes are signed by the members of the board of directors.<sup>25</sup> There is a need for imbibing good corporate governance culture at the functional head level

and also the scaling down of management audit. Greed and weak internal controls are the major reasons for corporate frauds.<sup>26</sup> The frauds relating with the securities are intellectual crimes. There are different manner in which the manipulation of the system may take place which ultimately leads to finding loopholes in the legislations and using it for their advantage. The advantage may be for the corporation or for the mind of the corporation, that differs from case to case. The requirement of the hour is that since there is an increase in the number of companies that are registered every year on the stock exchanges, the securities present in the market are also increasing. The more the security, the more ways in which their misappropriation may take place. To combat such wrongs, even today we have to refer various legislations that need to be referred in order to conclude the crime that has been committed. The modus operandi of these Acts is not clear and due to this, a comprehensive legislation covering every aspect of such frauds needs to be carried out. The SEBI has to be a stringent watchdog in order to ensure that no person is able to find a loophole that bypasses the law.

