Surveillance: Challenge and Reality

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BACKGROUND OF SECURITIES LEGISLATION IN INDIA

I would like to start with a brief recapitulation of the securities market in India and the development of securities regulations. Securities markets in India have a long history. The Stock Exchange, Mumbai (BSE), the country's oldest exchange has its origins in the informal trading stocks that flourished in the 1850s and 1860s. Formal trading on the BSE began in 1875, and since then, the number of stock exchanges in the country has grown to 22. Prior to Independence in 1947, securities markets in India were largely unregulated. There were no restrictions on the issue of securities and there was no regulation of market intermediaries or stock exchanges. In 1947, the Capital Issues (Control) Act was enacted, which formalised and continued initial controls on the issue of securities that were introduced during the Second World War. This act was administered by the office of the Controller of Capital Issues (CCI) which was a part of the Ministry of Finance in the Central Government. The incorporation, regulation and winding up of companies came under the purview of the companies Act of 1956, administered by the Department of Company Affairs (DCA) a part of the Ministry of Law, Justice and Company Affairs in the Central Government. In 1956 the securities Contracts (Regulation) Act, 1956 (SCRA) was also enacted which brought stock exchanges, their members and contracts in securities which could be traded under the regulation of the central government, through the Ministry of Finance.

After independence the government followed a policy of giving predominance of public sector and the industries such as coal, oil, telecom, banking, insurance and transport etc. were not open to the private sector due to a system of industrial licensing. The access of private sector to equity was restricted through the Controller of Capital Issues and its fund requirements were primarily met through loans from nationalized commercial banks and public sector financial institutions. As a result for nearly 4 decades after independence, securities market in India remained largely under developed.

CURRENT REFORMS

The present process of economic reform, which began in 1991 has focused on increasing output, efficiency and competitiveness of Indian industry, at home and abroad by pulling down artificial quantitative entry barriers for industry, removing restrictions on growth in size of firms and licensing requirements. The reform of the financial services sector, especially the securities markets has been at the very heart of this effort, which had aimed at engendering a much larger role for the private corporate sector in the economy, and at the allocation of capital through market channels. In this context, the need for an independent regulatory body, which would be empowered to regulate the securities markets and be responsible for fostering its development was widely felt. Thus the Securities and Exchange Board of India (SEBI) was set up as an administrative arrangement in 1988. In 1992, the SEBI Act was enacted, which gave statutory status to SEBI.

The preamble of SEBI provides for "The establishment of a Board to protect the interest of investors in securities and to promote the development of, and to regulate the securities market".

Thus the twin objectives for which SEBI has been created is

1. Development of the capital market and

2. Protection of the interest of the investors and the regulations of the securities market.

It has been well realized all over the world that only the best regulated markets are the most developed markets. An efficient regulatory environment fosters investor's confidence in fairness and integrity of the markets by ensuring true and fair price discovery, prompt detection of market manipulations like price rigging, circular trading, insider trading, creating of false market etc., safety of the market through risk containment measures, leading to orderly and healthy development of the capital market. Only investor confidence can bring about investor participation in the market, without which no development is possible in the capital markets. In this context the role of surveillance becomes very crucial. It is only through a very efficient surveillance system that one can ensure the fairness and safety in the markets.

CAPITAL MARKETS IN INDIA

The Indian Capital Markets have a very wide spectrum in terms of number of stock exchanges, listed companies, turnover, number of borkers and other intermediaries. Some figures are given in the Table 10.1.

Table 10.1 Some Indicators of Capital Market Development

	1997	1990
Stock Exchange	22	1
Listed Companies	9332	5968
Average Daily Turnover	2400 cr	11.36
Market Capitalization, Rs. Core	488270	70521
No. of Brokers	8867	
No. of Merchant Bakers	1163	
No. of RTAs	386	
No. of Mutual Funds (Corpus, Rs. Cr)	34 (8532)	
No. of FIIs (Total Net Investment, Rs. Cr)	434 (25300)	

Apart from the wide spectrum, the Indian capital markets have been riddled with several complexities in terms of infrastructure, systems, practices etc. For example, the stocks have multiple listing apart from trading in the permitted categories in several exchanges. There is not only absence of rolling settlement but even weekly settlement cycles which have been introduced only recently, are coupled with different dates of settlement in different exchanges. The other problem arises out of the paper based system and resultant bad deliveries due to signature differences and fake and stolen shares. Some other complexities arise out of lack of intermediary training and certification process, absence of educational awareness of investors. Deficient banking infrastructure also adds to settlement and payment delays.

SEBI's WORK IN SURVEILLANCE

In the background of such complexities we have taken surveillance as a challenge and the effort has been to turn this challenge into a reality. The effort of SEBI has been on the one hand to create a regulatory infrastructure based on transparency and strict disclosure norms. Thus in the areas of primary markets the disclosure norms have been made more elaborate and stringent to ensure that only good issues access the market and the investors have maximum information to make informed investment decisions. Effort has also been made to create transparent rules and regulations for various intermediaries to bring about greater accountability and due diligence on the part of the intermediaries like merchant Bankers etc. In the field of secondary markets we have been endeavoring to make the trading and settlement systems more efficient and transparent. The emphasis given by SEBI on automation of the exchanges has made significant difference. A large number of exchanges have already become on line and that gives the transparency of transaction and the capability of audit trail. Coupled with these efforts a positive thrust was made to create a very efficient market surveillance structure which would ensure fairness, integrity and safety of the markets. Before the surveillance activity was initiated by SEBI the market scene was one, where price rigging was rampant and one would come across artificial fluctuations ranging from 100% to 1000% and even more during the short duration of few weeks. Market manipulation like front running, circulate trading, short squeeze was very common. The problem was compounded by the presence of mid capital companies with smaller equity where manipulation was easier. Then there was wide spread misuse of issue process and also pre-issue manipulations to misguide the investors. In the stock exchanges there were problems of payments leading to defaults. Margin system was not very effective and was not even enforced properly.

In this background SEBI set up market surveillance department in July 1995 and also initiated the setting up of independent surveillance departments in various exchanges. The establishment of these cells of the exchanges have improved the capability of the exchanges to defect unfair trade practices and market manipulations. Some steps to make the surveillance system and structure more effective have been as under:

- *Prohibition of Fraudulent and Unfair Trade Practices* A very significant addition in this process has been framing of Prohibition of Fraudulent and Unfair Trade Practices Regulations in October 1995 which gave SEBI investigative powers over any entities indulging in such practices.

- *Monitoring Reports* SEBI has prescribed monitoring reports, which the exchanges are required to send on daily and settlement basis. Pre-issue Monitoring Report are also to be filed with SEBI whenever a listed company comes with further issue for public or on rights basis for its share holders. The daily and the settlement report mainly concentrate on abnormal price and volume variations, intraday intra settlement etc., and also reflect on brokers abnormal position, trading suspension etc.

- *Suspension of scrips* the The exchanges can suspend a scrip for not more than three days consecutively. Beyond that they require the permission from SEBI. A mechanism has been evolved to enable the other exchanges also to act when indefinite suspension takes place at any exchange. Such suspensions also require investigation by the exchanges and their report is sent to SEBI.

- *Circuit Filters, Price Bands and Weekly Caps* In order to enhance the market safety and reduce the risks in the markets, various measures like circuit filters, daily price bands and weekly caps have been introduced by SEBI to monitor the movement of the scrips effectively. Initially, there was no uniformity in the bands, caps and filters and hence SEBI has laid down the ground rules for the same which has brought in uniformity and also reduced the level of the inter-exchange volatility in the scrips.

- *Inter Exchange Market Surveillance Group* There are 22 Stock Exchanges in India and there are multiple listing of same scrips. Hence the same scrip is traded in various exchanges and at differing prices though normally within a narrow range. However, from the surveillance point of view, the other exchanges need to be aware of the movements and also the measures they initiate in a particular situation needs to be coordinated and has to be taken simultaneously by the other exchanges also. With a view to promote meaningful interaction between the exchanges on the surveillance related matters, an Inter Exchange Market Surveillance Group was formed. SEBI is also guiding the group to enhance the level of communications between the exchanges on such matters.

- *Margining* Margins are an effective tool to make the market safe and reduce the risks. Again to bring in uniformity between the exchanges on the margin systems and the implementations, a margin structure was proposed to the exchanges. The system of the margin covers mark to market margin, concentration margin and the daily margins. In cases of suspected price manipulations, the exchanges are to levy special margin on the buyers of the scrip and also on the short sellers.

- *Inspection of Intermediaries* SEBI regulations for market intermediaries allow SEBI to inspect their activities and records. SEBI is also empowered to inspect stock exchanges and mutual funds. The operations of the stock exchanges also are subject to regular inspections by SEBI. SEBI also inspects mutual funds and intermediaries such as brokers and registrars. In cases where there have been serious violations, inquiry proceedings have been initiated, which in the case of brokers have lead to suspension and freezing / impounding of profits.

- *Freezing / Impounding of Manipulation proceeds* within the scope of our broad regulatory powers, we froze about Rs. 45 crore (US $ 12 million) which were considered to be the proceeds of manipulation. This was done in 14 cases of investigations out of which (US $ 10 million) Rs. 35 crore have been impounded on completion of investigation. This has created an effective deterrence against price rigging in Indian Stock Markets. In some of these cases there is litigation before Higher Courts.

- *Supercesion of Governing Board of the Stock Exchange* On the basis of investigation when it was found that certain members brokers were carrying on unauthorized transaction on the stock exchanges, action has been initiated by issuing enquiry proceedings in respect of 35 brokers. Besides there were some investment companies who abated in such transactions. Further for the first time an extreme action of issuing regulatory directions was taken for supercesion of the Governing Board of one of the Stock Exchanges as it was found that some of the Directors on the Governing Board had also indulged in such unauthorized transactions. This created a very significant regulatory impact.

- *Investigation Process* SEBI has strengthened its investigative process and several investigation actions have been taken up to detect and punish manipulations.

SEBI has initiated action against issuers for misstatements in the prospectus and against merchant bankers for failing to fulfill their due diligence obligations. Where gross misstatements have been discovered, SEBI has withdrawn its acknowledgement card, or has directed issuers to refund all application money to investors. As a result of these actions, the standard of compliance with SEBI disclosure requirements has improved and in several cases, merchant bakers have begun to dissociate themselves from issues upon discovery of material information that had been previously withheld by issuers. Action has also been taken against issuers for violation of the provision of the Companies Act relating to issue of refunds, dispatch of certificates and dividends; under powers delegated to SEBI.

Several investigation cases have been taken up for price rigging and various other type of market manipulations. Since July 1995, 122 such investigations have been done either at preliminary enquiry level or at formal investigation level. In the course of these investigations a large number of intermediaries have been injected and testimonies have been recorded. Some of these have already resulted in suspension of brokers and issue of further process under statue against non – intermediaries. Investigations have also resulted in filing of prosecution in courts. Besides in a large number of cases issue amounts have been refunded to the investors where issue manipulation was established.

SEBI'S INITIATION IN DEVELOPMENT OF SROs

n all developed capital markets Self Regulatory Organizations (SROs) form a very important layer of regulatory structure. Stock Exchange perform basic regulatory functions over its members in ensuring integrity and fairness of the market and exercising discipline over the members. With the fast changes and the innovation which the market undergoes, self regulation is necessary to keep pace with these changes. However, the regulator has to play an important role in development and creation of the SROs. SEBI has been taking initiative and encouraging the stock exchanges to undertake more and more self regulatory functions as can be seen from various regulatory actions which are now being taken by the exchanges especially the National Stock Exchange and The Stock Exchange, Mumbai, as indicated in the Table 10.2.

Table 2 *Indicative actions of SRO's functioning*

REMARKS	ASE	BSE	CSE	DSE	NSE
Stocks suspended for less than 3 days	12	856	38	36	6
Stocks suspended indefinitely	10	20		4	1
Stocks where special margin applied for suspected manipulation	21	178	30	18	
Brokers suspended for margin shortfall etc. for periods <7 days	3	48	105	-	2
Brokers suspended for manipulation	-	9	-	-	-
Investigations undertaken by exchange	6	31	3	25	29

SEBI has also been guiding the other intermediaries and associations like Association of Merchant Bankers of India (AMBI), Association of Mutual Funds of India (AMFI), to create a code of conduct for their members and enforce it. The concept of SROs also requires better governess, professional management and technical capabilities on the part of organizations and the bodies which aspire to become SROs.

THE SYSTEM WORKS!

Various steps taken towards creating a surveillance system have resulted in a very effective market oversight by SEBI which partly works on interactive basis with the exchanges with frequent informal exchange of information. In recent past on 2/3 occasions during January 97 and March 97, market witnessed a sharp movement of prices and a very pronounced volatility when market gained 120 points in the first 20 minutes on January 16, 1997 and shed more than 350 points in the last over on the same day. The system of monitoring at the level of the exchanges and SEBI immediately go activated. The stock exchanges strictly monitoring margins including mark to market margins, exposure limits and various price bands. The terminals of the defaulting members on margins were deactivated by NSE 27 cases, CSE in 12 cases, BSE in 3 cases, LSE in 2 cases and BGSE in 2 cases. The meeting of the Inter Surveillance Market Group was also held in January 17, 1997 itself. As a result of this process the market safety was ensured and there was not a single default in the market. Similar upward movements were noticed in the post budget session and during that period also because of some of the surveillance systems being in place, no perceptible problems were created in the market.

AGENDA FOR FUTURE

I am not even for a moment trying to suggest that we have reached the required level of market surveillance and regulatory enforcement. What I have tried to highlight is that we have taken this task seriously, and significant steps have been taken in this direction. It is an ongoing agenda which needs continuous strengthening and innovation. Towards this ongoing agenda, development of a ‘stockwatch system’ which could create capabilities across the exchanges to trigger alerts of abnormal prices and manipulative transactions and further analyze the same with proper data base, is a priority. We have already set up a group consisting of SEBI and some representatives of exchanges, and we are also harnessing expertise from developed markets to start some stock watch system at least by the beginning of 1998.

We will work towards training of personnel performing surveillance tasks. Other important areas to be dealt with are regulatory and legal changes for effective enforcement through enhanced monetary penalties, investigative powers, disgorgement of profit to investors etc. We are also developing international co-operation in the areas of enforcement and surveillance. This is essential as the markets are getting globalised and the actions of players in faraway parts of the world affect our markets. As we further enter into the areas of cross border transactions and internet-based trading, new problems will surface.

I would like to sum up by saying that what is most relevant is not merely the infrastructure and the system of surveillance but to develop a culture of surveillance, not only by the regulators but also by the market players.