Financial Market Regulation-Security Scams In India with historical evidence and the role of corporate governance

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1 Financial Markets

1.1 Introduction

The financial system consists of specialized and non-specialized financial institutions, of organized and unorganized financial markets, of financial instruments and services, which facilitate transfer of funds. Procedures and practices adopted in the markets, and financial interrelationships are also parts of this system**.** In product or other service markets, purchasers part with their money in exchange for something now. In finance, money "now" is exchanged for a "promise to pay in the future". However, in product or service markets, if the object sold – from a car to a haircut – is defective, the buyers often find out relatively soon.[1] On the other hand, loan quality is not readily observable for quite some time and can be hidden for extensive periods. Moreover, banks and non-bank financial intermediaries can also alter the risk composition of their assets more quickly than most non-financial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. Theoretically, the financial market facilitates allocation of resources efficiently, which involves quick dissemination of information and reaction to it.

The financial markets are susceptible to manipulation as some participants have information that others do not that is information asymmetry is ubiquitous in financial markets. To overcome this problem corporate governance is required to ensure that suppliers of finance to

[1] Caprio, Gerard Jr. and Ross Levine, "*Corporate Governance In Finance: Concepts and International Observations*"(2002)

corporations are assured that they get their return on their investment[2]. Despite the existence of institutional and legal framework numerous financial scams continue to be perpetuated both in developed and developing countries.

1.2 The objectives of this study are :

a) To examine some of the major misdemeanors which perpetuated in the financial system in 1991 and 2001 in India .

b) Understand the financial regulatory measures which have been adopted after the 1991 share scam in India and why despite such measures adopted security scam has recurred in 2001.

c) Examine the theoretical structure of corporate governance for analyzing security scams that have occurred in the 1990s and the new millennium.

The second section contains a summary of the events that occurred leading to the share scams and financial frauds in India and abroad during the recent decade that shook the financial markets. The third section surveys the rationale for regulation of securities markets and the functional procedures adopted in India in the aftermath of the scams. The fourth section looks at the theoretical underpinnings of corporate governance which, is followed by a discussion of the shortcomings of the regulatory set up in India which fails to prevent the recurrence of financial misdemeanors.

Financial Liberalization is a phenomenon that is almost all pervasive in the world today. While liberalization has led to substantial benefits in terms of increased transparency, it has ushered in opportunities of corporate

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[2] Anderei Sheleifer and Robert Vishny (1997) 'A Survey of Corporate Governance'

misgovernance. This implies that the mechanism by which legal institutions ensure that suppliers of funds receive the return on investment is not sufficient or appropriate. Recent trends through the 1990s in India and abroad reveal how corporate governance has not been effective permitting unscrupulous and opportunistic individuals to manipulate the market in their favor. The process of financial market regulation ensures that important guidelines are issued regarding how primary dealers (brokers) should operate with regards to mode of operation, conduct, litigation, amount of business to be handled, management of risk, internal control etc.

These security scams and financial scandals discussed here involved the manipulation of huge amounts of money. The perpetrators of these gross transgression had such a comprehensive knowledge of how the system worked that they manipulated it to their advantage operating in an opportunistic manner[3]. The essence of the argument in is that the occurrence and reoccurrence of such security scams and financial scandals can be attributed to a failure of corporate governance in finance[4] despite the existence of an functioning regulatory authority empowered with the legal sanctions.

3 Machiraju H.R. ',Indian Financial System' (1997)
4 Sanyal. Sreejata, Regulation of Securities Markets in India'1997, Ph.D.

2 Security Scam: Introduction

A security scam has the following features:

a)manipulation in share prices.

b)monopoly in dealing with a huge number of shares of a company.

c)money laundering-borrowing money to trade in securities but using the funds for unconnected purposes.[5] According to the Securities Exchange Act(1934)SEA-"It shall be unlawful for any person to engage in any act, practice or course of action which operates or would operate as a fraud or deceit upon nay person in connection with the purchase or sale of a security." While understanding the causes or possible mechanisms by which a security scam takes places we can on a parallel plane understand the motives for financial market regulation otherwise called the economics of financial market regulation. There is a certain systemic risk involved if brokers or banks get into settlement problems during the process of transacting in securities. If so, it results in a domino effect, which could create problems for other banks and brokers in the system. A systemic risk also can occur when there is not enough liquidity in the system due to very few brokers, monopolizing in the transaction of a security. Also insider trading is another problem when traders who are insiders to an organization trade when they have superior knowledge which is considered unfair and an extension of asymmetric information. Also concentration tendencies of traders towards dealing in one security only should be avoided. There is also a consumer protection to ensure that the price formation process is efficient as possible and also to ensure sufficient competition among traders, brokers and other market participants.

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[5] "Securities and Exchange Commission: Securities fraud and insider trading", Palgraves' Dictionary Of Money And Finance (1994)

Table 1:Scams in India

Year	Victim	Perpetrator	Mechanism	Economics Of Financial Market Regulation Misdemeanor
1991	Public buyers of shares of companies dealt with by manipulators, National Housing Bank(NHB) State Bank Of Saurashtra SBI Capital Markets Ltd(SBI Caps) Standard Chartered Bank	Harshad Mehta,Hiten Dalal, Batliwala & Karani ,M/s V.B. Desai , N.K. Aggarwala & Co., Mukesh Babu etc.	Borrow money from banks on a ready forward basis thus violating RBI guidelines and dealing in security transactions with banks where issue of bank receipts and SGL forms were not supported by genuine holding of securities	[6]Clearing and settlements problem(Systemic Risk),Money Laundering
2001	Public,Buyers of shares of companies dealt with by manipulators, UTI,MMCB, Calcutta Stock Exchange	Ketan Parekh	Same as above but in this case much of the transactions had taken place through companies owned by Ketan Parekh,FII's(Foreign Institutional Investors,Banks ,**Unit Trust Of India**	[7]Clearing and Settlement Problem,Money Laundering

[6] Table 4 and 5(Appendix)

2.1 Security Scam In India-1991

In April 1992, press reports indicated that there was a shortfall in the Government Securities held by the State Bank of India. Investigations uncovered the tip of an iceberg, later called the securities scam, involving misappropriation of funds to the tune of over Rs. 3500 Crores[8]. The scam engulfed top executives of large nationalized banks, foreign banks and financial institutions, brokers, bureaucrats and politicians: The functioning of the money market and the stock market was thrown in disarray. The tainted shares were worthless as they could not be sold. This created a panic among investors and brokers and led to a prolonged closure of the stock exchanges along with a precipitous drop in the price of shares. Soon after the discovery of the scam, the stock prices dropped by over 40%, wiping out market value to the tune of Rs. 100,000 crores. The normal settlement process in government securities was that the transacting banks made payments and delivered the securities directly to each other. The broker's only function was to bring the buyer and seller together. During the scam, however, the banks or at least some banks adopted an alternative settlement process similar to settlement of stock market transactions. The deliveries of securities and payments were made through the broker. That is, the seller handed over the securities to the broker who passed them on to the buyer, while the buyer gave the cheque to the broker who then made the payment to the seller. There were two important reasons why the broker intermediated settlement began to be used in the government securities markets:

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[7] Table 6(Appendix)
[8] Stock market Scam in India of 1991:The Janakiraman Committee Report

• The brokers instead of merely bringing buyers and sellers together started taking positions in the market. They in a sense imparted greater liquidity to the markets.

• When a bank wanted to conceal the fact that it was doing an [9]Ready Forward deal, the broker came in handy. The broker provided contract notes for this purpose with fictitious counterparties, but arranged for the actual settlement to take place with the correct counterparty. This allowed the broker to lay his hands on the cheque as it went from one bank to another through him. The hurdle now was to find a way of crediting the cheque to his account though it was drawn in favour of a bank and was crossed account payee. It is purely a matter of banking custom that an account payee cheque is paid only to the payee mentioned on the cheque. In fact, privileged (corporate) customers were routinely allowed to credit account payee cheques in favour of a bank into their own accounts to avoid clearing delays, thereby reducing the interest lost on the amount. The brokers thus found a way of getting hold of the cheques as they went from one bank to another and crediting the amounts to their accounts. This effectively transformed an RF into a loan to a broker rather than to a bank. But this, by itself, would not have led to the scam because the RF after all is a secured loan, and a secured loan to a broker is still secured. What was necessary now was to find a way of eliminating the security itself.

Three routes adopted for this purpose were:

• Some banks (or rather their officials) were persuaded to part with cheques without actually receiving securities in return. A simple explanation of this is that the officials concerned were bribed and/or negligent. Alternatively, as long as the scam lasted, the banks benefited from such an arrangement. The management of banks might have been sorely tempted to adopt this route to higher profitability.

• The second route was to replace the actual securities by a worthless piece of paper – a fake [10]Bank Receipt (BR). A BR like an IOU has only the borrower's assurance that the borrower has the securities which can/will be delivered if/when the need arises.

• The third method was simply to forge the securities themselves. In many cases, PSU bonds were represented only by allotment letters rather than certificates on security paper. However, it accounted for only a very small part of the total funds misappropriated. During the scam, the brokers perfected the art of using fake BRs to obtain unsecured loans from the banking system. They persuaded some small and little known banks – the Bank of Karad (BOK) and the Metropolitan Cooperative Bank (MCB) - to issue BRs as and when required. These BRs could then be used to do RF deals with other banks. The cheques in favour of BOK were, of course, credited into the brokers' accounts. In effect, several large banks made huge unsecured loans to the BOK/MCB which in turn made the money available to the brokers.

2.2 Security Scam in India-2001

In Spite of the recommendations made by the Janakiraman Committee Report in 1992 to prevent security scams from happening in the future another security market took place in 2001. This involved the actions of one major player by the name of Ketan Parekh. He manipulated a large amount of funds in the capital market though a number of his own companies which

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[9] Glossary(Definition)
[10] Glossary(Definition)

is probably why the scam remained a mystery for quite some time the RBI,SEBI and DCA(Department Of Company affairs) had gone slack in their regulatory operations.During 1999 and 2000 the SENSEX reached a high and after than the stock market crashed in 2001.Some of the major companies he invested in were [11]Nirma, Adani Group, Essel Group,DSQ and Zee Cadila.Ketan Parekh manipulated the stock market through FII's (Foreign Institutional Investors), OCB's (Overseas Commercial Borrowings),Banks and Mutual Funds(Unit Trust Of India). In fact an important extension of this scam remains the Unit Trust Of India Scam.

2.3 UTI Scam

Of all the recent encounters of the Indian public with the much-celebrated forces of the market, the Unit Trust's US-64 debacle is the worst[12]. Its gravity far exceeds the stock market downswing of the mid-1990s, which wiped out Rs. 20,000 crores in savings. [13]The debacle is part of the recent economic slowdown which has eliminated one million jobs and also burst the information technology (IT) bubble. This has tragically led to suicides by investors. And then suspension of trading in US-64made the hapless investors more dejected at the sinking of this "super-safe" public sector instrument that had delivered a regular return since 1964. There is a larger lesson in the US-64 debacle for policies towards public savings and public sector undertakings (PSUs). The US-64 crisis is rooted in plain mismanagement. US-64 was launched as a steady income fund. Logically, it should have invested in debt, especially low-risk fixed-income government bonds. Instead, its managers increasingly invested in equities, with high-risk

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[11] Appendix:Graphical Evidence Of Security Scam in India In 2001

[12] Joint Parliamentary Committee Report(2001)

speculative returns.In the late 1980s UTI was "politicised" with other financial institutions (FIs) such as LIC and GIC, and made to invest in certain favoured scrips. By the mid-1990s, equities exceeded debt in its portfolio. The FIs were also used to "boost the market" artificially as an "endorsement" of controversial economic policies. In the past couple of years, UTI made downright imprudent but heavy investments in stocks from Ketan Parekh's favourite K-10 portfolio, such as Himachal Futuristic, Global Tele and DSQ. These "technology" investments took place despite indications that the "technology boom" had ended. US-64 lost half its Rs. 30,000 crore portfolio value within a year. UTI sank Rs. 3,400 crores in just six out of a portfolio of 44 scrips. This eroded by 60 percent. Early this year, US-64's net asset value plunged below par (Rs.10). But it was re-purchasing US-64 above Rs. 14! Today, its NAV stands at Rs. 8.30 - a massive loss for 13 million unit-holders.It is inconceivable that UTI made these fateful investment decisions on its own. According to insiders, the Finance Ministry substantially influenced them: all major decisions need high-level political approval. Indeed, collusion between the FIs, and shady operators like Harshad Mehta, was central to the Securities Scam of 1992. The Joint Parliamentary Committee's report documents this. In recent months, the Finance Ministry became desperate to reverse the post-Budget market downturn. UTI's misinvestment now coincided with the global technology "meltdown." US-64 crashed. UTI chairman resigned. Although culpable, he was probably a scapegoat too. The Ministry has kept a close watch on UTI, especially since 1999.The US-64 debacle, then, is not just a UTI scam. It is a governance scam involving mismanagement by a government frustrated at the failure of its macroeconomic calculations. This should have ensured the

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[13] www.hinduonnet,com

Finance Minister’s exit in any democracy which respects parliamentary norms. There are larger lessons in the UTI debacle. If a well-established, and until recently well-managed, institution like UTI cannot safeguard public savings, then we should not allow the most precious of such savings - pensions - to be put at risk. Such risky investment is banned in many self-avowedly capitalist European economies. In India, the argument acquires greater force given the poorly regulated, extremely volatile, stock market—where a dozen brokers control 90 percent of trade. Yet, there is a proposal by the Finance Ministry to privatize pensions and provident funds. Basically, the government, deplorably, wants to get rid of its annual pension obligation of Rs. 22,000 crores.

Table 2:Security Scams in some Developed Countries

Year	Country	Victim	Perpetrator	Mechanism	Misdemeanor in

					Economics of financial regulation'
1995	U.K.	Barings Bank	Nick Leeson	Excessive arbitraging in futures trading between the Singapore Monetary Exchange(SIMEX) and Osaka Stock Exchange(OSE)	Systemic Risk,Settlements Problem
2001	U.S.A.	Enron	Enron Executives	Manufacture losses by mismanagement of capital structure through SPEs (Special Purpose Entities),hiding losses, keeping debt off books	Insider Trading,Bad Accountability
1990	Luxemburg	BCCI and Sheikh Zayid of Abu Dhabi	The owner Agha Hasan Abedi and two shipping magnates from Pakistan The Gokal Brothers	Inflating loans from the bank by the two brothers for their shipping busness, arbitraging in derivatives market of Gulf through The BCCI-Gulf Transport Group consortium which lead to huge losses	Money Laundering,, Systemic Risk

2.4 Barings Bank

The aftermath of the bankruptcy of Barings Bank provides an excellent case study of [14]systemic risk. Representative Those who cite Barings as an example of derivatives causing market failures point to the fact that the authorities in Shanghai temporarily closed its bond-futures market and told investors to wind down positions in an attempt to limit damage from a trading scandal. In addition, they argue that "if anything, the Barings name

[14] 'Economics Of Financial Market Regulation'-Chapter 3.2 Niemeyer,Jonas, “Where to Go after the Lamfalussy Report?An Economic Analysis of Securities Market Regulation and Supervision”(2001)

may have contributed to its undoing, if it turns out to have been the bank's familiarity that blinded the authorities at Singapore's futures exchange to the enormous wrong-way bet its trader made on the future direction of Japan's Nikkei average." A closer look at the reaction of market participants and volatility after the fall may provide insight into the magnitude of the contagion effect. Barings' young trader Nicholas Leeson was supposed to be "arbitraging", seeking to profit from differences in the prices of Nikkei-225 futures contracts listed on the Osaka Securities Exchange (OSE) in Japan and Singapore Monetary Exchange (SIMEX). Such arbitrage involves buying futures contracts on one market and selling them on another. Since the margins on this are small, the volumes traded by arbitrageurs tend to be large. However, this strategy is not very risky: a long position in one market (betting on a rise) is offset by a short position (betting on a fall) in the other). However, in addition to arbitraging the Osaka Exchange and the SIMEX, as far back as September 1994, Leeson began to simultaneously sell put options and call options on Nikkei-225 futures. This type of deal is known as a "straddle." If the market is less volatile than the options prices predict, the seller makes a profit. However, as a result of the Kobe earthquake, the Nikkei-225 fluctuated and Leeson began to exponentially increase the size of his open positions. By trading on a fraudulent account, numbered 88888, Leeson began to buy futures on a large scale in an attempt to almost single-handedly push up the Nikkei 225. This proved unsuccessful and eventually Leeson's losses were so large the bank eventually collapsed. A lifeboat by the Bank of England was not feasible due to the fact that many of the derivatives were impossible to wind down immediately, as the options did not expire for months. While this case has been widely cited as providing evidence of a market failure, others argue that the systemic risk from the loss was minimal. Others argue that in the event of a viable threat of systemic risk, the Bank of England would have bailed out Barings Bank, but the precise magnitude of the systemic risk is not known. Reports in the Wall Street Journal immediately following the collapse of Barings express that the markets were "shaken" but provide no quantifiable estimate of the effect of the collapse.

2.5 The BCCI (The Bank Of Credit and Commerce International) Affair

The perpetrators in this case were two brothers,the Gokal brothers, who were shipping magnates. The fraudulent brothers and BCCI's founder Agha Hasan Abedi, shared the confidence of a new world balance of power centered on the massive Middle East oil deposits. Agha Hasan Abedi went as far as to fund a very readable business magazine called SOUTH which was a welcome relief from the USA propaganda to be found in TIME and NEWSWEEK. BCCI's loans through Agha Hasan Abedi to the brothers shipping business were inflated, and their quality was upgraded by forgery. The fraud went on for over a decade.. The BCCI-Gulf Transport Group consortium wanted to dip their fingers into the coffers of one of their best sponsors, Sheikh Zayid of Abu Dhabi. The reason for this was the financial hole left by huge losses suffered by Gulf on the derivatives market. It is certainly true that Sheikh Zayid started to pick up the losses in 1990. This leaves open the argument of many muslims that the bank did not have to fail. There is also deception in the way that one of the perpetrators was brought to justice. He was flying to the USA in order to clear himself of liability for abbetting in the production of a Pakistani nuclear bomb. Almost any high-tech metallurgy going to a third world country is suspect. In the same way developments of high tech chemical refining processes or pharmaceutical products in the Third World are accused of forwarding chemical warfare or illicit drug refining ventures. The perpetrator took the plane from Karachi to New York in l994. British police arrested him during a refuelling stop at Frankfurt.

2.6 The Enron Case

At the heart of Enron's demise was the creation of partnerships with shell companies, these shell companies, run by Enron executives who profited richly from them, allowed Enron to keep hundreds of millions of dollars in debt off its books. But once stock analysts and financial journalists heard about these arrangements, investors began to lose confidence in the company's finances. The results: a run on the stock, lowered credit ratings and insolvency. According to claims and counter-claims filed in Delaware court hearings(of the Enron Case); many of the most prominent names in world finance - including Citigroup, JP Morgan Chase, CIBC, Deutsche Bank and Dresdner Bank - were still involved in the partnership, directly or indirectly, when Enron filed for bankruptcy. Originally, it appears that initially Enron was using [15]SPE's(Special Purpose Entities) appropriately by placing non energy-related business into separate legal entities. What they did wrong was that they apparently tried to manufacture earnings by manipulating the capital structure of the SPEs; hide their losses; did not have independent outside partners that prevented full disclosure and did not disclose the risks in their financial statements. There should be no interlocking management: The managers of the off balance sheet entity

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[15] Glossary

cannot be the same as the parent company in order to avoid conflicts of interest. The ownership percentage of the off balance sheet entity should be higher than 3% and the outside investors should not be controlled or affiliated with the parent: This was clearly not the case at Enron. Enron, in order to circumvent the outside ownership rules funneled money through a series of partnerships that appeared to be independent businesses, but which were controlled by Enron management. The scope and importance of the off-balance sheet vehicles were not widely known among investors in Enron stock, but they were no secret to many Wall Street firms. By the end of 1999, according to company estimates, it had moved $27bn of its total $60bn in assets off balance sheet.

These security scams and financial scandals examined in the section above involved the manipulation of huge amounts of money. The purpose of the "traders" or "investors" was not genuine. The perpetrators had such a comprehensive knowledge of how the system worked that they manipulated it to their advantage operating in an opportunistic manner[16]. The crux of the argument in this work is that the occurrence and reoccurrence of such security scams and financial scandals can be attributed to a failure of corporate governance in finance[17] despite the existence of an functioning regulatory authority empowered with the legal sanctions.

16*"Securities Exchange Commission:Securities Fraud and Insider Trading"*,Palgraves Dictionary On Money And Finance(1992)

17 Sanyal. Sreejata, Regulation of Securities Markets in India'1997, Ph.D.

3 Financial Market Regulation (Rationale)

The nature of securities markets is such that they are inherently susceptible to failures due to the existence of information asymmetries and existence of high transaction costs Sanyal (1997). It needs to be emphasized that when securities markets come into existence, the interest of the member brokers are taken care of through margin requirements, barriers to entry of membership, listing agreements. However the investors/clients who buy and sell via their brokers are not able to form an organization to safeguard their interests due to the cost of creation of such organizations and free rider problems. The distinctive nature of the market can be observed with reference to the commodity, its quality, the system of transactions and the participants in the market, as follows:

(a) the commodity(the security)has a life to perpetuity.

(b) while the outcome of the contract say the redemption of debt is certain, in the case of the government, it is not always so in the case of a private debt instrument, hence uncertainty comes into focus.

(c) the quality of private debt instrument is unobservable and hence, it is the trust reposed on the trader or the issuer that is the decisive factor, here the problem of information comes into focus.

(d) in any securities market in any transaction or deal there are at least four participants, two clients and two brokers. The brokers negotiate deals with each other on behalf of their clients and thus the problem of transaction cost comes into focus. When there is so much scope for failure and opportunism, there appears to be substantial ground for prescribing an institution that oversees the market at different stages to ensure its reliability, efficiency and it's very existence.

3.1 Objective of Financial Market Regulation

The objective of regulation and supervision is to facilitate the efficient and fair performance of economic functions, but a practical regulatory structure must deal with (and will influence) the products and institutions through which those functions are performed. This creates considerable complexities because there is no unique relationship between functions, products, and institutions. Several products might perform the same function, some functions might involve several products, institutions can provide a range of products, and these relationships can be changing over time, in response to technological change and in ways influenced by the existing regulatory structure. One focus of financial regulation is upon the characteristics of financial products, which are explicit or implicit contracts between parties, entered into with certain expectations on the basis of information held by those parties. Financial regulation stems in large part from the undesirable consequences of participants entering contracts with inappropriate expectations based on imperfect information. Participants may be unable to obtain information to appropriately evaluate the ability of a counter-party to meet a contractual obligation (such as payment of an insurance benefit), or may be given incorrect information which leads them to form inappropriate expectations of performance (such as of a managed fund). Ultimately, the focus of a regulatory structure must be on the welfare of the end users.

Financial products are contracts between two parties, issued under specific legal arrangements. While there may be an argument that individuals have a "natural" right to enter into such contracts as deposit takers, there is no "natural" right possessed by institutions, which allows them to do so. That is recognized internationally by financial legislation of most nations, which impose certain socially determined criteria upon institutions (institutional form, identity of owners, competence of managers, compliance with prudential standards etc.) if they are to be allowed to undertake such activities. Also they should be a good incentive structure for providing information in financial markets as information is very important to the investor. Often investors find it difficult to evaluate the quality of the security or service offered which calls for an intermediary to disseminate information and services that have to be regulated. Regulations also prevent monopoly of capital markets which otherwise jeopardize the market mechanism.

Here is a table indicating regulatory bodies of financial markets around the world.

Table 3:Financial Market Regulation around the World

Country	**Regulatory Body**
India	RBI(Reserve Bank Of India),SEBI(Securities Exchange Board of India)
United Kingdom	SIB(Securities Investment Board)
Netherlands	Securities Board
U.S.A.	SEC(Securities Exchange Commission)

A security scam involves the manipulation of funds in the capital market which could involve the usage of funds for highly speculative purposes resulting in the monopolization of capital market, trading in shares with money not used for their actual purpose etc.

3.2 Financial Market Regulation in India

3.2 (a) Guidelines Issued by Reserve Bank of India for the Regulation of Financial Markets

1) Management oversight, policy/operational guidelines[18] - The management of a Primary Dealer should bear primary responsibility for ensuring maintenance of appropriate standards of conduct and adherence to proper procedures by the entity. Primary Dealers (PD) should frame and implement suitable policy guidelines on securities transactions. Operational procedures and controls in relation to the day-to-day business operations should also be worked out and put in place to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. With the approval of respective Boards, the PDs should clearly lay down the broad objectives to be followed while undertaking transactions in securities on their own account and on behalf of clients, clearly define the authority to put through deals, procedure to be followed while putting through deals, and adhere to prudential exposure limits, policy regarding dealings with brokers, systems for management of various risks, guidelines for valuation of the portfolio and the reporting systems etc. While laying down such policy guidelines, the Primary Dealers should strictly observe Reserve Bank's instructions on the following:

1) Ready Forward deals

2) Transactions through SGL Account
3) Internal Controls/Risk Management System
4) Dealings through Brokers
5) Accounting Standards
6) Audit, Review and Reporting

Any other instructions issued from time to time The internal policy guidelines on securities transactions framed by the PD, duly certified by its management to the effect that they are in accordance with the RBI guidelines and that they have been put in place, may be perused by the Statutory Auditors and commented upon as to the conformity of the guidelines with the instructions/guidelines issued by RBI. The effectiveness of the policy and operational guidelines should be periodically evaluated.

2) Prohibition of short selling of securities - The Primary Dealers should not put through any sale transaction without actually holding the security in its portfolio i.e. under no circumstances, a PD should hold a oversold position in any security.

3) Concurrent audit of securities transactions - Securities transactions should be separately subjected to a concurrent audit by internal/external auditors to the extent of 100% and the results of the audit should be placed before the CEO(Chief Operating Officer)/ CMD(Chief Managing Director) of the PD once every month. The compliance wing should monitor the compliance on ongoing basis, with the laid down policies and prescribed procedures, the applicable legal and regulatory requirements, the deficiencies pointed out in the audits and report directly to the management.

4) All problem exposures where security of doubtful value, diminution of value to be provided for - All problem exposures, if any, which are not

[18] www.rbi.org.in

backed by any security or backed by security of doubtful value should be fully provided for.

5) Provision also for suits under litigation - Even in cases where a PD has filed suit against another party for recovery, such exposures should be evaluated and provisions should be made to the satisfaction of auditors.

6) Claims against the PD to be taken note of and provisions made - Any claim against the PD should also be taken note of and provisions made to the satisfaction of auditors.

7) Problem exposures to be reflected clearly in Profit and Loss Account - The profit and loss account should, reflect the problem exposures, if any, as also the effect of valuation of portfolio, as per the instructions issued by the Reserve Bank, if any, from time to time. The report of the statutory auditors should contain a certification to this effect.

8) Business through brokers and contract limits for approved brokers - A disproportionate part of the business should not be transacted through only one or a few brokers. PDs should fix aggregate contract limits for each of the approved brokers. A limit of 5%, of total transactions (both purchase and sales) entered into by a PD during a year should be treated as the aggregate upper contract limit for each of the approved brokers. This limit should cover both the business initiated by a PD and the business offered/brought to the PD by a broker. PDs should ensure that the transactions entered into through individual brokers during a year normally does not exceed this limit. However, the norm would not be applicable to PD's dealings through other Primary Dealers.

9) Investments in and Underwriting of Shares, Debentures and PSU Bonds and Investments in Units of Mutual Funds-Guidelines. PDs should formulate, within the above parameters, their own internal guidelines, as

approved by their Board of Directors, on securities transactions either by directly subscribing or through secondary market with counter-party or counter-party group, including norms to ensure that excessive exposure against any single counter-party or group or product is avoided and that due attention is given to the maturity structure and the quality of such transactions. The PDs will also need to take into account the fact that such securities are subject to risk weight and necessary depreciation has to be fully provided for.

10) Material changes in circumstances - The PDs should report any material changes in circumstances such as change in the ownership structure, business profile, organization etc. affecting the conditions of licensing as PD to RBI immediately.

3.2 (b) Guidelines Issued by Securities and Exchange Board of India for the Regulation of Securities Markets

1)Prohibition of certain dealings in securities

a) No person shall buy, sell or otherwise deal in securities in a fraudulent manner.

2)Prohibition against Market Manipulation

No person shall -

(a) effect, take part in, or enter into, either directly or indirectly, transactions in securities, with the intention of artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by any person;

(b) indulge in any act, which is calculated to create a false or misleading appearance of trading on the securities market;

(c) indulge in any act which results in reflection of prices of securities based on transactions that are not genuine trade transactions;

(d) enter into a purchase or sale of any securities, not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress, or cause fluctuations in the market price of securities;

(e) pay, offer or agree to pay or offer, directly or indirectly, to any person any money or money's worth for inducing another person to purchase or sell any security with the sole object of inflating, depressing, or causing fluctuations in the market price of securities[19].

3) Prohibition of misleading statements to induce sale or purchase of securities

No person shall make any statement, or disseminate any information which -

(a) is misleading in a material particular; and

(b) is likely to induce the sale or purchase of securities by any other person or is likely to have the effect of increasing or depressing the market price of securities, if when he makes the statement or disseminates the information-

(i) he does not care whether the statement or information is true or false; or

(ii) he knows, or ought reasonably to have known that the statement or information is misleading in any material particular.

Nothing in this sub-regulation shall apply to any general comments made in good faith in regard to -

(a) the economic policy of the Government,

(b) the economic situation in the country,

(c) trends in the securities markets, or

(d) any other matter of a similar nature, whether such comments be made in public or in private.

4) Prohibition on unfair trade practice relating to securities

No person shall -

(a) in the course of his business, knowingly engage in any act, or practice which would operate as a fraud upon any person in connection with the purchase or sale of, or any other dealing in, any securities;

(b) on his own behalf or on behalf of any person, knowingly buy, sell or otherwise deal in securities, pending the execution of any order of his client relating to the same security for purchase, sale or other dealings in respect of securities.

Nothing contained in this clause shall apply where according to the clients instruction, the transaction for the client is to be effected only under specified conditions or in specified circumstances;

(c) intentionally and in contravention of any law for the time being in force delays the transfer of securities in the name of the transferee or the dispatch of securities or connected documents to any transferee;

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[19] http://www. sebi.gov.in

(d) Indulge in falsification of the books, accounts and records (whether maintained manually or in computer or in any other form);

(e) When acting as an agent, execute a transaction with a client at a price other than the price at which the transaction was executed by him, whether on a stock exchange or otherwise, or at a price other than the price at which it was offset against the transaction of another client

3.3 Economics of Financial Market Regulation

This section includes the motives behind financial market regulation. There are several factors which motivate financial market regulation. One if them is the systemic risk .Individual agents take into consideration only the private cost and often forget the social cost involved in their transactions.If one trader finds difficulty in delivering the proposed security under consideration it could set a chain or reactions which could affect several other traders in the system.So will be the case if banks get into settlement problems or failures.It could affect several other banks and traders in the system.Also it should be ensured that there is enough liquidity in the system. This can be allowed by making sure that there is perfect competition and removing barriers to entry-the more traders in the system, more liquidity. Also insider trading should be prohibited-i.e when some traders possess superior information than other which cause the latter to get suboptimal returns in transactions. This can be corrected by having an investment banker to mediate between traders and ensuring an adequate supply of information. Insider trading allows people to manipulate with prices and cause monopolised holding of shares. As more and more traders access the system it leads to benefits(positive externalities) to all as opposed to monopoly. Such a monopoly condition is more a characteristic of security markets because of the associated low transaction costs and greater regulation which raise the barriers to entry. Also these is need for consumer protection to ensure that the price formation process is as efficient as possible. Consumers are better off in a more efficient market than a less efficient one. A more efficient market can be ensured by reducing asymmetric information. Principal agent relationships are common in securities markets. Retail investors typically invest in different funds and other financial services firms. Here the former are principals and the latter agents. It is essentially than in all transactions agents do not deviate from what they are bound to so as mentioned in the contract. Also money which is used for the transaction of securities should not be used for any king of personal benefit of traders nor should drug traders or criminals be allowed to trade in securities thereby allowing themselves to perpetuate their evil deeds.

3.3 a)The Systemic Risk Motive

The prime objective of most existing financial regulation and supervision is to ensure that no systemic risks will threaten the financial system. [20]In principle, there are two assumptions underlying the concept of systemic risk. The first assumption is the existence of a market failure, often in terms of an externality. The individual agents only take the private costs into account and any "potential social cost [or benefit] is not incorporated in the decision making" of the agents. For instance, if one trader encounters problems in delivering the securities after a trade, problems may easily spread to other agents through the settlement system. The existence of an externality is

[20] Niemeyer,Jonas, "Where to Go after the Lamfalussy Report?An Economic Analysis of Securities Market Regulation and Supervision"(2001)

however not enough to create a systemic risk. The scope of the effect is also at hand. The second assumption is based on the notion that if problems occur, they “would damage the financial system to such an extent that economic activity in the wider economy would suffer.” The traditional example of systemic risks is when financial problems in one bank lead to a bank run which in turn undermines the confidence in the whole banking system, makes the payment system collapse, the money supply contract and potentially results in a recession or even depression. In this case, the effects on other banks and economic agents, let alone the social costs of a general depression, are not taken into account in the risk analysis of the bank or the agent. In this paper, the focus is not on banking issues but on the problems related to the securities markets. In terms of systemic risks resulting from activities in financial markets, there are two main concerns , a) the settlement systems and b) the liquidity of the markets. Even though the focus of the paper is not on banking issues, in practice the banks play such an important role in the payment and therefore in the settlement of financial securities that banks and other financial intermediaries cannot be completely ignored in a discussion of securities regulation.

3.3 b)Clearing and Settlement

The clearing and settlement of financial securities entails several problems. First, if a seller of a financial security is not able to deliver, it may cause delivery problems in other transactions, i.e. have domino effects on many other traders. If one trader is unable to fulfill her obligations, all her counterparts could run into problems, thus spreading the financial instability. The netting, used in most settlement systems, makes many transactions dependent on each other and therefore amplifies this problem. Second, a dominating and increasing part of the daily flows in the payment system emanates form the securities markets and the payment system is a vital part of the financial infrastructure. Most other activities rely on a well-functioning payment system. If the payment system would collapse all other economic activity would run into serious problems. It is difficult to imaging any economic activity, which does not involve payments. Therefore, a disruption in the settlement of financial securities may have far reaching consequences for the entire economy. Furthermore, clearing and settlement organizations have features similar to natural monopolies. There are substantial economies of scale. As a consequence, most countries only have one settlement organization, at least for the same type of financial securities. If such an organization would default due to technical problems or fraud, settlement may be difficult and the risk of major macroeconomic disturbances is not negligible. There are however not only operational reasons for systemic risks. Such risks are also present if financial problems for one agent involved in the system spread to other agents. The typical way to deal with this systemic problem is to set up different forms of prudential regulation, including stringent supervision standards. Normally the central bank assumes responsibility of the payment system, while the clearing and settlement organizations often fall under the jurisdiction of the general financial supervision. Given the special status and importance of the clearing and settlement organizations, it has even been argued that they should be governed more like public utilities than as privately held companies. In any case, by imposing regulations on the clearing and settlement as well as the payment systems, there is clearly a risk of inducing moral hazard, by increasing the agents' propensity to take risks, and thus raising the probability of systemic problems.

3.3 c)Market Liquidity

Another type of systemic risks emanates from the fact that liquidity in the securities markets has externality features. “Investors want three things from markets: liquidity, liquidity and liquidity.” As a consequence, most investors will prefer to trade when liquidity is as high as possible, i.e. when and where most other investors trade. Also, if one agent supplies more liquidity, everybody gains, since the service provided by the liquidity supplier is available to everybody in the market. Thus, as more traders access a certain trading system, the benefits for everybody in the trading system will rise. Also, while trading in a market, or supplying liquidity, agents are not likely to take the aggregated benefit to all other agents of the increased liquidity into account, i.e. liquidity has a positive externality. Thus, market liquidity feeds market liquidity. However, there is a backside of the coin as well. If liquidity falls it may also disappear fast. Thus, there is a substantial risk that liquidity will dry up if a crisis occurs, in ways similar to what happened at the stock market crash of 1987. In a crisis the cost of supplying liquidity is likely to increase. Thus, when liquidity is most needed, it may become increasingly scarce. In this sense the first requirement for a systemic risk is fulfilled, i.e. there is a potential market failure. As a consequence, many agents, especially financial intermediaries, are increasingly dependent on the securities markets for funding and risk management. Liquidity problems in the securities markets could easily spread to the banking sector. Serious disturbances in the securities markets could severely affect the funding of a bank. Also, “sale of assets to cover funding needs may itself depress the value of other holdings, or be impossible due to the market-liquidity crisis”, with contagious effects for the entire banking sector. If these banks run into problems, it may jeopardize the payment system with severe effects on the entire economy. Thus, the funding of and the risk management systems in banks have become so dependent on the securities markets that systemic risks may follow if liquidity falls. As banks are becoming increasingly active in securities business, including issuing, trading, underwriting and providing back-up facilities the potential problems are increasing.

3.3 d)Insider trading

Prohibiting insiders from trading when they have superior knowledge, and forcing them to disclose all their trades are measures aimed at reducing the asymmetric information and restoring market confidence among market participants and the general public. Here, it is not obvious that any market solution, such as signaling or reputation, would solve the problem. Therefore, potentially rules and regulations to reduce the asymmetric information may be welfare increasing, given that a well-functioning market can be seen as a public good. There are four means through which insider trading could potentially harm the company. First, insider trading may reduce the efficiency of corporate decisions by delaying the transmission of information within the company. However, if a manager wants to trade on price sensitive information before transmitting it to her superior – a phone call to her broker would suffice and this would not take more than a few minutes. Thus, the delay story is not convincing. Second, insider trading may increase the individual manager’s incentives to choose high-risk projects, where the benefits from insider trading are larger. However, this may attenuate the conflict that managers are more risk averse than shareholders. Third, managers may manipulate share prices, by disclosure policies etc, in order to maximize their insider trading profits and at considerable social costs. However, prohibiting insider trading is also costly. Fourth, insider trading may harm the company's reputation. The main problem is that the insider information is the property of the corporation. Therefore the insider trading is primarily a contractual dilemma and could be resolved through contracts between the corporation and the user of any insider information. In practice, insider trading rules and regulations could entail establishing and verifying standards of information, supervising disclosure requirements and enforcing obligations to include audit reports in the annual statements of companies, etc.

3.3 e)Externalities

There are also other externality problems. As more traders access a certain trading system, the benefits for everybody in the trading system will rise. Thus, there are clearly externalities involved in market liquidity. One problem with this externality is that it results in a consolidation of trading to a limited number of trading venues. These concentration tendencies are likely to limit competition. Thus, financial markets have a certain number of features in common with natural monopolies. From economic theory, we know that monopolies charge prices that are higher than the socially optimal. This results in a too low production of the services supplied by the monopolist and an economic loss to society and investors. Economic theory indicates that the ideal situation is perfect competition on all markets. The concentration tendencies described above may be seen as a market failure. Put differently, if we let the market forces work, the competition between the providers of the financial markets may be limited and the level of financial services production sub-optimal. The obvious regulatory response is to lower the barriers to entry, in order to stimulate competition. The question here is if the concentration tendencies are higher in the securities business than in other areas. There are surely also other industries with significant concentration tendencies. However there may be two reasons why securities markets are more exposed to this problem than other markets. Firstly, financial securities have very low transaction costs, such as transportation and legal costs. In many other markets, these costs make market integration prohibitively expensive. Therefore, concentrations tendencies in securities market may be large compared to other markets. Secondly, securities regulation imposed for other reasons – may raise the barriers-to-entry and reduce competition. The traditional test of “fit and proper” is one example of a regulation, which in this sense could be counterproductive in terms of efficiency. In defining securities regulations, – motivated for other reasons– it is therefore important to take the concentrations tendencies into account. Still, the main question is whether these concentrations tendencies necessitate regulation specific to the securities industry or whether the general anti-trust laws and competition regulations are sufficient. There are also other externalities. For example, all market participants would be better off if everybody followed high ethical standards, but market participants often have strong incentives to break these standards as long as everybody else acts ethically. The result without rules and regulation may be that many participants break the ethical rules and everybody is worse off. There is a market failure if the incentives of the market participants (be it exchanges, brokers, major investors, corporations etc) are not aligned. The problem is that they cannot coordinate their actions. This is a classical prisoner’s dilemma problem and can be generalized to many situations. Another example of a coordination dilemma is the monitoring problem, common to securities markets. The basic problem is the combination of three features. First, there is a principal agent problem. Investors – the principals – supply capital into corporations but delegate the decisions to the management – the agents. Small investors – the principals – buy investment services from professional investors – the agents. Second, contracts cannot specify all contingencies, and thus leave the agents with some freedom to deviate from what is optimal for the principals. Third in securities markets, the principals are typically small. Given these features, the competitive situation is likely to result in low levels of monitoring, due to free riding. Contracts that align the incentives of the agents and the principals could potentially be difficult to obtain. An aggregated low level of monitoring could therefore harm efficiency and appropriate regulation inducing coordination of the monitoring efforts could enhance efficiency.

3.3 (f)The Consumer Protection Motive

One frequently used argument for securities regulation and supervision is t that the consumers need protection. Generally speaking, an efficient way to protect consumers in the securities markets is to ensure, a) that the price formation process is as efficient as possible, and b) that there is sufficient competition between the traders, brokers and other market participants. Thus, if a large number of professional traders compete in assembling and interpreting new information, securities market prices will reflect that information and unsophisticated traders do not need any additional information and analysis. In this case, the observed prices are sufficient. Given that rules and regulations are needed for some other reason, effective ways to protect uniformed traders are therefore to enact measures to reduce transaction costs, to guarantee efficient trading mechanisms, to introduce antitrust policies, to lower barriers to entry and to improve competition. If the markets are efficient, all trades will be performed at correct prices and the need to protect consumers will in principle vanish. Thus, one basic conclusion is that consumers are better protected in an efficient market than in a less efficient market. Thus, an effective way of protecting the consumers is to ensure an efficient market. However, securities markets cannot always be perfectly efficient in an informational sense. One of the reasons is that there is asymmetric information. The consumer protection argument for regulation is typically based on the existence of asymmetric information. Price sensitive information is not immediately spread to all traders. Some investors, especially small investors, normally have less access to information than other traders. As a consequence, securities regulations are often aimed at either reducing the asymmetric information between different agents, or limiting the perceived damage of asymmetric information. However, reducing the asymmetric information may also have significant adverse effects. If the regulation prohibits agents from taking advantage of superior information, this information will not be incorporated into the securities prices. It is exactly the search for information, not yet reflected in the prices, which makes prices informationally efficient. This search, which is costly, has to be profitable otherwise prices will not be as informative. Therefore, accepting a certain limited level of asymmetric information may be the price we have to pay to get informative prices on a well-functioning market. There are also other problems. The main reason for investor protection is based on a free-riding problem, combined with a principal agent conflict and incomplete contracts. Principal agent relationships are common in securities markets. Retail investors typically invest in different funds and other financial services firms. Here the former are principals and the latter agents. These investment funds, trusts and financial services firms invest in stocks, bond etc and then act as principals towards the management of the issuing companies (agents). Given that complete contracts are not feasible or enforceable, that all contingencies cannot be foreseen, and that it is not obvious that contracts that align the incentives are always available, there is a potential economic problem. Under these circumstances, the free market may yield a. socially sub-optimal solution, and thus there may be scope for regulations based on the consumer protection motive. socially sub-optimal solution, and thus there may be scope for regulations based on the consumer protection motive. The overall conclusion is therefore that the main consumer protection argument for the regulation of investment services is based a) on the principal agent problem between the retail investor and the investment service provider, b) on the difficulty of the retail investor to monitor the performance of the service provider, even ex post, c) on the long term aspect of many investment services, and d) all under the assumption that the public se0ctor has a responsibility for some minimum living standards. Another question is then how these problems can be solved. Other Motives Occasionally other motives for separate securities regulations are presented, such as competitiveness and money laundering. Historically, a number of other politically motivated arguments have been made, including the need to channel funds to politically favored sectors of the economy, or to help financing public deficits. However after the deregulation of securities markets, the latter argument have more or less disappeared.

3.3 (g)Money Laundering

With the exploding volume of international financial transactions and the lifted regulation on these transactions, it has become easier also for drug traders and organized crime to use the financial system to hide criminal revenue and transform them into legitimate financial positions. Therefore a number of countries have imposed reporting requirements for major currency transactions. As long as it is only a question of requirements to report, the costs are likely to be small and not to influence legitimate transactions in any major way. However, if additional restrictions are imposed, even for ‘good’ causes such as in the combat against terrorism, It may severely affect the efficiency of international securities markets. Money mobilized in security markets by monopoly brokers used for their own personal benefit(luxuries) is also considered as money laundering.

4 Corporate Governance(defined)

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments[21] .Most advanced market economies attempted to solve the problem of corporate governance to the extent that they have assured the flows of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance. But this does not imply that they have solved the corporate governance problem perfectly, or that the corporate governance mechanisms cannot be improved. Corporate governance mechanisms are economic and legal mechanisms that can be altered through the political process. Corporate governance is a straightforward agency perspective sometimes referred to as separation of ownership and control.

4.1Corporate Governance in Finance

Corporate governance influences the efficiency of firm production at the corporate level, so that the effectiveness of a nation's corporate governance system shapes economic performance at a country level[22]. Standard agency theory defines the corporate governance problem in terms how equity and debt holders influence managers to act in the best interests of the providers of capital. To the extent that shareholders and creditors induce managers to maximize firm value, this will improve the efficiency with which firms allocate resources. These mechanisms, however, do not work well around

[21] Caprio, Gerard Jr. and Ross Levine, "Corporate Governance In Finance: Concepts and International Observations"(2002)

[22]Anderei Sheleifer and Robert Vishny (1997) 'A Survey of Corporate Governance'

the world. Small investors have a difficult time exercising corporate governance because of informational asymmetries and poor legal, bankruptcy, and regulatory systems. If the world is to rely on banks – and other financial intermediaries – to exert effective corporate governance, then the managers of financial institutions must themselves face sound corporate governance. If bank managers face sound incentives, they will be more likely to allocate capital efficiently and then implement effective corporate governance over the firms in which they invest. If bank managers, however, have enormous
discretion to act in their own interests rather than the interests of the bank's equity and debt holders, then this will adversely affect corporate governance. In particular, banks will allocate capital less efficiently and bank managers may actually induce firm managers to behave in ways that favor the interests of bank managers and firms but hurt overall firm performance. Thus, the corporate governance of banks and other financial intermediaries is crucial for shaping capital allocation at the firm level and at the country level. Nevertheless, the financial sector has generally received far less attention in the corporate governance literature than seems warranted by their central role in a nation's corporate governance system. How do the suppliers of capital influence managers to act in the best interests of capitalists?

First, governments construct the basic legal system underpinning corporate governance. Second, governments may influence the flow of corporate finance by restricting corporate activities and insuring corporate finance in the case of banks and occasionally other intermediaries. We consider each of these stakeholders and also discuss the market for corporate control.

4.2 Problems of Corporate Governance in Finance

In particular, we examine three interrelated characteristics of financial intermediaries and how these traits affect corporate governance. First, banks and other intermediaries are more opaque, which fundamentally intensifies the agency problem. Due to greater information asymmetries between insiders and outside investors in banking, it is (i) more difficult for equity and debt holders to monitor managers and use incentive contracts, (ii) easier for managers and large investors to exploit the private benefits of control, rather than maximize value, (iii) unlikely that potential outside bidders with poor information will generate a sufficiently effective takeover threat to improve governance substantially, and (iv) likely that a more monopolistic sector will ensue and will generate less corporate governance through product market competition, compared with an industry with less informational asymmetries. Second, banks, like most intermediaries, are heavily regulated and this frequently impedes natural corporate governance mechanisms. For instance, (i) deposit insurance reduces monitoring by insured depositors, reduces the desirability of banks to raise capital from large, uninsured creditors with incentives to monitor, and increases incentives for shifting bank assets to more risky investments, (ii) regulatory restrictions on the concentration of ownership interfere with one of the main mechanisms for exerting corporate governance around the world: concentrated ownership, (iii) regulatory restrictions on entry, takeovers, and bank activities reduce competition, which reduce market pressures on managers to maximize profits, and (iv) bank regulators and supervisors frequently have their own incentives in influencing bank managers that do not coincide with value maximization. Finally, government ownership of banks fundamentally alters the corporate governance equation. Since state ownership of banks remains large in many countries, this makes corporate governance of the banking industry very different from other industries.

4.3 Strategy for improving Corporate Governance

[23]Existing research shows that countries in which the government supports the ability of private sector entities to monitor banks, permits banks to engage in a wide-range of activities, in banking. As a first step, it is critical that governments recognize and curb any of their own behaviors that thwarts the private sector's ability and incentive to monitor banks. Thus, for example, in countries in which government ownership is pronounced, private sector monitoring cannot be expected, and competitive forces clearly are blocked. Moreover, as argued above, government supervision of government banks also cannot be expected to be thorough and independent as we observe in India. In these cases, embarking on a program to reduce government ownership where it is pronounced would seem to be essential; without this step it is difficult to conceive of the success of other efforts to ameliorate the governance problem. Countries with blanket deposit insurance, or extremely generous deposit insurance coverage (certainly the levels of 10 to 15 times per capita GDP that are found in very low income countries) also are sure to be those in which private sector monitoring is virtually nonexistent. Reducing such coverage to much lower levels also would be essential in order to enhance private sector monitoring. A second step in improving governance in banking involves directly reducing the opacity of banks by improving the flow of information. Although

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23 Caprio, Gerard Jr. and Ross Levine, "*Corporate Governance In Finance: Concepts and International Observations*"(2002) transparency of banking information in emerging markets is receiving increased attention in the wake of the East Asian crisis (and perhaps more so in the aftermath of the Enron collapse), the likely reinforcement of opacity by existing ownership patterns in emerging markets suggests that this task is even more important and yet more difficult than has been recognized. In effect, authorities will need to engage in the unpopular task of shaking-up cozy relationships among powerful interest groups in their society. This task is not as simple as superficial adherence to international standards; rather, it is a process that will require sustained commitment over a period of time in order to effect. In addition to much greater attention to improving accounting and auditing, improvements to credit information will facilitate the expansion of banking by those interested in providing finance to groups that were previously excluded. Enhancing corporate finance reporting in the media, and education as to the importance of this issue in a wide swath of civil society, will help make a lasting contribution to better corporate governance. This is not easy: the same family groups that control banks may also control the media, so broader antitrust activity may be necessary in order to make this work. Moreover, it is worth stressing again that these changes will not happen to the extent that governments underwrite risk. Third, although better information may indirectly enhance the contestability of the banking market and invigorate the market for corporate control in banking, opening to foreign banks offers a direct mechanism for creating competitive pressures in banking. It was not so much the presence of foreign banks as the contestability of markets (associated with relative openness to foreign entry) that contributed to the development and stability of emerging market banking. Foreign banks, and indeed foreign entry in other markets, will serve to increase the competitiveness of the economy in general and lessen the reliance on family or conglomerates relationships. Increased foreign presence in emerging market banking has the attractive benefit of improving access to credit, even by small and medium-sized enterprises. The resulting increase in competition in the economy can pay dividends in the long-term to the corporate governance problems discussed here. Clearly the same should apply to foreign competition in insurance and pension management. Fourth and most importantly, the potential monitors of banks – owners, markets (large creditors in particular) and supervisors – need clear and strong incentives to do their jobs well. As stressed above, the legal and bankruptcy systems do not operate well in many countries. Thus, bank managers can control banks with little to fear from outsider investors, or even from bankruptcy as is clearly evident from Japan’s ten-year banking crisis. Owners, particularly controlling shareholders, will have the incentive to monitor their banks well (meaning in accordance with society’s goals), only to the extent that their own resources are really at risk and to the extent that there are healthy profits in return for safe and sound banking. Unfortunately, ensuring that capital is real and that weak lending practices have not eroded is not simple in practice. The incentives facing insider owners and managers can be enhanced in a number of ways. The ability of authorities to influence inside owners and managers is enhanced if regulators can impose penalties when there is evidence of fraud or of improper conduct. Similarly, the incentives of inside owners and managers will clearly be enhanced if small shareholders and debtors can confidently use an efficient court system that supports their rights.More generally, regulation has not focused much attention on the compensation of senior managers. For example, an attempt to vary capital requirements in line with the extent to which banks' compensation policies encourage or discourage excessive risk taking is a promising area for new research. The supervisory process in some countries is getting close to this issue when supervisors examine the systems that banks have in place for managing their risks. We suspect that as important as risk management is as a process, the incentives inside the individual banks for taking risk will determine the efficacy of any processes that are written down. Certainly, the threat of legal recourse for those who suffer losses when directors do not fulfill their fiduciary duties would improve the incentives for this group, and it might also encourage them to support reforms in compensation policies for senior bank officers. Compensation policies of directors themselves also demand greater attention and further research into the extent to which bank and corporate performance is a function of differences in this area would be highly useful. To improve corporate governance of financial intermediaries, policy makers must seek to enhance the ability and incentives of creditors and other market participants to monitor banks. Recently, subordinated debt proposals have received increased attention. It should be clear that the governance problem in finance is severe, but it is not hopeless. Recognition of the difficulty of the process, and the need to get governments focused on. Better-governed banks, in the sense of those able to contribute to development yet also robust to macro disturbances, used to be more common. Notwithstanding, waves of failure by small U.S. banks in the nineteenth century, depositor losses in the now industrialized countries were minor and taxpayers' losses nil. This state of affairs resulted from clear incentives for the various actors reviewed here, not least of which was the practice for bonds to be posted by bankers and even deferred compensation for supervisors. We can only hope that the scale of losses in emerging market banking and the consequent increased attention to this topic will help promote reform efforts.

4.4 Corporate Governance in India

[24]In India recently ,March 2003, a committee has been formed by **SEBI** to discuss the scope of **Corporate Governance in India** which is headed by the **CEO of Infosys,Narayana Murthy**.

Excerpts from the Committee report:

A corporation is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.

Corporate governance is about ethical conduct in business. Ethics is concerned with the code of values and principles that enables a person to choose between right and wrong, and therefore, select from alternative courses of action. Further, ethical dilemmas arise from conflicting interests of the parties involved. In this regard, managers make decisions based on a set of principles influenced by the values, context and culture of the

[24] "Report Of The Committee On Corporate Governance"(2003),SEBI Comittee Report,www.sebi.gov.in

organization. Ethical leadership is good for business as the organization is seen to conduct its business in line with the expectations of all stakeholders.

Corporate governance is beyond the realm of law. It stems from the culture and mindset of management, and cannot be regulated by legislation alone. Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. It is about openness, integrity and accountability. What legislation can and should do is to lay down a common framework – the "form" to ensure standards. The "substance" will ultimately determine the credibility and integrity of the process. Substance is inexorably linked to the mindset and ethical standards of management Corporations need to recognize that their growth requires the cooperation of all the stakeholders; and such cooperation is enhanced by the corporation adhering to the best corporate governance practices. In this regard, the management needs to act as trustees of the shareholders at large and prevent asymmetry of benefits between various sections of shareholders, especially between the owner-managers and the rest of the shareholders.

Corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their Boards are accountable to the shareholders. This, in turn, helps assure that corporations operate for the benefit of society as a whole. While large profits can be made taking advantage of the asymmetry between stakeholders in the short run, balancing the interests of all stakeholders alone will ensure survival and growth in the long run. This includes, for instance, taking into account societal concerns about labor and the environment.

Often, increased attention on corporate governance is a result of financial crisis. For instance, the Asian financial crisis brought the subject of corporate governance to the surface in Asia. Further, recent scandals disturbed the otherwise placid and complacent corporate landscape in the US. These scandals, in a sense, proved to be serendipitous. They spawned a new set of initiatives in corporate governance in the US and triggered fresh debate in the European Union as well as in Asia. The many instances of corporate misdemeanours have also shifted the emphasis on compliance with substance, rather than form, and brought to sharper focus the need for intellectual honesty and integrity. This is because financial and non-financial disclosures made by any firm are only as good and honest as the people behind them. By this very principle, only those industrialists whose corporations are governed properly should be allowed to be a part of committees. This includes the Prime Minister and Finance Minister's advisory councils, committees set up by the Confederation of Indian Industry ("CII"), the Securities and Exchange Board of India ("SEBI"), the Department of Company Affairs, ministries, and the boards of large banks and financial institutions.

5 Conclusion

Findings and Recommendations

The security scams and financial scandals discussed here involved the manipulation of huge amounts of money. The purpose of the so called "traders" or "investors" was not genuine. The perpetrators had such a comprehensive knowledge of how the system worked that they manipulated it. It is clearly evident that the occurrence and reoccurrence of such security scams and financial scandals as some point in time be attributed to a failure of corporate governance in finance and that of financial regulation. Corporate Governance vs Financial Regulation **is** more a personal thing which involves the adherence to rules regulations and ethics by officials (management).It is more self enforced as a ethical behavior or a matter of pursuing codes of conduct without an outside agent monitoring , but financial market regulation in exercised more by an external organization either a regulatory body authorized to monitor and impose a surveillance mechanism to ensure frauds or misdemeanors are not perpetuated and so that the market functions efficiently to over see the functions of the market participants and impose fines and other penalty for non-compliance. [25]Though standard corporate governance theory states that corporate governance includes the role that equity and debt holders have to play in influencing managers to act in the best interests of suppliers of capital it should not be forgotten that it also includes the role that creditors, owners and government in the same capacity. While corporate governance

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25 Caprio, Gerard Jr. and Ross Levine, "*Corporate Governance In Finance: Concepts and International Observations*"(2002) mechanisms are decided by economic and legal institutions and are influenced by politics it's success depends a great deal on the principles, diligence and sincerity of management when it comes to the adherence to rules and regulation. Also they must have a concern for the welfare of shareholders(investors) and other suppliers of capital to ensure that they get a fair and regular return for their investments. While corporate governance ensures a regular supply of capital and fair share of profit to investors it's role does not end there. Corporate Governance at that level does not mean that it is entirely solved but definitely can be improved on. Shareholders and other parties find difficulty in exercising corporate governance because of poor legal systems, corruption and bankruptcy. Also managers have the incentive to act in their own interests rather than the interests of equity and debt holders which could definitely affect corporate governance. Also informational asymmetries in the system make it difficult for equity and debt holders to monitor mangers. It also induces bank mangers to act according to their own incentives and not according to value maximization. Also heavy regulation induces bankers to invest in high risk ventures rather than borrowing from uninsured borrowers who have a greater incentive monitor .Also regulations and prohibitions of entry of foreign banks reduces competition and market pressures on managers to earn profits. Corporate Governance problem can be improved by increasing private monitoring and reducing government ownership when it interferes with private monitoring. The opacity of banking processes should be removed and a proper information flow should ensue. A lack of this can be attributed to the Asian Crisis and collapse of Enron. Entry of foreign banks should induce competition and make mangers do their job well without relying on family conglomerates and politicians. Also managers in banks should be given strong incentives to do their jobs well and their good efforts should be rewarded and mistakes corrected. They should be remunerated well. In India corporate governance revolves around ethical behavior on part of management, knowing to make right decisions and also knowing to choose between right and wrong.. It also calls for the managers to behave in the interests of economics efficiency of the firm and shareholders. Management should be made more accountable for their actions in terms of deployment of funds , making decisions and also transmitting information. However though standard corporate governance theory states that it's realms of control include assuring a fair return to suppliers of capital it's scope has changed in recent years. Often, increased attention on corporate governance is a result of financial crisis. For instance, the Asian financial crisis brought the subject of corporate governance to the surface in Asia. Further, recent scandals disturbed the otherwise placid and complacent corporate landscape in the [26]US. These scandals, in a sense, proved to be serendipitous. They spawned a new set of initiatives in corporate governance in the US and triggered fresh debate in the European Union as well as in Asia. [27]One cannot forget the security scams in India. The many instances of corporate misdemeanors have also shifted the emphasis on compliance with substance, rather than form, and brought to sharper focus the need for intellectual honesty and integrity. This is because financial and non-financial disclosures made by any firm are only as good and honest as the people behind them. By this very principle, only those industrialists whose corporations are governed properly should be allowed to be a part of committees. [28]This includes the

[26] Table 2
[27] Table 1
[28] "Report Of The Committee On Corporate Governance"(2003),SEBI Comittee Report,www.sebi.gov.in

Prime Minister and Finance Minister’s advisory councils, committees set up by the Confederation of Indian Industry (“CII”), the Securities and Exchange Board of India (“SEBI”), the Department of Company Affairs, ministries, and the boards of large banks and financial institutions

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7 Glossary

Bank Receipt :Bank Receipts are issued by the selling bank, signifying that it has received money and is holding the securities in trust for the buyer. Bank Receipts are supposed to be non-transferable and to be discharged after the securities are delivered.

Public Debt Office(PDO)-In ledgers earmarked for each bank , the PDO of RBI records transactions between banks in government securities .Each kind of security transaction is recorded separately.

Subsidiary General Ledger (SGL)-The Subsidiary General Ledger maintained by the PDO in which government security transactions are recorded. The SGL will show balance standing in the name of a particular bank in a particular security.

Ready forward Deal-Known worldwide as repurchase options or repos. The Reserve Bank Of India's records refer to it as buyback .It involves selling securities with the purpose of buying them back after a short period of time, usually at a slightly higher price. The seller thereby creates temporary liquidity for himself for which he pays the higher price.

Double Ready Forward-Simultaneous buying and selling of two sets of securities with the buyback options created by both the parties. The seller's objective could be to create liquidity by selling one kind of security(normally ready forward)and at the same time buying some other kind for the portfolio.

Special Purpose Entities(SPEs)-A business interest formed solely in order to accomplish some specific task or tasks. A business may utilize a special purpose entity for accounting purposes, but these transactions must still adhere to certain regulations.

8) Appendix

A)Stock Market Scam in India of 1991:The Janakiraman Committee Report

On the basis of the information received that some banks -National Housing Bank(NHB),State Bank Of Saurashtra,SBI Capital Markets Ltd (SBI Caps),Standard Chartered Bank,Canfina etc -were undertaking large-scale transactions in Government securities through the medium of brokers in the course of which they were violating the Reserve Bank Of India (RBI's) detailed guidelines issued to them in July 1991,RBI had started making enquiries into the securities transactions of some of the banks since January 1992.Towards the end of March 1992 ,information was also received that State Bank Of India (SBI) had purchased a large quantity of Government securities on a ready forward basis one day prior to the date on which the coupon rate of Govt of India securities was raised. Therefore the securities transactions of SBI were also taken up for scrutiny immediately.The bank was advised on 2 April 1992 to furnish to RBI a statement of as on 31 March 1992 as soon as the statement was compiled. It was observed that the bank was unable to furnish the statement as it had not reconciled the balance of securities held by it as shown with the actual balance held in the [29]Subsidary General Ledger (SGL) Account with the RBI beyond November 1991.

(1)The following banks, subsidiaries of banks and institutions have made payments for purchase of investments for which they do not hold either securities, SGL forms or BRs to the extent indicated below:

[29] Glossary(Definition)

Table 4: Payments for purchase of investments for which Subsidiary General Ledgers and Bank Receipts are not held during security scam 1991 in India

Name of Bank	Rs in crores
National Housing Bank(NHB)	1199.39
State Bank Of Saurashtra	175.04
SBI Capital Markets Ltd(SBI Caps)	121.23
Standard Chartered Bank	300.00
Total	1795.66

(2)Banks ,subsidiaries of banks and institutions are holding BRs/SGLs issued by the Bank Of Karad Ltd and the Metropolitan Co-operative Bank for which the issuing banks do not appear to have sufficient backing to the extent indicated below:

Table 5:Banks,subsidiaries of banks and institutions holding Bank Recipts and Subsidiary General Ledgers for which there appears to be no sufficient backing during security scam of 1991 in India

Name Of Bank	Rs in crores
Standard Chartered Bank	755.00
Canbank Financial Services Ltd(Canfina)	425.00
Canbank Mutual Fund	102.97
Total	1282.97

A1) Recommendations

Based on the committee's preliminary findings it made the following recommendations

(1)The diversion of funds has been largely facilitated by the practice of banks executing a large number of "ready forward" and "double ready forward" transactions . Since there is no permanent sale of transfer of investments in such cases ,there is no real need to effect transfer of actual scrips of SGL forms or to deposit SGL forms when issued with the [30]PDO(Public Debt Office-that which records all the banks transactions in government securities). These transactions have, therefore, presumably been supported by BRs or SGL(ledger accounts maintained by the PDO which records all the banks transactions in government securities with balances)forms not intended to be deposited with the PDO.As the transactions effectively get reversed on the due date, it is also possible that the transactions were effected without the sale of BRs ,SGL forms by the issue of unauthorized BRs or SGL forms. A "ready forward" transaction in substance could also be a mere lending of funds for the period of the contract in the guise of a purchase/sale of investments. The Committee recommended that-

(a) the practice of banks entering in to "ready forward" and "double ready forward" deals with other banks be restricted to Government securities only (as permitted by the RBI) and guidelines be laid down specifying the circumstances in which such transactions would be permitted.

[30] Glossary(Definition)

(b) Banks be prohibited from entering into “ready forward” and “double ready forward” deals in other securities including PSU bonds , units and shares;

(c) The prohibition regarding banks entering into “buy back” deals with non-bank clients (already imposed by the RBI) be strictly enforced and action be taken against banks which have violated this direction;

(d) Banks be prohibited from entering into “ready forward” and “double ready forward” deals on behalf of customers under portfolio management scheme (PMS).

2)The internal control procedures of banks regarding their treasury functions be immediately reviewed by the RBI,inter alia,with regard to-

(a)the segregation of duties between

(a1) persons responsible for entering into deals

(a2)persons having custody of investments and

(a3) persons responsible for recording the transactions in the books of accounts and other records

(b)the periodic reconciliation of investment account and the independent verification thereof;

(c) controls over the issue of SGL forms and BRs and record keeping in respect thereof;

(d) controls for verification of the authenticity of BRs and SGL forms and confirmation of authorized signatures;

(e)procedures for confirmation with counterparties of brokers’ contracts as also of overdue BRs;

(f)the segregation of responsibilities of persons handling the bank’s own investment and those deleing on client’s accounts.

(3) Banks should be required to formulate and get approved internal exposure limits which ensure that there is no undue reliance on a few brokers. These limits should also cover the maximum amount of outstanding BRs or SGLs issued by other banks which can be accepted by the bank.

(4)Brokers' contract notes should be required to indicate the counterparty so that direct communication with such parties is possible.The notes should also indicate separately the brokerage charged on the transactions.

(5)When banks act as custodian of brokers' or other parties' securities ,all transactions effected for such customers (including all documentation)must clearly disclose that the bank is acting as a custodian and not as a principal.

(6)The existing prohibition on banks issuing cheques drawn on their account with the RBI for third party transactions should be strictly enforced. Such payments should be made through normal instruments like bankers' cheques, drafts or a transfer advice which clearly discloses the identity of the person on whose behalf the transfer is made.

(7)When banks exercise custodial functions on behalf of their merchant banking subsidiaries these functions should be subject to the same procedures and safeguards as would be applicable to other constituents. Therefore, full details should be available with the subsidiaries of the manner in which the transactions have been executed.

(8) the issuance of a large number of BRs in respect of transactions in PSU bonds may have been justified by the banks on the ground that there has been undue delay in the issue of scrips by the PSUs and therefore trading in such bonds has been possible only through BRs. The issue of a large number of BRs in respect of units may also have been justified by the banks

on the ground that the transfer of the units in the name of the buyer involves stamp duty and therefore transfers need to be effected only when the units need to be lodged with the UTI payment of dividend. These are no doubt valid assertions but the practice of issuance of BRs in respect of these instruments have been largely responsible for the diversion of funds to the brokers;

(9)The issuance of BRs in respect of Government securities as also the apparent short-trading has been sought to be justified by the banks on grounds of the inability of the PDOs in the RBI to record speedily the transactions effected and to communicate the credit advices in time to banks. Banks, therefore do not know the fate of SGL forms lodged when they in turn issue SGL forms. The Committee is not convinced that this justification is valid particularly since objection memos have generally been communicated in time. However ,the work of the PDOs needs to be considerably speeded up and more relevant information furnished to banks. This information should include;

(a) immediate advice of all objection memos. Unless a bank makes arrangements on a regular basis to collect objection memos over the PDO counter the advices should be by courier for which acknowledgement would be debited to the account of the concerned bank;

(b) a weekly statement of all transactions in individual ledger accounts together with the balance thereof.

It is also necessary that there is a daily verification of all securities held in the SGL accounts of all banks in the aggregate and that on a weekly basis the PDO submit to the Department of Banking Operations and Development (DBOD) of the RBI a report giving bank-wise details of all SGLs returned for want of sufficient balance.The Committee believes that given the large number of accounts the large number of individual securities and the number of transactions, the work of the PDO cannot be done manually and needs to be immediately computerized.

(10)The Committee recognizes that with 80 banks having over 60000 branches it is virtually impossible for the RBIs inspection procedures to examine individual transactions of banks. At present the RBI carries out an annual financial review(AFR) and a financial inspection once in four years. Even the financial inspection is largely concerned with the advances portfolio of the banks and the adequacy of provisions. The committee understands that the inspection system and procedures of the DBOD have been recently reviewed by a committee appointed by the RBI governor and its recommendations are in the process of being implemented. However the primary responsibility in this regard must remain with the bank managements which must remain with the bank managements which must ensure that there are adequate internal control (including internal audit) procedures. The committee would ,therefore recommend that:

(a) On-site inspection by the RBI should be supplemented by reporting of compliance by banks with prudential and other guidelines. To lend authenticity to this compliance reporting, banks should be required to get compliance in key areas certified by statutory auditors of the banks.
(b) The scope of the RBI inspection should be widened to include greater emphasis on the treasury function
(c) The RBI should review the adequacy of the internal audit departments of the banks and the scope of their operations.

(d) The portfolio management operations of banks should be subjected to a separate audit by the banks’statutory auditors as these operations are in the nature of trusteeship functions.

(e) The RBI should strengthen it’s organization responsible fro market intelligence so that early action can be taken when there are market rumours of irregularities.

11)Ready Purchase Operations

It would be counter productive to ban REPO transactions as they serve a useful purpose as money market instrument for equilibrating liquidity and for covering the needs of banks and bulk investors for short-term funds at varying points of time. While continuation of REPOs even in PSU bonds and units could be allowed. It is important that the transactions should be covered by prudential guidelines to be stipulated by RBI, limiting overall maximum position as also portfolio turn over ratios per player and stipulating that all transactions are put through a centralized clearance system, which can inter alia make the necessary information available to the authorities.Only banks, mutual funds and financial institutions may be allowed to participate in the REPO operations .These also would necessarily be the members of the centralized clearing agency. The need of some of the PSUs who have large stocks of existing PSU bonds also has to be recognized and they should be allowed to participate in REPO transactions with banks/mutual funds/financial institutions for a limited period of say ,two years.RBI may look into the manner in which banks and financial institutions account in their books their investments in PSU bonds and units and ensure that these are valued at market prices rather than at prices nominated in REPO transactions.

12)Role of Brokers

As regards role of brokers the committee recommends that the firms dealing in the money market transactions should be segregated from those dealing in shares. RBI would be the right authority to regulate such firms with regard to adequacy of their capital, extent f transactions etc. These brokers should be allowed to take positions, but they should cat as genuine intermediaries.

13)Phased Electronic Clearance, Settlement and Depository (ECSD)

All the transactions should be routed through a centralized agency which will operate an electronic book-entry clearance and settlement system and would also act as depository (ECSD).RBI should ensure that all the bulk investors (i.e. banks, mutual funds ,financial institutions and PSUs) become members of the ECSD and all their transactions in PSU/units irrespective of whether they are traded on stock exchanges or outside on spot basis are reported cleared and settled through ECSD.There be only one ECSD in Bombay/New Bombay as the setting up to many smaller organizations may not be cost effective and may create problems in monitoring and control.To give a legal standing to the depository legal changes would also be required for registration of PSU bonds and units in the name of the depository .Legal changes will also be required for exemption of revenue stamp duty in respect of PSU bonds/units whilst registering in the name of the depository.ECSD should be formed and become operative straightaway even in a limited fashion so that it can act as a centralized agency fro monitoring the transactions and making the data available for monetary and regulatory authorities.

B) Security Market Scam of 2001:Joint Parliamentary Committee (JPC) Report

The terms of reference of the Committee were as follows:—

1. To go into the irregularities and manipulations in all their ramifications in all transactions,
including insiders trading, relating to shares and other financial instruments and the
role of banks, brokers and promoters, stock exchanges, financial institutions, corporate
entities and regulatory authorities.

2. To fix the responsibility of the persons, institutions or authorities in respect of such
transactions.

3. To identify the misuse, if any, of and failures/inadequacies in the control and the
supervisory mechanisms.

4. To make recommendations for safeguards and improvements in the system to prevent
rec urrence of such failures.

5. To suggest measures to protect small investors.

6. To suggest deterrent measures against those found guilty of violating the regulations.

B1) Overview

Parliament, through a motion in the Lok Sabha on 26.4.2001, mandated this JPC(Joint Parliamentary Committee) to enquire into the stock market scam. This scam was distinct and different from the scam enquired into by a Joint

Parliamentary Committee in 1992-93. While the enquiry into the earlier scam related to ‘irregularities in securities and banking transactions’, the present scam mainly relates to financial misconduct in the stock market. Both the scam enquired into in 1992-93 and the present one have some common features like the failure of some banks as also high volatility in the stock market.The Committee were given an additional task after they had been constituted and started functioning. As announced by the Speaker, Lok Sabha on 3.8.2001, the Committee were further asked to look into all matters relating to the Unit Trust of India (UTI). This additional task to the Committee was necessitated by the freeze on resale of US-64 units by UTI in July 2001. Accordingly, the Committee enlarged their enquiry to include UTI in addition to the Stock Market Scam.During the working of this Committee, simultaneous actions pertaining to the enquiry were initiated by the Regulatory agencies like SEBI(Securities And Exchange Board Of India),RBI(Reserve Bank Of India) and DCA (Department Of Company Affairs).Information was gathered by the Committee from all these agencies through written questions, perusal of relevant departmental documents including files and depositions in person by heads/representatives of Banks, Regulatory bodies, Stock Exchanges, UTI(Unit Trust Of India) and officials of Government departments. The Committee were also assisted by the present Finance Minister and his three immediate predecessors. Flowing from the terms of reference were some of the questions that were discussed in-house by the JPC: Why do scams occur frequently? Are the rules and regulations obsolete or inadequate? Do regulatory authorities lack adequate power, or, are they deficient in implementation and vigilance? Do the stock exchanges follow laid-down guidelines and procedures? Are the managem ents of banks following the norms of accountability and corporate governance and are they running them according to guidelines laid down by the regulator? Should the stock market be self-disciplined and self-regulating or, should the regulators and the Government keep a close watch all the time? Have Government shown themselves alert to emerging problems?

B2) The Mechanics of the Stock Market Scam of 2001

The period of the scam, the main players involved, and its intensity have been examined by the Committee. The present scam includes the role of banks, stock exchanges, brokers, the Unit Trust of India (UTI), corporate bodies and chartered accountants. Regulatory authorities like SEBI, RBI and the Department of Company Affairs (DCA) should have been able to lay down and implement guidelines and procedures that could prevent such a scam or at least activate red alerts that could lead to early detection, investigation and action against fraud as well as the rectification of any systemic deficiencies discovered. Moreover, the Ministry of Finance, the Regulators and all others concerned had the benefit of the voluminous and detailed Action Taken Reports (ATRs) submitted by Government to Parliament on the numerous recommendations of the 1993 Report of the Joint Committee on irregularities in securities and banking transactions. Concerted mutual interaction between Government and the Regulators, especially through the institutional mechanism of HLCC, could have signally contributed to effective pre-emptive and corrective action to forestall or moderate the scam by the early detection of wrong-doing. Investigations were undertaken by SEBI against the manipulator's entities in the wake of allegations that manipulator's entities were involved in market manipulation in some scrips. The manipulator was operating through a large number of entities which facilitated hiding the nexus between the source of fund flows to him from corporate houses, banks, financial institutions and foreign institutional investors and the ultimatedeployment of these funds in the stock market. It was observed that funds received by certain entities from banks as loans and overdrafts were diverted to other entities for acquiring shares/meeting other obligations. It also appeared that, transactions for purchase and sale of shares were done in the name of a large number of entities so that concentration of positions/transactions in a particular scrip could not be readily detected. Thus, various layers were created so that it became difficult to link the source of fund with the actual users to which these fund were put. He used a net working of various FII sub accounts, OCBs, institutions and mutual funds for large transactions thereby creating an impression of market interest in certain select scrips.To begin with, he normally identified companies with relatively low floating stocks,acquired substantial holdings in these companies either directly or through associates including FII sub accounts, OCBs etc.He also used the presence of a number of exchanges and different settlement cyclesto systemically shift positions from one Exchange to the other Exchange. While being interested in increasing or maintaining the prices of select scrips, he appears at various point of time to have systematically sold/off-loaded his holdings to book profits and take further positions therefrom to further increase the prices.. Some of the corporate groups which had given funds to the manipulators entities during January 2000-April 2001 are Adani, HFCL, DSQ, Cadila, Essel,Kopran and Nirma and the amount outstanding from the manipulator to these entities is over Rs. 1273 crore. His entities received around Rs. 80 crore from Vidyut Investments, a subsidiary of Ranbaxy. Most of the companies have claimed that the funds given by them to the manipulator's entities were in the nature of Inter Corporate Deposits(ICDs) under the Companies Act. They also claim that they have given some money to buy the shares of other companies but not their own. (i) Shares of DSQ Biotech, DSQ Industries were given by entities associated with promoters to the manipulator's entities who sold these shares through CSFB and Dresdner Kleinwort Benson (DKB) and availed of immediate funding. (ii) Shares of HFCL were reportedly given by promoter group entities to the manipulators entities for selling to strategic investors. Against the sanctioned limit of Rs. 205 crore, there is an outstanding balance ofRs. 888.25 crore against the manipulators company Group towards Madhavpura MercantileCo-operative Bank (MMCB). As, against a limit of Rs. 92 crore, an amount of Rs. 225.63 crore is outstanding to MMCB from the Mukesh Babu Group. Shri Mukesh Babu has stated under oath that Rs. 57 crores was used for entities connected with the manipulators and Rs. 115 crores has been utilized for transactions made for Madhur Shares which is controlled by a son of Mr. Ramesh Parekh, Chairman of MMCB. There are close knit relations between the manipulator and Madhur Shares. Large funds have flowed from the manipulators account to the Madhur Shares account. It is suspected that dealings for Madhur Shares as well as through Manniar are for the manipulators entities mainly. The amount outstanding to Global Trust Bank from the manipulator's entities as on 23.03.01 was Rs. 266.87 crore. The manipulator's Company Group had also received funds from Centurion Bank, ICICI Bank and Bank of Punjab against which a total amount of Rs. 65.47 crore was outstanding. MMCB issued Pay Orders (POs) in favour of the manipulators entities from time to time even when there were no sufficient credits/securities to cover these loans/over drafts.The manipulator's entities would then discount these POs with Bank of India

(BOI). The Stock Exchange Branch of BOI would present these Pay orders for realisation to the clearing house in the normal course of their business. On 8.2.2000 and 9.3.2001, MMCB issued Pay Orders totaling Rs. 137 crore in favour of the manipulator's entities, which were immediately discounted with BOI and the proceeds received were utilized by the manipulator's entities. But on this occasion when BOI presented these Pay Orders to the clearing house for realisation , MMCB declared its inability to pay, since sufficient funds were not available with the bank. Hence, BOI was left with a debit balance of Rs. 137 crore against the three manipulator's entities concerned—Classic Credit Ltd. Panther Fincap and Panther Investrade Ltd.Triumph Group did not provide delivery to its OCB clients on several occasions. European Investments Ltd. (EIL) had lodged a complaint with SEBI, National Stock Exchange (NSE) & RBI against Triumph International Finance India Ltd. (TIFIL) regarding dishonouring of three cheques issued to EIL by TIFIL totaling Rs. 70.71 crore toward sale proceeds. On many occasions Triumph Group did not make payment to its OCB clients for sale transactions made by them. The amount of non-payment by TIFIL to four OCBs viz. Brentfield, Kensington, Wakefield and Dossier for sales effected from December 2000 to March 2001 stood at Rs. 105.95 crore. The amount of non-payment from Triumph Securities Ltd. to Wakefield was Rs. 16.7 crore. The Committee enquired whether he and his associated entities built large concentrated position in some select scrips like HFCL, Zee Tele, DSQ Software, Global Tele, etc. and whether these companies provided him large funds to jack up their prices. In reply, the witness conceded that they had large investments in these companies and said 'We did build huge positions in the market in these companies, and probably because of that I suffered that losses that I suffered.' He further said that , 'none of the corporates has ever given us money to invest in their own shares or to buy their own shares. The moneys received from the corporates were for specific contracts - for purchase of shares in the companies that they were interested in, either which we were holding or to buy them from the market. Parts of the contracts were completed in time, part of the contracts are still pending because I got into problems. The moneys that have come from these corporates have come when the markets have, in fact, started going down drastically and when the valuations thought by them were right for investing in the companies they wanted. In the whole rise of 1999-2000, not a single corporate has ever given us any money to invest in the shares. Even during the down side also, there was no money fromany corporate given to us to buy their own shares or for jacking up the price. Referring to SEBI reports, the Committee pointed out that funds were available to the manipulator from HFCL Group, Zee group, Madhavpura Bank and OCBs, the witness said that 'all these monies have come in from the period of September, 2000 to March 2001' after the fall started. According to the manipulator, the biggest rise in the market was during the period 1999-2000 and that his borrowings during that period was in the region of Rs. 50 crore to 100 crore. On the other hand the money borrowed by him or his entities when the market started falling was around Rs. 1500 crore.payable by them to various institutions, banks, corporates, brokers, OCBs, etc. According to SEBI,it appeared that the manipulators entities suffered loss in range of Rs. 3000 crores to Rs. 4000 crore.

The amount payable by the manipulator's entities is stated to be as follows :

Table 6:Amount payable by Ketan Parekh's Entities to banks and companies during security scam of 2001 in India

Name of the entity	Amount (Rs. in crore) approx
Madhavpura Mercantile Co-operative bank	888.00
HFCL	550.00
Essel Group	450.00
Adani Group	132.00
DSQ Group	75.00
Shonkh Technologies	37.00
Kopran	28.00
Global Trust Bank	267.00
ICICI Bank/Centurion/Bank of Punjab, etc	66.00
OCBS (delivery of shares not given and sale proceeds not paid)	480.00
Total	3323

The Committee find that the manipulator was a key person involved in all dimensions of the stock market scam which surfaced in March 2001, as also in payments problem in the Calcutta Stock Exchange (CSE) and the crash of Madhavpura Mercantile Cooperative Bank (MMCB). He was operating through a large number of entities which facilitated hiding the nexus between source of funds flow and their ultimate use. Various layers were created in his transactions so that it became difficult to link the source of fund with the actual user of fund. SEBI's investigations after the scam have revealed that the amount outstanding from the manipulators entities to certain corporate houses at the end of April, 2001 was over Rs. 1,273 crore. Dues of the manipulators entities to MMCB were around Rs. 888 crore and to Global Trust Bank over Rs. 266 crore. There were also dues to other entities. The funds received from corporate houses and banks have gone to three major broker groups in CSE and been utilized in capital market operations. The manipulators entities appear to have chosen CSE mainly to exploit the known weaknesses of the EXchange. They also used a networking of various Overseas Corporate Bodies, Foreign Institutional Investor sub-accounts and mutual funds for large transactions. Not till the MMCB crash occurred did the regulatory authorities even begin looking in the manipulators directions although this was being underlined in Parliament and the media. It is difficult to believe that the Stock Exchanges or SEBI were quite unaware of what was going on in the market when the manipulators entities were manipulating the market using their network. Nor did the High Level Coordination Committee (HLCC) or the SEBI seek a check on where the mnaipulator was getting his funds from or his methods of manipulating the market. This is all the more disturbing in the context of the previous JPC's findings against the manipulator. The main regulator of Stock Exchanges, SEBI, has been in place since 1988 and has been working under an Act of Parliament since 1992 and should have been able to regulate the liberalized market more efficiently. The Committee found that SEBI has still a long way to go before becoming a mature and effective regulator. If SEBI had continued to improve its procedures, vigilance, enforcement and control mechanisms, it could have been more effective in a situation where the stock market became unusually volatile, leading to an unprecedented surge and subsequent depression in the capital markets. It was also clear that the capitalmarket in India is neither deep nor wide enough to moderate volatility and, therefore, a fewplayers could attempt to manipulate the stock markets. Clearly, the various regulatory authorities were not able to foresee the situation leading to the scam and prevent it. “Nor was adequate attention paid in government circles particularly the Ministry of Finance as the custodian of the financial health of the economy.Wrong doing by banks have also contributed significantly towards the scam although the number of banks involved in committing irregularities in comparison to the total number of banks functioning in our country is small. Notably, major banks were nationalized in 1969 but pursuant to economic liberalization, new private banks including foreign banks were allowed into banking sector. Public sector banks were in general not involved in the scam and have fared well but private sector banks need to be closely watched, especially in the area of risk management and stricter regulation. Cooperative banks have tended to ignore rules, procedures and risk management. This should set the RBI and the Government thinking. There is need to have more effective regulation in the banking sector as a whole with particular emphasis on cooperative banks.One of the major concerns of the Committee was to look at the trading practices and procedures adopted in the stock market. Stock Exchanges, brokers and regulators play a very important role in determining the transparency of procedures and practices in the stock markets. The Committee went into the functioning of these entities and generally found that the quality of governance and the practices followed in the stock exchanges were different from exchange to exchange, having evolved from different local economic, social and historical conditions. SEBI, as a regulator, had made some attempts at standardizing the practices in these exchanges and had also instituted arrangements whereby the happening in the stock exchanges would come to its notice. But, in practice, the system did not function efficiently or in a transparent manner. When stock markets were rising, there was general lack of concern to see that such a rise should be in consonance with the integrity of the market and not the consequence of manipulation or other malpractice. On the other hand, when the markets went into a steep fall, there was concern all over. Such dissonance in the approach to issues of regulation and good governance needs to be replaced with effective regulation which concentrates on market integrity and investor protection whether at any given point of time the market is buoyant or not. This Committee did not concern itself with either the rise or fall of the market but specifically with manipulations or irregularities that caused unusual rise and fall. The procedures, adherence to rules and the concern for common investor appear to have been quite loose in the CSE. The payment problem that surfaced in Calcutta Stock Exchange brought to light many ills of the institution. Worse, those ills such as unofficial badla could have been recognized and corrected well in time. The Committee discussed the period in which the present Scam surfaced, resulting ultimately in the crash of the stock market in March 2001 onwards. During the year 1999 and early 2000, the market, particularly ICE stocks, rose sharply. Thereafter, from June 2000 onwards it showed a decline which was gradual but consistent. From March 2001 onwards the decline in the SENSEX was sharp and could be termed a crash. There are a number of factors that contributed to this crash, one of which is over-reaching by one particular broker and his inability to sustain his position. In addition, during the month of January-February 2001 the Committee have found indications of large funds being withdrawn from the stock market. Whether withdrawal of large sums from the stock market was responsible for the crash or the large players withdrew the money because they knew that the SENSEX was likely to take a beating was another aspect the Committee deliberated upon. The Committee note that the manipulator who emerged as a key player in this scam received large sums of money from the banks as well as from the Corporate bodies during the period when SENSEX was falling rapidly. This led the Committee to believe that there was a nexus between the manipulator, banks and the corporate houses. The Committee recommend that this nexus be further investigated by SEBI or Dept. of Company Affairs expeditiously. The process of liberalization of the economy has continued apace and it is market forces that will increasingly determine economic trends in the country. With liberalization, the role of the Government as a direct player in the financial market will diminish. This makes it all the more necessary that the procedures and guidelines laid down for the creation and perpetuation of fair and transparent financial markets and institutions like stock exchanges and banks have to be more specific, and effective mechanisms have to be put in place to ensure that they are regularly followed. That job will have to be done by the regulatory authorities; viz., SEBI, RBI and DCA in liaison with investigative agencies like the Income Tax Department, Enforcement Directorate and the Central Bureau of Investigation. Coordination with Government on policy issues will, however, continue to be central to good governance as there can be no escaping Government’s responsibility to Parliament and the country. Therefore, Government must recognize that transactions in the market will be insulated from scams only if the relinquishment of Government control over the economy is accompanied by strong and effective regulatory bodies. This point had also been underlined by the earlier JPC Report, 1993 on Irregularities in Securities and Banking Transactions.The proceedings before the Committee themselves acted as a catalyst for many reforms in the system, which were put in place during the Committee’s pendancy. These actions by regulators like SEBI and RBI and by the Ministry of Finance have been touched upon in various chapters. The Committee feel that after the presentation to Parliament in August and December 1994 of the Action Taken Reports (ATRs) on the scam relating to irregularities in securities and banking transactions, the will to implement various suggestions of the previous Committee petered out. But, as soon as this Committee began its sittings and searching questions were asked, SEBI,RBI and other regulatory authorities including Ministry of Finance, went into active mode. Had this state of affairs prevailed after the Action Taken Report, the probability of the present Scam would have been negligible.

B3) Reasons for the Reoccurrence of Security Scam in 2001 Inspite of Guidelines Issued by RBI in 1992

The Committee did not have the benefit of a report on the lines of the Janakiraman Committee Report which was made available to the previous JPC on the scam in securities and banking transactions. Reliable evidence was difficult to find and took much time to cull. The Committee had to rely on a number of reports that dealt with specific and limited subjects. The enquiry reports of the regulators also displayed many gaps which had to be filled by securing answers to a very large number of questions asked by the Committee. The Special Cell constituted by the Ministry of Finance in June, 1994 to investigate the nexus between brokers and industrial houses in pursuance of the recommendation of the earlierJPC having gone defunct since May 22, 1995, without coming out with any tangible findings or recommendations for remedial action, is one of the examples of apathy on the part of different agencies and departments concerned. The Committee were informed by the Central Board of Direct Taxes that on May 19, 1995 the DGIT (Investigation), Bombay, who headed the Special Cell, had sought from CBDT adequate empowerment and administrative support for the Cell in the absence of which the Cell was unlikely to reach to any firm conclusions about the role of any one or more industrial houses in comprehensive manner but the Chairman, CBDT, in his response thereto had suggested that due to limited scope of task of the Special Cell no additional manpower was required. Also in the minutes of the last meeting of the Special Cell held on May 22, 1995, the members recorded that principal obstacle in unearthing the exact role of the industrial houses in the scam was due to the scope of the Cell was limited only to Bombay region due to which investigation into the activities of the suspects outside Bombay was not within the jurisdictional authority. Thus, the Special Cell was virtually rendered a still-born baby. The lack of concern of Government demonstrated in this casual approach to such an important issue is regrettable. This Scam is basically the manipulation of the capital market to benefit market operators, brokers, corporate entities and their promoters and managements. Certain banks, notably private and co-operative banks, stock exchanges, overseas corporate bodies and financial institutions were willing facilitators in this exercise. The scam lies not in the rise and fall of prices in the stock market, but in large scale manipulations like the diversion of funds, fraudulent use of banks funds, use of public funds by institutions like the Unit Trust of India (UTI), violation of risk norms on the stock exchanges and banks, and use of funds coming through overseas corporate bodies to transfer stock holdings and stock market profits out of the country. These activities went largely unnoticed. While the stock market was rising, there was inadequate attempt to ensure that this was not due to manipulations and malpractices. In contrast, during the precipitous fall in March 2001 the regulators showed greater concern. Another aspect of concern has been the emergence of a practice of non-accountability in our financial system. The effectiveness of regulations and their implementation, the role of the regulatory bodies and the continuing decline in the banking systems have been critically examined, for which the regulators, financial institutions, banks, Registrars of Co-operative Societies, perhaps corporate entities and their promoters and managements, brokers, auditors and stock exchanges are responsible in varying degrees. The parameters of governmental responsibility have also been taken into account.

It is the considered view of the Committee that the lack of progress in implementing the recommendations of the last Joint Parliamentary Committee set up in 1992 to enquire into Irregularities in Securities and Banking Transactions emboldened wrong-doers and unscrupulous elements to indulge in financial misconduct. The Special Cell constituted by the Ministry of Finance in June 1994 to investigate the nexus between brokers and industrial houses in pursuance of the recommendation of the previous Committee having gone defunct since 22 May 1995, without coming out with anytangible findings or recommendations for remedial action, is one of the examples of apathy on the part of different agencies and departments concerned. The Committee express their concern at the way the supervisory authorities have been performing their role and the regulators have been exercising their regulatory responsibilities. That the regulatory bodies failed in exercising prudent supervision on the activities of the stock market and banking transactions, became evident during the course of evidence taken by the Committee and this has been detailed in the succeeding chapters. In the Committee's view no financial system can work efficiently even if innumerable regulations are put in place, unless there is a system of accountability, cohesion and close cooperation in the working of different agencies of the government and the regulators. In August 2001, after the freeze by UTI in US-64 unit repurchases, the Committee were additionally mandated by Parliament to enquire into UTI matters. The Committee find that weaknesses in management and regulations of stock exchanges was compounded by serious management deficiencies in the UTI and financial institutions.

B4)Mr R Janakiraman's (Ex Deputy Governor of RBI) views on the Reoccurrence of a Security Scam in India and Corporate Governance in this regard.

"New brains are out to circumvent rules in the system. Politicians and politics have a major role to play. They is a pressure in PSUs to hire every X, Y and Z and hence overstaffing and inefficiency. They have become more commercial in operations. These workers are also inefficient and have no incentive to work hard. As much as how good work is not rewarded so are mistakes not found out and corrected. While people in major banks are paid less they have no initiative to work hard. In order to prevent another scam from happening a more comprehensive set of guidelines have to be prepared. Master Circulars have to be made available to bankers so that they work honestly and efficiently. In India justice is so much delayed and people often fall into old ways without following guidelines."