Chapter III

Regulation of Indian Securities Market

In this chapter we first present an overview of the structure and organization of the Indian securities market. We then examine the key elements of the regulation of the securities market as a whole. This will serve as a background in which we examine the working of the primary market.

3.1 Participants in the Indian Securities Market

The Indian securities market comprises a wide range of institutions as may be seen from the table below.

Institution Type (as on March 31, 2007)	**Nos**
Securities Appellate Tribunal	1
Regulators	4
Depositories	2
Stock Exchanges	
With Equities Trading	22
With Debt Market Trading	2
With Derivative Trading	2
Brokers	9443
Of which Corporate Brokers	4076
Sub-brokers	27894
Foreign Institutional Investors (FIIs)	996
Portfolio Managers	158
Custodians	11
Registrars to an Issue / Share Transfer Agents	82
Primary Dealers	17
Merchant Bankers	152
Bankers to an Issue	47
Debenture Trustees	30
Underwriters	45

Venture Capital Funds	90
Foreign Venture Capital Investors	78
Mutual Funds	40
Collective Investment Schemes	--

Source : National Stock Exchange of India Ltd.[51]

While the Bombay Stock Exchange has been in operation since 1878, as noted by S.T. Gerela,[52] the securities markets have expanded since the reform process in 1991 in terms of daily turnover on the stock exchanges, the number of listed companies, market capitalisation and the number of domestic and foreign institutional investors and retail investors. The large number of retail investors who participate in the securities market directly (19 million investors) or indirectly (through mutual funds – 23 million investors)[53] - makes the securities market important from a public policy perspective.

3.2 Regulatory Structure

Five agencies have a significant regulatory influence, directly or indirectly, over the securities markets in India currently. These are

- o The Board of Company Law Administration (Company Law Board or CLB) which is responsible for the administration of the Companies Act, 1956[54]. This has been replaced by the National Company Law Tribunal (NCLT), vide the Companies (Second Amendment) Act, 2002.[55]
- o The Reserve Bank of India (RBI) which is primarily responsible, inter alia, for the supervision of banks and money markets

[51] National Stock Exchange of India Ltd., "Indian Securities Market Review". Mumbai (2007).
[52] S.T. Gerela, The Working of the Stock Exchange, Mumbai, Mumbai, The Stock Exchange Mumbai (2003).
[53] National Stock Exchange of India Ltd., "Indian Securities Market Review". Mumbai (2002).
[54] Constituted under Section 10E of the Companies Act, 1956
[55] The Company Law Board was dissolved by S 10 FA of the aforesaid Amendment Act; however due to litigation pending in the Apex Court the NCLT could not be constituted. Consequently the Company Law Board is still in operation.

Securities and Exchange Board of India (SEBI) which is responsible for the regulation of capital markets and the various participants and activities therein.[56] In addition to the functions of SEBI under SEBI Act, many of the powers of the Central Government under various provisions of the Companies Act, 1956 have been transferred to SEBI in the case of listed public companies insofar as they relate to the issue and transfer of securities and non-payment of dividend.[57] Further, many powers of the Central Governmentt under the Securities Contract Regulation Act 1956, SEBI Act 1992, Depositories Act 1996are now vested in the SEBI.

- Department of Economic Affairs (DEA) which is responsible for the economic management of the country and is the arm of the government that is concerned with the orderly functioning of the financial markets as a whole
- Ministry of Corporate Affairs (MCA)[58] which is the arm of the government responsible for the administration of incorporated entities.

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[56] Ss 11, 11A, 11 AA, 11B, 11C, 12 and 12A of the Securities and Exchange Board India Act, 1992, (SEBI Act, hereafter).

[57] See S 55A of the Companies Act, 1956 (Ins. by Act 53 of 2000, sec. 16, w.e.f. 13-12-2000), which reads as follows:

The provisions contained in sections 55 to 58, 59 to 84, 108, 109, 110, 112, 113, 116, 117, 118, 119, 120, 121, 122, 206, 206A and 207, so far as they relate to issue and transfer of securities and non-payment of dividend shall,-
(a) in case of listed public companies;
(b) in case of those public companies which intend to get their securities listed on any recognized stock exchange in India,
be administered by the Securities and Exchange Board of India; and
(c) in any other case, be administered by the Central Government.
Explanation.- For removal of doubts, it is hereby declared that all powers relating to all other matters including the matters relating to prospectus, statement in lieu of prospectus, return of allotment, issue of shares and redemption of irredeemable preference shares shall be exercised by the Central Government, [2][Tribunal] (Substituted by Act 11 of 2003, sec. 9, for "Company Law Board") or the Registrar of Companies, as the case may be.]

[58] Formerly known as the Department of Company Affairs

Of these, the agency that is directly charged with the supervision of the capital markets in India is SEBI. The working of SEBI is the primary focus of this chapter.

3.3 Securities Market Regulation prior to SEBI

Prior to the establishment of SEBI stock exchanges were under the administrative control of the Stock Exchange Division of DEA. The stock exchange division was responsible for the administration of the Securities Contract (Regulation) Act, 1956 (hereinafter referred to as SCRA) which governed the business of buying, selling and dealing in securities.

The mobilization or issuance of capital through the public securities market or otherwise was regulated by the Controller of Capital Issues (CCI), an authority of the Central Government. The CCI had to fulfill several social and economic objectives in the discharge of its functions such as[59] (i) public investor protection; (ii) alignment of corporate investments with plan priorities; (iii) ensuring that the capital structure of companies was sound and in public interest (iv) ensuring that undue congestion of public issues did not occur in any part of the year; and (v) regulation of foreign investment. The CCI's means of realizing these objectives included (i) micro-management of the securities issuance process (ii) centralised administration and cumbersome procedures and (iii) Tight controls on quantum of issue, terms (price and non -price) and even timing of issue. The CCI regime thus represented an extreme instance of "merit regulation". The net result of the CCI regime was that it (i) impeded resource mobilization (ii) led to unhealthy administrative practices (iii) resulted in the inability of the system to cope with the increasing resource mobilisation load (iv) led

[59] Based on a review of the Controller of Capital Issues Act,

to the development of a grey market and consequent unhealthy developments in the capital market and (v) paid little or no attention to the development of institutions in the capital market.

With the benefit of hindsight one might conclude that the CCI appears to have suffered from many drawbacks. However, the role of CCI would have to be seen in the context of the political economy that prevailed at that time, with the government assuming a large role in the allocation of resources, an overarching concern with distributive goals and the relatively inadequate level of development of institutions that could have supported a market economy.

3.4 The Legal Levers that SEBI Operates

In this section we look at the two pieces of statute that SEBI draws upon to discharge its statutory roles. These are the Securities and Exchange Board of India Act, 1992 (SEBI Act hereafter) and the Securities Contract Regulation Act, 1956 and the rules made thereunder. We briefly survey how these provisions enable SEBI to regulate the capital market.

3.5 Securities and Exchange Board of India Act, 1992

SEBI was brought into existence by the Securities and Exchange Board of India Act, 1992 (the SEBI Act, hereafter), which came into effect on January 30, 1992. The preamble to the act describes the purpose of the Act in broad terms as "an act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto". The provisions of the SEBI Act define its role in more specific terms.[60] The provisions states that it shall be the duty of SEBI to protect the interest of investors in securities and promote the development of and to regulate the securities market by such measures as it thinks fit. These broadly relate to (i) Regulating the business in stock exchanges and any other securities markets (ii) Registration and regulation of a range of financial intermediaries and trade participants (iii) Prohibiting practices that are considered to be unhealthy for development of the securities market such as insider trading and fraudulent and unfair trade practices for promoting and regulating self regulatory organisations (iv) Promoting investors education and training of intermediaries of securities markets (v) Inspection and calling for information from various regulated entities referred to in (ii) above (vi) Conducting research (viii) Collecting fees or other charges for carrying out the purposes of this section and (ix) Performing such other functions as may be prescribed.

However, the provision states at the outset, while delineating these areas that the spelling out of specifics areas of concern is without prejudice to the generality of the earlier part of the section. Thus, should SEBI find that development of a particular facet of the market is important SEBI would be at liberty to concern itself with that facet *suo motu,* even though that has not been spelt out in the areas above that are of concern to SEBI.

3.5.1 Scope and source of SEBI's authority

The wide coverage of these powers may be observed from three other aspects. First, SEBI is empowered to perform such functions and exercising such powers under the provisions of the SCR Act as may be

[60] Ss 11(2),. 11 (2A), 11(3), 11(4), 11A, 11AA, 11B, 11C, 11D, 12 and 12A of SEBI Act

delegated to it by the central government.[61] Secondly, the SEBI Act leaves open the room for SEBI to perform such other functions as may be prescribed.[62]

The other principal source from which SEBI draws authority is the Companies Act[63] which empowers SEBI to administer a number of provisions of the Companies Act[64] insofar as they relate to issue and transfer of securities and nonpayment of dividend in the case of listed companies, as well as those public companies which intend to get their securities listed on any stock exchange.[65] These sections pretty much govern the capital mobilization process (issuance of capital), liquidity creation process (transfer) and the realization of return (dividend), the three important aspects of the issuer's relationship with investors. Further, unlisted companies are now allowed to list their debt securities without listing their equity securities.[66] Thus the provisions of the Companies Act to be administered by SEBI will now extend to those companies whose debt securities are listed even if their equity shares may be closely held, should these companies be considered as listed companies as indeed they ought to be. As noted earlier, companies which propose to expand their equity shareholder base to more than fifty members will be deemed to have made a public offer.[67] As such companies which have more than fifty members should fall under the

[61] S 11(2)(j) of the SEBI Act
[62] S 11(m) of the SEBI Act
[63] S 55A of the Companies Act inserted by the Amendment Act 2000
[64] The sections identified are Sections 55 to 58, 59 to 84, 108, 109, 110, 112, 113, 116, 117, 118, 119, 120, 121, 122, 206, 206A and 207 of the Companies Act.
[65] The sections of the Companies Act above relate to procedure for issue of prospectus, and the contents mandated by the company law, authorization and responsibility of those authorizing the issue of the prospectus, procedure for allotment of shares and debentures, payment of brokerage and commission, buyback of shares, issue of shares at a premium or discount, further issue of capital (rights or otherwise), issue and redemption of preference share capital, administration of share capital (such as numbering, certificates and so on) transfer of shares and certification of shares, provisions relating to issue of debentures and protection of debentureholders such as creation of trust and redemption reserve and payment of dividend.
[66] Regulation 8.2 of SEBI's (Disclosure and Investor Protection) Guidelines, 2000 as amended
[67] S 67(3) of Companies Act

regulatory purview of SEBI since all companies that intend to make a public offer are required to get their shares listed on a recognized stock exchange.[68]

3.5.2 SEBI's regulatory strategy

The principal approaches resorted to by SEBI for achieving its objectives as a regulator are (i) Registration and licensing of market participants (other than investors) (ii) Mandating disclosure of information by issuers, various intermediaries and participants (iii) Making rules governing the conduct of market participants (iv) Enforcement of compliance with the rules through (a) Collection of information (b) Inspection of intermediaries' business and records (c) Penal action against errant participants, where appropriate or necessary (v) Market development initiatives (vi) Investor protection and education initiatives.[69] We discuss all but the last two aspects in this section.

3.5.2.1 Registration and Certification

Under the SEBI Act, SEBI licenses various market participants such as stockbrokers, sub-brokers, merchant bankers, bankers to the issue, depositories, depository participants, custodians, credit rating agencies, mutual funds, venture capital funds, foreign institutional investors and collective investment schemes and so on. Further SEBI lays down regulations governing their business. Typically these regulations, inter alia, specify conditions relating to the size, capital adequacy, business conduct, record keeping and so on.

[68] Proviso to 67(3) of Companies Act, 1956
[69] These are based on the provisions of S 11 of SEBI Act

3.5.2.2 Mandating disclosure of information

Disclosure of information in the primary market is mandated by the Companies Act, 1956 as well as by the rules and regulations or the guidelines under the SEBI Act and the listing agreements of the stock exchanges.

3.5.2.2.1 Disclosure requirements under the SEBI Act, allied rules and regulations

SEBI mandates governing disclosure extend to several facets of a company's working. In this thesis we focus on disclosure at the time of a public offering of securities. These requirements are spelt out in SEBI's guidelines governing issuance of securities. At the same time, SEBI mandates a set of continuing disclosure requirement through the listing agreements of the stock exchanges[70]. Two reasons may be advanced in favour of driving disclosures through SEs. First, prior to the advent of SEBI, SEs have historically collected this information as part of the listing agreement. Second, SEs are likely to be better equipped than SEBI to speedily acquire and disseminate this information, which is price sensitive. Thus it makes sense for SEBI to continue that arrangement. SEBI further requires intermediaries associated with the capital markets to provide information related to the transactions that they are associated with, compliance with which is mandatory.[71]

[70] Clause 41 of the listing agreement mainly which relates to publication of financial information and Clause 36 which relates to disclosure of developments of a material nature.

[71] These are under the various rules and regulations governing the conduct of the respective type of intermediary.

In the absence of regulatory compulsion there would be under-production of information, as has been witnessed in the case of market for privately placed debt.

3.5.2.3 Making rules and Issuing Directions

The SCR Act and Rules and the SEBI Act empower SEBI to make rules and regulations. The regulatory powers under SCRA were originally conferred on the Central Government; but most of them were subsequently transferred to SEBI exclusively or concurrently with the Central Government.[72] The power of the Central Government to make rules cannot however be delegated. The SEBI Act provides for SEBI "to make regulations consistent with this Act and the rules made there under to carry out the purposes of this Act."[73] SEBI may issue directions to intermediaries in the market as well as issuers so as to protect investors or to ensure proper management of the intermediary's affairs.[74]

3.5.2.4 Compliance Enforcement

In addition to being armed with powers to enforce compliance with the rules and regulations that it makes SEBI has been provided powers to administer the relevant parts of the Companies Act and SCR Act. For eg., SEBI is empowered to carry out inspection of listed companies to the extent that it is necessary for enforcement of the provisions that it is responsible for[75]. SEBI is also empowered to lodge a complaint to

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[72] See S 3 (application for recognition of the SE), S 4 (grant of recognition of the SE), S 5 (withdrawal of recognition), S 7 (annual report to be furnished by SE), S 11 (power to supersede the governing body of recognized SE), S 12 (power to suspend the business of recognized SE), S 13 (contracts in notified areas), s 16 (power to prohibit contracts in certain areas), S 17 (licensing of dealers in securities) andS 18 (2) (control of spot delivery contracts).
[73] S 30 of SEBI Act and S 11, 11A and S 30 of the SEBI Act
[74] S 11B of SEBI Act
[75] S 209 A (1) (iii) read with the proviso to the subsection. The SEBI's power of inspection shall be confined to matters covered by S 55A of the Companies Act, 1956.

initiate legal proceedings in a court against listed companies in respect of the provisions of the Companies Act that it is responsible for.[76] Further, SEBI is also authorized to file criminal proceedings in respect of the offences under SCRA[77] and SEBI Act.[78] Under the SEBI Act, only SEBI has the authority to file a criminal complaint in respect of offences under the Act and under the Depositories Act, 1996.[79]

Under the SEBI Act, the Board has the power to call for periodic information and undertake routine or one-off inspections of the books of intermediaries, records, facilities and premises, and conduct audits and inquiries.[80,81] During the course of an investigation SEBI is empowered to call for information and record statements from any bank or any other institution established under a state, central or provincial statute insofar as it relates to a transaction in securities, which is under investigation.[82] SEBI's information gathering activities go beyond these formal and official channels as in the case of public issues for eg., where it gathers information from a variety of other non official sources. As an emergency measure, pending the investigation or completion of inquiry SEBI may order the suspension of trading of a security on a stock exchange, restrain persons from accessing the securities market, buy sell or deal in securities or suspend office bearer(s) of stock exchanges or SROs, impound or retain securities

[76] Second proviso to s 621(1) of the Companies Act 1956. SEBI's locus standi to launch prosecution is confined to offences relating to the issue and transfer of securities and non payment of dividend.

[77] S 26 of SCRA

[78] S 26(2) of SEBI Act and S 26 of SCR Act. The offences under these Act may be tried by a court not inferior to that of the magistrate of the first class]

[79] S 22 of SEBI Act.

[80] S 11(2)(i) of SEBI Act and S 11C(8) of SEBI Act

[81] Powers to inspect the books of a company under grounds of suspected insider trading or unfair trade practices is exercisable under section 11(2A) of SEBI Act. In case the books and records required are not made available by the issuer by the intermediaries or issuer concerned SEBI may seek permission from a first class magistrate to enter the premises of the business concerned and seize such records as necessary.

underlying the transaction being investigated or attach bank accounts with magisterial permission.[83]

In case the information gathering, inquiry or inspection exercises reveal non-compliance with the provisions of the SEBI Act, rules or regulations, SEBI has powers under the SEBI Act as well as the rules and regulations thereunder to enforce compliance, deter continued or further non-compliance or cure any breaches in the compliance through a series of measures ranging from passing strictures and issuing warnings to the non-compliant participants, to enforcing reversal of non-compliance to imposition of fines, suspension of the delinquent intermediary from the market, cancellation of licenses or in instances of grave violation to prosecute the violator. But the criminal proceedings have to be tried in a court not inferior to that of a court of sessions.[84] Finally, the SEBI Act provides for a set of monetary penalties for most of the major violations of the regulations.[85] It is interesting to note that the SEBI Act may be one of the few laws, if not the only one, that provides for disgorgement of profits made out of practices that violate the law.[86] To enforce the powers vested under the SEBI Act and many of the related regulations, including the Depositories Act, 1996, SEBI has been conferred the powers of a Civil Court, governed by the Court of Civil Procedure, 1908 in respect of matters specified in SEBI Act.[87,88]

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[83] [S 11(4) of SEBI Act]
[84] The procedure for carrying out these inquiries and warding penalties under the SEBI Act and the related rules, regulations and guidelines are provided for under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002. These regulations specify a uniform set of procedures to be followed across the entire set of rules and regulations made by SEBI or related to SEBI.
[85] S 15A to S 15HB of the SEBI Act
[86] S 15HA which levies penalty for fraudulent and unfair trade practices.
[87] Matters specified in S 11(3) of SEBI Act
[88] The powers referred to in S 11(3) of SEBI Act relate to (i) Discovery and production of books of account and other documents, at such place and such time as may be specified by the Board (ii) Summoning and enforcement of attendance of persons and examining them on oath (iii) Inspection of books, registers and other documents of any person referred to in S 12 of SEBI Act (iv) inspection of any book, or register, or other document or record of the company

3.5.2.5 Review and Appeal Mechanism

A person aggrieved by an order of SEBI or by an adjudicating officer under this Act may appeal to the Securities Appellate Tribunal.[89] The SAT may confirm, modify or set aside SEBI's order or that of the adjudicating officer.[90] An appeal against an order of the SAT would lie at the Supreme Court (SC). The provisions relating to the appointment of the Presiding Officer and other members of SAT and restrictions on movement of personnel from SEBI to SAT are meant to ensure an arm's length relationship between the regulator and the appellate body and that the SAT plays the role of an independent agency.[91]

3.6 The Securities Contract Regulation Act and Rules

Trade in securities in India has been regulated primarily through the Securities Contract Regulation Act, 1956 (14 of 1956) (SCR Act, hereafter) and the rules made thereunder, namely, the Securities Contract Regulation Rules, 1956 (SCR Rules, hereafter). The object of the SCR Act is to provide for the regulation of stock exchanges and of securities dealt with thereat with a view to maintaining a healthy market and preventing undesirable speculation in them. It also regulates the buying and selling of securities outside stock exchanges through its various provisions. The post war boom in the stock exchanges between 1945 and 1946 and its aftermath emphasized the urgency of stock exchange reform on an all-India basis. Two

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referred to in Section 12(2A) of SEBI Act and (v) Issuing commissions for the examination of witnesses or documents.

[89] S 15T of SEBI Act

[90] Appointed under S 15 Iof SEBI Act, 1992

[91] In the SEBI Act, S 15L SEBI deals with the appointment of the members and the presiding officer of SAT, 15M provides restrictions on appointment of serving and former officers of SEBI to SAT.

debt securities without listing their equity instruments [98]would fall under the regulatory purview of the SCR Act.

The principal elements of the regulatory role of SCR Act are[99] : (i) Licensing of stock exchanges[100] (ii) Limiting and prohibiting contracts in securities to defined constituencies, geographical areas or trading fora[101] (iii) Controlling of stock exchanges[102] and (iv) Control over the Listing Agreement. We will discuss each of these elements in some detail and analyse the purpose they serve on the basis of the framework outlined earlier. Many of these powers have now been vested with SEBI. Hence we discuss these as powers to be exercised by SEBI.

3.6.1 Licensing of Stock Exchanges

Contracts in securities may be entered into and performed only on recognized stock exchanges.[103] The power to grant recognition stock exchanges has been vested in SEBI,[104] which may be accorded in response to an application in the form prescribed for that purpose

[98] Under Regulation 8.2 of the Disclosure and Investor Protection Guidelines 2000, as amended

[99] For immediate reference the relevant section numbers have been mentioned in the footnotes here. They have also been mentioned in the appropriate places in the discussions that follow.

[100] S 3 of SCR Act. The application for grant of recognition is to be made to SEBI in the format given in the SCR Rules.

[101] Ss 13 and 16 of SCR Act

[102] Ss 8, 9(1),10 and 11 of SCR Act

[103] S19 (1) of the SCR Act which provides as follows: No person shall except with the permission of the Central Government, organize or assist in organizing or be a member of any stock exchange (other than a recognized stock exchange) for the purpose of assisting in, entering into or performing any contracts in securities.

[104] S 4 of SCR Act: The application for grant of recognition Under S 3 of the SCRA the application for grant of recognition is to be made to SEBI in the format given in the SCR Rules. However, many of the powers exercisable by SEBI are actually concurrent with those of the central government. (A list of such powers is provided at the end of this note in Annex I. In these discussions all powers exercisable by SEBI are concurrent with the central government unless stated otherwise. Many of such powers have been delegated by the Central Government to SEBI under S 29A of the SCR Act.) The power to grant recognition has been delegated to SEBI vide Press Note dated 13-9-1994 issued by the Department of Economic Affairs.

amendments in 1995 and 1999[92] brought about several important changes to the scope and the administration of the SCR Act, resulting in the current form of the law.[93] One of the more significant of the amendments that were made was in 2004.[94] The SEBI Act and the SCR Act, together with the Rules and Regulations thereunder, provide the basic legal framework for the regulation of the securities market in India, while the Companies Act provides the legal framework for the administration of body corporates in India.

The statutes[95] provide an inclusive and broad definition of "securities" as "shares, scrips, bonds, debentures, debenture stock or other marketable securities of a like nature". The definition covers derivatives, units of collective investment schemes (such as mutual funds) and government securities.[96] Courts have interpreted the term "marketable" to include shares that are freely transferable even if they are not listed on a stock exchange.[97] Further, the SCR Act deals with contracts in securities and hence those companies that list only their

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[92] Securities Laws (Amendment) Act 1995 and Securities Laws (Amendment) Act 1999 respectively

[94] Securities laws (Amendment) Act 2004, which provided for corporatization and demutualization of stock exchanges

[95] S 2 (44AA) of Companies Act, S 2(i) of SEBI Act, S 2 (h) of SCR Act. The first two statutes provide that the term has the same meaning as that given in the SCR Act and the latter resorts to an inclusive definition. S 2(h) of SCR Act defines securities as "shares, scrips, bonds, debentures, debenture stock or other marketable securities of a like nature" and covers derivatives, units of collective investment schemes (such as mutual funds) and government securities.

[96] S 2(h) of SCR Act reads as follows:
"Securities" include –

> (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
> (ia) derivative;
> (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes
> (ii) Government securities;
> (iia) Such other instruments as may be declared by the Central Government to be securities; and
> (iii) rights or interests in securities

[97] See (1980) 2 Cal HN 205 (208) : 84 Cal WN 876

along with necessary enclosures, if SEBI feels that the granting of the license is the in the interests of the trade as well as the public.[105] The process of licensing has important economic, legal and policy implications. Licensing provides the stock exchange a monopolistic position.[106] At the same time the fact that the stock exchange is also deemed to be a statutory body with a public duty ameliorates the risk of arbitrary behaviour by the exchange as a monopolist in the conduct of its business.[107]

3.6.2 Limiting and prohibiting contracts

SEBI may notify that in a particular state or area every contract which is entered into after the date of the notification has to be between, through or with members of a recognised stock exchange.[108] Failure to comply with this would make the contract illegal.[109] SEBI may also prohibit contracts in certain notified securities in notified areas (other than those notified under S 13 as above) to be carried out by persons who have been licensed by the central government. In addition, the Central Government has the power to notify contracts in certain circumstances as void,[110] prohibit members from acting as principals[111] and the power to prohibit contracts in certain cases.[112] The provisions limiting or prohibiting contracts have been invoked by the Central Government in the past on many occasions against what was felt to be build up of unhealthy speculative activities or positions, with the

[105] S 3 of the SCR Act.
[106] Radhakrishnan vs Cochin Stock Exchange Ltd. (1994) 80 Com Cases (Ker).
[107] AIR 1996 Andh. Pra 413
[108] S 13 of the SCR Act
[109] The distinction between an illegal contract and a void one is that in the former case allied transactions are also treated as void. Further, any consideration passed under an illegal contract is not recoverable. (There are a few exceptions to this rule under general law.) Thus investing public who are not aware of the "illegality" of the transactions in violation of S 13 would be detrimentally affected by the provision.
[110] S 14 of SCR Act
[111] S 15 of SCR Act
[112] S 16 of SCR Act

prospect of leading to loss of investor welfare and eventually loss of investor confidence in the securities market system.

3.6.3 Controlling Exchanges

SEBI has the power to direct stock exchanges *suo motu* to make rules or to draft rules wherever it deems necessary.[113] SEBI has also been conferred power to make rules or amend the rules of any recognized stock exchange in certain circumstances.[114] The power originally conferred on the Central Government is now exercisable by SEBI. SEBI has to approve the bye-laws of a stock exchange before they came into effect.[115] SEBI may direct changes to be made to all or any of the provisions of the bye-laws where it feels the need for the same.[116] Further, where appropriate, SEBI may supercede the governing body of the stock exchange, or, in an "emergency"[117] SEBI may direct that the business of the stock exchange be suspended for a period of seven days to begin with and for subsequent periods of seven days at a time if it feels that it will be in the interests of the trade and public interests to do so.[118] Thus SEBI has a wide range of tools at its disposal to control the affairs of stock exchanges, from controlling the key levers of the management and administration of the business to bringing the conduct of business to a halt for such lengths of time as it finds necessary. The important aspects of the functioning of a SE that are subject to SEBI's control are discussed briefly below.

[113] S 8 of SCR Act
[114] S 8(2) of SCR Act 1956. This is when the stock exchange concerned to which direction under subsection(1) was given did not comply with the order of SEBI.]
[115] S 9(1) of SCR Act
[116] S 10 of SCR Act
[117] S 11 of SCR Act
[118] S 12 of SCR Act

3.6.3.1 Bye-Laws of Stock Exchanges

The bye-laws are the basic contract that governs the conduct of the members of an exchange inter se, as well as the conduct between the members and the management of the exchange and between issuers and the exchange.[119] By requiring that the bye-laws require SEBI's approval and allowing SEBI to amend the bye-laws through the management of the exchange or through fiat, SEBI wields control over nearly every facet of the functioning of the exchange. The SCR allows SEs to differentiate themselves through the bye-laws that govern their functioning. This scope for differentiation probably does not amount to much in practice though. However, as we shall see later, SEBI has been setting minimum standards for the exchanges on many of these aspects of the functioning of SEs by exercising its powers to modify the bye-laws as in the case of trading and settlement systems.

The enforcement of uniformity of organization and business standards has also been the basis for some criticism of the move to demutualise SEs. Vide an ordinance in 2004 all SEs were required to corporatise and separate ownership from trading. The case for corporatisation demutualisation gathered momentum with the success of the NSE; but the proposal was nonetheless widely debated in the business media. The reasons in favour of demutualisation are well known: It decouples ownership from the trading activity and thereby makes the trader more accountable to the investor for whom he is executing the trade. It thus

[119] As noted above, the bye-laws allow the exchange management to lay down the business rules on the exchange relating to matters such as trading hours, establishing of clearing and settlement mechanisms, terms and conditions of contracts, consequences of default or insolvency, criteria for and conditions of listing of securities, brokerage terms, separation of functions of jobbers and brokers, dealings of brokers on their own accounts and providing of information by brokers to the governing body.

mitigates an important conflict of interest that the BSE and many of the regional SEs had often been accused of.

The criticism has centred on two grounds.[120] One, mandating demutualisation as the only permissible form of organizing SEs stifles innovations in the organization of securities trading. In the process the regulation is taking away at least one lever of competition from the industry. The alleged ills of the mutual form of ownership, this line of reasoning argues, may be addressed through appropriate regulation intended to curb such abuse. Second, demutualisation comes at a substantial cost. This cost is an avoidable burden for many of the SEs, especially the regional ones which have been struggling for a share of the securities trading business after the advent of the national markets under NSE and the Stock Exchange, Mumbai. Instead, the latter argument proceeds to suggest, the regulator would have done well to think about addressing the future of these struggling regional SEs. While the argument about stifling organizational innovation appears to hold some merit the latter argument about cost does not come across as such a convincing reason against demutualisation. Much more importantly the decision does not seem to have been preceded by a rigorous examination of whether it was the ownership structure that contributed to the success of the NSE as much as the ownership of the Stock Exchange Mumbai is touted to have contributed to the many problems faced by the investors trading on the latter exchange.

In the absence of such research one may at best conclude that the jury is out on whether in the Indian context demutualisation will deliver the expected results.

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[120] This discussion is based on M S Narasimhan, "Demutualisation of stock exchanges.", The Hindu Businessline, November 22, 2004 and G.Ramachandran and Ramachandra, "Will decreed demutualisation deliver?", The Hindu Businessline, July 17, 2003.

3.6.3.2 Information, Investigation, Offences and Penalties

SEBI has the right to call for periodical returns[121] as well as annual reports.[122] Where the need arises in the interests of the public or the trade, SEBI has the right to initiate an inquiry into the affairs of individual members of the stock exchange or the stock exchange as a whole.[123] If in the interests of the trade or the public, the Central Government feels the need, it may ask for an inquiry into the affairs of a stock exchange by SEBI or an inquiry into the affairs of an individual member by the governing body. Finally, SEBI may withdraw recognition to the stock exchange, if it is convinced that it is necessary to do so in the interests of the trade or in public interest.[124]

The SCR Act specifically recognizes a few offences, which are deemed to be a cognizable offence under the Code of Criminal Procedure.[125]

3.6.3.3 Ensuring market integrity

In the process of granting the license SEBI is expected to ensure that the applicant has the infrastructure and that its charter documents such as the bye-laws have provisions to conduct the business of securities trading in an orderly manner. The bye-laws provide the mandate to the

[121] S 6 of the SCR Act
[122] S 7 of the SCR Act
[123] S 6(3) of the SCR Act
[124] S 5 of SCR Act
[125] S 25 of the SCR Act. The offences are unwillingness to co-operate in an investigation by the central government of the affairs of a stock exchange, contracting in contravention of the restrictions in certain areas or restrictions on certain types of contracts discussed earlier, owning or managing a place for the purpose of carrying on trading in securities other than a recognized stock exchange or gathering at a place other than the place of business specified in the bye-laws of the stock exchange, and inducing people that they can invest through oneself or advertising for securities business when one is not a member of a recognized stock exchange or a dealer licensed under S 17 of the SCR Act. These offences can be punished with imprisonment of up to one year or fine or both.

stock exchange to frame appropriate rules, the type of order system that the exchange may adopt, rules for qualifications for brokers, the kind of trading systems that the exchange may adopt, clearing and settlement procedures, criteria for listing and so on. The bye-laws empower the stock exchange to deal with the issue of counter-party risks in a variety of ways. By providing a framework of rules that deal with the issue of defaults and procedure for dealing with defaults (such as auctioning of defaulting parties position) the bye-laws can mitigate counter party risk at individual traders' level. By providing for appropriate documentation of trades executed by brokers on behalf of clients, the exchange can improve the confidence level of investors trading on that exchange. Exchange level crises may be avoided by providing for margining systems, monitoring the position of brokers and dealers so as not to let them build positions that can increase the risk of an exchange level default and providing for a settlement and trade guarantee fund that will minimize the risk of loss due to an exchange wide crisis. Notionally, the bye-laws as provided for on the books allow for a great deal of differentiation among the exchanges.

3.6.3.4 Production and Dissemination of Information

Similarly, in the area of information disclosure SEBI has driven the content and the frequency of the continuous disclosure regime. Continuous disclosure requirements are governed by Clause 41 of the Listing Agreement. Instantaneous dissemination of related information is now possible now thanks to information technology. Disclosure by issuers at the time of listing largely comprises the disclosure in the prospectus. SEBI has specified these requirements in detail in the DIPG which we discuss later in this thesis. The basic provision requiring the issue of a prospectus are in S 58 of the Companies Act, 1956 and format for disclosure are in Schedule II of the Companies

Act. [The listing agreement requires more of supportive documentation such as copies of contracts and records and does not require much additional substantive content by itself that is not already included in the prospectus or offer document.] At the trading level the exchange can minimize instances of trading on the "kerb" or off market transactions which may result in incomplete information flowing through to the rest of the market. The exchange may on its own, or under a SEBI directive, prohibit certain specific types of trades or trading practices in case they hinder the flow of information and consequently or otherwise affect the microstructure of the market. For eg., SEBI directed that bulk deals which were getting executed outside the market trading mechanism be routed through the electronic trading systems of the stock exchange so that the information may be absorbed immediately by the market. [126] The exchange may also invest in market surveillance systems which could help detect insider trading or market manipulation transactions.

3.6.3.5 Minimising transaction cost

Transaction costs, as we noted earlier, consist of direct costs such as brokerage and indirect costs such as illegitimate gains of the broker (in not passing on the benefits of the best price or in simply misreporting the purchase or sale price of the order), the cost of funds blocked due to the settlement cycles or delays at the issuer's end by delaying or mishandling the transfer of securities. The bye-laws provide enough

[126] Vide circular No. SEBI/MRD/SE/Cir-7/2004) dated January 14, 2004. The circular defined a bulk deal as deal consisting of "all transactions in a scrip (on an exchange) where total quantity of shares bought/sold is more than 0.5% of the number of equity shares of the company listed on the exchange." The effect of this order was sought to be mitigated by an order (No MRD/DoP/SE/Cir- 19 /05 dated September 2, 2005), which provided for block deals, as opposed to bulk deals, as follows. In order to facilitate execution of such large trades, the stock exchanges are being permitted to provide a separate trading window. A trade, with a minimum quantity of 5,00,000 shares or minimum value of Rs.5 crore executed through a single transaction on this separate window of the stock exchange will constitute a "block deal" as distinguished from "bulk" deal defined earlier.

leverage to fix brokerage rates, form operational procedures and rules that will force brokers to provide the break up of the purchase price and the brokerage (in the contract note) and install an electronic trading system which will help the client ensure that the price of his trade has not been misreported to him by the broker. The minimum offer to the public and conditions for continued listing essentially are aimed at ensuring a minimum floating stock of the company's securities in the market. A minimum non-promoter holding just by itself does not ensure the level of liquidity that is required to bring down impact costs. However, it is a first step in that direction. Stock exchanges could also look at other liquidity enhancement measures such as market making that will reduce impact costs. These are within the purview of the exchange's business policies. The Over The Counter Exchange of India (OTCEI), for eg., has always required issuers to provide for at least market makers, with some minimum performance conditions thrown in.[127] Many of the initiatives at the SE level have been driven by SEBI.

3.6.4 Issuer Conduct with Investors

[127] The following discussion is based on information available at the OTCEI website. The most important feature of the OTCEI listing and trading rules is the role accorded to the sponsor.

The OTCEI describes the role of a sponsor as follows: "Every company that intends to get listed has to be sponsored by a merchant banker (Member/ Sponsor) of the Exchange."

The relationship between the sponsor and the issuer is governed by the sponsorship agreement. The agreement is an important precursor to the subsequent steps on the listing process and incorporates many of the features of the listing arrangement on the OTCEI. The sponsor has to arrange for continued liquidity in the scrip through market makers who have to give buy and sell quotes in the securities.

Market Makers are of two types: (i) Principal Market Makers (PMM) have to offer buy & sell quotes for a period of at least 18 months from the commencement of initial trading in the company's scrip and (ii) Additional Market Maker (AMM) have to offer buy and sell quotes for a period of at least one year from the commencement of initial trading.

The Principal and Additional Market Makers subscribe to such percentage of the total offer to the public as decided by OTCEI, for the purpose of market making. The OTCEI expects that apart from providing liquidity market makers will help the complement the efforts of the market in discovering the value of the scrip through their research and insight into the company. Additionally, competition among market makers will ensure that bid-ask spreads are minimized resulting in more efficient pricing.

The SCR Rules have provisions relating to allotment and transfer of shares,[128] book closure dates,[129] forfeiture of dividends,[130] and so on. These steps ensure that the management of the company does not misuse the trade and transfer or allotment process to their benefit and the detriment of the investor. Market manipulation, creation of a false market and price rigging by promoters and owner managers of companies followed by dumping of share, causing losses to the outsider investor can be mitigated by the tracking of trading patterns with the help of surveillance systems mentioned earlier. The listing agreement provides for a set of penalties for issuers who do not comply with these provisions. At the extreme this could go up to delisting the securities of the issuer.

Termination of membership of the brokers and withdrawal of listing for the securities of the delinquent issuer are two extreme options that are well within the ambit of the bye-laws of stock exchanges.

The agency problems between brokers and their clients have been discussed as part of the transaction cost. In addition, there could be conflicts between sub-brokers and the main brokers. The bye-laws allow exchange to frame rules that will make it costly for sub-brokers to act against the interest of the main broker and thus mitigate some of the agency problems.

In short, the discussion above shows that the SCR Act does, directly as well as indirectly, address the various issues or problems that could potentially impede the functioning of the securities market. The

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[128] Rule 19(3)(b) of SCR Rules, 1957
[129] Rule 19(3)(o) of SCR Rules, 1957
[130] Rule 19(2)(a)(iv) of SCR Rules, 1957

regulation leaves enough flexibility with the exchanges to make rules which will mitigate the problems at the level of individual exchanges. Further, it empowers SEBI to monitor whether exchanges play that role. Where SEs do not play that role it empowers SEBI to influence them to do so.

To what extent have stock exchanges used the powers vested in them by the bye-laws in addressing the problems that we have discussed? That is a matter for research in itself and is beyond the scope of this thesis.

3.6.5 Listing Agreement and Listing of Securities

The conditions for listing of securities are a matter that fall under the powers of the stock exchange. It is one of the matters on which the stock exchange may establish rules as part of the bye-laws.[131] As such, companies or collective investment schemes which wish to get their securities or units respectively listed on a stock exchange have to apply to the stock exchange on which they wish to get registered and comply with the necessary conditions in that regard. In case the stock exchange does not list the shares or does not communicate the decision not to list with reasons within ten weeks from the closure of the subscription list[132], the aggrieved company or the collective investment scheme may appeal to the Securities Appellate Tribunal[133]. The stock exchange's decision may be set aside or varied by SAT after hearing the stock exchange's views.

The SCR Rules specify the documents and information that a company needs to furnish to the stock exchange while seeking listing of its

[131] S 9(1)(m) of the SCR Act
[132] S 73(1) of the Companies Act
[133] S 22A of SCR Act

securities and a collective investment scheme alongwith the scheme for listing of its units.[134] Further, it may also stipulate additional conditions apart from a few basic requirements regarding the articles of association specified in the SCR Rules.[135]

Companies may offer a minimum of 10% of each of the securities sought to be listed if they satisfy the following conditions: Minimum 20 lakh securities to be offered(excluding reservations, firm allotments and promoters' contribution), minimum offer size to public of Rs 100 crores and book built issue with 60% to be offered to Qualified Institutional Buyers (QIBs). A company that does not satisfy these criteria would need to offer a minimum of 25% of the securities instead of the 10%.[136] Stock exchanges have the right to relax the minimum issue rule with the prior approval of SEBI.[137]

3.6.5.1 Consequences of violation of rules of listing agreement

A recognized stock exchange may suspend or withdraw the admissions to dealing in the securities of a company in case of non-compliance with the conditions of the listing agreement, which can be contested by the company with the Securities Appellate Tribunal.[138] In addition to the above, the SCR Rules specify a detailed set of rules that companies seeking to list need to comply with.[139] The extremely

[134] Rules 19 of the SCR Rules and Rule 20 of the SCR Act. The information sought for typically includes copy of the memorandum and articles of association, prospectus, copies of key contracts with vendors, promoters, underwriters and top management, brief terms of key commercial agreements entered into by the company, historical financial statements of the company, copies of all documents and reports referred to in the prospectus, copies of acknowledgement card from SEBI, list of ten largest holders of each class of securities and so on.
[135] Rule 19 (2)(a) of the SCR Act
[136] Rule 19(2)(b) SCR Rules
[137] Rule 19(6A) of SCR Rules.
[138] Rule 19(5) of SCR Rules
[139] These rules govern the processes of allotment, splitting of share certificates and so on, commit the company to provide periodic information and updates on exceptional material events to the exchange, and intimate the exchange of "any other information necessary to

specific and administrative nature of some of these requirement raises the question of whether they should form part of the listing rules or be left to administrative circulars from the MCA or SEBI. The Rules leave an overarching authority in the hands of SEBI to waive or relax the enforcement of the listing requirements of SCR Rules.[140]

As mentioned earlier, the relationship between the stock exchange and the issuer company is governed by the listing agreement.[141] The primary purpose of the agreement is to ensure that the issuer complies with certain requirements relating to the disclosure of information, allotment, investor servicing, transfer of shares, etc. so that the interests of the traders, investors and brokers who avail of the services of the exchange are protected.

One of the means by which SEBI tries to ensure a minimum level of investor protection is proposing a draft listing agreement, which has the minimum provisions that SEBI deems necessary. Exchanges are at liberty to provide for additional requirements in their agreements.[142].

The listed company is required to maintain the non promoter holding at the minimum level that is required as part of the conditions of listing.[143]

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enable shareholders to appraise the company and to avoid the establishment of a false market in the shares of the company". Rule 19(3) of SCR Rules

[140] Rule 19(7) of SCR Rules

[141] Rule 21 of SCR Rules, 1957

[142] Some of the key issues that the standard agreement deals with are format and issue of letters of allotment and certificates, procedure and standards of servicing of investor application for transfer and issue of duplicate certificates, closure of books, disclosure of information relating to dividends, bonus shares, due process for new or further issue of shares, furnishing of periodic and annual financial and other reports, quarterly information on shareholding patterns, committing not to create a lien on shares, not to forfeit dividend earlier than required by law, agreeing to communicate material developments such as change in nature of business, disruption of operations due to natural calamity, commencement of commercial production / operations, regulatory changes in pricing / realization, litigation / dispute with a material impact, revision in ratings any other information having a bearing on the operation or performance of the company as well as price sensitive information, examples of which are given in Clause 36 (7)] furnishing unaudited quarterly results and half yearly results with a limited review. [These observations are based on the draft listing agreement of The Stock Exchange, Mumbai.]

[143] Clause 40A of the Listing Agreement

The company will not make preferential allotment of shares in case the post issue holding will drop below the minimum as a result of the allotment. In case the percentage of non-promoter holding falls below the minimum and the company does not manage to raise the non promoter holding to at least 10% it will be required to buy the shares of the company back as provided for in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. In case there is a takeover offer or change of control of the company, the new management as well as the company will continue to comply with the requirements of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Conclusion

The analysis in this chapter brings out a few salient aspects of SEBI's working. As an institution SEBI appears to have started off with a regulatory legacy that it inherited from a planned political economic paradigm. When SEBI opened a market driven securities regime, the Indian capital market responded with an enthusiasm that SEBI or its creators had not anticipated, much less prepared for; which is surprising considering the exuberance displayed by market participants in the controlled era, albeit in unpredictable and short bursts. SEBI seems to have responded to the needs of the market, both in terms of its own activities as well as in terms of working with the government, in evolving regulatory changes that would empower it to play its in part in the emerging securities market scenario. The SEBI and the securities regime it runs presently have come a long way from the powerless extension of the Government of India that it started out as in 1992.

That said, viewed in the light of our current understanding of the regulation of securities markets and the role that one expects of SEBI, the analysis of the features of SEBI's regulatory regime raises several questions. The current regulatory framework puts SEBI in charge of the capital market whereas the regulation of the money markets comes under the ambit of the Reserve Bank of India (RBI). As noted earlier this distinction between the capital and the money markets is somewhat arbitrary and can often get blurred. For eg., money market mutual funds invest in securities that are regulated by the RBI but the AMC is itself regulated by SEBI[144]. Financial and investment institutions such as Life Insurance Corporation of India also have acted as underwriters in the past, a business that is regulated by SEBI; but their core business of insurance or banking is regulated by designated regulators. These and other instances raise the question of whether it makes sense to have one single regulator along the lines of the FSA.

[144] Securities and Exchange Board of India (Mutual Funds) Regulations, 1996