Controlling securities market frauds at all three levels: issuers, intermediaries and investors

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Over the last few years, rising incidence of frauds in the securities market has posed a huge challenge to regulators and a significant threat to orderly development of the market. In order to negate the threats posed by increasing number of frauds in the securities market, and their growing complexity, regulators and market participants today at all levels need to brace themselves by incorporating effective controls around their processes.

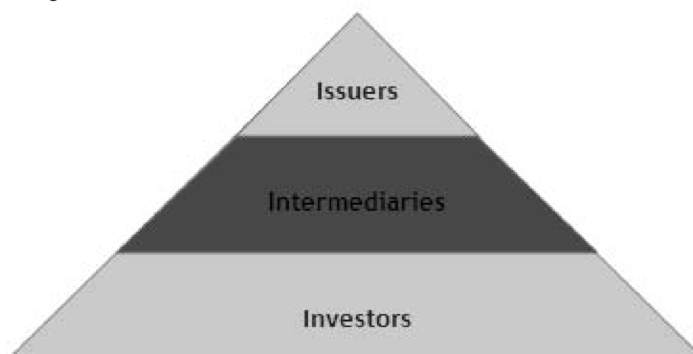
Speaking of fraud, the first insider trading case dates back to 1792 in the United States, when bond investors privy to treasury actions, would trade in debt issues and bank stocks on secret information, before it reached the public. In the late 1800s, there was a spurt in cases related to frauds, insider trading and stock market manipulation and this was at a time when regulations were undeveloped.

It was the twentieth century, which marked, the beginning of advanced regulations concerning stock market frauds, manipulation and insider trading. This was aimed to provide legal protection to parties adversely affected by such malpractices. Over the last few years, the nature of securities frauds has become more sophisticated and complex and the regulations governing them have evolved into a complex set of rules, encompassing a wide variety of issues. Globally, some of the biggest frauds perpetrated in this area have been of the nature of financial statement frauds, Ponzi schemes and high profile insider trading cases.

Let us delve a little deeper into this.

A. General types of securities frauds and their impact on securities markets

A clear distinction of frauds can be made basis the level of hierarchy of market participants in the securities market: This is elucidated by the diagram below.



i. Issuer frauds:

An issuer is an entity that raises finance in the securities market to fund its operations by issuing securities. Issuers in the securities market are generally corporates that need to raise capital for funding their businesses

The following may be categorised under 'issuer' frauds:

- Financial statement frauds
- Ponzi schemes
- Diversion of IPO funds
- Misutilisation of ADR/GDR proceeds
- Mis-statement and concealment of facts

ii. Intermediary frauds :

Intermediaries are persons/entities that facilitate mediation between two parties in a financial transaction. They are integral to the smooth functioning of the securities market and include market intermediaries like stock brokers, share transfer agents, investment banks, merchant bankers, depository participants, mutual funds and custodians

Following may be categorised under ‘intermediary’ frauds:
- Siphoning off dividends/shares (Registrar & Transfer Agents)
- Front-running
- Churning by brokers
- Siphoning off shares/funds (brokers)
- Illegal or Dabba trading

iii. Investor frauds :
An investor can be termed as any person who provides capital to businesses with the expectation of financial returns. They commit funds in diverse investment avenues in the form of various financial instruments. They can either be individuals, corporates, institutional investors, FPIs (Foreign Portfolio investors), etc.

Following may be categorised under ‘investor’ frauds:
- Circular trading (though it may be in connivance with promoters)
- Pump and dump
- Price rigging/volume manipulation
- Fictitious trades
- Laddering/cornering of shares (in public offerings)
- Wash trades

Apart from the aforementioned types of frauds, there are a few which are not confined to any one of the above levels of hierarchies, i.e. these can happen at all levels – issuer, intermediary and investor. This includes frauds such as insider trading, data leakages, cyber frauds and boiler room frauds.

Following is a brief case study that explains the malpractice of ‘Cherry Picking’:

Case study: Peculiar frauds that can catch an organization and regulator off guard

Cherry picking: This is an unethical way of allocating and providing profitable trades to favourable clients and unprofitable trades to unfavourable funds/clients.

Fund managers, portfolio managers and investment advisors at mutual funds, hedge funds, portfolio management companies and insurance companies allocate profitable trades to ‘favourable’ funds/clients and unprofitable trades to ‘unfavourable’ funds/clients for deriving personal benefit.

According to United States Securities and Exchange Commission (SEC) order (File No. 3-15446) –

JS Oliver, a registered investment adviser, and its founder, president, head portfolio manager, and control person, Mausner, engaged in fraudulent trade allocation by ’cherry picking’ favourable trades for JS Oliver’s affiliated hedge fund clients to the detriment of other, unfavoured client accounts from June 2008 to November 2009. JS Oliver and Mausner disproportionately allocated favourable trades to six client accounts, including four affiliated hedge funds, ultimately harming three unfavoured clients by approximately USD10.7 million. Mausner financially benefitted from the cherry picking scheme because he and his family were personally invested in the hedge funds, and he earned additional fees from one of the hedge funds based on the boost in its performance as a result of the cherry picking

Similarly, UK regulator (Financial conduct authority) had fined a global asset manager for approximately GBP 18 million for Cherry picking.

Regulations have been devised against ‘cherry picking’ in developed markets like the United States of America and the United Kingdom. Though such malpractices are relevant in the Indian context as well, there is little clarity on regulations against such a malpractice in India. This gives enough room to the fraudster to play with the regulations and expose the securities market to fraudulent activities such as ‘cherry picking’. Regulators need to consider this scheme in its reviews and evaluations of intermediaries.

B. Impact on securities frauds:
Securities fraud tend to have far-reaching and grave ramifications on the functioning of the entire securities market machinery. The impact may be severe enough to jeopardise the viability of smooth functioning of the markets. Below are some of the major consequences of securities fraud on the market:

a. **Capital erosion:** Securities fraud results in erosion of market participants' capital, ultimately leading to loss of valuable financial resources that can be constructively used in economic growth
b. **Loss of investors' trust:** Fraudulent and unfair trade practices by issuers, intermediaries and other market participants cause loss of investors' trust in the efficiency of functioning market
c. **Increase in litigation:** High level of litigation is a byproduct of the frauds in securities markets. With increase in the level of complexity related to regulation of securities market, the quantum of litigation has also increased manifold
d. **Higher costs of compliance:** Fraud risks entail significant compliance time and resources of entities at various levels, thus increasing costs.
e. **Adverse effect on market efficiency:** Fraudulent and unfair trade practices affect market efficiency by increasing costs and reducing profits of investors, intermediaries and issuers
f. **Distortion of price discovery mechanism:** Manipulative practices in the securities markets hamper the price discovery mechanism resulting in a market disequilibrium

D. Controls for fraud prevention at various levels:
Controls for prevention of securities fraud operate mainly at two levels i.e. regulatory controls and organisational controls.

i. Regulatory controls:
Regulatory framework around the securities market aims to protect investor interest, develop a competitive spirit, ensure market efficiency and control malpractices, among others. In doing so they also face challenges and have to be alert to changes in the market dynamics and ensure prevention of market abuse at all levels of market participants.

So what exactly is their responsibility?

Securities market regulators- Regulators or regulatory bodies are expected to have a strong enforcement, monitoring and surveillance mechanism for exercising oversight on market participants

Securities/stock exchanges-They act as quasi-regulatory bodies or Self-Regulatory Organisations (SROs) which exercise limited extent of authority over market participants such as issuers, intermediaries and investors. They have their own set of bye-laws governing themselves and exercise limited authority over market participants within the broad regulatory framework.

In the Indian context, the Securities and Exchange Board of India (SEBI) has devised the following policy framework governing all levels of market participants viz. issuers, intermediaries and investors:

Market participant	Some of the regulations
Issuers	• SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 • SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations,2008 • SEBI (Issue and Listing of Non-convertible Redeemable Preference shares) Regulations, 2013 • SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
Intermediaries	• SEBI (Intermediaries) regulations • SEBI (Investment Advisors) Regulations • SEBI (Stock Broker & Sub-broker) Regulations • SEBI (Portfolio Managers) Regulations • SEBI (Merchant Bankers) Regulations • SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 • SEBI (Registrar to an Issue and Share Transfer Agents) Regulations, 1993 • SEBI (Depositories and Participants) Regulations, 1996
Investors	• SEBI (Foreign Portfolio Investors) Regulations, 2014 • Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations 2000 • Securities and Exchange Board of India (Mutual Funds) Regulations • SEBI (Alternative Investment Funds) Regulations, 2012 • SEBI (Investor Protection and Education Fund) Regulations, 2009

Though the regulatory framework is constantly evolving, it is imperative that the legislation keeps pace with the changes in technology and securities market dynamics.

The overhaul of the current framework governing insider trading regulations by Securities and Exchange Board of India (SEBI) is a key step, in the right direction. This is expected to foster orderly development of securities markets in India, thereby protecting investor interest and making the regulations more transparent and stringent.

Summary of the recent major regulatory actions by SEBI:

'During 2015-16, proceedings under Section 11 of the SEBI Act, 1992 were initiated against 1,726 entities, adjudication proceedings were initiated against 1,257 entities and administrative warnings were given to 454 entities. Alternately, SEBI also issued nine interim orders in the same period related to the equity segment barring 904 entities from accessing the securities market or dealing in the same till further directions. The entities debarred included market participants at all levels viz. issuers, intermediaries and investors.'

Additionally, during the same period, SEBI issued 18 warning/deficiency/advice letters to other intermediaries of which eight were issued against depository participants, seven against debenture trustees, two against registrars and share transfer agents and one against a merchant banker. The body also initiated adjudication proceedings against three merchant bankers, two depository participants, two debenture trustees, one against a registrar to issue and share transfer agent and one against credit rating agency.

To prevent the occurrence of fraudulent and unfair trade practices, as a deterrent, SEBI initiated action (in terms of provisions of SEBI Act, 1992) including adjudication proceedings for levy of monetary penalty. SEBI imposed a monetary penalty of INR 7,273.13 crore on 103 entities during 2015-16 as compared to INR 241.70 crore in 2014-15.

ii. Fraud controls at an organisational level:

As mentioned earlier, controls for prevention of securities fraud operates at two levels one at regulatory control level and a second being that of organisational control.

Let us look at the fraud control at an organisational level now.

The market mechanism should be such that it does not favour one class of market participants over others. In addition to regulatory control, it is vital for organisations at issuer, intermediary and investor levels to adopt following aspects as a part of their operational framework to control the incidence of securities frauds:

Sr. No.	Controls	Applicable to		
		Issuers	Intermediaries	Investors
1.	Insider trading policy in line with SEBI regulations	✓	✓	✓*
2.	Monitoring conflicts of interest and policy violations	✓	✓	✓
3.	Transparency in accounting policies, operations and appropriate disclosure norms	✓	-	-
4.	Strong corporate governance framework	✓	✓	-
5.	Strict compliance with regulations related to issue of securities and listing agreements	✓	-	-
6.	Speedy complaints redressal mechanism	✓	✓	-
7.	Effective whistle blower policy	✓	✓	-
8.	Utilisation of data analytics tools to identify red flags	✓	✓	✓*
9.	Strong internal audit function	✓	✓	-
10.	Employees sensitisation/awareness programmes	✓	✓	-
11.	Effective surveillance mechanism	✓	✓	-
12.	Periodic fraud risk assessments	✓	✓	✓*
13.	Adoption of leading practices	✓	✓	✓*
14.	Strong internal controls including fraud risk controls	✓	✓	✓*
15.	Adherence to SEBI regulations on insider trading	✓	✓	✓
16.	Suspicious transactions reporting		✓	-
17.	KYC documentation	✓	✓	✓*
18.	Strong controls around dealing room function (Applies to most intermediaries associated with dealing of securities and Institutional investors)	-	✓	✓*
19.	Adherence to prudential requirements	-	✓	✓
20.	Pre-trade risk controls	-	✓	✓

*These controls are more pertinent to institutional investors

In addition to the above, it may be worthwhile for exchanges too to conduct thorough due diligence procedures to get insights into the organisation's listing their securities on their platform.

Challenges posed due to Algorithmic and High Frequency Trading

In addition to fraud risks, in the near future, regulators across the globe will now have to expend their resources to also address challenges faced by securities markets due to Algorithmic and High Frequency Trading (HFT). Some of these risks include:

a. Sharp market movements such as the 'Flash crash' of May 2010 in the United States.
b. Increase in market volatility and uncertainty
c. Misbehaving algorithms causing market dis-equilibrium
d. Multiplier effect on prices due to price-sensitive triggers

The stated risks may result in driving away investors from the securities market due to their loss of trust in the efficiency of markets. Though several regulators are aware of these risks and have issued guidelines to regulate Algorithmic and High Frequency Trading, any future incident like the 'Flash Crash' may again draw significant attention to these issues. SEBI also has been taking note of the development in this segment of the market to ensure transparency and trust and continuously built in the market.

In conclusion, it is critical to have a strongly regulated securities market to build confidence of all the stakeholders, and for a developing country like ours, it becomes all the more critical as we increase the investment depth and provide opportunity to investors in the India story. Greed is a desire which is the root cause of many ills and we need to ensure through appropriate governance that we are able to avoid Greed to become good!

Sources:

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