WHITE BLACK LEGAL LAW JOURNAL

ISSN: 2581-8503

Peer - Reviewed & Refereed Journal

The Law Journal strives to provide a platform for discussion of International as well as National Developments in the Field of Law.

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With this thought, we hereby present to you

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REGULATORY FRAMEWORK OF THE SECURITIES MARKET IN INDIA

AUTHORED BY: KARTIKEYA GOEL

A3221519260

DECLARATION

I, Kartikeya Goel pursuing BBA L.L.B.(H) from Amity Law School, Amity University Uttar Pradesh, do hereby declare that the Dissertation Report submitted by me of my NTCC is an original work and has not been submitted, either in part or full anywhere else for any purpose, academic or otherwise, to the best of my knowledge.

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ACKNOWLEDGMENT

I take this chance to express our profound gratitude and deep regard to our guide Ms. Pranjali Sahni for her exemplary guidance, monitoring, and constant encouragement throughout the course of this term paper. The invaluable suggestions and inputs given by her from time to time have enabled me to finish this term paper with ease.

I am obliged to staff members of Amity University, for the precious information provided by them in their perspective fields. I'm grateful to this cooperation during the period of my assignment.

Last but not the smallest amount, I thank almighty, my parents and my friends for his or her constant support and encouragement without which this research work would not be possible.

Signature of the Student--------------------------------

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INTRODUCTION

A securities market or financial market is a market that plays a vital role in the development of the country's economy. It facilitates capital formation, mobilizes savings, and enables efficient allocation of funds and resources.

The securities market was not like what it is today. The image and functioning were very different from what it is today. Many people were new to the concept and didn't know what securities markets are and how one can invest and trade in securities in various companies listed on the stock market and earn income as a return on their investments.

India saw many economic reforms in the 1990s which called for a proper regulatory framework for the securities market in India for proper functioning and market efficiency with an aim to

provide better transparency in the transactions, accountability, reliability, protect investor's interest, market manipulation, insider trading, unfair trade practices and fairness in the securities market.[1]

There are numerous issues such as market manipulation, Insider trading, securities issues, and transactions the securities market in India deals with. There was a need for a proper regulatory body and hence SEBI was introduced as a regulatory body by the government of India under the SEBI Act, of 1992 to regulate, develop, and protect the securities market in India. It regulates the issues of securities, the investors, and the market intermediaries. There are various rules and regulations which are made by the government and SEBI to deal with numerous issues. The regulatory framework of the Indian securities market is varied and comprises various laws, regulations, and guidelines.

In India, the securities market is regulated by SEBI (Securities Exchange Board of India) which operates under the Ministry of Finance in India. SEBI is the watchdog that ensures transparency and fairness in the market and protects the interests of the investors in the Indian financial market.

2. HISTORICAL DEVELOPMENT

The Indian securities market has grown significantly. Securities trading and investment in India goes back to the 18th century when East India Company began trading in loan securities. The derivatives market has been functioning in India in some form or other for a long time.[2]

Corporate shares with the stock of banks and cotton presses started being traded in the 1830s in Mumbai with the Bombay Cotton Trade Association being the first to start future trading in 1875 in the arena of commodities trading and by the early 1900s, India had one of the world's largest future industries. During the 1850s, a group of around 22 stockbrokers began trading opposite the town hall of Bombay under a Banyan Tree. The stockbrokers gradually increased settling in 1874 at Dalal Street and today it has formed as an association named Bombay Stock Exchange (established in 1875) and in 1965, the Government of India gave permanent recognition to the Bombay Stock Exchange under the Securities Contract (Regulation) Act, 1956. Bombay Stock Exchange is Asia's oldest stock exchange. In 1875, The Native Share and Stock Brokers' Association in Mumbai was formed. There were many stock exchanges formed in various major cities like Ahmedabad, Calcutta (now Kolkata), Madras (now Chennai), and

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[1] Abheek Barman, "Watchdog at War" Indian Express (April 20, 2010). 2. Ajay Mathur, "Role of Audit Committee in Ensuring Good Corporate Governance Practices in Bank" The Chartered Accountant (March 2009).

[2] Aparna Sharma, "Regulatory Authorities" **SEBI and Corporate Laws** (March 11,2007).

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Bombay (now Mumbai). Ahmedabad Stock Exchange (established in 1894) and Bengal Stock Exchange came into operation and began trading shares of textile mills and shares of plantation and jute mills respectively. Then Madras Stock Exchange was formed. Bombay Stock Exchange was the dominant stock exchange in the country at that time but still not many were aware of the securities market and stock exchange in India. The stock exchange remained exclusive to a small number of individuals in the country.

After Independence, India saw a significant development in the securities market in India. In the year 1956, The Government of India passed The Securities (Contract) Regulation Act intending to organize stock trading. In 1964, India got its first mutual fund scheme by Unit Trust of India (UTI), US 64 and the scheme raised massive funds of Rs. 6,400 crores by 1988 and this made UTI one of the biggest players in India. Reliance Industries Ltd. Was one of the initial companies that filed Initial Public Offerings (IPO) and it saw massive public attention and attracted retail investors to start investing in the stock market.

The securities market was regulated by the Government of India as there was no independent regulator. There were various acts like the Securities Contracts (Regulations) Act, of 1956 (SCRA), The Capital Issues Contract Act, of 1947, and The Companies Act, of 1956.

The Securities Contracts (Regulations) Act, 1956 (SCRA) was the primary legislation and the main objective of the act was to regulate the contracts executed in the stock market and the securities market in India. Controller of Capital Issues was formed under Capital Issues Contract Act, 1947 and this was the regulatory body of the securities market in India. The Controller of Capital Issues had to first approve the securities for the primary market as Initial Public Offerings then only the securities could be listed on the stock market. The government had to extensively look after the procedure and hence there was a need for an independent regulatory body to regulate the securities market in India and hence Securities Exchange Board of India (SEBI) was established. [3]

As there was no proper regulatory body regarding the securities market in India, the period of 1980-90 saw many instances that indicated a lack of transparency in the transactions regarding investment and trading in the securities market in India. The securities market also faced several issues in clearing and settlement of the securities in the market and hence it was promoting disbelief regarding investing and trading of securities among the retail investors as they were investing their hard-earned and lifetime savings in the securities market but due to

[3] Ashish Rukhaiyar & Reena Zachariah, "SEBI may Seek Details on Funds via Pledged Shares" **The Economic Times** (February 10, 2009).

the several issues, the investment got limited. There were several transaction issues as well which didn’t provide security for the investor’s transactions and strengthen the investors' confidence.

So, the government introduced the Securities and Exchange Board of India (SEBI) as a non-statutory body on 12th April 1988, by passing a resolution. In the year 1992, the Securities and Exchange Board of India (SEBI) was given statutory powers by the government through the SEBI Act, 1992[4] with an aim to protect investors’ interests, improve transparency, prevent unfair trade practices, and promote a healthy functioning of the securities market.

The year 1992 saw the founding of the National Stock Exchange of India Limited (NSE) was established. With the bull market led by Harshad Mehta, the securities market saw a huge spike in the number of investors. In 1994, the NSE became the first Indian exchange to provide a revolutionary, fully automated screen-based electronic trading system.

As the Securities and Exchange Board of India (SEBI) came into existence in the 1990s, the period 1990s - 00s saw many developments as well as market scams which helped in the growth of the Indian securities market.

Some of the developments which were seen during this period were: -

1. **Electronic Trading was introduced** - As with time, there was an increase in the trading volume, there was a need for more transparent and easy trading instead of the traditional floor trading. So, the floor trading was shifted towards electronic trading.

2. **Depository system** - It is a system that makes investment and trading of securities paperless. Introduction of DEMAT Account or Dematerialized Account which helped in shifting of physical share certificate to digital form and providing more transparency and efficiency to the investor. It is also known as paperless trading. There were many challenges with the physical share certificates such as delay in transfer, forgery, theft, damage to the certificate, and loss of the physical share certificate. The DEMAT Account was introduced to eliminate these challenges. These are managed by two depositories in India, the National Securities Depository Limited (NSDL) and the Central Depository Services Limited (CDSL). This helps with the proper and secure operations of the stock market. The equity settlements take place at the depository. This system is also economical as it reduces the cost of paperwork and transaction costs of the securities that are frequently transferred and only charges Depository Participant (DP) charges. A Depository Participant is an agent which acts as a link between the investor and the depository. Some examples of Depository Participants are banks,

[4] *Available at:* https://www.sebi.gov.in/about-sebi.html, last accessed on April 2024

stockbrokers, financing institutions, and custodians and they must get registered with the SEBI. It also provides an option where a nominee can also be appointed so that after the death of the person, the securities could be transferred to the nominee.

3. **Dematerialization and Rematerialization of shares** - The physical shares can be dematerialized into electronic form as well as the investor having an option to rematerialize the securities into physical form.

Dematerialisation is the process of converting physical share certificates and debentures into electronic format. The term ‘demat’ in Demat accounts stands for dematerialisation as investors essentially use the account to hold dematerialised shares and securities virtually. You need to open a demat account in India with a Depository Participant (DP) in order to dematerialize your securities.

The process of converting digital securities into physical certificates in known as rematerialisation. Investors who have converted or have their securities in electronic format stored in Demat accounts can opt for the rematerialisation process. However, while securities are undergoing the rematerialisation process, investors cannot trade them on the relevant exchange.

2.1. **OTHER DIFFERENCES: DEMATERIALISATION VS REMATERIALISATION**

Apart from the difference in definitions and processes, there are various other differences between the dematerialisation and dematerialisation processes.

- **The convenience of process**:

Investors use dematerialisation owing to its easy and transparent process. The only thing you need to utilise in the dematerialisation process is a trusted Depository Participant of your choice to open a Demat account. Whereas, rematerialisation is a much more difficult and cumbersome process as compared to dematerialisation. The process can also take a long time and often requires professional expertise to be done properly.

- **Ease of Trading**:

Dematerialisation is a seamless, transparent, and a simple process. All your transactions can easily take place online via your online demat account. This is not the case with rematerialisation. The process of rematerialisation converts securities into physical formats, investors must conduct all transactions physically by visiting the required locations.

- **Costs of Maintenance:**

Rematerialised securities are stored as physical certificates, hence, do not come with a

maintenance cost. The physical certificates are stored with the investor and takes responsibility for holding and maintaining the securities. However, dematerialised securities can only be held in a Demat account that brokers and financial institutions provide. Therefore, they levy a maintenance charge for the service and the Demat account maintenance. However, these costs are minimal when considering the convenience of having your securities stored securely and conveniently in a digital format.

- **Security**:

The matter of security of assets and transactions is an important distinction between dematerialisation and rematerialisation. Dematerialisation ensures a much higher level of security than rematerialisation.

In dematerialisation, securities are directly converted into a digital format and stored in demat accounts. As a result, there is a lesser chance of forgeries, fraud or theft, which is possible in the case of physical certificates. On the other hand, rematerialisation involves paperwork and dealing with physical forms of securities, thereby increasing the chances of encountering the problems mentioned above.

- **Authority of Account**:

Another distinction between dematerialisation and rematerialisation is the matter of who holds the authority of your account. In the case of rematerialisation, the account maintenance authority lies with the company. However, in dematerialisation, the account maintenance authority rests with the depository participant (NSDL or CDSL). Since these services are instituted by the Securities and Exchange Board of India (SEBI), they are reliable and transparent.

4. **Regulations regarding Market Manipulation** - The SEBI introduced measures to prevent market manipulation in which the prices of the stock are manipulated with the aim of earning unfair gains. SEBI also launched stock watch software for surveillance of the market movements and to show movements of historical patterns so that market manipulation and price rigging could be prevented. [5]

Market manipulation may lead to a lack of trust in the fairness of the capital markets, resulting in higher risk premiums and reduced investor participation. A reduction in the efficiency of a local capital market may negatively affect the growth and economic health of the country and may also influence the operations of the globally interconnected capital markets. Although market manipulation may be less likely to occur in mature financial markets than in emerging

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[5] Azmi, S.H., “Prospective investor as consumer: A critique of mutual fund”, **Aligarh Law Journal, 11, (2006).**

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markets, cross-border investing increasingly exposes all global investors to the potential for such practices.

5. **Rolling Settlement** - Rolling Settlement is a method of settlement of securities in which the trades are settled on a continual basis. The trades completed today will have a settlement date of one working day later than the day the trade was executed. The rolling settlement system in India is T+1 days. This means that after the day trade is executed, it will take one additional day to complete the trading settlement. Earlier the Badla system was practiced but on July 2nd, 2001, it was banned, and then in the year 2002, the government introduced the T+5 rolling settlement system. Later, the rolling settlement period for equity shares was converted to T+3, and then in the year 2003, the settlement period for equity shares and government securities was converted to T+2 and now it has been converted to T+1. This means that the trade settlement will be done one business day after the trade date. The government is planning to introduce a T+0 settlement period soon.

6. **Insider trading** - When an individual has access to any material information or news related to a company that is not public, and the information can directly impact the prices of the stock of the company and uses that information to gain unfair profit, it is known as Insider Trading. It was a common practice at that time and there was a need for guidelines and rules against insider trading hence, SEBI laid down the SEBI (Prohibition of Insider Trading) regulations which provide guidelines regarding prevention of Insider Trading.

7. **Regulations in relation to the Stockbrokers and sub-brokers** - SEBI also made regulations related to the stockbrokers and sub-brokers in which they must be first registered with the SEBI and the Stock Exchanges. If not registered, certain penalties are imposed against the stockbroker and sub-broker. The sub-broker also has to be registered with the stockbroker. They must keep the books of accounts of the clients updated and brokerage and the transaction cost of the trade and investment should also be provided to the client as a contract note.

8. **Regulations of Mutual Funds** - SEBI introduced Mutual Funds Regulations, 1996 provide guidelines regarding mutual funds in India. It provides guidelines that all mutual funds must be registered with the SEBI. It provides mutual funds to follow the code of conduct and investment guidelines by disclosing information to the investors and ensuring proper management of investors' funds. The regulations are framed with an aim to protect the investor's interest in the securities market.

9. **Regulations regarding Foreign Venture Capital Investors** - SEBI also provides regulations regarding Foreign Venture Capital Investors (FVCI) Regulations, 2000 which provides guidelines regarding foreign venture capital investors' investment in India. Various

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regulations regarding stockbrokers, sub-brokers, and portfolio managers are also provided by the SEBI in which rules and regulations are provided which are to be followed by them with the main aim of protecting the interest of the investors in the securities market.[6]

10. **Demutualization and Corporatization** - Demutualization is a process in which a member-owned organization like a stock exchange is converted into a shareholder-owned corporation. It involves a separation of ownership and trading rights from the management and governance of the stock exchange. Before the introduction of demutualization, the stock exchanges were operated by the members who were brokers and dealers. The demutualization process aims to increase transparency and efficiency in the stock market which helps in improving governance and accountability. Corporatization is the process of converting an entity like a stock exchange into a corporation. It often accompanies demutualization as an exchange transition from a member-based model to a corporation.

11. **Introduction to Derivative Segment** - In the late 1990s, the badla system was removed from the securities market, and in the early 2000 derivative segment was introduced. Derivatives are essentially contracts that derive their value from an underlying asset. Derivative contracts are short-term financial instruments that come with a fixed expiry date. The underlying asset can be stocks, commodities, currencies, indices, exchange rates, or even interest rates. Derivative trading involves both buying and selling of these financial contracts in the market. With derivatives, you can make profits by predicting the future price movement of the underlying asset.

2.2. DIFFERENCE BETWEEN A FUTURES AND OPTIONS CONTRACT

There's a key difference between a futures and an options contract. In the case of options, the buyer or the seller can either choose to exercise their right to buy or sell the underlying asset, or they could let the right lapse upon the expiry of the contract. With a futures contract, both the buyer and the seller are legally obligated to honour the contract upon expiry, and both parties must exercise the contract before expiry.

Prerequisites for trading in derivatives

To get started with trading in derivatives, you are required to fulfil three key prerequisites:

- Firstly, you need to possess an active demat account.
- Secondly, you have to open a trading account in India. If you don't already possess a trading account, you could get in touch with stockbroking firms like IIFL, which can

[6] B.R. Atre, "Special Economic Zone and Corporate Governance" **SEBI and Corporate Laws** (January 11,2010).

help set up a free trading account in India for you. Once you set up both the Demat and trading account, you need to link both accounts.

- Lastly, you are required to maintain a specific percentage of cash in your trading account to trade in derivatives. This amount is called margin money.

As the securities market saw many developments in this period, it also saw many challenges and scams in the market and forced SEBI to identify the loopholes and introduce new rules and amendments for the development of the SEBI Act so that the market could operate more efficiently and transparently manner.

Some of the popular scams that took place in the country are: -

- **Harshad Mehta Scam (1992)**: - The Harshad Mehta scam was one of the first and biggest scams in the securities market in India. This scam was the first scam that made it to the headlines and front pages of the newspapers. The scam was related to market manipulation, and he used a banking system loophole to manipulate the stock market. Harshad Mehta used the loophole in which he borrowed money from the banks and used the funds to buy large quantities of equity stocks of the companies in the stock market creating demand in the market which resulted in artificially inflating the stock prices hence, forming a bubble. The market scam resulted in the crash of the stock market which caused investors to lose more than Rs. 4000 crores. This scam brought attention to the weaknesses in the Indian financial sector and resulted in significant alterations to the nation's banking and securities laws. Additionally, it raised awareness of how crucial accountability and transparency are to the financial sector in the country. This scam helped in the formation of the SEBI.
- **CRB Scam (1996):** - C.R. Bhansali or CRB Scam was a scam that was related to mutual funds in India. The scam was related to market manipulation worth Rs. 1200 crores in which C.R. Bhansali created a group of companies that dealt with finance and non-finance companies. C.R. Bhansali was involved in manipulative and illegal practices. He was involved in speculative trading activities and used to divert the funds and manipulate the stock prices in the securities market. He used to provide false statements to the investors about their investments. However scams came out in the securities market, and they resulted in significant losses on the investors' investment. The Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI) investigated the scam and legal proceedings were initiated against him. It was the biggest scam in relation to mutual funds in India.
- **BPL, Videocon, and Sterlite Scam (1998)**: - The BPL, Videocon, and Sterlite scam is a scam that included Harshad Mehta (Scam of 1992) who made a market bubble by artificially

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inflating the stock prices of various companies. He manipulated the stock prices of all three companies in the stock market with the help of the management of the companies but was not able to maintain the liquidity to maintain his leveraged position in the market when the market crashed due to a major fall in the index. Even the top management of Bombay Stock Exchange (BSE) were also involved in the scam and to avoid the payment crisis they tampered with records in the trading system. This scam marked the failure of SEBI. [7]

There were many scams in the 2000s which also marked faults and forced SEBI to improve market efficiency and transparency. Some of the scams are: -

- **Ketan Parekh Scam (2001)**: - Ketan Parekh Scam was a scam headed by Ketan Parekh. This scam was one of the biggest scams in the late 1990s and early 2000s. He was famous for his circular trading in the stock market which artificially inflated the stock prices of the listed companies. He used to artificially inflate the prices by swapping shares of small and mid-cap company shares in which Ketan Parekh had a large stake. The SEBI got to know about the scam in the year 2001 and after that inquiry took place it was held that Ketan Parekh made many false accounts and then he practiced circular trading which resulted in artificially increasing the stock prices. This scam amounted to almost Rs. 40,000 crores.
- **NSE Colocation Scam (2015)**: - The scam is also known as the Algo Trading Controversy. This scam roughly amounted to Rs. 50,000 crores. In this scam, there were colocation facilities that allowed several brokers to place their servers in the data centre of the National Stock Exchange (NSE) and this allowed the brokers to get first access to the prices to be distributed by the National Stock Exchange (NSE) which gave unfair gains to the brokers having first place knowledge about the prices over others. Some of the brokers were provided preferential access and were manipulating the securities market for their advantage and earning unfair gains by violating SEBI rules and regulations. The scam helped SEBI in raising concerns about fairness, transparency, and accountability in the securities market.
- **Karvy Scam (2019)**: - This scam involved a stock broking company named Karvy Stock Broking Limited. This scam amounted to Rs. 2,300 crores. In 2019, the Securities and Exchange Board of India found irregularities in the company's financials and audit. The company misused their clients' securities and funds and took a loan against the securities of their clients lying in their accounts as collateral and diverted their funds into their group companies. They took loans from various banks against the securities of their inactive clients. Karvy was accused of pledging their clients' securities for obtaining loans without any consent

[7] Bimal R. Bhatt, "Corporate Governance - A Necessity" **SEBI and Corporate Laws** (October 15,2007).

from their clients and using the funds for their own benefit. The scam highlighted the lapse and made SEBI focus more on the protection of investors' interests and monitoring of the broking firm's operations to maintain market integrity. The SEBI barred Karvy from taking new clients, revoked its license, and even restricted its activities in the securities market. This scam helped in understand the importance of proper regulatory mechanisms enhancing transparency, strengthening regulations, and safeguarding investors' interest in the securities market.

These are some of the scams that marked the failure of SEBI as there were many instances of market manipulation and insider trading and hence made SEBI work towards protecting investors' interest, improving transparency, preventing unfair trade practices, market manipulation, insider trading and promoting healthy functioning of the securities market.[8]

CONCLUSION

The regulatory framework of the securities market in India has evolved significantly over the years with an aim to protect the interests of the investors and promote transparency, accountability and market integrity which ensures fair, orderly and efficient markets. The Securities and Exchange Board of India (SEBI) was introduced as a regulatory body by the government of India under SEBI Act, 1992, to regulate the securities market in India. It also works towards development and protection of the securities market in India. SEBI has worked tremendously over time and has taken several measures to protect the market integrity and to ensure fair and efficient markets. To ensure fair and efficient functioning of the securities market, certain rules and regulations have been created and enforced by the Securities and Exchange Board of India (SEBI). Various rules, regulations and guidelines are introduced by SEBI for regulating different areas including investor protection measures, disclosure and listing requirement in the securities market.

Over the time, SEBI has introduced several measures to enhance the regulatory framework such as electronic trading, depository system, dematerialization of securities, rolling settlement and regulations regarding insider trading, fraudulent and unfair trade practices, to protect the interests of the investors and promote fair, transparency and orderly market.

India aims to create a fair, transparent, and well-regulated securities market that ensures the protection of investor interest and supports the economic growth of the country.

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