CHAPTER 6

PROBLEMS AND CONSTRAINTS IN THE FUNCTIONING OF INDIAN CAPITAL MARKET

6.1 Introduction

This chapter broadly covers the major threats to the smooth functioning of the capital markets in India. In the earlier chapters, an attempt has been made to bring out the phase-wise development in respect of the capital markets in India. While this development was taking place, there may have been some barriers causing hindrance to the development of capital market. These problems or barriers may be political, socio-economic or administrative in nature. All these problems are examined in this chapter.

Throughout the various phases, capital market in India has experienced growth and at the same time, some bottlenecks were also experienced. This chapter shows how some of these problems proved to be hindrance in development of capital market. Similarly, an attempt is also made to study how these problems were overcome in the subsequent phases of development. There is repetition of some of the problems as they are observed in various phases.

6.2 Problems Observed During Inception Phase (1875-1914)

During this phase, there were inevitable, natural problems faced by the capital market. Since this phase was just a beginning of the capital market in India, it experienced following problems.

6.2.1 Unorganized Nature

During the inception phase, there was no formal structure of capital market. Even the stock exchanges particularly BSE, were formed as a voluntary-non-profit making associations, the operations and functions performed in the market were based on practices developed by some of the brokers (called as ‘Dalals’). There was no formal structural or functional system prevalent during the initial phase.
6.2.2 Dominance Of Few Stock Exchanges

This initial phase was marked by concentration or domination of capital market activities by only few exchanges², particularly BSE. It was almost a monopoly of BSE in respect of operations and functions related to capital market. Up to 1914, there were only three stock exchanged viz. Mumbai, Ahmadabad and Kolkata. But still, there was dominance in activities of Mumbai stock exchange,(BSE). This led to imbalanced growth for both corporate as well as investors intending to invest in the market.

6.2.3 Public Response

As that was just a beginning of the capital market activity in India, naturally, the response from the public at large was very poor³. Due to lack of information about the capital market activities, there was no enthusiasm among the people towards capital market. Initially, the capital market was looked as a place only for elite reach class in the society. Hence, majority of the population which falls in middle class as well as lower middle class was ignorant about the capital market. This problem also led to the liquidity crunch in the market because only few players were present in the market. Thus, scope for further growth was limited.

6.3 Problems Observed During 1914-1947

This phase was characterized by an umbrella growth. The number of stock exchanges increased from three to seven during this phase. The number of companies listed in the stock exchanges throughout the country also increased to over one thousand. As there was quantitative growth in the Indian capital market, some inherent problems also emerged during this phase.

6.3.1 Possibility Of Manipulation

The stock exchanges provided a facility to transfer securities freely and thereby some procedures were also developed for transferring of securities. But the system prevalent at that time left scope for operator to manipulate the trade. The operators were in a position to make such manipulation⁴ as the information flow was totally dominated by the brokers. This was also a reason for limited spread of the market.
6.3.2 Low Liquidity

This feature of the market has been prevailing for almost hundred years. The response from the public at large increased in quantitative terms, but still in order to provide the liquidity, this increase was not sufficient. Due to low liquidity, public outreach of the capital market has remained limited.

6.3.3 Wasteful Procedures

The procedures involved in the functioning of the capital markets were cumbersome. There was wasteful expenditure on application forms. Apart from these, there were too many intermediaries involved in the process. Brokers, sub brokers, managers, co-managers and collection centers had to play their role in the market for smooth functioning. This added a cost as well as time required to raise the capital from market. This problem was particularly faced by the New Issue Market, which is also called as Primary Market. Even today, some of these problems are still being faced though the procedures have been reduced/simplified to a great extent.

6.3.4 Lack of Professionalism

With the quantitative increase in the number of stock exchanges, number of brokers, it was expected that some kind of professionalism would automatically get built into the system. Especially, highly competent and professional brokers were expected to emerge during this phase. But, many brokers lacked professional standards. Inadequate financial support, little skill about market operations and less experience were the factors which left the operators less competent. Out of these limitations, some limitations are felt even today. Due to such problems default like bad delivery, kerb trading may emerge which affects capital market.


This phase experienced the industrial advancement in the country. The independent India adopted ‘mixed economy’ and selected a growth path through five year plans.
The first two decades after independence have seen only one new stock exchange in the country i.e. Bangalore Stock Exchange. But the number of companies listed in the stock exchanges rose from 1125 in the year 1947 to more than 1500 in the year 1969. Capital of the listed companies increased from Rs. 270 Crores to Rs.1800 Crores during the same period. When these developments were taking place, some problems also emerged during this phase.

6.4.1 Speculative Influence

Though the capital markets world over faced the evil of speculative motives in India speculative influence started along with other developments taking place. With increasing number of companies listed and increase in capital formation, some speculative motives started hitting the market. Though initially their volume of trading was low, gradually, it increased and this particular drawback is observed in Indian capital market even today. This particular drawback makes the market more vulnerable towards fraud and instability.

6.4.2 Cost Of Public Issues

This problem continued to have impact on development of capital market in general and primary market in particular. Brokerage, underwriting commission, prospectus printing and distribution were some of the elements of cost involved during the public issue. Similarly, there was a time gap between announcement of the issue and actual generation of capital. The companies also were subject to risks involved in it. The huge time and cost involved in public issues, made the companies think twice before going to public.

6.4.3 Isolated Stock Exchanges

The stock exchanges in India have a presence only at particular locations. At the respective locations, normally trade takes place which is also characterized by
regional features. But it must also be noted that stock brokers of one stock exchange were not allowed to operate on their own in any other stock exchange. The stock exchanges were even not allowed to have branches at different locations. Due to this problem, only few stock exchanges like BSE dominated the trade in capital markets. But this had made other stock exchanges isolated. These stock exchanges were located in distant places throughout the country. But these regional stock exchanges were not much backed by volume of trading. Now, we have Interconnected Stock Exchange of India Ltd.(ISE) where these problems are not there but in early post-independence phase, this problem persisted.

6.4.4 Multiple Regulations

After independence, some steps were taken to regulate the Indian capital market. During the post-independence phase, Indian Companies Act was passed in the year 1956. Before this Capital Issues (Control) Act, 1947 also came into existence. Then Securities Contract (Regulation) Act was passed in the year 1956. Though the objectives of these acts were good, some provisions of these different acts were contradictory to each other. These multiple regulations also had an impact on capital market developments.

6.5 Problems Faced During 1969-1991

This phase of capital market development was marked by various characteristics. The number of stock exchanges increased from just 8 in the year 1969 to 20 in the year 1991. Number of listed companies also crossed 6000 mark. Capital of listed companies also went upto over Rs. 32000 Crores. This phase experienced huge increase in respect of trading volume, trading hours, market capitalization etc. Trading pattern and investment objectives of the people also underwent few changes during this phase. The various constraints in the functioning of capital market which were observed in this phase are presented below.

6.5.1 Lack of Protection to Investors
Though some laws were enacted during the earlier phase, there were no provisions ensuring investors’ protection\textsuperscript{12}. There was no separate mechanism to look after grievances of investors. No guidelines were given for various players in the market. This was one of the reasons why there was still poor response from the households. Later on, with the formation of SEBI, this problem was removed. Now SEBI has issued guidelines for various participants of the capital market and there is a separate mechanism for grievances redressal for investors.

\textbf{6.5.2. No Linkage With International Market}

This phase experienced development in a controlled and restricted regime. The Indian market was marching ahead with its inherent strength. But the global factors were not affecting valuation in India markets. Therefore, the Indian capital markets, to some extent were isolated\textsuperscript{13} from other global markets. Later on, with the advent of LPG policy, Indian opened doors for foreign investors. This has both positive as well as negative effects on the Indian markets. But upto 1990’s the markets were isolated, not going in either way that the global markets were developing.

\textbf{6.5.3 Open Outcry}

When the capital markets started functioning, few brokers used to come together at a particular place and perform trading activities. As the number of listed companies increased over six thousand and number of brokers also increased, it was difficult to perform trading. Usually, some gestures and shouting was necessary to find the matching trade. For example, if one would have to purchase shares of X. Ltd. in a particular quantity at a specific rate, he had to shout and find another person willing to sell the shares of the same company and then, he could negotiate the prices. This system had a limitation that due to open outcry\textsuperscript{14} very few participants showed their interest in trading. Further, this type of market is not suitable for genuine investors as they shy away from open outcry. But in late 90’s the NSE came out with screen based trading system and online trading also. This move removed the problem of open outcry and it also forced other stock exchanges including BSE to start screen based trading.
6.5.4 Physical Delivery of Shares

Even though there was a great increase in the number of stock exchanges, listed companies, trading volume etc, there was trading in securities with physical transfer. If one has to sell the securities, he personally had to sign a certificate and hand it over to the broker, who, in turn would go to the stock exchanges and place the order. Similarly, the person who intended to purchase the securities would receive share certificate for the number of shares purchased. This particular ‘physical transfer’15 required quite a time. Due to this, when actually the securities were traded the prices at that time were different from those recorded for physical delivery. This led to lower volumes of trade in the market. When trading in the market started with dematerialized form, in the first decade of twenty first century, this problem was removed.

6.5.5 Dominance Of Financial Institutions

During the pre-LPG period, few financial institutions like UTI, LIC and GIC continued to dominate16 the Indian capital market. Hence the markets were significantly influenced by actions or operations of these few financial institutions. This reduces the degree of competition and leads to concentration of economic power in few hands. This was not a healthy thing for the overall growth of capital markets in India. Another feature observed during this phase was that most of these financial institutions were public sector enterprises. Therefore, private sector had limited success in equity mobilization during this phase.

6.5.6 Settlement Procedure

During initial phase participants faced a drawback of physical delivery of securities. The settlement procedure17 involved physical transfer of securities in the form of certificates from seller to his broker and then to buyer’s broker and then, ultimately the buyer. This procedure made settlement of trades very rigid and time consuming. There were delays in transfer of securities as well as in payments. ‘Account Period Settlement’ slightly improved this wherein the trades were settled in a cycle of five days. But this system was present initially only in OTC market. Now, due to
technological advancement even faster settlement is possible. But during this particular phase, the settlement procedure was cumbersome.

6.5.7 Scarcity Of Floating Securities

The institutional investors during this phase, owned majority of equity capital issued by the companies. On the other hand retail individual investors were not much exposed to wider investment. Majority of the companies had issued very less amount of capital and the public holding was also poor. The holding of promoters and financial institutions was so large that public interest was very low. Hence trading could not take place in volumes.

6.6 Problems Faced During The Post – Liberalization Period (1991 Onwards)

The two decades have lapsed after India accepted the globalization policy as a weapon for financial sector reforms. From restricted regime, slowly the economy moved towards open economy. Instead of control and restriction, the words management and development were used frequently. Even legal terminologies were also relaxed to some extent. By the year 1991, the number of listed companies was over six thousand which crossed eleven-thousand mark in the year 2011. The market capitalization, daily trade volumes increased by leaps and bounds during the last two decades. As the private as well as foreign investment was allowed in various sectors, it provided a huge boost to the capital markets in India. If we look at the index numbers or share prices of companies, there has been huge upswing after 1991, after inception of financial sector reforms. But when all this was happening, there were some problems and constraints being developed in the financial market in general and capital market in particular. This part of the chapter not only stresses on the problems developed in the last two decades, but it also highlights some problems which were evolved earlier, but they still persist in the Indian capital market.

6.6.1. Insider Trading

Insider trading has become an inevitable practice in capital market in India. In the organizational structure, there are some persons who have access to price sensitive
information by virtue of their position in the company. If these people use this sensitive information for their own advantage, it results in insider trading\textsuperscript{19}. SEBI has introduced some regulations against insider trading but still it is difficult to entirely eliminate this drawback. In the market operators, it is commonly argued that preventing insider trading is as difficult as controlling black money.

**6.6.2. Price Rigging**

This drawback is normally observed when companies come up with capital issue in the primary market. The prices of shares are artificially\textsuperscript{20} pulled up before issue of securities by companies. This artificial increase in price is done by some buyers and sellers among themselves or among group which engages itself in such type of activities. This push-up results into bull movement in the market.

**6.6.3. Lack of Liquidity**

Even though there are more than ten thousand companies listed in Indian stock markets, the shares of only few companies are actively traded in the market. Out of the total turnover taking place in the stock exchanges more than 50 % of such trade is concentrated in just 10 corporate stocks. Hence investors of other companies find it difficult to perform the trade. This results into severe problem of liquidity\textsuperscript{21} which prevails in the Indian market. It can also be proved from the trade volumes of ‘A’ and ‘B’ Group trades in BSE. While trades in ‘A’ group companies increase in volume, trades in ‘B’ group companies decline in volume. Hence only actively traded shares have the liquidity. But overall, in nearly 90 % of the companies there is no liquidity. It clearly shows that Indian markets are suffering from poor skewed liquidity.

**6.6.4 Lack Of Transparency**

During this phase, there has been emergence of SEBI as a regulating authority in Indian Capital market. But in spite of its efforts to preserve transparency in the Indian markets, there has not been 100 % success in this respect. Many brokers are involved in unethical practices, violating regulations imposed in the market. Some of the data relating to opening, closing, high and low prices are reported, but regarding volumes
of trade carried out at the highest and lowest prices, the proper information is not provided to the investors. The time taken to execute a transaction is also not reported. This may lead to price distortions and undue advantage is taken by the brokers. Due to this genuine investors find it difficult to have full and perfect knowledge about the market, leaving lack of transparency in the market.

**6.6.5 Timing of New Issues**

Due to the advantages of primary market, the companies are interested to raise the capital through primary market. But if number of companies queue up for raising the capital at a time, then the market gets crowded. When the secondary market performs well, primary market gets flooded with new issues by the companies. It also has been experienced in the last decade that sometimes, in one week there are 8 to 10 new issues in the market at a time. This is hazardous to the companies as well as the investors. Since a number of companies come up with the issue at a time, the investors get divided and the company may not get entire subscription. From investor’s point of view also it is difficult for them to opt for a particular company. If at a time there are a number of issues ongoing, research, analysis and risk assessment becomes difficult. Investors may get confused.

**6.6.6 Cost Of Capital Issues**

Normally, debt form of capital is preferred by the companies for tax advantage. The equity capital is cheaper over debt, but if opportunity cost or alternative use of capital is considered, it is not the cheapest form of capital. In order to satisfy the investor, companies have to pay dividend to the investors. Apart from this, the cost involved in the primary market like prospectus printing and distribution, arrangement and collection of subscription, commission and brokerage are also important cost considerations.

**6.6.7 Odd Lots**

The securities listed are included in group A or group B. The other tradable securities which are not listed are called ‘odd lots.’ These securities are classified into Group C.
Since these securities are not actively traded, all the transactions of odd lots leave investors into the loss. At the time of sales of odd lots\textsuperscript{25}, there is discount of 10-15 % while for purchase of odd lots, there is premium of 10-15 %. In any case, the investor has to suffer the loss. This fact discourages investment in such shares and thereby limits trading activities in the market.

\textbf{6.6.8 Volatility}

During the recent past, Indian markets have experienced high volatility\textsuperscript{26}. Over the last twenty years, there has been huge increase in the popular indices like Sensex or Nifty. But in the meanwhile, there have been large amount of fluctuations. This volatility has two important reasons. Firstly, the increasing influence of FIIs in the market which is permitted during this phase only. Another thing which is associated with this is that delivery-based-trading is declining while the day-trading activities are increasing. Delivery based trading is normally a genuine investment activity while day-trading is speculative in nature. As more and more trades are in the form of day-trading, it makes the market volatile. In the recent past, the banks and financial institutions, foreign institutional investors and domestic mutual funds have pumped in huge funds in the market. But whenever there are negative sentiments, all such funds are withdrawn which make the markets even more volatile and unpredictable.

\textbf{6.6.9. Drawback For The New Company}

In primary markets, the funds can be raised in huge quantity by the companies. If the track record of a company is sound and the company has a good reputation in the market, it can further raise the funds by way of follow on public offer or rights issue. But a company which is totally new, which is newly registered and not much popular, finds it difficult to raise the funds. In this case, company formed recently, may have good prospects, but still investors prefer the established company. This fact underlines the reality that even though primary market is for new issues of capital, still the new companies have lot of problems\textsuperscript{27} while raising the funds from the market.

\textbf{6.6.10 Fly-By Night Companies}
In Indian capital market, there have been the experiences that the capital is raised by the promoters and directors. But after tapping the capital from market, these promoters and directors disappear from the market. These companies are also called as Vanishing companies. This results into loss of faith among the investors as they have to suffer total loss in case of such investment in vanishing companies. Recently, SEBI has initiated action against promoters and directors of such ‘Fly-by night companies.’ Due to this move by SEBI, the threat of presence of such companies in the market has been reduced.

6.6.11 Unethical Mergers Of Companies

The primary market is advantageous to the economy as it provides capital to the enterprises. But there are some unethical practices being developed in the primary market also. For example, a large unlisted company gets merged with small listed company through public offer. Here large company which is not listed, purchases shares of a small listed company in a big way and such mergers are dangerous as the identity of the company may get changed.

6.6.12 Risk Of Rumours

Most of the time market is driven by rumours about a particular company or overall market. Rumours may get floated in the market by websites, news agencies, and financial newspapers or even by word of mouth. It may happen that management of the company, with the help of the brokers spread the rumours in the market. This influences the investor’s perception about valuation of securities. The brokers or even promoters of a company may get undue advantage out of such rumours. It is expected that the investors should keep themselves away from the rumours, they should desist from acting on rumours.

6.6.13 System Risk

During the trading session, at a particular time, there are high volumes of trade. At the time of opening or at the closing, the trading volume is high. These high volumes may cause delays in execution of orders and confirmation of the same. During the volatile
trade activities, participants continuously modify/cancel the orders. Therefore there are delays in execution of order. When there is high volatility, some circuit filters are imposed to prohibit unusual trading. When circuit filters are active, it is difficult or even impossible to liquidate a position in the market. Sometimes, the market operations have to be suspended for sometime due to extreme volatility. This risk is an important factor emerging from volatility and unusual trade.

### 6.6.14 Unethical Practices

Various participants in the market viz. existing companies, new companies, entrepreneurs, brokers and other intermediaries are sometimes involved in unethical practices in various ways. Mergers and acquisitions through malpractices, entering into insider trading, rigging up of price before a new issue, spreading misinformation or rumours, promoting fake shares are some unethical practices prevailing in the market. In spite of SEBI’s continuous check against such practices, total control on such activities is remote. To some extent, SEBI has been successful in controlling unethical practices, but still a lot needs to be done to control these practices.

### 6.6.15 System / Network Congestion

With the advent of NSE, screen based trading system and online trading has been possible since last two decades. But it requires use of technology and also adequate infrastructure. Communication failure, system problems may result in delay in order execution, or inability to access the market at a point of time. Some of these problems may be temporary in nature, but still these problems affect processing of orders.

### 6.6.16 Thin And Restricted Trading

In the stock exchanges, the number of hours for which trading is open for participants, is very less. On an average only six hours of trade per day is permitted in the stock exchanges. Apart from this, there are number of holidays due to which an investor finds it difficult to have liquidity throughout a month. A study has observed that about 64% of the listed scrips were not traded at all on BSE during 1995-97.

### 6.6.17 Oligopolistic Nature
Earlier, during the initial phases of development of capital market, BSE was the dominant stock exchange. Apart from this now NSE has taken over BSE, but collectively these two stock exchanges account for more than 90% of trades in stock exchanges. Membership of these exchanges is also restricted. The traders/brokers also speculate in shares without processing them. This hampers the general belief that capital market is a perfectly competitive market.

6.6.18 Speculation

An excessive speculation in the stock exchanges has now become a well settled/established fact. Share prices in the market are determined by the speculative forces and these prices have very low references of fundamentals or performance of economy, industry or company. The dealers, merchants, insiders, fund managers etc. try to speculate the prices of share. As this has nothing to do with the performance of company/industry, a genuine and studied investor tries to be aloof from the trading. This reduces the presence of genuine investors and thereby increases the speculative motive among the other market participants also.

6.6.19 Underdeveloped Debt Markets

The shares issued in the primary market are later on traded in the secondary markets i.e. stock exchanges. But a part of primary market also involves debenture financing. The debentures are issued in the primary market. But in stock exchanges there is no room for trading in debentures. The secondary market in industrial debentures remained underdeveloped over the years. Even though equity market has developed rapidly throughout the last two decades, the debentures market has remained underdeveloped. This results into less enthusiasm of long term investors in the market.

6.6.20 Imbalanced Growth

There has been considerable growth in terms of companies, capital raised, number of intermediaries in the capital market, but this growth has remained lopsided. Only 2 exchanges viz. NSE and BSE account for the major trading activities of the market.
throughout the country. The stock markets are almost urban oriented with a very little relation with the vast rural economy. Most of these stock exchanges are in metropolitan cities while no stock exchange is located at rural location. The rules, restrictions, and legal compulsions are such that the rural entrepreneurs find it difficult to get the benefit of capital market. This structural and organizational imbalance in the growth of stock markets keeps the majority of population away from the markets.

6.6.21 Bad Delivers

Due to excessive speculative business beyond manageable resources, the market has experienced payment crises frequently. Monitoring and controlling these speculative transactions has become difficult even for the regulators. Due to this, settlements have been delayed many times. Such bad deliveries are crippling the market. One of the reasons for this may be lack of professionalism among brokers and intermediaries. These bad deliveries limit liquidity considerably.

6.6.22 Concentration/ Dominance Of Big Corporates

In the recent past, stock market activities are becoming more concentrated, centralized and non-competitive. It has served the interest of only big establishments. Due to FIIs and domestic institutional investors, small investors find it difficult to protect their own interest in the market. There is mandatory minimum number of shares which needs to be applied for in the primary market. This minimum investment, when multiplied by issue price, may be beyond reach of small and common investors. The allocation towards retail individuals is also low which enables big corporates/FIIs to have concentrated holding. Besides these, only those companies which need to raise a minimum capital of Rs. 5 Crores, are allowed to enter in the primary market. Thus, the doors for the smaller companies are almost closed. Similarly, for small investors, also the market does not provide the expected competitive nature. Thus overall, markets are mostly dominated by the big shots of the corporate sector including big companies as well as big and institutional investors, leaving a very small space for smaller corporates as well as investors.

6.6.23 No Price- Time Priority
This problem was faced in the Indian markets in the 1990’s when there was no SBTS and online trading, with all trading floors, there was no price-time priority. The investors had to depend on brokers for getting the details of trade. Investors were not in a position to know whether the trade was executed at the best possible price. Now, though this problem has been, to some extent, solved, still the investors may not get the perfect information as to the best price at the time of trade. But to a large extent, this problem has been sorted out by the use of technology.

6.6.24 Other Problems

There are other problems prevailing in the Indian markets like inflating project costs and fixing unreasonable premium in the primary market, preferential and reserved allotment of substantial part of capital, benami traders, rackets and tampering with public issue application forms, badla finance etc. Some of these problems have been sorted out, but in general, this results into loss of confidence among small and retail investors. If the secondary markets are healthy, primary markets are attractive. Hence, primary markets, most of the times do not go along the fundamentals of company, industry in particular and economy in general. Lack of protection to the small and genuine investors is also one of the drawbacks of the Indian markets.

During this phase itself, there has been emergence of SEBI as a regulator in the Indian capital markets. Initially, SEBI looked just like a ‘Tiger without teeth’. But as the time progressed, SEBI became more and more strict and slowly, it became a strong regulator. But still, SEBI has not been successful in all respects. Especially, speculation, insider trading and inefficiency of information are the drawbacks which are still affecting the health of market.

6.7 Scams in the Indian Capital Markets

A study of capital markets essentially involves a study / observations regarding scams which have taken place since the establishment of capital markets. This is not only applicable to Indian markets, but even globally these scams have influenced the market sentiments. In the earlier days, especially in India, there was no independent body to regulate the capital market. This was, to a large extent, one of the reasons why
there were number of scams in the history of stock exchange. Due to insignificant or poor regulatory mechanism, there was automatically, a scope for manipulation in the prices of stocks. But as the time progressed, in India, SEBI shouldered responsibility as an efficient regulator in the financial markets in India. Though initially SEBI was reactive i.e. it was responding after occurrence of frauds, later on, it has become proactive i.e. in order to avoid the manipulations, number of guidelines or regulations have been prepared. But still one cannot ignore the scams which have happened during these developments. This part of the chapter analyses the background of some of the major frauds/scams in the Indian stock markets. It also encompasses some measures which have been taken by the regulators from time to time. As also, it focuses on impact of such scams on the market sentiments in the respective times. The volume of the scams or relative impact of these scams may be fluctuating or sometimes it may be limited, but one cannot ignore these evils in the market as they have huge negative impact on the genuine investors in the market. Sometimes, promoters/ directors of the company may get involved in such scams or the brokers may also be involved in the some of the scams, but in any case, sufferer is the genuine investor who is an important element in the capital market.

Ravi and MeheSh Puliani\textsuperscript{43} have defined word scam in the following way : ‘scam is the US word for fraud, swindle, probably derived from early 19\textsuperscript{th} century British English Scamp’ meaning ‘cheater swindler.’ The scam, not exhaustively is a stock market term, but it is widely used in relation to the stock market, especially after the stock market scandal in 1992 in India.

\textbf{6.7.1. First Stock Scam of The World}

The first scam of the world stock markets was witnessed in Europe. In 1815, Duke of Wellington and Napoleon were involved in the most decisive battle which was momentous for the future of Europe. Investors in London were worried as German army was not coming to the rescue and consequentially, England was losing the battle. The British East India Company’s trade with India and China was threatened during this time.
Nathan Rothschild, a leading merchant banker had invested a considerable sum to develop a private intelligence system. He had invested this for English victory. In this situation, believing that England would lose the battle, Rothschild began to sell everything he owned. When he started selling there was panic in England market as Rothschild was a leading merchant. After this panic, market started to collapse. At this time, Rothschild again stepped in to the market and started buying when there was panic. Suddenly, the news of Wellington’s victory sent the market booming. By this time, Rothschild earned thousands of pounds. He took the advantage of information he had and arbitrarily, he sent some news in the market and made profit for himself.

The recent scams in the Indian stock markets are of similar nature.

6.7.2. India’s First Stock Market Scam

Even though formally, we had a beginning of stock exchange in 1875, the stock trading and similar activities by brokers were carried out by the brokers informally since 1830’s onwards, though with a very small volume. These transactions were in the nature of trading and loans. The ‘Share Mania’ during 1860-65 is regarded as first scam in Indian markets. Due to American Civil War in 1860, supply of cotton from the US to Europe was totally stopped. This made huge rise in export and profit of Indian cotton industry as after US, India was the major option for cotton left for Europe market. This resulted into pumping in huge capital in cotton industry and allied business units. Considering the huge scope for the industry in the entire globe, traders in Mumbai became wild with spirit of speculation. Companies were started for every imaginable purpose banks, financial corporates, cotton clearing, pressing and spinning, hotel companies, land reclamation, brick making companies etc.

During this period capital raised from the market was almost Rs. 30 Crores, but premium raised was Rs. 38 Crores. The amount of premium collected by these companies was more than paid up capital of companies.

Asiatic Banking Corporation and Bank of Bombay raised huge capital at premium. Some of the banks and financial institutions recovered a premium of 50% to 100% of the paid up value without being tested by the fundamentals. Similarly, the shares of
other companies like Back Bay Reclamation, Port Canning, Mazgaon Land etc. had a premium of 10 times its paid up value. The Asiatic Bank share of Rs. 200 was quoted Rs.460 and Bank of Bombay share valued Rs.500 was stretched to Rs. 2850. Everybody started experiencing the boom and interested to get benefited from it. For this, the transactions were taking place even at higher prices.

This madness about ‘scrips’, ‘allotments’, ‘shares’, crippled into the market. These words became buzzwords in the streets of Mumbai as everybody was enthusiastic about these transactions. But later on, the American Civil War came to an end. In July 1865, after knowing that the potential which was speculated about various companies won’t come true, everybody rushed to sell the assets purchased at premium. The disaster started due to a huge selling pressure without buying enthusiasm. Hence, bargains were difficult to settle. A share of Bank of Bombay which had reached Rs.2850 could be sold at just Rs. 87. Back Bay Reclamation which had generated a maximum value of Rs 50,000 came to be sold at Rs. 1750 only. The bubble was burst and everybody again started fearing about ‘shares’, ‘scrips’ etc. It all happened during 1861 to 1865 due to widespread desolation. A large number of companies had to shut down their operations in Mumbai.

6.7.3. Scams In Indian Capital Market : Pre And Post Liberalization

After inception of formal stock exchanges in the later part of nineteenth century, initially, the people were shying away from the market as they had their hands shaken by ‘share mania’ during 1861-65. After independence, India accepted a mixed economy model wherein the controls and restrictions were imposed on lot of market activities. Foreign investment, institutional investment, corporate behavior of promoters/ directors everything was strictly controlled by the Government. But still a few scams emerged in controlled regime, though having a very low impact on market. But after 1991, when economy was opened for private as well as for foreign players (to some extent), the scope for manipulation increased. Apart from that initially SEBI also was not as successful as it is today to control the manipulations and price
distortions in the market. This generated an environment where the brokers like Harshad Mehta and Ketan Parekh took the undue advantage of the mechanism and got them involved in the scams.

Some of the major scams after 1990 in Indian stock markets are enlisted herewith

- Harshad Mehta Scam – 1992
- NBFC Ghotala – 1995-98
- Plantation Companies Scam – 1997
- Vanishing Companies Scam – 1999
- Name Changing ‘Game’ – 2000
- Dot com Scam – 2000
- Ketan Parekh scam – 2001
- UTI Fiasco – 2000

Apart from these major scams, some disasters which had an impact (to a limited extent) on the market are as follows.

- Home Trade Scam in Pune Stock Exchange
- Cooperative Banks scam in Gujarat
- P N Route (Mauritius route abuse of funds)

Out of these scams, the genesis of some of the major stock market scams is presented below.

**6.7.4. Harshad Mehta Scam**

This scam occurred due to use of illegal bank money for share transactions. The initial public offers (IPOs) were weapons used by public sector companies to generate the capital from the market. The amount raised, was required to be deposited
separately by the bankers and to be given to the companies. But in some cases, the money was not immediately deposited with the companies. Instead, the same money was temporarily used for investment in shares for a short period of time. This money was used to have additional capital gain of short term nature. Artificially, liquidity and demand for stocks was created with the use of this money. This resulted in sudden and artificial Bull Run in the stock exchange during 1991-92. From April 1991 to June 1991, the SENSEX rose to 1361 from 1193 (more than 16% in 2 1/2 months.)

By December 1991, it reached 1915 points and further to 2302 in January 1992 to 4467 on April 1992. This was an unprecedented growth in SENSEX. An amount of Rs. 3650 Crore was pumped in into the market by this illegal way. After April ‘92, when the amount was to be taken back by these brokers, the market crashed and within a week SENSEX came down by more than 10%. Some of the notified brokers and companies involved in this scams apart from Harshad Mehta, were- Fairgrowth Financial Services Ltd., Hiten Dalal, Bank of Karad, Bhupen Dalal, T.D. Ruia, A D Narottam etc. In all, this scam was a deliberate misuse of public money through securities transactions with an intention to get speculative return. The lacunas which allowed this scam were non transparency and non-accountability of the banking system, absence of governance in capital market, lack of awareness of investors, information inefficiency etc. Extensive use of bank receipts was made by the intermediaries involved in the scam for forward transactions.

6.7.5 Vanishing Companies Scam

Vanishing Companies Scam came to be known in 1990’s, but even in 1978-79 and 1984-85, there were IPO Booms in the Indian markets. Primary markets were flooded with public issues. About 700 companies entered in the market during 1984 to 1986. The amount of public issue ranged between Rs. 60 lakhs to Rs. 100 lakhs. But unfortunately, some of the promoters and brokers saw in it, an opportunity to raise funds. Then a phase came when 80% of the newly registered companies disappeared after generating capital. These companies are normally known as ‘Vanishing Companies’ which generate capital and then disappear.
During 1993 to 1997, a total of 4797 companies collected Rs.43 339 Crores from the market by way of IPO. But the vanishing companies scam was so disastrous that after 1997, in the next six years only 263 companies entered the market and could generate only Rs. 9209 Crore of capital. This drastic slump in the primary market was mostly due to price rigging. This scam particularly came out just when the economy started to move from ‘controlled’ to ‘open’ regime. The abolition of Controller of Capital Issues, created a gap. Without proper education, face pricing policy for IPOs was brought in. All these shocks came in a short period of time. The dubious promoters, speculative brokers and manipulative management were responsible for collection of crores of rupees from public and then simply vanished.

6.7.6 NBFC Ghotala

Non Banking Financial Corporations evolved in a financial system which required diversified instruments in 1990’s. About 40,000 NBFCs applied to RBI in 1997 for license. More than Rs. 40,000 Crores were raised by these NBFCs such as CRB Finance, JVG Group, Prudential Finance, Kirloskar etc. These NBFCs collected the funds from investors and then passed on these funds to their sister concerns who misused the funds and defaulted. Though directly the money was not coming into or going out of stock markets in this scam, investors who had invested their amount with NBFCs, had some investment in stock markets also. The small investors investing in NBFCs had to suffer from this misuse of funds. Most of these NBFCs had to liquidate their business and shut down their business and this left the large number of small depositors in huge losses.

6.7.7 Ketan Parekh Scam (2000-01)


Initially, it had some relevance with emergence of I.T. companies in Indian Markets. Later on, communication companies and some entertainment companies also participated in the Bull Run (Teji) in the market. In February 2000, sensex crossed 6000 points. But this was artificially created upward movement. In January 2001, BSE
sensex was hovering around 4000 points. After presentation of the Budget in the Parliament, sensex reached at 4271 and further at 4321 on the subsequent day. During this phase, besides the volatility in the movement of the index, prices of ‘some’ companies registered violent fluctuations. The SEBI instituted an investigation against such fluctuations. This began with six broking entities and was subsequently expanded to cover the entire gamut of scam.\textsuperscript{49,50}

It was Ketan Parekh who started to talk about future of I.T. companies in India. His projections about future and expected profitability of these companies had driven upward prices of such companies. Ketan Parekh, then, emerged as a key player in the market as his projections were quoted by many brokers. Ketan Parekh received large sums of money from the banks as well as some corporate entities. During the same time, however, sensex was falling. This was enough for the investigators to believe that there is a nexus between the banks, corporate entities and Ketan Parekh. It was not only an ‘Individual Case’ but ‘Persistent and pervasive misappropriation of public funds and involving the issues of governance’ which leads to a ‘scam’. Then SEBI further investigated into this manipulation and 23 entities were found to have association with Ketan Parekh.

These entities are listed below.

V.N. Parekh Securities Ltd.

K.N.P. Securities Ltd.

Triumph International Finance India Ltd.

Triumph Securities Ltd.

Classic Shares and Stockbroking Services

N.H. Securities

Classic Credit Ltd.

Classic Infin Ltd.
SEBI has finally observed that Ketan Parekh was operating through a large number of entities with a nexus among corporate houses, banks, financial institutions and even FIIs. This helped him to arrange flow of funds from banks and corporates into the stock markets. In order to avoid the detection of manipulation, Ketan Parekh had done the transactions in the name of different companies, not concentrating on any one or few companies. He used the network of FIIs and also systematically sold his holdings to book profits and further to take position there from to again increase the prices of shares further. He had identified the companies with relatively low floating stocks and acquired substantial holdings through various associates. He also used number of
stocks exchanges and different settlement cycles to shift positions from exchange to exchange.

Against the sanctioned limit of Rs. 205 Crores, there was an outstanding balance of Rs. 888 Crores against Ketan Parekh group towards Madhavpura Mercantile Cooperative Bank. As against a limit of Rs. 92 Crores, the same bank had an amount outstanding to the extent of Rs.225 Crores from Mukesh Babu Group. Payment problem in Calcutta Stock Exchange in 2001 and crash of Madhavpura Mercantile Cooperative Bank (MMCB) were the effects of the Ketan Parekh scam.

SEBI further revealed that the amount outstanding from Ketan Parekh entities/group to the corporate houses was to the tune of Rs. 1273 Crores at the end of April, 2001. Dues of the Ketan Parekh Group to Madhavpura Mercantile Cooperative Bank were around R. 888 Crores and to Global Trust Bank were around Rs. 266 Crores. Later on, MMCB totally crashed while GTB got merged. The small investors also had to suffer huge losses as the artificial Bull Run manipulated by Ketan Parekh resulted in crash in the stock market when sensex plunged from 6000 points in February 2000 to 3700 points in April 2001. Simultaneously, money invested in mutual funds, UTI and financial institutions was also lost to a great extent as these institutions also had a considerable investment in the stock market.

**6.8 Factors Which Make Scams Possible**

The scams in the Indian capital markets have hurt the sentiments of investors in the past. In spite of many scams which emerged throughout last one and half century, still the market has overcome and with emergence of regulators as well as legal actions from time to time. But some factors which have made such scams possible are briefly elaborated below.

**6.8.1 Lack of Operational Efficiency**

Efficiency in case of capital market is understood with reference to the availability of information to different sectors/players in the market. Indian capital market is not fully developed or competitive in nature as the flow of information is not always smooth.
Insider trading has also resulted in adding operational inefficiency. Sensitive information relating to the financial and operational performance of the company may get leaked from the insiders/decision making authorities of the company. The people who have access to such information are in a position to take undue advantage of having access of sensitive information. The same information reaches out to the ultimate investors after some time gap and by that time, the persons having access to the information earlier, already get benefited, thus leaving small and genuine investors at distance. Due to this particular problem the genuine investors try to keep themselves away from the market as they may not be in a position to make the ‘timely decisions’.

6.8.2 Structural and Organizational Imbalance

Pherwani Committee has given a suggestion to have a two-tier system in organizational structure of stock exchanges. It recommended four premium stock exchanges in metropolitan cities and then, for semi-urban areas, more stock exchanges in emerging cities/towns. But unfortunately, till today both the premier stock exchanges in India are located in Mumbai viz. BSE and NSE. These two stock exchanges account for almost 90% of the total turnover of turnover in all the stock exchanges in India. Those investors who do not have access to these stock exchanges are not much benefited or find it difficult to keep themselves in the market. It is true that due to online and screen based trading, the geographical barriers are no more, but still, the regional stock exchanges see a very dark future. The players associated with these stock exchanges also do not have a bright future. Now a days, demutualization of stock exchanges is also a good move. Earlier most of the stock exchanges were ‘not for profit’ organizations. Hence, there were some problems in regulating these stock exchanges. But now due to demutualization, all the stock exchanges are expected to be corporates. This would certainly help in regulating operations in the stock exchanges. But in the past, due to the non-corporate nature of stock exchanges, there was scope for malpractices as there was no legislative and specific action against such type of organization.

6.8.3 Dominance of Few Corporates and FIs
Indian capital markets, since the last several years have been dominated by big corporate houses and by the domestic and foreign institutional investors. To a common man the stock exchange seems to be a place for only elite group or big corporates. To some extent, this is true also as the movements of stocks of few companies direct the way of the entire market. While calculating the values of popular indices (like Sensex or Nifty), also the more weightage is given to the big industrial houses like Reliance, ICICI, Tata etc. This is scientific way to calculate the index as it is based on free-float methodology, but still if few corporates are in a position to drive the markets, it may result into fraudulent actions by market players while making investments in such stocks.

Another feature of Indian capital markets is that domestic and especially foreign institutional investors have been dominant in bringing the market down or taking it upwards. The small and genuine investors may be huge in number. But the funds which they pump into the market are too small as compared to the funds poured by FIs and FIIs. The foreign institutional investors are always in search of a better market and hence the money invested by them may quickly be withdrawn by them also if they find a better environment. This particular phenomenon may create emergence of speculative broker/intermediary (domestic or international) which may get into the market whenever the FIIs are positive about a country. They can benefit from their investments and when there is negative or downward trend, such intermediaries may immediately get out of the market. As these players have access to international agency’s research report about a country, they can enter into the market with fraudulent intention.

6.8.4 Speculation

To some extent, speculation is required to provide liquidity in the market. Without speculation, the turnover in the markets may come down which creates a problem of liquidity. But excessive speculation is dangerous for the health of the markets. In Indian capital markets, speculation has become a well established phenomenon. Often, prices of stocks in the stock exchanges are determined or driven by future expectations than the fundamentals or track record of the respective company. The brokers or
insiders try to speculate the prices of shares. Sometimes, even they are involved in spreading rumours in the market about a particular company or a specific sector. They try to convince the other brokers or small investors and force them to go for shares of a particular company. This does not have any relation with company’s financial or operating performance. This, in future, would not provide positive returns as such decisions are purely based on speculative motives. A genuine investor who makes analysis about company’s performance and makes his decision is on one hand and a large section of investors who are influenced by brokers and speculative operators is on the other hand. Naturally, as a common man is not in a position to analyze the company’s performance, he intends to go with broker’s tips/anticipation. In such situation, brokers may get into a fraudulent position as investors rely on them for their decisions. Hence, the company which has no prospect or future may wrongly become attractive only due to recommendation of brokers. Today, day-trading has become more popular than long term investment. This is purely speculative trading and the increasing significance of day-trading highlights more and more inclination of investors towards speculation. The brokers, in this situation, may utilize their knowledge to promote speculation and excessive speculation may lead to scams. In India Harshad Mehta and Ketan Parekh were able to involve themselves in such fraudulent activities because of speculation only.

6.8.5 Volatility

Another factor which ultimately causes the scams in Indian capital market is volatility. The two important factors which are described earlier viz. presence of FIIs and speculation have made markets more volatile. A genuine investor normally goes for delivery based trading which is a long term investment. On the other hand, day-trader who is a speculator does not go for delivery based trading. Instead, he goes for quick returns and even he is ready to bear the risk of loss in such trade. As the number of such trades is high, it results into volatility. Normally, volatility is the standard deviation of daily returns. More the volatility more is the instability in the markets. Though the volatility is a phenomenon which is experienced in the markets throughout the world, in India also, this feature has been experienced since past few decades. If
we compare the volatility in major stock markets in India, this shows an increasing trend. In 1997-98, BSE recorded volatility of 2.30 % while in 2008-09, the same was 2.80 %. Similarly, NSE recorded a volatility of 2.02 % in 1997-98 while the same was 2.66 % in 2008-09. Due to volatility, genuine investors try to remain away from the markets. This is the time when the speculators grab this opportunity and force the investors to trade in a particular company’s shares. This provides the speculators a platform to be involved in a scam to get a benefit in short run.

6.9 Conclusion

A study of capital markets significantly involves a study of problems which emerged in various phases of development of capital market in India. This chapter has presented these problems in a phased manner. Apart from this, an attempt has also been made to analyze the frauds which have taken place during last one and half century. The problems experienced in the Indian capital markets as well as the scams were significant as they proved to be hindrances in the smooth functioning of capital markets. Due to these hindrances a genuine investor has remained aloof from the market while more and more speculators and institutional investors continued to dominate the capital markets in India. This has also resulted into increased volatility in the Indian capital market. When the financial sector reforms were initiated, it was also emphasized to have a strong regulator for the Indian capital market. This task of regulation is being shouldered by SEBI to a great extent along with other regulators like RBI, Department of Company Affairs etc. The detailed role of regulators in the Indian capital markets has been elaborated in the next chapter.
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