

PN. ACB-458

95486

**Investigation Module for
Market Manipulation -
Over The Counter Exchange of India**

**Financial Institutions Reforms and
Expansion (FIRE) Project**

August 13, 1997

**Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)
Contract #386-0531-C-00-5010-00
Project #386-0531-3-30069**

**Price Waterhouse LLP
1616 North Fort Myer Drive
Arlington, VA 22209
Tel (703) 741-1000
Fax (703) 741-1616**

A

Price Waterhouse LLP



August 13, 1997

Mr. Pushpangadan
Managing Director
Over The Counter Exchange of India Limited
Cuff Parade
Bombay

Dear Mr. Pushpangadan,

Subject : Investigation Module for Market Manipulation

At the request of the Over The Counter Exchange of India Limited (OTCEI), Price Waterhouse LLP (PW) arranged for Mr. Cliff Kennedy, Senior Consultant, Price Waterhouse LLP, US, to develop an investigation Module for Market Manipulation for OTCEI. Mr. Cliff Kennedy, former Chief Enforcement Attorney in US Securities and Exchange Commission (SEC) has experience in market surveillance and enforcement activities in the US and relevant emerging markets and his expertise is appropriate for this report.

The work for this study is carried out under the US Agency for International Development (USAID) Financial Institutions Reform and Expansion (FIRE) project which is administered by Price Waterhouse LLP.

I. Purpose of Report

This report is to assist the OTCEI in creating a set of guidelines to develop evidence that establishes violations of anti-manipulation regulations. These guidelines will assist OTCEI to build evidence for a strong market manipulation cases.

II. Contents of Report

The report begins with a brief description of the basic characteristics of a market manipulation scheme, common variations and warning signals. The legal framework that prohibits market manipulations and enables OTCEI to investigate and take action against the members reviewed. The report, there after sets forth the steps that OTCEI inquiry should follow when gathering evidence to build a market manipulation case.

III. Next Steps

The report covers the legal frame work and the internal investigation model at OTCEI and their linkage for the development of the market manipulation case building. It also suggests the legal relationship inter alia with the members, other stock exchanges, investors.



We want to thank you for the cooperation of the OTCEI staff for the excellent support provided to Mr. Cliff Kennedy in gathering and furnishing the information required to make this report.

If you have any questions or clarifications, please feel free to contact me at the FIRE project.

Thanking you,

Yours sincerely,

W. Dennis Grubb
Principal Consultant

**OTCEI INVESTIGATION MODULE
FOR MARKET MANIPULATION**

TABLE OF CONTENTS

I.	Introduction.....	2
II.	Market Manipulation Generally.....	2
	A. Illegal Purpose.....	2
	B. OTCEI Role.....	2
III.	Market Manipulations Schemes.....	2
	A. Indicia of a Manipulation.....	2
	B. The Basic Scheme.....	3
	C. Manipulation in the Secondary Offering.....	4
	D. Manipulation to Maintain the Price of a Script.....	4
	E. Manipulation in the Initial Public Offering.....	5
	F. Creation of Pre-Offering Gray Market.....	5
IV.	Legal Framework.....	6
	A. Applicable Legal Elements of a Market Manipulation Scheme.....	6
	B. Importance of Intent to Manipulate.....	6
	C. General Market Manipulation Prohibitions.....	6
	1. SEBI Regulations Applicable to Any Person.....	7
	2. SEBI and OTCEI Regulations Applicable to Members.....	7
V.	OTCEI Investigations.....	9
	A. Authority For Conducting Investigations.....	9
	B. Sources of Cases.....	10
	C. The Investigatory Process.....	12
	D. Obtaining Evidence and Information.....	12
	1. Internal Sources.....	12
	2. Other Stock Exchanges.....	13
	3. Brokers.....	14
	4. Issuers.....	17
	5. Investors and Other Individuals.....	18
VI.	Report of Investigation.....	18

I. INTRODUCTION

This document presents a set of guidelines intended to assist the OTCEI develop evidence that establishes violations of anti-manipulation regulations. It begins with a description of the basic characteristics of a market manipulation scheme, common variations, and warning signs. The guidelines then review the legal framework that both prohibits market manipulation and enables the OTCEI to investigate and take action against Members and to make referrals to SEBI. Finally, it sets forth the steps that a OTCEI inquiry should follow when gathering evidence to build a market manipulation case.

II. MARKET MANIPULATION GENERALLY

A. Illegal Purpose

Market manipulation is usually a series of transactions intended to artificially raise or lower the price of a security or to give the appearance of trading for the purpose of establishing an artificial price for a script contrary to the OTCEI Rules, Bye-Laws and Regulations and to the SEBI Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations.

B. OTCEI Role

Market manipulation alters the free-market forces of supply and demand, the principle upon which investors rely when making financial decisions. By distorting share prices on the OTCEI, manipulation undermines the integrity of the market and damages investor confidence. Therefore, it is the role of the OTCEI to vigorously detect and pursue instances of price-rigging and other forms of market manipulation.

III. MARKET MANIPULATION SCHEMES

A. Indicia of a Manipulation

When investigating the possibility of a manipulation, there are many signs that may indicate whether price rigging has occurred. Set forth below are some of the more frequent warning signs of a manipulation.

Sudden Activity in Thinly Traded Script. Manipulators often look to thinly traded script because their price is generally easier to influence. Here, prices can be altered with only a limited number of buy or sell orders. Conversely, it is difficult to manipulate the price of script that is widely-held, well-capitalized and actively-traded.

Large Scale Advertising and Other Increased Marketing Efforts. In manipulation cases involving corporate management, a company may

engage in a wide-scale advertising campaign that occurs just prior to or in conjunction with an initial public offering or secondary offering of script. The advertising is intended not only to promote the company's products, but also to create interest in the forthcoming sale of script.

Statements About the Future Price of a Script. In an effort to raise the price of a script, the company or its promoter may begin issuing encouraging reports which suggest that a script is undervalued or predict that investors can expect the price to rise in the near future.

Trading In "Benami" Accounts. To disguise their activities, manipulators often resort to trading through accounts opened under the names of family members, business associates or companies that they control. This practice aids the manipulator in concealing his activities.

The Circulation of Rumors. Sometimes manipulators will actively spread rumors about a company in hopes of creating interest in a particular script. These rumors are sometimes published in the financial press.

Consistent Late Day Trades. The financial press regularly prints only the closing price of a script. A person wishing to create the appearance of a rising price might succeed by making a series of end-of-day purchases, on a regular basis, over a short period of time.

Direct Financial Benefit to Manipulators. Persons attempting to manipulate the price of a script will almost invariably have a direct financial interest in the success of their scheme. Evidence of direct financial interest is often a conclusive way to prove intent.

B. The Basic Scheme

The basic market manipulation scheme - sometimes referred to as "ramping" - occurs when an individual or small group of people begin purchasing a script of a company with a view to cornering the market. This process often takes several weeks, but can be accomplished in only a few days. By constantly purchasing more shares, the manipulator begins to force up the price of the script. After gaining effective control over the outstanding shares, the manipulator engages in a few additional trades to force the price even higher. When the manipulator is satisfied that the price has risen sufficiently high, he makes the decision to sell his shares at the inflated price. The manipulator thereby earns a huge profit, typically at the expense of unsuspecting investors. Once the manipulator withdraws from the market, the price of the script crashes, often falling below levels that existed before the manipulator commenced his scheme.

Illustration. Shares of company XYZ sell for Rs. 40 each and the company has 100,000 shares outstanding. A market manipulator decides to buy shares with the intention of cornering the market and artificially driving up the price. Consider a ten-day manipulation cycle. On day one, the manipulator buys 20,000 shares at

Rs. 40 each. He continues to aggressively buy shares of Company XYZ as follows:

Day	Shares	Price Per Share (Rs.)
One	20,000	40
Two	20,000	42
Three	20,000	45
Four	20,000	50
Five	20,000	60

By the end of day five, the manipulator has cornered the market for XYZ shares. For the next three days, the manipulator proceeds to trade the securities back and forth, typically between accounts maintained with different brokers. This activity allows the manipulator to raise the price of the stock further, to approximately Rs. 120 per share. The price rise and trading activity also creates strong interest among unsuspecting public investors. On day nine, the manipulator decides to sell, or “dump” the securities on the open market. He sells the securities for an average price of Rs.110 per share. The following day, without support from the manipulator, the price of XYZ shares crashes to Rs. 35 per share.

In summary, during the ten-day period, the manipulator bought 100,000 XYZ shares for an average of Rs. 47.4 and sold all of the shares for an average of Rs. 110. The manipulator reaped a total profit of Rs. 62.6 per share.

C. Manipulation in the Secondary Offering

This type of manipulation occurs when a company already has script traded in the market and the promoters of the company attempt to raise additional funds through a secondary offering. The promoters manipulate the price of the outstanding script by engaging in a covert buying effort immediately prior to the secondary offering. This activity is sometimes accompanied by a large advertising campaign touting the business prospects of the company. They engage in this activity to create a demand for the secondary offering. When they have succeeded in raising the collective interest of the market and demand for the script is high, the promoters sell the secondary offering at the inflated price. Although the price of the script may remain at a relatively high level for a temporary period after the sale of the secondary offering, it will soon fall to its pre-manipulation levels.

D. Manipulation to Maintain the Price of a Script

In a price maintenance scheme, the manipulator does not attempt to raise the price of a script; rather, he attempts to prevent it from declining. These types of schemes occur most frequently when the overall market is falling. The manipulator often owns a significant percentage of the outstanding shares of the company. The shares are sometimes pledged as assets for loans or otherwise leveraged, thereby increasing the importance of the price to the manipulator. The manipulator attempts to support the price of the script by creating the appearance of active trading. He does so by placing small purchase orders at a price greater than the current market price, often at the end of the day. These types of schemes are

generally successful for only a short period of time, until market forces cause a collapse in the price of the security.

E. Manipulation in the Initial Public Offering

In some instances, a manipulator will form a corporation and sell its script for the sole purpose of defrauding the market. Under this scheme, a promoter forms a corporation that will supposedly begin operations in a leading industry such as "high tech" computers, energy production or international trade; when, in fact, the corporation has no assets or legitimate business prospects. The promoter files a prospectus that states only a vague purpose for the offering, fails to commit the company to a specific use of the funds, or simply misrepresents the purpose of the offering.

In the initial public offering, the promoter distributes the shares to affiliated persons or otherwise retains control over the shares through covert means. The manipulator and his affiliates then create the appearance of interest by trading between themselves. This activity creates public interest that raises the price of the script higher. When the price has risen high enough, the manipulator and his associates "dump" the script on unsuspecting buyers. The manipulator then disappears with the funds, the price of the script collapses and the secondary purchasers lose their money.

F. Creation of a Pre-Offering Gray Market

Another type of manipulation that occurs in connection with initial public offerings involves trading in the "gray market". When a company decides to issue new securities, it must file a prospectus with SEBI. SEBI then reviews the submitted prospectus to determine whether it meets the required disclosure standards. This process is referred to as vetting. If the prospectus meets the required disclosure standards, SEBI will issue an acknowledgment card authorizing the issuer to sell securities. The actual offering price will be determined just prior to the offering date and will depend on investor interest and prevailing market conditions. After obtaining the acknowledgment card, the issuer begins preparations to sell the securities. This process includes printing application forms and prospectuses, establishing marketing and distribution programs, holding investor conferences, and several other planning steps.

During the preparation period, brokers sometimes begin trading interests in the as yet unsold securities. In effect, they are betting on the actual offering price by engaging in "futures" type trading. This gray market activity can have a strong influence in the actual offering price by creating the false appearance of interest in the stock. In the worst cases, the issuer may be in collusion with the brokers in an effort to reap greater profits at the time of the sale. When the sale is completed and the brokers and the issuer cease their trading activity, the securities fall in price and investors are left with sharply devalued shares.

Gray market trading has the effect of undermining investor confidence in the markets. At a minimum, gray market trading can alert the OTCEI staff to securities that are likely to be

manipulated further in the future and it identifies brokers that may be willing to engage in additional manipulative behavior.

IV. LEGAL FRAMEWORK

A. Applicable Legal Elements of a Market Manipulation Scheme

Members of the OTCEI staff should attempt to establish the following three legal elements during the course of their investigation of a possible scheme to manipulate the price of a script trading at the OTCEI:

- i. identity of the person or group with an interest or intent to engage in activity which has the purpose the deliberate raising, lowering or pegging of the price of a script
- ii. conduct or activity that-
 - a. created actual or apparent active trading, or
 - b. caused a rise, decline or pegging of the price of a security
- iii. activity that was undertaken to induce the purchase or sale of script by others

B. Importance of Intent to Manipulate

Persons associated with the securities market often engage in activities that cause the price of a security to rise or fall, but that are not illegal since there is no intent to manipulate. For instance, a large investor may attend a shareholder meeting and conclude that the script of the company is overvalued. Based on this conclusion, the shareholder may decide to sell his securities. This action may depress the price of the script.

Similarly, a member of the financial press may write a positive news story about a company based on the performance of a new management team. This action may cause a rise in the price of the script of the company.

In both examples, individuals took action that caused a change in the price of a script. However, no manipulative intent existed and thus there was no violation of free-market principles or the securities laws. Thus, the intent to manipulate is a key element in establishing a manipulation case.

C. General Market Manipulation Prohibitions

1. SEBI Regulations Applicable to Any Person

Market manipulation is specifically prohibited by the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 1995. Regulation 4 of this law establishes that no person shall -

- a) effect, take part in, or enter into, either directly or indirectly, transactions in securities, with the intention of artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by any person;
- b) indulge in any act, which is calculated to create a false or misleading appearance of trading on the securities market;
- c) indulge in any act which results in reflection of prices of securities based on transactions that are not genuine trade transactions.
- d) enter into a purchase or sale of any securities, not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress, or cause fluctuation in the market price of securities.
- e) pay, offer or agree to pay or offer, directly or indirectly, to any person any money or money's worth for inducing another person to sell any security with the sole object of inflating, depressing, or causing fluctuations in the market price of securities.

In addition, market manipulation may be further prohibited by the "catch-all" anti-fraud provision contained in Regulation 7 of the same law, which states that no person shall -

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

These regulations are broad in scope and coverage; they apply to the activities of all "persons." The term person should be understood to include any individual or entity that buys, sells or otherwise deals in securities. As a result, these regulations can be used to address the conduct not only of licensed individuals and entities, but also non-licensed individuals and entities, such as customers.

2. SEBI and OTCEI Regulations Applicable to Members

a. SEBI Regulations

Both the SEBI rules and regulations which specifically apply to stock brokers and sub-brokers and OTCEI regulations which specifically to Members prohibit market manipulation activity. The SEBI (Stock Broker and Sub-Broker) Rules and Regulations, 1992, contain a Code of Conduct that prohibits manipulative practices. Specifically, Regulation 7A proscribes the following behavior:

- (3) Manipulation: A stock broker shall not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumors with a view to distorting market equilibrium or making personal gain.

- (4) **Malpractices:** A stock broker shall not create false market either singly or in concert with others or indulge in any act detrimental to the investors interest or which leads to interference with the fair and smooth functioning of the market.

This prohibition against market manipulation should also extend to circumstances where the broker or sub-broker, although not the primary manipulator, nevertheless assists the scheme by knowingly entering manipulative trades.

b. **OTCEI Regulations**

The OTCEI Bye-laws describe certain misconduct by a member which is subject to the Penalties provisions, set forth in Chapter XV.02, as follows:

Penalty for Misconduct, Unbusinesslike Conduct and Unprofessional Conduct

In particular and without in any way limiting or prejudicing the generality of the provisions in sub-clause of above a member shall be liable to expulsion or suspension or withdrawal of all or any of its membership rights and or to payment of a fine and/or be censured, reprimanded or warned for any misconduct, unbusinesslike conduct or unprofessional conduct in the sense of the provision in that behalf contained therein.

The Bye-laws continue on to describe misconduct in Chapter XV.03, as follows:

Misconduct

A member shall be deemed in the opinion of the OTC Committee guilty of misconduct for any of the following or similar acts or omissions namely-

- (i) **Fraud:** If he is convicted of a criminal offense or commits fraud or a fraudulent act which in the opinion of the OTC Committee renders him unfit to be a member;
- (ii) **Improper Conduct:** If in the opinion of the OTC Committee it is guilty of dishonorable or disgraceful or disorderly or improper conduct on the OTC Exchange or of willfully obstructing the business of the OTC Exchange

Chapter XV.04, of the Bye-laws also states that certain trading practices and activities are unbusinesslike conduct, which includes activity usually found in a market manipulation or rigging scheme as follows:

Unbusinesslike Conduct

A member shall, in the opinion of the OTC Committee, be deemed guilty of unbusinesslike conduct for any of the following or similar acts or omissions, namely-

- (i) **Fictitious Names:** if it transacts its own business or the business of its constituent in fictitious names;
- (ii) **Fictitious Dealings:** if it makes a fictitious transaction or gives an order for the purchase or sale of securities the execution of which would involve no change of ownership or executes such an order with knowledge of its fictitious character;
- (iii) **Prejudicial Business:** if it makes or assists in making or with such knowledge is a party to or assists in carrying out any plan or scheme for the making of any purchase or sales or offers of purchase or sale of securities, for the purpose of upsetting the equilibrium of the market or bringing about a condition of demoralization, in which prices will not fairly reflect market values (also a member may have its business suspended in part or in whole for conducting prejudicial business);
- (iv) **Rumors:** if it directly and in any manner whatsoever circulates or causes to be circulated rumors

The OTCEI anti-manipulation provisions included in the Bye-laws may be applied to persons set forth in Chapter XV.06, which states the following:

Offenses by Partners, Agents and Employees of Members

The OTC Committee may warn or fine or censure or suspend or expel the authorized official or a member or its attorney, agent, authorized signatory or employee for any act or omission which if committed or omitted by the member would subject him to the same penalties.

V. OTCEI INVESTIGATIONS

A. Authority For Conducting Investigations

The OTCEI Governing Board may initiate an investigation to determine whether the Exchange rules, bye-laws or regulations have been violated, and require Members and others to testify and produce information, such as any books and records deemed relevant or material to the investigation. The authority to investigate is included in the OTCEI Bye-laws at Chapter XV.10, which states:

Members and others to testify and give information

A member shall appear and testify before and cause its partners, attorneys, agents, authorized signatories and employees to appear and testify before the OTC Committee or before other sub-committee(s) or an officer of the OTC Exchange or before other sub-committee(s) or before an officer of the Exchange authorized in that behalf, such books, correspondence, documents, papers and records or any other part thereof

which may be in its possession and which may be deemed relevant or material to any matter under inquiry or investigation.

The OTCEI Bye-laws at Chapter XV enable the OTC Committee to sanction a member refuses to cooperate during a OTCEI investigation. The provisions of Chapter XV. 02 of the Bye-laws state the following:

Penalty for Misconduct, Unbusinesslike Conduct and Unprofessional Conduct

In particular and without in any way limiting or prejudicing the generality of the provisions in sub-clause above a member shall be liable to expulsion or suspension or withdrawal of all or any part of its membership rights and or to payment of a fine and/or to be censured, reprimanded or warned for any misconduct, unbusinesslike conduct or unprofessional conduct in the sense of the provision in that behalf contained therein.

Misconduct

A member shall be deemed in the opinion of the OTC Committee guilty of misconduct for any of the following or similar acts or omissions namely-

- (vi) **Failure to testify or give information:** if he neglects or fails or refuses to submit to the OTC Committee or to the Managing Director, or to a sub-committee or an officer of the OTC Exchange authorized in that behalf, such books, correspondence, documents and papers or any part thereof, as may be required to be produced or to appear and testify before or cause any of its partners, attorneys, agents, remisiers, authorized signatories or employees to appear and testify before the OTC Committee or the Managing Director or such sub-committee or officer of the OTC Exchange

B. Sources of Cases

Information about possible market manipulation cases can come from a variety of sources, including the following:

OTCEI Surveillance. This system tests for combinations of activity, such as identification of unusual activity based on historical profiles that raise alerts for combinations of events that must be reviewed by the OTCEI staff, even though no one component or event may appear unusual. Events alerted include:

- a. Price and volume aberrations
- b. Unexplained volume
- c. Volume exceeding historical norms
- d. Unusual volume prior to material news announcements

- e. Price rises exceeding specified amounts based on historical data for specific periods of time such as a day, week or month
- f. Sharp rises or declines in price not explained by corporate events
- g. Unusual transactions at the close, and
- h. Patterns of buying and selling indicative of matched orders or wash sales

Trading Member or Client Complaints. Any complaint that describes suspicious activity that could indicate possible market manipulation should result with appropriate referral to OTCEI staff for evaluation and further investigation.

SEBI Referrals. Members of the SEBI staff regularly monitor activities in the primary and secondary markets that may result in referrals to the OTCEI for investigation. These activities include:

- a. Monitoring of exchange trading screens - SEBI has computer terminals linked to a number of exchanges that provide a wide range of real-time information about the price and volume movements of individual securities, as well as the whole market.
- b. Monitoring of reports produced by regional exchanges. Regional exchanges are required to provide SEBI with hard-copy reports of daily trading activity.
- c. Monitoring reports in the financial press.
- d. Receiving complaints from investors.

Referrals from other Stock Exchanges. As self-regulatory organizations, stock exchanges are required to police activities of their members, as well as the trading activity that occurs in their markets. A manipulation can take place over two, three or more exchanges thus, in effect, mandating regulatory interface. Although the degree of surveillance varies at each exchange, they face limitations in pursuing potential violations such as price rigging. Also, the jurisdiction of each exchange and ability to take disciplinary action extends only to its broker-members. This limitation prevents exchanges from compelling information from customers or taking enforcement action against them. As a result, exchanges must refer some matters, data and information to other exchanges or to SEBI for further investigation and possible prosecution.

C. The Investigatory Process

The purpose of an OTCEI investigation is to ascertain relevant facts in order to determine whether violative activity has occurred and to follow up with appropriate action. The staff should obtain relevant documents from Members, listed issuers, and customers who may have been harmed by violative activity and take testimony from individuals from Members and listed issuers, and from other persons who are willing to cooperate in the investigation.

When the staff has received information indicating that a manipulation may have occurred, it must proceed by narrowing the period of time that the investigation will cover. For example, if the price of a security has shown an unusual or unexplainable movement over a ten-day period, it may be sufficient to examine trading records for thirty days prior and ten days after this period. By focusing on this limited period, the staff should be able to identify adequately all brokers and customers who may have entered manipulative trading, while also conserving limited OTCEI staff resources. Nevertheless, because each manipulation differs, judgment will dictate a longer or shorter period of review in each case.

D. Obtaining Evidence and Information

Most market manipulation cases are based on circumstantial evidence or implicating testimony of others, rather than a direct admission by the wrongdoer. Therefore, it is important for the OTCEI staff to obtain and examine all potential pieces of circumstantial evidence. This section of the guideline provides a detailed summary of potential pieces of evidence that should be examined, along with a brief description of the evidence.

1. Internal Sources

An investigation into a potential price-rigging case should begin with a review of information already located in the OTCEI offices. This information may include:

- i. the original market surveillance referral documents;
- ii. regular trading reports compiled by the exchange;
- iii. disclosure documents and reports filed with the exchange by listed issuers;
- iv. files from previous inspections or investigations;
- v. various internal database information; and
- vi. external databases, such as Investment Decision Support System (IDSS), a private information service that provides:
 - a. company data
 - b. price graphs, past price movements and company fundamentals, and

- c. significant news announcements

2. Other Stock Exchanges

Other stock exchanges may provide OTCEI with a variety of price and volume reports. In addition, exchanges maintain detailed databases regarding trading and settlement activity. For example, the computerized systems of the NSE and the OTCEI enable their respective surveillance departments to generate trading and settlement reports according to the following items:

- a. scrip
- b. volume and price
- c. settlement, and
- d. executing broker (including individual trader)

These types of reports can be extremely valuable in helping to identify manipulations and determine the identity of the brokers who entered suspicious trades. Although the non-computerized exchanges cannot generate such sophisticated reports, all exchanges are required by SEBI to maintain and preserve the same basic information for such periods not exceeding five years.

The OTCEI must assure that its own records are preserved since SEBI may request information from OTCEI concerning suspicious trading activity and exchanges are specifically required to provide this information to SEBI. The Securities Contracts (Regulation) Act, 1956, Section 6, sub-section (4) further states -

Where an inquiry in relation to the affairs of a recognized stock exchange or the affairs of any of its members in relation to the stock exchange has been undertaken under sub-section (3),

- a) every director, manager, secretary or other officer of such stock exchange;
- b) every member of such stock exchange;
- c) if the member of the stock exchange is a firm, every partner, manager, secretary or other officer of the firm; and
- d) every other person or body of persons who has had dealing in the course of business with any of the persons mentioned in clauses a), b) and c), whether directly or indirectly, shall be bound to produce before the authority making the inquiry all such books of account, and other documents in his custody or power relating to or having a bearing on the

subject-matter of such inquiry and also to furnish the authorities within such time as may be specified with any such statement or information relating thereto as may be required of him.

Manipulations often take place through more than one exchange. Thus, it may be necessary to request trading and settlement records from several exchanges. The OTCEI staff must then take the initiative to piece together the various exchange records in order to complete a successful investigation.

After the OTCEI staff has examined trading records and determined that a manipulation has occurred, it can contact other exchanges and request trading records that provide the identity of the brokers who entered the trades and request voluntary cooperation of individuals who might have relevant information. The OTCEI staff may also obtain the cooperation of another exchange that can require its own member provide documents that could be shared with the OTCEI.

3. The Brokers

The Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Rules and Regulations, 1992, Chapter IV, General Obligations and Responsibilities, 17(1), require brokers to maintain certain records. These records can provide critical information in determining the identity and trading activity of customers who engaged in price rigging. The records - which must be maintained for a minimum period of five years - are stated below, followed by an individual description of each document.

Every stock-broker shall keep and maintain the following books of accounts, records and documents, namely:

a. Register of transactions (Sauda Book)

Explanation: The Sauda Book is record of daily transactions conducted by a broker-dealer. The record contains the following information for each transaction: name and code number of contra-broker, name and code number of the scrip, quantity, transaction cost, customer, price to customer.

b. Clients ledger

Explanation: A clients ledger, also known as a Partywise Report, is a detailed report showing all transactions executed for a particular client during a specific settlement period. Brokers generate this report to determine client deliverables and payables. The typical partywise report will contain the following information: customer or sub-broker name and internal code, scrip name and code, purchase and sales list, and outstanding client balance.

c. General ledger

Explanation: This document refers to the brokerage firm's general accounting records for tracking all trades executed by the firm.

d. Journals

Explanation: These documents are also part of the brokerage firm's general accounting records.

e. Cash book

Explanation: The cash book is a record of a brokerage firm's cash transactions. The book can be generated for any period of time. Often, cash book records are categorized according to customer and reflect individual debits or credits and billing numbers.

f. Bank pass book

Explanation: Brokers are required to maintain a segregated bank account for customer funds. The bank pass book is a statement generated by the broker's bank that contains a record of all transactions occurring in the customers' account.

g. Documents registered should include particulars of shares and securities received and delivered.

h. Member's contract books showing the details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos or confirmation issued to such other member;

Explanation: The contract book contains a daily list of all trades entered into by a brokerage firm. Prior to computerization of the OTCEI the contract book was sent to the exchanges at the end of each day to confirm trades with contrabrokers. This practice is still used by some regional exchanges. The same information is now generated by computer and can be obtained from the brokers, as well as the exchanges.

i. Counterfoils or duplicates of contract notes issued to clients;

Explanation: Counterfoils are the broker's copy of the contract note, a legally binding contract between the broker and the customer for the purchase or sale of securities. The contract note confirms a customer's order with a detailed description containing the name of the scrip, number of shares bought or sold, brokerage fee and date of the customer order. The broker sends the contract note to the customer for approval and signature. The contract note is significant for the investigator because

it provides a detailed record of all transactions and identifies the name and address of the customer ordering manipulative trades.

j. **Written consent** of clients in respect of contracts entered into as principals;

Explanation: At times, a broker sells securities to a customer from the firm's inventory. In this instance, the broker is acting as a principal, rather than an agent of the customer. The broker must keep written consents from clients that allow brokers to act in this capacity.

k. **Margin deposit book**

Explanation: Between transaction date and settlement date, exchanges can require brokers to pay a stated percentage of the price of a security. Margin requirements are generally imposed on securities that are trading very actively. The requirements tend to (1) cool the market, and (2) ensure payment at time of settlement. The margin deposit book reflects deposits made by brokers to exchanges for this purpose.

l. **Registers of accounts of sub-brokers**

Explanation: This document contains a record of accounts with sub-brokers.

m. **An agreement with a sub-broker** specifying the scope of authority and responsibilities of the stock-broker and such sub-broker.

Explanation: This document is a contract defining the relationship between brokers and sub-brokers.

In addition, Trading Members must comply with recordkeeping requirements established by the OTCEI as a condition of being an exchange member. The OTCEI recordkeeping requirements are very comprehensive rules in this area and require members to maintain several additional records. These records can prove useful in building a price-rigging case.

In conducting a review of documents, the OTCEI staff should also look to obtain the following records:

a. **Customer Bills**

Explanation: At the end of each settlement period, the broker will net a customer's trades to determine the amount of money or securities to be received or delivered. The broker will then issue a bill to the customer. The bill will confirm the execution of all trades, including references to contract notes. It will also identify the name and address of the customer.

b. Delivery Slips

Explanation: At the end of the settlement period, the exchanges issue delivery slips to brokers. These slips represent instructions for brokers to deliver net amounts of money or securities to contra-brokers.

c. Inward/Outward Record

Explanation: This document contains a daily record of all securities received or delivered. Most entries are made at the time of settlement. It lists the certificate numbers of individual shares.

d. Bank Slips

Explanation: Bank slips are documents generated by the broker's bank and show the flow of funds from the firm to its customers. These documents are often the most important pieces of evidence in establishing connections between accounts and individuals and for proving the intent to manipulate.

Finally, pursuant to Chapter XV.03(vi) of the OTCEI Bye-laws, the staff should obtain a written statement or testimony from the Members who entered the possible manipulative trades. These brokers are in position to provide the staff with information about the customer and the nature of the trading scheme. The broker can reveal any conversations that the customer may have had or any unusual circumstances surrounding the trading. In addition, the broker may have been an active participant in the manipulation.

4. The Issuer

The OTCEI staff should also look to the listed issuer of the manipulated securities as a source of additional information, particularly where the manipulation was possibly orchestrated or aided by officers, directors, employees or associates of the issuer. The OTCEI listing agreement with listed companies requires issuers to comply with laws relating to securities dealings and OTCEI and SEBI rules and regulations.

Specific information is required to be provided by the listed company to OTCEI pursuant to the listing agreement which describes the information and filing requirements that the company agrees to follow in order to continue its listing on the OTCEI.

The staff should request issuer documents that may help identify manipulators and possible connections between individuals. Such documents include:

- i. records that disclose the names of officers and directors
- ii. records that contain the names and holdings of large shareholders

- iii. information and chronologies that could explain the rise or fall in the price of the company's securities, including news about company projects, new contracts or financial results, and
- iv. any information that could establish the likelihood of a manipulation, the identity of potential manipulators, or the motivation for price rigging

5. The Investors and Other Individuals

The OTCEI cannot compel customers and other persons who are not associated with a member or listed company to provide documents or testimony. However, the staff should attempt to obtain a voluntary statement from all individuals who may have actively participated in the alleged manipulation, as well as any other individual who may be able to supply relevant information.

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 1995, provides the necessary authority for SEBI staff to compel statements from individuals in the event OTCEI is unsuccessful in obtaining voluntary cooperation from customers and other individuals.

In terms of investigatory strategy, the staff should usually gather all documentary evidence before seeking statements from individuals. This approach will enable the staff to recognize immediately inconsistencies between the statements of individuals and the events as established by the documents.

VI. REPORT OF INVESTIGATION

At the conclusion of an investigation, the OTCEI staff should gather all evidence and prepare a detailed report for presentation to the OTC Committee. The report should set forth the staff's findings, including the evidentiary basis for any factual conclusions and recommendations that formal or informal disciplinary action be taken. Relevant information and data such as customer and broker statements, trading records, charts and graphs should be summarized and attached. All other information should be retained in the staff files.

The Report of Investigation should include a legal analysis of possible violations of OTCEI and SEBI regulations that pertain to each Member and associated person. Any evidentiary weaknesses must be discussed.

The OTC Committee will then make a final determination as to whether the OTCEI should seek appropriate sanctions against the alleged manipulators and/or refer the information to SEBI for whatever action they deem appropriate.

If the OTCEI staff concludes that the nature of the violation is such that formal discipline is not warranted it may instead determine to impose informal discipline such as a letter of admonition or an education letter.

The letter of admonition advises the Member that the OTCEI staff has serious concerns about the conduct of the Member, and warns that any future misconduct may result in formal disciplinary action. An education letter serves to remind the Member of an applicable regulation or standard of conduct, rather than to reprimand the Member.