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**INDIA SECURITIES LAW STRATEGY**

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## *Price Waterhouse LLP*



December 2, 1997

Committee for Amendment of the  
Securities Law (Dhanuka Committee)  
c/o Mr. Cyril Shroff, Esquire  
Lentin Chambers, 3<sup>rd</sup> Floor  
Dalal Street, Fort  
Mumbai 400 023

Dear Mr. Shroff,

**Subject: Working Draft Securities Law**

In furtherance of Price Waterhouse FIRE Project continuing assistance to the Dhanuka Committee efforts to identify areas in the India securities laws, which may require enhancement, I have enclosed a memorandum on "India Securities Law Strategy", which was prepared by Mr. Cliff Kennedy Esq., Price Waterhouse LLP consultant. Mr. Kennedy is a US Securities lawyer and former District Director of the US SEC. He has worked on Securities regulations matters in a dozen emerging markets.

The purpose of the memorandum is to provide additional guidance and assistance to the Dhanuka Committee in their review of the First Working Draft Securities Law, we previously delivered to the Committee during September. The memorandum includes a discussion of a number of specific issues raised by the Dhanuka Committee during several of our meetings and provides a general overview of the provisions of our working draft. **The memorandum also contains a number of suggestions concerning the vital role of an enhanced SEBI in the administration and enforcement of any new comprehensive securities law for the Indian securities industry.**

Please feel free to call on the Price Waterhouse FIRE project regulatory and legal consultants, Mr. Kennedy, Mr. Frank Wilson, Mr. David Strandberg and Mr. Michael Sommer, who are ready to provide assistance to the Committee under the USAID funded FIRE Project and further elaborate on our working draft or on any additional issues.

As always, please let me know if there is anything else I can do. I can be reached at the FIRE project office by telephone on 496 3566 or 496 3599.

Sincerely yours,

**W. Dennis Grubb**  
**Principal Consultant - Capital Markets**

cc Mr. L.K.Singhvi, Senior Executive Director, SEBI, Bombay  
Mr. U. Sarat Chandran, MoF, New Delhi

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## **I. WORKING DRAFT SECURITIES LAW GENERALLY**

### **A. Definitions**

The attached working draft securities law provides that a single government agency, the Securities and Exchange Board of India (SEBI), oversee the Indian securities market. The working draft establishes a clear framework for securities market regulation in India through the efforts of SEBI. The draft includes only important powers, allocation of responsibilities and limits on authority. Everything else is left to SEBI to accomplish by regulation. By using this approach the securities law should not have to be amended frequently, and SEBI can adapt regulations to the Indian securities market as it develops.

The working draft embodies the minimum necessary elements and specificity for the Indian securities markets. The draft includes many defined terms in Articles 1 and 2, which are intended to improve the understanding of the law. These defined terms are necessary in any modern securities market. Some of the terms are virtually the same as are now used in India. Many of them are different because of the conclusion that certain existing terms are not specific enough.

The definition of a security contained in Article 1(1) of the working draft is purposely broad and not limited to specific types of securities. The term is also broadly defined so as to include all instruments and schemes with respect to which persons invest money in a common enterprise with the expectation of earning profit through the efforts of someone other than themselves. The reason for this approach is to assure that SEBI has jurisdiction over all activities in the securities market. For example, if a person devised a form of instrument that was not covered by the definition, he could avoid complying with the securities law, to the detriment of Indian investors.

### **B. Dhanuka Committee Issues**

The working draft also addresses certain specific issues raised by the Committee for Amendment of the Securities Law (Dhanuka Committee), such as the need for increased enforcement powers and fining authority for SEBI. These enforcement powers include temporary and permanent cease and desist proceedings (Articles 4(n) and 24(7)A and B) and judicial and administrative remedies (Articles 4(a) and 24)-- SEBI would also have additional administrative jurisdiction over non-licensed persons and entities including issuers, officers, directors, employees and anyone else who caused or could have prevented securities law violations.

Further under the working draft, SEBI would also have enforcement authority to issue administrative orders that address past violations of the Indian securities law through remedies such as disgorgement and an accounting; halt ongoing violations by issuing freeze orders; prevent further violations through administrative orders similar to injunctions; and in order to act quickly, be able to issue an order without prior notice and opportunity for hearing if SEBI determines that notice and hearing prior to entry is impracticable or contrary to the public interest.

Substantial civil, administrative and criminal penalties for violations of the provisions (Article 24)-- a principal problem in many emerging and developed markets is the difficulty of obtaining recourse for violations because courts generally do not have expertise in securities matters. One solution for the India securities markets is to develop a quasi-judicial body as part of SEBI that would have jurisdiction to deal with most violations by licensed entities and associated persons.

SEBI should also continue to strengthen a working relationship with criminal prosecutors in securities fraud cases involving chronic violators and in instances where significant investor losses occur. The working draft specifically provides for SEBI referral of matters to criminal prosecutors and others under Article 23(3).

Inspection powers and investigations(Article 23)-- SEBI would have authority to conduct inspections of all licensed entities, without restriction, including the examination of all business books and records of the entity and supporting records, such as bank records. Further, SEBI would have authority to conduct investigations of all possible violations by issuers, licensed entities or any other person, by compelling production of books and records, including bank records, and testimony. The inspection and investigation authority of SEBI would be supported by civil and criminal penalties and/or fines under Article 23(2).

It is important to stress that the new enforcement powers contained in Article 24(11) would enable SEBI to obtain a court order which would require the performance of specific kinds of activity, including the freeze of bank accounts or other assets of any person; and that additionally, under Articles 24(1), (7), (8) and (12), SEBI could seek substantial fines of up to three times the profit gained illegally or loss avoided, as well as an accounting and disgorgement of illegal profits or losses avoided, in cases involving insider trading, market manipulation and other violations. Appeals of SEBI decisions and orders could be taken to a strengthened Securities Appellate Tribunal.

In connection with the strengthening of SEBI authority, the Dhanuka Committee raised the issues of trading suspensions and listing cancellations, which are addressed in Article 4(f), and securities de-materialization, which is provided for under Article 4(h).

### **C. Enhanced SEBI Structure**

Recognizing that SEBI has been a statutory body in India since 1992, to the extent possible, the proposed structure for SEBI has been based on existing law and regulations. However, the provisions relating to the establishment of SEBI, contained in Article 3 of this working draft, are much more complete in their coverage and create a legal basis for SEBI to become an independent, deliberative and effective government regulatory body for the Indian securities industry. For example, provision has been made in Article 3(3) and (4) for five full-time SEBI members with no other official responsibilities. Also, in Article 3(3) the terms of the members are staggered so that one term expires each year to provide for continuity.

Existing regulations that permit SEBI to nominate up to three persons as members of the governing bodies of all exchanges are not included in the working draft so that the

involvement of SEBI in the operations of the twenty-three Indian stock exchanges is only that of a regulator.

#### **D. SEBI Authority and Jurisdiction**

The overall goal of the working draft is that all authority and jurisdiction with respect to the securities market and its participants be centered in SEBI as provided in Article 4 and that the Indian self regulatory structure be strengthened and have broad legal support. This will promote equal regulation and enforcement of standards for all securities market participants regardless of their institutional structure.

The working draft law provides SEBI with regulatory jurisdiction over all institutions and individuals participating in the securities market and through Articles 6, 7 and 9 clearly mandates self regulation for stock exchanges and securities associations and supervisory requirements for securities companies that would establish day-to-day oversight as a compliment to the broader responsibilities of SEBI. Further, Articles 23 and 24 authorize increased inspection and enforcement powers in SEBI, enabling greater direct and oversight regulation.

The working draft provisions also provide a clear legal basis to establish a system for self regulation and significant required supervision in the Indian securities industry at several levels of activity to protect investors. For example, Article 6 of the working draft provides the criteria for becoming licensed as a stock exchange or securities association. SEBI is also provided with a basis under, Article 6(5), to reject any application by a stock exchange or securities association if SEBI determines that the applicant does not have the organization and capacity to comply, and to enforce compliance by its members and associated persons, with the provisions of the working draft as well as its own rules and requirements.

Further, the working draft introduces an additional level and system of regulation that places heavy reliance on the exercise of effective supervision by brokers, dealers, mutual funds and other securities companies to prevent violations by their employees. For example, Article 6(7)(c) will require entities establish operating, supervisory and internal control procedures and a system for applying such procedures that will reasonable be expected to prevent and detect violations by securities company employees and others. Also, Article 10(4) holds a securities company responsible for the securities related conduct of its associated persons or persons required to be supervised by the company as prescribed in SEBI regulations.

SEBI may effectively enforce these supervisory provisions through Article 24(8) by imposing administrative sanctions against any person under its jurisdiction that failed reasonable to supervise a violator. In order to defend such SEBI actions, a securities company will have to demonstrate both that it established a reasonable supervisory system required by Articles 6 and 10 of the working draft and that it enforced the system.

Article 24(10) imposes control person liability on controlling persons unless the control person can show that he fulfilled all his responsibilities and did not induce the act constituting the violation. Controlling persons are typically corporate officers, directors and employers and will face a substantial risk under these provisions that they will be held liable in a SEBI

enforcement action when their employees engage in improper securities transactions, such as insider trading. As a consequence, controlling persons will be compelled to adopt procedures to prevent securities law violations by employees and others under their control.

SEBI has started to actively build a self regulatory structure in the Indian securities industry. For example, stock exchanges are required by SEBI to have market surveillance programs that monitor securities traded on their exchange for potential abuses such as market manipulation and insider trading. Other required self regulatory activity by stock exchanges includes routine broker inspections, review of customer complaints, financial monitoring of members and disciplinary actions. The SEBI staff now conducts inspections of stock exchange operations, including their market surveillance programs, and will start oversight inspections of brokers in order to monitor and evaluate the effectiveness of exchange inspection programs and other self regulatory efforts of the exchanges. However, much remains to be done by SEBI to ensure that Indian self regulatory organizations require their members to comply with their own rules as well as the Indian securities laws and regulations.

#### **E. SEBI Rule-Making and Regulations**

Generally, the basic structure of the working draft provides comprehensive rule-making authority to SEBI (see Article 4(v)). Many of the more technical aspects that are necessary to be dealt with by SEBI rule-making and regulations are found in Articles 4(p)-(s). Providing comprehensive rule-making to SEBI is important for two reasons. First, that is the approach already taken in some of the existing Indian securities law and regulations directing the securities market. Second, securities market development, even in fully developed markets, is very dynamic and unpredictable. Therefore, it is important that a securities law only include the most basic legal principles, authority and structure. Otherwise, the securities law would be too rigid to deal with changing securities market conditions.

This comment is not intended to suggest that nothing more should be added to the working draft. The final proposal should be based on the input from knowledgeable persons as much as possible. We understand that the degree of specificity beyond what is contained in the working draft is a matter of judgment on which informed persons could disagree. However, we suggest that changes should not be made lightly and should not alter the basic structure of the draft law.

## **II. INTRODUCTION**

### **A. Legal and Regulatory Framework**

The legal and regulatory framework for the Indian securities market must clearly and unambiguously define and establish basic concepts, activities and participants in the market. It should have minimum standards, reporting requirements, division of responsibilities, professional qualifications, inspection, enforcement and administrative remedy powers and liabilities and penalties for improper activities.

In India, the securities market is at least as important as the banking system as a source of capital for economic development and growth. Moreover, it provides a mechanism through which all persons may participate and share in the rewards of such development and growth to the extent that they are able and desire to invest. Therefore, it is important that the regulation and oversight of the securities market be vested in one regulatory body, SEBI, with authority to license, supervise, inspect, set standards and assure compliance with the law and such standards by all participants in the securities market.

To the extent different types of institutions are authorized to participate, regulations and enforcement must be equal for all. This can be done best and most efficiently if entities are regulated on the basis of function, rather than on the basis of the type of institution performing the function. It is also important that all participants have an opportunity to compete equally.

Finally, because securities markets are international in nature, it is important that the terms and definitions used, the system, and the standards of operation are in accord with those generally prevailing in most other markets to the maximum extent possible. The markets in India must also be efficient enough to attract investors from other markets. Although much progress has been made in the Indian securities markets, existing practices, procedures and the regulatory structure fall far short of these goals.

### **B. Role of SEBI**

It is recommended that SEBI be established, pursuant to Article 3 (1)-(19), as the sole regulator of the securities market and its participants in India. It should be as independent as possible to minimize political pressures. It should have a stature and independence similar to that generally held by the Reserve Bank of India. SEBI members should be full-time with no other government or private sector employment. SEBI must also have an adequate professional staff.

### **C. Role of Private Sector and Securities Industry**

Private sector professionals should be encouraged to participate in SEBI rule-making because of their expertise and ability to assist in making the rules more effective and less burdensome. Bodies such as stock exchanges and securities associations of other securities market industry

participants should be given self regulatory responsibilities over their members, subject to SEBI oversight, and SEBI should work with the best elements in the private sector and support their efforts.

There can be a number of kinds of self regulatory organizations. Stock exchanges and associations of securities industry participants such as brokers, dealers, mutual funds and others that require a license from SEBI should be required to receive approval of SEBI as self regulatory organizations under Article 6(5) and be required to supervise their own activities and employees under Article 6(7). Others such as associations of professional persons who receive licenses from other agencies and provide services in the securities market, such as attorneys and accountants, need not receive approval from SEBI. However, SEBI should issue a formal statement as to what, if any, relationship it has with such associations and the extent that SEBI will rely on standards set by such groups (see Article 13).

The number of associations to be permitted is a matter of judgment for SEBI. The greater the number, the more difficult and time consuming it is to maintain the proper oversight and relationships.

### **III. CONSIDERATIONS FOR INDIAN REGULATORY STRUCTURE**

#### **A. Indian Needs and Conditions**

Every country is unique, with a different history, economic development, customs, political makeup and legal framework that must be considered before any regulatory changes are undertaken. Because of the significant changes that have and are taking place in the Indian economy and its securities markets, there is a good opportunity to build on the Indian capital market and SEBI reforms already underway and on the experience of existing systems around the world while avoiding the many problems that exist in such systems.

To be most effective in meeting present and anticipated needs and conditions, the regulatory structure in each country must be based on its unique characteristics and embody basic securities market development and regulatory principles. That cannot be accomplished by making recommendations based only on a review of existing and proposed securities market laws, decrees, rules, instructions and regulation, regardless of the experience and expertise of the reviewer.

It is also important to have a good understanding of the practices and conditions in the country and to consider the interests and capacity of all participants in the market including issuers of securities, investors, securities market professionals such as brokers, dealers, sub-brokers, merchant bankers, underwriters, stock exchanges, investment advisors, investment managers, registrars, custodians, and institutions that provide clearing, settlement and depository services for securities transactions.

#### **B. Key Elements**

The Indian securities regulatory structure and system provided by the working draft should facilitate and maintain an environment in which securities can be issued and traded in a fair, efficient and orderly way and in which responsible investors may make informed decisions and be protected from improper securities activities of others.

Key elements of the regulatory structure and system should include the following:

- a. Regulatory responsibility and authority for all aspects of the market should be specific, not general, and should be given exclusively to one authority, SEBI (see Article 4).
- b. SEBI and its officials should be as insulated as possible from political considerations and pressures. This includes appointment and removal from office as well as their decision making (see Article 3 generally and Sections 3 and 5 thereunder). Such insulation provides investors with greater confidence that all participants in the market are being treated fairly.

- c. SEBI should establish minimum licensing and operational requirements for industry professionals and assure compliance with such standards. (see Articles 4(2)(a) and (c), and Articles 6(3),(5) and (7) )
- d. SEBI should, to the maximum extent possible, consistent with public policy considerations, permit private sector participants in the market to make decisions with respect to types and amounts of securities to be offered, as well as the timing and prices of such securities offerings. (see Article 4(2)(j) )
- e. SEBI should minimize its interference with the operations of free market forces and maximize the use of its resources by establishing a regulatory structure in which industry participants are permitted to engage in self regulation, with government oversight and enforcement as necessary. (see Articles 7(6) and 9(4) )
- f. To the extent self regulatory organizations, such as exchanges and mutual funds, establish rules for their members, SEBI should have the authority to deny or grant approval of such rules before they go into effect, in order to insure that the rules are not anti-competitive and that they take into consideration the legitimate interests of issuers, members and investors as well as the general public. (see Articles 4(1), 7(6) and (8), and 9(2) and (4) )
- g. SEBI should have authority to interpret provisions of the law and to issue rules, regulations and guidelines on all matters under its jurisdiction. (see Articles 4(v) and (w) )
- h. SEBI must have authority to limit or withdraw the license or authority for any licensed or approved person to participate in securities market activities. (see Articles 4(2)(a)-(c) )
- i. Persons who suffer loss due to illegal or prohibited activities or negligence of others should be able to obtain redress through arbitration, administrative, or court procedures. (see Article 22(6) )
- j. Established standards and practices should be consistent with recommended international standards if foreign investor participation is desired in the market. (see Article 4(q) )
- k. Regulatory requirements established by the government should be limited to what is necessary to protect public confidence, assure adequate opportunity for competition and prevent insolvency in market intermediaries. (see Article 4(1) )
- l. The law should set minimum qualification and operational standards but should not include operational details. (see Article 4(c) )
- m. Maximum penalties should be provided for in the law, but in the administration of the law SEBI should have specific authority to adjust such penalties based on the facts and conditions of each case. (see Articles 4(2)(a) and (b) )

- n. Industry participants, investors and issuers should have the opportunity to give their views on proposed laws, rules and regulations in order to make use of their expertise and avoid unnecessary regulatory burdens. (see Articles 3(n) and 4(o) )
- o. Because stock exchanges are service organizations, all affected persons should be given an opportunity to give their views on proposed trading, clearance and settlement systems. (see Article 4(p) )
- p. No sanctions should be imposed by SEBI without giving the intended recipient an opportunity to give his views (Article 24(7) )and there should be an opportunity for all recipients of sanctions to appeal their case to a higher administrative authority or court. (see Article 24(13) )
- q. SEBI should have flexibility with respect to the allocation of its staff and budget on the basis of its needs. (see Articles 3(14), (15) and (19), and 4(2)(z) )

### **C. Key Action Required**

In India, the primary and secondary markets have both been very active for years. Screen based trading takes place on the major stock exchanges, including BSE, NSE, and OTCEI. Many activities related to a mature securities markets take place, including mutual fund activities, rapid development of a new exchange, the NSE, and a new depository. Share certificates are in the process of being dematerialized in order to facilitate electronic book entry transfers in the new depository system. An Inter-Exchange Co-ordination Group has been established by SEBI to improve stock exchange cooperation and market surveillance efforts. And SEBI has initiated the process of developing self regulation in the Indian stock exchanges, mutual fund and registrars.

In order to keep pace with India's rapid business and technical development and create a fair and orderly environment for securities transactions, it is important to establish a sound regulatory structure with proper legal based authority and resources so that the process will continue to develop in an appropriate manner. Key actions required to do so and that must be considered in connection with any changes in the Indian securities law are:

- a. Determine an appropriate allocation of jurisdiction among Indian governmental authorities;
- b. Develop a legal foundation for SEBI action; and,
- c. Establish a regulatory goals and administer and enforce securities law.

#### IV. ALLOCATION OF GOVERNMENTAL JURISDICTION

##### A. Regulation By Function Approach

Both SEBI and the Reserve Bank of India have important roles to play in the regulation of the Indian financial markets. As was mentioned earlier, SEBI should regulate all aspects of the securities market, including disclosures in connection with primary issuance of securities, secondary trading markets, and oversight of participants in the market. The regulatory jurisdiction of SEBI should also include all mutual funds and trust companies, including UTI (see Article 1(2) and Article 2), and the periodic disclosure requirements of public companies which are presently the responsibility of the stock exchanges. (see Article 15)

In order to avoid conflicts and diffusion of responsibility, it is generally recommended that jurisdiction be allocated among governmental authorities by function. The respective responsibilities of each government regulator over financial markets must be clearly defined.

##### B. SEBI and RBI Regulatory Roles

Following the regulation by function approach it is recommended that jurisdiction of SEBI and the Reserve Bank of India (RBI) be as follows:

- a. SEBI would regulate all activities related to financial instruments that are generally defined as securities and futures that are traded in public securities markets, including derivatives of securities, other than securities or transactions that are exempted for public policy purposes as not requiring regulation at all (see Article 4(2)(I)).
- b. The RBI would regulate all activities which relate to banking or deposit and lending; but all activities of banks, quasi-banks, non-bank financial institution and trust corporations related to public securities markets other than for their own accounts through brokers or dealers licensed by SEBI, would be under the jurisdiction of SEBI.

In addition, the function of regulating the formation and internal operation of companies should not be combined with the function of regulating disclosures in connection with the issuance of securities and the trading of securities in secondary markets. These functions are separated in order to allow SEBI to focus its attention on developing expertise regarding the securities markets and to use its resources to address problems that arise in public securities markets.

##### C. SEBI and DCA Roles

Due to the high volume of paperwork associated with oversight of routine corporate matters, resources and attention are often diverted from securities markets when the functions are combined. For this reason, the Department of Company Affairs should continue to administer the Companies Act, except for those functions assigned to SEBI under Articles 15

and 4(2)(o, q and r) because they relate to disclosure practices of public companies and their officers and directors, including required financial and securities transaction reporting.

Further, Article 5(2) of the working draft requires that all filings required to be made with SEBI, including issuer periodic reports, must be available at a SEBI public reference facility according to procedures established by SEBI. As a result, SEBI would have the primary responsibility over the timely disclosure of relevant information by issuers and their officers and directors.

## V. LEGAL FOUNDATION FOR SEBI ACTION

### A. Working Draft Provisions

The legislation that empowers SEBI must support a fair, orderly and efficient market that enables participants to make investment decisions on the basis of adequate disclosure. Existing legal structure should be enhanced to achieve these goals. The structure must not burden companies with excessive regulation and should balance regulatory concerns with the need to continue market development. Simplicity should be emphasized to avoid the excessive legal burdens apparent in many developed economies. The working draft generally provides that SEBI have authority to:

- a. establish conditions and procedures for registration of public offerings; (see Article 4(j) and Article 14)
- b. exempt specified classes of securities from registration; (see Article 1(2) )
- c. grant or revoke licenses for persons to operate as broker, dealers, investment managers, investment advisors and individuals who represent these entities, as well as clearing agencies and transfer agents; (see Article 4(2)(a) and Article 6)
- d. approve or disapprove of auditors and other professionals who practice in the securities markets; (see Article 4(2)(b) and (u) and Article 13(1) )
- e. administer regulations on takeovers involving securities of public companies or companies that have made a public offering; (see Article 4(2)(s) and Article 16)
- f. establish accounting rules applicable to publicly held companies which modify generally accepted standards applicable to all companies, if necessary; (see Article 4(2)(q) )
- g. supervise any activities of exchanges and other self regulatory organizations that participate in the securities markets and are required to obtain a license, and approve or disapprove of rules of these organizations; (see Article 4(2)(c) and Articles 7 and 9)
- h. suppress manipulation(Article 19) and insider trading(Article 21); (see also Article 24)
- i. inquire into the securities-related affairs of any person and require production of securities related information; (see Article 4(2)(l) and Article 23)
- j. conduct inspections of the office, accounts or records of any person or entity licensed by SEBI; (see Article 4(2)(l) and Article 23)
- k. suspend trading of any securities; (see Article 4(2)(f) )

- l. conduct administrative hearings and impose sanctions and penalties for violations of securities laws; (see Articles 4(2)(a), (b) and (n) and Article 24)
- m. publish findings of improper conduct by any person licensed by SEBI and companies that have, or should have, registered their securities with SEBI; (see Article 4(2)(m) )
- n. impose fees for filings and on exchange transactions to help finance its operations; (see Article 3(16) )
- o. establish rules and interpretations on all matters within its jurisdiction; (see Articles 4(2)(v) and (w) ), and
- p. issue cease and desist orders regarding violations of the securities laws pending a hearing. (see Article 4(2)(n) and Article 24(7)(B) )

### **B. Qualified and Independent SEBI Members**

Fundamental to a well-functioning SEBI is the need for its members to have expertise in the capital markets. The Chairman and other members must be able to devote full time to the task. If members have conflicting responsibilities, they will not be able to devote the attention required to develop and regulate the capital markets.

It is desirable to have SEBI independent (as compared to regulation by a division or bureau of a ministry) because it increases the stature of the organization, reduces bureaucratic problems, focuses responsibility and accountability for actions and increases the possibility of finding persons with top qualifications willing to serve. Because of its efficiency and effectiveness, an independent commission is a model for securities market administrators in most countries.

Although all governments have not granted significant independence to securities regulatory agencies, the trend continues in that direction. The advantages of independence include:

- a. Greater willingness of qualified persons to serve on the commission and in top staff positions;
- b. Greater freedom to act quickly without bureaucratic delay by persons who have other major responsibilities and sometimes conflicting interests;
- c. Greater accountability by agency officials for actions, thereby improving decision-making;
- d. Greater public visibility of securities market issues;
- e. Freedom from political or self-interest input from an additional layer of supervisory department officials;

- f. Greater freedom to administer securities laws against anyone regardless of position or stature;
- g. Greater public and market participant confidence; and
- h. Limitations of problems to its own jurisdictional issues without being affected by those of a supervisory department.

## **VI. REGULATORY GOALS AND ADMINISTRATION AND ENFORCEMENT PLAN**

### **A. Establish SEBI Goals**

Article 4(1) of the working draft assigns SEBI full responsibility for the administration and enforcement of the securities market. One of the first activities of SEBI under a new securities law should be to establish regulatory goals that will enable SEBI to meet its responsibilities and duties.. The goals should be designed to facilitate the continued development of a securities market that conforms with international standards and (a) protects investors and the public; (b) assures that securities are issued in the primary market and traded in the secondary market in a fair, orderly and efficient manner; and (c) monitors market participants and enforces the securities laws and rules and regulations.

### **B. Protect Investors and the Public**

The working draft contains provisions that permit companies to offer securities whenever they need capital by complying with registration and disclosure requirements and enable investors to make informed investment decisions. SEBI attempts to assure that the process is fair and that investors are protected by (a) requiring full disclosure of material information so that investors may make informed decisions with respect to securities, (b) licensing market participants and establishing minimum financial and operational standards for their conduct, and (c) defining just and equitable principles of trade for persons engaged in the securities business.

Under this approach, investors have the opportunity to obtain certain information about securities and persons engaged in the securities business. With this information, investors may make their own investment decisions. With a full disclosure system, SEBI does not attempt to protect investors, either individually or as a group, from the results of their own decisions. However, there are penalties for misrepresentation, deceit, market manipulation and other fraudulent acts and practices. This method attempts to provide a fair, orderly and efficient market in which prudent investors receive a reasonable degree of protection.

SEBI should focus on promoting a fair, orderly and efficient market in which investment decisions can be made by individual investors on the basis of adequate disclosure of all material information. SEBI should avoid any regulation that deals with price, timing or investment merit of securities. Investors should face normal market and business risks, and SEBI's efforts should be focused on curtailing unacceptable risk that comes from predatory behavior of unscrupulous individual, unethical, grossly negligent, or irresponsible behavior by market participants or issuers, and other risks that are associated with an unfair, disorderly or inefficient market.

SEBI should not make decisions that can be made better by market forces, such as the price at which securities should be sold and the amount that can be charged as a commission or fee by exchanges, clearing, settlement and depository institutions, registrars, underwriters, brokers or dealers. Also, SEBI should not attempt to protect investors from normal price fluctuations, their own unrealistic expectations or imprudent behavior.

### **C. Assure Fair, Orderly and Efficient Markets**

The principal goal of securities regulators is to maintain fair, orderly and efficient markets so that investors can have confidence in the marketplace. To accomplish this, SEBI should focus on establishing basic rules and standards, controlling market access and monitoring and enforcing conduct in such a way as to develop a fair market in which investors have protection comparable to those in other markets. Thus, fairness, orderliness and efficiency in the market should be based on international standards.

Unfortunately, there are no accepted international standards for an "orderly, fair and efficient" market. However, representatives from various nations do join together into international associations in order to use their combined experience and expertise to develop and recommend common acceptable standards.

Such organizations include the Federation International des Bourses de Valeurs (FIBV), International Society of Securities Administrators (ISSA), the International Organization of Securities Commissions (IOSCO), and the International Accounting Statement Committee (IASC). There are also numerous regional groups, and special committees such as the Group of Thirty and the EEC Work Group on Settlement. SEBI is already a participating member of IOSCO.

In setting standards for securities market participants, SEBI should consider recommendations made by international organizations as well as practices in those countries in which the securities markets have a good reputation. SEBI should also consult with market participants, both domestic and international, to obtain their views with regard to proposed standards.

### **D. Establish and Enforce the Self Regulation Model**

The self regulation model regulatory method, already introduced in the Indian markets, is being used successfully in many markets and is recommended for SEBI for the Indian markets on a wide-scale basis. The working draft in Article 6(5)(a) provides a legal basis for SEBI to use self regulation in the Indian securities industry. This approach relies on selective rule-making, monitoring and review by SEBI, while depending on substantial cooperation from market participants themselves.

Under a self regulatory structure, basic rules and standards would be established by SEBI in conformance with the requirements contained in Articles 6, 7, 9 and 10 of the working draft. These include requirements for registration and licensing of stock exchanges, securities associations, brokers, dealers, merchant bankers, underwriters, mutual funds, investment managers, portfolio managers, investment advisers, underwriter's representatives, broker-dealer's representatives, sub-brokers, custodians, registrars, and other professional participants in the capital market, record keeping, reporting, supervision, prohibited activities, sanctions and appeals.

As discussed earlier, the working draft provides for a regulatory framework that requires self regulation be exercised by market participants on three different levels: (1) by stock

exchanges and securities associations, who regulate their members and enforce compliance with the securities law and their own rules; (2) by brokers, dealers, sub-brokers, mutual funds, registrars and others, who may be required to be licensed by a stock exchange or securities association, supervise their own employees and comply with the securities laws and SRO rules and regulations; and (3) by SEBI oversight of the various market participants and SROs to assure their compliance with the securities laws, rules and regulation and the supervisory requirements.

Private sector regulators such as stock exchanges and securities associations are responsible to establish more detailed operational and supervisory standards for their members under Articles 7 and 9. Article 6(1) of the working draft enables SEBI to delegate certain of its licensing responsibilities to stock exchanges and securities associations and to require brokers, dealers and others to be licensed with an association in order to conduct business. Further, Article 10(4) of the working draft enable SEBI to establish a duty for brokers, dealers and other to supervise employees and others.

Self regulation is not only the preferred regulatory philosophy to promote a fair market, it is also a good choice on practical grounds. The range, number and complexity of issues that must be dealt with by SEBI are too great to be handled adequately by SEBI alone. Thus, SEBI must enlist the support and assistance of private sector participants, such as exchanges, brokers, dealers, underwriters, attorneys, accountants, academicians, other professionals, and professional and industry organizations representing these groups, in order to make its regulation effective.

The long-term success of participants in a securities markets depends on the fairness, orderliness and efficiency of the marketplace. Therefore, the long-term interests of market participants and SEBI are compatible. For this reason, if a proper relationship exists, responsible private parties will support and work with SEBI.

Self regulation works when: (a) most participants in the marketplace have an interest in assuring that others are penalized for unscrupulous behavior so that they can conduct business in a fair environment; (b) the government oversees the self regulators to assure they are in fact performing their obligations as regulators; and (c) other deterrents to unlawful conduct, such as effective civil remedies, exist.

Effective self regulation will depend on mutual trust, respect and cooperation among SEBI, reputable brokers, dealers, underwriters, mutual funds, stock exchanges and other market participants who share the goal of promoting a fair market. This requires that the SEBI members and staff have a thorough understanding of the operations and legitimate business needs of private sector participants in the market.

It also requires that private sector participants understand the securities laws and regulations as well as SEBI's responsibilities to protect the interests of investors and the public. It means that a large part of the job of rule-making, controlling access to the market, surveillance and enforcement must be done by the private sector.

Whether the system operates successfully depends on the willingness of private sector participants to be involved in rule-making and in setting standards and supervising their own

employees. It also depends on the willingness of SEBI to permit and encourage private sector involvement. SEBI must support the best elements in the private sector, recognizing that their constructive involvement in the regulatory process will improve the rules, assist in regulating access to the market, help monitor the behavior of market participants and enhance compliance with established rules and regulations.

## **E. Market Participant Monitoring and Regulation**

### **1. Rules and Standards**

Under the working draft of the Securities Law, only SEBI would possess the authority and the responsibility to assure that appropriate rules and standards are established for all participants in the securities market. For example, see Articles 7(6) and (8) concerning stock exchange rule-making, and see Articles 9(2) and (4) regarding securities association rule-making. Nevertheless, under the self regulatory structure of the working draft, other participants would have some authority and responsibility and they would have an important role in the rule-making process (see Article 7(1)(a) and Article 9(1)(a) ). Such authority is granted to self regulatory organizations under SEBI oversight by the law or by SEBI.

Basic rules and standards would be established by SEBI in conformance with broad policies contained in the law. These standards would include requirements for licensing, approval, registration of professionals, registration statements for public offerings and public companies, record keeping, reporting, prohibited activities, sanctions and appeals. All other participants can help SEBI to properly establish these rules and standards, based on their expertise and experience.

### **2. Stock Exchange Rule-making**

Stock exchanges are the primary self regulatory organizations in most developed securities markets. SEBI should focus on establishing exchange rules of a general nature that should apply to all exchanges, and leave rule-making regarding to operational matters to the exchanges under Articles 7(1) and 7(1)(a). The exchanges can issue detailed listing requirements including rules for disclosure for issuers, rules of admission of members and for their operations and rules for the trading, clearing and settlement of transactions under Articles 7(6) and (7).

In order for such rules to be effective, according to the working draft, they would have to receive approval by SEBI under Article 7(8). This is to assure that the rules are not unnecessarily anti-competitive and that they reflect the interest of market participants who are not members of the exchange, such as investors, issuers and the general public.

Because of the need for close coordination between SEBI and the stock exchanges, SEBI should continue the practice of meeting with such groups as the Inter-market Surveillance Committee and schedule formal meetings with other representatives of the exchanges at least quarterly to discuss a broad range of issues. The Director of the Market Regulation Division should generally represent SEBI at these meetings, but occasionally members of SEBI may also desire to participate in the discussion of items on a predetermined agenda.

### 3. *Securities Companies*

Securities companies, such as brokers, dealers, sub-brokers, underwriters, registrars and mutual funds are institutions which offer a variety of securities market services to issuers and investors. The most important of these services is intermediation in the offering and trading of securities. The long-term success of securities companies depends on the fairness, orderliness and efficiency of the marketplace. Therefore, the long-term interests of securities companies and SEBI are compatible. For this reason, in most markets, responsible securities companies support the efforts of the government regulatory agency, if a proper relationship exists.

Securities companies deal directly with investors, their own employees, other securities companies and with stock exchanges and issuers. They know where the problems are. They are also in a position to know whether existing rules and regulations are effective, whether they are too burdensome and whether additional rules are needed. In addition, they can recommend whether changes should be made in rules at the securities company level, the stock exchange level or by SEBI.

### 4. *Securities Associations*

Securities associations include such groups in India as an association of mutual funds and an association of registrars. Such associations establish standards for their members (see Article 9(1)). They are also in a good position to assist SEBI in establishing rules that will apply to their members. SEBI should make use of their expertise. For example, in order to obtain an individual license under the proposed law, applicants would need to be qualified. SEBI would grant licenses and thus must be sure that appropriate standards are met. In the spirit of self regulation, SEBI should continue to request associations to assist in the process by developing and giving qualification tests to be passed as part of application requirements for a license.

### 5. *Professional Associations*

Article 13 of the working draft law supports rule-making and standard-setting by professional associations. It does this by requiring all professionals who operate in the securities market to follow applicable codes of ethics and professional standards.

SEBI should rely on the professional associations for accountants and attorneys and the authorities licensing such persons to establish appropriate professional standards. Professional associations should assist SEBI in its rule-making and standards-setting responsibilities by recommending any additional requirements that SEBI should have in order to permit such professionals to practice in the securities market.

### 6. *Accounting and Auditing Standards*

Article 3(q) of the working draft gives SEBI authority to adopt accounting regulations that apply to public offerings, public companies, and licensed securities market entities and associated persons. Paragraphs (b) and (u) of Article 3 also authorize SEBI to give

accountants binding instructions with respect to their accounting and auditing activities in the securities market and to disqualify them from providing professional services in the securities market or limit such activities.

With such broad powers, SEBI could take on the responsibility to establish all standards and practices for accountants and auditors in their securities market services, in order to assure that investors will have access to fair, reliable, financial reports. However, the accounting profession's members have constant interaction with issuers and public companies and are thus able to recognize areas in accounting that need attention.

To be most effective, SEBI should make maximum use of existing Indian professional expertise and experience. This will require a unique relationship with the accounting profession. SEBI must be willing to use its authority, if necessary. It must also realize that if its participation or involvement in the process of standard-setting is too pervasive, the private sector's efforts will be undermined.

SEBI should adopt a policy of supporting and relying on standards and procedures approved by the accounting profession unless SEBI has expressed a contrary view in an official ruling. SEBI should have a continuing dialogue with leaders in the accounting profession to identify areas where existing accounting and auditing standards and practices may need improvement. The profession should be given a reasonable opportunity to resolve such issues. SEBI should establish its own accounting standards only if the results of industry efforts are not satisfactory for investor protection purposes.

#### **E. Regulate Access to the Market**

Under the working draft law, SEBI would control access to the market by all professionals by means of its authority to license, approve or register persons for certain activities. This would include persons who wish to act as securities exchanges, clearing, settlement and depository institutions, brokers, dealers, sub-brokers, underwriters, custodians and registrars, as well as professionals in the securities market such as accountants and lawyers. Initially, SEBI should also consider delegating responsibility for licensing individuals to work as underwriter representatives, broker-dealer representatives and various associated persons, and possibly including sub-brokers, to the stock exchanges and securities associations as provided for under Article 6(1).

The working draft law does not authorize SEBI to preclude or control access to the market by issuers. However, Article 14 would permit SEBI to establish disclosure standards that must be complied with by issuers before making offerings of their securities to the public. Such offerings must be registered with SEBI and become effective either by the passing of 30 days (see Article 14(3)), if the SEBI does not request any additional disclosures, or upon a declaration of effectiveness by SEBI (see Article 14(5)).

SEBI has authority to review registration statements and request amendments if the review indicates that such documents contain false statements or omit to state material facts needed so as not to be misleading (see Article 14(4)). The review is not intended as a guarantee of required disclosure. It is intended only to assist issuers and public companies to provide required disclosure.

SEBI is prohibited from approving any securities or making any representation that the disclosure is accurate or adequate (see Article 14(8)). The responsibility for accurate and adequate disclosure lies with the issuer and those that the issuer chooses to assist it with its disclosure responsibilities. Such persons include underwriters who manage new offerings, accountants, legal consultants and any other person who assists in preparing disclosure documents.

## **F. Monitoring Market Participants**

### **1. By SEBI**

The working draft law gives SEBI broad powers to monitor the behavior of market participants. In order to monitor such activities, SEBI must require both periodic and event-driven reporting, and not totally defer this responsibility to the stock exchanges. It must conduct inspections, it must investigate complaints, and it must conduct constant surveillance.

SEBI's powers to monitor the market may be exercised directly, with its own staff, or indirectly through the staffs of bodies such as stock exchanges, securities associations and other market participants. SEBI may also require reporting that is audited or attested to by certain supporting professionals.

Once a formal system is established, SEBI need not undertake to review all documents submitted to it. The determination of which documents will be reviewed should be based on the resources available, the volume and type of documents received and the monitoring being done by others. For example, all reports received from auditors or by issuers or public companies should probably receive immediate attention.

Even before a formal report is received under Article 15 of the working draft both the SEBI and an exchange on which securities of the company are listed should have been informed so that a halt in trading might be imposed to protect investors from trading until the material information has been distributed to the public. Other reports submitted by issuers and other market participants might be subject to a full review, only a full financial review, a review of one or more specified items, or perhaps no review.

### **2. By Stock Exchanges**

Exchanges should be major contributors in monitoring securities market activities because they are responsible for monitoring the activities of their members and for the disclosure and reporting activities of companies whose securities are listed on their exchange. Monitoring the quality of stock exchange self regulation and their market surveillance effort should be accomplished through regular SEBI annual and cause inspections of exchanges and appropriate inspections of exchange members to verify the effectiveness of self regulation by the exchanges.

SEBI should ensure that stock exchanges fulfill their regulatory responsibilities by:

- a. assuring that exchanges are organized in a way that enables them to carry out their duties as self regulatory organizations;
- b. assuring that exchanges have capable professional management;
- c. assuring that exchange management represents the broad interests of its members, issuers and of the investing public;
- d. requiring the exchange to have a written program for monitoring the activities of its members, with records of all inspections;
- e. requiring the exchange to have a written program for monitoring trading activities;
- f. requiring the exchange to have a written program for monitoring disclosures made by its listed companies; and
- g. evaluating the effectiveness of these programs in an annual inspection of the exchange.

### 3. *By Accountants and Auditors*

Accountants and auditors assist in monitoring the activities of market participants because most participants must submit reports containing audited financial statements to SEBI. Also, the working draft law requires accountants that audit financial statements of licensed or approved securities market participants to notify SEBI about any violations of the law or rules thereunder or any other condition they find which may jeopardize the condition of the institution or the interests of its clients (see Article 13).

SEBI monitors the activities of accountants and auditors by reviewing financial statements contained in registration statements and reports submitted to it. This responsibility should not be left to the stock exchanges to perform.

## **VII. ADMINISTRATION AND ENFORCEMENT BY SEBI**

### **A. Enforcement of Standards**

The working draft in Article 23 provides SEBI authority to inquire into the securities related activities of any person and require securities related information from any person. Information found indicating violations may also be published in order to inform the public. SEBI is also authorized to inspect and give binding instructions to all persons who are licensed, approved or registered with SEBI, as well as to issuers and public companies.

### **B. Administrative, Civil and Criminal Enforcement Actions**

Under Article 24 of the working draft, cease and desist orders against any person and specified administrative sanctions including fines and also disgorgement, can be imposed without a court proceeding, on all persons who are licensed, approved or registered by SEBI and on all other persons. In most situations, such sanctions may only be imposed after giving an opportunity for persons who are believed to have engaged in a violation of the law or rules thereunder to present evidence in their defense. However, in situations when SEBI must be able to quickly to deter the harmful effect of false statements and fraudulent activity by a licensed person on the Indian securities markets, Article 24 (7)B may be use by SEBI to enter a temporary cease and desist order.

The working draft law also places civil liability, under Article 22, on persons who have not properly performed their duties or who have violated the law or any rules or regulations thereunder for any losses suffered by others as a result of their improper actions or negligence in fulfilling their responsibilities. Persons who suffer losses for these reasons, may sue for recovery, individually or in conjunction with other persons who have similar claims.

Also, criminal penalties are provided for in Article 24 (1)-(6) of the working draft. The penalties included are much greater than exist in current law.

### **C. SEBI Enforcement Strategy**

Clearly, a market weakened by securities fraud, deceitful salespersons, misrepresentation, insider trading, price manipulation and financially precarious institutions requires government intervention. A free market system does not mean a market completely free of government imposed and enforced standards. There is a need for appropriate accounting standards, full disclosure of all material information, proper registration statements, prospectuses and periodic company reports.

Minority shareholders must be protected from controlling shareholders who may use mergers, acquisitions, corporate reorganizations and other actions in which there is a conflict of interest to deprive them of their fair share of the enterprise. Enforcement action by SEBI with respect to any of these matters must be taken in a way to promote its overall mission.

Regulatory agencies in major securities markets do not attempt to apply a sanction for every violation of their rules. The usual strategy is to try to resolve most situations without the imposition of a penalty. For example, the United States SEC, which is considered to be

among the best of securities market regulators receives less than one complaint per thousand investors annually.

The selectivity of the SEC in using its enforcement powers is illustrated by the fact that it initiates criminal, civil or administrative enforcement proceedings for less than one percent of these complaints. This does not mean that nothing is done about the other cases. It means that they are usually resolved without a formal enforcement proceeding. Many of the complaints are referred by the SEC to a self regulatory organization or directly to a broker for resolution and a timely report of resolution is requested.

The SEBI enforcement staff has increased in size from a total of eight persons in 1995 to approximately twenty today. In addition, the Indian financial press has reported on an increasing number of SEBI investigations and enforcement actions involving market manipulation and other abuses. Working within the existing regulations and its limited enforcement resources, SEBI has reported the institution and conclusion of several cases and has recovered some investor losses that had resulted from fraudulent trading practices by brokers. Further, SEBI has increased its oversight of market surveillance conducted by Indian stock exchanges and is requiring a greater contribution and effort by self regulators to the monitoring of trading activities by market participants.

However, much more remains to be done. As the SEBI enforcement staff continues to grow in size and experience, SEBI should consider tailoring its enforcement strategy to become more similar to the strategy used by other regulatory agencies in major capital markets. Such a strategy should have the following elements:

- a. All enforcement actions should be for the purpose of assisting SEBI to accomplish its mission to promote the development of a market in which securities can be issued and traded fairly, in an orderly manner, and efficiently so as to mobilize funds which are needed to develop the national economy.
- b. SEBI should not attempt to apply a sanction for every violation. Instead, SEBI's enforcement actions should be used primarily as an example to serve as a deterrent or to assist investors to recover losses arising from unlawful conduct.
- c. The working draft in Article 22 has provisions through which injured investors have adequate redress for wrongful actions. To the extent that the Indian courts are effective, the fear of civil suit provides a deterrent to misconduct and SEBI does not have to become involved in as many enforcement actions.
- d. Whenever possible, SEBI should refer problems with respect to the activities of exchange members to an exchange for resolution and request a timely report on the action taken. In this way, SEBI is not directly involved in most actions against individual exchange members.
- e. When SEBI determines that it is necessary to take direct action against a market participant, it should base its action and the sanction imposed, if any, on consideration of all the facts and circumstances. The decision whether to impose a

sanction must be made in a fair and consistent manner, and the severity of such sanctions must be even-handed.

- f. SEBI must distinguish between minor technical infractions committed by persons who are trying to work within the system and flagrant improprieties by persons who intentionally evade rules and regulations. Companies and individuals that are attempting in good faith to follow the rules should be given every opportunity to correct errors and omissions without sanctions. On the other hand, firms which are not acting in good faith or that continue to ignore rules, despite prior comment, warning or instructions should be subject to increasing penalties. If violations by a company or an individual constitute a danger to the public or a threat to the development of a fair, orderly and efficient market, SEBI should not be reluctant to fine or suspend that company or individual or expel it or him from the market.
- g. When SEBI decides to discipline market participants, it should publish such actions in order to educate market participants as to particular improper conduct, and to act as a deterrent against similar actions by others. (also see Article 4(2)(m) )
- h. SEBI and the stock exchanges should enforce any established capital requirements strictly.
- i. SEBI should encourage the development of an arbitration panel for the resolution of investor disputes. The decisions of such a panel should be binding. Investors must be informed that if they agree to arbitration, they must accept the decisions of the arbitration panel.