Investigation of Share frauds

- P. Sarath Kumar, FCA

The normal human nature is to save monies earned. People expect returns on their savings and hence, there are a lot of opportunities for them to invest. One of the lucrative investments in which people find huge returns in lesser periods is Investment in Shares. Though there are various regulations controlling the share market operations we have been coming across various frauds one after the other like Security Scam (Harshad Mehta) in 1995 and the latest scam (by Ketan Parekh), which has unearthed the involvement of various bigwigs in the investment market frauds. These are only big scams. But in the day-to-day transactions in the investment market various frauds are committed by various people, which affect the financial status and investor sentiments.
Let us know briefly about the concept of Company, shares and trading in shares.

FORMATION OF A COMPANY

Under the Companies Act, 1956, two or more promoters come together to form a Company in which they invest their monies to carry out an objective of business. There are two kinds of companies – Private Limited and Public Limited. Private Limited Company is a form of organization in which maximum of 50 shareholders can come together. Public Limited Company is a form of organization in which there is no limit for the number of shareholders. Depending on the financial and other needs of the business, the organization would be decided as Private Limited or Public Limited.

ISSUE OF SHARES TO GENERAL PUBLIC

In the case of a Public Limited Company with the prior permission of SEBI and other statutory bodies, the company would come to public seeking funds towards share capital. The Share Capital is divided in to shares, each share being assigned a particular amount say, a minimum of Rs. 10/- per share. As public funds are involved in Public Limited Companies, a market place is provided for sale and purchase of the shares – i.e. a **STOCK EXCHANGE**. It is a place where shares are traded at the market values.
Issue of shares to General Public by the Company is called Primary Sale or Initial Public Offer or in general terms it is called Public Issue by a Company. The market for issue of shares initially is called **PRIMARY MARKET**.
Trading of shares in a stock exchange is a secondary sale and the stock market, in general terms is called a **SECONDARY MARKET**.
In order to facilitate secondary sales of shares in the Stock Market, THE SECURITIES EXCHANGE BOARD OF INDIA (SEBI), has facilitated appointment of Brokers at Stock Exchanges who further facilitate sale and purchase of shares on behalf of clients / customers, who come to the Brokers for exchange / sale of shares.

STOCK EXCHANGES

A stock Exchange is a place shares are sold / exchanges by Stock Brokers on behalf of the clients / customers.
It is a market place for sale / purchase of shares.
Stock Exchanges are authorized by the SEBI for acting as a Market Place for trading of shares.

SENSEX

SENSEX is an index showing the volume and amount of transactions at a Stock Exchange taking a base figure of the prices of index shares, which is an indicator to give the direction of the share market. The Sensex moves upward when there is an increase in the volume / amount of transactions. The Sensex moves downward when there is a decrease in the volume / amount of transactions. Either Volume or Amount or both affect the Sensex and makes it directly proportional to the transactions.

BOOKS & RECORDS NORMALLY MAINTAINED

The following are the normal books and records to be maintained by various persons and organizations in relation to share transactions.

1. **COMPANIES**
   Companies have to maintain various records consisting of the particulars of the shareholders in the names of the transferors and transferees of shares.
   - Application and allotment Register
   - Ledger consisting of details of Share Holders along with Folio numbers with code numbers
   - Ledger consisting of details of foreign shareholders
   - Share holder Index
   - Share Transfer Register
   - Dividend Warrant Register

   When a sale or purchase of shares takes place at a stock exchange, the transferor or transferee of the shares send the particulars of the transfer along with the Transfer Form to the concerned Company. Generally, companies do not maintain all the records and the same is entrusted to another concern called **Registrars or Share Transfer Agents** which are especially dedicated for recording the transfers and providing related services to the shareholders of the Company. In this case, the above-mentioned records are maintained by the Registrar or the Share Transfer Agent.

2. **FACILITATORS**
   Stock Brokers, Public Issue Registrars, Handling Agents are the facilitators for sale and purchase of shares in a secondary market.
   The following are the books and records to be maintained by a Stock Broker -
   - Cash & Bank Registers
   - Client Ledger – consisting of transactions of the Client
   - Scrip wise Ledger – consisting of details of shares in which he has dealt on daily basis
   - Copies of Broker Notes consisting of particulars of transactions made on behalf of a client
   - Copies of Client Contract Notes consisting of details of instructions of the client

3. **INDIVIDUALS**

   Individuals buy and sell shares in the secondary market. They are obliged to maintain various records on their own to have a control over the transactions made by them.

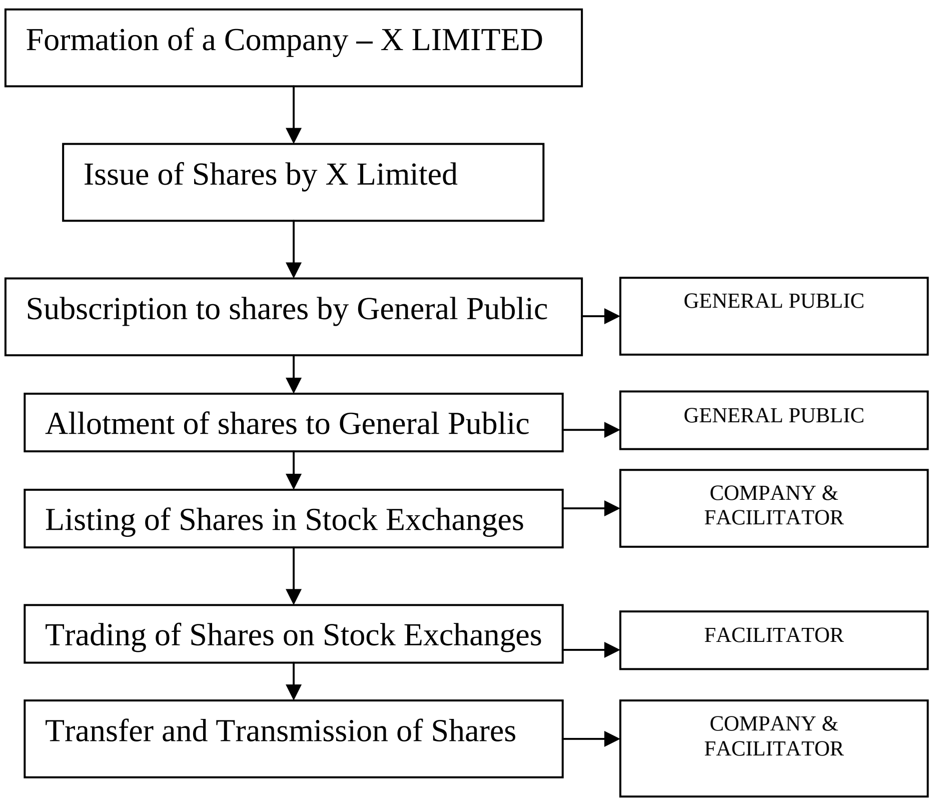
- Account with a Broker
- Demat Account
- Bank Account

4. OTHERS

There are other persons who deal with shares in the secondary markets – like Foreign Institutional Investors, Overseas Corporate Bodies, Banks, Financial Institutions, and Mutual Funds etc. These persons also should maintain the records consisting of transactions of the shares. The following are the important records -

- Account with a Broker
- Demat Account
- Bank Account
- Cash & Bank Registers
- Scrip wise Ledger

TRANSACTION FLOW OF SHARES AND SHARE MARKET



BROAD CATEGORIES OF PERSONS INVOLVED IN THE FRAUDS

1. Companies
2. Facilitators
3. Individual Investors
4. Others

TYPES OF FRAUDS

Various frauds are committed in the transactions relating to shares and can be better explained by bifurcating them in relation to their relevance to the investigator.

MARKET RELATED FRAUDS

Market related frauds are those frauds, which are committed by various persons occupying higher positions and are usually carried out on a massive basis and are explained here only for academic interest.

1. **BULLS / BEARS OPERATIONS**
   Bull is a speculator who purchases shares in anticipation of price increase. A bear is a speculator who sells shares in anticipation of fall in the prices of shares. The strategies that are being adopted by the Bulls are
   - Use of funds siphoned off from Banking Sector that has been flush with funds for a long time.
   - Transferring positions from one market to another market (BSE to NSE & vice versa) taking advantage of asynchronous settlement cycles and thereby avoiding having to take delivery of shares convincing the management of the companies whose shares are being bought to finance the purchase.

2. **CIRCULAR TRADING**
   Circular Trading is a method whereby buyer and seller of the shares / stocks come to an understanding whereby both sell order and buy order will be matched with both price and quantity and thereby creating large volumes in the trading of specific scrip of those companies with whom they both enter in to an agreement thereby pushing the share price of the company and thereby take undue advantage from the increase in prices.

3. **BENAMI DEALS**
   Most of the frauds in the Share Market are committed through Benami Deals only whereby defrauders occupying higher and prestigious positions in Stock Exchanges, Big Companies, Financial Institutions and various other institutions use price sensitive information, which comes under their purview from various sources to gain undue advantages and gains from deals in the share market. Such people violate the market regulations and misuse their positions for unlawful activities.

4. **PRICE RIGGING**
   Price Rigging is an activity whereby Traders select a few scrips and pump their funds in to buying of those scrips and send the prices of those scrips to lucrative levels and also create artificial demand of the scrips in the market and provoke common investors to pump in their savings in to those scrips.

The common and long-term investor, who is ignorant of all these activities, put in his monies and will be left in darkness when all these issues come to light.

There are instances where companies who borrow long term funds from financial institutions, have diverted the funds in to the stock market and rigged up their share prices, thereby attracting common investor to invest in their deposit schemes and make their share a fancy item.

5. **INSIDER INFORMATION**

Fraudsters misuse their official positions to obtain sensitive information about the market exposure of various brokers and investors and pass on the information to other operators and also use the information for operations of benami trades creating false market.

6. Concentration of Market in a few hands / Inter Stock Exchange Dealings

The Stock market is concentrated in the hands of a few institutions and big stocks brokers whose transactions affect the whole market and also affect the buying and selling sentiments of the small investors and thus resulting in the raise or fall of the stock market.

Indulging in Price Rigging by big corporates before any takeover or acquisition by them in coalition with various stock brokers results in making the small investors lose huge monies, who are unaware of the things behind the scenes.

The Players in the Stock Market do not restrict their operations to a single Stock Exchange, but they extend their hands to other Stock Exchanges and make circles with the help of other brokers listed on other Stock Exchanges like NSE, BSE, other Regional Stock Exchanges and make underhand dealings in Inter Stock Exchange Transactions. With this, the circular effect would not be limited to a group of stock brokers of a particular stock exchange, but it extends to other stock exchanges and involves stock brokers from different stock exchanges.

This makes a bigger circle and develops frenzy amongst the individual investors across the country. By the time frenzy and the circle become bigger, the Stock Brokers leave the circle leaving behind gullible individual investors, who lose their monies, because of the undue appreciation / fall in the prices of the shares. They make use of the non-uniformity in the settlement dates of various stock exchanges and shift their positions from one exchange to the other, with out transfer of funds.

FRAUDS HAVING MORE RELEVANCE TO THE INVESTGATOR:

A. **Duplicate Share Certificates**

Duplicate Share certificates are introduced in to the stock markets by various stockbrokers, big investors and even by the companies with dubious folio numbers. These share certificates of big companies are used in the process of obtaining loans from various banks and institutions and eating away the funds of those banks and institutions and in defrauding them. Thanks to the recent Dematerialization of shares introduced by Stock Exchanges by which all the real share certificates are traced. But, it has not yet been made mandatory for all the scrips listed on the Stock Exchanges. Hence, a vigil is to be maintained until all the scrips are dematerialised.

Officers dealing with the cases of Duplicate Share Certificates can obtain the information in relation to the share certificates from either of the sources provided below and compare the information provided by them with the particulars of the Share Certificates complained to be duplicate.

The following are the places where the information regarding the shares and shareholder information is maintained and available for verification -

1. The Company
2. The Issue Registrar / Share Transfer Agent
3. **The Registrar of Companies**

A copy of the Share Certificate Format has been enclosed with the material to enable the Officers know the contents of the Share Certificate and the information to be obtained in the paper trial.

B. **Stock Brokers – Frauds – Manipulative Activities**

1. Stock Brokers delay the delivery of scrips bought by the client and use the same to compensate their day to day transactions of buying and selling their shares and adopt teeming and lading methods, by which the client will be kept in dark about the transaction.
2. Stockbrokers use clients' funds to pay for their own trades and they evade margin requirements and violate fair trade norms by colluding with other brokers.
3. Stockbrokers deal in fictitious trades in association with other brokers and deliberately hammering the prices, delaying transfer from broker's pool account to beneficiaries beyond stipulated limits and fraudulent and unfair trade practices.
4. Stock brokers facilitate circular trading through their proprietary accounts thereby creating an artificial market in number of specific scrips and these acts are in violation of SEBI code of conduct.
5. Stock brokers violate substantial holding limits set under takeover code without informing the companies and Stock Exchanges and hold voluminous number of shares in a single company and make the shares not available in the open market and create artificial demand for the same.

What the Investigator has to do –

1. Verify the Books maintained by the Stock Broker in conjunction with the information obtained from Stock Exchanges, Registrar of Companies, Bank Account copies of the Investor and the Broker.
2. Obtain the information in relation to the sister concerns or associate companies of the Stock Broker.
3. Verify the client order notes and instructions given by the client from the client ledger and the information provided by the client.

C. **Frauds by Investors**

Frauds are committed by big investors by opening various accounts with various names and different addresses to pump in the unexplained money or money which is not supposed to be invested in shares to take the undue advantage of share price increase and also to violate the SEBI norms for takeovers. This kind of frauds can be controlled, if a common identity like the PERMANENT ACCOUNT NUMBER of the applicant should be obtained by the Depository or the Brokers or the Stock Exchanges and correlation should be made by using the common identity.

What the Investigator has to do –

1. Obtain the information about the identity of the person, place of residence, bank accounts, and income tax payment particulars and obtain other information relevant to the particular case and compare with the information made available to the authorities.

D. Frauds by Other Facilitators

There are various facilitators in relation to the transfer of shares like Issue Registrar / Share Transfer Agent, Courier Man etc.

1. **Issue Registrars / Transfer Agents** hold very confidential information about the particulars of the Share Certificates Issued like the Code Numbers, Names of allottees, Number of shares etc. They either circulate the information to others or they themselves print duplicate share certificates and pledge them with banks and defraud the banks and in turn the Public Monies.

   What the Investigator has to do –

   a. Officers dealing with these cases can obtain the information in relation to the share certificates from the sources provided above and compare the information provided by them with the particulars of the Share Certificates complained to be duplicate and find out the collusion between anybody, which resulted in issue of duplicate share certificates.
   b. Obtain the information provided to the Banks and compare the same with the particulars on the share Certificates and ascertain whether the Banker has taken necessary steps before providing loan on the share certificates and also ascertain any collusion between the borrower of the loan and the banker.

2. Share Certificates in transit are stolen and are transferred in the names of **benami or non-existent persons** and are sold and tried to be transferred to others.

3. Dividend warrants in transit are stolen and are encashed by opening new afresh accounts in banks.
   To curb this, it has recently been introduced to seek the Bank Account Number of the recipient of Dividends and the same are mentioned on the Warrants. But, this has not been made compulsory. Until it is made compulsory this angle should also be under close scrutiny and coverage.

STEPS TO OVERCOME

1. Particularly in the cases of influencing the share prices through circular trading, dummy deals and price rigging, SEBI has to monitor and control these activities and make suitable guidelines to curb such instances and activities.

2. DEMAT – Accounts, which are maintained by depositories recognized by NSDL, are those, which consist of the real information regarding the ownership of shares in electronic form. The system has recently been introduced and is not yet made compulsory for all the stocks. To overcome the share frauds and to avoid the problem

of duplicate shares it is essential to make it compulsory for all the scrips listed and traded on a stock exchange.

FRAUDS AFTER DEMAT INTRODUCTION –

Unauthorized usage of Demat Operation forms and selling away the securities has been observed in many cases. Similarly, unauthorized transfer of entire shares or part of the shares in DEMAT account to another account and selling away the same has also occurred.
SEBI woke up to the fact and introduced the system of issue of pre-printed serially controlled Demat Operation Forms to prevent the above-mentioned frauds.

OTHER SECURITIES

In addition to Shares, Debentures, there are various other government securities like

1. National Savings Certificates
2. Indira Vikas Patra
3. Kissan Vikas Patra

Huge public savings are invested in the above securities. Various frauds take place in relation to these government securities also.

RELATED FRAUDS –

1. **Duplicate Certificates**
   Duplicate Certificates are printed and are pledged with the Bank and the Bank has the duty of verifying the authenticity of the certificates pledged before the loans are sanctioned. It is usually lacking on the part of the Bank to verify the authenticity and the public funds invested or deposited in the banks are misappropriated.
2. **Stolen Certificates**
   Fraudsters steal the certificates held by general public and go for pledging of the same with the banks and it is the duty of the bank to verify the authenticity which is usually lacking and in such cases the public funds invested in the banks are misappropriated.

   What the Investigator has to do –
   a. The officer dealing with the case can obtain the information from the concerned post office and compare the same with the certificates found to be duplicate.
   b. Ascertain whether there is any collusion between the borrower and the banker and also ascertain whether the banker has taken necessary information about the borrower before lending the amount.

UNLISTED COMPANIES GOING FOR A PUBLIC ISSUE

WHERE THE COMPANY HAS PAST 3 YEARS TRACK RECORD AND NETWORTH

An unlisted company shall make a public issue of any equity shares or any security convertible into equity shares at a later date subject to the following –

i. It has a pre-issue net worth of not less than Rs. 1.00 crores in three (3) out of proceeding five (5) years, with a minimum net worth to be met during immediately preceding two (2) years, and

ii. It has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, 0 at least three (3) out of immediately preceding five (5) years.

    Provided that the issue size (i.e. offer through offer document + firm allotment + promoters' contribution through the offer document) does not exceed five (5) IMES its pre- issue net worth as per the last available audited accounts, either at the time of filing draft offer document with the Board or at the time of opening of the issue.

WHERE THRE IS NO REQUIRED TRACK RECORD OF 3 YEARS.

An unlisted company can make a public issue of equity shares or an security convertible into equity shares at a later date, only through the book- building process if,

i. It does not comply with the conditions specified above, or,

ii. Its proposed issue size exceeds five times its pre-issue net worth as per the last available audited accounts either at the time of filing draft offer document with the Board or at the time of the issue

Explanation – 1

i. Profits emanating only from the information technology business or activities of the company shall be considered for the purposes of computation of the track record of distributable profits in following cases -
    a. For companies in "information technology 'sector or proposing to raise monies for projects in "information technology' sector.
    b. For companies whose name suggests that they are engaged in information technology activities / business, etc., viz., the company's name containing the words 'software, hardware, info, InfoTech, .com, informatics, technology, computer information, etc.,

<u>BSE LISTING NORMS FOR INITIAL PUBLIC OFFER</u>

The Governing Board of the Exchange in its meeting held on 2nd February, 2002, has decided that for new companies the threshold limit for listing on this Exchange will be as follows with immediate effect –

CATEGORY I (for companies with post issue equity capital of Rs. 10 crores and above)

i. Post issue capital of Rs. 10 crores.

ii. Post issue net worth of Rs. 20 Crores and

iii. The Project / activity of the applicant must have been appraised by a financial institution as described in Section 4 (a) of the Companies Act, 1956 or State Finance Corporation or Scheduled Commercial Bank with a paid-up capital of Rs. 50 Crores or Category I Merchant Banker with a net worth of Rs. 10 Crores.

CATEGORY II (for companies with post issue equity capital of Rs. 5 crores and above, but less than Rs. 10 Crores)

i. Post issue capital of Rs. 5 Crores.
ii. Post issue net worth of Rs. 20 Crores
iii. The minimum market capitalization should be of Rs. 50 Crores. (The Capitalisation will be calculated by multiplying the post issue subscribed number of equity shares with the issue price) and
iv. The Project / Activity of the applicant must have been appraised by a financial institution as described in Section 4 (a) of the Companies Act 1956 or State Finance corporation or Scheduled Commercial Bank with a Paid-up Capital of Rs. 50 Crores or category I Merchant Banker with a net worth of Rs. 10 Crores.

All the applications will continue to be scrutinized by the Listing Committee of the respective Stock Exchange.