

STUDENT RESEARCH PROJECT

**Conflict of Interest, Fair Play, and Fixing Accountability
of Market Intermediaries: An Indian Legal Perspective**

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Abstract

This paper examines the growing menace of conflicts of interests prompted by capital market intermediaries, by studying the nature of the relationship between investors and market intermediaries and discussing the various situations involving conflicts of interests that prevail in today's market or may potentially arise with increasing market complexities. Further, we assess the impact of such conflicts on investors, investments, other market participants, and the market as a whole.

We identify the challenges confronted in the intermediaries-driven market regime, especially in preventing intermediaries' conflicts of interests vis-à-vis investors and issuer companies. Moreover, in the paper we attempt to ascertain if the existing regulatory framework is cognisant of such challenges and if it encompasses measures to fix intermediaries' accountability and liability in conflict of interests situations. Currently, a rule-based avoidance regime of conflicts of interest is predominant in India, in contrast to the principle-based compliance seen in more mature capital markets. Given that regulations and rules alone cannot remedy such situations of conflict, the rules need to be supplemented with enduring principles and an ethical business culture. Creating robust internal control systems and self-regulation would be the two primary and predominant mechanisms to establish this culture. We conclude that conflicts of interests of intermediaries are inevitable, and we make recommendations to combat the conflict of interest crisis and mitigate risks while scrutinising India's regulatory approach towards this menace from a practical standpoint. The establishment of SEBI-registered Self-Regulatory Organisations for market intermediaries is expected to bring the Indian market at par with international markets.

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Conflict of Interest, Fair Play, and Fixing Accountability of Market Intermediaries: An Indian Legal Perspective

I. Introduction

Intermediaries occupy an indispensable and pivotal space in today's capital market. While some trade dealings may involve only a single intermediary entity, more complex transactions comprise networks and chains of intermediaries at different levels. These market dynamics are further complicated by proprietary dealings by such intermediaries, where the thin line of distinction between investors and intermediaries as separate market players gets diluted.

In the face of such market complexities, market intermediaries often tend to put themselves in conflict of interests situations. Given the sensitive market scenario, it is imperative to keep a vigil on the growth of intermediaries, especially the new categories of intermediaries who may or may not be covered by the existing regulatory framework, particularly in the context of the new, innovative, and hybrid products that are frequently launched.

Thus, it is essential to revisit the significance of fair play by intermediaries in the context of their multifaceted operations, the issues related to conflict of interests, and contemporary challenges from a practical standpoint.

II. Who Are Market Intermediaries?

In the era of closed markets, intermediaries were not common because buyers and sellers transacted in close proximity to one another and a "middleman" was not required. However, as financial markets expanded and matured, it was no longer possible for buyers and sellers to have direct dealing; thus, contemporary capital markets are substantially dependent on market intermediaries.

To understand this dependence, to comprehend how market intermediaries are driving the market today, and to ascertain the regulatory contours of India's securities market regulator—the Securities and Exchange Board of India (SEBI)—in respect of intermediary governance, it is imperative to understand who these market intermediaries are.

In simple terms, market intermediaries operate as the bridge between capital providers and capital seekers. According to this understanding, any person operating in the capital markets other than the issuer and the investor may be considered a market intermediary. Does the regulatory understanding of "market intermediaries" conform to this interpretation?

Interestingly, the SEBI does not offer any conceptual or exhaustive definition of "market intermediaries." Nevertheless, it is worthwhile to refer to the definition of intermediaries provided in the SEBI (Intermediaries) Regulations, 2008 (henceforward, the Intermediaries Regulations), which in turn makes reference to Sections 11(2)(b), (ba), and Section 12(1),

(1A) of the SEBI Act, 1992.² According to these provisions, intermediaries comprise the following:

- (a) stock brokers and sub-brokers
- (b) share transfer agents
- (c) bankers to an issue
- (d) trustees of trust deeds
- (e) registrars to an issue
- (f) merchant bankers
- (g) underwriters
- (h) portfolio managers
- (i) investment advisers
- (j) depositories and depository participants
- (k) custodians of securities
- (l) credit rating agencies
- (m) asset management companies
- (n) clearing members
- (o) trading members
- (p) any other intermediary who may be associated with securities markets in any manner

The Intermediaries Regulations specifically excludes foreign institutional investors, foreign venture capital investors, mutual funds, collective investment schemes, and venture capital funds from the definition of intermediaries. Further, it is imperative to note that since only Chapters V and VI of the Intermediary Regulations are effective, the clause containing the definition is not yet operative. Nevertheless, it may be referred to in order to understand the concept from a regulatory perspective.

Ambiguity arises while interpreting the residual category, i.e., (p), much of which depends on how the SEBI interprets “associated with securities market.” Although not in the context of intermediaries, courts have held that “persons associated with market” would include everyone who has something to do with the securities market.³ For instance, audit firms without any direct association with share market activities are reckoned to be “associated with securities market,” since the auditing accounts of a company has a direct impact on the investor’s interest and market stability.⁴ While this issue is currently pending in appeal before the Supreme Court of India,⁵ a study of decided cases indicates that the SEBI interprets

² Regulation 2(1)(g) of the Intermediaries Regulations.

³ *Karnavati Fincap v. SEBI*, (1996) 10 SCL 5 (Guj.).

⁴ *Price Waterhouse & Co. v. SEBI*, [2010] 103 SCL 96 (Bom.).

⁵ Appeal Civil D. 30997 OF 2011, Supreme Court of India.

“associated with market” to include all persons having any direct or indirect link with the securities market.

III. Why Market Intermediaries?

The primary need for market intermediaries in the securities market is to match its demand and supply forces. In other words, intermediaries facilitate economies in confronting the critical challenge of the allocation of savings to investment opportunities, as shown in Figure 1.

Figure 1: Flow of Funds in the Capital Market



Economies that are able to match their available resources/savings to appropriate investment opportunities are successful in the creation of novel business avenues and the generation of more wealth and progress. Thus, to say that intermediaries are capable of making or breaking economies would not be an overstatement.

Further, investors and issuers are no longer homogenous; issuers and investors today are diverse and depict heterogeneous characteristics. To connect and manage such diverse groups, a mature market with sophisticated middlemen is essential.

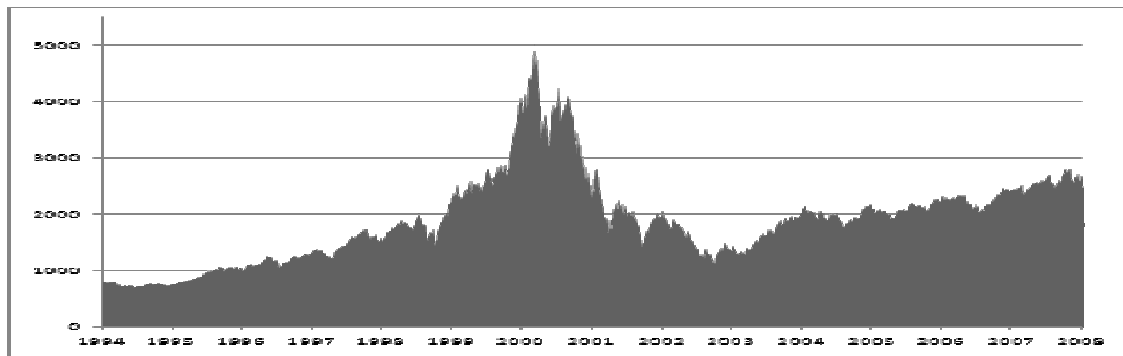
Additionally, in contemporary securities markets, investors and issuers rely heavily on intermediaries to operate on well-informed decisions. Investors, especially retail investors, do not have adequate information, knowledge, or expertise, and issuers do not have adequate resources to reach out to individual investors spread across the country and the globe. Therefore, intermediaries have a very crucial and sensitive role to play in making the market matrix—especially anonymous order-driven trading platforms—work smoothly.

The relevance of intermediaries in the securities market was brought to the forefront by the “dot-com bubble” in the U.S. In 1999, several Internet consulting companies (which were around two years old) went public on NASDAQ, claiming that they would bring in their information technology and web expertise to traditional “old economy” companies and lead to a new era of the Internet. The capital markets seemed to rely on these claims; from July 1999 to February 2000, the NASDAQ Composite Index (heavily weighted with technology

and Internet stocks) rose by 74.4%, and the Dow Jones Industrial Average (composed mainly of old economy stocks) fell by 7.7%.⁶

The pumping of funds into these companies by venture capitalists raised the market expectations, and the share prices of these Internet companies inflated tremendously. However, these valuations proved to be unsustainable as the share prices of these companies dropped sharply in April 2000. Eventually, these led to the “bubble burst”, having far-reaching implications on the U.S. economy as a whole, which economists refer to as the “lemons problem.”⁷ This state of affairs is illustrated in Figure 2 through the movements in the NASDAQ Composite Index from 1994 until 2008.

Figure 2: Movements in the NASDAQ Composite Index



Source: http://www.newyorkfed.org/research/directors_charts/ipage20.pdf (accessed on 2 October, 2012).

The technology-heavy NASDAQ Composite Index touched 5,048 in March 2000, reflecting the peak of the dot-com bubble (Palepu et al., 2007).⁸

While the dot-com bubble illustrates the flipside of the not-so-well-founded but ambitious manoeuvres of intermediaries, they do have their advantages such as full market coverage, investor and issuer outreach, lower costs, systematic fund flow, marketing and distribution services, and logistic support, *inter alia*. Thus, intermediaries may be acknowledged as the “necessary evils” of contemporary diverse capital market.

⁶ http://www.cengagebrain.co.uk/content/palepu17490_1408017490_02.01_chapter01.pdf (accessed on 5 October, 2012).

⁷ http://cws.cengage.co.uk/palepu_peek/students/weblinks_sample_ch/sample_ch1.pdf (accessed on 7 October, 2012).

⁸ See also:

http://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=6&cad=rja&ved=0CFEQFjAF&url=http%3A%2F%2Fwww.econ-pol.unisi.it%2Ffineng%2F4._The_dot.com_crash.doc&ei=7d7GULmaF8nKrAfpn4C4Cg&usg=AFQjCNFi-O1TDoZfjn2KjvCSbluYKM-w6w&bvm=bv.1354675689,d.bmk (accessed on 17 October, 2012).

IV. Indian Laws Governing Securities Market Intermediaries

The SEBI crafted a comprehensive regulatory framework encompassing all intermediary categories—the Intermediary Regulations. However, most of the provisions are yet to be notified, except those dealing with enforcement orders and procedures.

Today, intermediaries continue to be governed by the specific regulations governing each category of intermediaries, which *inter alia* include: the SEBI (Stock Brokers and Sub-brokers) Regulations, 1992; the SEBI (Depositories and Participants) Regulations, 1996; the SEBI (Bankers to an Issue) Regulations, 1994; the SEBI (Merchant Bankers) Regulations, 1992; the SEBI (Portfolio Managers) Regulations, 1993; the SEBI (Registrar to an Issue and Share Transfer Agents) Regulations, 1993; and the SEBI (Underwriters) Regulations, 1993.

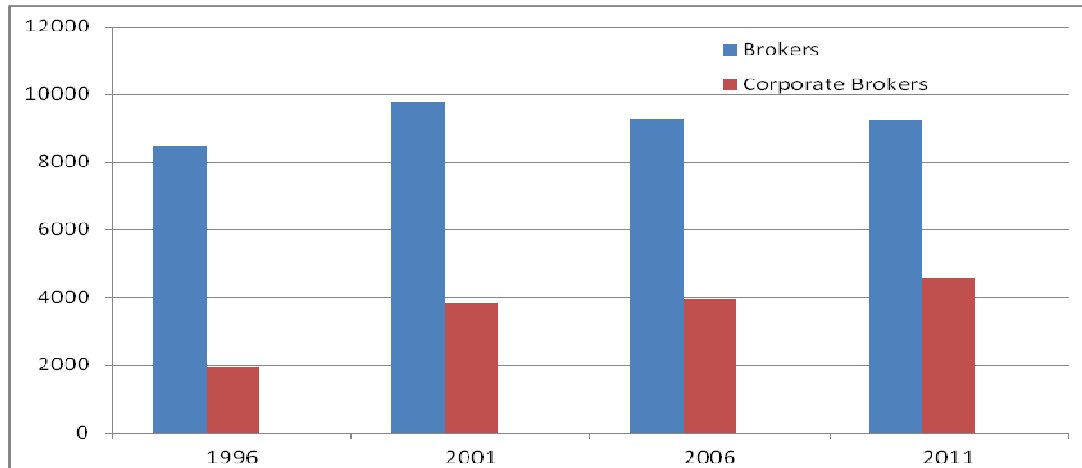
The basic structure of all these regulations includes the registration requirements, eligibility conditions, continuous compliance requirements, perpetuity or renewal of registrations (as the case may be), code of conduct, disclosures, maintenance of books/records, inspection and disciplinary proceedings, investigation, enquiry, adjudication, enforcement orders, and appeal powers.

Despite the basic structural commonalities, the specific regulations pertaining to the various categories of intermediaries are not uniform in terms of continual disclosures, display of registration certificate at intermediary offices, prohibition of irresponsible investment advice and disclosure of interests involved, permanency of registration, redressal of investor grievances, and specific conflict of interests and corporate governance provisions found in Regulations 4, 12(2), 15, 11, 13 and the Code of Conduct of the Intermediary Regulations, *inter alia*. A consolidated intermediary regulatory framework based on consistent objective standards—which would be able to account for the common requirements of intermediaries while preventing conflicts in interpretation with the specific regulations for each category—is essential today. From an administrative perspective, a consolidated framework would be convenient, especially while legally amending the common intermediary requirements/mandates. Hence, effectuating the Intermediary Regulations is critical to disciplining the market.

V. The Trend of Intermediary Registrations

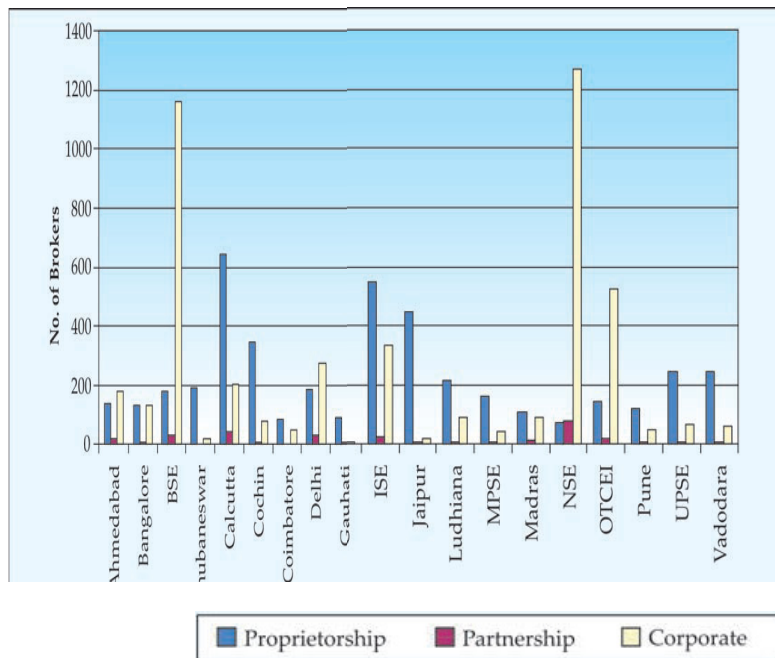
With the maturity of India's capital market, intermediary registrations have increased. Figures 3(a), 3(b), and Figure 4 illustrate the trend in registrations of various intermediary categories in India from 1995 to 2011.

Figure 3(a): Number of Stock Brokers and Proportion of Corporate Brokers in Cash Segment



Source: Handbook of Statistics 2011, SEBI (SEBI, 2011)

Figure 3(b): Ownership pattern of Registered Stock Brokers

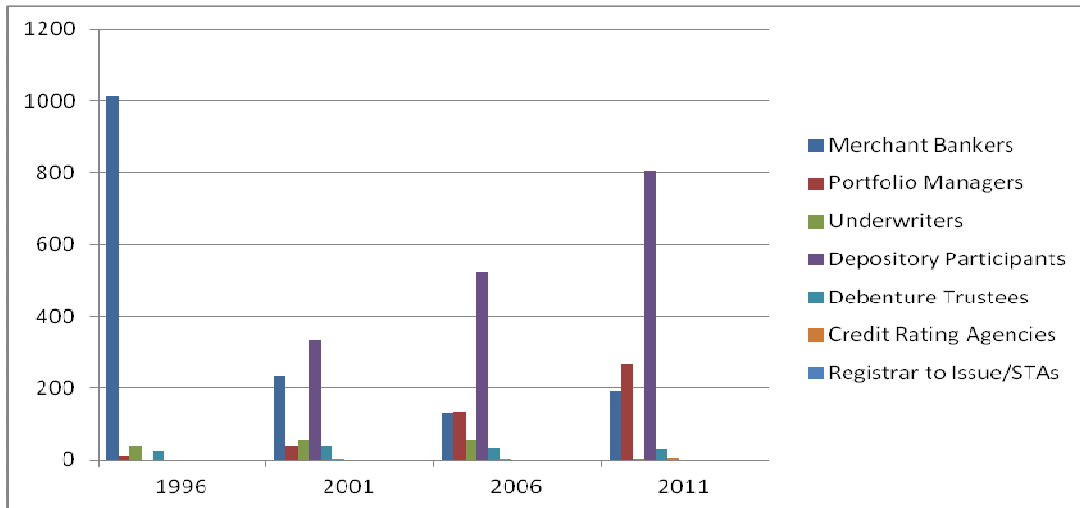


Source: Annual Report 2011-2012, SEBI (SEBI, 2012a)

Figure 3(a) presents the proliferating number of stock brokers in the cash segment as of 31 March in 1996, 2001, 2006, and 2011. Further, the increase in the number of corporate brokers as a percentage of stock brokers in Figure 3(b) depicts the increasing maturity and sophistication in the intermediaries segment of India's securities market. An analysis of the

varying population of the other major intermediary categories over the years (until 31 March 2011) is provided in Figure 4.

Figure 4: Trends in Registration of Various Categories of Intermediaries



Source: Handbook of Statistics 2011, SEBI (SEBI, 2011)

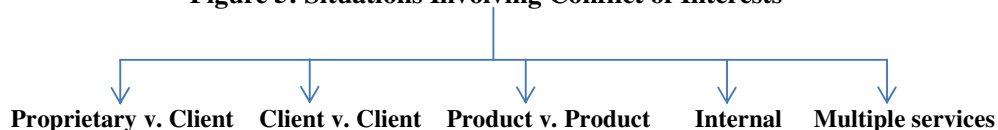
Figure 4 shows that after stock brokers, the intermediary categories in decreasing order of popularity are depository participants, portfolio managers, merchant bankers, debenture trustees, credit rating agencies, and underwriters. An interesting observation is the sharp decline in the number of underwriters after 2008, which may be attributed to the global meltdown consequent to the U.S. subprime crisis. Figure 4 also denotes a consistent decline in merchant bankers over the years with the advent of newer intermediary categories.

VI. Situations Involving Conflict of Interests

The term “conflict of interests” is widely used to identify situations where pecuniary or other competing interests prevent a party from acting in a certain manner, which would otherwise be legally or ethically appropriate; however, there is no universally accepted definition for the same. A conflict of interests situation can generally be understood as a situation where the multifaceted interests of an individual are in *inter se* conflict.

In the context of market intermediaries, such conflicts are augmented by the vast and diversified client base, endless product innovations, undisclosed and complex market mechanics, and simultaneous operations in multiple intermediary services. The various situations involving conflict of interests that are witnessed in the context of securities market intermediaries, particularly in India, can be broadly classified as shown in Figure 5.

Figure 5: Situations Involving Conflict of Interests



A. Proprietary v. Client Conflicts

This category of conflicts of interests can be explained as follows:

- (i) **Dealing in securities on proprietary account versus client account:** While the intermediary undertakes trade for its clients' account on its client's behalf for certain commissions, dealings on proprietary account comprise of sale and purchase of securities for the intermediary's own account. When these dealings are undertaken concurrently by an intermediary, the probability of the latter outweighing the former is very high. **Front-running**, a type of proprietary versus client conflict, arises when a stock broker undertakes proprietary trade based on the knowledge of pending orders from its client.⁹
- (ii) **Client financing by intermediary:** Where the intermediary has extended finance facility (loans/credit) to any of its clients, it will tend to invest the client's funds in a manner that facilitates the expeditious recovery of the loan/credit, regardless of the investment objectives of the client.
- (iii) **Churning:** Churning refers to a situation where a broker, for the sole purpose of generating commissions and maximising its income, is involved in excessive trading on a client's account, even when such trading involves unprofitable investments or unnecessary transaction costs for the client.
- (iv) **Use of clients' funds for proprietary trades:** Intermediaries may give advice to their clients that is contrary to what the real circumstances demand, and then use the funds earned by commission to trade as per the real market conditions on the proprietary account. This conflict is more prevalent when the intermediary is operating in different capacities; for instance, as a market analyst and investment advisor for the client and also as a stock broker undertaking proprietary trades.
- (v) **Aggregation of orders:** Aggregation of orders placed by clients with proprietary accounts, undertaken primarily for reducing administrative costs and enhanced convenience, may benefit the intermediary at a client's cost.
- (vi) **Competitive actions:** Intermediaries may indulge in unfair competitive practices, such as soliciting and inducing other intermediaries' clients, which is detrimental to investors and market functions.
- (vii) **Circular trading:** Circular trading involves the buying/selling of certain scrips *inter se* the intermediary and its group entities or other intermediaries to create artificial volume in the scrip, thus causing an increase in the price of the scrip.

⁹ For instance, WorldCom's lead advisor and banker prior to its 2002 bankruptcy filing had to pay \$2.65 billion by way of settlement towards the class action suits filed against it for having front-run WorldCom executives transactions (Office of New York State Comptroller, 2004).

B. Client v. Client Conflicts

- (i) **Big institutional clients v. small retail clients:** An intermediary may show preference to its bigger institutional clients who regularly undertake large trades and generate more revenue/commission for it (such as a large pension fund or financial institution), over smaller or individual investors.
- (ii) **Representing both sides of the market:** Conflicts are bound to arise when an intermediary represents both the issuer as well as the investor; the most common area in which this conflict becomes apparent is pricing of the issue.¹⁰
- (iii) **Front-running:** As discussed earlier, front-running may be applied by an intermediary to benefit a favoured client based on the orders placed by another not-so-favoured client.
- (iv) **Representing multiple investors in the same issue:** While representing and advising multiple investors in the same issue may be attractive for the intermediary's revenue/commission, it may result in the intermediary rendering wrongful advice to one client so as to benefit another, which is influenced by the varying depth of client relationships.
- (v) **Underwriting v. investor interest:** When an intermediary underwrites an issue and simultaneously represents investors in the same issue, the investors might end up paying a higher issue price. Moreover, the intermediary may make false and fraudulent statements to sell the issue. Further, underwriters often shift their potential loss from unsuccessful underwritings to a client account that is not well monitored by the client and is subject to the underwriter's discretion and decisions. This is known as **stuffing**.
- (vi) **Opening multiple demat accounts for favoured clients:** The SEBI took cognisance of this conflict in the IPO scams of 2006, which involved IPO subscriptions by the same set of investors through a large number of *benami* accounts opened with depository participants.¹¹
- (vii) **Laddering:** Laddering involves favourable share allotment to investors (mostly institutional investors) who promise to purchase further shares from the secondary market through the same intermediary. Such practices not only result in discriminatory market practices but also create artificial stock prices to lure retail investors.

C. Product v. Product Conflicts

This category of conflicts of interests can be explained through the downfall of the mutual fund industry in India's market, which was caused by SEBI's ban (in 2009) of the 2.5% entry load that mutual fund houses charged from investors to meet distributor commissions and

¹⁰ In the U.S., some hedge funds had funnelled a significant part of their IPO gains to the underwriting firms in the form of excessive commissions on unrelated secondary market trades (Attorney General of the State of New York, 2003).

¹¹ SEBI Order no. WTM/GA/101/ISD/11/06, dated 21 November, 2006 and SEBI Order no. WTM/GA/43/ISD/01/06, dated 12 January, 2006: SEBI passed orders for the disgorgement of ill-gotten gains against depositories and several depository participants for having failed in their duty of diligence while opening demat accounts, resulting in large losses to investors.

expenses. Consequent to the ban (which is still in force), mutual fund intermediaries drifted away from mutual fund products to other products.

To ensure synergies and lower cost of operations, intermediaries would prefer to deal in products in which it has business volume and economies of scale, as compared to products that are not routine, regardless of their profitability to clients.

D. Internal Conflicts

This category involves intra-intermediary conflicts, such as in the case of an intermediary having group operations. What is in the best interests of the group may not be in the best interests of a specific branch or subsidiary. In such a situation, decisions are usually taken factoring the overall interest of the group, resulting in losses to the branch/subsidiary concerned and its related clients. This conflict has become more rampant with the increasing percentage of corporate intermediaries.

Similarly, when intermediaries under common ownership deal in diverse categories of intermediary services, what is profitable for one service may be detrimental to another.

E. Multiple Services Conflicts

This category includes the conflicts inherent in the practice of multiple intermediary services by the same intermediary (or intermediaries under common ownership). For instance, when two intermediaries are owned by the same proprietor, with one providing analyst and advisory services and the other underwriting an issue, the analyst's report and investment advice is likely to be prejudiced and biased in favour of the underwritten issue.

Similarly, the common owner may use the insider information procured during the underwriting process by one of its concerns for subsequent trading in those shares, either on its own account or on behalf of clients through another concern.

Another example of this conflict category is where a merchant banker rolls out a public issue and recommends investor subscription to this issue in the capacity of an investment advisor, regardless of the actual health of the issue.

The variety of services rendered by an intermediary is directly correlated with the situations involving conflicts of interest; i.e., with the increase in such services, the probability and likelihood of conflicts of interests also rise.

VII. Fixing Accountability

Conflicts of interests involving securities market intermediaries are inevitable and can be expected to increase with further progression and maturity of the market. While this issue cannot be eliminated, it can certainly be regulated to check any exorbitant abuse and to mitigate losses. Some regulatory efforts to this end are discussed below.

A. International Regulatory Efforts

The International Organisation of Securities Commissions (IOSCO) promulgated its Report on “Guidance for Efficient Regulation of Conflicts of Interest Facing Market Intermediaries” (henceforward, the IOSCO Report) in 2010, to develop guidance for IOSCO member jurisdictions for the efficient regulation of the conflicts of interests involving intermediaries. While advocating optimal regulation, the IOSCO Report states that strong and harsh regulation for dealing with conflicts can take away the advantages a market intermediary possesses through the means of economies of scale. On the other hand, soft regulation will create an incentive for intermediaries to exploit the interests of their clients, which would lead to a loss in investor confidence. Therefore, the IOSCO Report recommends that the regulatory framework should be balanced and should aim to mandate strict internal control measures to avoid situations involving conflicts of interest.

India, being an active member of the IOSCO, strives to bring in an optimal blend of rules and principles into its intermediary linked regulatory regime (as discussed in the following section). Various regulatory measures that have been enforced internationally are discussed below.

- (i) **Client prejudice:** In Korea, Article 68 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act prohibits soliciting an investor without factoring its investment objectives, financial status, investment experiences, and so on.
- (ii) **Churning:** In the Cayman Islands, the Securities Investment Business Regulations’ Code of Conduct requires intermediaries to ensure that client trades are fair. Moreover, the Statement of Guidance on Client Understanding, Suitability, Dealing, and Disclosure prohibits an intermediary from undertaking transactions of abnormal frequency or size.
- (iii) **Front-running:** Front-running (also known as stepping in front or “pennying”) is forbidden by the U.S. Securities and Exchange Commission (SEC) as a form of insider trading. There are several instances where intermediaries (such as brokers) indulging in front-running have been convicted under U.S. federal securities laws.¹²

In Malaysia, the Capital Markets & Services Act, 2007 and the Guidelines on Market Conduct and Rules of the Bursa Malaysia Securities Exchange state that priority must be given to the client’s orders; both administrative as well as civil actions may be taken for non-compliance.

Insider information: The U.S. and most other jurisdictions extend insider-trading liability to any individual or person who trades on the basis of any unpublished, price-sensitive information. Sections 16(b) and 10(b) of the Securities Exchange Act, 1934, read with Rule 10b5-1, address insider trading in the widest sense. Moreover, the concept of “constructive insiders” (established by the case of *Dirks v. SEC*) extends

¹² *Carpenter v. United States*, 484 U.S. 19 (1987).

the insider-trading prohibitions to lawyers, investment bankers, and others who receive confidential information from a company while providing services to the corporation. Thus, the insider-trading prohibitions apply to any underwriter procuring unpublished, price-sensitive information of a company while underwriting its scrip.¹³

In Pakistan, the Securities and Exchange Ordinance, 1969 strictly prohibits insider trading, and thus, restricts conflicts arising from underwriting information being used for subsequent trading, front-running, and so on.

Most jurisdictions, including Thailand, Bermuda, and Montenegro, prohibit insider trading, which encompasses the use of any insider/non-published information procured during underwriting for subsequent trading in the same securities.

- (iv) **Analyst/Research Reports:** On 10 May, 2002, the SEC issued Release No. 34-45908 approving the changes proposed by the National Association of Securities Dealers, Inc. and the NYSE to address conflicts of interest that arise when analysts work for firms that have investment banking or other business relationships with the issuers of the securities that they recommend, or when analysts or firms own securities of the recommended issuer. This regulatory mandate came up consequent to a global settlement plan of certain federal and state enforcement actions in 2002–2003 against popular investment firms alleging undue influence of investment banking interests on securities research at brokerage firms (SEC, 2003). On parallel lines, Title V of the Sarbanes Oxley Act, 2002, disciplines analysts by segregating them from investment banking or share broking activities, protects them from retaliations triggered by any adverse reports, and regulates the sources of their compensation to avoid situations involving conflicts of interests.

Certain jurisdictions such as Dubai and Jordan enable their investors to recover damages caused by analyst misconduct. Pakistan requires analysts to include justifications in their research recommendations, disclose any conflicts of interests that can potentially harm the objectivity of the report, and retain all base records on which the report is premised. Chinese Taipei and Bermuda require the disclosure of any relationship that can potentially impair the objectivity and independence of research/analyst reports. As a safeguard against such conflicts, Thailand prohibits its market intermediaries from publishing any analysis report for an issuer fifteen days before the issuing date and until the issue closes.

- (v) **Aggregation of Orders:** To curtail the arbitrary aggregation of orders, brokers in Dubai are permitted to aggregate orders only when such aggregation does not impair any client, when the basis and implications of the aggregation are disclosed to the clients, and when the broker has put in place objective standards for aggregation. On the contrary, Pakistan completely prohibits brokers from indulging in any aggregation of a client's order with another client's orders or with proprietary orders.

¹³ 463 U.S. 646, No. 82-276, U.S. Supreme Court (1983).

- (vi) **Improper Pricing:** Unlike Thailand, where the pricing of issue/underwriting is not regulated, Chinese Taipei requires a full disclosure of the methods and principles involved in pricing while underwriting securities. Additionally, in certain suspicious circumstances, further explanation for price differences may be required. On similar lines, in Turkey, if the IPO price is different from the listed or nominal price, an evaluation report needs to be disclosed by the intermediary concerned.
- (vii) **Client Favouritism:** The exercise of discretion in favouring one client over another by intermediaries while allocating shares in the case of oversubscription of an issue is regulated by the Securities and Exchange Commission of Thailand by requiring such intermediaries to submit an allocation report mentioning the allocation standards, the persons to whom shares were allocated, and the proportions of securities allocated.
- (viii) **Multiple Investors in Same Transaction:** To avoid conflicts arising from advising multiple investors in the same transaction, Chinese Taipei requires the lead managers of issues to publish a book-building/competitive auction announcement in newspapers with detailed bid information. Other jurisdictions such as Columbia, Dubai, and Korea have also implemented measures to address such conflicts of interests.
- (ix) **Misrepresentations to Sell Issues:** Misleading statements made to sell an underwritten public issue are condemned in most jurisdictions, including the U.S., Malaysia, Pakistan, and Thailand.

B. Regulatory Efforts in India

1. SEBI: The SEBI is cognisant of the menace of conflicts of interests at the intermediary level, as reflected in several of its regulatory provisions.

- (i) **Regulation 15 of the Intermediary Regulations:** This requires an intermediary as well as its directors, officers, employees, and key management personnel (henceforward, “related persons”) to disclose any direct or indirect interest of itself or its dependents in any security of which it renders any investment advice. Further, it forbids them from rendering any investment advice unless they have reasonable grounds to believe that the recommendation is suitable. However, the SEBI does not explain what grounds will qualify as reasonable to make an advice appropriate, and much is left for the intermediaries to interpret.
- (ii) **Regulation 16 of the Intermediary Regulations read with the Code of Conduct (Schedule III):** An intermediary, along with its related persons, are required to conform at all times to the Code of Conduct (henceforward, the Code), which includes the following provisions for conflicts of interests:
 - (a) Specific provisions for conflict of interests, requiring intermediaries to avoid situations involving conflicts of interests, to make adequate disclosures of its interests (including potential sources and areas of conflict) to the public, and to resolve any such conflicts in an equitable manner. (Article 4 of the Code)

- (b) Best efforts to protect investors having considered the client's needs, environment, and its own professional skills. (Article 1.1 of the Code)
 - (c) High standards of integrity, fairness, dignity, ethics, and professionalism in conduct of business. (Article 1.2 of the Code)
 - (d) Exercise of due diligence, independent professional judgment, and no collusion with other intermediaries. (Article 1.3 of the Code)
 - (e) No misrepresentation, misleading, or exaggerated statements to clients. (Articles 3.2 and 3.3 of the Code)
 - (f) Quality disclosures to enable clients to make well-informed and balanced decisions. (Article 3.1 of the Code)
 - (g) No indulgence in any unfair competition practices that are prejudicial to investors. (Article 5.1 of the Code)
 - (h) No indulgence in corrupt practices such as price rigging, creation of false market, passing of price sensitive information, or activities distorting the market equilibrium, for personal gain. (Article 5.3 of the Code)
 - (i) Arm's length relationship with respect to activities undertaken in different intermediary categories or market positions.
- (iii) **Regulation (17)(2)(b) of the Intermediary Regulations read with Article 6.1 of the Code:** An intermediary is required to implement adequate internal control systems and safeguards.
 - (iv) **Regulation 12(4) of the Intermediary Regulations read with Article 5.2 of the Code:** An intermediary is required to maintain records, data, and back-up at all times, which can facilitate tracing any defaults and manipulations.
 - (v) **Regulation 3 of the Intermediary Regulations read with Form A (Schedule I):** An intermediary is required to disclose its ownership structure and the details of its promoters at the time of registration, which could potentially help the regulator to manage conflicts of interests arising from the same proprietors undertaking multiple intermediary services or from the owners having any conflicting engagements.

As was stated earlier, since most of the Intermediary Regulations are not yet operative, these provisions are only persuasive in nature. Nevertheless, most of these provisions are mirrored in the specific intermediary regulations and their respective codes of conduct as well, and intermediaries are mandatorily bound by similar provisions for conflicts of interests (discussed later in more detail).

- (vi) **SEBI (Investment Advisors) Regulations, 2012:** While the SEBI approved this regulation in August 2012, it is yet to be notified. This regulation requires an investment adviser to act in a fiduciary capacity towards its clients, segregate other

activities undertaken—such as distribution, referral, or execution business—from advisory services, and disclose all conflicts of interests, including any commission remuneration or compensation received from such other services.

While direct commercial exploitation of investors from irresponsible and ignorant investment advice may be curtailed by regulating the entities providing investment advice to investors for a commission, the advice rendered without any fee attributable to it is excluded from the ambit of this regulation, as suggested by the Investment Advisory Board of the SEBI in the 3–4 November, 2012 meeting (SEBI, 2012c). Thus, it is yet to be seen how these regulations are implemented with regard to the otherwise specifically exempted intermediary categories in practice (SEBI, 2012b).

Further, these regulations encompass the class of investment advisers providing investment advisory services to private investment trusts, family offices, private equity funds, venture capital funds, and hedge funds. The regulations do not exempt from certification this class of advisers, although their services are directed towards sophisticated institutional investors, who are expected to be aware of investment risks.

It is pertinent to note that the U.S. Investment Advisers Act, 1940 provides exemptions from registration with the SEC to investment advisers in certain circumstances; e.g., if the investment adviser has less than fifteen clients, it does not hold itself out generally to the public as an investment adviser, and it does not advise investment companies.¹⁴ Likewise, under the Financial Advisers Regulations, 2002 of Singapore, a financial adviser is exempt from holding a financial adviser's license if it provides advice to only thirty accredited investors.¹⁵

Therefore, an exemption along these lines in the Regulations would be very beneficial, as this would enable the regulator to focus on and commit its resources to monitoring the investment advisers that cater to the more vulnerable investor category of retail investors, and would greatly reduce the administrative burden.

- (vii) **The SEBI (Prohibition of Insider Trading) Regulations, 1992 (henceforward, the Insider Trading Regulations):** Any dealing in securities by an insider while in possession of unpublished price-sensitive information is prohibited.

Thus, although the Insider Trading Regulations is not specific to intermediaries, it condemns dealing in securities by intermediaries based on or while in possession of insider information, e.g., information procured while underwriting an issue, whether as an agent for its clients or as the principal on its proprietary account.¹⁶

The Insider Trading Regulations also mandate the creation of a “Chinese wall” for the segregation of the departments/undertakings with access to unpublished price-

¹⁴ Section 203(b)(3) of the Investment Advisers Act, 1940.

¹⁵ Regulation 27(1)(d) of the Financial Advisers Regulations, 2002.

¹⁶ Regulation 26(viii), (ix), and (x) of the SEBI (Stock Broker & Sub-broker) Regulations, 1992.

sensitive information from the public areas.¹⁷ Following this, the intermediaries are required to put in place “Chinese walls” to check abuse of confidential information, more so when the same entity operates as intermediary in different capacities, such as underwriter as well as investment advisor.

Further, analysts preparing the research reports of a company are forbidden from trading in its securities for thirty days from the preparation of such report, and are required to disclose their interest, if any, in the company.¹⁸

- (viii) **Specific intermediary regulations:** The SEBI has issued several circulars under the SEBI (Stock Broker & Sub-broker) Regulations, 1992, mandating the segregation of broker proprietary monies from client monies,¹⁹ the disclosure of proprietary trading undertaken to its clients,²⁰ and so on. Similar preventive provisions are also found in the SEBI (Portfolio Managers) Regulations, 1993,²¹ the SEBI (Merchant Bankers) Regulations, 1992,²² and the SEBI (Underwriters) Regulations, 1993.²³
- (ix) **SEBI’s move against unauthenticated news or rumours:** In March 2011, the SEBI issued directions to market intermediaries to control unauthenticated news and rumours related to scrips that are circulated by the employees of such intermediaries without any regard to the serious implications of such news/rumours, despite the mandate under the Intermediary Regulations and the various intermediary-specific regulations.²⁴
- (x) **SEBI on churning in the context of mutual funds:** While condemning conflicting practices like churning in the context of mutual funds, the SEBI recommended the inclusion of misselling as a “fraudulent and unfair trade practice” under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 (henceforward, the FUTP Regulations) (SEBI, 2012b).
- (xi) **Regulation 4(2) of the FUTP Regulations:** In addition to general fraudulent and unfair trade practices such as false statements or concealment of truth, promises made without intending to perform, and so on, the FUTP prohibits certain practices specific to intermediaries, such as an intermediary reporting transactions in an inflated manner to its client so as to increase its commission/brokerage; circular transactions with respect to a security entered into between intermediaries to provide a false and

¹⁷ Regulation 12(1) read with Schedule I of the Insider Trading Regulations.

¹⁸ *Ibid.*

¹⁹ SEBI Circular no.SMD/SED/CIR/93/23321, dated 18 November, 1993; SEBI Circular no. SEBI/MRD/SE/Cir-33/2003/27/08, dated 27 August, 2003; SEBI Circular no. MRD/DOP/SE/Cir-II/2008, dated 17 April, 2008; and SEBI Circular no. MIRSD/SE/Cir-19/2009, dated 3 December, 2009.

²⁰ SEBI Circular no. SEBI/MRD/SE/Cir-42/2003, dated 19 November, 2003.

²¹ Regulation 15 of the SEBI (Portfolio Managers) Regulations, 1993.

²² Regulations 13, 21A and 26; read with the Code of Conduct (Schedule III) of the SEBI (Merchant Bankers) Regulations, 1992.

²³ Regulations 13 and 15, read with Code of Conduct (Schedule III) of the SEBI (Underwriters) Regulations, 1993.

²⁴ SEBI Circular no. CIR/ISD/1/2011, dated 23 March, 2011 and SEBI Circular no. CIR/ISD/2/2011, dated 24 March, 2011.

inflated impression of trading; an intermediary buying/selling securities in advance of a substantial client order, or where a futures or option position is taken about an impending transaction in the same or related futures or options contract, and so on.

Despite these FUTP provisions, it appears that fixing the liability of intermediaries under these regulations is qualified by the onerous “knowledge” test; i.e., unless it can be proved that the broker had the knowledge of the circular nature of trades directed by its client, the broker cannot be held liable.²⁵

Further, the FUTP Regulations need clearer interpretations, more so in view of the recent Securities Appellate Tribunal (SAT) order²⁶ stating that the FUTP Regulations do not clearly define “front-running” and therefore, setting aside the SEBI order penalising certain intermediaries for front-running.²⁷

Having said that, there have been several instances recently where the SEBI took proactive measures against intermediaries under the FUTP Regulations.²⁸

Considering that most of these regulatory provisions prefix the conflicts of interests aspect with the word “shall,” it appears that the SEBI intends to create mandatory obligations of intermediaries in this regard. However, there are a few exceptions to this rule-based regime, such as the requirement of arm’s length relationship (mentioned earlier in this section), which is a “shall endeavour to” provision, and thus, is only recommendatory in nature. Therefore, it may be stated that the law relating to conflicts of interests of intermediaries in India is a blend of rule-based and principle-based regulations. While it is well acknowledged that most of the conflicts of interests are dependent on internal controls, the Indian capital market is still not mature enough to rely completely on self-regulation and culture rectification. Thus, despite containing several lacunae and loopholes, the current combination of rule-based and principle-based regulatory framework in India is appreciable in today’s context. The onus now lies on the effective implementation of this framework, which continues to be a challenge.

- (xii) **SEBI enforcement actions:** Upon suspicion of any violations or defaults by intermediaries, the SEBI can initiate enquiry under Section 11B, investigation under Section 11C, and/or adjudication under Section 15-I of the SEBI Act.

As the data available in the public domain does not identify the investigations and adjudications against intermediaries separately from such proceedings against other

²⁵ *Networth Stock Broking Ltd. v. SEBI*, SAT Order in respect of Appeal No. 5 OF 2012, dated 19 June, 2012.

²⁶ SAT Order in respect of Appeal No. 216 of 2011, dated 9 November, 2012; and SAT Order in respect of Appeal No. 74 of 2012, dated 9 November, 2012.

²⁷ Adjudication Order No. PG/AO- 104/2011, dated 30 September, 2011, issued by the SEBI.

²⁸ Appeal pending before the Supreme Court of India from the SAT’s order setting aside penalty imposed by SEBI in 2009 over certain alleged reverse trades in the futures and options segment. Further, the SEBI had taken cognisance of certain stock brokers appearing on both the buyer as well as the seller side of the market. Source: SAT Order in respect of Appeal No. 51 of 2009, dated 26 October, 2010. See also: <http://www.thehindubusinessline.com/markets/article1611765.ece> (accessed on 25 September, 2012).

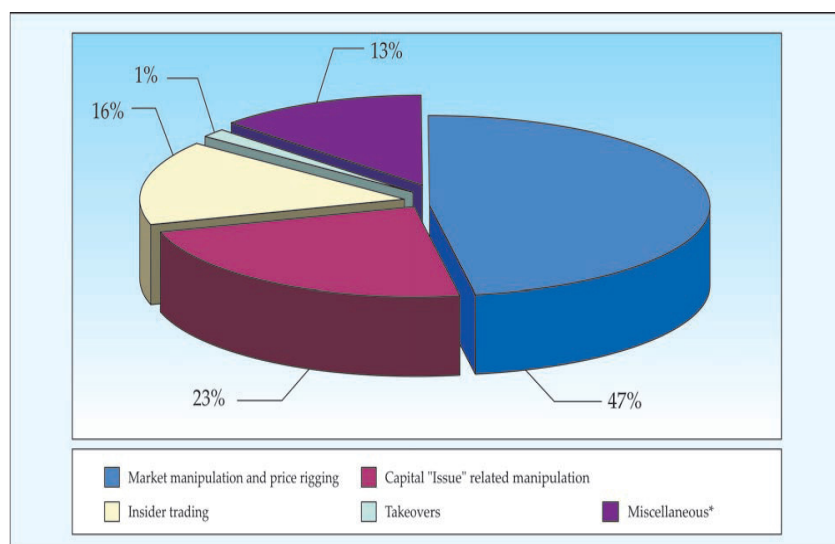
market participants, an assessment of the SEBI's enforcement through enquiry (which are specific to intermediaries alone) during 2011–2012 is listed in Table 1 (SEBI, 2012a).

Table 1: SEBI Enquiry Proceedings 2011–2012

Enquiry 2011–2012	Number
Orders passed/reports submitted	24
Proceedings initiated	8
Pending enquiry as of 31 March, 2012	123

Aside from the enquiry proceedings, the nature of violations taken up for investigation by the SEBI Investigating Authority during 2011–12 reveals that manipulation, price rigging, and public issue irregularities, normally attributable to alleged misconduct and lack of due diligence by market intermediaries, are very common (Figure 6).

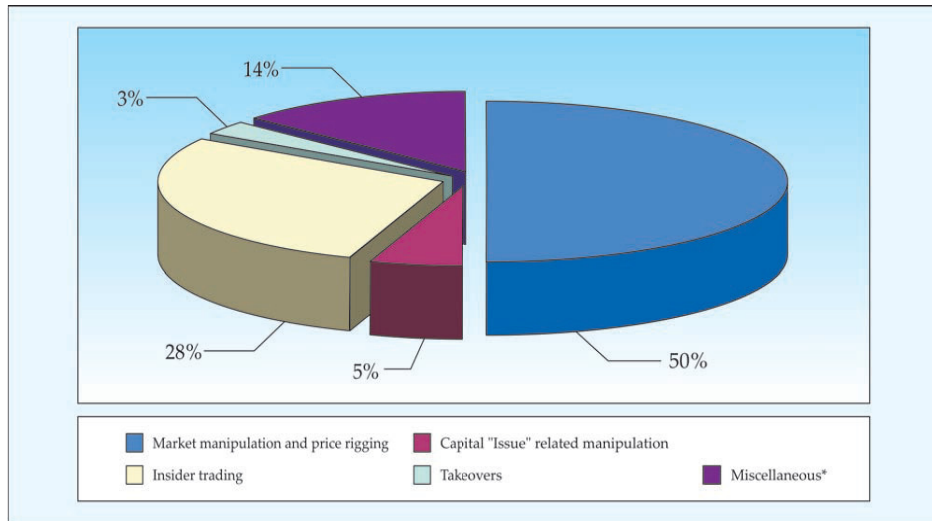
Figure 6: Nature of investigations taken up for scrutiny by the SEBI in 2011–2012



Source: Annual Report 2011–2012, SEBI (SEBI, 2012a)

Similarly, investigations completed by the SEBI in 2011–2012 reveal that price rigging and public issue irregularities are the most prevalent malpractices in the Indian market (Figure 7).

Figure 7: Investigations completed by the SEBI in 2011–2012



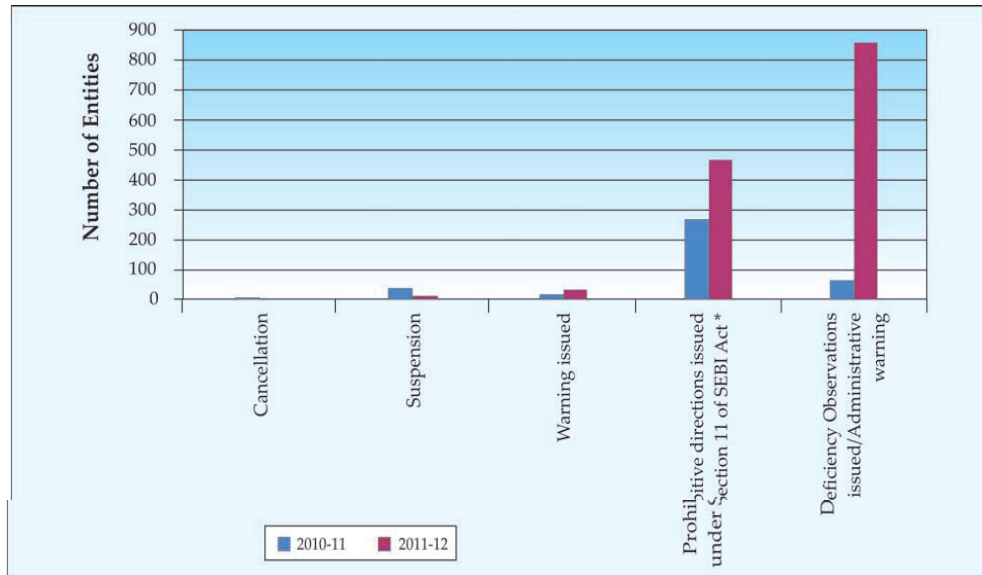
Source: Annual Report 2011–2012, SEBI (SEBI, 2012a)

Pursuant to the enforcements against intermediaries undertaken by the SEBI through enquiry, investigation, adjudication, and prosecution, the directions which can be issued by the SEBI include (without limitation) warnings, suspension of intermediary registrations, cancellation of intermediary registrations, debarring the intermediaries from market access or participation, cease and desist orders, disgorging of profits, imposing monetary penalties, and/or punishing by imprisonment.²⁹

A diagrammatic comparison of the regulatory actions undertaken by the SEBI in 2011–2012 as against those undertaken in 2010–2011 is provided in Figure 8 (SEBI, 2012c).

²⁹Sections 11(4), 11B, 15-I of the SEBI Act read with Regulation 27 of the Intermediary Regulations.

Figure 8: Comparison of the SEBI regulatory actions in 2011–2012 as against those undertaken in 2010–2011



* Other than consent orders

Source: Annual Report 2011-2012, SEBI (SEBI, 2012a)

However, it must be noted that the data illustrated in Figure 8 (except the enquiry proceedings) is not limited to intermediaries alone.

It is clear that the enquiry proceedings (exclusive to intermediaries) are much fewer in number than the adjudication proceedings. For instance, the total number of enquiry proceedings pending as of 31 March, 2012 is 123 against 1270 pending adjudication proceedings of the SEBI (SEBI, 2012a). However, no specific statistical data on the proportion of adjudication orders and directions under Section 11 that can be attributed solely to intermediaries is available.

A crucial paradigm of the SEBI’s investigation and enforcement orders against market intermediaries was witnessed in the interim, *ex-parte* orders passed by the SEBI on 28 December, 2011 against 208 entities, directing (*inter alia*) the following (SEBI, 2012a):

- a) The book-running lead managers/merchant bankers and their CEOs are prohibited from taking up any new assignment or involvement in any new issue of capital including IPO, follow-on issue, and so on, from the securities market in any manner.
- b) In some cases, stock brokers are prohibited from buying, selling, or dealing in any securities in their proprietary accounts, and are also prohibited from entering into any fresh agreements with new clients.

2. Reserve Bank of India (RBI)

The RBI, vide the Master Circular on Prudential Norms for Classification, Valuation, and Operation of Investment Portfolio by Financial Institutions (RBI, 2012), prescribed an internal control system for investments made by specified financial institutions:

- a) Clear functional separation of trading, accounting, and settlement, with monitoring and control.
Clear separation of proprietary account, portfolio management client account, and other constituents' (such as brokers) account. Further, any transactions between the financial institution's proprietary account and portfolio account are required to be strictly at arm's length rates.
- b) Portfolio management client's account must be subjected to a separate audit by an external auditor.
- c) In the case of placement of funds for portfolio management by the same client on more than one occasion, on a continuous basis, each such placement should be treated as a separate account.
- d) Portfolio management client services are required to be in the nature of investment consultancy/management for a fee, entirely at the client's risk without any guarantee of investment returns.
- e) A client having a portfolio account is entitled to get periodic statements of its portfolio account.³⁰

VIII. Challenges and Way Forward

Managing conflicts of interests of intermediaries and fixing their accountability is an onerous challenge, which further intensifies with the increasing complexities and diversities of the market. Some of the emerging aspects that can potentially increase the abuse of conflict of interests by intermediaries (if not managed on time) are discussed below.

- (i) **Outsourcing of intermediary services:** Intermediary services are no exception to the surge of inbound and outbound outsourcing witnessed by India. Taking cognizance of this, the SEBI issued certain guidelines on outsourcing by intermediaries in 2011,³¹ similar to the 2011 Guidelines on Outsourcing for Capital Market Intermediaries issued by the Securities Commission (Malaysia).³²

While the SEBI (through this circular) retains accountability and liability of the registered intermediaries with respect to all outsourced services, it does not require the third-party outsourced entities to procure any regulatory approval or registration prior to undertaking such outsourced assignments. Further, unlike the 2011 Malaysia Guidelines, it does not make any distinction between domestic and offshore/outsourced entities in terms of due diligence, regulation, and governance. Considering that this circular is still in a nascent stage, it is yet to be seen how the intermediaries implement and conform to these outsourcing principles.

- (ii) **Market analysts and researchers:** While analysts/researchers associated with mainstream intermediaries such as broking houses, merchant bankers, and so on are regulated, those operating on an independent and standalone basis, especially

³⁰ *Ibid.*

³¹ SEBI Circular no. CIR/MIRSD/24/2011, dated 15 December, 2011.

³² http://www.sc.com.my/eng/html/resources/guidelines/stockbroking/GL_outsourcing_110809.pdf (accessed on 2 October, 2012).

those providing services other than for a fee (SEBI, 2012c), remain outside any registration requirements of the regulator, which necessitates a comprehensive regulatory regime for them, similar the U.S. rules (discussed earlier in Section VII.A.(v)).

- (iii) **Rapid growth of intermediaries:** With the rapid increase in the number of intermediaries in the Indian market, it becomes difficult to identify the genuine and authorised intermediaries from the disguised, fraudulent ones. In this context, it is essential that the SEBI publishes a comprehensive updated database of all registered intermediaries, similar to what the Monetary Authority of Singapore publishes.³³ While the SEBI website provides lists of recognised intermediaries,³⁴ these lists are not updated; some of the lists date back to 2009.

To combat the menace of abuse of market mechanics caused by the faceless market interface of the anonymous technology-driven trading platforms, a comprehensive institutionalised definition of “intermediaries” is urgently needed to determine the regulatory contours and eliminate the unrecognised entities floating in the market without any streamlined accountability.

Moreover, standardised benchmarks regulating intermediaries’ conduct, on similar lines as the Intermediary Regulations, must be made operational at the earliest to facilitate the fixation of accountability.

- (iv) **Lack of expertise and advent of hybrid products:** The risks linked to market dealings aggravate manifold owing to the complex and hybrid products floating in the market today. The dearth of expert intermediary services increases the market apprehensions. It is high time that the dealings in complex products were restricted to only intermediaries having expertise/qualifications, ascertained through certification programs, minimum experience conditions, and so on.
- (v) **Irresponsible and unauthenticated news/rumours:** Despite the SEBI’s directions to control the circulation of unauthenticated news/rumours having serious market implications, this problem persists, more so in smaller towns and remote areas lacking sophisticated corporate intermediaries. The “stock guru” scam involving crores of investors’ monies duped by certain individuals through fake offices, celebrity promotion, and ambitious promises of returns equalling double the invested amount within six months, which was unravelled recently is a glaring example of the abuse of naive investors. To this end, the SEBI must take proactive steps towards investor education and awareness, with a focus on retail investors, such that investors are able to exercise prudence and judgement to filter information prior to making investments based on such information. This becomes

³³ <http://www.sc.com.my/eng/html/licensing/LoLI/LTFC.pdf> (accessed on 15 September, 2012).

³⁴ <http://www.sebi.gov.in/sebiweb/home/list/5/33/0/0/Recognised-Intermediaries> (accessed on 10 December, 2012).

all the more critical considering that the SEBI is an active player at the IOSCO, and heads the Asia-Pacific Regional Committee of the IOSCO.

- (vi) **Extensive anti-corruption laws:** Factoring the impact of the U.S. Foreign Corrupt Practices Act, 1977, along with the U.K.'s Bribery Act, 2010, Indian companies and individuals all over the world with foreign exposure, including market intermediaries, must put in place anti-corruption compliance policies and procedures. Failing to do so may trigger strict enforcement actions and prosecutions by the U.S. Department of Justice and the SEC. Further, anti-corruption compliance must be factored by intermediaries while selecting their outsourcing/business partners, as any direct or indirect U.S./U.K. exposure can trigger anti-corruption enforcement actions.

Companies and commercial ventures are now significant interested parties to corruption matters pursuant to extensive corruption laws at the international level. Therefore, the SEBI must take cognisance of this less explored but critical area in the context of actions of market intermediaries and market participants as a whole.

IX. Conclusion

From this discussion, it appears that conflicts of interests involving intermediaries are inevitable and cannot be eliminated. However, efforts have been made to curtail it and mitigate the risks and consequent losses.

Since the reliance on principle-based compliance demands a more mature capital market and since the Indian capital market has still not matured, a rule-based avoidance regime of conflicts of interest is predominant in India, which is evidenced in various SEBI Regulations and the Code of Conduct, the SEBI enforcement actions, and the RBI Guidelines.

While a shift from a rule-based towards a principle-based compliance regime should not be hasty, and must be aligned with India's market conditions, regulations and rules³⁵ alone cannot remedy such situations of conflict, which need to be supplemented with enduring principles and an ethical business culture.

Creating robust internal control systems and self-regulation are the two primary and predominant mechanisms to establish this culture. Although India has been debating over the establishment of SEBI-registered Self-Regulatory Organisations (SROs) for market intermediaries for a long time, and despite the SEBI having promulgated the SEBI (Self-Regulatory Organisations) Regulations, 2004 (the "SRO Regulations") for the recognition and constitution of SROs, this concept continues to remain theoretical. While the SEBI has advocated the formation of a registered SRO for intermediaries³⁶ and has more recently

³⁵ http://articles.economictimes.indiatimes.com/2011-11-06/news/30366624_1_market-entities-market-intermediaries-capital-market (accessed on 14 October, 2012).

³⁶ http://articles.economictimes.indiatimes.com/2008-01-14/news/27726178_1_capital-market-brokers-market-capitalisation (accessed on 15 October, 2012).

proposed the formation of a self-regulatory board for investment advisors,³⁷ the proposition to this end is yet to materialise. Most jurisdictions like the U.S., Japan, Korea, and Turkey have established SROs—the National Association of Securities Dealers for brokers, Japan Stock Dealers Association, Korean Stock Dealers Association, and the Association of Capital Market Intermediary Institutions for all capital market intermediaries, respectively. Although India has a few functional industry associations like the Association of Mutual Funds of India for the mutual funds industry, they are not yet registered with the SEBI as SROs under the SRO Regulations.³⁸ To work at par with international markets and to cope with intermediary challenges, the Indian market eagerly awaits the launch of its first SEBI-registered intermediary SRO.

³⁷ Concept Paper on Regulation of Investment Advisors, dated 26 September, 2012, issued by the SEBI.

³⁸ <http://www.sebi.gov.in/boardmeetings/124/mfdistributors.pdf> (accessed on 17 October, 2012).

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