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A CRITICAL STUDY OF SECONDARY MARKET IN INDIA: EVALUATING SCAMS FROM 1991 – 2023

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I. INTRODUCTION

The financial system consists of specialized and non-specialized financial institutions, of organized and unorganized financial markets, of financial instruments and services, which facilitate transfer of funds. Procedures and practices adopted in the markets, and financial interrelationships are also parts of this system**.** In product or other service markets, purchasers part with their money in exchange for something now. In finance, money "now" is exchanged for a "promise to pay in the future". However, in product or service markets, if the object sold – from a car to a haircut – is defective, the buyers often find out relatively soon.[1] On the other hand, loan quality is not readily observable for quite some time and can be hidden for extensive periods[2]. Moreover, banks and non-bank financial intermediaries can also alter the risk composition of their assets more quickly than most non-financial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. Theoretically, the financial market facilitates allocation of resources efficiently, which involves quick dissemination of information and reaction to it.

II. SECURITY SCAM IN INDIA-1991

In April 1992, press reports indicated that there was a shortfall in the Government Securities held by the State Bank of India. Investigations uncovered the tip of an iceberg, later called the securities scam, involving misappropriation of funds to the tune of over Rs. 3500 Crores[8]. The scam engulfed top executives of large nationalized banks, foreign

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[2]Caprio, Gerard Jr. and Ross Levine, "*Corporate Governance In Finance: Concepts and International Observations*"(2002)

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banks and financial institutions, brokers, bureaucrats[3] and politicians: The functioning of the money market and the stock market was thrown in disarray. The tainted shares were worthless as they could not be sold. This created a panic among investors and brokers and led to a prolonged closure of the stock exchanges along with a precipitous drop in the price of shares. Soon after the discovery of the scam, the stock prices dropped by over 40%, wiping out market value to the tune of Rs. 100,000 crores. The normal settlement process in government securities was that the transacting banks made payments and delivered the securities directly to each other. The broker's only function was to bring the buyer and seller together. During the scam, however, the banks or at least some banks adopted an alternative settlement process similar to settlement of stock market transactions. The deliveries of securities and payments were made through the broker. That is, the seller handed over the securities to the broker who passed them on to the buyer, while the buyer gave the cheque to the broker who then made[4] the payment to the seller. There were two important reasons why the broker intermediated settlement began to be used in the government securities markets:

- The brokers instead of merely bringing buyers and sellers together started taking positions in the market. They in a sense imparted greater liquidity to the markets.

- When a bank wanted to conceal the fact that it was doing an [9]Ready Forward deal, the broker came in handy. The broker provided contract notes for this purpose with fictitious counterparties, but arranged for the actual settlement to take place with the correct counterparty. This allowed the broker to lay his hands on the cheque as it went from one bank to another through him. The hurdle now was to find a way of crediting the cheque to his account though it was drawn in favour of a bank and was crossed account payee. It is purely a matter of banking custom that an account payee cheque is paid only to the payee mentioned on the cheque. In fact, privileged (corporate) customers were routinely allowed to credit account payee cheques in favour of a bank into their own accounts to avoid clearing delays, thereby reducing the interest lost on the amount. The brokers thus found a way of getting hold of the cheques as they went from one bank to

[3]Table 6(Appendix)
[4]Stock market Scam in India of 1991:The Janakiraman Committee Report

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another and crediting the amounts to their accounts. This effectively transformed an RF into a loan to a broker rather than to a bank. But this, by itself, would not have led to the scam because the RF after all is a secured loan, and a secured loan to a broker is still secured. What was necessary now was to find a way of eliminating the security itself.

Three routes adopted for this purpose were:

- Some banks (or rather their officials) were persuaded to part with cheques without actually receiving securities in return. A simple explanation of this is that the officials concerned were bribed and/or negligent. Alternatively, as long as the scam lasted, the banks benefited from such an arrangement. The management of banks might have been sorely tempted to adopt this route to higher profitability.
- The second route was to replace the actual securities by a worthless piece of paper – a fake Bank Receipt (BR). A BR like an IOU has only the borrower's assurance that the borrower has the securities which can/will be delivered if/when the need arises.
- The third method was simply to forge the securities themselves. In many cases, PSU bonds were represented only by allotment letters rather than certificates on security paper. However, it accounted for only a very small part of the total funds misappropriated. During the scam, the brokers perfected the art of using fake BRs to obtain unsecured loans from the banking system. They persuaded some small and little known banks – the Bank of Karad (BOK) and the Metropolitan Cooperative Bank (MCB) - to issue BRs as and when required. These BRs could then be used to do RF deals with other banks. The cheques in favour of BOK were, of course, credited into the brokers' accounts. In effect, several large banks made huge unsecured loans to the BOK/MCB which in turn made the money available to the brokers.

III. SECURITY SCAM IN INDIA-2001

In Spite of the recommendations made by the Janakiraman Committee Report in 1992 to prevent security scams from happening in the future[5] another security market took place in 2001. This involved the actions of one major player by the name of Ketan Parekh. He manipulated a large amount of funds in the capital market though a number of his own companies which is probably why the scam remained a mystery for quite some time the

[5] Glossary(Definition)

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RBI,SEBI and DCA(Department Of Company affairs) had gone slack in their regulatory operations.During 1999 and 2000 the SENSEX reached a high and after than the stock market crashed in 2001.Some of the major companies he invested in were [11]Nirma, Adani Group, Essel Group,DSQ and Zee Cadila.Ketan Parekh manipulated the stock market through FII's (Foreign Institutional Investors), OCB's (Overseas Commercial Borrowings),Banks and Mutual Funds(Unit Trust Of India). In fact an important extension of this scam remains the Unit Trust Of India Scam.

IV. UTI SCAM

Of all the recent encounters of the Indian public with the much-celebrated forces of the market, the Unit Trust's US-64 debacle is the worst[6]. Its gravity far exceeds the stock market downswing of the mid-1990s, which wiped out Rs. 20,000 crores in savings. [13]The debacle is part of the recent economic slowdown which has eliminated one million jobs and also burst the information technology (IT) bubble. This has tragically[7] led to suicides by investors. And then suspension of trading in US-64made the hapless investors more dejected at the sinking of this "super-safe" public sector instrument that had delivered a regular return since 1964. There is a larger lesson in the US-64 debacle for policies towards public savings and public sector undertakings (PSUs). The US-64 crisis is rooted in plain mismanagement. US-64 was launched as a steady income fund. Logically, it should have invested in debt, especially low-risk fixed-income government bonds. Instead, its managers increasingly invested in equities, with high-risk speculative returns.In the late 1980s UTI was "politicised" with other financial institutions (FIs) such as LIC and GIC, and made to invest in certain favoured scrips. By the mid-1990s, equities exceeded debt in its portfolio. The FIs were also used to "boost the market" artificially as an "endorsement" of controversial economic policies. In the past couple of years, UTI made downright imprudent but heavy investments in stocks from Ketan Parekh's favourite K-10 portfolio, such as Himachal Futuristic, Global Tele and DSQ. These "technology" investments took place despite indications that the "technology boom" had ended. US-64 lost half its Rs. 30,000 crore portfolio value within a year. UTI

[6]Appendix:Graphical Evidence Of Security Scam in India In 2001
[7]Joint Parliamentary Committee Report(2001)

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sank Rs. 3,400 crores in just six out of a portfolio of 44 scrips. This eroded by 60 percent. Early this year, US-64's net asset value plunged below par (Rs.10). But it was re-purchasing US-64 above Rs. 14! Today, its NAV stands at Rs. 8.30 - a massive loss for 13 million unit-holders.It is inconceivable that UTI made these fateful investment decisions on its own. According to insiders, the Finance Ministry substantially influenced them: all major decisions need high-level political approval. Indeed, collusion between the FIs, and shady operators like Harshad Mehta, was central to the Securities Scam of 1992. The Joint Parliamentary Committee's report documents this. In recent months, the Finance Ministry became desperate to reverse the post-Budget market downturn. UTI's misinvestment now coincided with the global technology "meltdown[8]." US-64 crashed. UTI chairman resigned. Although culpable, he was probably a scapegoat too. The Ministry has kept a close watch on UTI, especially since 1999.The US-64 debacle, then, is not just a UTI scam. It is a governance scam involving mismanagement by a government frustrated at the failure of its macroeconomic calculations. This should have ensured the Finance Minister's exit in any democracy which respects parliamentary norms. There are larger lessons in the UTI debacle. If a well-established, and until recently well-managed, institution like UTI cannot safeguard public savings, then we should not allow the most precious of such savings - pensions - to be put at risk. Such risky investment is banned in many self-avowedly capitalist European economies. In India, the argument acquires greater force given the poorly regulated, extremely volatile, stock market— where a dozen brokers control 90 percent of trade. Yet, there is a proposal by the Finance Ministry to privatize pensions and provident funds. Basically, the government, deplorably, wants to get rid of its annual pension obligation of Rs. 22,000 crores.

Table 2: Security Scams in some Developed Countries

					Economics of financial regulation'

[8]www.hinduonnet,com

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1995	U.K.	Barings Bank	Nick Leeson	Excessive arbitraging in futures trading between the Singapore Monetary Exchange(SIMEX) and Osaka Stock Exchange(OSE)	Systemic Risk,Settlements Problem
2001	U.S.A.	Enron	Enron Executives	Manufacture losses by mismanagement of capital structure through SPEs (Special Purpose Entities),hiding losses, keeping debt off books	Insider Trading,Bad Accountability
1990	Luxemburg	BCCI and Sheikh Zayid of Abu Dhabi	The owner Agha Hasan Abedi and two shipping magnates from Pakistan The Gokal Brothers	Inflating loans from the bank by the two brothers for their shipping busness, arbitraging in derivatives market of Gulf through The BCCI-Gulf Transport Group consortium which lead to huge losses	Money Laundering,, Systemic Risk

V. BARINGS BANK

The aftermath of the bankruptcy of Barings Bank provides an excellent case study of [14]systemic risk. Representative Those who cite Barings as an example of derivatives

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causing market failures point to the fact that the authorities in Shanghai temporarily closed its bond-futures market and told investors to wind down positions in an attempt to limit damage from a trading scandal. In addition, they argue that "if anything, the Barings name may have contributed to its undoing, if it turns out to have been the bank's familiarity that blinded the authorities at Singapore's futures exchange to the enormous wrong-way bet its trader made on the future direction of Japan's Nikkei average ." A closer look at the reaction of market participants and volatility after the fall may provide insight into the magnitude of the contagion effect. Barings' young trader Nicholas Leeson was supposed to be "arbitraging", seeking to profit from differences in the prices of Nikkei-225 futures contracts listed on the Osaka Securities Exchange (OSE) in Japan and Singapore Monetary Exchange (SIMEX). Such arbitrage involves buying futures contracts on one market and selling them on another. Since the margins on this are small, the volumes traded by arbitrageurs tend to be large. However, this strategy is not very risky: a long position in one market (betting on a rise) is offset by a short position (betting on a fall) in the other). However, in addition to arbitraging the Osaka Exchange and the SIMEX, as far back as September 1994, Leeson began to simultaneously sell put options and call options on Nikkei-225 futures. This type of deal is known as a "straddle." If the market is less volatile than the options prices predict, the seller makes a profit. However, as a result of the Kobe earthquake, the Nikkei-225 fluctuated and Leeson began to exponentially increase the size of his open positions. By trading on a fraudulent account, numbered 88888, Leeson began to buy futures on a large scale in an attempt to almost single-handedly push up the Nikkei 225. This proved unsuccessful and eventually Leeson's losses were so large the bank eventually collapsed. A lifeboat by the Bank of England was not feasible due to the fact that many of the derivatives were impossible to wind down immediately, as the options did not expire for months. While this case has been widely cited as providing evidence of a market failure, others argue that the systemic risk from the loss was minimal. Others argue that in the event of a viable threat of systemic risk, the Bank of England would have bailed out Barings Bank, but the precise magnitude of the systemic risk is not known. Reports in the Wall Street Journal immediately following the collapse of Barings express that the markets were "shaken" but provide no quantifiable estimate of the effect of the collapse.

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VI. THE BCCI (THE BANK OF CREDIT AND COMMERCE INTERNATIONAL) AFFAIR

The perpetrators in this case were two brothers, the Gokal brothers, who were shipping magnates. The fraudulent brothers and BCCI's founder Agha Hasan Abedi, shared the confidence of a new world balance of power centered on the massive Middle East oil deposits. Agha Hasan Abedi went as far as to fund a very readable business magazine called SOUTH which was a welcome relief from the USA propaganda to be found in TIME and NEWSWEEK. BCCI's loans through Agha Hasan Abedi to the brothers shipping business were inflated, and their quality was upgraded by forgery. The fraud went on for over a decade.. The BCCI-Gulf Transport Group consortium wanted to dip their fingers into the coffers of one of their best sponsors, Sheikh Zayid of Abu Dhabi. The reason for this was the financial hole left by huge losses suffered by Gulf on the derivatives market. It is certainly true that Sheikh Zayid started to pick up the losses in 1990. This leaves open the argument of many muslims that the bank did not have to fail. There is also deception in the way that one of the perpetrators was brought to justice. He was flying to the USA in order to clear himself of liability for abbetting in the production of a Pakistani nuclear bomb. Almost any high-tech metallurgy going to a third world country is suspect. In the same way developments of high tech chemical refining processes or pharmaceutical products in the Third World are accused of forwarding chemical warfare or illicit drug refining ventures. The perpetrator took the plane from Karachi to New York in l994. British police arrested him during a refuelling stop at Frankfurt.

2.6 The Enron Case

At the heart of Enron's demise was the creation of partnerships with shell companies, these shell companies, run by Enron executives who profited richly from them, allowed Enron to keep hundreds of millions of dollars in debt off its books. But once stock analysts and financial journalists heard about these arrangements, investors began to lose confidence in the company's finances. The results: a run on the stock, lowered credit ratings and insolvency. According to claims and counter-claims filed in Delaware court

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hearings(of the Enron Case); many of the most prominent names in world finance - including Citigroup, JP Morgan Chase, CIBC, Deutsche Bank and Dresdner Bank - were still involved in the partnership, directly or indirectly, when Enron filed for bankruptcy. Originally, it appears [9]that initially Enron was using [15]SPE's(Special Purpose Entities) appropriately by placing non energy-related business into separate legal entities. What they did wrong was that they apparently tried to manufacture earnings by manipulating the capital structure of the SPEs; hide their losses; did not have independent outside partners that prevented full disclosure and did not disclose the risks in their financial statements. There should be no interlocking management: The managers of the off balance sheet entity cannot be the same as the parent company in order to avoid conflicts of interest. The ownership percentage of the off balance sheet entity should be higher than 3% and the outside investors should not be controlled or affiliated with the parent: This was clearly not the case at Enron. Enron, in order to circumvent the outside ownership rules funneled money through a series of partnerships that appeared to be independent businesses, but which were controlled by Enron management. The scope and importance of the off-balance sheet vehicles were not widely known among investors in Enron stock, but they were no secret to many Wall Street firms. By the end of 1999, according to company estimates[10], it had moved $27bn of its total $60bn in assets off balance sheet.

These security scams and financial scandals examined in the section above involved the manipulation of huge amounts of money. The purpose of the “traders” or “investors” was not genuine. The perpetrators had such a comprehensive knowledge of how the system worked that they manipulated it to their advantage operating[11] in an opportunistic manner. The crux of the argument in this work is that the occurrence and reoccurrence of such security scams and financial scandals can be attributed to a failure of corporate governance in finance despite the existence of an functioning regulatory authority empowered with the legal sanctions.

CONCLUSION

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[9]Glossary

[10]*Securities Exchange Commission:Securities Fraud and Insider Trading",* Palgraves Dictionary On Money And Finance(1992)

[11]Sanyal. Sreejata, Regulation of Securities Markets in India’1997, Ph.D

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The security scams and financial scandals discussed here involved the manipulation of huge amounts of money. The purpose of the so called "traders" or "investors" was not genuine. The perpetrators had such a comprehensive knowledge of how the system worked that they manipulated it. It is clearly evident that the occurrence and reoccurrence of such security scams and financial scandals as some point in time be attributed to a failure of corporate governance in finance and that of financial regulation. Corporate Governance vs Financial Regulation **is** more a personal thing which involves the adherence to rules regulations and ethics by officials (management).It is more self enforced as a ethical behavior or a matter of pursuing codes of conduct without an outside agent monitoring , but financial market regulation in exercised more by an external organization either a regulatory body authorized to monitor[12] and impose a surveillance mechanism to ensure frauds or misdemeanors are not perpetuated and so that the market functions efficiently to over see the functions of the market participants and impose fines and other penalty for non-compliance. [25]Though standard corporate governance theory states that corporate governance includes the role that equity and debt holders have to play in influencing managers to act in the best interests of suppliers of capital it should not be forgotten that it also includes the role that creditors, owners and government in the same capacity.

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