

**INSULATION OF INVESTORS IN CAPITAL MARKETS FROM THE ACTIONS
OF LAW ENFORCEMENT AGENCIES ON THE LISTED ENTITY(IES)
PROMOTERS/DIRECTORS**

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ABSTRACT

Many of the listed companies see law enforcement agencies swinging into action on alleged violations of the law. Often, these actions get publicized even before they reach a definitive stage, and in a few cases, the share price of the company suffers. An analysis of the legal and regulatory position in relation to regulatory actions has been made, and after examining the relevant regulations, the article seeks to plead for a suitable framework in respect of actions by the law enforcement agencies and their disclosures, thereby insulating the share prices of the company from any due to these actions.

Keywords: *Companies, Disclosures, Law Enforcement, Regulatory actions and Share Price.*

1. INTRODUCTION

Governments and regulators across the globe have been paying great attention to safeguarding and protecting the interests of investors. India, with its democratic credentials and a well-sized and well-regulated capital market, shares the above goal in the pursuit of its growth in the capital market.

With a market capitalisation of Rs 3,22,00.725.02 crores covering 5257 listed corporate entities as of October 13, 2023(as per data taken from the website of BSE) and with the share of retail investors seeing rapid growth on a continuous basis, the percentage of market capitalisation of retail investors in the capital market has been increasing, and rapid strides are being made in this regard.

Retail investors who invest in the companies as shareholders aim to gain from an increase in the share price of the companies they invested in. These retail investors look at the stock market as a place where they can make gains based on the movement of the price of shares. These shareholders expectations are more pronounced when they are individuals. The investors expect to fulfil their financial goals by entering the stock market and making financial gains.

It is a fact that all corporate entities undertaking their business must comply with various legal provisions, make appropriate and timely disclosures to various authorities, and be subject to regulatory oversight. The standards of conduct for listed entities are several notches higher when compared to non-listed companies. This is called the burden of compliance. Corporates invest their time, resources, efforts, and energy towards securing compliance and earning a reputation, in addition to other parameters like sales, growth, profitability, a strong asset profile, etc. The regulators also lay down various norms from time to time intended to ensure that the corporate entities carry on their business as per the regulations so framed.

The compliance position of various laws and regulations is often verified by the designated authorities constituted under different statutes. To illustrate, compliance with income tax laws is ensured by the income tax authorities; compliance with labour laws is ensured by the labour authorities; and compliance with employee benefits legislation, like employee provident fund,

gratuity, workers' compensation, etc., is ensured by the respective authorities entrusted with such responsibilities and indicated in the respective statutes.

The higher the compliance, the greater the overall socio-commercial, economic, and legal benefits will be to society at large. The problem of enforcing authorities' actions to secure compliance plays out in a different manner when the news of their action becomes a matter of public knowledge. The dissemination of such information about the actions of law enforcement agencies sometimes costs very dearly, not just to the corporate entities but also to the shareholders and/or investors.

In the Indian context, there are several law enforcement agencies that have the responsibility of ensuring compliance with various laws, rules, and regulations applicable to a company. In discharge of their duties, the law enforcement agencies, being authorised by the statutory framework, take actions that can take different forms. It is necessary to understand the relationship between such actions by law enforcement agencies and their impact on the share price of a company, especially when the news of impending action gets circulated either by design or otherwise. It is often seen that the actions taken by law enforcement agencies get highlighted in the public domain, and as a result, the share price of the corporation gets impacted. The share price of a company can be hit very badly when the news of an income tax raid or any other law enforcement agency's actions gets publicity.

The shareholders of a listed corporate entity can either be just traders, short-term investors, or long-term investors. Each of the categories of investors has their own rationale and reasons for being the kind of investor they are. It is the information that comes out in the public domain about the actions of law enforcement agencies that hurts the economic interests of investors. News of an impending raid or an ongoing raid has the effect of influencing the share price of the company. These share price movements typically hurt retail investors far more than other types of investors.

Retail investors are a separate class by themselves, and their fortunes undergo changes based on several factors, including the actions of law enforcement agencies. It is no secret that any news about searches and seizures, raids by law enforcement authorities, etc. has a severe impact on the

share price of the company, and in most cases, in the short term, it has negative connotations and adversely impacts the shareholders.

2. CAPITAL MARKETS: MEANING AND CONCEPT

The capital market is the place where different financial instruments, such as equity shares, preference shares, bonds, and debentures, are traded through stock exchanges. The equity shares of a company and the debt securities of a company are listed on the exchanges as per the guidelines issued, and thereafter, they are traded on stock exchanges.

The Securities and Exchange Board of India is the regulator in our country to regulate capital markets. The Securities and Exchange Board of India Act 1992 confers powers of regulation, supervision, and enforcement on the Securities and Exchange Board of India. It has diverse functions and responsibilities¹. It frames regulations and ensures the compliance of such regulations. In addition to ensuring compliance with regulations, SEBI is also tasked with ensuring that noncompliance is met with penal consequences. In effect, SEBI plays a vital role in the development and growth of various players in the capital market.

2.1 Constituents of the Capital Market

The main constituents of Capital market comprise Issuers, Stock exchanges, Merchant Bankers, holders of the Instruments(investors), Stockbrokers, depositories, and depository participants and the finally the regulator itself. All of the above together constitute the participants of a Capital market.

2.2 Categories of Investors

In the context of primary issue of shares, subscribers of shares of a company are classified into the following categories. SEBI (Issue of Capital and Disclosure Requirements) Regulations as amended up to 2018 classifies Investors as follows.”

¹ Securities and Exchange Board of India Act, 1992, No. 15, Acts of Parliament, 1992 (India)

2.2.1 Qualified Institutional Buyer means: Regulation 2(1)ss of the ICDR Regulations defines a qualified institutional buyer as a

- a mutual fund, venture capital fund, alternative investment fund and foreign venture capital registered with the Board,
- foreign portfolio investor other than individuals, corporate bodies, and family offices)
- a public financial Institution
- a scheduled commercial bank
- a multilateral development and bilateral development financial institution
- a state industrial development corporation
- an insurance company Registered with Insurance Regulatory and development Authority of India
- a provident fund with a minimum corpus of Rs twenty-five crores
- a pension fund with a minimum corpus of Rs twenty-five crores
- National Investment fund set up by Resolution No F. No2/3/2005 -DDII dated November 23rd, 2005, of the Government of India published in the Gazette of India
- insurance funds set up and managed by army, navy or Airforce of the Union of India
- insurance funds set up and managed by the department of Posts, India
- systematically important non-banking financial companies

2.2.2 Non-Institutional investors: These are investors who apply for shares in an IPO above Rs 2 lakhs².

2.2.3 Retail Individual Investor means Regulation 2(1) uu of ICDR Regulations define a Retail investor as an individual investor who applies or bids for specified securities for a value of not more than Rs 2 lakhs³.

3. FACTORS THAT AFFECT THE SHARE PRICE OF A LISTED COMPANY

² Dr Harish Tigari and R Aishwarya, *Capital Markets in India: A Conceptual Framework*, 8 SHANLAX INT'L J. ECON. (2019)

³ *Id.*

Subject and economic experts would agree that there are many factors that are likely to impact the share price of a company. The operational performance, the financial performance, efficiencies of scale, and such other factors are directly visible parameters that investors would be monitoring to assess the movement of the share price. There is a greater probability of the views of different stakeholders synchronising on the macro factors that would influence the share price of a company. Factors such as inflation, interest rates, the position of imports and exports, government policies, political factors, and foreign exchange all impact the price movement of shares in a company⁴. In the prevailing framework, reference to the actions of the law enforcement agencies and the publication of the same in print, electronic, or social media channels is not taken into consideration as a material event. There are a number of instances where the share prices have undergone a downward revision due to news items coming out in the public domain about the actions of law enforcement agencies. To appreciate this aspect, the following instances are quoted to show the impact of news items on share price movements in the recent past:

S.No	Name of the Company	Law enforcement Agency	Share price decreased by
1	Uflex Ltd	Income Tax Dept	15%
2	Cipla Ltd	Income Tax Dept	2.5%
3	Shoba Ltd	Income Tax Dept	5%
4	Mankind pharma Ltd	Income Tax Dept	2%

⁴ Taimur Sharif, Harsh Purohit and Rekha Pillai, *Analysis of Factors Affecting Share Prices: The Case of Bahrain Stock Exchange*, 7(3) INT'L J. ECON. & FIN. (2015)

5	Mannapuram Finance Ltd	Income Tax Dept	2%
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The Securities and Exchange Board of India, the Reserve Bank of India, and the central and state governments have been continuously making relentless efforts to safeguard investors. Indian stock markets have also evolved over a period, and many instances of corporate failures have given an opportunity to the regulators and the government of India to come out with laws and regulations that will help strengthen the eco-system and help the cause of investors. Regulations such as the Prevention of Insider Trading Regulations 2015, the Issue of Capital and Disclosure Requirements, etc. are all successful efforts made in this direction. Many acts, regulations, and rules have been framed from time to time. It is necessary and essential to look at these regulations to understand their import and their impact.

4. LAWS AND REGULATIONS GOVERNING CAPITAL MARKET IN INDIA

The Securities and Exchange Board of India, while exercising its powers, frames regulations over various activities related to the capital market. The purpose of framing regulations, especially in the context of investors, is to bring clarity and transparency and have the larger goal of safeguarding the interests of investors in the capital market. A few of such regulations whereby investors' interest is sought to be protected are highlighted below:

4.1 Prohibition of Insider Trading Regulations 2015

The Securities and Exchange Board of India, as per global practices, came out with Prohibition of Insider Trading regulations in 2015.

These Regulations are intended to ensure that no advantage is gained or taken by insiders, as defined in the Regulations, who may have access to unpublished price-sensitive information⁵.

⁵ *Capital Market and Security Laws: Module II- Paper 6*, THE INSTITUTE OF COMPANY SECRETARIES OF INDIA (Oct. 10, 2023, 6:00 PM), <https://www.icsi.edu/media/webmodules/publications/CapitalMarketandSecuritesLaw.pdf>

The possession of such information by a few insiders may confer an unfair advantage over others who do not have access to such information. In order to negate any such unfair advantage, the Prohibition of Insider Trading Regulations are brought in by SEBI⁶. Regulations 3 and 4 of the Prohibition of Insider Trading Regulations 2015 are the governing sections by which trading is prohibited by insiders who are in possession of unpublished price-sensitive information as defined in the regulations.

Regulation 3(1) states that no insider shall communicate, provide, or allow any access to any unpublished price-sensitive information of a company or its securities listed or proposed to be listed to any other person, including other insiders, except where such communication is in furtherance of legitimate purposes, performance of duties, or discharge of obligations.

Regulation 3(2) states that no person shall procure or cause the communication by any insider of unpublished price-sensitive information relating to a company or securities listed or proposed to be listed, except in furtherance of legitimate purposes, performance of duties, or discharge of legal obligations.

Regulation 4 states that:

No insider shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price-sensitive information⁷.

Clause 4(1) of Schedule B, read with Regulation 9 of the Prohibition of Insider Trading Regulations, inter alia, states that:

“Designated persons may execute trades subject to compliance with these regulations. To this end, a notional trading window shall be used as an instrument for monitoring trading by the designated persons. The trading windows shall be closed when the compliance officer determines that a designated person or class of designated persons can reasonably be expected to have possession of unpublished price-sensitive information (UPSI). Such closure shall be

⁶ *Id.*

⁷ Akshaya Kamalnath, *A Critical Review of the Development of Capital Markets in India*, SSRN ELEC. J. (2022)

imposed in relation to the securities to which UPSI relates. Designated persons and their immediate relatives shall not trade in securities when the trading window is closed."

4.2 Unpublished price sensitive information:

Unpublished price-sensitive information means any information relating to a company or its securities, directly or indirectly, that is not generally available and, upon becoming generally available, is likely to materially affect the price of the securities and shall ordinarily include but not be limited to:

(i) Financial Result

(ii) Dividend

(iii) Change in Capital Structure

(iv) mergers, de-mergers, acquisitions, delisting, disposals and expansion of business and such other transactions.

(v) Changes in Key Managerial Personnel

The Regulations have specified a code of conduct to be followed by the key managerial personnel and senior personnel of a listed company. These Regulations also cast an obligation on the corporate-listed entities to make certain disclosures to the regulators on the happening or occurrence of a material event. The material events have now been brought into the SEBI Listing Obligations and Disclosure Requirement Regulations.

A combined reading of Regulations 3 and 4 would signify that both communication and trading based on possession of unpublished price-sensitive information are frowned upon by the regulator and invite penal consequences. The penalties provided for the breach of these regulations are given in the following table.

As per Section 15G of the SEBI Act⁸, a penalty of not less than Rs 10 lakh and which may extend up to Rs 25 crore or three times the profits, whichever is higher, can be levied in the case of insider trading.

4.3 Prohibition of Fraudulent and Unfair Trade Practices relating to Securities market Regulations 2003:

These regulations are intended to prohibit fraudulent, unfair, and manipulative practices in dealing with securities. The position is brought out below⁹:

A recollection of the major financial irregularities in the capital markets would immediately draw anyone's attention to the financial misdemeanours that took place. It is interesting to note and observe that despite the intent and serious efforts of the Government of India, the violators of the Regulations, through their unethical and unlawful acts, indulge in practices only with the sole intention of making financial gains at the expense of others, and that too in an unethical manner. What is more disturbing are the violations that each time throw up either the inadequacy of regulations or a lack of monitoring or surveillance as it is known, as well as other inadequacies of the system. The anticipation by regulators and governments based on their experiences would definitely curb these kinds of unethical and unlawful practices. In the Indian context, the repeated occurrences of financial irregularities in the capital market had a devastating effect on investors. Another disturbing trend that is observed is that financial scams make their appearance with some alacrity. The occurrence of financial scams at different points in time and intervals shows that there is a lot of planning and intelligence employed to make financial gains. The confidence of the markets is also eroded, resulting in investors choosing either to enter the stock market or withdraw from the market¹⁰.

Another serious consequence is the cost of punishing the violators and enforcing the breach of regulations. Based on the past, it is seen that special legislation has to be enacted and special courts have to be established to bring the violators to justice. Enforcing the discipline required by

⁸ Securities and Exchange Board of India Act, 1992, § 15 G, No. 15, Acts of Parliament, 1992 (India)

⁹ James Grandolfo, Ajit Sharma, Vandana Shroff, H. Jayesh, Rajiv K. Luthra and Kavita Mohan, *Recent Developments in Indian Capital Markets Regulation*, 44 INT'L LEGAL DEV. YEAR IN REV. (2010)

¹⁰ *Id.*

adhering to the regulations would necessarily involve a lot of precious judicial time. These kinds of costs to the economy are often overlooked while evaluating the overall performance of the stock markets.

SEBI, with the object of prohibiting manipulative, fraudulent, and unfair trade practices, has come up with regulations to counter the serious menace to the capital markets. These regulations cannot be static in nature, and they would obviously involve changes from time to time to suit the requirements of the day.

4.4 Prohibition of unfair dealings in Securities

The Prohibition of Fraudulent and Unfair Trade Practices Regulation passed on July 17, 2003, lists the following as unacceptable in the securities market: Chapter II (3) of this regulation deals with the prohibition of unfair dealings in securities.

It states that no person shall, directly or indirectly¹¹:

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- (i) Buy, sell, or otherwise deal in securities in a fraudulent manner.
 - (ii) Use or employ, in connection with the issue, purchase, or sale of any security listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or regulations made thereunder, any device, scheme, or artifice to defraud in connection with the dealing in or issue of securities that are listed or proposed to be listed on a recognised stock exchange.
 - (iii) engage in any act, practice, or course of business that operates or would operate as fraud or deceit upon any person in connection with dealing in or issuing securities that are listed or proposed to be listed on a recognised stock exchange in contravention of the provisions of the Act or the rules or regulations made thereunder.

¹¹ Capital Market and Security Laws: Module II- Paper 6, *supra* note 5

Any breach of the above would constitute a breach of the said regulations. If any of those breaches are committed by any individual or company, they will be investigated by SEBI, and appropriate actions will be taken against the party who commits such unlawful activity.

Similarly, regulation 4, prohibits the manipulative, fraudulent and unfair trade practices.

(1) Without prejudice to the provisions of Regulation 3, no person shall indulge in a fraudulent or unfair trade practice in securities.

(2) Dealing in securities shall be deemed to be a manipulative, fraudulent, or unfair trade practice if it involves fraud and may include all or any of the following, namely:

- indulging in an act that creates a false or misleading appearance of trading in the securities market.
- dealing in a security not intended to effect the transfer of beneficial ownership but intended to operate only as a device to inflate, depress, or
- inducing any person to subscribe to an issue of securities by fraudulently securing the minimum subscription to such issue of securities by advancing or agreeing to advance any money to any other person or through any other means.
- inducing any person to deal in any securities by artificially inflating, depressing, maintaining, or causing fluctuation in the price of securities through any means, including by paying, offering, or agreeing to pay or offer any money or money's worth, directly or indirectly, to any person.
- any act or omission amounting to manipulation of the price of a security, including, influencing, or manipulating the reference price or bench mark price of any securities.
- knowingly publishing or causing to publish or reporting or causing to report by a person dealing in securities any information relating to securities, including financial results, financial statements, mergers and acquisitions, regulatory approvals, which is not true or which he does not believe to be true prior to or while dealing in securities.
- entering into any transactions in securities without the intention of performing or without the intention of changing such security.

- selling, dealing, or pledging stolen, counterfeit, or fraudulently issued securities, whether in physical or dematerialized form¹²:

Provided that if:

- (i) the person selling, dealing in, or pledging stolen, counterfeit, or fraudulently issued securities was a holder in due course; or
 - (ii) The stolen, counterfeit, or fraudulently issued securities were previously traded on the market through a bona fide transaction.
 - (iii) Such selling, dealing, or pledging of stolen, counterfeit, or fraudulently issued securities shall not be considered manipulative, fraudulent, or unfair trade practice.
- disseminating information or advice through any media, whether physical or digital, which the disseminator knows to be false or misleading in a reckless or careless manner and which is designed to or likely to influence the decision of investors dealing in securities.
 - a market participant entering transactions on behalf of the client without the knowledge of or instructions from the client or misutilizing or diverting the funds or securities of the client held in fiduciary capacity.
 - an intermediary not disclosing to his client transactions entered into on his behalf, including taking an option position.
 - circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress, or cause fluctuations in the price of such security.
 - fraudulent inducement of any person by a market participant intermediary to deal in securities solely with the object of enhancing his brokerage, commission, or income.
 - an intermediary predating or otherwise falsifying records (including contract notes, client instructions, balance of securities statements, and client accounts statements).
 - any order in securities placed by a person while directly or indirectly in possession of information that is not publicly available regarding a substantial impending transaction in

¹² Akshaya Kamalnath, *supra* note 7

those securities, its underlying securities, or its derivative buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract.

- Knowingly planting false or misleading news that may induce the sale or purchase of securities.
- misselling of securities or services relating to the securities market.

4.5 SEBI (Investor Protection Fund and Education Fund Regulations) 2009

Investor education is paramount in a country like India, where the level of financial literacy is not significant. SEBI has constituted a separate fund for this purpose and has been taking various initiatives to spread financial literacy and increase the awareness of investors. An informed and educated investor will always handle the issues with confidence and a complete understanding.

It is to the credit of SEBI, the RBI, the Government of India, and various state governments that our markets have undergone a dramatic transformation over the years in the capital market. The participation of retail investors (35% allocation in IPOS) is a measure of maturity and confidence that our capital markets have acquired¹³.

4.6 Maintaining Confidentiality of the actions by law enforcement agencies

The law enforcement agencies under different statutes function under the direction of the authorities, which are vested with quasi-judicial and judicial powers. Ideally, in any case of any measure being taken under a statute, such information needs to be sent only to authorities who perform quasi-judicial and judicial functions. However, we have seen that in an age where electronic, print, and social media have occupied the public space beyond one's imagination, information hits the public through these channels much faster and quicker than even before they came under the consideration of the judicial authorities. It has been seen in many cases that such preliminary actions by law enforcement agencies may not necessarily lead to or result in detrimental and severe actions against corporate entities. However, by the time findings are arrived at and conclusions are drawn, the damage to the investors is already done, and as far as

¹³ James Grandolfo, *supra* note 9

that day or moment is concerned, the same is irreversible and irretrievable damage that has been done to the share price of a company.

The listing obligation and disclosure requirements of 2015 cast an obligation on the listed identity to make disclosures to the stock exchange exchanges of any event or information that, in the opinion of the board, is considered to be material. These regulations also specify what events or information can be considered material.

On an action initiated by any law enforcement agency, the corporate-listed entity is required to report the same to the stock exchanges. This disclosure to stock exchanges is different from the news that gets circulated.

The current disclosure requirements, no doubt, specify the events or information that are to be disclosed by listed entities to stock exchanges. In Schedule III, Parts A and B of the Listing Obligations and Disclosure Requirements (Regulation 30), these have been described in detail.

5. CONCLUSION AND SUGGESTIONS

The current framework of disclosure requirements by listed entities for regulatory actions serves certain purposes. Often, these disclosures are made to the authorities concerned after the information has already come into the public domain. The present regulations do not cover situations where information flows into public channels through other sources. It is time to think and consider whether any kind of regulation is possible to deal with these situations. For example, if an income tax department takes any measure, it may be made obligatory on the part of the IT department to ensure that the flow of information is channelized in a defined manner.

By way of an analogy, if the insiders of a company are prohibited from communicating any unpublished price-sensitive information to its insiders as per the Prohibition of Insider Trading Regulations, a similar framework may be considered by the Government of India by which the information of a search and seizure operation may only be communicated to the persons who need it for the discharge of their legitimate purposes. In other words, a suitable framework may have to be devised regarding the flow of information provided by the law enforcement

department during such searches and seizures. The law enforcement agency may, by law, treat the information as confidential until it is communicated officially to the listed company.

On receipt of such advice from the law enforcement agency, the listed entity may make the disclosures to the stock exchange as per the applicable regulations.

This is not to equate a law enforcement agency with a listed company. The main purpose and intent are to ensure that any premature leakage of information does not hurt investors. As stated above, sometimes the actions taken by the law enforcement agency may not even reveal any kind of infraction of the law, and the preliminary verification may itself end in favour of the listed entity. In such situations, it is critical to ensure that the share price remains uninfluenced by the preliminary actions of the law enforcement agencies. A few suggestions are given below.

- Enforcement Agencies Actions are to be strictly confidential and handled only by the officers authorised in this regard.
- The law Enforcement agencies may be prohibited from disclosing or causing to disclose either intentionally or unintentionally any information to any other person other than to the persons who require it for their legitimate purposes.
- On reaching a particular stage and with the approval of the designated authorities, the information about their actions may be shared with the listed entity.
- A listed entity may deal with such information and discharge its responsibilities as per the various rules and regulations applicable to it.