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Anatomy of Capital Market Fraud: Companies Flouting the Regulations

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ABSTRACT

Corporate fraud is a business risk which ultimately leads to death of the company. According to recent Economic Times, one out of five top executives of global corporations are apprehensive of investing in India because of concerns around frauds said Global Fraud and Risk Survey for 2016 published by Kroll, a global risk solutions provider. Corporate fraud is one of the major reason for discouraging foreign investors to invest in India. In corporate fraud generally top key managerial persons, accounting heads are involved for fund diversion. Corporate fraud encompasses wide area of fraud in private companies, public companies, government companies, public sector undertakings etc. This research is limited to a class of corporate fraud i.e capital market fraud. After Satyam in 2008, Kingfisher, Sahara, Sharada scams have created havoc in capital market. Investors are hysterical to invest in capital market. Despite of numerous SEBI and Companies Act, 2013 legislation, regulation, rules, circulars, notifications it is difficult to prevent fraud in capital market. Anticipating similar kinds of frauds every time SEBI plays an active role in promulgating new regulation, rules, notification to prevent such scams in future. The companies always outsmart such legislation, regulations etc. to commit corporate fraud. The companies should set boundaries of their own to prevent corporate fraud. In the era of transparency and accountability the investors should be assured to make a well informed investment. The real cause of corporate fraud is information based on which the fraud is organized by the companies which the regulators fail to anticipate.

Keywords: Capital market fraud, transparency, accountability, economic fraud

I. INTRODUCTION

Corporate fraud is a business risk which ultimately leads to death of the company. According to recent Economic Times, one out of five top executives of global corporations are apprehensive of investing in India because of concerns around frauds said Global Fraud and Risk Survey for 2016 published by Kroll, a global risk solutions provider². According to the

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² According to the survey report 545 respondents were being reached 19% of them were discouraged to invest in India due to increase rate of economic frauds in India. The major kinds of economic fraud are as follows: 27% in corporate fraud, 27% from corruption and bribery, 27% from market collusion and 25% from internal sources. http://economictimes.indiatimes.com/articleshow/56647389.cms?utm_source=contentofinterest&utm_m

survey report 545 respondents were being reached 19% of them were discouraged to invest in India due to increase rate of economic frauds in India. The major kinds of economic fraud are as follows: 27% in corporate fraud, 27% from corruption and bribery, 27% from market collusion and 25% from internal sources. So, corporate fraud is one of the major reason for discouraging foreign investors to invest in India. The numerous scams and frauds of Sahara, Kingfisher, Nirav Modi, have compelled the government to determine the regulations to govern the companies in more stringent manner. The pro regulation imposes restriction on the companies to conduct their business but regulations has now been proven to be failure because of increase in number of scams in India. Due to negligence and recklessness of promoters, management within the company government fails every time to restore the confidence of the investors in the market. There are piles of regulations to govern the company by monitoring the roles of auditors, independent directors etc. which is not the only solution for such frauds³.

In corporate fraud generally top key managerial persons, accounting heads are involved for fund diversion. Corporate fraud encompasses wide area of fraud in private companies, public companies, government companies, public sector undertakings etc. This essay is limited to a class of corporate fraud i.e capital market fraud. After Satyam in 2008, Kingfisher, Sahara, Sharada scams have created havoc in capital market. Investors are hysterical to invest in capital market. Despite of numerous SEBI and Companies Act, 2013 legislation, regulation, rules, circulars, notifications it is difficult to prevent fraud in capital market. Anticipating similar kinds of frauds every time SEBI plays an active role in promulgating new regulation, rules, notification to prevent such scams in future. Table No. 1 exhibits famous corporate frauds in India till 2017.

Table No. 1

Serial No.	Name of Corporate Frauds	Year	Amount of Fraud (in crores)	Reasons of Fraud	Whether new Laws or Regulation passed?
1.	Harshad Mehta	1992	4000	Invested in Equity market through forged Bank	Establishment of SEBI

edium=text&utm_campaign=cppst.

³ Beverley Alleyne & P. Amaria, *The effectiveness of corporate culture, auditor education, and legislation in identifying, preventing, and eliminating corporate fraud*, 7 INT. J. BUS. ACCOUNT. FINANCE 34–62 (2013).

				receipts	
2.	M. S. Shoes	1994	270	Attracted Investors and Financial Institution by Share Price Manipulations	None
3.	C.R. Bhansali	1997	1,200	Established Shell companies to channelize black money by setting up mutual funds and bank.	SEBI (Mutual Funds) Regulations) 1996
4.	Ketan Parekh	2001	1273	Raised funds by pledging shares as collateral security to the banks. Used around 16 such accounts, either directly or through other broker firms, to obtain funds from banks.	SEBI imposed restriction on short sales. Banned Badla system.
5.	Satyam Fraud	2008	8000	Fictitious and inflated Accounts were created by auditors. Insider Trading	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 In 2009, MCA released voluntary guidelines for corporate governance such independent directors, whistle

					blower policies etc. Amendment of Listing Agreements in 2010 for appointment of CFO SEBI (Prohibition of Insider Trading) Regulations, 2015
6.	Sahara Real Estate	2012	24,000	Raised funds by issuance of OFCDs through private placements	SEBI's absolute power to investigate both listed companies and unlisted companies.
7.	Sharadha Chit Fund	2013	10,000	Over 200 private companies were running CIS (chit fund) and collapsed in April 2013 causing an estimated loss of 1000crore to over 1.7 million depositors	Collective investment schemes worth Rs 100 crore or more are now under SEBI jurisdiction. SEBI issued a Circular on 'product labelling' for MFs for helping investors to assess the risk associated with the schemes. SEBI issued directives for listed companies to attain 25% of public shareholding by June 03, 2013

8.	Kingfisher Scam	2013	9000	Loan amount of 9,100 crore taken from consortium of banks led by State Bank of India. Diversion of funds as per the Initial Inquiry Report between 2010 and 2013, from the Company and/or its subsidiaries to certain UB Group companies, including in particular, Kingfisher Airlines Limited	SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
9.	Nirav Modi Scam	2018	10,000	Letter of Undertaking issued to Punjab National Bank	Ban on Letter of Undertaking

The companies always outsmarts such legislation, regulations etc. to commit corporate fraud. The companies should set boundaries of their own to prevent corporate fraud. The primary objective of a company is profit maximization due to which the companies tends to commit corporate fraud assuming that they will not be intercepted. In the era of transparency and accountability the investors should be assured to make a well informed investment. The real cause of corporate fraud is information based on which the fraud is organized by the companies. As information is a tradable commodity based on which the prospective investors invest in the company. An investor before investing in a company meticulously investigates about the information of the company like historical data, market value of the company, managers leading the company and then invests in such companies. In capital market information plays a vital role for the increase or decrease in share price of a company. If there

is news for instance like Cyrus Mistry is ousted by Tata sons from the Chairmanship, the moment such information is circulated there is re computation of share price. The companies can prevent fraud if they provide appropriate, timely and non-colorable information to the investors. Such information has to be provided to the investors till the time they exit such companies. Information plays a vital role in each stage of capital market starting from IPO/FPO process to Secondary Market.

II. PROBLEM OF CAPITAL MARKET FRAUD

Capital market plays an important role in fostering the economic growth in determination of country's financial system by supplementing long term investment and capital formation. It provides allocative efficiency to investors in investible instruments⁴. In capital market investors invests in both equity and debt instruments. The demand and supply of securities determine the prices of such securities and such prices depends upon the condition in goods and securities markets. The investors always wishes the equity prices should go up continuously. Capital market borrowing and lending is maintained by private individuals and corporations, institutional investors, government. One of the prime factor for determination of securities price is information. Information has direct relationship with price of securities. Hence, information is a saleable commodity. Securities are offered in both debt and equity. Capital market is segregated in to primary and secondary markets. In primary markets securities are offered for the first time to the investors includes initial public offer, further public offer and private placement. According to SCRA, Securities⁵ includes shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate, derivative securities, government securities, security receipts, units issued under mutual funds, collective investment schemes and such other instruments declared by the Government as securities. The definition of securities is inclusive not exclusive. There can be issuance of shares by initial public offer, further public offer or by private placement limited to 50 persons. The most regulated is the public offer of securities because it include wide range of investors from well informed to ill-informed investors. In public offer various scheme are being adopted to defraud the investors for which merit based regulators put quality tests. In public issue companies issues a document of appealing called prospectus⁶ to induce the investors. The quality test for issuance

⁴ P. K. Gupta & Sanjeev Gupta, *Corporate frauds in India-perceptions and emerging issues*, 22 J. FINANC. CRIME 79-103 (2015).

⁵ Section 2(h) of Securities Contract Regulation Act.

⁶ Section 2(70) "prospectus" means any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in section 31 or any notice, circular,

of prospectus for public issue by companies in India are laid down in various legislations such as Securities Contract Regulation Act, 1956, Companies Act, 2013 and SEBI Act, 1992. The reason for such legislations is to have required level of disclosures for investors to take decisions. A prospective investor will have to judge based upon the company's future prospects, investment decision, management of the company etc. Despite of disclosure rules and regulation there are capital market frauds.

Fraud means active concealment of facts, false assertion made to induce the investors to invest in the company without any intention to perform such assertion made. Fraud is defined under section 17 of Indian Contract Act, 1872. Fraud is committed where one man causes another to act on a false belief by a representation which he does not himself believe to be true. In Satyam scam fictitious assets were being created to induce the investors with attractive high share price. All corporate fraud⁷ are being executed with a false representation knowingly, without belief in its truth and recklessly or carelessly for inducing the investors to finance in such fraudulent investment plans. Kingfisher through its complex financial transaction tried its best to hide debts to institutional investors. Fraudulent practices are organized by companies with intent to deceive the creditors and investors. The perpetrators involved in such fraudulent practices are top level executive such as directors, executive managers, auditors etc. Corporate frauds executed at Sahara, Kingfisher, Sharada proved SEBI as big failure to curb corporate fraud. SEBI is a merit regulation as being a regulator it permits a public offer only if the company passes quality test. For protection of the investors. SEBI Act, Rules and Regulations obligates the public companies to provide high degree of investor protection through adequate, accurate and authentic information and disclosure of information on a continuous basis. SEBI as regulator can set boundaries for the companies to play safe. But companies successfully outwits regulators to commit fraud by taking advantages of legal loopholes.

The capital market plays an important role in providing allocative efficiency to investors⁸. It is a market where investors invests in securities of their choice at competitive prices depending upon the business of the companies, person leading the company, historical data and risks in ventures. Suppose Company A & B are offering their shares through public offer. Investor

advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.

⁷ In *Derry v. Peek* (1889) LR 14 App Cas 337, it was held that first, in order to sustain an action of deceit there must be proof of fraud, nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly (2) without belief in its truth (3) recklessly, carelessly whether it be true or false.

⁸ Zabihollah Rezaee, *Causes, consequences, and deterrence of financial statement fraud*, 16 CRIT. PERSPECT. ACCOUNT. 277–298 (2005).

will invest in any one of the company A or B depending upon the share price and information inducing the investors to invest in any of the companies. The share price of Company A & B reflects the information of the respective companies in the market. In 1969 E.F Fama had postulated that a market in which prices always "fully reflect" available information is called "efficient"⁹. According to the efficient market theory market efficiency were classified in to three categories weak form¹⁰, semi strong form and strong form. In weak form securities price depicts the historical data of the security traded where investor could make profit by accessing recent information. In semi strong prices of securities depicts all the publicly available information where investor cannot make profit as it is available to all. In strong form, price of securities reflects all information possessed by insiders of the company and designated market makers. In this Fama has just categorized three kinds of market behavior but failed to define fully reflect available information¹¹. Do they really exist or not? In efficient or fair market the securities prices reflect all available information. So, a market where prices of securities reflect fraudulent information will be called inefficient market. In inefficient market there are greater chances of fraud as prices of securities does not depict fully reflect information. For investors in capital market the fully reflect available information should be appropriate, time-bound and non-colorable information. Such information should be available easily, less transactional cost by the company dealing with securities.

As a company suffering from loss will try to induce the investors by concealing the information based on the information in the prospectus. In *Sahara India Real Estate Corpn. Ltd. v. SEBI*, the merchant bankers coined OFCD's as hybrid instruments to outwit SEBI rules and regulations. The two companies of Sahara¹² group i.e. Sahara India Real Estate Corporation Limited (SIRECL) and Sahara Housing Investment Corporation Limited (SHICL) involved in capital market fraud. SIRECL's expenses for the three quarters ending 31.12.2007 were Rs.9,292 and was suffering from loss as per the Balance Sheet was Rs.3,28,345. Through Extra Ordinary General meeting SIRECL passed special resolution to raise funds through private placement process. The Board of Directors issued a red herring prospectus indicating they have no intention to list their securities in stock exchange. Along with the red herring prospectus an information memorandum was circulated. The red herring

⁹ Corporate Fraud and Business Conditions: Evidence from IPOs - Google Scholar, , https://scholar.google.co.in/scholar?hl=en&as_sdt=0%2C5&q=Corporate+Fraud+and+Business+Conditions%3A+Evidence+from+IPOs&btnG= (last visited Mar 29, 2018).

¹⁰ Id P. 56.

¹¹ Corporate Fraud and Business Conditions: Evidence from IPOs - WANG - 2010 - The Journal of Finance - Wiley Online Library, , <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2010.01615.x> (last visited Mar 29, 2018).

¹² (2012) 10 SCC 603.

prospectus stated that the funds raised will be invested for acquisition of townships, residential apartments, shopping complexes etc. and construction activities would be undertaken by the company in major cities of the country and also would finance other commercial activities/projects taken up by the company within or apart from the above projects. According to Section 32(3) of Companies Act, 2013, a red herring prospectus shall carry the same obligations as are applicable to a prospectus and any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus. Such prospectus are issued to raise funds from the public as stipulated in section 2(70) of Companies Act, 2013. Here SIRECL outwitted Registrar of companies and SEBI by raising funds from public in namesake of private placement. The merchant bankers colored OFCD as hybrid instrument to escape from SEBI's rules and regulations. The investors relied on the integrity of the information provided by the company. Information Memorandum stated the issue is private placement and does not constitute an offer as it is intended to whom it is addressed. Investors are required to make their own evaluation before investing in such instruments. The information provided in the information memorandum is inadequate leading to financial statement fraud causing a loss of crore. As private placement was not defined in the law due to which Sahara India Real Estate succeeded in misleading the investors. Its not possible regulate the companies in total as it will constrain them to do business. For which the management of the company along with the promoters coin different ways to commit fraud by outwit the regulators.

The prospectus projecting honest and true statements about the company rather than inflated and fraudulent statement will lead to free and fair competition in the market¹³. Investors in the capital make investment decisions based on information disseminated by the companies. In case of misstated information the investors don't have scope to counter check such information. The investors are trapped in the fraudulent stated information which leads to the death of company. The financial statement of affairs of the company are essential for the efficiency of capital market. Business of the company includes newer projects, future investment, merger and acquisition, joint ventures for which the Investors and creditors are deceived due to fraud in the financial statement of companies.

III. REGULATORY RESPONSE TO CORPORATE FRAUD

SEBI as regulator can set boundaries for the companies to play safe. But companies always finds ways to bypass such regulators to commit fraud. SEBI regulation cannot legislate in

¹³ Rezaee, *supra* note 9.

each minute area because over regulations encourages the companies to commit fraud. Both SEBI and RBI set parameters to prevent the kinds of fraud that has happened in the past. From Harshad Mehta where the regulatory response was to set up SEBI to regulate the mutual fund by putting u restrictions. SEBI enacted SEBI (Mutual Funds) Regulations) 1996 post CR Bhansal scam which had established shell companies to channelize black money by setting up mutual funds and bank. The Table No. 1 exhibits famous corporate frauds in India till 2017 along with response of regulatory authorities to combat such frauds in future. Even recently in Nirav Modi scam RBI has banned Letter of Undertaking to be issued by the Banks. So RBI failed again in spite of demarcation set up for banking authorities to operate it failed to reign them. The Banking Sectors' corporate governance is to be restructured to prevent such frauds again. The number of fraud creating more and more barriers for the market to operate by laying down. But financial regulators fail every time to anticipate the frauds for orderly function of capital market. The regulators cannot intervene in day to day business in financial market by laying down the laws in order to prevent frauds.

IV. CONCLUSION AND SUGGESTIONS

Every financial disaster or scam triggers the government to lay down regulations to prevent similar frauds. But companies' hardly commit similar kinds of frauds as they tend to commit new frauds which is never anticipated by the market regulators in spite of stringent regulations. Due to rise of capital market fraud in India the financial regulators' major concern is to determine the ways to detect and prevent such frauds. The financial regulators efforts to promulgate new laws to protect the interests of retail investors, financial institutions fail to deter future frauds in India. Public ordering of regulating capital market fraud is a failure which is evident from the kinds and number of frauds in India. The news telecast of sudden frauds or market collapse shakes the confidence of all the stakeholders of the company such as financial institutions, shareholders investors, employees etc. Moreover, the recent trends of scammers flying to U.S.A, London to escape from the financial regulators is great relieve for them. Even after the detection of fraud the government is only left with seizing of property of such fraudsters. The numbers of scams has now increased over the years deterring the GDP growth of India by stripping the tax payers' and investors' money. The foreign investors are also reluctant to invest in India due to increase in numbers of frauds. The repeated failures of auditors to detect frauds who is considered to be the watchdog for the investors rendering them liable for such frauds is also a failure. Now there is need of private ordering in companies to prevent fraud. The mandatory disclosure requirement imposed by statutes are inadequate to protect the interests of the investors. Because companies providing adequate

information to its investors beyond the regulations are sold at higher price in comparison to those which are unaccompanied by disclosures. In case of fraudulent disclosure, the companies loses its market participants due to the liability imposed by financial regulators. The private ordering approach will help the companies to gain more market participants setting up standard disclosures.
