



## Investor protection measures in India yet needs improvement

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### Abstract

Strong investor protection is associated with effective corporate governance. In fact, corporate governance has been advocated by everyone interested in the long-term shareholder value, which in turn promotes orderly development of industries and economies. When an investor places his hard-earned money in the securities of a corporation, he does so with certain expectations of its performance, the corporate benefits that may accrue to him, and above all, the prospects of income from, and the possibilities of capital growth of the securities he holds in the firm. At the same time, while he makes an investment decision the investor would have obviously taken note of and evaluated the attendant risks that go with such expectations, especially the possibility of the risk that the income and/or capital growth may not materialise. This mismatch between the expectations of the investors and the unexpected final outcome in terms of income and/or capital growth arises mainly because their hard-earned money is entrusted to managers in a corporation whose investment decisions, apart from carrying certain risks of their own, may not match those of the investors. Investors protection measures in India yet needs improvement.

**Keywords:** Corporate governance, investors protection, N K Mitra Committee, SEBI, The Companies Act 2013

### Introduction

Investors by virtue of their investments in securities of corporations obtain certain rights and powers that are expected to be protected by the State which gave the charter or the legal entity to the corporate bodies or the regulators designated by the State to do so. Their basic rights include disclosure and accounting rules that will enable them to obtain proper, precise and accurate information to exercise other rights such as approval of the executive decisions on substantial sale or investments, voting out incompetent or otherwise ineligible directors and appointment of the auditors. There are also laws that mainly deal with bankruptcy and reorganisation procedures that outline the measures and the procedures to enable creditors repossess collateral to protect their seniority and make it difficult for the firms to seek court protection in reorganisation. In many countries, laws and legal regulations are enforced in part by the different law enforcing agencies such as the market regulators, ie. SEBI, courts or government agencies, Le. the Department of Corporate Affairs in India and the markets themselves. If the investors' rights are effectively enforced by one or all of these agencies, "It would force insiders to repay creditors and distribute profits to the shareholders and thereby protect external financing mechanism from breaking down". Thus, investor protection can be defined as both (i) the extent of the laws that protect investors rights and (ii) the strength of the legal institutions that facilitate law enforcement.

### Need of Investor Protection

An appropriate definition of investor protection is very much needed to relate it to corporate governance and to establish the correlation between these two. When the investors finance the companies, they take a risk that could land them in a situation in which the returns on their investments would not be forthcoming because the managers or those whom they appointed to represent them on the board may keep them or expropriate them either

covertly or overtly. This kind of betrayal of the investors by the "insiders" as the managers or the board of directors of the company may shake their confidence, which in the long run would have a detrimental impact on the overall investment climate with serious repercussions on the economic development of the country. The economic parameters of a nation such as output, employment, income, expenditure, and above all, overall economic growth will be badly jeopardised due to declining investment. Therefore, there is a very strong reason to maintain the investors morale, protect their interests and restore their confidence as and when there is a tendency for investors to lose confidence in the system or when their investments are at stake. Research findings also reveal that when the law and its agencies fail to protect investors, corporate governance and external finance do not fare well. If there is no investor protection, the insiders can easily steal the firm's profits, while, when it is good, they will find it very difficult to do it

### Investor Protection and Corporate Governance

Recent research confirms that an essential feature of good corporate governance is the strong investor protection. Rafael La Porta et al (1999) opine that corporate governance to a large extent is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders. Expropriation is possible because of the agency problems that are inherent in the formation and structure of corporations. The Shareholders or the investors of a firm are numerous and scattered and therefore cannot manage it. Hence, they entrust the management of the firm to the managers who include the board of directors and the senior executives such as the CEO and the CFO. However, managerial actions depart from those required to maximise shareholder returns. Such mismatch of objectives results in the agency problem. Investors do realise and accept to a certain level of self-interested behaviours in the managers while they delegate responsibilities to them. But when such self-indulgence by managers exceed reasonable limits,

principles of corporate governance come in to check such abuses and malpractices. The core substance of corporate governance lies in designing and putting in place, mechanisms such as disclosures, monitoring, oversight and corrective systems that we can align with the objectives of the two sets of players (investors and managers) as closely as possible and minimise the agency problems.

### **Expropriation by the Insiders**

The insiders, both the managers and the controlling shareholders, can expropriate the investors in a variety of ways. Rafael La Porta et al (1999) describe several means by which the insiders siphon off the investor's funds. "In some countries, the insiders of the firm simply steal the earnings. In some other countries, the arrangements they go through to divert the profits are more elaborate. Sometimes, the insiders sell the output or the assets of the firm they control, but which outside investors have financed, to another entity they own at below market prices. Such transfer pricing and asset stripping have largely the same effect as theft. In still other instances, expropriation takes the form of installing possibly under-qualified family members in managerial positions, or excessive executive pay. In all these instances, it is clear that the insiders use the profits of the firm to benefit themselves (either as excessive executive salaries or in the form unjustifiable perquisites), instead of returning the money to outside investors to whom it legitimately belongs. In this context, the minority shareholders and the creditors are far more vulnerable.

Expropriation also is done by insider selling additional securities in the firm they control to another firm or subsidiaries they own at below market prices, with assistance from obliging interlocking directorates, and also by diverting corporate opportunities to subsidiaries and so on. Such practices, though often legal, have the same effect as theft. However, it must be stressed that these sharp practices of insiders vary from country to country depending on the existence or non-existence of the democratic and corporate values, the maturity or otherwise of the securities market, the financial systems, the pace of new security issues, the corporate ownership structures, the dividend policies, the efficiency of investment allocation, the legal system and the competence of the securities market regulator.

### **Status of Investor Protection: Indian Context**

Investor protection is not attainable without adequate and reliable corporate information. All outside investors, whether they are the shareholders or the investors, have an inalienable right to have certain corporate information. In the fact, several other rights provided to them under the law cannot be exercised by shareholders unless companies in which they have invested in, share with them such information. For instance, "without accounting data, a creditor cannot know whether a debt covenant has been violated. In the absence of these rights, the insider does not have to repay the creditors or to distribute profits to shareholders". Apart from the rights to information, creditors have also certain other rights, and these are to be protected. Minority shareholders have the same rights as majority shareholders in dividend policies and in accessing new security issues. The significant but non-controlling shareholders need the right to have their votes counted and respected. This is the reason why the SEBI-appointed Kumar Mangalam Birla Committee recommended postal

ballot for the benefit of those who could not attend the AGMs held by the corporations in cities where their corporate offices are located. The Committee recommended that in case of the shareholders, who are unable to attend the meeting, there should be a requirement, which would enable them to vote by postal ballot on important key issues such as corporate restructuring, sale of assets, new issues on preferential allotment and matters relating to change in management. Likewise, even the large creditors such as institutional investors who are powerful enough by virtue of their large stakes need relatively few formal rights, should be able to "seize and liquidate collateral, or to reorganise the firm". Investors would be unable to protect their turfs even if they have a large number or chunk of the share, if they are not able to enforce their rights.

There are, however, rules and regulations that are designed to protect investors. Some of the important regulations are with regard to disclosure and accounting standards, which provide investors with the information they need to exercise other rights of investors such as the "ability to receive dividends on pro-rata terms, to vote for directors, to participate in shareholders' meeting, to subscribe to new issues of securities on the same terms as the insiders, to sue directors for suspected wrongdoing including expropriation, to call extraordinary shareholders meeting, etc. Laws protecting creditors largely deal with bankruptcy procedures and include measures which enable creditors to repossess collateral, protect their seniority and make it harder for firms to seek court protection in reorganisation. In different jurisdictions, rules protecting investors come differently from various sources, including company, security, bankruptcy, takeover and competition laws but also stock exchange regulations and accounting standards". In India, for instance, rules protecting investors emanate from the Department of Corporate Affairs of the Ministry of Finance, the Securities and Exchange Board of India, the Listing Agreements of Stock Exchanges, the Accounting Standards of the Institute of Chartered Accountants of India, and sometimes decisions of the superior courts of the country. It should be stressed though that the enforcement of laws by these agencies are as crucial as their content and in most emerging economies these are lax, delayed and dilatory, resulting in poor corporate governance.

### **Investor Protection Measures in the Companies Act, 2013**

The Companies Act, 2013 has been enacted with the main aim to assure maximum protection to every section of investors irrespective of their classes. The Companies Act, 2013 has been embedded with several new provisions in regards to the protection of investor's interest. Some of the provisions to protect investor's interest under the Companies Act, 2013 are discussed hereunder:

- **Acceptance of deposits:** The acceptance of deposit from the general public is not permitted under the Act and violation of any of the provision is a punishable offense. Section 73 of the Act provides that no company shall accept or review deposit under this Act from the public except in a manner recognized under Chapter V of the Act and Companies (Acceptance of Deposit) Rule 2014.
- **Misstatement in prospectus:** The prospectus is a written statement issued by the company to the general public containing brief information regarding companies' profile and their investment proposals. Section 34 of the Act deals with the criminal liability

for mis-statement in the prospectus issued by a company. The prospectus issued, circulated or distributed, include any statement, which is untrue or misleading in form or context to induce people to make an investment, shall be liable for action under Section 447.

- **Fraudulently inducing person to invest money:** Section 36 of the Act deals with the punishment of the person who intentionally or recklessly induces the investor to make the investment through any agreement for the purpose or the pretended purpose of which to secure a profit. This kind of deliberate concealment of fact shall be liable for punishment under Section-447.
- **Non-payment of dividend:** Declaration of the dividend is usually one of the items of agenda of every AGM. The dividend is nothing, but profits earned by the company and divided among shareholders in proportion to the amount paid-up shares held by them, i.e., return on the investment made by shareholders. Section 125 of the Act provides for the establishment of investors education and protection fund by the central government. This fund is credited with the unpaid/unclaimed amount of application money/matured money or mature deposits. Such accumulations of the fund are to be utilized for promotion of investor's awareness and protection of investor interest. Section 123 of the Act states that the dividend should be credited in investors-account within in five days after the declaration.
- **Right to demand financial statements:** Section 136 of the Act provides for the right of a member to obtain copies of the Balance Sheet and Auditors Reports. In the case of default in complying with this requirement, the company shall be liable for a penalty of 25 rupees and the authorized officer who is in default shall be liable for a penalty of five thousand rupees. Besides, this investor has the option to proceed against the company or its authorities in a court of law under the guidelines determined under Section 436 of the Act.

#### **The N. K. Mitra Committee on Investors Protection**

This committee chaired by N. K. Mitra submitted its report on investors' protection, in April 2001, with the following recommendations:

1. There is a need for a specific Act to protect investor's interest. The Act should codify, amend and consolidate laws and practices for the purpose of protecting investors' interest in corporate investment.
2. Establishment of a judicial forum and award of compensation for aggrieved investors
3. Investor Education and Protection Fund which is under the Companies Act should be shifted to the SEBI Act and be administered by the SEBI.
4. The SEBI should be the only capital market regulator, clothed with the powers of investigation.
5. The regulator, the SEBI, should require all IPO's to be insured under third party insurance with differential premium based on the risk study by the insurance company.
6. The SEBI Act 1992 should be amended to provide for statutory standing committees on investors protection, market operation and standard-setting

7. The Securities Contracts (Regulation) Act 1956 should be amended to provide for corporatisation and good governance of stock exchanges.

#### **Problems of Investors in India**

Investor protection is a broader term that covers various measures to protect the investors from the malpractices of companies, brokers, merchant bankers, issue managers, registrar of new issues and so on. It is also incumbent on the investor to take necessary and appropriate precautions to protect their own interest, since all investments have some risk elements. But where they find that their interests are adversely impacted because of the malpractice by companies, brokers or any other capital market intermediaries, they can seek redressal of their grievances from the appropriate designated authorities. Most of the investor complaints can be divided into the following three broad categories:

1. **Against member-brokers of stock exchanges:** Complaints of this category generally centre around the price, quantity, etc., at which transactions are put through defective delivery, delayed payments or non-payments from brokers.
2. **Against companies listed for trading on stock exchanges:** Complaints against companies generally centre around non-receipt of allotment letters, refund orders, non-receipts of dividends, interest, etc.
3. **Complaints against financial intermediaries:** These complaints can be against sub-brokers, agents, merchant bankers, issue managers, etc, and generally centre around non-delivery of securities and non-settlement of payment due to investors. However, these complaints cannot be entertained by the stock exchanges, as per their rules.

#### **Law Enforcement for Investor Protection**

There are several agencies in India that are expected to protect investors. In fact, there are so many with overlapping functions that they cause confusion to the investors as to who they should go for redressal of their grievances. The stated primary objective of the country's sole capital market regulator, the Securities and Exchange Board of India, popularly known as SEBI, is protection of investors interests. But, investor protection is a multi-dimensional function, requiring checks at various levels, as shown below:

- **Company level:** Disclosure and Corporate Governance norms.
- **Stock brokers level:** Self-regulating organisation of brokers.
- **Stock exchanges:** Every stock exchange has to have a grievance redressal mechanism in place as well as an investor protection fund.

#### **Regulatory agencies**

- Investors' Grievances and Guidance Division of the SEBI
- The Department of Corporate Affairs
- The Department of Economic Affairs
- The Reserve Bank of India
- The Consumer Courts
- The Courts of Law

#### **Grievance Redressal Mechanisms**

When an investor has a complaint and feels that his interest as an investor has not been protected, he should approach

the company concerned, the Mutual Fund or the Depository Participant as the case may be. If he is not satisfied with their response,

the investor can approach the SEBL The SEBI on its part, has instituted a Redressal Mechanism as detailed below in Table 1.

**Table 1:** Redressal Mechanism of SEBI

Type	Nature of grievance	Can be taken up with
I	Issue related to non-receipt of refund order, allotment advice, cancelled stock invests, etc.	Investors' Grievances and Guidance Division (IGG)
II	Non-receipt of dividend	Investors' Grievances and Guidance Division (IGG)
III	Share-related, i.e. non-receipt of share certificates	Investors' Grievances and Guidance Division (IGG)
IV	Debenture related, i.e., non-receipt of debenture certificates, non-receipt of warrants	Investors' Grievances and Guidance Division (IGG)
V	Non-receipt of letter of offer of rights and interest on delayed payments of refund orders	Investors' Grievances and Guidance Division (IGG)
VI	Complaints relating to collective investment scheme	Investors' Grievances and Guidance Division (IGG)
VII	Complaints relating to MFs	Mutual Funds Dept., SEBI
VIII	Complaints relating to Dematerialisation or DPs	Depositories and Custodian Cell, SEBI

It is likely that there may be complaints that may be sometimes beyond the purview and jurisdiction of SEBL There may be many problems arising due to corporate misgovernance. Table 1 provides a comprehensive mechanism of legal protection to investors.

**Lacunae in Investor Protection**

Though there is a redressal mechanism in place in the country, investors can not get their complaints adequately addressed to, much less solved to their satisfaction by these public authorities. The multiplicity of authorities, the overlapping functions, the lack of knowledge and the understanding by the common investor about these agencies and the lack of enforcement have all acted against investor protection Notwithstanding the existence of this seemingly comprehensive network of public institutions established for investor protection in India, a series of scams have taken place that has shaken the confidence of investors since 1991, the year of economic liberalisation The loss of investor confidence due to these scandals that conveyed an image of fraud and manipulation was so great that for several years stock market remained moribund. To understand the policy issues connected with the securities market, it is important to know how these scams burst out in the open due to misgovernance, greed, corruption, inefficiency and market manipulations.

**Summing-up**

The Securities and Exchange Board of India (SEBI), the designated capital market regulator, has a sort of mixed record in fostering and nurturing corporate governance in the Indian corporate sector. Since its inception in 1992, the SEBI has registered substantial growth in its stature and reach. Presently, its regulatory framework is robust. It has also played a significant role in creating the country's capital market infrastructure that is recognised as one of the better advanced in the world. If the SEBI's growth and reach over the past 25 years have been significant, its failure too has been spectacular.

An analysis of Indian Scams like Harshad Menta Scam, Ketan Parekh Scam, CRB Scam, Satyam Computer Scam and many more clearly shows that though the SEBI has emerged as the one and only capital market regulator in the country, its functioning has been ineffective so far due to its failure to exercise its authority and bring to book the violators and the wrongdoers. It has also let itself to be

influenced unduly and unjustifiably by some corporate big-wigs. Therefore, SEBI badly needs to improve its administration and accountability and restore its credibility, as a powerful regulator. There is an urgent need to enhance its manpower skills. It should simplify and trim regulations. It should tone up quality of disclosures. It should solve issues of IPOs and mutual funds. Besides, the Auditors also have to play a key role as they are among independent functionaries in a Company to look after the affairs of the Company from the outsider point of view.

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