



GNLU CENTRE FOR LAW & ECONOMICS
Policy Recommendations

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**Comments to the Securities and Exchange Board of
India on the Consultation paper on Institutional
mechanism for Stock Brokers to ensure prevention
and detection of fraud or market abuse**

Comments on behalf of the Research Group on SEBI,
GNLU Centre for Law & Economics

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I. Introduction

The Securities and Exchange Board of India released the Consultation paper on institutional mechanism for Stock Brokers to ensure prevention and detection of fraud or market abuse, soliciting comments from stakeholders and members of the public. Keeping in mind the mandate of the Centre for Law and Economics at the Gujarat National Law University, Gandhinagar, an endeavor was made to study and analyze the Paper in order to provide comments for regulating the crucial space of Securities Markets with the purpose of enhancing investor protection.

Therefore, the Centre for Law and Economics constituted a Research Group to study the Paper and research on the proposals to suggest comments which would further guide the policy draft for efficient regulations in India. Comments have been provided on setting up of robust surveillance systems, escalation and reporting mechanism and the whistle-blower policy

II. Clause-wise comments

Details of respondent				
Name of the Person/Entity		Centre for Law and Economics, Gujarat National Law University		
Contact details		cle@gnlu.ac.in		
Category		Academician		
Sr. No.	Extract from Consultation paper	Issues (with page/para nos., if applicable)	Suggestions	Rationale
1	5.B.i. The broker shall have in place robust trade surveillance systems and internal control procedures that are	The guidelines are too broad and not well defined in terms of whether the software should do a real time report or passively track any violations,	Either some software need to be developed, or any existing software such as the Nasdaq Trade Surveillance (SMARTS) should be made mandatory. Also, they can be used for the	In markets such as the US, surveillance softwares keep track of violations in real time and flag suspicious transactions, if any. This allows identification of

	<p>commensurate with the nature of business and the size of its operations, to detect potential fraud or market abuse by its clients, promoters, employees (including senior management), APs, directors, or analogous persons.</p> <p>Standard Operating Procedures (SOPs) shall clearly document trade surveillance policies and procedures, roles and responsibilities and guidelines on the corrective action to be taken.</p>	<p>and it places the onus of reporting the violations on the broker. Moreover, the onus of installing the software is only on the broker, so it leaves room for malpractice on the part of senior management.</p>	<p>determination by the SEBI and the so generated reports can be directly received by the SEBI. Alert parameters can also be prescribed by SEBI for the same.</p>	<p>violations at an early stage, allowing for prevention of greater crimes, in line with the broken windows theory, which had suggested a focus on prevention of smaller crimes to avert the more dangerous one.</p>
2	<p>5.C.v. Broker shall also</p>	<p>The conclusions may not be</p>	<p>The consultation with the members</p>	<p>The members of the SEBI are experienced</p>

	<p>engage with the stock exchanges in case it needs guidance on trade surveillance observations, such as trading activities which were repeatedly flagged but no conclusion could be made due to the limited information available with the broker.</p>	<p>reached by the members of the committee due to several reasons and in such a case, the efficiency of the system comes into question.</p>	<p>of the SEBI should be mandated by the way of their presence on the board which discusses the report to reach the conclusions.</p> <p>There should be penalty for continuous ignorance of the deviations in the observations.</p>	<p>in detection of such deviations in the data, and the same shall help to improve the efficiency of the self-regulation mechanism. In case of the presence of such experts on the panel, it will also ensure transparency as the members would be supervised to ensure that they make true efforts to identify the deviations and not only superficial attempts are shown.</p> <p>Continuous ignorance of the deviations, necessitates a review of the self-regulation process by the broker and in case it is not conducted the process will lose its efficacy. Thus, it is important to understand that if the penalty will be imposed, the brokers may take regular</p>
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				steps to ensure that their process conforms with necessary requirements to find and correct deviations.
3	5.D.i The broker shall establish, implement and maintain a well-documented policy that sets out the availability of whistle blowing channels, process for raising concerns about suspected fraudulent, unfair or unethical practices, violations of regulatory or legal requirements, governance weaknesses etc. by stakeholders including employees	The framework set out is ambiguous and does not set out clear guidelines for the composition of the committee for working on the protection of the employees who whistle blows. There is no incentive mechanism for the whistle-blower as well as for the company to encourage whistle-blowing in their company.	The external reporting (ER) system should be mandated, while having internal reporting (IR) system. This will create a incentive for the company to have an internal reporting system as reporting internally would allow early detection, avoiding legal sanctions and reputational loss. The external reporting system should entail allowing informants to directly approach SEBI. There should be a monetary reward for the whistle-	These recommendations are supported by economic theory using incentive analysis. In accordance with the 2019 amendment to the SEBI (Prohibition of Insider Trading) Regulations, SEBI has also carried out the same. Whistle-blowers could be thought of as "rational" in the sense that they weigh costs and benefits before acting. Employees will experience lower transaction costs with IR compared to ER. Yet, it also provides anonymity and a better reaction. In the short term,

	<p>without any fear of punishment or - 6 - unfair treatment and procedures to ensure adequate protection of whistle blowers, and the procedures to handle whistle blowing complaints.</p>		<p>blower as deemed fit or assigning a committee to calculate the same. Also, there should be a clear provision added in the mechanism for maintaining the confidentiality of the whistle-blower.</p>	<p>encouraging ER may reduce IR. The marginal social benefit from an increase in ER, however, outweighs the marginal social loss from any brief drop in IR. Incentivizing ER will encourage enterprises to develop IR systems to recruit staff, producing a positive feedback loop that will ultimately result in a net increase in societal welfare because ER has higher costs for businesses. Employees will continue to report internally as long as IR costs are kept below ER costs (less potential reward). Theoretically, a very high reward could lead to employees refusing IR because</p>
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				<p>they would lose out on a higher net award in comparison to the non-cash rewards. It is therefore important to maintain a good balance; in the future, SEBI may change the award cap if results call for it. It can be claimed that the government should step in to prevent the businesses from causing these losses, rather than relying on financial incentives to recompense whistle-blowers for potential Future costs (censure, career sidelining, dismissal, etc). (costs). This strategy entails giving employees who report misconduct the private right to sue their employers for these penalties, such as through an action for unfair dismissal under UK Law. Nonetheless, the</p>
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				<p>employee must bear the duty of upholding these rights. Such "costs" are hidden and challenging to identify and demonstrate in court. Such a treatment is more expensive, time-consuming, and uncertain for the workers. An incentive in the form of money would be a faster, more effective, and credible solution. Also, a guaranteed compensation provides more confidence and aids potential whistleblowers in making decisions. Perhaps in this spirit, the board should have sole authority over whether to offer an interim prize.</p>
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