



Long Article

Unfair Trade Practices in Securities Market – Critical Analysis of SEBI (Prevention of Fraud and Unfair Trade Practices) Regulations, 2003

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Published on: May 16, 2021

Page No.: 69 – 82

Manuscript No.: 2021/LKLR/16069

Cite as: Siddhart Behera, 'Unfair Trade Practices in Securities Market – Critical Analysis of Sebi (Prevention of Fraud and Unfair Trade Practices) Regulations, 2003' (2021) 1(1) LKO. L. REV. 69

Find here:

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Abstract: *The economy of any country largely depends upon its securities or capital market. The securities market is the place wherein various business entities raise funds by selling securities to the general public and other financial institutions. Owing to its dynamic nature, the securities market establishes a link between the demand for and supply of long-term capital funds. During the initial years, markets were ridiculed with instances of unfair practices. The market reforms intensified after 1992 wherein the Securities Exchange Board of India (SEBI) was vested with the powers for monitoring and regulating the securities market. However, despite the establishment of SEBI, every 2-3 years a new scam has emerged. Each scam has led to SEBI being conferred with greater powers. SEBI came up with SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations in the year 2003 which provides for the identification of unfair practices and confers the powers of investigation and prosecution on SEBI. The SEBI (PFUTP) Regulations, 2003 were recently amended to broaden the scope and ambit of the protection measures concerning the various Supreme Court judgements which have dealt with matters related to fraud and unfair trade practices. Based on several judgments and recommendations of the T K Viswanath Committee, the scope and ambit of the PFUTP Regulations were broadened vide the Amendment Regulations in 2019 and 2020. Many legal scholars observed that although surveillance and monitoring have improved, the regulators still need to further tighten up on penalties/punishments. The Regulations in place have proved to be helpful to a great extent, however, there's still room for improvement.*

Keywords: *Fraud, Unfair Trade Practices, Securities, Regulations, SEBI, Market.*

Introduction

The securities market is a dynamic financial market where buying and selling of securities take place. Owing to its nature, the securities market establishes a link between the demand for and supply of long-term capital funds. A fully functional and well-oiled securities market mobilizes the savings of the people and channelises them towards productive investment purposes. With the economic development and growth of our country, the role of securities markets has amplified by leaps and bounds. However, there are many challenges involved in this process. The last few decades have witnessed several scams along with structural and regulatory changes.

The Indian securities market is one of the oldest in Asia. For a long period, the infrastructure was poor which ultimately led to the market being unregulated. There was no system in place to keep a check on the problems of insider trading or fraudulent and unfair trade practices. The market reforms intensified after 1992 wherein the Securities Exchange Board of India (SEBI) was vested with the powers for monitoring and regulating the securities market.

Unfortunately, fraudulent and unfair trade practices in the securities market have been happening with tedious regularity. Failure of system, lack of implementation of regulations, etc. are some of the major causes of such notorious scams. The gullible public and the inefficient banking system provide ample opportunities for the financial institutions to play and squander the public funds. Also, institutional loopholes further aggravate the matter. Manipulation of the stock exchange, practices such as wash sale, front running, price rigging, price fluctuation, insider trading, etc. are some common examples. Such unfair practices are generally resorted to for private gains.

The regulatory authorities have put several provisions in place relating to investigation, arrest and prosecution, however, in due course of time new scams emerge. The ambit of the existing laws is wide enough to break this vicious cycle provided the authorities play a much pro-active role and focus on nipping the problem at the bud. Steps must be taken at every step to ensure that such unfair practices are prevented.

The following paper deals with the scope and ambit of such fraudulent and unfair trade practices in the securities market, the existing legal and institutional framework, critical analysis of SEBI

(Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 (PFUTP Regulations). The paper further looks into a few landmark judgements on the matter and enlists certain suggestions/ recommendations.

Fraudulent and Unfair Trade Practices Related to Securities Market

Unfair trade practices are known by several names such as securities fraud, stock fraud, investment fraud etc. which lead to investor losses. The following are a few unfair practices which are widely prevalent in the securities market: -

1. **Embezzlement by Stockbrokers** – It is commonly referred to as theft from investors. It is the act of dishonestly withholding assets by such persons who have been entrusted to secure the assets for a particular purpose. The motive behind such an act has to be that of stealing the assets. Embezzlement is often done in a pre-planned manner since it involves concealment of activities. It is classified as a statutory offence. The main elements include fraud, conversion of property, ill intention and theft.
2. **Manipulation of Stock Exchange** – It refers to the inflating or deflating the price of security artificially to obtain personal gain. However, manipulation is easier in the share prices of small companies whereas it is difficult for large companies as there are a lot of players involved. It is very difficult to catch manipulation but at the same time, it is also difficult to manipulate. Manipulation is variously called price manipulation, stock manipulation, and market manipulation.¹
3. **Insider Trading** – It refers to malpractice wherein authorised persons trade the company's securities by gaining access to the otherwise non-public information. In other words, the key employees use the company's stocks or securities for trading in a certain manner which would cause injustice to other investors. However, insider trading can be legal when the directors of the company disclose the transactions.
4. **Front running** – It is the illegal trading of stock or any asset by a broker who has prior knowledge of the substantial price hike of a transaction. It is prohibited under the PFUTP

¹ James Chen, Manipulation, INVESTOPEDIA <<https://www.investopedia.com/terms/m/manipulation.asp>>

regulations of 2003 as per regulation 4(2)(q) which defines front running as the procurement of a client order in anticipation before the factum of receiving such order or the investment in an impending futures or options contract attached to another similar futures or options contract.²

5. **Prohibition of Certain Dealings in Securities** – Regulation 3 of PFUTP Regulations prohibits the buying, selling and fraudulent use of securities. It further provides for a complete prohibition on any scheme which is floated with a purpose to defraud or is in contravention of the provisions of the Act or the rules or the regulations made thereunder.³

SEBI has also enlisted certain regulations to the intermediaries to keep a check on fraudulent and unfair trade practices⁴. The regulations are mentioned herein below: -

- Intermediaries should not promise a fixed price to any person nor can they profit from any excess of price.
- Intermediaries are not authorised to share any unverified information regarding securities.
- Advertisement with partial information is often misleading and hence is prohibited.
- Intermediary handling inflated security on behalf of a person cannot charge higher brokerage because of the said security.
- Every transaction done on behalf of the person must be reported without fail.
- Intermediaries cannot project a fake view of buying and selling of securities with the help of circular transactions.
- Intermediaries should not falsify or predate any documents like contracts.
- No intermediary should resort to the malpractice of front-running.

² Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003, reg 4(2)(q).

³ Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003, reg 3.

⁴ Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) (Amendment) Regulations, 2015.

- Intermediaries must not be involved in spreading fake news.

It is very important to understand that the stocks, bonds and other securities are not guaranteed by the government and hence their value can depreciate because of the abusive practices by market participants. Therefore, regulations are crucial in securities markets and in the absence of which allows certain participants to take unfair advantage by exploiting regulatory inadequacy.⁵ These fraudulent and unfair trade practices not only cause substantial financial losses but also disturb the entire structure of the securities market and the efficient allocation of investible resources of the economy.⁶

Legal and Institutional Framework

Currently, there are many regulations about the functioning of securities markets in India which seek to promote fair market practices with full disclosure of all material information and ensure that the correct balance is established to create a level playing field.⁷ The following bodies govern the securities market in India: -

- Department of Company Affairs;
- Reserve Bank of India (RBI);
- Securities Exchange Board of India (SEBI);
- Stock Exchanges.

Similarly, the following significant legislations play a crucial role in regulating the securities market:

1. **The SEBI Act, 1992** – SEBI exercises its power under this Act to protect investors from unfair trade practices and regulates the securities market to ensure growth⁸.

⁵ Suchismita Bose, 'Securities Market Regulations: Lessons from US and Indian Experience' (2005) Money and Finance – ICRA Bulletin <<http://www.icra.in/Files/MoneyFinance/2005-jan-june-suchismita%20bose.pdf>>

⁶ *Ibid.*

⁷ Suchismita Bose, 'Securities Market Regulations: Lessons from US and Indian Experience' (2005) Money and Finance – ICRA Bulletin <<http://www.icra.in/Files/MoneyFinance/2005-jan-june-suchismita%20bose.pdf>>

⁸ The Securities and Exchange Board of India Act 1992, s 12A.

2. **The Companies Act, 2013** – This Act lays down a code of conduct for the corporate sector concerning the issue, allotment and transfer of securities to be made through public issues. The Act also empowers SEBI to list the securities of public listed companies and public companies⁹.
3. **The SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 2003** – These Regulations define the unfair trade practices and empower SEBI to investigate into cases of such malpractices. The regulations specifically prohibit fraudulent dealings, market manipulation, misleading statements to induce sale or purchase of securities, unfair trade practices relating to securities.

Further, SEBI has the power to conduct an investigation, suo moto or upon information received by it, through an investigating officer in respect of conduct and affairs of any person buying, selling, and otherwise dealing in securities¹⁰. The investigating officer then prepares a report, based on which SEBI can initiate action for suspension or cancellation of registration of an intermediary.

4. **SEBI (Mutual Fund) Regulations, 1996** – These Regulations make it mandatory for mutual fund companies to project the disclaimer i.e., “Mutual funds are subject to market risk. Please read the scheme-related offer documents carefully.”
5. **The Depositories Act, 1996** – The Act empowers SEBI to administer the rules and regulations concerning the electronic maintenance and transfer of ownership of dematerialised securities. SEBI has also the power to call for investigation and enquiry.¹¹
6. **Prohibition of Insider Trading Regulations, 1992** – These Regulations are aimed at curbing the problem of insider trading. It vests the power with SEBI to direct the person who acquired the securities in violation of these regulations to deliver the securities back to the seller or to transfer the proceeds of the deal to the investor protection fund of a stock exchange.

⁹ Companies Act 2013, s 24.

¹⁰ Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations 2018, reg 5.

¹¹ Depositories Act 1996, s 18.

7. **The Securities Contracts (Regulation) Act, 1956** – The Act provides for the regulation of transactions in securities through control over stock exchanges. It was enacted to prevent undesirable transactions in securities by regulating the business of dealing therein by providing for certain other matters connected therewith. It was enacted in the seventh year of the Republic of India. The SEBI regulates the working of stock exchanges and companies at the secondary market under the provisions of the Securities Contracts (Regulation) Act, 1956 and the Securities Contracts Regulation Rules 1957.

The interplay of these legislations provides a tightly woven structure to prevent fraudulent and unfair trade practices in the securities markets.

Critical Analysis of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003

Recently, SEBI attempted to broaden the ambit of the PFUTP Regulations according to the various Supreme Court judgements which have dealt with matters related to fraud and unfair trade practices. These changes aim at expanding the scope of Regulations to secure the interests of innocent investors. These amendments were notified by SEBI on 31st December 2018 which came into effect from 1st February 2019. SEBI had constituted a Committee on Fair Market Conduct to re-look into the SEBI (Prohibition of Insider Trading) Regulations, 2015 and the PFUTP Regulations, 2003. Based on the recommendations of the said Committee, the amendments were made.

The 'definition' clause was broadened. The meaning of 'dealing in securities' has been expanded to include activities undertaken to influence the decision of investors in securities and any assistance provided to carry out the aforesaid activities.¹² For example, the activities of a statutory auditor of a listed company will now be under the purview of the Regulations.

Similarly, Regulation 4 has been amended to cover more persons and entities under the ambit of the Regulations. The element of 'knowledge' has also been introduced to ensure sufficient

¹² Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations 2018, reg 2.

safeguards from manipulative, fraudulent or unfair trade practices. An effort has been made to address the difference between acts done in good faith and the acts done with a fraudulent intention. A strong need was felt to evolve the Regulations keeping in mind the advancements of technology, finance and emerging market practices. For example, before the 2019 amendment, in cases of front-running, the term ‘an intermediary’ was used. However, it was amended to ‘a person’ to allow more individuals to be covered under Regulation 4(2)(q).¹³ Further, before the 2019 amendment, the opening words of Regulation 4 read as “*fraud and may include all or any of the following, namely*”, which was changed to “*include any of the following*” which shows that the word ‘may’ has been omitted. This proves the view of SEBI to strengthen the existing machinery and curb the rampant problem of unfair trade practices.

Further, the terms ‘knowingly’ and ‘fraudulently’ have been incorporated in Regulation 4(2)(a), (c), (f) and (r). Furthermore, broad safeguards have been provided in Regulation 4(2)(h) and (s) to protect bonafide activities.¹⁴

Before the substitution the provision 4(2)(h) read as follows - “*(h) selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form;*”. It now also includes “*counterfeit or fraudulently issued securities*” to cover various aspects of fraud relating to securities. The proviso was also amended to differentiate between bonafide activities/transactions and unfair trade practices.¹⁵ The idea behind such an amendment was to protect the bonafide transactions and to not equate them with manipulative, fraudulent, or unfair trade practices.

Overall, these amendments to the Regulations have not only broadened the scope of the subject-matter but has also incorporated sufficient safeguards to restrict such unfair trade practices. The major feature of the amendment lies in the protection of bonafide cases of dealing with securities. Protection is accorded to the inadvertent or accidental trades of innocent

¹³ Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations 2018, reg 4.

¹⁴ Sandeep Parekh, ‘Analysis: What the amendments to the fraudulent and unfair trade practices regulations mean’ <<https://www.cnbctv18.com/views/analysis-what-the-amendments-to-the-fraudulent-and-unfair-trade-practices-regulations-mean-2583521.html>>

¹⁵ Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations 2018, reg 4.

investors. Lastly, the wide ambit of the words ‘fraudulently’ and ‘knowledge’ are open for the adjudicating authorities to debate, discuss and provide an inclusive definition with a view of imparting justice¹⁶.

2020 Amendment

On 13th March 2020 SEBI issued the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2020 to further amend the 2003 Regulations. The amendments are made under Regulation 2 and 5 of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, the word “person” shall be used in place of the words “officer of the Board not below the rank of Division Chief,”. This Notification shall come into force on the date of their publication in the Official Gazette that is March 17, 2020.¹⁷

Major Scams in India

To protect the interests of an investor, it’s important to take a closer look into the various scams which plagued the securities market of India to understand the causes, lapses and negligence on the part of regulators. The following section entails a brief account of major scams that took place after the formation of SEBI and which shook the whole nation along with the Indian securities market.

1. Harshad Mehta Scam

Also known as the 1992 scam, it was the biggest stock market scam of India which exposed the inherent loopholes of the financial system. He was indulged in using fake Bank Receipts (BRs) to obtain unsecured loans from the banking systems. Two banks namely, the Bank of Karad (BOK) and the Metropolitan Cooperative Bank (MCB) issued such BRs as and when required. Besides taking money under the pretext of a ‘fake’ BR, securities which were pledged/sold were also represented only by allotment letters rather than certificates on security paper. He further

¹⁶ Kaushik Laik, *Unfair Trade Practices in Securities Market* (Taxmann Publications Private Limited 2013).

¹⁷ ‘SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2020’ <<https://www.avantis.co.in/updates/article/8305/sebi-prohibition-of-fraudulent-and-unfair-trade-practices>>

secured securities from SBI against forged cheques and never delivered securities.¹⁸ The amount involved in this closely knitted scam including top officials and banks was approximately 5000 crore rupees. The scam came to light due to the reduction in interest rates and distortion in the valuation of securities. The shares became 'tainted shares' and were reduced to mere pieces of paper. It ensued a complete structural change of the security system. The inefficiency of RBI, bypassing banking rules, widespread corruption were the major lapses which led to this scam. Following the scam, National Stock Exchange of India (NSE) came up; SEBI was formed to monitor the NSE and securities depositories.

2. Ketan Parekh Scam

From 1999-2001, Ketan Parekh alone caused one of the biggest scams of the Indian financial market. Several charges were pressed against him involving defrauding Bank of India of about \$30 million. He resorted to "circular trading" and "pump and dump scheme" wherein he asked his subordinates to buy and sell share frequently throughout the day to increase the 'traded volume' which would attract investment from all sources and would also purchase 20-30% shares of a company and once price hike is reported and investors are lured he would dump and liquidate his holdings. However, in 2000 he started losing out on money due to market crashes. The major lapses attributed to this scam are the lax attitude of SEBI, circular trading practice, rigging by brokers¹⁹.

3. Roopal Ben Panchal - Benami Demat Accounts Scam

Also known as the IPO scam, it came to light in 2005 when Yes Bank launched its IPO. It was found that the IPO involved manipulation and use of fictitious Demat accounts. One Ms Roopalben Panchal allegedly opened several fake Demat accounts and subsequently raised finances on the shares allotted to her through Bharat Overseas Bank. Ms Panchal would often woo people to get free photographs and would then use the photographs in opening Demat accounts. There were around 6000 accounts and the amount was in the range of 30-45 crore

¹⁸ Debashis Basu, *The Scam: Who won, Who lost, who got away: From Harshad Mehta to Ketan Parekh* (South Asia Books 1993).

¹⁹ Varishika Dinesh, 'Ketan Parekh Scam: All that you must know' <<https://blog.finology.in/investing/ketan-parekh-scam>>

rupees. The fraudsters targeted the primary market to make a quick buck at the expense of the gullible small investors. The non-existence of KYC norms, lack of vigilance by SEBI were the major loopholes in this case. Post the scam, ED attached the properties of the fraudsters under the PML Act²⁰.

4. Satyam Computers Scam

Satyam Computer Services was founded by Ramalinga Raju and DVS Raju in 1987 and it went public in 1992. Gradually it became one of the leading IT services company. It tried to make it to the big three, namely Tata, Infosys and Wipro. In pursuance of this, the founders exploited the systemic lacunae and indulged in fraudulent auditing practices. Company's accounts were misrepresented to the to its board, stock exchanges, regulators, investors and all other stakeholders. This was carried on through the period of 2002-2009 wherein fake invoices and bills were created and funds were diverted. Acquired funds were used in purchasing land and properties. Further, promoters sold shares at inflated prices. However, later, accepting the sole responsibility for the scam, Mr Raju resigned. The scam amount was estimated to be at around 8,000 crore rupees. Poor vigilance by SEBI, absence of whistle-blowing techniques, casual approach by auditors and Income Tax Department are the major lapses²¹. Similarly, several scams such as **CRB scam**, **Dinesh Dalmia scam**, **Vanishing Companies scandal**, etc. have rocked the Indian securities markets time and again. However, looking at the silver lining, these scams have provided ample opportunities to come up with stronger regulations.

Important Orders & Judgements

SEBI has regulated the securities market with the help of some important orders and judgements:

SEBI v. Rakhi Trading (P) Ltd.²² - The SC defined unfair trade practices as follows - *“Having regard to the fact that the dealings in the stock exchange are governed by the principles of fair*

²⁰ N Sundaresha Subramanian, 'The Scam that Changed India's Primary Market' <<https://www.business-standard.com/article/markets/the-scam-that-changed-india-s-primary-market.html>>

²¹ Lal Madan & Madan Bhasin, 'Creative Accounting Scam at Satyam Computer Limited: How the Fraud Story Unfolded?' (2016) Open Journal of Accounting <<https://www.researchgate.net/publication/308628071>>

²² (2018) 13 SCC 753.

*play and transparency, one does not have to labour much on the meaning of **unfair trade practices** in securities. Contextually and in simple words, it means a practice which does not conform to the fair and transparent principles of trades in the stock market.”*

Nirmal Bang Securities Pvt. Ltd. v. SEBI²³ – The SAT observed that “Synchronized trading is violative of all prudential and transparent norms of trading in securities. Synchronized trading on a large scale can create false volumes... Many transactions are giving an impression that these were all synchronized, otherwise, there was no possibility of such perfect matching of quantity price etc. In a synchronized trading intention is implicit”.

Ketan Parekh v. SEBI²⁴ – The SAT observed that “any transaction executed to defeat the market mechanism whether negotiated or not would be illegal. The nature of the transaction executed, the frequency with which such transactions are undertaken, the value of the transactions, whether they involve circular trading and whether there is a real chance of beneficial ownership, the conditions then prevailing in the market are some of the factors which go to show the intention of the parties.

SEBI v. Shri Ram Mutual Fund²⁵ - The Hon’ble SC held that “once the violation of statutory regulations is established, the imposition of penalty becomes the sine qua non of violation and the intention of parties committing such violation becomes irrelevant. Once the contravention is established, then the penalty is to follow”.

Ms Sharmila Karve, Partner, Price Waterhouse and Co. v. SEBI and Whole Time Member Mr M.S. Sahoo²⁶ - The Bombay HC held that “SEBI has jurisdiction under provisions of Securities and Exchange Board of India Act and Regulations framed therein to inquire into and investigate matters in connection with manipulation and fabrication of books of accounts and balance sheets of a listed company.”

²³ 2004 49 SCL 421 SAT.

²⁴ (Appeal No. 2 of 2004, date of order July 14, 2006).

²⁵ [2006] 68 SCL 216 (SC).

²⁶ 2010 (112) Bom LR 3871.

Further, the Apex court has interpreted the term ‘fraud’ to be wider than fraud as understood in the Indian Contract Act, 1872²⁷. It has also been laid down by the Court that any practice which does not conform to the fair and transparent principles of trades in the stock market is an unfair trade practice²⁸. Recently, in the matter of Indiabulls Ventures Ltd., SEBI passed an order impounding rupees 87 lakhs belonging to the non-executive director of IVL Ltd. and her husband for the practice of insider trading at an annual interest rate of 12%. The Apex Court has also recently held that with the growth of the market, market abuse is also becoming prominent and the only way to ensure investors’ protection is by strengthening the means of protection of investors’ interests.²⁹

Recommendations and Conclusion

The proper functioning of every market relies on regulations which prohibit and strive to do away with harmful and illegal practices. Taking into consideration the dynamic nature of the securities market, it is prone to great risks of frauds and manipulation. SEBI has actively worked towards restricting such unfair practices over the years and has taken every step possible to maintain constant growth to ensure that the market flourishes fairly. To ensure the smooth functioning of the securities market the following recommendations must be borne in mind: -

1. Since we’re moving towards an era dominated by technology, India should strengthen its position concerning cybersecurity. Most of the securities are handled through online portals and hence SEBI should bring about provisions concerning cybersecurity.
2. Despite being in 2020, a large section of the population still lacks awareness regarding the securities market and hence proactive steps must be taken to educate the masses.
3. Increased coordination between the various regulators must be ensured.
4. There should be effective implementation of the existing laws.

²⁷ *SEBI v. Kanaiyalal Baldev Patel* (2017) 15 SCC 1.

²⁸ *SEBI v. Rakhi Trading (P) Ltd.* (2018) 13 SCC 753.

²⁹ 2019 SCC OnLine SEBI 81.

5. It must be ensured that harsh and time-bound punitive actions are taken against the violators.

Although late, India has now joined the arena by a quasi-legislative measure in the shape of SEBI's Regulations 1992 relating to Securities Market. The efficacy of these Regulations will, of course, depend upon their effective implementation and if so implemented the regulations may help curb the tendency of such practices. A new market structure altogether which facilitates the developments in technology and flow of information coupled with easy access to market features is the best way to protect the interests of investors. Further, broadening the powers of Regulators will ensure a safe market place.