

STOCK MARKET SCANDAL: A STUDY ON THE EMERGENCE OF CORPORATE GOVERNANCE

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Abstract

This study is intended mainly to focus on the great stock market scandal of 1992, and how it led to the emergence of corporate governance in Indian subcontinent. The Stock Market crash of year 1992 is also known as the Harshad Mehta scam, it is also known as the SBI fraud. This was one of the major shocks experienced by the stock market, and hence its relevance can be still found in the Stock Market. Corporate Governance means governing the corporates based on the rules and regulations defined in the particular said act by the governing body, SEBI. This study provides for a detailed analysis of the Scam 1992, along with the amendments in the SEBI act. Lastly the implications of corporate governance are also discussed.

Keywords: Scam 1992, Corporate Governance, Harshad Mehta, Clause 49, Companies Act 2013

INTRODUCTION

Corporate governance is the term which has been into use since decades now, but the true meaning of it has been implemented into the Indian companies only after the great stock market scandal of the year 1992. There have been various crashes in the history of the Indian Stock market. A crash may be referred to a huge fall in index value of the stock exchange due to various internal and external reasons. The Indian stock market which comprises of the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) and various other recognised stock exchanges have also faced various crashes over the year. BSE was established in the year 1875 as the Native Share & Stock Brokers Association. Later after independence the name BSE was coined and it gained the recognition of a stock exchange in the year 1957. NSE was established in the year 1992 but it became functional in the year 1994 with its working in the wholesale debt market and the equity trading market. With the implementation of the corporate governance the companies had to incorporate several changes in their working structure and employee composition. The books of accounts as well as the other workings of the company needs to be transparent and all the shareholders must be aware of the financial position of the company, they are investing in.

REVIEW OF LITERATURE

Arya V.V (2017) examined the importance of corporate governance in the Indian market. There had been several corporate scams in the 1970-1990 in the developed nations like the USA and the UK, and it gave a rise to the urgency of implementation of the corporate governance. The

researcher found that corporate governance was crucial even in the Indian corporate world, and especially after the Harshad Mehta case in 1992. The scam led to strengthen governance by ensuring transparency and responsible board structure. 'Desirable Code on Corporate Governance' initiated by CII in 1998 was one of the first initiative in this direction. The

researcher also examined the other major scams in Indian sub-continent including the Satyam Scam. The study was conducted mainly for the leading 8 banks which included 4 private sector banks and 4 public sector banks. Data is collected from the secondary sources of bank's latest annual report for 2015-16. Key parameters including composition, mandate and frequency of meetings of the Board, Risk Management Committee, Audit Committee, Remuneration Committee and CSR Committee, etc., is analysed. The analysis of the research depicted that ICICI bank Ltd had proper amount of independence and transparency whereas State Bank of India was proactive in terms of a PSU bank.

Sudhakar, Bhushan D, & Kumar, A (2005) examined the real story of the corporate scandals which were mere stories of the greed for want of more money. The tendency in India has been to dismiss the large-scale corruption as a minor aberration. The reluctance to recognize the unpleasant fact is due to two reasons. Continuously fed on the infallibility of liberalization and the new global capitalist order, the researchers found it convenient to ignore these inherent contradictions of globalization. Thus, leading the large corporations to disappear under the weight of excessive debt or accounting frauds. The supposed gatekeepers of the system: auditors, stock market regulators, market analysts, fund managers and bankers have all failed, again, under the competitive compulsion to checkmate the globalization need to get-rich-quick by any means. The absence of a critical media added to the present plight. The researcher in his research takes a critical outlook at some of the major scandals and their solutions in India.

Kumar and et. al (2014) examined the new National Spot Exchange Limited scam which involved approximately 1500 retail HNI Investors with an investment of Rs. 5600 crore seems to be moving on the same track alike the Harshad Mehta scam and Ketan Parekh scam. After 33 weeks of closure of scam hit spot exchange, only Rs 330 crore has been paid to the investors as on April 6, 2014. The researches felt the need to examine the increasing stock scams of Indian stock market, as India lost crores of its money, the investors who are the catalytic agents of economic development unfortunately bear the wrath innumerable times. Here, the researcher has studied and put forth the happenings of the National Spot Exchange Limited scam.

Goswami (2002) examined the long history of corporate and the ignorance of the word corporate governance until 1993. It came to the fore at that time because of a spate of corporate scandals that occurred during the first flush of economic liberalization. The first scandal was a major securities scam that was uncovered in April 1992. The researcher found that the scam involved a large number of banks, and resulted in the stock market nose-diving for the first time since the advent of reforms in 1991. It was found by the researcher that between July 1993 and September 1994 the stock index shot up by 120 percent. During this boom, hundreds of obscure companies made public issues at large share premiums, buttressed by sales pitch by obscure investment banks and misleading prospectuses. This shattered investor confidence and resulted in the virtual destruction of the primary market for the next six years. Such scams led to the prominence of the concept of corporate governance among the financial press, banks and financial institutions, mutual funds, shareholders, more enlightened business associations, regulatory agencies, and the government. It was concluded by the researcher that almost nine years after the start of economic liberalization, the beginnings of desirable corporate governance practices can be discerned, and indicators suggests that the trend will intensify in the next few years.

Sharma. A (2014) the researcher has extensively examined the various financial scandals that have ever occurred in the corporate world. The researcher has mainly focused on the scams developing in the past two decades in the Indian sub-continent. There has been examination done for several prominent scams and highlights the administrative and the legal lapses that were exploited by their operators. The researcher has also focused on the contemporary regulatory framework to combat corruption and examined if the lessons learnt from these incidents helped in strengthening such framework. The researcher finally concluded an analysis of the road that lies ahead for the public institutions to ensure that none of such scams resurface again to undermine the general confidence in our public institutions.

AIMS AND OBJECTIVES

The aims and objectives for the study are stated as follows:

- To find out the reasons behind the 1992 crash.
- To find out the steps taken by the government after the crash.
- To find out the implications of corporate governance by the corporates.

METHODOLOGY

The research was mainly conducted by having a detailed and historical analysis of the facts. The incident of Harshad Mehta has been a big learning for all, and hence there has been various publications for the same. The research data has been collected from various newspaper articles, published journal articles in various recognised journals. The amendments in the act were referred to from the official website of the said act.

ANALYSIS

While investing there is a factor of risk involved, as per the many researchers it is found that with greater return there is a greater risk involved. Investments can be done in various forms; these investments are mainly depended on the thinking and the requirements of the investor. The basic types of investments may be named as: Fixed Deposit at Banks, Real Estate, Shares, Bonds, Mutual Funds, and other such direct and indirect sources of investments can be done. Investments are nothing but a way to drain out the excess funds from the society and use those funds to generate income in such a way which is beneficial for both the investor and the society as a whole. In the past years there has been major scandals in big corporates and as well as the Stock Market. Among which the three greatest scam which shook the nations stock market can be listed as follows:

- The Harshad Mehta Scam 1992
- The Ketan Parekh Scam 2002
- The Satyam Scam 2008

Discussion on the Massive Stock Market crash in 1992

BSE was a leading stock exchange in India and it experienced the first of its crash ever in 1982, leading to a shutdown of the stock exchange for 3 days at a stretch. But this was just the start for something even bigger to happen in the next ten years. The year 1992 is noted as a year of major changes in the Indian Stock Market. On one hand there was revelation of a major scam involving 5000 crores and on the other hand a new stock exchange was being setup. The Stock Market crash of year 1992 is also known as the Harshad Mehta scam, it is also known as the SBI

fraud. This was one of the major shocks experienced by the stock market, and hence its relevance can be still found in the Stock Market. Harshad Mehta dreamt of becoming the big bull of the stock market, and thus had a huge number of brokers and investors who considered him as their idol at that time. After the scam the government put his foot in the operations of the stock market and certain protocols such that if any investor tries to follow his footsteps, then the investor shall be in the limelight of the government immediately and strict action would be taken. The following points put focus on the massive stock market crash of 1992:

- After the initiation of liberalisation in the year 1991, it became very difficult for the banks to continue their operations smoothly. This was mainly because they were required to maintain a Statutory Liquidity Ratio (SLR) as per the laws. The big players of the Banking system were easily able to maintain such ratio, but the small players i.e., the small private banks found it difficult to maintain this ratio.
- The big players of the banking system faced the problem of having excess cash with them, as the banks were stopped from trading directly at the stock market. In order to source their excess fund these banks decided to lend out a helping hand to the small banks who fail to maintain their desired SLR.
- The big players would provide for Ready Forward Deals (RDF) to the small banks, which would allow the small banks to receive the surplus money of the big players. The banks instead issued Bank Receipts (BRs), which meant that the banks actually never transferred the securities, but instead just gave the right to short-term buying and selling.
- These BRs would be given to stock market brokers like Harshad Mehta. The big players issued these BRs in the name of the brokers, as these brokers acted as a middle man in between the players. Both the players from either of the end would remain unaware of whom they are lending their money ultimately, and who they are receiving their money from.
- In this system of lending and borrowing through BRs there was a massive loophole, and brokers like Harshad Mehta would take advantage of such loopholes. He involved a huge number of banks in this borrowing and lending of money, and asked the bank officials to create dummy BRs, which had no collateral in reality. With the help of these dummy BRs, he raised a huge amount of money and traded in the stock market to earn profit.
- With following this system repeatedly, he had a huge amount of money and hence he created a bullish trend in the market, and the share price of ACC Ltd was raised from INR 200/share to INR 9000/share in just a span of 3 months. This rise was artificially created and the company actually had no perpetual growth to have a share value of INR 9000/share.
- This artificially created image of the company could not withstand the market pressure, and soon the market started to collapse and, and it was very difficult for Harshad Mehta to sell his shares to repay the money of all the lenders.
- This crash was one of the biggest crashes of the stock market, and on interrogation it was found that Harshad Mehta had involved an insider of the SBI to help him with fake BRs. Harshad Mehta was found guilty of indulging in fraudulent activities of INR 5000 crores, and hence sentenced to serve a term of 9 years in custody.

After this massive crash the Indian economy also suffered from a shock and to avoid any future

shocks major amendments were brought into the SEBI Act, 1992, to overcome the existing loopholes.

Amendments of the SEBI Act, 1992

After experiencing the major crash of the Stock Market Securities Exchange Board of India (SEBI) decided to incorporate certain amendments in the act so as to overcome the loopholes and ensure a secured future for both the stock exchange and as well as the government. The amendments were made with the primary perspective of protecting the interest of the investors and the companies whose shares are being traded in the stock market. The major amendments to be mentioned with this regard are mentioned as follows:

- Chapter IV, Section 11(2), Clause ia: as per the clause ia SEBI had the power to ask for any kind of information and records from any individual investor including the other institutional investor or any corporate which perform any kind of transaction at any time in the stock exchange. SEBI has the power to seek for the details of such transactions at any time, SEBI holds such power with regards to foreign investors as well.
- Chapter IV, Section 2A: as per the Sec(2A) SEBI has the power to ask for the financial statements of any company which is listed in any recognised stock exchange. When SEBI seeks for the documents it is the obligation of the companies to fulfil the requirements and submit the same with SEBI.
- Chapter VIA, Section 15A, Clause b: as per the clause b SEBI has the power to exercise penalty on such companies who default in presenting the required documents at the allotted time are liable to pay a penalty. The amount of such penalty cannot be less than one lakh rupees, which may extend up to one lakh per day until failure continues which may extend up to a maximum of one crore rupees.
- Chapter VII, Section 26D: as per the Sec(26D) SEBI has given the power of providing application of code to proceedings before Special court. The provisions of the Code of criminal Procedure 1973 shall apply to the proceedings before a Special Court.

These were a few of the major amendments made in the SEBI act immediately. But apart from these government made major changes in the other acts as well, and developed the concept of Corporate Governance, so as to avoid the brokers from falsely raising the stock prices of any organisation.

Corporate Governance and its implications

The term 'Corporate' means companies or business set up by the intention of making profit from the society in return of providing for products or services. The term 'Governance' means governing any organisation, institute as per the set of rules and regulations set by the government. Therefore, Corporate Governance means governing the corporates based on the rules and regulations defined in the particular said act by the governing body, SEBI. The Harshad Mehta Scam was revealed to the world in 1992, and almost 12 years later in 2004 SEBI regulated a clause which defined all the mandatory rules to be followed by all the listed companies. The companies must be a public company to be listed at any recognised stock exchange. With the implementation of clause 49, there were many loopholes in the companies act 1956, and hence it was becoming very difficult to implement the clause 49 to its full scope. Hence to overcome these loopholes, the companies act was amended in 2013, and henceforth

the applicability of clause 49 also increased. The major relevance of Clause 49 of the listing agreement, along with the provisions of companies act 2013 can be discussed as follows:

- There should be presence of executive, non-executive and independent director in the composition of the Board of Directors. There should be at least one women director as well in the board.
- There should be complete transparency with regards to the related party transactions. As per the rules, the details of all material transactions of the company by the promoters and top management should be included in the financial reports. And such transactions should not be the result of any personal interest of any small shareholder.
- There should be presence of a proper remuneration committee to decide upon the remuneration applicable for the top management of the company. As per the disclosure norms the company needs to disclose the ratio of the remuneration for top management to the middle management. This disclosure helps the shareholders to understand what percentage of revenue is used for paying the remuneration of the management and whether is it worth spending the funds.
- There has to be an independent audit committee, whose duty is to prepare an unbiased report on the financial position of the company. With further amendments, the duty of audit committee extended for up to running a scanning process of the financial documents, and if any loophole is found, then the whistle blower mechanism should be implemented and the corporate veil should be raised.

The above-mentioned implications, have relevance even now. The companies are bound to abide by these rules and amendments, and the companies not following such rules shall be scanned under the rules of clause 49 of the listing agreement, and be liable to pay the penalty imposed. By the help of such strict vigil mechanism the SATYAM scam was also revealed. This system of whistle blower has given the power to all the shareholders of the company to have a in-depth knowledge about the financial position of the companies, and if any error or suspicion is found then they can report the same immediately. Now the companies can not tamper with the financial statements of the companies and have to show their actual profits, which leads them in distributing the correct number of dividends. If any company is facing loss and heading towards a shut down, that is also clearly visible, and hence this stops the investors to create another Harshad Mehta scam in the stock market.

CONCLUSION

The Harshad Mehta Scam was a major learning not only for the government, but also for the individuals who invest in the stock market. By analysis it was found that an SBI official was also involved in the scam, and the official helping Mr Mehta was finally sentenced after 23years of the scam. This scam moved the whole functioning of the companies, and the urgent need of corporate governance was felt. Corporate governance was implemented by Clause 49 of the listing agreement, along with implication of companies act 2013. Lastly, it can be concluded that the great scam of 1992 was the breakthrough for the emergence of corporate governance in the Indian sub-continent.

LIMITATIONS AND RECOMMENDATIONS

No study is free from limitations. While conducting a research variety of hurdles cross paths with the researcher, similarly while conducting this research as well there were certain

limitations which can be stated as follows:

- The research is entirely based on secondary analysis, hence restricting the researcher to do an in-depth analysis of the mental situation of the parties involved in the scandal.
- The researcher found it very difficult to find out the various reliable sources to know the true and fair reasons behind the scam.

Along with limitations, recommendations are yet another area which is discussed by researchers. No research is free from recommendations for future research and development on the topic. Hence, the recommendations of this research may be stated as follows:

- The study can be further explored with the taxation system of India affecting the scam.
- The study can be further expanded with including the details of the leverage system working in the stock market.

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