

INVESTOR'S PROBLEMS AND PROTECTION

OBJECTIVES

The core, essence and substance of corporate governance is long term shareholder value that can be realised only through investor protection. This chapter studies investor protection needs, problems, and grievance redressal mechanisms that are available in India.

CHAPTER OUTLINE

- ▶ **Introduction**
- ▶ **Relationship Between Investor Protection and Corporate Governance**
- ▶ **Corporate Governance Through Legal Protection of Investors**
- ▶ **Investor Protection in India**
- ▶ **SEBI's Poor Performance—Suggestions for Improvement**

Introduction

Strong investor protection is associated with effective corporate governance. 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.

Why is Investor Protection Needed?

When investors finance 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” may shake their confidence, which in the long run would have a deleterious impact on the overall investment climate with serious repercussions on the economic development of the country.

Why is Investor Protection Needed? (contd.)

Research findings 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.

Definition of Investor Protection

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 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 executive decisions on substantial sale or investments, voting out incompetent or otherwise ineligible directors and appointment of auditors.

Definition of Investor Protection (contd.)

There are also laws that mainly deal with bankruptcy and reorganisation procedures that outline measures and procedures that enable creditors to repossess collateral to protect their seniority and to make it difficult for firms to seek court protection in reorganisation.

In many countries, laws and legal regulations are enforced in part by market regulators in part by courts or government agencies and in part by 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 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.

Relationship Between Investor Protection and Corporate Governance

Recent research confirms that an essential feature of good corporate governance is strong investor protection. According to Rafael La Porta et al, *“Corporate Governance is to a large extent 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 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 the objectives of the two sets of players (investors and managers) as closely as possible and minimise the agency problems.

Rights to Information and Other Rights

Investor protection is not attainable without adequate and reliable corporate information. All outside investors, have an inalienable right to have certain corporate information. 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 access to new security issues. 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.

Rights to Information and Other Rights (contd.)

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.

Rights to Information and Other Rights (contd.)

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, rules protecting investors emanate from the Department of Company Affairs of the Ministry of Finance, the Securities and Exchange Board of India, the Listing Agreements of Stock Exchanges, Accounting Standards of the Institute of Chartered Accountants of India, and sometimes decisions of the Superior Courts of the country.

INVESTOR PROTECTION IN INDIA

Small investors are the backbone of the Indian capital market and yet a systematic study of their concerns and attempts to protect them has been relatively of recent origin. Due to lack of proper investor protection, the capital market in the country has experienced a stream of market irregularities and scandals in the 1990s.

SEBI itself, though formed with the primary objective of investor protection, took notice of the issue seriously only after the Ketan Parikh Scam (2001) and the UTI crisis (1998 and 2001) and has developed sophisticated institutional mechanism and harnessed computer technology to serve the purpose. Yet, there are still continuing concerns about the speed and effectiveness with which fraudulent activities are detected and punished, which is after all, should be the major focus of the capital market reforms in the country.

Law Enforcement for Investor Protection

There are several agencies in India that are expected to protect investors. 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 SEBI
- Department of Company Affairs
- Department of Economic Affairs
- Reserve Bank of India
- Consumer Courts and Courts of Law

SEBI's POOR PERFORMANCE - SUGGESTIONS FOR IMPROVEMENT

1. Poor Tackling of Price Manipulation and Insider Trading

Issues:

2. Poor Conviction Rate:

3. Need to Enhance its Manpower Skills:

4. It should Simplify and Trim Regulations:

5. It should Tone up Quality of Disclosures:

6. It should solve Issues of IPOs and Mutual Funds: