Show them the money

For the first time, Sebi will compensate affected investors with illegal profits collected by it. Let it become the norm for all market frauds

Redistribution of unlawful profits will restore confidence of small investors and discourage crooks

Prithvi Haldea

November 21 was a red-letter day for small investors, as Sebi took its first step to introduce 'disgorgement' -- the practice of compensating investors from the ill-gotten gains made by the guilty -- to the Indian capital market. The disgorgement order passed by Sebi in the IPO allotment scam makes me happy because I have been campaigning for such a compensation policy (like 'The Algebra of Justice', March 27) to look after the small investors.

Investors want money…

The small investor has been the fall guy in virtually every market fraud in the past two decades. So damaging was the impact of these that household allocation to stocks dropped from 23 per cent in 1991-92 to 1 per cent in 2004-05.

Several frauds are not even discovered. Even the ones that come to knowledge, identifying the culprits is a tedious task. If they are caught, indicting or prosecuting them is a timeless exercise, given the quality and speed of our investigation and judicial processes. Very few are convicted or punished, in terms of penalties, imprisonment or a ban from operating in the market. In these few success cases too, small investors, who were actually defrauded, don't figure anywhere. Much as they would feel some sense of justice being done if cheats are punished, the real satisfaction would come only if they got back the money they lost.

In market frauds where it is not possible to identify investors who lost money, unlawful profits should go to the Investor Protection Fund. But when it is possible to identify investors who lost out, compensation should be given to them.

The IPO scam is one such case. A handful of investors like Roopalben Panchal had filed multiple applications, and used benami demat accounts to corner huge quantities of shares from the quota reserved for small investors. Those who made multiple applications have been identified. The registrar can remove these fraudulent applications, and draw up a fresh basis of allotment, based on which it can identify which successful applicants should get more shares and which unsuccessful applicants get some allotment.

This process will establish the rightful beneficiaries of the compensation. Deciding the amount of compensation too is simple: the difference between the closing price on the date of listing and allotment price, multiplied by the number of additional shares small investors will now be entitled to. The lead manager or registrar of the issue can be mandated to carry out the above exercise, the cost of which can be deducted from the total amount available for distribution.

…and fair play

Some might argue that the compensation each small investor will receive will be very small -- and therefore, not worth the effort. That argument doesn't hold water. First of all, the total amount, at Rs 116 crore, is large. In any case, what is a small amount for large entities is a big sum for small investors.

Anyway, this is not just about the money, it's also about sticking to principles and about creating deterrents. Redistribution of unlawful profits will show the scam-ravaged and disillusioned small investors that regulators care for them. It will give them some succour that even if they are gypped, they might get some compensation. In some frauds, compensation may even accrue to large investors. It should, as a system like this shouldn't differentiate between investors. Of course, the knowledge that their ill-gotten gains can be taken away will serve as a greater deterrent for the unscrupulous.

One question, though, will be debated. Typically, ill-gotten gains of the real beneficiaries are disgorged. In this case, Sebi has made the intermediaries accountable. Probably, for two reasons: they are a party to the fraud, by design or by default; and because they are registered with Sebi, which can enforce an order on them.

Another debatable point is the ratio of allocation of disgorgement between the depositories and the depository participants on a 50:50 basis. One can also argue the usage of the closing price to determine the gains made by the fraudsters. I hope these issues will be sorted out and won't dilute the key development -- disgorgement is now in place.

It is said that a bad fish spoils the entire lake. Unfortunately, our capital market is infested with hundreds, if not thousands, of bad fishes. The clean-up has begun. The last Sebi order has had the impact of improving allotments to small investors, with fraudulent application now out of vogue. While about 52,000 demat accounts have been closed and fraudsters are wary of opening multiple/fictitious accounts, intermediaries too are exercising greater diligence while opening new accounts. It's all for the better.