

# **CHAPTER -I**

## **INTRODUCTION**

### **1.1 Background of the Study**

Nepalese Economy is still a matter of through study and research not because of its achievements but because of its backwardness. The economic development of Nepal in comparison to other developed and developing countries seems much sluggish. Hence, we need a basic foundation for economic growth with social justice. For which an in-depth study of every aspects of Nepalese economy is needed.

Economic development of any nation is highly influenced and characterized by development and expansion of capital market. The capital market and economic activities move in similar cyclical patterns. In Nepalese economy, the demand and supply of funds for investment in productive enterprise is low due to the absence of mechanism for transferring risk which, in turn, may be attributed to the absence of well developed stock market.

Securities market in Nepal, till the recent past, had all the characteristics of an underdeveloped economy. It was characterized by the absence of professional promoters, underwriting agencies, market intermediaries, organized market, regulatory bodies and rules and regulations. However, after the restoration of democracy in 1990, a trend towards an organized stock market can be marked with numerous developments in the Nepalese securities market, removing its earlier deficiencies (Upadhaya, 2004, p. 93)

### ***Capital Market***

The term capital market refers to the markets for long-term securities, such as bonds, preferred stock, convertible securities, and common stock. Capital market has been defined as a financial relationship created by a number of institutions and arrangements that allows suppliers and demanders of long term funds to make transaction. The main objective of capital market is to create opportunity for maximum number of people to get benefit from the return obtained by directing the economy towards the productive sector and by mobilizing the long-term capital. For it, securities market is one of the mechanisms, which enables the efficient transformation of savings from the hands of surplus spending units to those of deficit spending ones who can use them more productively and/or have risk of aversion.

The capital market has more significant role in developing economies like Nepal. Nepal, the capital deficient economy requires a huge amount of investment in productive activities for its rapid economic development. The capital market can play a big role by encouraging and channeling the savings to provide the entrepreneurs for investment in profitable projects in the Nepalese economy. A number of institutional bodies like Securities Board Nepal (SEBO/N), Nepal Stock Exchange (NEPSE), Office of Company Registrar (OCR), Shareholders Association of Nepal (SAN) and listed companies are established to practice securities trading in Nepal in an international standard.

Capital market is broadly divided in two parts, Primary Market and Secondary Market. The financial market in which securities are initially issued, the only market in which issuer is directly involved in the transaction is called primary market. On the other hand, the financial markets in which pre-owned securities are traded are

secondary market. The best example of secondary market is organized stock exchange like Nepal Stock Exchange (NEPSE) in Nepal.

### ***Institutional Arrangement of Capital Market***

With the first amendment of the 'Securities Exchange Act, 1983' in 1992 A.D., the government initiated the policy to reform capital market. As a result, Securities Board, Nepal (SEBO) was established in May 26, 1993. As a part of its continuous effort to build a secure system, the Securities Exchange Act, 1983 was amended for the second time on Jan 30, 1997. This amendment paved the way for establishing SEBO as an apex regulatory body and as an advisory authority for Nepal in the field of securities transaction. Further to this, with the third amendment of the Securities Act, 2006, SEBO has been established as a dictatorial body to work for the protection and facilitation of the investors in the securities market. Likewise Nepal Stock Exchange Ltd. (NEPSE), as the successor of Securities Exchange Center (SEC) was established to facilitate the transaction of the stocks in its floor through its member intermediaries such as brokers, security dealers and market makers. Even though these executing and regulatory bodies are functioning, the voice of malpractices, securities fraud, misleading manipulative investors' defraud is still on the up.

### ***Investors' Protection***

There are many parties involved in the transaction of securities in the securities market. Among them, investors are one of the main parties from whom the corporation acquires the funds. So the investors are in the center of capital market process, and protection of their interest is essential, otherwise they will run away from the capital market causing problems in the capital formation and hence in the national

economy. Thus the issue of investors' protection has greater relevance in today's dynamic, turbulent and global business environment.

Investors' protection aims at encouraging shareholders (investors) to invest in the productive sectors through capital market. Investors are protected if they feel that they are protected and facilitated by the concerned regulatory authorities, listed companies and associated investors' organizations. Investors' ultimate protection can be regarded as safeguard of their investment on sustainable basis, which is most essential to sustain a capital market in the long run. Further, investors' protection can be maintained through fair rate of return on investment, liquid and efficient market, timely disclosure of information, avoidance of insider trading, prompt share transfer facility, holding of regular Annual General Meetings (AGMs), share transfer, voting rights and of course, an appreciation in the value of their capital invested. Only administrative provisions and execution bodies are not enough matters for the proper protection of investors. So, the legal component is the matter of study on this regard for properly putting those administrative provisions into practice.

### ***Securities Laws***

Laws and rules, though seem to be onerous (burdensome), are essential to maintain the practicable competition in the society. The securities transaction system is directly related to laws and rules. Legal provisions and institutional arrangements are basic infrastructure of capital market development. The protection of investors depends on their adequacy, efficiency and effectiveness of implementation. In this concern many laws and by-laws relating to this system have been applied in the country. Presently there are many legal provisions regarding securities allotment, registration, issue approval, membership etc. Some laws are being formulated to restrict what should be

done and what should not by the investors, companies and brokers. Similarly some laws are being formulated to protect their interest. But they are not sufficient for the advancement in the security transactions field. Furthermore, many provisional and administrative problems have to be faced while involving in the activities relating to this system. Therefore, it seems necessary to revise the securities laws and other laws relating to it. It is true to some extent that these legal provisions limit the managerial flexibility, but in the absence of law, safe and healthy environment for security transaction cannot even be imagined. There would be the dominance of frauds in the security market.

The securities laws are unclear and inadequate from several aspects. Process and procedure for enforcement and investigation in securities legislations are not clear. This restricts the regulator from correcting the unethical and unfair market practices. The regulator also does not have the power to suspend market intermediaries indulging in such practices. This increases chances of fraudulent activities and investors' are cheated easily. This will erode the investors' confidence. Due to inadequate legal provisions, the regulator can not review and make further inquiry into the financial reports submitted by issuer and listed companies. Besides, it does not specify the liability of directors who sign in the prospectus and the experts who prepare the financial statements. There are such large gaps in securities laws. Laws such as insolvency laws, arbitration laws, trust laws etc., which are supplementary to the securities laws, are still absent. In addition, several inconsistencies and duplications in between the companies' laws and securities laws exist (Adhikari, 2005, p.43).

Some of the major legal provisions relating to securities transactions are Companies Act, 2006, Securities Act, 2006, Securities Exchange Regulations, Securities Listing By- laws, Guidelines etc.

## **1.2 Statement of the Problem**

In the Nepalese context, a number of institutional bodies are functioning to safeguard the interest of the investors. Various acts, laws, by-laws and regulations are also in operation. But the problem of investors' protection still remains unsolved. For making the securities market productive one, interest of investors should be taken care of. There must be sufficient laws, regulation and its implementation to regulate the securities market. Then only investors' protection can be ensured.

Foreseeing this importance of securities laws and investors' protection in Nepalese securities market, this study has been undertaken. Related literatures are review before going through this study and most of them found to be quite helpful for conceptual clarity. But they are found on the scattered form and based on personal judgments. Hence after reviewing available literature on the subject matter, this study has tried to accumulate and to add available information, to make primary data collection, to make the qualitative as well as quantitative analysis, to generalize the result and at large to fill the research gap in regard to laws and practices for investors' protection in Nepal. Literatures show that there are number of areas where investors' protection is lacking. Hence this study will be focused on the following problems related to the subject chosen.

1. Is there sufficient legal mechanism governing securities transaction in Nepal?
2. What is the implementation status of securities laws?
3. Is investors' rights fully recognized and protected?

4. Do the defrauded investors have a proper understanding about the securities laws and do they really have some say in the law-making process?
5. What improvements are needed in terms of legal and institutional arrangements for investors' protection in Nepalese capital market?

### **1.3 Objectives of the Study**

The main objective of this study is to identify and explore the sufficiency and effectiveness of the existing legal arrangements for investors' protection in Nepalese capital market.

The specific objectives are:

- To examine the inter-relationship between securities laws and investors' protection.
- To analyze the existing legal provisions and its sufficiency regarding investors' protection and weakness of execution bodies in Nepalese capital market.
- To analyze the trend of implementation of those legal provisions in regard to investors' protection.

### **1.4 Focus of the Study**

Nepalese capital market is inefficient in comparison to other efficiently developed capital markets. There are few numbers of brokers; limited numbers of listed companies; very few transactions; and most importantly investors unknown to the pros and cons of securities market. In such a situation, there is further requirement of sufficient rules and regulation, acts, regulatory institutions for the development of capital market through investors' protection. If there occur single malpractice in the

functioning of securities market, the whole capital market and even national economy may be badly affected. Once the investors' confidence is lost, it would be very difficult to regain it.

Most of Nepalese investors and individuals know very little about capital market and its legal and institutional arrangements. In this regard, this is a study to draw a general picture of securities laws, investors' protection and a general observation on the major issues. The whole research work is based on Nepalese perspective.

For the detail and analytical study, Securities Exchange Act, 2007 and Securities Exchange Regulation, 1993 are chosen as the subject matter of the study.

## **1.5 Significance of the Study**

I don't claim that this research is extremely sufficient in the topic it has touched, but hopefully it is a notable attempt in the field of research in these regards.

- This paper may be relevant to some extent for investors, brokers, professionals and for all those who are keen and conscious towards securities transactions.
- Securities law is not a new law at the present business world but obviously there is lack of through and extensive studies on the subject in Nepal. This paper may be helpful as a research material for concern students, teachers and other more relevant researchers.
- This paper may be more useful for concern member of the Security Board of Nepal (SEBO/N), Nepal Stock Exchange (NEPSE) and those Nepalese companies and business houses, which are listed there in.



## **1.6 Limitations of the Study**

This study has the following limitations:

1. The term ‘investor’ in this study means those who invest in corporate securities either in primary market or in secondary market. Those who invest in government securities are not included.
2. The study is concentrated on the legal aspect of securities transaction in relation with institutional arrangements. Other aspects are excluded from the study.
3. Currently existing legal arrangements are considered for study. No previous provisions, which are replaced by existing one and those, which are in process of making are considered.
4. Investors’ protection variables identified and analyzed in this study are relevant to Nepalese capital market for current period and may not necessarily be relevant to the other capital markets and to the past and future period of Nepalese capital market.

## **1.7 Organization of the Study**

The report is the entire conclusion of research work, which aims to present the situational analysis of securities laws, investor protection especially of Nepalese capital Market.

The study consists five sections.

**Introduction:** The first section deals with introduction of the study, its objectives, problems faced and its significance. Similarly limitations, focus and organization of the study are also included.

**Review of Literature:** Some past research works related on the topic are analytically reviewed. After reviewing the whole literature, the research gap has been identified for justification of the study. Conceptual framework descriptively provides a conceptual framework on the definitions, importance, problems, prospects relating to capital markets, securities laws, listed companies, brokers, investment, investors, investors' protection etc.

**Research Methodology:** Include methodology used to achieve the objectives of the study, sources of data, method of data collection, population and sample, statistical tools used.

**Presentation and Analysis:** Existing legal provision has been extensively analyzed in terms of investors' protection. The basis of the analysis is descriptive, empirical and critical.

**Summary, Conclusion and Recommendation:** Finally, the whole study has been summarized, the findings and conclusions are drawn and future priorities and recommendations are provided.

Bibliographies have been presented in the last part of the study. Thus research paper is organized by combining the various constituents.

# **CHAPTER-II**

## **REVIEW OF LITERATURE**

### **2.1 Conceptual Framework**

#### **2.1.1 Investment**

Investment is a commitment of funds made in expectation of some positive rate of return. If the investment is properly undertaken, the return will be commensurate with the risk the investor assumes.

Most of the people earn and spend money. It is rare that people's current income exactly balances with their consumption. These imbalances will lead them to borrow or to save money. When current income exceeds current consumption desires, people tend to save the excess money. The saving should be employed in such a way that its value is preserved and some additional income can be generated at a future date. Thus, investment is the current commitment of the savings that compensates for the time, the expected rate of inflation and the uncertainty involved (Thapa, 2003, p.12).

Investment is the sacrifice of certain present value for the uncertain future reward. It is done to increase the value of property or to get extra income. The essential of doing investment is to wait time to get some return from it. Investment involves long-term commitment waiting for a reward.

Investment entails arriving at numerous decisions such as type, mix, amount, timing, grade etc. of investment and disinvestment. Further, such decision-making has not only to be continuous but rational too. Broadly speaking, an investment decision is a

trade off between risks, return and time factor. All investment choices are made at points of time in accordance with the personal investment ends and in consideration of an uncertain future.

It is an information oriented subject. Investors make their investment decisions on the basis of their expectations for the future. Many pieces of information influence investment decisions. Investors need to know the characteristics of various investment alternatives and must keep informed on the institutions and markets where they are available. Up-to-date information is required on the status of and trends in the economy, particular industries, and firms (Subedi, 2003, p.22).

Investment choices or decisions are found to be the outcome of three different but related classes of factors (Bhalla, 1994, p.3).

The first may be described as *factual or informational premises*. The factual premises of investment decisions are provided by many streams of data which taken together, represent to an investor the observable environment and general as well as particular features of the securities and firms in which he may invest.

The second class of factors entering into investment decisions may be described as *expectational premises*. Expectations relating to the outcomes of alternative investments are subjective and hypothetical in any case but their foundations are necessarily provided by the environmental and financial facts available to investors. These limit not only the range of investments which may be undertaken but also the expectations of outcomes which may legitimately be entertained.

The third and final class of factors may be described as *valuation premises*. For investors generally these comprise the structure of subjective preferences for the size

and regularity of the income to be received from and for the safety and negotiability of specific investments or combinations of investments, as these are appraised from time to time.

Importance of Investment can be judge by its increasing popularity. Investing has been an activity confined to the rich and business class in the past. This can be attributed to the fact that availability of investible funds is a pre-requisite to deployment of funds. But, today, we find that investment has become a household word and is very popular with people from all walks of life. Apart from the fact that there was a dearth of attractive new issues in the capital market, the typical risk-averse nature of the investors who preferred safer instruments to deploy their savings marked the behaviors of the household during this period (Bhalla, 1994, p.9).

Increasing popularity of investments can be attributed to the following factors:

1. Increase in working population, larger family incomes and consequent higher savings;
2. Provision of tax incentives in respect of investments in specified channels;
3. Increase in tendency of people to hedge against inflation;
4. Availability of large and attractive investment alternatives;
5. Increase in investment related publicity;
6. Ability of investments to provide income and capital gains, etc.

### **2.1.2 Investors**

Simply saying, an individual or organization who postpones current consumption of income or surplus with an expectation of getting more in future is investor. Investors may be individual or institutional or even they can be Foreign Institutional Investor

(FII). Investors who invest in securities can also be grouped into different categories; first type of investors are those who involved in management and the operation of the company and second type of investors are those who are not involved in management or operation of business and gets published information only. Investors' protection is largely concerned with second categories of investors.

In Nepal, the investors do not properly understand the risk and reward of investing in the stock market. This leads to increase the savings into bank deposits rather than direct investment in the shares by the individual investors. In order to make informed decisions, investors must have access to accurate and timely information (Subedi, 2003, p.26).

#### **2.1.2.1 Types of Investors**

According to Pandey (2002), in Nepalese context, general investors can also be categorized as:

##### **a. Informative Investors:**

Informative investors are those who are aware of price sensitive information and know capital market closely. They can be called VIP (Vigilant, Intelligent and Professional) shareholders.

##### **b. Non-informative Investors:**

Non-informative investors are those who once buy and hold the security and are not aware of day-to day capital market conditions. Most of the Nepalese shareholders are non-informative.

**c. Dependent Investors:**

Dependent investors are those who run after rumors. They neither possess their own professional knowledge to analyze independently nor do they remain quite. Thus, they are the shareholders who are highly sensitive with rumors. Some insider traders and VIP shareholders stimulate them through propagated rumors.

**2.1.2.2 Investors' Protection**

In simple words protection of investors means safeguarding their principal amount of investment and providing handsome return on a sustainable basis. Investors are protected if they feel that they are protected.

With the development of the economy, the scale and pattern of investment also changed. The concept of collective and portfolio investment has emerged. Gradually, it crossed the national boarder in the form of foreign direct investment (FDI). Due to the large number of shareholders in a company it is not possible for every owner to engage in management and day-to-day operation of business. That's why separate group of agent called 'Management' is appointed to work on behalf of shareholders. Thus, management and ownership are separated with the development of corporate culture. This separation between management and ownership made the issue of investors' protection more relevant. The possibility of management not doing agency role fairly and involve in their own vested interest has increased. Management might involve in activities against the interest of investors in coalition with employees, auditors and other outsiders (Pandey, 2002, p.16).

The most important means for ensuring investors' protection is the requirement of full disclosure of information materials. Investors invest in securities on the basis of information, which provide knowledge of the financial and managerial effectiveness of the company. But if such information is wrong, fake and is influenced by fraudulent motive, investors easily get cheated. Similarly, insider who has direct and indirect connection with the indoor management can get price-sensitive information which will negatively impact on securities trading system and to general investors as well. Safeguarding investors' wealth and their interest from such misleading manipulative and fraudulent practices is investors' protection in the true sense. Disclosure is all very well if the information disclosed is true. Companies' accounts are subject to audit, which accords the investor a large measure of protection, but the overburdened ROC does not check the accuracy of prospectus, merely that they comply with the statutory regulations. Many of the scandals affecting companies and their shareholders are revealed, not by the Department of Trade and Industry, but by the investigations of publications (Winsfield and Curry, 1985, p.294).

Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running and the misuse of client assets. The most important means for ensuring investors protection is the requirement of full disclosure of information material to investors' decisions. Investors are thereby; better able to protect their own interests. As key components of disclosure requirements, accounting and auditing standards should be in place and they should be of a high, transparent and internationally acceptable quality.

Only duly licensed or authorized persons should be permitted to hold themselves out to the public as providing investment services, for example, as market intermediaries



or the operators of exchanges. Initial and ongoing capital requirements imposed upon those license holders and authorized persons should be designed to achieve an environment in which a securities firm can meet the current demands of its counter parties and if necessary, wind down its business without loss to its customers (Lamichane, 2003, p.28).

Supervision of market intermediaries should achieve investor protection by setting minimum standards for market participants. Investors should be treated in a just and equitable manner by market intermediaries according to standards, which should be set out in rules of business conduct. There should be a comprehensive system of inspection. Further the complex character of securities transactions and of fraudulent schemes requiring strong enforcement of securities laws. Where a breach of law does occur, investors should be protected through the strong enforcement of the law.

Investors should have access to natural mechanism such as courts (The District Court of Nepal is empowered to hear such type of cases under the Company Act 2006, Sec. 133) or other mechanisms of dispute resolution or means of redress and compensation for improper regulator at the domestic and international levels.

Investors' interest can be regarded as protected if all activities directly or indirectly related to investment are in their favor. Following variables are significant regarding investors' protection.

#### **2.1.2.2.1 Prospectus**

Prospectus is a document consisting full and accurate information of a company and be issued only after appropriate auditing by concerned authorities. It is the most important means of corporate disclosure. General investors invest their money in

primary market on the basis of prospectus of issuing company. The company is required to send a draft prospectus for the approval of the Stock Exchange. The draft prospectus must be complete in all respects and that for the underwriting amount (given to individual brokers) the approval of Stock Exchange must also be obtained (Bhalla, 1994, p.57). Therefore, the reliability of information contained in a prospectus has long-term impact in investors' protection.

As per the provision of Securities Exchange Act, 2006 and Companies Act, 2006, companies issuing their securities to the public should first get their prospectus approved from CRO and then apply to SEBO/N along with the approved prospectus to get issue approval. In this context, in order to make the prospectus more informative and reliable, SEBO/N and CRO were cooperating with each other (SEBO Annual Report, 2005, p.12).

According to Section 24 (3) of Company Act, 2006, "If any published prospectus contains untrue statements made maliciously or deliberately and any person sustains any loss or damage by reason of his subscription of securities on the faith of that prospectus, the directors who have signed that prospectus shall be personally liable to pay compensation for the actual loss or damage so sustained"

But there is a threat for investors in regard of prospectus as well. They should not believe blindly in prospectus as it has been often seen companies issuing false prospectus. Discrepancy in actual and projected in prospectus is clearly a cheating from promoters of company and is also an outcome of ineffective regulation of concerned authorities. It is because on the one hand, ROC is lacking technical capabilities to inquire and analyze the prospectus filed by issuing companies. And on the other they are lacking competent manpower qualified enough to make detailed

analysis and inquire upon the prospectus. In this regard, SEBO during the fiscal year 2004/05, provided comments on the prospect uses of 18 companies consisting of six commercial banks, two development banks and 10 finance companies (SEBO Annual Report, 2005, p.12).

#### **2.1.2.2.2 Annual General Meeting (AGM)**

AGM is only forum where general shareholders can exercise their rights of being true owner of the company. Fair, transparent and regular AGMs are signs of good corporate governance hence the protection of investors (Pandey, 2002, p.56).

According to Company Act, 2006 (Section 76), public company should hold first AGM within one year of authorization or licensing and thereafter every year within six months after the expiry of its financial year. (2) If company is unable to call AGM within this period, ROC could grant additional three months period. (3) Again, if company could not hold AGM within this additional period, any shareholder may make a petition, setting out of the matter, to the court. The court may either cause to hold the AGM or issue any other appropriate order. Company Act, 2006 (Section 67) stressed that the notice of AGM is to call at least 21 days prior of actual day of holding AGM stating date, place and agenda for discussion.

There are many such companies, who conduct the AGM just to fulfill their desire and do not consider the voices of the majority of the shareholders. It is not a good practice for protection of general investors who have put their money with a belief that management will work in their favor.

As prescribed by the prevailing securities legislation, listed companies should conduct their AGM within six months of the expiry of the fiscal year. Accordingly, out of 135

listed companies, 69 companies have held their AGM for the fiscal year 2004/05 on time. During this fiscal year, 91 companies consisting of 15 commercial banks, five development banks, 43 finance companies, 10 insurance companies, four hotels, 10 manufacturing and processing companies, two trading companies and two companies from other groups held their AGM for the fiscal year 2004/05 (SEBO Annual Report, 2006, p.42).

#### **2.1.2.2.3 Annual reports**

Annual reports of company are to be disclosed in time and to reflect true state of affairs of the company. They are end products of accounting and non-accounting information. Annual report measures the financial performance and lists out the sources and application of cash. These sources of information are vitally important in the investment market. The reliability and timeliness of such reports have significant impact on investors' protection.

Company Act, 2006 (Section 84) has provisions regarding preparation and submission of annual financial reports. Section 84 (1) has stated that, a company listed in the stock exchange is not required to send the annual financial statement or directors' report to its shareholders or debenture holders. However, an abstract of financial statement shall be sent to every shareholder along with the notice of AGM. (2) The abstract of financial statement shall be prepared on the basis of the annual financial statement of the company and the directors' report. The format of such statement shall be as specified by the CRO based on the suggestions of the body specifies to set accounting standards under the prevailing law.

Under section 84 (4) Company Act, 2006, instead of sending the abstract of annual financial statement to the shareholders at their personal addresses, the company may

publish it at least twice in a national daily newspaper at the time of publishing the notice of meeting.

Though there are adequate legal provisions regarding disclosure of annual financial reports but in practice, it is not so as stated in law.

In the fiscal year 2003/04, out of 125 listed companies, 86 companies submitted their annual reports for the fiscal year 2002/03 to SEBO/N. out of these 86 companies, only eight companies have submitted the reports within the prescribed time. In the fiscal year 2004/05, 78 companies submitted their annual report of the fiscal year 2003/04 to SEBO/N after the expiry of the report submission date (SEBO Annual Report, 2005, p.38).

#### **2.1.2.2.4 Shareholders Rights**

Shareholders are allowed to exercise their rights including voting rights freely and fairly. Protection of investors' rights is primary prerequisite to gain their confidence in the stock market. Security investors' confidence means to protect their interest. It is essential that investors who are unaware of their rights should be made aware and those who know their rights learn to exercise their rights to reap the benefit.

The rights of shareholders can be grouped as collective rights and specific rights; some of the major rights are (Pandey, 2002, p.18).

##### ***Collective Rights:***

- Right to approve/disapprove the books of Account.
- Right to give suggestions to the management.
- Right to appoint auditors.
- Right to approve/disapprove the proposal submitted.

- Right to approve the changes in Memorandum and Article of Association, etc.

***Specific Rights:***

- Right to see books of Accounts
- Right to participate in AGMs
- Right to vote
- Right to be elected
- Right to trade
- Right to get residual amount at the time of liquidation
- Right to get dividend, etc

Regarding the voting right in the general meeting, Company Act 2006, has following provisions. According to Section 71 (1) a shareholder whose name is in shareholders register can vote at the rate of one vote for one share. (2), (3) Under proxy voting, a shareholder can assign his authority of voting and attending general meeting to any other shareholder as his proxy by writing/signing. Section 59 has provision of voting directors using ‘cumulative voting system’. Section 72 has the provision of cumulative voting. In a cumulative voting, total power of a shareholder is equal to the number of shares held multiplied by number of directors to be elected and can be casted to a director or more.

**2.1.2.2.5 Cash Dividend**

Investors’ confidence in the Nepalese stock market is relatively low because of stock market volatility. Investors put their money in shares expecting reasonable return to earn from it. Such returns in the form of both dividend appreciation and capital appreciation should be reasonable enough to attract them. Dividend as a prime motivator is worthy enough to attract the investors to make the investment decision if

provided enough and regularly. But the dividend policy and calculation is not so easy to analyze (Subedi, 2003, p.26).

Section 33 (1) of Company Act, 2006 stipulated the provision of distribution of Share Certificate within two months after the allotment of shares to all shareholders. Similarly, Section 182 (1) has provision for the distribution of dividend declared. Under this provision, dividend should be distributed within 45 days of declaration.

Out of the 91 companies that held AGM in the fiscal year 2005/06, 52 companies have declared cash dividend and bonus shares. Out of these companies, 25 declared dividends, 13 declared bonus shares, 12 declared cash dividend and bonus shares, one declared share capitalization and one declared both dividend and the share capitalization. The range of dividend is from 0.53 to 400 percent and the bonus share declaration is 10 to 100 percent (SEBO Annual Report, 2006, p.43).

#### **2.1.2.2.6 Corporate Information Disclosure**

Success in investment will be largely depend on discovering new and credible information rapidly and in more detail than others do and applying better judgment so as to ascertain the relevance of the information to the decision at hand.

Information helps the investors that affect the best investment decision making among the above available. Information affects the prices of securities of a company. Any information that affects the value of a company will also affect the prices of its securities. This includes firm specific information of its future earnings, cash flows, and growth prospects; macro economic information on inflation, interest rates and the industry specific information.

User of information can be broadly divided into two groups; individual investors and institutional investors, individuals are usually part-time investors with neither the time nor the ability to digest a complex flow of information.

A large amount of information is available to investors from companies that specializing in providing investment information and advice. The usual sources of information for institutional investors are as follows:

- The media
- Insiders
- Stock Brokers
- Tips from colleagues, friends and acquaintances
- Professional investment consultants

#### **2.1.2.2.7 Investors' grievances**

Investors' grievances are to be listened and resolved. With the objective of handling investors' grievances efficiently, SEBO/N has developed a format of grievance for the use of the investors. The format consists of possible grievances related to stock brokers, issue managers, stock exchange and listed companies. SEBO/N has also sought comments on the format from stock exchange, brokers association and issue managers. The format has also been made available to the investors from web site of SEBO/N (SEBO Annual Report, 2005, p.15).

In the fiscal year 2004/05, SEBO/N received a total of seven grievances, out of which only three were within the jurisdiction of SEBO/N (SEBO Annual Report, 2004/05, p.18).



#### **2.1.2.2.8 Legal provisions**

It is to make sure that all legal provisions are properly and adequately compiled by all concerned authorities. The legal and institutional framework should be progressively supportive for the protection of investors' right.

The government has adopted many financial policies in order to provide effective services and facilities to the investors. But in practice, there are still abundant difficulties. The spirit of law and policies in terms of securities transaction has not been taken seriously by the governmental agencies.

Ensuring these factors in investors' favor is a must for their protection. But investors themselves should be careful about their investment. Like the saying 'charity begins at home' in many instances, investors can be their own protectors. However, regulations and ethical codes would be of great assistance and guide to help them to make rational decision.

Thus, the first and foremost things in protection of investors is making them aware of the pros and cons of security trading system and help them protect themselves. But it does not mean that other measures are not necessary. Investors' protection can be ensured only when there are adequate and appropriate legal provisions and there is, efficient and effective regulating body, which can boldly enforce the laws and provisions.

The history of the legal procedures of securities transaction in Nepal is only about 20 years old. The legal arrangement for the execution and management of securities transaction started with Securities Exchange Act, 1983. The Act has been amended twice (Sharma, 2004, p. 99).

With the first amendment of the 'Securities Exchange Act, 1983' in 1992 A.D., the government initiated the policy to reform capital market. As a result, Securities Board, Nepal (SEBO) was established in May 26, 1993. As a part of its continuous effort to build a secure system, the Securities Exchange Act, 1983 was amended for the second time on Jan 30, 1997. This amendment paved the way for establishing SEBO as an apex regulatory body and as an advisory authority for Nepal in the field of securities transaction. Likewise Nepal Stock Exchange Ltd. (NEPSE), as the successor of Securities Exchange Center (SEC) was established to facilitate the transaction of the stocks in its floor through its member intermediaries such as brokers, security dealers and market makers.

SEBON drafted the Securities Board of Nepal Regulation, Stock Exchange Regulation, Broker/Dealer Regulation and the Securities Registration Regulation for the implementation of the new Securities Act, 2006. In light of completion of legal arrangements to trade government bonds in the stock exchange, SEBON initiated the process of providing license for stock brokers and market makers for the trading of bonds.

#### **2.1.2.2.8.1 Prevailing Securities Legislation**

As a primary source of information, the study has undertaken the provisions made under Securities Transaction Acts, Laws, Bye-laws, Guidelines, Rules and Regulations existing presently.

##### **a. Securities Act, 2006**

The first Securities Exchange Act was enacted in 1983 to regulate the trading of securities in Nepal. The Act restricted the exchange of unlisted securities and

provided the role of stock exchange. Security Board Nepal (SEBO/N) is the apex body to regulate the Nepalese securities markets. It was established on 26 May 1993 under the provision of the securities Exchange Act, 1993. The objectives of the SEBO/N are to promote and protect the interest of investors by regulating the securities markets. SEBO/N also regulate, monitor, direct, control and coordinate the entire capital market. SEBO/N works under the Ministry of Finance. NEPSE is the sole organization for the operation of secondary market for listed companies. NEPSE is working under Security Board Nepal (SEBO/N). Rules and regulations under following provisions need to be followed by the issuing companies, investors and brokers in the securities markets of Nepal. Board is empowered to issue guidelines and directives to the stock exchange, issuing company and brokers (Thapa, 2003 p. 324).

SEBON drafted the Securities Board of Nepal Regulation, Stock Exchange Regulation, Broker/Dealer Regulation and the Securities Registration Regulation for the implementation of the new Securities Act, 2006. In light of completion of legal arrangements to trade government bonds in the stock exchange, SEBON initiated the process of providing license for stock brokers and market makers for the trading of bonds.

Features of New Securities Act (SEBO Annual Report, 2006, p.14):

- Provisions for strengthening regulatory system and empowering Securities Board of Nepal.
- Provisions to reform dual regulation in securities issuance and of making prospectus more transparent.

- Upgrading the stock exchange at par with the international standards and developing it as a self-regulatory organization.
- Approve the operations of mutual funds.
- Arranging alternative market for the securities not fulfilling the listing criteria.
- Provision for the establishment and operation of Central Depository System of securities for the efficient transfer of ownership.
- Necessary provisions regarding the expansion of market services.
- Provision for the operation of Investors' Compensation Fund.
- Provisions for strengthening market inspection, supervision and investigation.
- Provision for enforcement system.

As new Securities Act has empowered SEBON with an authority to draft the regulations on different areas of securities markets, SEBON drafted the following regulations during the last fiscal year.

#### **b. Securities Board of Nepal Regulation, 2006**

The new Securities Act has empowered SEBON for the regulation of securities registration and issuance, stock exchange operation, and securities businesses as well as for the supervision, inspection and investigation relating to securities market activities. In this context, SEBON has drafted Securities Board of Nepal Regulation, 2006 and submitted it to the Government of Nepal on 12/01/2006 for its approval.

#### Features of Securities Board of Nepal Regulation

- Clear provisions for the duties, responsibilities and authorities of the Board and the Chairman.

- Necessary provisions regarding the internal management and governance of the Board.
- Procedures for the suspension and cancellation of licenses of the stock exchange and securities businesses.
- Procedures for the inspection, investigation and legal enforcement regarding the non-compliances and securities market frauds.

### **c. Stock Exchange Regulation, 2006**

For the licensing of stock exchange, and supervision, inspection and investigation of its activities, SEBON drafted Stock Exchange Regulation, 2006 and submitted it to the Government of Nepal on 14/06/2006 for its approval.

#### Features of Stock Exchange Regulation

- Provision for the requirement of SEBON's recommendation for the registration of corporate body to operate stock exchange.
- Setting minimum provisions to be incorporated in the Memorandum of Association and the Article of Association of the stock exchange in order to make its operation effective and well governed.
- Provisions for broad-based ownership and management structure of the stock exchange.
- Provision for giving certain time limits for the existing stock exchange for its governance and operational reforms as per the provisions of new Act.
- Provisions requiring the stock exchange for the disclosure of information on listed companies, securities businesses and securities trading.

- Provisions prescribing the qualification of chief executive officer and the directors of the stock exchange.
- Provision for independent director in the board

#### **d. Broker/Dealer Regulation, 2006**

For the licensing of stock exchange, and supervision, inspection and investigation of its activities, SEBON drafted Broker/Dealer Regulation, 2006 and submitted it to the Government of Nepal on 09/07/2006 for its approval.

##### Features of Broker Dealer Regulation

- Provisions for licensing process of stock broker and dealer.
- Provisions prescribing the necessary infrastructures for the operation of broker/dealer.
- Provisions for addressing the non-compliance issues of broker/dealer and maintaining records of non-compliers.
- Provisions for capital requirement and other necessary resources.
- Provisions for qualification and appointment of directors, chief executive officer and the representatives of stock broker and dealer.
- Provisions prescribing the securities businesses that a stock broker or dealer can do.
- Provisions for the stock broker to maintain records of clients' identification.
- Provisions that requires the broker/dealer to maintain transaction records of their businesses and clients' accounts, and reporting to SEBON.

#### **e. Draft of Securities Registration and Issue Regulation, 2006**

Implementing the provisions relating to registration of securities of public companies and approval of prospectus under the new Securities Act, SEBON drafted Securities Registration and Issue Regulation, 2006. SEBON is in the final stage of submitting it to the Government of Nepal for its approval. The regulation has entailed necessary provisions regarding the procedures of securities registration and prescribed the format of the prospectus required to be published for issuing securities. The other provisions incorporated in the draft regulation are accountability of the directors of issuer company, issue manager and the experts preparing prospectus to the authenticity of the contents of the prospectus, and provisions for more credible and transparent prospectus.

#### **2.1.2.2.8.2 Other Legal Provisions**

##### **a. SEBON's Policy for Debenture Trustee**

Company Ordinance, 2005, has made provision of appointing a trustee for issuing debenture. However, the institutions providing trustee services are limited and the regulatory mechanism is yet to clearly emerge. Hence, during this fiscal year, SEBON, in consultation with Nepal Rastra Bank and Company Registrar's Office adopted a policy enabling institutions to function as debenture trustee. As per the SEBON's policy only those financial institutions that have objective of providing trustee services mentioned in their article of association and memorandum of understanding and fulfilling the capital adequacy requirement as prescribed by the regulatory authority can work as a debenture trustee.

#### **b. Policy for Public Issue**

New Securities Act has made some new provisions in public offering process. However, the regulations required to implement the Act is in the drafting process. So, for this transitional period, SEBO/N has adopted the policy of granting approval for the issuance of securities as per the provisions of existing policies and guidelines to the extent that they do not contradict with the provisions of the Act. Similarly, Company Ordinance, 2005 has exempted requirement for issuer companies to publish Prospectus while issuing shares to the existing shareholders. However, Securities Act requires registration of issuance of rights shares with SEBON and accordingly SEBON requires the issuer to prepare and register a disclosure document as per the disclosure policy of SEBON.

#### **c. Membership of Stock Exchange and Transaction Bye-laws, 1993**

The law states that companies interested to operate as securities businesspersons can apply for membership only when NEPSE publishes a notice for the same.

#### **d. Securities Listing Bye Laws, 1996**

NEPSE is empowered to issue Securities Listing Bylaws 1996 to regulate listing and trading of securities.

#### **e. New Issue Management guidelines, 1997**

Board has also issued the Issue Management Guidelines, 1997 for the management of sales of securities.



**f. Securities Allotment Guidelines, 1994**

Similarly, Board has issued the Securities Allotment Guidelines, 1994 to make the share distribution among general investors fair and transparent.

**g. Securities Registration and Issue Approval Guidelines, 2000**

Board has issued Securities Registration and Issue Approval Guidelines, 2000 to regulate the issue of Securities by companies.

**h. Bonus Share Issue Guidelines, 2001**

**i. Guidelines on Business Code of Ethics for securities Brokers, 2001**

**j. Stock Exchange Licensing Regulation, 2006**

**k. Securities Businessperson (Stock Broker, Dealer and Market Maker) Regulation, 2006**

**l. Compliance Guidelines for Securities Broker**

**m. Government Securities bylaws of SEBO, 2005 / Government Securities Transaction bylaws of NEPSE, 2005**

With a view to implementing the program for the trading of government bonds in the stock exchange as announced in the budget speech for the fiscal year 2003/04, SEBON issued Government Securities Trading Management Bylaws, 2005 on 19/07/2005. On the same day, SEBON also approved Government Securities Secondary Transactions Bylaws, 2005 submitted by NEPSE.

### **2.1.2.2.8.3 Other Related Acts**

Under these heading other corporate acts which do not has any direct provisions regarding securities transaction but would be useful to stakeholders involved in share business and to conscious investor while taking investment decisions are listed down.

#### **a. Company Act, 2006**

Irrespective of level of development of a country, company law is treated as one of its basic legal infrastructure. Company Act, 2006 provides general legal framework for the incorporation, management, operation and dissolution of companies in Nepal. The Act has some provisions regarding the transaction of securities, share price, share issue allotment, prospectus, AGM, Underwriting of securities etc.

#### **b. Insurance Act, 1992**

#### **c. Bank and Finance Company Act, 2007**

#### **e. Foreign Exchange (Regulation) Act, 1962**

#### **f. Foreign Investment and Technology Transfer Act, 1992**

### **2.1.2.3 Guidelines to investors in Nepal**

The history of security market in Nepal is not longer. There is lack of knowledge about security in Nepalese investors. More investors are investing in security without sufficient knowledge and information. Here are some guidelines to Nepalese security investors:

1. Company issue and sell securities to fulfill their fund requirement. It provides investment opportunities and profit to investors.

2. Securities can be bought by two way- first at public offering time through issue manager and secondly at Stock Exchange, NEPSE in Nepal.
3. The listed securities is bought and sold through stockbroker. The buyer and seller both have to pay brokerage commission fixed by NEPSE.
4. Before making important decision, investor should analyze past performance, financial statement, annual report, price sensitive factors, and nature of business, risk and board of directors of the related company. It is better to consult with stock broker or finance specialists for buying and selling securities.
5. After buying securities, the investor should send a filled form to the company through stockbroker to receive certificate of security. The ownership should be transferred within 15 days. In the case of selling securities, the broker pays to the seller within the 3 day of transaction.
6. If security certificate or amount is not received in time. The buyer or seller should contact stock exchange i.e. NEPSE immediately.
7. Securities bought but not registered ownership transfer; do not get dividends and other facilities. So investor should be aware to register ownership transfer.
8. The price of security is determined by its demand and supply. Performance and operating result, dividend, development and future growth of the company affect the price of security.
9. A common stock holder has the rights of claiming dividend, participating in annual general meeting, voting, getting information, about the company and own electing in board of directors.
10. Common stock are more profitable but more risky. Preferred stocks and debt securities are less profitable and less risky.

11. Collective investment scheme i.e. mutual fund, debt securities and preferred are better for those investors who do not like risk.
12. If the company liquidates, common stock holders have the last claim on assets after paying all liabilities.
13. Common stockholders have the limited responsibility in the company. The responsibility is limited within the maximum value of their stock.
14. Investors can place their grievances in NEPSE or SEBO.
15. Common stock, preferred stock, corporate bond, government bonds, mutual funds are available in Nepal for security investment.
16. The more information about security market can be received from Nepal stock Exchange (NEPSE) or Securities Board, Nepal (SEBO/N).

### **2.1.3 Securities**

As defined in Nepalese Securities Act 2006, Section 2(6), the term securities means share, stock, bond, debenture, debenture stock and debt bond issued by Nepal Government and this term also includes the receipts and right and authority of securities.

Simply stated, a security is a legal document that shows an ownership interest. In other words, security is a piece of paper evidencing the investors' right to the asset. It is the legal representation of the right to receive prospective future benefits under the stated conditions and to acquire or sell ownership interests. Share, bond, preferred stock, Treasury bill, commercial paper etc are the examples of securities (Thapa, 2003, p.14).

As defined in Black's Law Dictionary (1983), securities mean evidence of debts or a property, evidence of obligation to pay money or of rights to participate in earnings and distribution of corporate trust and other property. Stock, bonds, notes, convertible debentures, warrants or other document represent a share in a company or a debt owned by a company.

In Nepalese context, share, debenture, bond, stocks which have been approved and admitted or listed on stock exchange will be automatically recognized as securities. Similarly, other types of securities such as promissory note, Treasury bill are recognized as securities only if they are issued by Nepal Rastra Bank (NRB).

#### **2.1.4 Securities Market**

A security market is a market where financial assets are traded to generate sufficient liquidity and the profit through efficient allocation of financial assets with supporting conditions to encourage transaction among the participants with minimum cost (Fabozzi, Frank and Ferri, 2002, p.72)

A security market (or financial market) can be defined as a mechanism bringing together buyers and sellers of financial assets in order to facilitate trading. Alternatively, security market is a place where securities are brought and sold, the facilities and people engaged in such transactions, the demand for and availability of securities to be traded, and the willingness of buyers and sellers to reach agreement on sales (Thapa, 2003, p.32).

One of its main functions is 'price discovery' i.e. to ensure that security prices reflect currently available information. The faster and more accurately price discovery is achieved, the more efficiently financial markets will direct capital to its most

productive opportunities, thereby leading to greater improvement in public welfare. It is the mechanism created to facilitate the exchange of financial assets (Ghimire, 2006, p.46).

To effectively fulfill its functions as an allocator of capital, securities market should be influenced solely by economic considerations; the prices of the various securities should reflect their expected returns and risk characteristics. In an efficient market current prices for a company's securities will reflect the investors' best estimates of the firm's anticipated profitability and of the risks attaching to these profits. And since-other things being equal- rising stock prices attract investors, the allocation of capital will be biased in favor of firms with relatively high levels of risk-adjusted profits. On the other hand, firms with low profitability or excessive riskiness will find it difficult, expensive, or on occasion even impossible to raise additional capital for expansion.

The prerequisites for such an efficient securities market are roughly the same as those of any 'perfect' or purely competitive market (Bhalla, 1994, p.156).

- The products traded in the market must be homogenous;
- The market must be comprised of many relatively small buyers and sellers;  
and
- There must be free entry and exit into and out of the market.

A modern securities market is made up of a large number of relatively small buyers and sellers so that it is difficult for any individual to influence prices. This rather optimistic view of the stock market and its impact on the allocation of capital is not universally held. To some the *Stock Exchange is a den of iniquity*; to other, more

sophisticated observer, stock market prices reflect mass psychology with little if any connection to underlying economic values. The case against the stock exchange was most forcibly expressed during the 1930s by the most famous economist of the time, John Maynard Keynes. In a characteristically brilliant passage which goes a long way towards explaining his own success as an investor, Keynes described the stock exchange as a place where most investors attempt to guess what average opinion thinks average opinion will be like one month hence, while others practice the 'fourth, fifth and higher degrees' of this art' (Bhalla, 1994, p.156).

Securities transaction system is a major component of capital market system. The securities market reduces the government investment and increases the private sector investment and mobilizes the capital of the people in corporate activities. The surplus capital of the government can be used in social welfare. Unless securities transaction system is properly operated, the contribution of private investment can't be significantly increased. The improper procedures of securities transaction may discourage the investor to invest their capital in capital market. Thus the importance of securities transaction system can not be undervalued.

In Nepalese context, NIDC capital market, Rastriya Banijya Bank (Treasury Department) and Citizen Investment Trust are primary market makers which are the issuer of the securities Nepal Stock Exchange (NEPSE) where the transaction and transformation of listed securities are done is secondary market.

#### **2.1.4.1 History of Securities Market in Nepal**

The history of securities markets began with the flotation of shares to the general public by Biratnagar Jute Mills Ltd. and Nepal Bank Ltd. in 1937. However, the

development of securities markets could not be a national policy for a long time. The then industrial policy of Nepal led to the development of securities markets with the establishment of Securities Marketing Centre (SMC) in 1976. Before the establishment of SMC, there was no institutional arrangement to undertake and to manage the new issues of securities, Initial Public Offerings (IPOs) had to be made as per the provision of Companies Act, 1936, which were not adequate and relevant. The Act had not even included preference share as corporate security. It was recognized as corporate security only by Companies Act, 1964 (Adhikari, 2005, p.42). The SMC was renamed Securities Exchange Centre (SEC) in 1984. The SEC was the only institution at that time managing and operating primary and secondary markets of long-term government and corporate securities.

A need to develop different institutional mechanisms relating to securities market was strongly felt to avoid potential conflict of interest between the services provided. The first amendment in the Securities Exchange Act, 1983 in 1993 paved the way for the restructuring of securities market in Nepal, which led to the establishment of Securities Board of Nepal (SEBO) in 1993 with a mandate to regulate and develop the securities markets. SEBO started to register securities and grant approval for issuing securities to the public in 1993. The first amendment in the Act also led to conversion of SEC into Nepal Stock Exchange Ltd. (NEPSE) in 1993 with the objective of operating and managing secondary transactions of securities. The initial efforts led to the opening of a full-fledged stock exchange in January 13, 1994 (Adhikari, 2005, p.43).

The second amendment in Securities Exchange Act, 1983 was made in 1997. This amendment made provision for registering securities businesspersons in SEBO. As



per the provision of the second amendment, SEBO provided licenses to the securities businesspersons in 1997. The amendment made mandatory provisions for the listed companies to submit annual and semi-annual reports to SEBO. This amendment also required securities businesspersons to submit annual reports incorporating the securities transactions carried out by them to SEBO (Adhikari, 2005, p.43). Further to this, with the third amendment of the Securities Act, 2006, SEBO has been established as a dictatorial body to work for the protection and facilitation of the investors in the securities market.

Over-the-counter markets (OTC), the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) and Nepal Stock Exchange (NEPSE) are the examples of security markets.

Till the year 2008 November, there are 23 stock brokers, one securities dealer, seven issue managers, one stock exchange and 143 listed companies in the Nepalese securities market ([www.sebon.com](http://www.sebon.com)).

#### **2.1.4.2 Types of Securities Market**

On the basis of the economic function, security market can be categorized into primary market and secondary market.

##### **2.1.4.2.1 Primary Market**

Bhalla (1994) defines primary market as the primary market for securities is the new issues market which brings together the 'supply and demand' or 'sources and uses' for new capital funds.

The market through which the funds are transferred from savers to investors is called primary market. Securities available for the first time are offered through the primary markets. Hence, the transaction of securities issued for the first time takes place in primary market. It is the market place where securities are sold to mobilize the saving for the establishment and operation of the business. It is also known as original sale of securities. In this market the securities can be sold either at par or premium or discount.

In primary market the principal source of funds is the domestic savings of individuals and businesses; other suppliers include foreign investors and governments. The principal uses of funds are: the long term financing of the investment in housing (mortgages), the long term investment if corporations and other businesses, and long-term borrowing of government. The ultimate suppliers of funds are those sectors with a surplus of current income over expenditure (savings); and these funds flow to their ultimate users, namely, economic units which issue securities to finance a surplus of expenditures over their current incomes (Bhalla, 1994, p.155).

In primary securities market, securities can be offered by either public flotation or private placement.

### ***Public Flotation***

The institution that performs the role of an expert in issuing new securities is called investment bankers and the method they follow to issue share is called public flotation. Investment bankers are traditional middlemen in the primary market. These bankers make available advice to the business firms regarding the nature of security, maturity, interest rate and underwrite the issue of securities. When a company decides to acquire new funds from the outsiders, it will frequently do so through the

intermediation of an investment banker in the developed countries. The investment banker's principle activity is to bring sellers and buyers together in the market. They are specialist in the design of the securities (Cheney and Moses, 1992, p.64).

### ***Private Placement***

Sometimes a business firm can make direct sale of the securities to the buyers without underwriting them. Such direct sale is called direct/private placement of securities. In private placement, the issuer of the securities sells securities directly to investors without the underwriting services of and investment banker. This method is cheaper, and it avoids the underwriting costs (Shakya, 2004, p.13).

Once investors purchase security in the primary market, they need the place to sell those securities in the secondary market.

#### **2.1.4.2.2 Secondary Market**

The market where the existing and pre-developed securities are bought and sold is called secondary market. It is the market place where second hand securities are traded. It means securities once purchased through primary market are traded in secondary market. Both the primary and secondary markets are complementary to each other. A secondary market provides liquidity to the purchase of the securities. High liquidity of the secondary market encourages the investors to invest in the primary market as well. The secondary market can be regarded as the centre to convert stocks, bonds and other securities into cash immediately (Thapa, 2003, p.15). The majority of all capital market transactions occur in the secondary market.

Nepal Stock Exchange (NEPSE) is the only secondary market in Nepal. It is noteworthy that the firm, whose securities are being traded in the secondary market, is not involved and thus does not receive any funds from such a transaction.

The purpose of a stock exchange or secondary securities market, like any other organized market, is to enable buyers and sellers to effect their transactions more quickly and cheaply than they could otherwise. However, since a stock exchange typically deals in existing securities rather than in new issues, its economic significance may be misunderstood. The proceeds from the sale of securities in secondary market do not go to the original issuer (i.e. it doesn't create new additional capital) to the owners of the securities. In other words, securities are traded among individuals as well as institutional investors. Transactions in existing securities represent shifts in ownership that do not provide additional funds to finance capital formation.

As we noted above, the primary function of the capital market relates to the channeling of savings into capital formation; hence the capital market's economic significance stems from its impact on the allocation of capital resources among alternative uses. But an increase in the volume of securities trading in the secondary market does not represent an increase in the economy's aggregate savings, every purchase of an existing being exactly offset by the sale of the same security (Bhalla, 1994, p.156).

The basic economic function of secondary market is to provide marketability and liquidity for long-term investments, there by the supply of equity and long-term debt capital for the financing of business enterprises (Shakya, 2004, p.14).

Secondary market comprises *Organized Stock Exchange* and *Over The Counter Market (OCT)*.

### ***Organized Stock Exchange***

Stock exchanges are voluntary associations of members who come together for the purpose of buying and selling for the general public. Only listed securities of the companies are traded in the exchange and are bought and sold by auction. Since the members of these exchanges have branches through out the country, the stock exchanges are truly a national market in which virtually any one may participate. However, the secondary market is said to give liquidity to primary issues, and this liquidity is an essential ingredient in the capital formation process of the economy.

The essential function of a stock exchange is to provide active market place for corporate shares and other listed securities. The stock exchange plays an indispensable role in mobilizing funds in capital market.

The basic economic function of a stock exchange is:

- Enhanced marketability of securities,
- Rational allocation of investible funds,
- Facilitate economic growth, wealth generation and proper maturity,
- broadening the supply of equity and long-term debt capital for the financing of business enterprise,
- Liquidity in listed securities,
- reducing the personal risk incurred by investors and
- Diversification of investment.

Above functions of stock exchange can be made clear by this example,

Even though the investment in equity shares is fixed for the life of the firm, the ability to shift ownership to others during the course of this period permits more individuals to participate in the long-term financing of the companies. In an economy with a well developed secondary securities market, the fixed investment of firms is provided by a changing group of individuals, none of whom may have been willing to commit his personal resources for the entire or even a substantial part of the life of the enterprise. Thus in an efficient stock exchange the supply of credit, which from the private investor's viewpoint is often inherently short-term, is transformed into a supply of long-term investment fund for the financing of capital formation. The ability to transfer the risks of investment forges a link between the stock exchange and the new issues market, and this greatly enhances the ability of business enterprise to mobilize additional long-term capital to finance the creation of new, or the expansion of existing production facilities (Bhalla, 1994, p.156).

### ***Over The Counter (OTC) Market***

The phrase 'over-the-counter' originated in the days when securities were traded over the counters of various dealers. Today, the OTC market is more a way to do business than a place. The OTC market competes with investment bankers and the organized stock exchanges because OTC dealers can operate in both the primary and the secondary markets.

OTC is the market for those securities, not listed on the stock exchange. When company first sells its securities to the public, the securities are traded in OTC. It includes all transactions in securities other than that taking place on the stock exchanges. OTC has very low entry barriers and traders may range in size from very

large houses doing an international business to one person firms that trade only in the local markets (Shakya, 2004, p.16).

National association of securities dealers automated quotation system (NASDAQ) is an example of OTC market. This is the computer-linked network for trading of OTC securities. It was initiated in 1971. It provides immediate information on a computer linked system of bid asked prices for stocks offered by various dealers. The bid price is that at which a dealer is willing to purchase a security and asked price is that at which the dealer is willing to sell a security. In the OTC market all types of securities are traded (Ghimire, 2006, p.52).

Nepal does not have OTC market secondary markets arrange liquidity in listed securities. It is also known as economic barometer of the country. This is because it reflects the economic policy of the country (Ghimire, 2006, p.47).

To place the capital market in proper perspective it is useful to differentiate “primary market” with that from “secondary securities market”.

### ***Margin between Primary and Secondary Market***

For the economy as a whole, an increase in savings in the form of securities ownership is measured by the volume of net issues of securities, while transactions in existing securities represent shifts among owners, which always cancel out in the aggregate. Similarly, transactions in existing securities do not provide additional funds to finance capital formation; here again it is the volume of net new issues which provides additional financing to business enterprise. An analogy can readily be drawn from the automobile market (Bhalla, 1994, p.156).

The sale of new Maruti cars (new issues) by the Maruti Udyog (issuing firm) provide revenue (investment funds) to the company; transactions in older models of Maruti cars (existing securities) in the used car market (stock exchange) do not. But just as the existence of a resale market for cars affects the willingness of consumers to purchase new Marutis, the availability of an efficient secondary market for securities is one of the more important factors inducing investors to acquire new issues of securities. And the connection between the primary and secondary markets is even stronger in the case of the securities market, since new issues are often close, or even perfect, substitute for outstanding securities.

#### **2.1.4.3 Securities Market Intermediaries**

Market intermediaries play a vital role for the effective functioning of the securities transaction system. Key market intermediaries are brokers, issue manager, security dealers and market makers. They facilitate the selling and buying process of securities, execute transaction in the floor of the stock exchange, hold securities for safe keeping, provide information and advice relating to investment alternatives, extend margin loans, facilitating short sales, help issuer companies to raise funds, helps in procedure relating to issuing securities etc. SEBO is regularly regulating, monitoring and supervising these market intermediaries. The brokers required to be registered with the Securities Board (SEBO) to perform securities dealing. A broker seeking registration with the Board has to apply through the stock exchange. Similarly, only those companies registered with SEBO are qualified to perform as issue manager. But despite these efforts some market intermediaries are not effectively providing services to the investors and the issuing companies.



#### **2.1.4.3.1 Brokers**

Brokers are agents or middle men, who facilitate the buying and selling of securities for investors. They take buy or sell orders from the investors in their own office and execute the transactions in the floor of the exchange. Besides, the basic service of executing orders, brokers also provide services such as (Joshi, 2003, p.23):

- Holding securities for safe keeping,
- Providing information and advice relating to investment alternatives,
- Extending margin loans and
- Facilitating short sales.

Securities brokers are sometimes called ‘customer’s men’ because they provide services for their clients. Most brokers will gladly provide free investment research, credit with which to make margin trades, free storage for customers’ securities, and an occasional free lunch, and the firms execute the clients’ trading instructions as expeditiously as possible (Francis, 1987, p.81).

Any individual, a firm or company desiring to engage in the business of buying or selling of securities and in other related activities in the capacity of only an intermediary for clients without purchasing securities directly in its own name is granted membership as a broker. If a broker wishes to purchase securities for himself or in his own name, he can do through other brokers by giving advance notice to the Stock Exchange.

The brokers required to be registered with the Securities Board (SEBO) to perform securities dealing. A broker seeking registration with the Board has to apply through the stock exchange.

The conditions for grant of a certificate of registration to act as stock brokers are (Joshi, 2003, p.23).

- Should be the member of a Stock Exchange as per the provision of Act.
- Shall abide by the rules, regulations and bye-laws of the Stock Exchange of which he is a member.
- Shall pay the amount of fees for registration.

A stock broker is expected to maintain high standards of integrity, promptitude, and fairness in the conduct of his business. S/he is expected to exercise due to skill, diligence, and comply with statutory requirements and not to indulge, manipulations and practices.

Investor can leave their securities with a broker for free safekeeping. They are thus relieved of the responsibility of renting a safe-deposit vault or finding some other means of storage, and they don't have to physically transfer their securities to and from the broker's office every time they wish to buy or sell. If an investor owns bonds and leaves them with the broker, the broker will clip the coupons, collect the interest due, and credit the customer's account.

Free literature is compiled and published by research departments of brokerage houses. This literature ranges from booklets of essential information for beginning investors to computer printouts of the most up-to-date information on securities compiled by the financial analysts of the firm's research staff. Some brokerage houses also provide free newsletters and brochures on commodities, foreign exchange, and various industries.

A brokerage firm can function as a credit agency. When a customer is buying on margin, the broker will loan the funds. The rate of interest charged is usually varies with the amount of the customer's loan. Large loans get slightly lower rates.

### ***Brokerage Fees***

Rule 32, sub-rule 1 and annex 14 of Securities Businessperson Regulation, 2006 states that the securities businesspersons can take the following commissions for providing securities business services.

***Table 2.1: Stock Broker's Commission of Securities Trading***

<b>S.N.</b>	<b>Amount of Securities Trading</b>	<b>Commission</b>
1.	Up to Rs. 50,000	1.00 %
2.	Rs. 50,000 to Rs. 5,00,000	0.9 %
3.	Rs. 5,00,000 to Rs. 10,00,000	0.8 %
4.	Above. 1,00,000	0.7 %

*Source: Securities Businessperson Regulation, 2006*

The cost of providing services must ultimately be paid from clients' brokerage commissions. Brokerages that provide such services for their clients and as a result charge high commission rates are called ***full service brokers***.

A ***discount broker*** is a new type of brokerage firm, sprung up to compete with the full-service brokers. Discount brokers compete with full service brokers by offering fewer brokerage services and passing their cost savings on to clients in the form of lower (or discounted) commission rates. Discount brokers originated in USA during the 1960s in what is called the 'third market' and the 'fourth market'.

An investment banker is a firm that acts as a securities broker and dealer as it issues new securities. After the primary issues of stocks and bonds sold by investment bankers are in the hands of the public, they are sold from investor to investor in secondary securities markets.

When an investor wishes to trade securities either on an organized exchange or in the OTC market, specific instructions must be given to a broker. First, the investor must decide whether only to make cash investment or to buy on margin. Then, after a particular security is selected, the investor can give the broker various kinds of instructions. The market order is the most common instruction given to brokers, but limit orders, stop orders, and GTC orders may also be employed (Francis, 1987, p.82). Presently there are 24 securities brokers in Nepalese capital market.

Stock brokers are required to submit their annual reports including profit and loss account, balance sheet, cash flow statements and securities trading report to SEBON within four months of the expiry of the fiscal year. In the fiscal year 2005/06, 22 stock brokers submitted their annual reports of the fiscal year 2004/05 to SEBON. In the fiscal year 2005/06, SEBON and NEPSE jointly conducted on-site inspection of stock brokers. NEPSE, as per the Stock Exchange Member and Trading Byelaws, 1998, suspended those brokers who were unable to keep updated records of securities transaction and the orders for transaction. As and when the stock brokers reported with the updated records, NEPSE revoked suspension of those brokers (SEBO Annual Report, 2005/06, p.17).

#### **2.1.4.3.2 Issue Manager**

Issuer manager has a greater role in developing and promoting the primary market of securities. They not only help issuer companies to raise funds but also help investors

to make informed investment decision in initial public offerings. Their services are more pronounced in bringing transparency in the public offerings. In addition, they support regulators in regulating primary markets.

Services such as preparing prospectus and fulfilling other procedural aspects required for public issue provided by issue managers to the issuer companies make fund raising process more easy and certain. Generally, the situation of market, perception of investors and procedure relating to issuing securities are the major areas of support provided by the issue managers to the issuer companies. Issue managers could also suggest the types of instruments to be issued through joint discussion with the issuer companies. As issue managers are more tuned to the general perception of investors, market trend, and advantages and disadvantages of a particular instrument, their suggestions greatly help the issuer companies to select the right type of instruments (SEBO Journal, 2005, p.62).

The principal functions of an issue manager are:

- Issue advising,
- Helping to prepare prospectus with required disclosure,
- Helping allotment and refunding,
- Listing of securities,
- Assisting in compliance with the issue related legal provisions.
- Services relating to registrar to the issue and underwriting.

Companies issuing securities to general public must register their securities with SEBO. For this, the company and issue manager must file detailed registration

statements. SEBO vets the registration statements and the prospectus for legal compliance, information integrity and clarity.

The issuer company is mainly accountable for the authenticity, reliability and adequacy of the information disclosed in their prospectus, along with, its board of directors, valuers and auditors and this is attested by the issue managers. The issue managers are required to present the due diligence certificate regarding the proposed issue. As provisioned in the prevailing securities legislation, SEBO uses this due diligence certificate from the issue manager as a key basis for approving the issuance of securities.

The second amendment of the Act in 1997 made a provision to allow only those registered in SEBO to perform as issue managers. Accordingly, issue managers were registered with SEBO to qualify for trading license since then. SEBO has been monitoring and supervising the activities of issue managers for the past 12 years. With view of initial development of securities markets in Nepal, this period is quite sufficient to assess the performance of the issue managers, and seek measures to further improve their performance. Presently there are 9 issue managers in Nepalese capital market.

Issue managers are required to submit their annual reports including profit and loss account, balance sheet, cash flow statements and securities trading report to SEBON within four months of the expiry of the fiscal year. In the fiscal year 2005/06 eight issue managers have submitted their reports of the fiscal year 2004/05 to SEBON (SEBO Annual Report, 2006, p.17).

#### **2.1.4.3.3 Dealers**

Dealers trade for themselves and are prohibited from handling public orders. Since dealers have access on the floor and can own securities on their own name. They benefit from buying at low and selling at high prices. The benefit of the dealers to the market is that their buy and sells actions added up liquidity of the securities (Joshi, 2003, p.25).

Members are permitted to act both as brokers and dealers. No member can enter into a contract as a principal with any person other than a member of a recognized stock exchange unless he secures the consent or authorization of such person and discloses in the note, memorandum or agreement of sale or purchase that he is acting as a principal. In such cases, it is obligatory under the stock exchange bye-laws and regulations that the price at which the transaction is completed should be fair and reasonable and justified by the condition of the market (Jones, 1988, p.232).

On the basis of the functions relating to transactions in securities, the security dealers are classified into two types of members:

##### ***Security Dealers (primary Market)***

The security dealers (Primary Market) are the dealers who provide pre-issue and post issue services for the sale management of securities which are being newly issued by a corporate body through a public issue or the circular method, underwrite the purchase of unsold issue shares, or perform other related functions.

### ***Security Dealer (Secondary Market)***

The Secondary Dealer (Secondary Market) are the dealers who deal in securities through brokers in the name of the investors or in his own name with the objective of managing investments in securities presented at the Stock Exchange for transactions in his own name or by concluding investment management contracts according to the current law.

The security dealers specializes in buying and selling securities, i.e., securities issued by government and public bodies like Nepal Industrial Development Corporation (NIDC), Citizenship Fund and Credit Development Banks etc. They act mainly as a jobber and prepare to take risk inherent in the ready sale of securities to meet current requirements

#### **2.1.4.3.4 Market-maker**

Market makers, also known as specialists, facilitate the trading of securities by maintaining inventory in particular securities. They are similar to dealers in many ways except that they always stand ready to buy and sell securities at their bid and asked price for which they are market makers.

The market maker is any company or corporate body which deals in securities at the Stock Exchange in its own name or under its name on the basis of a pledge to provide liquidity to the securities issued by Government of Nepal, as well as to the securities listed at the Stock Exchange by conducting necessary contracts with the concerned corporate bodies or to the securities of at least three corporate bodies, and not to let to occur improper instability in the prices of such securities, shall be granted membership a Security Market Maker.



With the change in the legal provision, out of six market makers, five market makers so far registered with the Nepal Stock Exchange have left the business of market making and confined their activities as dealers in primary market (new issue market) and as dealers in secondary market they did not operate as market makers. At present, there is purely only one market maker, Nepal Share Market. Similarly, there is only one company dealing as primary dealer and market maker, which is known as Nepal Merchant Banking and Finance. At present, thirteen companies have received license to operate in the primary market and four security dealers have received license to carry on activities as dealers in the secondary markets.

#### **2.1.4.4 Revenue Structure in Nepalese Securities Markets**

##### **2.1.4.4.1 Licensing, Membership and Renewal fee for Securities Businesspersons**

For the purpose of Rule 3, sub-rule 1; rule 4, sub-rule 2; rule 6, sub-rule 1; rule 8, sub-rule 1, Securities Businessperson Regulation 2006 (annex 2) has made provision regarding the licensing and renewal fees for the securities businesspersons.

Similarly, By-Law 3, sub-by-law 1 and annex 2 of Membership of Stock Exchange and Transaction By-Laws, 1993 has made provision for the membership and annual renewal fees.

With the objective of promoting the service efficiency of the securities businesspersons, minimizing transaction cost in the government securities to enhance liquidity, and making provision of the transaction fee for SEBO/N, Securities Businessperson Regulation 2006 has following provisions.

**Table 2.2: Licensing, Membership and Renewal Fees (Rs) for Securities Businesspersons**

S.N.	Particulars	Application Fees	Licensing Fees	Annual Fees
1.	Stock Broker	5,000	40,000	25,000
2.	Securities Dealers	8,000	60,000	40,000
3.	Market Maker	8,000	60,000	40,000

Source: Securities Businessperson Regulation 2006

### **Licensing**

The securities business persons should renew their licenses for the coming fiscal year before the expiry of the current fiscal year. In this regard, Section 42 of Securities Act 2006 states that the securities businesspersons not being able to renew their licenses within the stipulated period should pay additional 25% of renewal fees as penalty.

#### **2.1.4.4.2 Securities Registration and Issue Approval Fee**

Rule 17, sub-rule 1 and annex 5 of the Securities Exchange Regulation, 1993, has made provisions for securities registration and issue approval fees as presented in Table 2.3.

**Table 2.3: Securities Registration and Issue Approval Fees**

S.N.	Amount of Issue Approval	Fees
1.	Up to Rs. 50,00,000	0.25%
2.	Rs. 50,00,001 to 1,00,00,000	0.20%
3.	Rs. 1,00,00,001 and above	0.15%

Source: SEBO Journal, 2005

#### 2.1.4.4.3 Securities Listing Fees

Rule 23, sub-rule 2 and annex 9 of Securities Exchange Regulation, 1993 has made provisions for the listing fees and annual listing renewal fees for a corporate body as presented in table 2.4. As per the provision, the annual fees should be paid to NEPSE within the three months of the expiry of fiscal year.

**Table 2.4: Securities Listing and Annual Listing Renewal Fees (Rs)**

S.N.	Amount of Securities*	Listing Fees	Annual Listing Renewal Fees
1.	Up to 10 Million	0.20%, or Minimum 15,000	15,000
2.	10 to 50 Million	0.15%, or Minimum 45,000	25,000
3.	50 to 100 Million	0.10%, or Minimum 75,000	35,000
4.	Above 100 Million	0.075%, or Minimum 1,00,000	50,000

*Source: Securities Exchange Regulation, 1993*

#### 2.1.4.4.4 Trading Commission

As per the by-law 11, sub-by-law 2, part 3 of Membership of Stock Exchange and Transaction By-laws, 1998, Stock Exchange receives 25% of total commission received by stock brokers on trading of securities. Similarly, as per the provision of by-law 11, sub-by-law 4, part 24; Stock Exchange receives 10% of the total commission received by the members who provide portfolio management services. Stock Exchange also receives 5% of the total commission from the issue managers providing issue management and underwriting services as per the provision of sub-by law 5, part 17 of Membership of Stock Exchange and Transaction By-laws, 1998.

#### **2.1.4.4.5 Fees for Changing Representative**

By-law 16, sub-by-law 5 of Membership of Stock Exchange and transaction By-laws, 1993, states that stock brokers and the market makers while appointing new representatives in place of earlier, should pay Rs. 500 and Rs. 700 respectively to the Stock Exchange.

#### **2.1.4.4.6 Issue Management and Underwriting Commission**

Issue managers could take commission as presented in table 2.5 for providing issue management services to the public issue of securities or issuing through circular method.

*Table 2.5: Issue Management Commission*

<b>S.N.</b>	<b>Amount of Issue Managed</b>	<b>Commission</b>
1.	Up to Rs. 25,00,000	2.25%
2.	Rs. 25,00,000 to Rs. 50,00,000	2.00%
3.	Rs. 50,00,000 to Rs. 1,00,00,000	1.75%
4.	Above Rs. 1,00,00,000	1.50%

*Source: SEBO Journal, 2005*

Securities businesspersons providing underwriting services to public issue or circular issue of securities can charge up to 3% of the underwritten amount as underwriting commission. Similarly, securities businesspersons involved in public issue or circular issue of securities can charge a commission up to 0.50% of amount of securities sold by the businessperson.

#### **2.1.4.4.7 Status of Securities Market Revenue**

The status of revenue shared by different market participants in the fiscal year 2001/02, out of total revenue generated in the securities market, issue managers received 41.29%, stock brokers 25.05%, NEPSE 20.91%, Government of Nepal 8.10% and SEBO 4.65%. Similarly, in the fiscal year 2002/03, out of total revenue, issue manager received 38.60%, NEPSE 28.51%, stock brokers 15.14%, Government of Nepal 13.18% and SEBO 4.57%. It is clear from the above figures that the issue managers obtain the highest portion of the total revenue and NEPSE obtains the second highest portion. At the same time, SEBO obtains the lowest portion of the total revenue.

#### **2.1.4.5 Securities Market Regulations**

Securities Board Nepal (SEBO/N) is the body to regulate security markets in Nepal. It regulates as per the provision of the Securities Act 2006 and Securities Board Regulation, 2006 and other various laws, bye-laws, guidelines. SEBO supervises and monitors public issue, stock exchange, securities business-person and listed companies to protect investors, to ensure fair, efficient transparent market and to reduce systematic risk. As per the Securities Act, 2006, the major objectives of SEBON are to regulate issue and trading of securities and market intermediaries, promote the market and protect investor's rights.

To regulate security market; SEBO supervised whether the investors are given access to the prospectus, memorandum and articles of association of the listing company, certificate of issue approval granted by SEBO and other important documents as well as checked whether the issuing companies and the issue managers are paying attention

to address investors complaints. Stock Exchange should provide various types of information regarding the securities exchange trading to the investors and such information should also be submitted to SEBO. SEBO gives directives to stock exchange to make market practices fair and transparent. SEBO monitors whether the issue managers perform issue management activities like allotment of securities, refunding and listing of securities and submission of their reports to SEBO. Issue managers and stock brokers are required to submit their annual reports including profit and loss account, balance sheet, cash flow statement and securities trading reports to SEBO. SEBO looks into the physical infrastructures. Human resources base organization and working system, record-keeping system etc. of stockbrokers. Listed companies are required to submit their annual reports including profit and loss accounts balance sheet and cash flow statements to the stock exchange and SEBO. SEBO handles the grievances regarding securities market under its market supervision and legal enforcement division (Ghimire, 2006, p.54).

#### **2.1.4.5.1 Disorders of Securities Market Regulation**

In America, because of a lack of effective federal legal controls, scandalous activities such as wash sales, corners on the market, churning, pools, and excessive pyramiding of debt preceded the great crash of the stock market, which lasted from 1929 to 1933. These elements are regarded as disorders for the regulation of securities markets. Each of these disorders will be briefly described below (Francis, 1987, p.107-112).

##### **2.1.4.5.1.1 A wash sale**

A wash sale is, essentially, no sale at all. In a wash sale a seller of securities immediately repurchases the securities. For example, if a person who owns some securities sells those securities to himself, this is a wash sale. Or a person may buy

and sell the same quantity of some security in the same day at either the same or a different price; this, too, is a wash sale. The purpose of a wash sale is to create a record of a sale. This may be done to establish a tax loss or to deceive someone into believing that a market price has changed.

If shares of the company were inactively traded, it would be easy to create a public record of a new price merely by transacting one small sale at the new price; thus, wash sales could be used to create illusion of a fallen price. The dishonest investor could buy and sell his or her own shares from a cooperating broker (one who would not report the illegal activity). Or accounts with two different brokers could be used to create the illusion (with less chance of being caught). The prices of these sales would be on public record and this would create the illusion that shares in the company had fallen in price. Then the dishonest investor might be able to purchase shares at less than the market price from an innocent party who owns shares but is unaware that the low prices from the wash sales were fraudulently generated.

#### **2.1.4.5.1.2 Cornering the Market**

Cornering the market in some security or commodity occurs when an investor buys all that is for sale of that security or commodity. This person then owns the only source of supply and can raise the price. Price manipulators who obtain a corner on the market of some asset may then liquidate it at a high price for a capital gain. Or a manipulating speculator may corner a market in hope of trapping, or “squeezing,” short sellers.

**Short sellers** are speculators who contract to sell an asset they do not own. They expect the price of that asset to fall, enabling them to purchase the asset at the newer

lower price and then deliver it at the higher price at which they had previously arranged to sell it. Thus, short sellers profit from price declines.

#### **2.1.4.5.1.3 Churning**

Churning is a very common and also a very safe way for securities brokers (who are paid a commission on every transaction they create) to steal funds from their clients' accounts while escaping detection by all but the most watchful clients. Churning can occur when a client grants the securities broker blanket permission to trade the clients' account without seeking the client's approval of every trade. Less obviously, it can occur when a broker feeds clients so-called hot tips (that is, seemingly urgent advice to buy or sell). The client buys or sells and sales commissions are generated for the broker, without regard to whether or not the client gains from the transactions. This practice is called churning because it involves "turning over" the client's account. The law defines churning as abuse of the customer's confidence for the personal gain of a securities broker by frequent and/or numerous transactions that are disproportionate to the size and nature of the customer's account.

#### **2.1.4.5.1.4 A pool**

A pool is a formal or informal association of two or more persons with the objective of manipulating prices and profiting there from. When this objective is attained, the pool is dissolved. A few manipulators may orally agree to operate as a pool, or a contract involving many members of the pool can be drawn up. Some of the members may provide capital, some may provide inside information, some may manage the pool's operations, or all members can participate in all these functions. Some pools have hired managers for a fee or a percentage of the profits. Some pools even have had specialists from securities exchange acting in collusion as hired managers or



members of the pool. In general, pools do not tend to conform to any particular organizational format.

When the market price of a pool's securities reached a high figure and was supported there by strong demand, the pool would liquidate its holdings as quietly as possible. In liquidating, it was essential to be discreet so as not to diminish the wave of optimism supporting the price (a colluding specialist on an exchange could be very helpful in this). After liquidating their holdings at a profit, pool members often went on to sell short in anticipation of the fall in price that was likely to ensure. Any profits earned by pools represented losses by investors not in the pool.

#### **2.1.4.5.1.5 Insider Trading**

Concept of insider trading is very important while discussing about investors' protection. Insider trading occurs when an individual or organization buys or sells securities while knowingly in possession of some pieces of confidential information which is not generally known and which is likely, if made available to the general public, to materially affect the prices of these securities.

One very frequently happening disorder in the securities market is insider trading. It is illegal for anyone to transact in securities to profit from inside information, that is, private information held by officers, directors, or major stock holders that has not yet been divulged to the public (Bodie, Kane and Marcus, 2002, p.95).

Company Act, 2006 has given no deliberation to 'Insider Trading'. This Act has never exposed the word 'insider trading' though it strictly prohibits some countable persons related to company to trade on share of own company. On the other hand, Securities

Act, 2006 contain some wider connotation than the company Act, 2006 regarding insider trading.

According to Securities Act, 2006:

A director, managing director, employee and any other person engaged in the management of any corporate body shall not be allowed to carry on or cause insider trading on the basis of internal notice or information for the benefit of himself or any other person related to him.

#### **2.1.4.5.2 Self-Regulation and Circuit Breakers:**

Much of the securities industry relies on self-regulation. The market collapse of 1987 prompted several suggestions for regulatory change in US A. Among these was a call for “circuit breakers” to slow or to stop trading during periods of extreme volatility. The idea behind circuit breakers is that a temporary halt in trading during periods of very high volatility can help mitigate informational problems that might contribute to excessive price swings. For example, even if a trader is unaware of any specific adverse economic news, if she sees the market plummeting, she will suspect that there might be a good reason for the price drop and will become unwilling to buy shares. In fact, the trader might decide to sell shares to avoid losses. Thus feedback from price swings to trading behavior can exacerbate market movements. Circuit breakers give participants a chance to assess market fundamentals while prices are temporarily frozen. In this way, they have a chance to decide whether price movements are warranted while the market is closed (Bodie, Kane and Marcus, 2002, p.94).

### **2.1.4.5.3 Objectives of Securities Market Regulation**

Securities regulation should aim to ensure that investors are given fair access to market, market facilities and price information. It should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable as well as market efficient. In an efficient market, the dissemination of relevant information has to be timely and widespread and should be reflected in the price formation process. Hence, the regulation of the market should be based on the three core objectives;

#### **2.1.4.5.3.1 Protection of investors**

Investors should be protected from misleading, manipulative or fraudulent practices including insider trading and the misuse of clients' assets. Full disclosure of information material to investors is the most important means for ensuring investor protection. This makes investors more capable of assessing the potential risks and rewards of their investment and thus helping them to protect their own interests. As a key component of disclosure requirement, accounting and auditing standards should be in place and should be of internationally acceptable standards.

#### **2.1.4.5.3.2 Ensure fair, efficient and transparent market**

The fairness of the market is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Regulation should detect, deter and penalize market manipulation and other unfair trading practices.

Regulation should ensure that investors are given fair access to market facilities and price formation. Regulation should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable.

Transparency may be defined as the degree to which information about trading is made publicly available on a real time basis.

#### **2.1.4.5.3.3 Reduction of systematic risk**

Although regulators cannot be expected to prevent the financial failure of market intermediaries, regulation should aim to reduce the risk of failure through capital and internal control requirement.

The three objectives are closely related and, in some respects, overlap. Many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and help to reduce systematic risk. Similarly, many of the measures that reduce systematic risk provide protection for investors. Further, matter such as through surveillance and compliance programs; effective enforcement and close cooperation with other regulators are necessary to give effect to all three objectives.

## **2.2 Review of Literature**

We do not have a long history of securities transaction system. Further, securities laws and investors' protection is still a new concept in Nepal. As being a specific aspect of securities transaction, it has not been able to gather much attention for itself.

### **2.2.1 Review of Related Studies**

Uprety (2000) in Annual Survey of Nepalese Law has made critical analysis to existing Company Law and has made some recommendations for amendment. He mentioned that the existing Company Law fails to provide for effective provision for

prohibiting and punishing insider trading in equity. He has further added the dual function of OCR and SEBO. According to him:

It is widely recognized that OCR is inefficient and understaffed. One of the reasons for its failure is the fact that the role of the OCR, as defined under the Act, is not clearly delineated from that of the SEBO or the Company Board.

But the study is silent about insufficiency and need for amendments of securities laws and regulations.

Bhandari (1994) in book entitled Company Law has described some provisions relating to company affairs but not covered the details in securities affairs like share, debenture, bond etc.

Bhalla (1994) has given some insights into investor awareness to get success while investing in securities after various research and studies on it. According to him more money has been lost in the stock market than one can imagine simply because of the failure of investors to clearly defines their objectives and assess their financial temperaments. He further explains, in analyzing the portfolios of individual investors, the most common errors observed are:

- Portfolio is over diversified, containing so many issues that the investor can not follow closely the developments in those companies
- Many portfolios suffer from over concentration in one or two issues
- All too often, the quality of these securities is not consistent with the stated investment goal and usually a portfolio contain too many speculative securities

- Many individual investors are afraid to losses, they want to wait for their stock to come back to the price they paid
- Most investors without realizing it, do not have a plan. They are buying and selling on tips and believe ingoing where the action is instead of sticking to an investment goal.
- Finally, most serious of all, some investors consider only profit potential and never take the risk factor. They try to wait for the bottoms to buy and tops to sell. They don't learn from their mistakes and sight of their financial goals or the time frame of the investment objectives, under pressure of hope, fear, or greed.

Should investor play a winner's game or a loser's game while buying securities?

Probably investors can guess whether buying securities is a winner's game or a loser's game. Recently, buying securities has become a loser's game even for professionals engaged in institutional investing. For those who are determined to win the loser's game it is required:

1. *Play your own game.* Know your policies very well and play according to them all the time.
2. *Do the things do best.* Make 'fewer' but 'better' investment decisions.
3. *Concentrate on your defenses.* Most investors spend too little time on sell-decisions. Sell decisions are as important as buy-decisions. Investors should spend at least equal time in making sell-decision

The crucial point of the loser's game is to put the balance sheet and the income statement through a fine screen. This is the first step in making sure to avoid a mistake and will help the investor to keep away from letting the excitement make him move him too quickly. Remember the old saying, 'A fool and his money are quickly parted.'

Further, he has given some provision of investor protection in India:

In order to further strengthen investor confidence and market safety, the Central Coordination and Monitoring Committee (CCMC) have been set up as a joint mechanism to initiate actions against companies which do not comply with the conditions of the listing agreement and which are not physically traceable at the registered office address. CCMC reviews periodically the various actions initiated against defaulting companies. As regards grievances of investors, SEBI has a separate Investor Grievances and Guidance Division at Head Office. The grievance letters received by this Division are classified under different categories like non-receipt of dividend, non-receipt of share certificates/bonus shares, collective investment schemes etc.

Francis (1987) in his book *Management of Investment* has mentioned the importance of securities laws and has differentiated the status of securities market before and after the enactment of securities laws.

Mainly because of a lack of effective federal legal controls, scandalous activities as wash sales, corners on the market, churning, pools, and excessive pyramiding of debt preceded the great crash of the stock market, which lasted from 1929 to 1933. In 1933 and 1934, federal legislation designed to curb these activities was enacted. Since that time more subtle problems involving

insider information and fraud have arisen, and more recent legislation has been devised to deal with these as well. The regulatory system just outlined has greatly reduced the incidence of fraud and price manipulation, has increased market stability, and has fostered thoughtful investment analysis. The Securities Act of 1933 and the SEA are the backbone of federal securities law.

He has further added the legal and institutional insufficiency to govern the securities market in United States as well. The 1933 act is inadequate by itself because it leaves several important areas of securities trading where criminal activity might occur ungoverned by laws and because no federal authority existed to enforce the law. The SEA established the SEC to enforce all federal securities laws, and it brought several areas of the securities business under legal control.

Securities market system has fostered in developed economies like USA, Canada and some other European countries because they have followed the self-regulating mechanism to run the system. And these mechanisms to the greater extent fill the gap of insufficiency of securities laws.

Bodie, Kane and Marcus (2002) in a book entitled Investment, has given emphasis to Self-Regulation System and has written:

Much of the securities industry relies on self-regulation. The SEC delegates to secondary exchanges much of the responsibility for day-to-day oversight of trading. The market collapse of 1987 prompted several suggestions for regulatory change. Among these was a call for “circuit breakers” to slow or to stop trading during periods of extreme volatility. The idea behind circuit breakers is that a temporary halt in trading during periods of very high volatility can help mitigate informational problems that might contribute to



excessive price swings. For example, even if a trader is unaware of any specific adverse economic news, if she sees the market plummeting, she will suspect that there might be a good reason for the price drop and will become unwilling to buy shares. In fact, the trader might decide to sell shares to avoid losses. Thus feedback from price swings to trading behavior can exacerbate market movements. Circuit breakers give participants a chance to assess market fundamentals while prices are temporarily frozen. In this way, they have a chance to decide whether price movements are warranted while the market is closed.

On account of securities laws and investors' protection in Nepal Thapa (2003) in a book entitled Fundamentals of Investment has stated the importance of SEBO/N as a regulating body for the protection of investors. He explains:

SEBO/N regulates both primary and secondary markets. To regulate the primary and secondary markets, there are various acts and laws. The rules and regulations of the transaction of securities provide the information to the potential investors of securities and encourage investment in securities markets.

The strength of the book in regard to investor protection is it has stated the securities issue process, guidelines to investors' protection, listing procedures, requirements, major stock markets world wide etc. He has listed the prevailing Securities Legislation and other related Acts but seems to be ignoring the insufficiency of prevailing laws and its weak implementation for the protection of investors.

Chenny and Moses (1992) in book entitled Fundamentals of Investment has provided the regulation in American securities market. They explained that the increase in

stock market volatility as evidence by the stock market ‘crashes’ in 1987 and 1989 and the recent disclosure of unethical and illegal activities in the security markets have created an impetus for additional regulation of the security markets. Many believe that fraudulent activities, such as insider trading, have undermined the fiduciary relationship that lies at the heart of securities industry. In most instances, regulations are already in place to curb securities fraud, but detecting trading abuses in order to enforce the regulations is difficult. Brokerage houses, stock exchanges and the OTC are working to develop electronic surveillance and reporting procedures to uncover insider trading and other forms of trading abuses.

Ghimire (2006) in his book *Fundamentals of Investment* has mentioned listing requirement, regulations of securities market, Guidelines to investors in Nepal, trading system of securities in Nepalese capital market. He has stated the functions and responsibilities of SEBO and NEPSE and the provisions of securities laws. It is also mentioned in the act that a board will be established in order to protect the interest of the investors, to systematize the securities transactions and to develop the capital market.

Adhikari (2005) in his article in *SEBO Journal* has stated the importance of regulatory mechanism for the smooth functioning of securities market and for investors’ protection.

He explains that with the objective of regulating securities transactions and protecting interest of investors, Securities Exchange Act was enacted in 1983. The Act provided some legal and institutional basis for the securities markets development. The first amendment in the Act in 1993 led to the establishment of Securities Board, Nepal (SEBO) to regulate and manage securities markets. The Securities Exchange Center

was converted into Nepal Stock Exchange Ltd. (NEPSE) with the objective of operating and managing secondary transactions of securities. After this conversion, the open out cry system of trading among stock brokers started. The second amendment of the same Act was made in 1997. This amendment made provisions for registering securities businesspersons in SEBO. The amendment also made mandatory provisions for the listed companies to submit semi-annual and annual reports to SEBO. He has mentioned about the insufficiency of legal provision for proper regulation of securities transaction.

Giri (2004) in an article on SEBO Journal has been reviewed and following information has been abstracted with regard to securities regulation and investor protection. He stressed that regulation should aim to ensure that investors are given fair access to market, market facilities and price information. It should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable as well as market efficient. In an efficient market, the dissemination of relevant information has to be timely and widespread and should be reflected in the price formation process. Hence, the regulation of the market should be based on the three core objectives;

- Protection of investors
- Ensure fair, efficient and transparent market
- Reduction of systematic risk

The three objectives are closely related and, in some respects, overlap. Many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and help to reduce systematic risk. Similarly, many of the measures that reduce systematic risk provide protection for investors. Further, matter

such as through surveillance and compliance programs; effective enforcement and close cooperation with other regulators are necessary to give effect to all three objectives.

Investors should be protected from misleading, manipulative or fraudulent practices including insider trading and the misuse of clients' assets. Full disclosure of information material to investors is the most important means for ensuring investor protection. This makes investors more capable of assessing the potential risks and rewards of their investment and thus helping them to protect their own interests. As a key component of disclosure requirement, accounting and auditing standards should be in place and should be of internationally acceptable standards.

Thapa (2007) in an article Nepalese Securities Market: Regulation and Development explains that The major regulatory framework for the securities market is provided by Securities Act, 2006, which has given authority to the SEBO/N for the regulation of securities market. As per the Act, the major objectives of SEBO/N are to regulate issue and trading of securities and market intermediaries, promote the market and protect investor's rights. Besides, the duties and responsibilities of SEBO are to register securities and approve prospectus of public companies, provide license to operate stock exchange, to provide license to operate securities business, permit operation of collective schemes and investment funds, draft regulation, issue directives and guidelines and appropriate bylaws of stock exchanges and securities business activities. Take enforcement measures to ensure market integrity, frame policies and programmes relating to securities markets and advice to the government in this regard. Thus the responsibility of developing and regulating the securities markets in Nepal rests solely on SEBO.

Phulara (2003) in an article named Nepali Share Market-Meeting the Challenges has reviewed investors' protection but he has said very least about the legal provisions because of which investors' protection can not be affirmed. Phulara found that diversified legal provisions regarding share transactions constitute no more than rhetoric, and ideal. Hence, reformulation of securities laws for the protection of investors is the need of the day. In this connection, we have to bring many vital changes in the capital market because future potentiality is highly encouraging. Communal and individual hush-hush are actively participating in securities market. If any profitable bank issues its shares to the public, people gather in a huge mass to buy them. Ample corporate governance is prerequisite for investors' protection in the market. Fairness, trustworthiness, effectiveness, precision and receptiveness are the basic essentials and vital mechanisms for building up the self-motivated and spirited market. We have not yet settled down such basics in our security market. More than three hundred thousand investors, who have invested millions of rupees in Nepalese stock, with a hope to harvest reimbursement are always in suspicion fearing the loss of their hard earned cash. Indeed, investors' self-confidence in the markets is diminishing day by day. He further added, contribution and co-operation of the government towards investors' protection is not encouraging. The Securities Board of Nepal established to advance the securities market by catering to the interest of investors' and to regulate the primary and secondary trading of securities has failed to convince the investors.

Agrawal (2004) in an article named Legal Environment: Affecting Capital Market has reviewed the sufficiency of legal provisions, implementation and interpretation of those laws to make them understandable to general investors for their protection. Agrawal pointed out that neither the Companies Act nor the Securities Exchange Act

do provide for some of the basic requirements regarding the capital market. The next problem is related to the interpretation of the provisions of the Acts and rules and also in application of a specific section of a law to a non-related case. While making or amending any law, the major objectives of the enactment should be put on record. Every section of the Act and rules should be explained carefully and where needed, examples should be given to avoid any misunderstanding. Such objectives and examples also should be passed by parliament thus giving them the same weight as that of the articles of the Act. And these explanations and examples should be published along with the Act making them integral part of the Act.

Securities Board of Nepal (SEBO/N) suspended the Merchant Banking licence of Nepal Finance Ltd (NEFISCO) for the time being due to investors' complaint against it. According to new Merchant Banking regulation, NEFISCO has applied for the licence to work as a merchant bank. SEBO/N, after receiving complaints from investors, has been investigating the company on its alleged fraudulent transaction of promoters's shares of Lumbini Bank. "According to the Securities Act-2063, Clause 58 (2)(D) and Clause 60 (C), Sebon has suspended Nefisco's application for merchant banking licence," said the regulatory authority of the capital market. "However, it can continue its earlier assignments," it added. Meanwhile, SEBO has granted licence to six financial institutions — National Finance Company Ltd, United Finance Ltd, Ace Development Bank, Nepal Share Markets and Finance Ltd, NIDC Capital Markets and Nepal Merchant Bank (NMB) Bank — for Merchant Banking, according to the new Merchant Banking regulation that SEBO/N has recently brought (<http://www.ngcci.org>; cited 2008)

### **2.2.2 Review of Thesis**

Pandey (2002) in his thesis entitled Legal and Institutional Arrangements for Investors Protection in Nepalese Capital Market of Nepal have stated following objectives and limitations of his thesis:

- Study and analyze the existing legal provisions regarding investors' protection in Nepalese Capital Market
- To make recommendations for the improvement in legal and institutional arrangements for the investors' protection in Nepalese Capital Market.

#### ***Limitations***

- The researcher had only studied the legal and institutional aspects of Nepalese Capital Market.
- Investors in the thesis mean to be the investors investing in corporate securities only either in primary market or in the secondary market. Those who invest in government securities are not included in his research.

#### ***Critical Analysis***

While making reviews to legal provisions, he has emphasized on provisions of Company Act but failed to address on the legal provisions of securities laws and regulations.

On the basis of analysis conducted in his thesis, following major findings are observed:

The existing legal provisions and regulations are insufficient for protecting investors' interest. Provisions are insufficient especially in case of timely disclosure of price sensitive information and insider trading.

Pokharel (2001) in the thesis entitled Legal Provisions to the Protection of Investors under the Nepalese Law: an analytical and critical study has the following objectives:

- To study Nepalese legal provisions in investors' protection.
- To analyze the trend of implementation of those legal provisions.

The study is mainly based on doctrinal approach. Non-doctrinal approach is also applied wherever needed to obtain information based on survey methods. For most part, source of data is secondary but some information is taken from primary source as well. Mainly the study is descriptive and diagnostic in its theoretical point of view.

The research is mainly conducted to analyze the trend of implementation of Nepalese legal provisions in regard to investors protection and to find out the legal lacunas and weakness of executive bodies in regards to investors protection.

***Findings of the researcher:***

- Nepal has been forming laws to protect the interest of investors in scattered forms in various Acts, regulations and bylaws but there is still absence of a particular, specific and separate legislation for the protection of investors.
- Nepalese investors are not governed under the corporate norms and values due to lack of proper knowledge of their rights. They can be victimized still they do not complain at concerned authority.



Thesis entitled A Study on Investors Awareness in the Securities Markets in Nepal written by Subedi (2003) has given different view regarding investors' protection. Investors' awareness is important for investors' protection more than anything else. Awareness on the other hand is possible with timely disclosure of information.

In order to make informed decisions, investors must have access to accurate and timely information. Fair and timely information disclosure is essential ingredients to function the securities market efficiently. Since the quality of information available to investors, the rationality of the investors in Nepal is to be quite low. They have very little knowledge of the trading procedures and price formation mechanism in NEPSE. Considerable efforts should be given to expand the role of training and to conclude research and investors' education.

### ***Critical Analysis***

The researcher stated that the disclosure of information and investors' awareness as prime factor for investor protection but seems ignoring the importance of securities related laws, rules and regulation and their implementation for investors protection and to regulate the securities transaction.

With the main concentration on the effectiveness of provisions under Securities Transaction Act, 1998, Lamichane (2003), in his thesis entitled Securities Transaction System in Nepal: Law and Practice has tried to recommend the reformatory provisions in securities transaction system. The research refers as a study of existing store of knowledge so as to generalize the result and to derive at a conclusion. One of the remarkable parts about the thesis is that the researcher has made comparative study of laws in several Asian Countries in terms of types of securities and entities covered and the chief regulatory authority for the securities market.

Thesis entitled Protection of Investors in the Capital Market in Nepal submitted by Pathak (2000) has concluded to know that how far the investors are protected and in what extent it could be changed in the rule and regulation of the listed companies for the safeguarding of the investors' interest and development of the capital market. These two elements are interdependent of the capital markets automatically protected. So listed companies, concerned authorities and associated investors' organizations have to think to change present situation of the capital market for the progress and prosperity of the investors and capital market as well.

### **2.3 Justification of the Study**

The role of securities market is vital in the economic development of a country. It provides a medium to mobilize financial resources from the non-productive sector to the productive sector. But for making the securities market productive one, interest of investors should be taken care of. There must be sufficient laws, regulation and its implementation to regulate the securities market. Then only investors' protection can be ensured.

Foreseeing this importance of securities laws and investors' protection in Nepalese securities market, this study has been undertaken. Related literatures are review before going through this study and most of them found to be quite helpful for conceptual clarity. But they are found on the scattered form and based on personal judgments. Hence after reviewing available literature on the subject matter, this study has tried to accumulate and add available information and to fill the research gap in regard to laws and practices for investors' protection in Nepal.

This study is mainly based on primary data analysis. Besides analyzing the sufficiency of securities laws with regards to investors' protection in Nepal, this study has also emphasized on and analyzed the implementation status of those laws. The institutional arrangements and their performance for protecting investors' interest are descriptively analyzed. Each and every research variables are analyzed for their provisioning in the law and their practice in the field. Loopholes in the provisions of existing securities and other related laws for the effective regulation of the secondary market are descriptively analyzed in order to safeguard the interest of investors in Nepal.

## **CHAPTER-III**

### **RESEARCH METHODOLOGY**

#### **3.1 Research Design**

The research design is the mixture of analytical and descriptive. This study is mainly based on primary data analysis. Opinions of the stakeholders of the securities market system like market intermediaries, listed companies, shareholders and legal and financial experts of the field are analyzed to observe the sufficiency of legal provisions and their implementation in the field for the protection of general investor's interest. The results are analyzed and then interpreted to derive at the conclusion. Most of the materials of the study either empirical or theoretical, are concerned with past and present phenomena and have tried to recommend the reformatory provisions in regards to legal aspect of securities transaction system. The study is also concentrated on the descriptive analysis of the provisions made under Securities Transaction Acts, Rules and Regulations existing presently. The source of data collection is primary as well as secondary as per the need and availability.

#### **3.2The Population**

'Population' or 'Universe' for this study comprises numbers of listed companies, institutional as well as individual shareholders. It also covers Market Intermediaries including Brokers, Issue Manager and Dealers. A number of institutional bodies and Regulatory Authorities such as SEBO/N, NEPSE, ROC and NRB are functioning to safeguard the interest of the investors. They too are also approached for interview but they oppose to provide opinions on government policies as being a government bodies

themselves. Similarly financial and legal experts are also inquired to analyze the sufficiency of laws related to securities transaction and efficiency of concerned bodies with regard to investors' protection in Nepal.

### **3.3 Sampling Procedure**

Judgment sampling procedure has been done in this research work. The total population is stratified into four broad categories as listed companies, market intermediaries, shareholders and experts of the field. Population of each category of respondents has been written in a piece of paper and dropped in a box and 10 names from each population have been taken out non-randomly as sample of the population.

- **Listed Companies:** Out of total 143 listed companies, bank, finance companies, insurance companies, manufacturing companies, hotels and trading companies are selected as population of the listed companies and 10 names in total are selected as sample size. It is assumed that the sectors included in the study represent the phenomenon of whole listed companies.
- **Market Intermediaries:** Market Intermediaries are sub-categorized into four groups: Brokers, Issue Managers, Dealers and Market Makers. Presently there are 23 securities brokers functioning in the securities market of Nepal. Out of them 5 securities brokers are selected as respondents. Similarly, Out of 8 issue managers (7 issue managers and one security dealer) 5 are selected as respondents totaling 10 in all.
- **General Shareholders:** General investors are at large scattered numbers; therefore, 10 individual shareholders who are trading in primary as well as secondary market in Kathmandu valley are used as primary respondents in this

study. It is assumed that the shareholders included in the study can better represent the whole community of general shareholders.

- Experts of the field: The expert group is categorized as legal and financial experts. Legal experts are selected from those law firms within the Kathmandu Valley which are providing services and information on corporate/ company laws. Similarly, teachers of finance, executives of share divisions of banks and companies within the Kathmandu valley are selected as financial experts for this study. In total 10 experts (5 legal and 5 financial) are selected as sample size.

In this way in total 40 respondents are selected non-randomly as sample size from four broad categories. As basically the selected respondents are found in the Kathmandu, the study has been done in and around Kathmandu itself. One person as a representative of the institution is selected as a primary respondent from a single institution or company.

### **3.4 Sources of data**

Data have been collected through primary as well as secondary source of information. All the possible and useful data as available have been used. The sources of data are as follows:

#### **3.4.1 Primary Data**

The primary data have been collected on the basis of responses of various persons and institutions representing the related sectors from market makers, stock brokers, share holders, to experts, lawyers and other personnel related to concern institutions through questionnaire and interview method.

As a primary source of data existing legal arrangements made in the field of securities transaction is reviewed for detailed analysis. The basic laws reviewed are:

- Securities Act, 2006
- Securities Board Regulation, 2006
- Securities Businessperson Regulation, 2006
- Securities Exchange Licensing Regulation, 2006
- Company Act, 2006

### **3.4.2 Secondary Data**

The secondary data have been collected through books, magazines, newspapers, reports, thesis, web sites and official records. Various Acts, laws, Bye-laws, Regulations, guidelines and directives etc. that directly relates to investors' protection are collected as secondary sources of information for the purpose of study.

### **3.5 Procedures/Techniques of Data Collection**

This study is equally based on published as well as primary sources of information.

**Primary data** are collected through structured and open-ended questionnaire from various respondents. The respondent categories are already stated in population and sampling section. Questionnaires are personally presented by hand to all the respondents. Information is also gathered by means of direct interviews with some of the respondents.

On the other hand **secondary data** are collected by reviewing literatures in various libraries related to the subject matter, by making direct visit to offices like SEBO/N, NEPSE and getting published information from there and some are downloaded directly from internet.

### **3.6 Data Analysis**

Analysis forms the main body of any research work. Each and every research variables are analyzed for their provisioning in the law and their practice in the field. The institutional arrangements and their performance for protecting investors' interest are also descriptively analyzed in chapter four.

In order to validate each research question, raw data are summarized in compact form by tabulation in such a way as to facilitate comparisons and show the involved relations. Data are orderly arranged in columns and rows presented mathematically in percentage. The results are analyzed and then interpreted. Findings from analysis of each research variables are observed and presented logically at the end chapter.

### **3.7 Limitations of Methodology**

The study aimed at analyzing adequacy of legal provisions and effectiveness of regulatory institutions arranged for investors' protection. As per the topic of study, the descriptive type of analysis is employed. On the other hand, primary survey is conducted in order to know opinions of various capital market players. Therefore, the design of study is limited to a combination of 'Ex post facto' and 'Survey' research.

Sampling is done non-randomly. Interviews are conducted and it is assumed that the opinions of senior staff of institutions represent their organizations. In case of listed companies it is assumed that the sectors included in the study represent the phenomenon of whole listed companies. Since general investors are at large scattered numbers, the questionnaire are not sent to them. There was also problem of sampling in covering general investors. The analysis and test of data is confined to tabulation, percentage and interpretation.



# **CHAPTER-IV**

## **PRESENTATION AND ANALYSIS**

### **4.1 Presentation and Analysis of Data**

In this chapter existing legal provisions have been extensively analyzed in terms of investor's protection. The primary sources of data has been analyzed to identify the sufficiency of the existing legal provisions under various Acts, Laws, Guidelines and regulations are sufficient in protecting the general investors' interest and their implementation status.

#### **4.1.1 Sufficiency of legal provisions in protecting general investor's interest**

Legal provisions and institutional arrangements are basic infrastructure of capital market development. The protection of investors depends on their adequacy, efficiency and effectiveness of implementation. In this concern many laws and by-laws relating to this system have been applied in the country. Presently there are many legal provisions regarding securities allotment, registration, issue approval, membership etc. But they are not sufficient for the advancement in the security transactions field. Furthermore, many provisional and administrative problems have to be faced while involving in the activities relating to this system. Investors' protection can be ensured only when there are adequate and appropriate legal provisions and there is, efficient and effective regulating body, which can boldly enforce the laws and provisions.

The following table shows the opinion of respondents regarding the sufficiency of legal provisions in protecting general investor's interest.

**Table 4.1: Sufficiency of legal provisions in protecting general investor's interest**

Respondent Category	Number and percentage of respondents						Total	
	Yes		No		Don't Know			
	no.	%	no.	%	no.	%	no.	%
Market Intermediaries	3	7.5	7	17.5	0	0	10	25
Listed Company	5	12.5	5	12.5	0	0	10	25
Shareholders	4	10	5	12.5	1	2.5	10	25
Experts	7	17.5	3	7.5	0	0	10	25
<b>Total</b>	<b>19</b>	<b>47.5</b>	<b>20</b>	<b>50</b>	<b>1</b>	<b>2.5</b>	<b>40</b>	<b>100</b>

*Source: Field Survey, 2008*

Among the 40 respondents, 20 (50%) respondents are of opinion that existing legal provisions are not sufficient in protecting general investor's interest. Among all, 19 (47.5%) respondents are satisfied with the legal provisions of security marker. One respondent (2.5%) out of 40 is found unknown to the existing legal provisions.

While analyzing the responses categorically, large number of (7) market intermediaries are found to be not satisfied with the status of the existing securities laws in protecting general investor's interest in capital market. Half of the listed companies (5) and half of the shareholders think that legal provisions are not adequate enough in protecting investor's interest and the rest half of listed companies and 4 shareholders are is positive about it. Similarly, among the experts, more (7) are found to be positive towards the sufficiency of legal provisions while rests 3 are not satisfied with it. The legal experts are found to have positive inclination towards the

sufficiency of legal provisions than financial experts. The above analysis indicates that even all the stakeholders of the security market themselves are not informed about the laws that exist for protecting investor's interest. But Nepalese security market is not deficient of laws and guidelines in protecting interest of the general investors. So it urge towards identifying some other factor responsible for insecurity of investors in capital market.

#### 4.1.2 Implementation of Securities Laws

Improper implementation of laws and regulation has always been a problem in every field. This same problem also implies in Nepalese security market. There are some laws and provisions for the protection of investors and to regulate capital market efficiently. If the laws are insufficient, we can amend them and issue new regulations and guidelines as per the need. But if they are not implemented properly, then a well developed capital market will be far away dream. The following table shows the opinion of respondents regarding the implementation of securities laws in Nepalese capital market.

**Table 4.2: Implementation of Securities Laws**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Satisfactory		Unsatisfactory		Don't Know			
	no.	%	no.	%	no.	%	no.	%
Market Intermediaries	4	10	5	12.5	1	2.5	10	25
Listed Company	3	7.5	7	17.5	0	0	10	25
Shareholders	3	7.5	5	12.5	2	5	10	25
Experts	4	10	6	15	0	0	10	25
<b>Total</b>	<b>14</b>	<b>35</b>	<b>23</b>	<b>57.5</b>	<b>3</b>	<b>7.5</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

Among 40 respondents, 23 (57.5%) respondents are found to be unsatisfied with the implementation of the legal provisions in security market. Among all, 14 (35%) said that the implementation is satisfactory and remaining 3 (7.5%) are unaware about it.

While analyzing the responses categorically, large numbers of respondents from all four groups are of the opinion that implementation of Securities Laws in Nepalese capital market is unsatisfactory. The most unsatisfied group among four is found to be the listed company. Out of 10 listed companies, 7 are found unsatisfied with the implementation of legal provisions. Among the expert groups, 6 (60%) says that the implementation is unsatisfactory. Even those respondents who gave positive responses regarding the sufficiency of legal provisions are not satisfied with the implementation of those laws.

The above analysis indicates that the implementation of the existing legal provisions for the protection of investor's interest is not satisfactory. Even those respondents who regard that legal provisions are sufficient are unsatisfied with the implementation of those laws. So, as much important as the securities laws for regulation of securities market, so is the proper implementation of those laws.

#### **4.1.3 Broker's engagement in scandalous activities**

Brokers are agents or middle men, who facilitate the buying and selling of securities for investors. They take buy or sell orders from the investors in their own office and execute the transactions in the floor of the exchange. Investors very much rely on the information provided by the brokers regarding the securities transaction. In Nepal, the brokers required to be registered with the Securities Board (SEBO) to perform securities dealing. A broker seeking registration with the Board has to apply through

the stock exchange. But despite this, some brokers are found to be involved in the scandalous activities.

The following table shows the opinion of respondents regarding the broker's engagement in scandalous activities.

**Table 4.3: Broker's engagement in scandalous activities**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Yes		No		Don't Know			
	no.	%	no.	%	no.	%	no.	%
Market Intermediaries	4	10	5	12.5	1	2.5	10	25
Listed Company	8	20	0	0	2	5	10	25
Shareholders	7	17.5	3	7.5	0	0	10	25
Experts	10	25	0	0	0	0	10	25
<b>Total</b>	<b>29</b>	<b>72.5</b>	<b>8</b>	<b>20</b>	<b>3</b>	<b>7.5</b>	<b>40</b>	<b>100</b>

*Source: Field Survey, 2008*

Among all 40 respondents, 29 (72.5%) respondents are found to believe that brokers are engaged in scandalous activities like wash sales, cornering the market, churning, pools and insider trading. The number of respondents who do not agree that brokers are engaged in scandalous activities is 8 (20%). Remaining 3 (7.5%) are found to be unaware of this.

While analyzing the responses categorically, among 10 all (100%) experts firmly believe that brokers are engaged in scandalous activities. Similarly, among 10 listed companies 8 agrees with the opinion of the expert groups and remaining 2 said they don't know about it. Except of 3 shareholders, all 7 are of the same opinion as the expert group i.e, believe in broker's engagement with scandalous activities. But the result is somewhat different with the market intermediaries. Among 10, five market

intermediaries don't believe in broker's engagement with scandalous activities. Brokers themselves are among the sub categories of the market intermediaries and they are not ready to accept their engagement in scandalous activities.

The respondents who believe that brokers are engaged in scandalous activities in securities transaction suggested some factors to address this problem. The suggestions are divided into four factors, A - Strict legal provision; B - Strict monitoring/supervision and regulations; C - Code of conduct/ ethical guidelines; D - Investors' Awareness. This can be shown in table below.

**Table 4.4: Factors responsible for broker's engagement in scandalous activities**

Respondent Category	Number and percentage of respondents								<b>Total</b>	
	A		B		C		D			
	no	%	no	%	No	%	no	%	no	%
Market Intermediaries	0	0	4	13.8	0	0	0	0	4	13.8
Listed Company	2	6.8	5	17	0	0	1	3.4	8	27.6
Shareholders	3	10	2	6.8	1	3.4	1	3.4	7	24.2
Experts	2	6.8	4	13.8	2	6.8	2	6.8	10	34.4
<b>Total</b>	<b>7</b>	<b>23.6</b>	<b>15</b>	<b>51.4</b>	<b>3</b>	<b>10.2</b>	<b>4</b>	<b>13.6</b>	<b>29</b>	<b>100</b>

Source: Field Survey, 2008

Among 29 respondents who believe in broker's engagement with scandalous activities, 7 (23%) suggested for strict legal provision to address this problem. Similarly, 3 (10%) suggested about code of conduct and ethical guidelines and 4 (13%) stressed for investor's awareness. But the larger number, 51% suggested for strict monitoring/supervision and regulations to address this problem.

Security broker's role is very important in the securities transaction system. Investors honestly believe in the information provided by security brokers. The above analysis indicates that numbers of brokers are engaged in the scandalous activities like wash sales, cornering the market, churning, pools and insider trading. And because of some brokers, the reputation and contribution of security brokers has been spoilt. The respondents who believe that brokers are engaged in scandalous activities in securities transaction suggested some factors to address this problem. While ranking these suggestions, the most important suggestion received is strict monitoring/supervision and regulations then strict legal provisions. This indicates that strict monitoring, supervision and regulation is equally important as strict legal provision to control the scandalous activities of securities transaction system. Besides that code of conduct and ethical guidelines is also necessary for effective regulation. No laws can protect any investors if they are not aware and sensitive about scandalous activities of security brokers.

#### **4.1.4 Companies fulfilling their commitments expressed in prospectus**

Prospectus is a document consisting full and accurate information of a company and be issued only after appropriate auditing by concerned authorities. It is the most important means of corporate disclosure. General investors invest their money in primary market on the basis of prospectus of issuing company. But some companies do not fulfill the commitments and information expressed in prospectus.

The following table shows the opinion of respondents regarding the Companies fulfilling their commitments expressed in prospectus.

**Table 4.5: Companies fulfilling their commitments expressed in prospectus**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Yes		No		Don't Know			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	6	15	4	10	0	0	10	25
Listed Company	9	22.5	1	2.5	0	0	10	25
Shareholders	5	12.5	4	10	1	2.5	10	25
Experts	4	10	6	15	0	0	10	25
<b>Total</b>	<b>24</b>	<b>60</b>	<b>15</b>	<b>37.5</b>	<b>1</b>	<b>2.5</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

It was found that, among 40 respondents, 24 (60%) believe that companies fulfill their commitments expressed in prospectus while 15 (37%) don't believe it.

Among the four categories of respondents, except for expert groups, most of the respondents from market intermediaries (15%), listed companies (22%) and shareholders (12%) believe that companies are fulfilling their commitments expressed in prospectus. Among 10, four (40%) respondents believe that companies fulfill their commitments expressed in prospectus while 6 (60%) don't believe it.

The above analysis indicates that most of the listed companies fulfill their commitments expressed in prospectus. But still some companies are not fulfilling them. Because of the strict legal provisions, companies are fulfilling their commitments expressed in prospectus but because of lack of proper supervision and monitoring by the regulating authorities some are just mentioning them in their prospectus instead of implementing in practice.



#### 4.1.5 Malpractices in securities transaction system and protection of Nepalese investors

Investors are in the center of capital market process, and protection of their interest is essential. Investors' protection aims at encouraging shareholders (investors) to invest in the productive sectors through capital market. Investors are protected if they feel that they are protected and facilitated by the concerned regulatory authorities, listed companies and associated investors' organizations. But because of the malpractices in the securities transaction system investors are not protected in Nepalese capital market.

The following table shows the opinion of respondents regarding malpractices in securities transaction system and investor's protection.

**Table 4.6: Nepalese investors are protected from malpractices in securities transaction system**

Respondent Category	Number and percentage of respondents						Total	
	Yes		No		Don't Know			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	3	7.5	7	17.5	0	0	10	25
Listed Company	0	0	10	25	0	0	10	25
Shareholders	1	2.5	9	22.5	0	0	10	25
Experts	1	2.5	9	22.5	0	0	10	25
<b>Total</b>	<b>5</b>	<b>12.5</b>	<b>35</b>	<b>87.5</b>	<b>0</b>	<b>0</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

According to the field study, out of total 40 respondents, 35 (87.5%) respondents strongly believe that Nepalese investors are not protected from malpractices in

securities transaction system. Whereas remaining 5 (12.5%) respondents are found positive about it.

Among the four categories of respondents, all most all respondents from listed companies (10), shareholders (9) and experts (9) don't believe that Nepalese investors are protected form malpractices in securities transaction system. Very few respondents from market intermediaries (3) are found with the positive answer.

The respondents who believe that Nepalese investors are not protected form malpractices in securities transaction system suggested some factors responsible for this. Those factors are divided into six broad categories, A - Insufficient Laws; B - Improper implementation of legal provisions; C - Poor Regulation; D - Under developed transaction system; E - Lack of investors' awareness; F - Government policy. This can be shown in table below.

**Table 4.7: Responsible Factors for Malpractices in securities transaction system**

Factor	Respondent Category									
	Market Intermediaries		Listed Company		Shareholders		Expert		Total	
	No	%	No	%	No	%	No	%	No	%
A	1	2.8	0	0	3	8.6	2	5.7	<b>6</b>	<b>17.1</b>
B	0	0	3	8.6	2	5.7	4	11.4	<b>9</b>	<b>25.7</b>
C	2	5.7	2	5.7	2	5.7	1	2.8	<b>7</b>	<b>20</b>
D	2	5.7	0	0	0	0	1	2.8	<b>3</b>	<b>8.6</b>
E	3	8.6	3	8.6	1	2.8	1	2.8	<b>8</b>	<b>22.8</b>
F	1	2.8	0	0	1	2.8	0	0	<b>2</b>	<b>5.7</b>
<b>Total</b>	<b>9</b>	<b>25.7</b>	<b>8</b>	<b>22.9</b>	<b>9</b>	<b>25.7</b>	<b>9</b>	<b>25.7</b>	<b>35</b>	<b>100</b>

*Field Survey: 2008*

Among 35 respondents who believe that Nepalese investors are not protected from malpractices in securities transaction system, 9 (25%) regard improper implementation of legal provisions as major factor responsible for this problem. Similarly, 8 (23%) consider lack of investors' awareness, 7 (20%) consider poor regulation 6 (17%) observe insufficient laws. Few respondents believe that under developed transaction system, Government policies are also responsible for this.

The above analysis indicates that Nepalese investors are not protected from the malpractices in the security transaction system. So it is necessary to identify major factors for it and address them explicitly. The respondents who believe that Nepalese investors are not protected from malpractices in securities transaction system suggested some factors responsible for this. Improper implementation of legal provisions is identified as a major factor responsible for the malpractices in the securities transaction system. Lack of investor's awareness, poor regulation and insufficient laws respectively are other factors responsible for it. Similarly, Nepalese investor's are suffering because of government policy and underdeveloped transaction system.

#### **4.1.6 Adequacy of 'Listing Requirements and Listing Practice' of NEPSE in protecting investors' interest**

For effective regulation of securities market and for the protection of investor's interest NEPSE issue the listing requirements for the companies that are interest to issue their share in secondary market. Only those companies which fulfill the listing requirements and listing practices of NEPSE can issue their share. Securities Exchange Regulation, 1993 has made provisions for the listing fees and annual listing renewal fees for a corporate body. Upto the year 2007 November, there were 139 listed companies in the Nepalese securities market.

The following table shows the opinion of respondents regarding listing requirements and listing practice of NEPSE.

**Table 4.8: Adequacy of 'Listing Requirements and Listing Practice' of NEPSE in protecting investors' interest**

Respondent Category	Number and percentage of respondents						Total	
	Yes		No		Don't Know			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	6	15	4	10	0	0	10	25
Listed Company	8	20	2	5	0	0	10	25
Shareholders	5	12.5	5	12.5	0	0	10	25
Experts	5	12.5	5	12.5	0	0	10	25
<b>Total</b>	<b>24</b>	<b>60</b>	<b>16</b>	<b>40</b>	<b>0</b>	<b>0</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

Among the 40 respondents, 24 (60%) respondents are of opinion that current 'Listing Requirements and Listing Practice' of Nepal Stock Exchange (NEPSE) is adequate in protecting investors' interest. While, 16 (40%) respondents don't find it adequate enough.

While analyzing the responses categorically, large number of (8) listed companies are found to be satisfied with current listing requirements and listing practice' of NEPSE in protecting general investor's interest. Fifty percent of shareholders and experts are of the same opinion and rest half against it. 4 market intermediaries out of 10 are not satisfied with the current listing requirements and listing practice of NEPSE.

The above analysis indicates that listing requirement and listing practices of Nepal Stock Exchange is adequate in protecting investor's interest. But still there are few efforts and actions that should be done to make it more practical and protective to investor's rights.

#### 4.1.7 Level of investor's awareness about Securities laws, Bye-laws, Regulations and Guidelines

The securities transaction system is directly related to laws and rules. Many laws and by-laws relating to this system have been applied in Nepal. Presently there are many legal provisions regarding securities allotment, registration, issue approval, membership etc. The government has adopted many financial policies in order to provide effective services and facilities to the investors. But investors are unaware about Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions. Investors' awareness regarding legal provision is important for investors' protection more than anything else. If they are aware and informed about the legal provisions they can protect themselves from malpractices in securities transaction system.

The following table shows the level of investor's awareness about Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions.

**Table 4.9: Level of investor's awareness about Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions**

Respondent Category	Number and percentage of respondents						Total	
	Yes		No		Don't Know			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	0	0	9	22.5	1	2.5	10	25
Listed Company	0	0	10	25	0	0	10	25
Shareholders	3	7.5	7	17.5	0	0	10	25
Experts	1	2.5	9	22.5	0	0	10	25
<b>Total</b>	<b>4</b>	<b>10</b>	<b>35</b>	<b>87.5</b>	<b>1</b>	<b>2.5</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

According to the field study, out of total 40 respondents, 35 (87.5%) respondents strongly believe that Nepalese investors are not aware about Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions. Whereas remaining 4 (10%) respondents are found positive about it and 1 (2.5%) don't have any idea about it.

Among the four categories of respondents, almost all respondents from listed companies (10), market intermediaries (9) and experts (9) don't believe that Nepalese investors are aware about Securities laws, Bye-laws, Regulations and Guidelines. Very few shareholders (3) are found with the positive answer.

The above analysis indicates that investors are not aware about the about Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions. Most of the investors invest in manipulation and rumors of the market. They do not even know what law exists with what provision for the protection of the investors. This may be because of the complexities and unclarity of the legal provisions, investors are not aware about them.

#### **4.1.8 Performance of the Company Board to hear and dispose lawsuits and advice to Government**

Government has formed a separate regulating body 'The Company Board' for the regulation of securities transaction system. The company board is authorized to hear and dispose lawsuits and advice to Government.

The following table shows the opinion of respondents regarding performance of the Company Board.

**Table 4.10: Performance of the Company Board to hear and dispose lawsuits and advice to Government**

Respondent Category	Number and percentage of respondents								Total	
	Excellent		Satisfactory		Unsatisfactory		Don't Know			
	No	%	No	%	No	%	No	%	No	%
Market Intermediaries	0	0	3	7.5	3	7.5	4	10	10	25
Listed Company	0	0	6	15	2	5	2	5	10	25
Shareholders	0	0	6	15	2	5	2	5	10	25
Experts	0	0	6	15	3	7.5	1	2.5	10	25
<b>Total</b>	<b>0</b>	<b>0</b>	<b>21</b>	<b>52.5</b>	<b>10</b>	<b>25</b>	<b>9</b>	<b>22.5</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

Above table shows that, 21 (52%) respondents are satisfied with the performance of Company Board to hear and dispose lawsuits and advice to Government. No respondents found the performance of Company Board in this regard excellent. Among 40 respondents, 10 (25%) respondents are unsatisfied with the performance of Company Board. Whereas, nearly same number, 9 (22%) respondents are not informed about its performance.

Among the four categories of respondents, listed companies, shareholders and experts are equally (6) satisfied with performance of Company Board. But very few (3) market intermediaries are satisfied with this performance. Most of the market intermediaries are found uninformed about its performance.

The above analysis indicates that performance of the Company Board is satisfactory to hear and dispose lawsuits and advice to Government. Few are unsatisfied with its performance. Even the stakeholders of the security themselves market are unaware

and uninformed about the roles and the performance of Company Board for the regulation of capital market effectively. Some do not even know about the involvement of the Company Board to facilitate the security transaction system. So it is necessary to inform and aware investors about its role and performances.

#### **4.1.9 Ranking the level of effectiveness of regulation made by Securities Board (SEBO)**

The major regulatory framework for the securities market is provided by Securities Act, 2006, which has given authority to the SEBO/N for the regulation of securities market. As per the Act, the major objectives of SEBO/N are to regulate issue and trading of securities and market intermediaries, promote the market and protect investor's rights. Besides, the duties and responsibilities of SEBO are to register securities and approve prospectus of public companies, provide license to operate stock exchange, to provide license to operate securities business, permit operation of collective schemes and investment funds, draft regulation, issue directives and guidelines and appropriate bylaws of stock exchanges and securities business activities. Take enforcement measures to ensure market integrity, frame policies and programmes relating to securities markets and advice to the government in this regard. Thus the responsibility of developing and regulating the securities markets in Nepal rests solely on SEBO (Thapa, 2007)

The effectiveness of regulation made by Securities Board of Nepal (SEBO/N) has been analyzed regarding listed companies, Stock Exchange (NEPSE), market intermediaries and regulation amendment/ guidelines issue.



#### 4.1.9.1 Effectiveness of regulation made by SEBO regarding Listed Companies

For effective regulation of securities market and for the protection of investor's interest NEPSE issue the listing requirements for the companies that are interest to issue their share in secondary market. Only those companies which fulfill the listing requirements and listing practices of NEPSE can issue their share. Securities Exchange Regulation, 1993 has made provisions for the listing fees and annual listing renewal fees for a corporate body. Upto the year 2007 November, there were 139 listed companies in the Nepalese securities market.

The following table shows the level of effectiveness of regulation made by SEBO regarding listed companies.

**Table 4.11: Effectiveness of regulation made by SEBO regarding Listed Companies**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Highly effective		Moderately effective		Ineffective			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	0	0	6	15	4	10	10	25
Listed Company	3	7.5	7	17.5	0	0	10	25
Shareholders	0	0	10	25	0	0	10	25
Experts	1	2.5	9	22.5	0	0	10	25
<b>Total</b>	<b>4</b>	<b>10</b>	<b>32</b>	<b>80</b>	<b>4</b>	<b>10</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

According to the field study, out of total 40 respondents, 32 (80%) respondents rank the level of effectiveness of regulation made by SEBO regarding listed companies to be moderately effective. Whereas, the respondents who said it highly effective and ineffective is equal (10%).

Among the four categories of respondents, almost all respondents from shareholders (10), expert (9) and most from market intermediaries and listed companies regard the regulation made by SEBO moderately effective regarding listed companies. Few listed companies (3) consider it highly effective whereas 4 market intermediaries completely consider it ineffective.

#### **4.1.9.2 Effectiveness of regulation made by SEBO regarding Stock Exchange (NEPSE)**

The objective of the SEBO of Nepal is to promote and protect the interest of investors by regulating the securities markets. SEBO regulate, monitor, direct, control and coordinate the entire capital market. NEPSE is the sole organization for the operation of secondary market for listed companies. NEPSE is working under Security Board Nepal (SEBO/N). Rules and regulations need to be followed by the issuing companies, investors and brokers in the securities markets of Nepal.

The following table shows the level of effectiveness of regulation made by SEBO regarding NEPSE.

***Table 4.12: Effectiveness of regulation made by SEBO regarding NEPSE***

Respondent Category	Number and percentage of respondents						Total	
	Highly effective		Moderately effective		Ineffective			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	4	10	4	10	2	5	10	25
Listed Company	1	2.5	9	22.5	0	0	10	25
Shareholders	1	2.5	7	17.5	2	5	10	25
Experts	3	7.5	7	17.5	0	0	10	25
<b>Total</b>	<b>9</b>	<b>22.5</b>	<b>27</b>	<b>67.5</b>	<b>4</b>	<b>10</b>	<b>40</b>	<b>100</b>

*Source: Field Survey, 2008*

According to the field study, out of total 40 respondents, 27 (67%) respondents rank the level of effectiveness of regulation made by SEBO regarding NEPSE to be moderately effective. Whereas, the number of respondents who said it highly effective is 9 (22%) and who said it ineffective is 4 (10%).

Among the four categories of respondents, almost all listed companies (9), and most of the shareholders (7), experts (7) and market intermediaries (4) regard the regulation made by SEBO regarding NEPSE moderately effective. Some expert (3) and market intermediaries (4) regard it highly effective whereas few shareholders (2) and market intermediaries (2) consider it ineffective.

#### **4.1.9.3 Effectiveness of regulation made by SEBO regarding Market Intermediaries**

Market intermediaries play a vital role for the effective functioning of the securities transaction system. Key market intermediaries are brokers, issue manager, security dealers and market makers. They facilitate the selling and buying process of securities, execute transaction in the floor of the stock exchange, hold securities for safe keeping, provide information and advice relating to investment alternatives, extend margin loans, facilitating short sales, help issuer companies to raise funds, helps in procedure relating to issuing securities etc. SEBO is regularly regulating, monitoring and supervising these market intermediaries. The brokers required to be registered with the Securities Board (SEBO) to perform securities dealing. A broker seeking registration with the Board has to apply through the stock exchange. Similarly, only those companies registered with SEBO are qualified to perform as issue manager. But despite these efforts some market intermediaries are not effectively providing services to the investors and the issuing companies.

The table below shows the level of effectiveness of regulation made by SEBO regarding market intermediaries.

**Table 4.13: Effectiveness of regulation made by SEBO regarding Market Intermediaries**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Highly effective		Moderately effective		Ineffective			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	2	5	5	12.5	3	7.5	10	25
Listed Company	0	0	8	20	2	5	10	25
Shareholders	0	0	7	17.5	3	7.5	10	25
Experts	0	0	6	15	4	10	10	25
<b>Total</b>	<b>2</b>	<b>5</b>	<b>26</b>	<b>65</b>	<b>12</b>	<b>30</b>	<b>40</b>	<b>100</b>

*Source: Field Survey, 2008*

According to the field study, out of total 40 respondents, 26 (65%) respondents rank the level of effectiveness of regulation made by SEBO regarding NEPSE to be moderately effective. Whereas, the number of respondents who said it highly effective is 2 (5%) and who said it ineffective is 12 (30%).

Among the four categories of respondents, most of the listed companies (8), shareholders (7) and half of the market intermediaries (5) and experts (6) regard the regulation made by SEBO regarding market intermediaries moderately effective. Some expert (4), shareholders (3), listed companies (2) and market intermediaries themselves (3) regard it completely ineffective. Only 2 market intermediaries regard it to be highly effective.

#### 4.1.9.4 Effectiveness of regulation made by SEBO regarding Regulation Amendment/ Guidelines issue

SEBON drafted the Securities Board of Nepal Regulation, Stock Exchange Regulation, Broker/Dealer Regulation and the Securities Registration Regulation for the implementation of the new Securities Act, 2006. SEBO is empowered to issue guidelines and directives to the stock exchange, issuing company and brokers.

The following table shows the level of effectiveness of regulation made by SEBO regarding regulation amendment/ guidelines issue.

**Table 4.14: Effectiveness of regulation made by SEBO regarding Regulation Amendment/ Guidelines issue**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Highly effective		Moderately effective		Ineffective			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	4	10	4	10	2	5	10	25
Listed Company	4	10	6	15	0	0	10	25
Shareholders	2	5	8	20	0	0	10	25
Experts	4	10	5	12.5	1	2.5	10	25
<b>Total</b>	<b>14</b>	<b>35</b>	<b>23</b>	<b>57.5</b>	<b>3</b>	<b>7.5</b>	<b>40</b>	<b>100</b>

*Source: Field Survey, 2008*

From the table above, among total 40 respondents, 23 (57%) respondents rank the level of effectiveness of regulation made by SEBO regarding regulation amendment/ guidelines issue to be moderately effective. Whereas, the respondents who said it highly effective is 14 (35%) and who said it ineffective is only 3 (7.5%).

Among the four categories of respondents, most of the shareholders (8) and half of the experts (5), listed companies (6) and market intermediaries (4) regard the regulation made by SEBO regarding market intermediaries moderately effective. Effectiveness of SEBO regarding regulation amendment/ guidelines issue is found highly effective as compared to other tasks. Some expert (4), shareholders (2), listed companies (4) and market intermediaries (4) regard it completely to be highly effective. Only 2 market intermediaries and one expert among 10 regard ineffective.

The regulation made by Securities Board of Nepal (SEBO/N) is moderately effective regarding listed companies, Stock Exchange (NEPSE), market intermediaries and regulation amendment/ guidelines issue. The analysis further shows that, SEBO's performance is quite satisfactory regarding regulation amendment/ guidelines issue. The performance of SEBO in regulating NEPSE is good enough. But it is not that satisfactory in regulating the market intermediaries specifically security brokers. The continuous coordinated effort is necessary among these regulatory institutions for the well developed capital market.

#### **4.1.10 Effectiveness of coordinated effort of Regulatory Institutions in protecting general investors' interest**

A number of institutional bodies like Securities Board Nepal (SEBO/N), Nepal Stock Exchange (NEPSE), Office of Company Registrar (OCR), Shareholders Association of Nepal (SAN) are established to practice securities trading in Nepal in an international standard. Even though these executing and regulatory bodies are functioning, the voice of malpractices, securities fraud, misleading manipulative investors' defraud is still on the up. Though the roles of these regulatory institutions differ from one another they cannot function in isolation. So a coordinated effort is necessary in and among these institutions to protect the general investor's interest and effectively regulate the securities market.

The following table shows the opinion of respondents regarding effectiveness of regulatory institutions in protecting general investors' interest.

**Table 4.15: Effectiveness of coordinated effort of Regulatory Institutions in protecting general investors' interest**

Respondent Category	Number and percentage of respondents						<b>Total</b>	
	Yes		No		Don't No			
	No.	%	No.	%	No.	%	No.	%
Market Intermediaries	3	7.5	7	17.5	0	0	10	25
Listed Company	7	17.5	3	7.5	0	0	10	25
Shareholders	5	12.5	4	10	1	2.5	10	25
Experts	6	15	4	10	0	0	10	25
<b>Total</b>	<b>21</b>	<b>52.5</b>	<b>18</b>	<b>45</b>	<b>1</b>	<b>2.5</b>	<b>40</b>	<b>100</b>

Source: Field Survey, 2008

Above table shows that among 40 respondents, 21 (52%) respondents are satisfied with coordinated effort of regulatory institutions in protecting general investors' interest. Nearly half, 18 (45%), respondents are negative towards the effort made by regulatory institutions. Only one (2.5%) respondent is not informed about it.

Among the four categories of respondents, more listed companies (7), half of the shareholders (5), experts (6) and few market intermediaries (3) are more positive towards the performance of regulatory authorities. Large numbers of market intermediaries (7) and some shareholders (4), listed companies (3) and experts (4) are not satisfied with the coordinated effort of these regulating authorities.

The above analysis indicates that existing regulatory institutions; SEBO/N, ROC, NRB, Company Board and NEPSE, collectively and coordinately are effective and

successful in protecting general investors' interest. But still the voice of malpractices, securities fraud, misleading manipulative investors' defraud is still on the up.



# **CHAPTER-V**

## **SUMMARY, CONCLUSION AND RECOMMENDATION**

### **5.1 Summary**

The main objective of this study is to identify and explore the sufficiency and effectiveness of the existing legal arrangements for investors' protection in Nepalese capital market and to analyze the trend of implementation of those legal provisions in regard to investors' protection.

The investors are in the center of capital market process, and protection of their interest is essential, otherwise they will run away from the capital market causing problems in the capital formation and hence in the national economy. Thus the issue of investors' protection has greater relevance in today's dynamic, turbulent and global business environment. Investors' protection aims at encouraging shareholders (investors) to invest in the productive sectors through capital market. Investors are protected if they feel that they are protected and facilitated by the concerned regulatory authorities, listed companies and associated investors' organizations. Investors' ultimate protection can be regarded as safeguard of their investment on sustainable basis, which is most essential to sustain a capital market in the long run. Further, investors' protection can be maintained through fair rate of return on investment, liquid and efficient market, timely disclosure of information, avoidance of insider trading, prompt share transfer facility, holding of regular Annual General Meetings (AGMs), share transfer, voting rights, an appreciation in the value of their capital invested and of course, sufficient legal provisions and their execution.

The securities transaction system is directly related to laws and rules. The protection of investors depends on their adequacy, efficiency and effectiveness of implementation. In this concern many laws and by-laws relating to this system have been applied in the country. Presently there are many legal provisions regarding securities allotment, registration, issue approval, membership etc. But they are not sufficient enough for the advancement in the security transactions field. Furthermore, the securities laws are unclear and inadequate from several aspects. Process and procedure for enforcement and investigation in securities legislations are not clear. Due to inadequate legal provisions, the regulator can not review and make further inquiry into the financial reports submitted by issuer and listed companies. Some of the major legal provisions relating to securities transactions are Companies Act, 2006, Securities Act, 2006, Securities Exchange Regulations, Securities Listing By- laws, Guidelines etc.

A number of institutional bodies like Securities Board Nepal (SEBO/N), Nepal Stock Exchange (NEPSE), Office of Company Registrar (OCR), Shareholders Association of Nepal (SAN) and listed companies are established to practice securities trading in Nepal in an international standard. But the problem of investors' protection still remains unsolved. Literatures show that there are number of areas where investors' protection is lacking.

We do not have a long history of securities transaction system. Further, securities laws and investors' protection is still a new concept in Nepal. As being a specific aspect of securities transaction, it has not been able to gather much attention for itself. There are very few studies done on this subject. So this study aims on analytically and

descriptively identifying the areas where the investors' protection is lacking in existing laws and weakness of execution bodies.

Following are the major findings of this study:

- Investors' protection can be ensured only when there are adequate and appropriate legal provisions and there is, efficient and effective regulating body, which can boldly enforce the laws and provisions.
- There are many legal provisions regarding securities allotment, registration, issue approval, membership etc.
- Stakeholders of the security market themselves are not informed about the laws that exist for protecting investor's interest.
- Implementation of the existing legal provisions for the protection of investor's interest is not satisfactory. As much important as the securities laws for regulation of securities market, so is the proper implementation of those laws.
- Brokers are engaged in the scandalous activities like wash sales, cornering the market, churning, pools and insider trading.
- Strict monitoring, supervision and regulation are equally important as strict legal provision to control the scandalous activities of securities transaction system.
- Some companies are fulfilling their commitments expressed in prospectus but because of lack of proper supervision and monitoring by the regulating authorities they are not implementing in practice.
- Nepalese investors are not protected from the malpractices in the security transaction system.

- Improper implementation of legal provisions is identified as a major factor responsible for the malpractices in the securities transaction system. Lack of investor's awareness, poor regulation and insufficient laws respectively are other factors responsible for it. Similarly, Nepalese investor's are suffering because of government policy and underdeveloped transaction system.
- Listing requirement and listing practices of Nepal Stock Exchange is adequate in protecting investor's interest. But it is necessary to make it more practical and protective to investor's rights.
- Investors are not aware about the Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions. Because of the complexities and unclarity of the legal provisions, investors are not aware about them.
- Performance of the Company Board is satisfactory to hear and dispose lawsuits and advice to Government.
- The regulation made by Securities Board of Nepal (SEBO/N) is moderately effective regarding listed companies, NEPSE, market intermediaries and regulation amendment/ guidelines issue.
- SEBO's performance is quite satisfactory regarding regulation amendment/ guidelines issue. The performance of SEBO in regulating NEPSE is good enough. But it is not that satisfactory in regulating the market intermediaries specifically security brokers.
- Existing regulatory institutions; SEBO/N, ROC, NRB, Company Board and NEPSE, collectively and coordinately are effective and successful in protecting general investors' interest.

## 5.2 Conclusion

As this study is concentrated to analyze the sufficiency of existing securities laws for the protection of investor's in Nepal, it can be concluded that there are many legal provisions regarding securities allotment, registration, issue approval, membership etc. which are sufficient for the protection of general investor's interest. The amendment of Securities Act 2006, Securities Board Regulation, 2006, Securities Businessperson Regulation, 2006, Securities Exchange Licensing Regulation, 2006, Company Act, 2006 is a landmark step of Government of Nepal for the regulation of security market. But because of lack of effective implementation investors are subjected to the malpractices and fraudulent activities in security market. Stakeholders of the security market themselves are not informed about the laws that exist for protecting investor's interest. Some security brokers are engaged in the scandalous activities like wash sales, cornering the market, churning, pools and insider trading. But regulatory authorities are not paying proper attention towards it. So strict monitoring, supervision and regulation are equally important as strict legal provision to control the scandalous activities of securities transaction system. It can also be concluded that because of the complexities and unclarity of the legal provisions investors are not aware about the Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions.

Improper implementation of legal provisions is identified as a major factor responsible for the malpractices in the securities transaction system. Lack of investor's awareness, poor regulation and insufficient laws respectively are other factors responsible for it. Similarly, Nepalese investor's are suffering because of government policy and underdeveloped transaction system. Effective implementation of the legal

provision is possible through the coordinated effort of existing regulatory institutions; SEBO/N, ROC, NRB, Company Board and NEPSE.

### **5.3 Recommendations**

This study indicates that because of ineffective implementation of legal provisions is the main barrier for the protection of investor's interest in Nepalese security market and because of the complexities and unclarity of the legal provisions investors are not aware about the Securities laws, Bye-laws, Regulations and Guidelines while making investment decisions. There are some regulatory authorities for the proper regulation of securities so there is need for a coordinated effort among these institution for the proper implementation and interpretation of legal provisions and frequent monitoring and supervision of the security market and its stakeholders.

On this basis of the findings of the study the following recommendations can be suggested to regulatory institution for effective coordination:

1. Regulatory Institution must have coordination among them before issuing any new guidelines.
2. Guidelines should be issued for long term purpose.
3. Regulatory Institution should create awareness among investors by organizing various trainings and seminars.
4. SEBO/N should come forward actively to regulate the stock market and to protect the interest of general investors.
5. Laws and guidelines have to be updated on the regular basis to meet the changing demand.

6. There should be proper coordination between and among the regulatory authorities.
7. Some stakeholders don't even know about the involvement of the Company Board to facilitate the security transaction system. So it is necessary to inform and aware investors about its role and performances.

SEBO's performance is quite satisfactory regarding regulation of NEPSE. Listing requirement and listing practices of Nepal Stock Exchange is adequate in protecting investor's interest. But it is necessary to make it more practical and protective to investor's rights.

Some recommendations to NEPSE regarding this area:

1. NEPSE should come forward more actively to take actions upon the defaulter companies.
2. Adequate law of listing practice should be brought.
3. Strong regulation is required.
4. Sufficient monitoring and supervision is required.