The algebra of justice

All ill-gotten gains of scamsters and fines paid by them should be redistributed among investors who lost out

In the IDFC IPO, Roopalben and others gained Rs 20 crore by cornering shares meant for small investors

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It is good to unearth a scam. It is good to reprimand the scamsters and initiate civil and criminal proceedings against them. Still, it's not enough if the guilty gets to keep their ill-gotten gains, while innocent investors absorb losses. Since such measures offer little help to investors who have lost money in a scam, it's only fair that such dishonest gains are used to compensate affected investors.

So far, all such gains and penalties went to the all-purpose Consolidated Fund of India. Now, they will go to the Investor Protection Fund with Sebi, the creation of which was announced in Budget 2006, and will be used to educate and protect investors. In capital market frauds where it is not possible to identify investors who lost money, fines and unlawful profits should indeed go to this fund. But in cases where it is possible to identify investors who lost out, compensation should be provided to them.

Use the IPO scam…

The recent IPO demat scam is one such instance. Here, a handful of investors like Roopalben Panchal filed multiple applications and used benami demat accounts to corner huge quantities of shares from the quota reserved for small investors. Investors with multiple applications can be easily identified, as they were by SEBI in the IDFC and Yes Bank IPOs.

The registrar can then remove these fraudulent applications, and draw up a fresh basis of allotment, based on which it can be identified which successful applicants get more shares and which unsuccessful applicants get some allotment. This process should establish the right beneficiaries of any compensation. When it comes to deciding the method of compensation, some fine-tuning is called for. There are three possible scenarios.

- If shares are lying in the demat accounts of the scamsters, they should be reallocated to affected investors at the issue price. The lead manager should make an offer to investors, specifying the number of additional shares they are entitled to. Interested investors would be required to pay the requisite amount at some designated banks by a certain date and the shares will be subsequently credited to their demat account. Unaccepted shares would be sold in the market and the resultant amount credited to the Investor Protection Fund. Alternatively, all shares lying in the demat account of the scamsters can be sold in the market and the proceeds redistributed among affected investors. It is not the best option if a large number of shares are to be sold – it could depress the share price.

- If scamsters have sold the shares. attach their ill-gotten gains and distribute it to investors who lost out. Alternatively, one could force scamsters to buy the number of shares they have sold, and allot these to affected investors. This might not be a feasible option, as large purchases might push up the share price.

- In cases where some shares have been sold and some are lying in demat accounts, both propositions described above can be applied.

  The lead manager or registrar of the issue can be mandated to carry out the above exercise, the cost of which can be deducted from the total amount available for distribution.

…to set precedents

Extending this argument, fines imposed by other regulatory bodies on intermediaries should also be distributed among losing investors. After all, these intermediaries erred to deprive small investors of their rightful share. So, in the recent IPO demat scam, the fines levied by the RBI (Reserve Bank of India) on some banks for the lack of due diligence should be distributed among investors who lost out.

Some might argue that, in most cases, the compensation each small investor receives might be very small -- and therefore, not worth the effort. First of all, the total amount itself could be large. In the IDFC IPO, 62 million shares, or 10 per cent of the issue, was cornered by Roopalben and others, and their profits amounted to around Rs 20 crore. That's not small. In any case, what is a small amount for big entities might be big for small investors.

Redistribution of unlawful profits and fines will give the scam-ravaged and disillusioned small investors a sigh of relief that regulators care for them. It will give them some succour that even if they are gypped, they might get some compensation in some cases. In some capital market frauds, the compensation may even accrue to large investors, as a system like this will not be able to differentiate between investors. And the knowledge that their ill-gotten gains can be snatched away will serve as a greater deterrent for those who are scheming to bend the rules to unlawfully profit from the market.