Regulatory Environment of Capital Market: A Study in Bangladesh

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Abstract: The regulatory framework of the capital market of Bangladesh comprises Parliament, the Ministry of Finance, the Securities and Exchange Commission (SEC), the Dhaka Stock Exchange Ltd. (SEC) and the Chittagong Stock Exchange (CSE). The Bangladesh Securities and Exchange Commission (BSEC) is the authority to monitor and control the activities of the stock exchanges of Bangladesh. The BSEC is controlled by the Ministry of Finance which is obviously empowered by the Parliament. In spite of the presence of structured and strong regulatory authorities, surveillant activities of BSEC and DSE and electronic settlement of shares, it is to be emphatically noted that the capital market had the bitter experience of a nightmarish economic explosion in the late 2010 and the early 2011 and the regulatory bodies are still in the failure doldrum zone to regulate the capital market of Bangladesh though a good number of laws are in force to regulate the functioning of the stock market mechanisms. The research will explore the loopholes existing in the statutes, ordinances and rules specifically regarding the efficacy of the regulation of the capital market. The critical investigation and analyses of the regulatory framework are also the prime concern of this research. At the end of the research, several recommendations have been categorily made to improve the regulation of the capital market for a more genuinely effective overall performance.

Keywords: Regulatory, Environment, Capital Market, Stock Exchange, Bangladesh.
1. Introduction

It is an undeniable fact that the stock exchange has enormously helped to mobilize the capital of the country as it ensures the sound economic development of the country. The capital market of Bangladesh is one of the smallest markets in Asia but the third largest in the South-Asian region. Bangladesh has two full-fledged automated stock exchanges, namely, the Dhaka Stock Exchange Ltd. (DSE) and the Chittagong Stock Exchange (CSE) whereas the Dhaka Stock Exchange Ltd. is the prime bourse of the country. Through its highly fault-tolerant automated trading system, the exchange can offer facilities for smooth, transparent and highly efficient provisions for secondary market activities of shares, debentures and wide varieties of other securities. Managed by a 25-member (13 after Demutualization) strong Board of Directors, the overall operations of the exchange are professionally run by a team of qualified executives. The bourse at present offers the trading facilities of 533 securities. With a nationwide membership of over 250 brokers and dealers, the DSE espouses the shared vision of Bangladeshi businesses all over the country. The exchange maintains the lead in providing the perfect launch pad to raise capital by mobilizing savings of the people in general to set up large industries. There are a good number of statutes, ordinances, rules and regulations dealing with the capital market in Bangladesh. However, sometimes the laws are not adequate to properly regulate the functions of a capital market. This research will critically analyze the existing laws and will finally offer some recommendations on a good governance of the capital market in Bangladesh.

2. Applicable Acts, Rules and Regulations

2.1 The Securities and Exchange Ordinance 1969

There is a useful provision under this act to check on the share market fluctuating bubble, not to mention the rampant and unscrupulous market manipulations. This is related to a short-selling which literally means the sales of shares before purchasing it.
In easy terms, investors at first purchase some shares when the price of those are lower and sell them when the price goes up. In the case of a short selling, if the investor anticipates the price will fall in the near future, they can sell their shares and then repurchase them when the price moves in their favour. This method may cause a temporary imbalance of price structure as a form of abnormality in the market; hence, prohibition of short-selling is applicable under this act. According to this act, no director or officer of an issuer of a listed equity security and no person who is directly or indirectly the beneficial owner of not less than ten percents of such securities shall practice directly or indirectly in short-selling such securities.¹

This act also attempts to check the insider trading and trading by directors, officers and principal shareholders. It requires any director or officer of an issuer of a listed equity security or any person who is directly or indirectly the beneficial owner of not less than ten percents of such securities shall make any gain by the purchase and sale, or the sale and purchase, of any such security within a period of less than six months, wherein such director or officer or beneficial owner shall make a report and tender the amount of such gain to the issuer.²

Secrecy maintenance is of the utmost importance for the companies listed in the stock exchange as this law vehemently emphasizes on the maintenance of secrecy by mentioning, “No person shall, except with the permission of the Commission, communicate or otherwise disclose to any person not legally entitled thereto any information which has been entrusted to him or which he has obtained or to which he has access in the course of the performance of any functions under this Ordinance.”³ For the breach of secrecy, this law provides the provision for penalty. For disclosure of information, the law states:

(1) The disclosure of any information in contravention of section 19 or 19A for the purpose of making profit through insider trading shall be an offence.
(2) Whoever contravenes sub-section (1) shall be punishable with imprisonment for a term which may extend to five years, or with a fine not exceeding taka five lakh, or with both.4

Any fraudulent act is prohibited by this law wherein there is another provision of penalty for fraudulent activities wherein it is specifically mentioned that whoever contravenes the provisions related to the prohibition of the fraudulent activities shall be punishable with imprisonment for a term which may extend to five years, or with a fine which shall not be less than five lakh taka or with both.5

This ordinance empowered the commission to make rules to implement the purposes of this ordinance by notification in the official Gazette.6 It also empowered the Stock exchanges to make regulations, subject to the previous approval of the Commission, not inconsistent with the rules to implement the purposes of this Ordinance.7

2.2 The Securities and Exchange Rules 1987

This rule defines the qualifications of members of the SEC, in terms of the manner of transaction of the members' business and the maintenance of consolidated customers' accounts including the submission of periodical returns by the stock exchange, submission of annual report by the stock exchange, listing of a security and submission of annual report by the issuers. It further emphasizes on the risk-based capital adequacy requirements according to which, a member of a stock exchange shall at all times maintain a net capital balance in the capital account of an amount which is not less than one hundred thousand taka8 for the purpose of assurance of the sufficiency of available funds to maintain the business transactions with the tacit implication that the aggregate indebtedness ratio between the net capital and the aggregate liabilities shall, at no time, exceed the ratio of 1:209 or 5%. Nonetheless, this rule may expose the members of the stock exchange to more liabilities which incidentally may create a conducive situation for unscrupulous exploitation on the vulnerability of the financial position of the members of the stock exchange.
2.3 Bangladesh Securities & Exchange Commission Act 1993

The responsibilities and functions of the Commission are to ensure proper issuance of securities, protect the interest of investors in the securities and develop and regulate the capital market on a much more manageable market platform.10 No stock broker, sub-broker, share transfer agent, banker to the issue, merchant banker, registrar to the issue, manager to the issue, underwriter, portfolio manager, investment adviser, mutual fund, trustee of trust deeds, asset management company, custodian, credit rating company and such other intermediary organizations as may be associated with the securities market shall sell or deal in securities except under and in accordance with the conditions of a registration certificate obtained from the Commission. 11 The Commission may, by notification in the official gazette, make rules for pursuing the purposes of this Act.12 Hence, BSEC is empowered to issue notifications and orders as and when it becomes necessary.

2.4 The Companies Act 1994

The Companies act 1994 mainly deals with the formation and other issues related to a company. Under the power entrusted under this act, the Government, by notification in the Official Gazette and subject to such restrictions and conditions as it thinks fit,13 may empower any District Court to fulfill the legal obligations. This Act has several weaknesses to overcome as its function is to check on the stock market's monetary bubble mainly created by unscrupulous manipulations. These limitations are mainly related to the inadequacy of severity of penalty for non-compliance with different sections of the Act. Sections 211 to 217 of this law deal with the appointment of auditors as well as reading and inspection of the auditor’s report. If any default is made by a company in complying with any of the provisions contained in section 211 to 217, the company, and also every officer of the company who is in default, shall be punishable with a fine which may extend to one thousand taka14 which seems to be absurdly insufficient for the commission such defaults.
Every company is required to hold its Annual General Meeting each year as per the requirement of this law. The penalty for non-compliance with this requirement shall render the company and every officer of the company, who is in default, to be punishable with a fine which may extend to ten thousand taka and in case of a continuing default, with a further fine which may extend to two hundred fifty taka per day after the first day during which such default continues. Such a punitive amount as a penalty may fail to create a strict accountability among the companies. There are a good number of companies which have flagrantly failed to hold their AGM each year. Although the DSE categorizes those companies in the Z-category, many investors fail to understand its significance.

2.5 SEC Merchant Banker and Portfolio Manager Act 1996

This act is related to the registration certificate and responsibilities of a Merchant Banker and that of a Portfolio Manager. There is a conflict between this Act and that of the Bank Companies Act 1994. Under the Bank Company Act, section 14A, there was a clear prohibition to trade shares under unanimous names. But using the omnibus type of accounts, the shares were traded in glaring contradiction to this act. Although the amount was invested by the general investors as only dummy account holders, however, the shares were in fact under the name of Merchant Banks not on behalves of the account holders but under the banks’ portfolios. Hence, there was no legal right of the investors over the shares purchased. This is a glaring loophole which deserves a very strict checkup by the law.

2.6 Dhaka Stock Exchange Automated Trading Regulations 1999

This act deals with the trading rated issues. It covers the regulations related to Trading day, Trading Period, Availability of workstation, Types of Market, Trading Sessions, Exposure Limit and other closely related issues. According to this act, the trading of securities shall be opened on all days except during bank holidays as declared under the Negotiable Instruments Act, 1881. Provided that the council of DSE, in
consideration of any exigencies, considers it expedient to declare that there shall not be any trading on any other day as may be specified in the resolution under the immediate intimation to the SEC. Thus, this regulation empowered the DSE Council to halt the transaction for the day, considering the change in circumstances.

The trading period of the Exchange shall be between 10:30 AM to 2:30 PM, unless otherwise decided by the Council, on all trading days. Depending on the availability, the DSE shall make available the system to the members by providing trading workstation connections. The number of trading workstations for each member shall be such as may be decided by the Council. The CEO may shutdown trading in the event the system becomes inoperative or inaccessible to all or part of the trading workstations under immediate intimation to the SEC.

The regulation specifies four types of markets which are:

(a) Public Market - Matching in this market is automatic based on the touchline price which follows normal settlement procedure.

(b) Spot Market - Matching in this market is also automatic, settlement of which follows procedure for spot transactions. The Management Team may put an instrument on the compulsory spot to curb volatility in prices of the instrument.

(c) Block Market - This is the market for bulk selling and buying on automatic matching with equal quantity and best price (all or none condition) basis. Orders entered in this market are immediately flashed on all trading workstations. The minimum amount for a bid of bulk lot for a certain security shall be Tk. 0.5 (point five) million at market price unless otherwise fixed by the Council from time to time with the approval of the SEC.

(d) Odd Lot Market - Odd lot shares are traded in this market on automatic matching with equal quantity and best price (all or none condition) basis.
There are five sessions of trading periods, namely: (a) Pre-opening session; (b) Opening session; (c) Continuous or Regular trading session; (d) Closing session; and (e) Post-closing session.

The regulation also mentions on the exposure limit of a member of the stock exchange. It empowers the DSE to regulate the net limit for its member. If a member exceeds the limit at any point of time, such member shall be automatically suspended by the system under immediate intimation to the SEC. The DSE shall, from time to time, determine the size of every security as the permissible limit of a single buy or sell order under immediate intimation to the SEC. Any order breaching these limits shall be automatically rejected by the system.

2.7 Dhaka Stock Exchange Investors’ Protection Fund Regulations 1999

This regulation is made as an expedient to frame regulations for establishing a Fund for the protection of the investors of a defaulting member of the Dhaka Stock Exchange Ltd. (DSE). On the commencement of these regulations, a Fund is established and known as the Dhaka Stock Exchange Ltd. Investors’ Protection Fund which strictly covers the issues related to this fund, like, recognition of the fund, board of trustees of the fund, accounts and audit of the fund, compulsory participation of members of the Exchange in the fund, amount of contribution, loss of fund, withdrawal and refund of contribution, and other issues related to the claim of the fund.

2.8 Listing Regulations of the Dhaka Stock Exchange Ltd.

Securities of any companies are not allowed to transact stock market dealings at the Exchanges, unless the company or the securities have been listed and permission for such dealing has been granted in accordance with these regulations which only deal with the listing of the companies with the stock exchange. To get them enlisted, the applications from the companies have to be approved in the manner prescribed by the Exchange which, in granting such permission, will sufficiently consider, among other
things of public interest in the company or the securities as determined by the Council of the Exchange in a well defined procedure.

2.9 Settlement of Stock Exchange Transactions Regulations 1998

For the purpose of this regulation, two terms are important to understand. These are: Clearing House and Settlement Day. Clearing means the facilities provided by the DSE for the completion of transactions through receipts and deliveries of securities and/or cheque/pay order/demand drafts. A Clearing House is set up for the purpose of settlement of the stock exchange trading transactions.

Settlement Day means the day on which transactions that are performed by the Members of the stock exchange on a trading day are settled by them through physical delivery of securities and/or cheque/pay order/demand draft to the Clearing House of the DSE. The date of settlement is related to the category of shares. There are 5 categories of the companies mentioned in this regulation, namely, A, B, Z, N and G category. The Settlement Day is different for a Z-category Company from that of other companies. It is the first day subsequent to the trading day, i.e., T+1 for the A, B, G and N category companies, and the fourth day subsequent to the trading day, i.e., T+4 for the Z-category companies.

A-Category Companies are those companies, which are regular in holding their current annual general meetings and have declared dividends at the rate of ten percents or more in the last English calendar year. B-Category Companies are those companies, which are regular in holding their annual general meetings but have failed to declare dividends at least at the rate of ten percents in the last calendar year. Z-Category Companies are those companies which have failed to hold their current annual general meetings or have failed to declare any dividend or which are not in operation continuously for more than six months or whose accumulated loss after adjustment of revenue reserve, if any, is negative and exceeded its paid up capital. N-category companies include all newly listed companies except Greenfield companies and their
settlement system would be like B-category companies.\textsuperscript{18} G-category Companies means Green-field companies whose shares are listed with the DSE before the company goes into commercial operation and prior to listing the said company declares the year of first declaration of dividend.

In settlement of trade, except Z-category securities, the buying and selling brokers deposit cheques and securities respectively to the clearing house on the 2\textsuperscript{nd} day of trading (T+1) and the clearing house delivers the securities and issues the cheques to the buying and selling brokers respectively on the 4\textsuperscript{th} day of trading (T+3). For settlement of the trades of the securities under the Z-category, the aforesaid periods are T+4 and T+7 respectively.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{flowchart.png}
\caption{Flow Chart of Clearing and Settlement (T+3)}
\end{figure}

These regulations were formerly in force during the stock market bubble burst, but are now not in force. New regulations then come into force to fulfill the same purpose of these regulations and are called the Dhaka Stock Exchange (Settlement of Transactions) Regulations, 2013 which will come into effect on Demutualization Date of the stock exchange.
2.10 Margin Rules 1999

As mentioned earlier, a margin is a form of credit facilities provided to the investors. This rule empowers the members to provide margin loans to the investors. According to this Rule, a member can extend credit facilities to his approved client for securities transactions subject to the margin account requirements of these rules. Margin account arrangements must be evidenced in the form of a written agreement executed between the member and the client. The margin deposited by client with the member can be in the form of cash, securities issued by the Government or its agencies, marginable securities and such other instruments as the Commission may from time to time prescribe.

A client who operates a margin account with a member shall authorize the member to sell, mortgage, pledge or hypothecate the client's securities or property for a sum not exceeding the debit balance in the margin account and without obligation to retain in his possession or control securities of like character. Hence, if any account of the client fails to maintain its margin requirement, the member can recover the credit amount by selling those shares. For this nature of margin accounts, the stock market crash is more likely to be triggered. If the share price falls, the value of investment in the clients' account will also accordingly decrease with a subsequent result in the value of the investment to progressively exceed the margin requirement. In such an untenable situation, the member can sell the shares of the client in order to maintain the margin requirements. Thus, a huge pressure is created in the selling side of the share market. With the demand for shares being static, even falling, a huge pressure for sale of shares leads the price to fall even more.

2.11 Securities & Exchange Commission (Stock Dealer, Stock Broker and Authorized Representative) Regulations 2000

According to this regulation, no stock dealer, broker or authorized representative can trade any securities without a registration issued under this regulation. The issues
covered under this regulation specifically includes the qualification to attain registration, application for registration, transfer of registration, duration of registration, issuance of a duplicate registration certificate, duties of registration certificate holder, cancellation and withdrawal of registration and maintenance of accounts of the stock broker and the stock dealer. The accounts so maintained can be audited at any time by the SEC and the regulations related to such audit have also been covered under this regulation.

3. Lapses in Applicable Statutes, Rules and Regulations

3.1 The Securities and Exchange Ordinance 1969

Recommendations offered are as follows:

a. Insertion of the definition of Market Manipulation and consequence of Market Manipulation

b. Insertion of the definition of aggressive attempt conducted by the stock broker/stock dealer/merchant bank/asset manager and the consequence of the aggressive attempt,

c. There is no power of the exchange as a self regulatory body to impose a fine on the stock broker/stock and the dealer/authorized representative for the non-compliance of the securities laws. In this respect, it is imperative to insert a section regarding the issuance of power to the Exchange to impose a proactive fine on the Stock Broker/Stock Dealer and the Authorized representative for the flagrant non-compliance of the securities laws.

3.2 The Securities and Exchange Rules 1987

Recommendations offered are as follows:

a. Rule 3(2) should be amended to a Net Capital Balance of not less than two million taka.
b. Items of the liquid asset and designated liabilities should be revised (Rule 2) to accommodate a specific quantum to necessarily address the situational circumstances.

c. Rule 4 should be amended, whilst the related data should be maintained and communicated electronically.

d. The Customer Information Form should be revised under Rule 8(1) (ccc) to include the relevant critical items.

e. There is no vested power for the Exchange as a self regulatory body to impose a fine on the Stock Broker/Stock Dealer. It is required to insert a statutory provision regarding the vested power for the Exchange to impose a fine on the Stock Broker/Stock Dealer and the listed company for the non-compliance of the securities laws.

3.3 Securities and Exchange Commission (Merchant Bankers and Portfolio Managers) Regulation 1994

The recommendations to this regulation can be as follows:

a. It is required to amend the provision of the Paid-up Capital to 100 crore taka for a full fledged Merchant Bank in order to strengthen the Capital Market.

b. To impose a penalty on the merchant bank which miserably fails to judiciously manage the funds of its clients as per the provision of laws.

3.4 Securities and Exchange Commission (Prohibition of Insider Trading) Regulations 1995

It is recommended that these regulations should include a clause, such as:

a. To impose a fine of an equivalent quantum of the benefit unscrupulously exploited by the Insider Trader(s).
3.5 Margin Rules 1999

These rules should include clauses, such as:

a. To impose a penalty on the stock brokers who fail to judiciously manage the funds of their clients as per provision of the laws.

b. Insert the provision of imposing a maximum interest limit on the customers.

c. Rule 3(4) should be amended with regards to the quantum of the initial margin.

3.6 Securities & Exchange Commission (Stock Dealer, Stock Broker and Authorized Representative) Rules 2000

Additional conditions that should be part and parcel of the rules:

a. Authorized Representative should possess a minimum graduate degree,

b. Paid up Capital of Stock Broker/Stock Dealer should be a minimum of 10 crore taka.

c. To amend the second schedule of the rules to accommodate proactive means and methods to prevent the market manipulation being willfully performed by the Stock Broker/Stock dealer/Authorized representative

3.7 Securities and Exchange Commission (Over-The-Counter) Rules 2001

An additional condition can be as follows:

a. OTC is seller oriented as it provides only the pick-and-choose facilities for the buyers. Trading facilities of the OTC market should be the same as that of the main market so as to facilitate the investors to invest in the unlisted/de-listed securities.

3.8 Depository (User) Regulations 2003

No one can change the BO name of the Account holder without the consent of the competent authority.
4. Conclusion & Recommendations

From the analysis made in this research, several inconsistencies have been found in the Securities and Exchange Commission (SEC) regulations, such as, the occasion when the SEC's notification comes only when the market rises continuously for many days, the performance of which does not at all reflect an effectively good regulation. Some regulatory laws are considered as still in the primitive stages as there are many legal loopholes in the existing laws which are open for unscrupulous manipulation by the stock market shrewd stock market traders or operators. For the betterment of the effective regulation of the capital market, the following measures should have been adopted by the Government:

1. The Securities and Exchange Commission should be empowered in such a transparent system so that it can work together with the Bangladeshi Bank and Stock Exchanges with tacit efficiency.

2. The Bangladeshi stock market needs to move towards a market-based system of regulation for capital market activities and the SEC should act proactively instead of its reactive response with lengthy time lapses.

3. The existing laws with regards to the regulation of the capital market should be modernized and harmonized with a provision of high penalty for those who breach the laws and as a deterrent to would-be stock market offenders.

4. The SEC does not immaculately evaluate and quantify the costs and benefits of its rapidly changing guidelines/regulations in terms of efficacy for highly commendable performance.

5. The SEC and the Government of Bangladesh should have long term futuristic visions regarding the stock market's enormous monetary contributions to the state and should conduct excellent cost-benefit analyses before framing any new rule/law as it intrinsically affects the investors’ returns.
6. Regulatory parity and consistency between all institutions and participants conducting related capital market activities have to be ensured at all times through a check-and-balance system.

References


1. Section 13, the Securities and Exchange Ordinance, 1969.
2. Section 14, the Securities and Exchange Ordinance, 1969.
5. Section 24, the Securities and Exchange Ordinance, 1969.
6. Section 33, the Securities and Exchange Ordinance, 1969.
7. Section 34, the Securities and Exchange Ordinance, 1969.
18. This category of shares was added on July 03, 2006.