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# **STOCK MARKET VS. OTC MARKET: REGULATORY FRAMEWORK AND CHALLENGES**

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## **Chapter 1: Introduction**

### **Overview of Financial Markets and Their Significance**

Financial markets are a cornerstone of modern economies, functioning as organized platforms that facilitate the exchange of financial instruments such as stocks, bonds, derivatives, and currencies. These markets serve as intermediaries between savers and borrowers, enabling the efficient allocation of capital across sectors and geographies. By doing so, they not only promote economic growth but also enhance productivity, innovation, and financial inclusion. There are two primary functions of financial markets: capital formation and liquidity creation. Capital formation allows businesses to raise funds for expansion, innovation, and employment generation, while liquidity ensures that investors can enter and exit investments with relative ease. Moreover, financial markets provide critical pricing information, risk-sharing mechanisms, and a platform for regulatory scrutiny, all of which contribute to a more stable and transparent economic environment.

In India, financial markets have evolved significantly since the liberalization of the economy in 1991, with the introduction of advanced technology, regulatory reforms, and institutional growth. The establishment of regulatory authorities such as the Securities and Exchange Board of India (SEBI) has further enhanced investor confidence by ensuring a transparent and fair-trading environment.

### **Introduction to Stock Markets and OTC Markets**

Financial markets are broadly divided into organized (formal) and unorganized (informal) segments. Stock exchanges fall under the formal category, while Over-the-Counter (OTC) markets are often viewed as part of the less regulated or informal segment, although they too are subject to some degree of regulatory oversight.

#### **1. Stock Markets:**

Stock markets are centralized and regulated platforms like the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) where securities such as equity shares,

bonds, and derivatives are bought and sold. These platforms operate under strict regulatory supervision, requiring companies to comply with listing norms, periodic disclosures, and corporate governance standards. The centralized nature of stock exchanges ensures transparency, high levels of liquidity, price discovery, and investor protection. Trades are executed through automated systems that minimize human intervention and reduce the chances of manipulation.

## 2. OTC Markets:

In contrast, OTC markets operate in a decentralized and less formal environment where securities are traded directly between two parties without the use of a centralized exchange. These markets are commonly used for trading unlisted securities, bonds, derivatives, and foreign exchange instruments. Because they are not subject to the stringent rules applicable to exchanges, OTC markets are more flexible but also pose greater risks related to transparency, liquidity, and counterparty default. This informality and lack of centralized oversight often make them more susceptible to market manipulation, inadequate disclosures, and higher investor vulnerability.

### **Importance of Regulatory Oversight**

Effective regulation is essential for the smooth and fair functioning of financial markets. A robust regulatory framework not only fosters investor confidence but also prevents malpractices such as insider trading, price manipulation, and fraudulent schemes. Regulatory bodies such as SEBI in India, the Securities and Exchange Commission (SEC) in the United States, and the Financial Conduct Authority (FCA) in the United Kingdom are responsible for formulating rules, monitoring compliance, and taking enforcement actions when necessary.

Stock exchanges operate under clearly defined regulations that encompass listing requirements, continuous disclosure obligations, trading norms, and grievance redressal mechanisms. These checks and balances ensure that investors are well-informed and protected.

In contrast, the OTC market lacks such centralized control. Regulatory oversight is more fragmented and often limited to post-facto reporting or voluntary disclosures. As a result, OTC markets are more vulnerable to price opacity, counterparty risk, and regulatory arbitrage. The disparity in oversight mechanisms between these two segments of the financial market creates significant regulatory challenges and necessitates a re-evaluation of existing frameworks to promote a more consistent and effective supervisory approach.

## Chapter 2: Literature Review

### Theoretical Perspectives on Financial Market Regulations

The regulation of financial markets is anchored in various economic and legal theories that provide the foundational rationale for why markets require oversight. Among the prominent theoretical perspectives are:

1. Public Interest Theory:

This theory posits that regulation is necessary to correct market failures and protect public welfare. It views regulators as neutral actors who intervene to enhance efficiency, maintain stability, and safeguard investors against asymmetries in information and power. In the context of stock and OTC markets, public interest theory justifies stringent oversight of trading platforms to reduce fraud and manipulation.

2. Capture Theory:

Advanced by George Stigler, this theory suggests that regulatory agencies may eventually serve the interests of the industries they regulate, rather than the public. In the context of OTC markets, where regulation is often lighter and fragmented, the risk of regulatory capture is higher due to closer industry-regulator ties and lack of transparency.

3. Market Efficiency Theory:

Rooted in the Efficient Market Hypothesis (EMH), this theory assumes that financial markets reflect all available information and self-correct through investor behavior. However, the presence of informational asymmetries and manipulative practices, especially in OTC markets, challenges this assumption and highlights the need for regulatory intervention to ensure that markets operate fairly.

4. Agency Theory:

This theory addresses the conflict of interest between principals (investors) and agents (managers or intermediaries). In capital markets, robust regulations, such as mandatory disclosures and governance norms, help align interests and reduce agency costs.

Applying these theoretical frameworks to stock and OTC markets reveals a spectrum of regulatory approaches ranging from highly regulated, transparent environments in stock exchanges to the relatively opaque and loosely governed OTC trading platforms. Theoretical insights underscore the critical need for differential but robust regulation tailored to the inherent risks of each market type.

## Stock Market Expansion and Regulatory Developments

The growth of stock markets over time has been closely tied to institutional developments and regulatory reforms. Several seminal studies provide insight into how regulatory changes influence market behavior and investor confidence.

1. O’Sullivan (2007)<sup>1</sup>:

In her study titled “*The Expansion of the U.S. Stock Market, 1885–1930*,” Mary O’Sullivan challenges the prevailing notion that stock market expansion during that era was driven primarily by legal reforms protecting minority shareholders. Instead, she emphasizes the role of broader institutional and economic dynamics—such as increased institutional investment, the rise of a retail investing culture, and corporate strategies like mergers and expansions financed through equity. This historical analysis illustrates how regulatory frameworks must evolve alongside market structures to support sustainable growth and investor trust.

2. Neely (1987)<sup>2</sup>:

In his paper “*Banking Acquisitions: Acquirer and Target Shareholder Returns*,” Walter P. Neely uses event study methodology to analyze stock market responses to banking acquisition announcements. The findings highlight that abnormal returns were observed both pre- and post-announcement, indicating that market reactions are sensitive to perceptions of regulatory compliance and corporate governance. The paper reinforces the importance of clear disclosure norms and regulatory scrutiny in mergers and acquisitions to protect shareholder interests.

These studies underline that regulatory compliance is not merely a legal formality—it significantly influences investor sentiment, market stability, and long-term economic growth.

## OTC Markets and Regulatory Challenges

The decentralized and flexible nature of OTC markets, while offering innovation and access, also exposes investors to substantial risks. Literature on OTC markets consistently underscores their vulnerability to manipulative practices and the inadequacy of existing oversight mechanisms.

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<sup>1</sup> O’Sullivan, Mary (2007) *The Expansion of the U.S. Stock Market, 1885–1930: Historical Facts and Theoretical Fashions*, Enterprise & Society, Vol. 8, No. 3. <http://www.jstor.org/stable/23700715>

<sup>2</sup> Neely, Walter P. (1987) *Banking Acquisitions: Acquirer and Target Shareholder Returns*, Financial Management, Vol. 16, No. 4. <https://doi.org/10.2307/3666110>

1. Aggarwal & Wu (2006):

In their comprehensive study “*Stock Market Manipulations*,” Aggarwal and Wu analyze data from enforcement actions undertaken by the U.S. Securities and Exchange Commission (SEC). Their findings reveal that OTC markets are particularly susceptible to manipulation, often perpetrated by insiders, brokers, or firms with privileged information. These manipulations lead to artificial price inflation, followed by a crash, resulting in volatility, investor losses, and erosion of trust. The study calls for stronger surveillance and disclosure obligations in OTC trading to reduce abuse.

2. Swary (1986):

Itzhak Swary’s paper “*Stock Market Reaction to Regulatory Action in the Continental Illinois Crisis*” provides empirical evidence on how markets respond to regulatory interventions during financial distress. The 1984 failure of Continental Illinois Bank, due to its exposure to non-performing Latin American debt, triggered market panic. Swary’s study found that regulatory responses were effective in calming depositor fears but failed to prevent market-wide losses in similar institutions. This case highlights the importance of proactive regulation and systemic risk monitoring—especially relevant for OTC markets that lack such embedded safeguards.

Both studies demonstrate the urgent need for consistent and proactive regulation in OTC environments to enhance accountability and mitigate systemic risk.

### **Global Regulatory Comparisons**

Understanding how different countries regulate their financial markets offers valuable lessons for policy reform. This section compares the approaches of SEBI (India), SEC (USA), and FCA (UK) in regulating both stock exchanges and OTC markets.

1. SEBI (India):

The Securities and Exchange Board of India is the primary regulator of capital markets in India. SEBI's framework focuses on investor protection, orderly development, and market integrity. While stock exchanges like NSE and BSE are strictly regulated, SEBI’s regulation of OTC segments, especially in unlisted debt securities and derivative contracts, remains limited. Recent initiatives, such as the development of the OTC derivatives reporting platform and tighter KYC norms, aim to bring more transparency, but enforcement gaps persist.

2. SEC (USA):

The U.S. Securities and Exchange Commission has a more extensive oversight

mechanism for both stock and OTC markets. It mandates registration of broker-dealers, enforces Rule 15c2-11 for disclosure in OTC trading, and has a dedicated platform for monitoring Alternative Trading Systems (ATS). The SEC's proactive enforcement, high-frequency audit tools, and whistleblower programs help detect and deter manipulative activities in decentralized markets.

3. FCA (UK):

The Financial Conduct Authority in the UK adopts a risk-based regulation model. It emphasizes both prudential and conduct supervision, even in OTC derivatives and fixed-income markets. The FCA collaborates with global regulatory bodies (like ESMA and IOSCO) and requires trade repositories for OTC derivatives under EMIR (European Market Infrastructure Regulation), which improves post-trade transparency. Comparative analysis shows that India can benefit from aligning more closely with global best practices, especially by strengthening disclosure norms in OTC transactions, improving surveillance infrastructure, and increasing regulatory accountability.

## **Chapter 3: Regulatory Framework of Stock and OTC Markets**

### **Role of Regulatory Authorities**

Effective regulation is indispensable for ensuring the integrity, transparency, and fairness of financial markets. Various regulatory authorities—both domestic and international—play a pivotal role in maintaining investor confidence and preventing market abuse.

1. Securities and Exchange Board of India (SEBI):

SEBI is the statutory body responsible for regulating the securities market in India. Established under the SEBI Act, 1992, its primary objectives include protecting the interests of investors, promoting the development of the securities market, and regulating its functioning. SEBI lays down regulations for stock exchanges, intermediaries, mutual funds, and portfolio managers. Its role is particularly prominent in stock markets where it enforces rigorous compliance standards, surveillance mechanisms, and investor grievance redressal systems.

2. Securities and Exchange Commission (SEC), USA:

The SEC is the apex regulator of securities markets in the United States. It enforces federal securities laws, requires public companies to disclose financial information, and monitors insider trading and market manipulation. The SEC also regulates OTC trading, although the decentralized nature of these markets poses significant enforcement

challenges.

3. Financial Conduct Authority (FCA), UK:

The FCA regulates financial markets and firms in the UK, focusing on consumer protection, market integrity, and competition. It employs a risk-based approach, especially in OTC derivative markets, and collaborates with global institutions to address cross-border regulatory challenges. The FCA plays a critical role in implementing post-trade transparency requirements, particularly under the European Market Infrastructure Regulation (EMIR).

These regulatory bodies adopt varied frameworks depending on the nature of the market and the level of risk associated with the financial instruments being traded.

### **Regulatory Framework for Stock Markets**

Stock exchanges operate under stringent regulatory norms designed to ensure market integrity, investor confidence, and systemic stability. Key features of the regulatory framework governing stock markets include:

1. Listing Requirements:

Companies wishing to list their securities on recognized stock exchanges such as the NSE or BSE must comply with a comprehensive set of listing criteria. These include minimum capital requirements, track records of profitability, promoter holdings, and public shareholding norms. These requirements are intended to filter out unviable or fraudulent entities from accessing public funds.

2. Disclosure Norms:

Listed entities are required to adhere to continuous disclosure obligations, such as the publication of quarterly and annual financial results, material event disclosures under Regulation 30 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, and corporate governance reporting. These disclosures enable investors to make informed decisions and ensure a level playing field.

3. Market Surveillance Mechanisms:

Stock exchanges and SEBI deploy advanced surveillance tools to detect unusual trading patterns, price manipulation, and insider trading. Systems such as the Integrated Market Surveillance System (IMSS) and Data Warehousing and Business Intelligence System (DWBIS) help in real-time monitoring and flagging of suspicious transactions. The exchanges also impose circuit breakers and price bands to contain volatility.

Collectively, these regulations promote transparency, mitigate risk, and ensure that the

stock market operates in an orderly and equitable manner.

### **Regulatory Framework for OTC Markets**

In contrast to stock exchanges, Over-the-Counter (OTC) markets operate through a decentralized network of dealers and are characterized by lower levels of regulation. The framework governing OTC markets is inherently flexible but carries several vulnerabilities.

1. Decentralized Structure:

OTC markets do not operate through a centralized platform. Instead, trades occur directly between two parties, either bilaterally or through electronic communication networks. While this allows for customized contracts, such as in derivatives and fixed-income securities, it also increases the risk of non-standardized practices and lack of price transparency.

2. Lower Disclosure Requirements:

Unlike stock markets, OTC transactions are not subject to strict and uniform disclosure obligations. There is no mandatory reporting of trade volumes, pricing data, or counterparties involved. This opacity limits the ability of regulators and investors to assess market behavior and increases the risk of information asymmetry.

3. Limited Oversight:

OTC markets fall outside the purview of formal exchanges and are subject to limited direct regulation. In India, SEBI has made efforts to extend regulatory reach to certain OTC segments, such as structured debt products and credit default swaps, but overall regulatory control remains fragmented. Globally, institutions like the SEC and FCA have implemented certain reporting mandates (e.g., trade repositories), but enforcement challenges persist.

The regulatory approach in OTC markets tends to be reactive rather than preventive, making these markets more susceptible to systemic risks and abusive practices.

## **Chapter 4: Challenges in Regulating Financial Markets**

### **Risks and Vulnerabilities of OTC Markets**

Over-the-Counter (OTC) markets, due to their decentralized and less regulated structure, are inherently more prone to certain financial risks and vulnerabilities. Unlike organized stock exchanges, OTC markets operate through bilateral transactions, often without a central clearing mechanism. This design fosters flexibility but introduces several systemic and transactional

risks:

1. Price Manipulation:

Due to the absence of a centralized trading platform and standardized pricing mechanisms, OTC markets are susceptible to price manipulation. Dealers and large market participants may exploit asymmetric information to distort prices, thereby misrepresenting the true value of securities.

2. Lack of Transparency:

One of the most fundamental concerns in OTC trading is the lack of pre- and post-trade transparency. Unlike stock exchanges, OTC markets do not mandate real-time public disclosure of trade data, such as pricing, volume, or counterparties. This opacity impedes accurate risk assessment and informed decision-making by investors.

3. Higher Counterparty Risk:

OTC transactions are typically bilateral, exposing each party to the risk that the other may default. The absence of a clearinghouse to guarantee trades increases the potential for settlement failures, especially during periods of market stress. This risk was notably observed during the 2008 financial crisis, where the unregulated trading of credit default swaps (CDS) in OTC markets significantly contributed to systemic instability.

### **Issues of Transparency, Liquidity, and Investor Protection**

The design and operational mechanisms of OTC markets pose multifaceted challenges, particularly in terms of transparency, liquidity, and investor protection.

1. Transparency Issues:

The limited disclosure obligations in OTC trading create an environment where information asymmetry thrives. Retail investors, in particular, face significant disadvantages as they lack access to critical trade data. This absence of transparency weakens market discipline and facilitates fraudulent behavior, including pump-and-dump schemes and insider trading.

2. Liquidity Constraints:

Liquidity in OTC markets is generally lower than in organized exchanges. Since trades are negotiated bilaterally and not broadcast to a wide market, the ability to quickly buy or sell a security without significantly impacting its price is limited. Illiquidity can lead to wider bid-ask spreads and potential capital losses during exit.

3. Investor Protection Deficits:

Investor protection in OTC markets is comparatively weaker due to the informal nature

of trade execution and the limited scope of regulatory oversight. Many OTC instruments are complex, and investors may not fully understand the embedded risks. Furthermore, in the event of a dispute or default, enforcement mechanisms are less robust than those available on regulated exchanges.

These structural deficiencies necessitate the development of specialized regulatory measures to ensure investor confidence and market integrity.

### **Case Studies of Market Manipulation and Fraud**

Empirical evidence and regulatory investigations have exposed multiple instances of fraud and market manipulation in OTC environments. Two prominent case studies illustrate the regulatory shortcomings and the potential impact on financial stability.

1. SEC Enforcement Actions (Aggarwal & Wu, 2006)<sup>3</sup>:

A comprehensive study by Aggarwal and Wu (2006) documented numerous SEC enforcement cases involving market manipulation in less regulated environments. Their findings reveal that manipulative practices—such as spreading false information, rigged trading volumes, and insider trading—were more prevalent in OTC settings, where the detection and prosecution of malpractices were delayed due to regulatory blind spots.

2. Continental Illinois Crisis (Swary, 1986)<sup>4</sup>:

The collapse of Continental Illinois National Bank in the mid-1980s marked one of the largest bank failures in U.S. history. Although not exclusively an OTC incident, the crisis highlighted the dangers of opaque financial dealings and insufficient risk disclosures. According to Swary (1986), the regulatory response came too late, and the lack of oversight over off-balance-sheet and derivative exposures contributed significantly to the bank's insolvency. This episode underscored the need for better oversight of loosely regulated financial instruments and institutions.

### **Regulatory Failures and Enforcement Gaps**

Despite the presence of regulatory institutions, enforcement gaps in OTC markets remain a persistent challenge. Several factors contribute to these regulatory failures:

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<sup>3</sup> Aggarwal, R., & Wu, G. (2006). Stock Market Manipulations. *The Journal of Business*, 79(4), 1915–1953. <https://doi.org/10.1086/503652>

<sup>4</sup> Swary, Itzhak (1986) Stock Market Reaction to Regulatory Action in the Continental Illinois Crisis, *The Journal of Business*, Vol. 59, No. 3. <http://www.jstor.org/stable/2352713>

1. Jurisdictional Limitations:

Cross-border OTC trades often fall through the cracks of national regulatory jurisdictions, making enforcement difficult. The global nature of many OTC instruments, especially derivatives, complicates coordinated supervision and consistent application of laws.

2. Insufficient Reporting Requirements:

Many OTC markets do not require standardized reporting of trade data. This lack of central repositories or trade repositories limits regulators' ability to monitor systemic risk buildup or detect anomalous trading patterns.

3. Reactive Rather Than Proactive Regulation:

Regulatory interventions in OTC markets often follow crises rather than preempting them. For instance, many reforms targeting OTC derivative markets were introduced only after the 2008 financial collapse, highlighting the lag in regulatory response.

4. Resource and Information Constraints:

Regulators frequently face constraints in terms of skilled manpower, technological resources, and access to trade data, which collectively hinder effective supervision. Without robust surveillance tools, real-time monitoring of OTC trades remains challenging.

## Chapter 6: Conclusion and Recommendations

The financial markets, comprising both stock exchanges and Over-the-Counter (OTC) markets, are instrumental in enabling efficient capital allocation and promoting economic development. However, these markets function under disparate regulatory frameworks, leading to notable differences in transparency, risk management, and investor protection. The present study examined the structure and regulatory environments of both markets, highlighted the key challenges associated with OTC trading, and explored the efficacy of existing legal frameworks in safeguarding investor interests.

Stock markets, due to stringent regulatory oversight by bodies such as SEBI (India), SEC (USA), and FCA (UK), offer a relatively robust and transparent trading ecosystem. These markets mandate strict disclosure requirements, listing norms, and compliance mechanisms that collectively enhance investor confidence and ensure market stability. In contrast, OTC markets, with their decentralized and less regulated nature, are often prone to manipulation, reduced transparency, and increased counterparty risks. While OTC trading provides flexibility

and access to non-standardized financial products, it also exposes investors to significant vulnerabilities.

A comparative analysis reveals that the regulatory asymmetry between stock exchanges and OTC markets poses a considerable challenge for policymakers. The study's findings suggest that while some level of deregulation may be necessary to promote innovation and flexibility, unchecked deregulation particularly in OTC segments can compromise the integrity of the financial system.

