Indian Capital Market
Recent Developments and Policy Issues

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Introduction

There are 22 stock exchanges in India, the first being the Bombay Stock Exchange (BSE), which began formal trading in 1875, making it one of the oldest in Asia. Over the last few years, there has been a rapid change in the Indian securities market, especially in the secondary market. Advanced technology and online-based transactions have modernized the stock exchanges. In terms of the number of companies listed and total market capitalization, the Indian equity market is considered large relative to the country’s stage of economic development. The number of listed companies increased from 5,968 in March 1990 to about 10,000 by May 1998 and market capitalization has grown almost 11 times during the same period.

The debt market, however, is almost nonexistent in India even though there has been a large volume of Government bonds traded. Banks and financial institutions have been holding a substantial part of these bonds as statutory liquidity requirement. The portfolio restrictions on financial institutions’ statutory liquidity requirement are still in place. A primary auction market for Government securities has been created and a primary dealer system was introduced in 1995. There are six authorized primary dealers. Currently, there are 31 mutual funds, out of which 21 are in the private sector. Mutual funds were opened to the private sector in 1992. Earlier, in 1987, banks were allowed to enter this business, breaking the monopoly of the Unit Trust of India (UTI), which maintains a dominant position.

Before 1992, many factors obstructed the expansion of equity trading. Fresh capital issues were controlled through the Capital Issues Control Act. Trading practices were not transparent, and there was a large amount of insider trading. Recognizing the importance of increasing investor protection, several measures were enacted to improve the fairness of the capital market. The Securities and Exchange Board of India (SEBI) was established in 1988. Despite the rules it set, problems continued to exist, including those relating to disclosure criteria, lack of broker capital adequacy, and poor regulation of merchant bankers and underwriters.

There have been significant reforms in the regulation of the securities market since 1992 in conjunction with overall economic and financial reforms. In 1992, the SEBI Act was enacted giving SEBI statutory status as an apex regulatory body. And a series of reforms was introduced to improve investor protection, automation of stock trading, integration of national markets, and efficiency of market operations.

India has seen a tremendous change in the secondary market for equity. Its equity market will most likely be comparable with the world’s most advanced secondary markets within a year or two. The key ingredients that underlie market quality in India’s equity market are:

- exchanges based on open electronic limit order book;
- nationwide integrated market with a large number of informed traders and fluency of short or long positions; and
- no counterparty risk.

Among the processes that have already started and are soon to be fully implemented are electronic settlement trade and exchange-traded derivatives. Before 1995, markets in India used open outcry, a trading process in which traders shouted and hand-signdaled from within a pit. One major policy initiated by SEBI from 1993 involved the shift of all exchanges to screen-based trading, motivated primarily by the need for greater transparency. The first exchange to be based on an open electronic limit order book was the National Stock Exchange (NSE), which started trading debt instruments in June 1994 and equity in November 1994. In March 1995, BSE shifted from open outcry to a limit order book market. Currently, 17 of India’s stock exchanges have adopted open electronic limit order.

Before 1994, India’s stock markets were dominated by BSE. In other parts of the country, the fi-
financial industry did not have equal access to markets and was unable to participate in forming prices, compared with market participants in Mumbai (Bombay). As a result, the prices in markets outside Mumbai were often different from prices in Mumbai. These pricing errors limited order flow to these markets. Explicit nationwide connectivity and implicit movement toward one national market has changed this situation (Shah and Thomas, 1997). NSE has established satellite communications which give all trading members of NSE equal access to the market. Similarly, BSE and the Delhi Stock Exchange are both expanding the number of trading terminals located all over the country. The arbitrages are eliminating pricing discrepancies between markets.

Despite these big improvements in microstructure, the Indian capital market has been in decline during the last three years. The amount of capital issued has dropped from the level of its peak year, 1994/95, and so have equity prices. In 1994/95, Rs276 billion was raised in the primary equity market. This figure fell to Rs208 billion in 1995/96 and to Rs142 billion in 1996/97. The BSE-30 index or Sensex, the sensitive index of equity prices, peaked at 4,361 in September 1994 and fell during the following years. A leading cause was that financial irregularities and over-valuations of equity prices in the earlier years had eroded public confidence in corporate shares. Also, there was a reduced inflow of foreign investment after the Mexican and Asian financial crises. In a sense, the market is now undergoing a period of adjustment. Thus, it is time for regulatory authorities to make greater efforts to recover investors’ confidence and to further improve the efficiency and transparency of market operations.

The Indian capital market still faces many challenges if it is to promote more efficient allocation and mobilization of capital in the economy. First, market infrastructure has to be improved as it hinders the efficient flow of information and effective corporate governance. Accounting standards will have to adapt to internationally accepted accounting practices. The court system and legal mechanism should be enhanced to better protect small shareholders’ rights and their capacity to monitor corporate activities. Second, the trading system has to be made more transparent. Market information is a crucial public good that should be disclosed or made available to all participants to achieve market efficiency. SEBI should also monitor more closely cases of insider trading. Third, India may need further integration of the national capital market through consolidation of stock exchanges. The trend all over the world is to consolidate and merge existing stock exchanges. Not all of India’s 22 stock exchanges may be able to justify their existence. There is a pressing need to develop a uniform settlement cycle and common clearing system that will bring an end to unnecessary speculation based on arbitrage opportunities. Fourth, the payment system has to be improved to better link the banking and securities industries. India’s banking system has yet to come up with good electronic funds transfer (EFT) solutions. EFT is important for problems such as direct payments of dividends through bank accounts, eliminating counterparty risk, and facilitating foreign institutional investment. The capital market cannot thrive alone; it has to be integrated with the other segments of the financial system. The global trend is for the elimination of the traditional wall between banks and the securities market.

Securities market development has to be supported by overall macroeconomic and financial sector environments. Further liberalization of interest rates, reduced fiscal deficits, fully market-based issuance of Government securities, and a more competitive banking sector will help in the development of a sounder and a more efficient capital market in India.

**Capital Market Reforms and Developments**

**Reforms in the Capital Market**

Over the last few years, SEBI has announced several far-reaching reforms to promote the capital
market and protect investor interests. Reforms in the secondary market have focused on three main areas: structure and functioning of stock exchanges, automation of trading and post trade systems, and the introduction of surveillance and monitoring systems. (See Appendix 1 for a listing of reforms since 1992). Computerized online trading of securities, and setting up of clearing houses or settlement guarantee funds were made compulsory for stock exchanges. Stock exchanges were permitted to expand their trading to locations outside their jurisdiction through computer terminals. Thus, major stock exchanges in India have started locating computer terminals in far-flung areas, while smaller regional exchanges are planning to consolidate by using centralized trading under a federated structure. Online trading systems have been introduced in almost all stock exchanges. Trading is much more transparent and quicker than in the past.

Until the early 1990s, the trading and settlement infrastructure of the Indian capital market was poor. Trading on all stock exchanges was through open outcry, settlement systems were paper-based, and market intermediaries were largely unregulated. The regulatory structure was fragmented and there was neither comprehensive registration nor an apex body of regulation of the securities market. Stock exchanges were run as “brokers clubs” as their management was largely composed of brokers. There was no prohibition on insider trading, or fraudulent and unfair trade practices (see Appendix 2).

Since 1992, there has been intensified market reform, resulting in a big improvement in securities trading, especially in the secondary market for equity. Most stock exchanges have introduced online trading and set up clearing houses/corporations. A depository has become operational for scripless trading and the regulatory structure has been overhauled with most of the powers for regulating the capital market vested with SEBI. The Indian capital market has experienced a process of structural transformation with operations conducted to standards equivalent to those in the developed markets. It was opened up for investment by foreign institutional investors (FIIs) in 1992 and Indian companies were allowed to raise resources abroad through Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). The primary and secondary segments of the capital market expanded rapidly, with greater institutionalization and wider participation of individual investors accompanying this growth. However, many problems, including lack of confidence in stock investments, institutional overlaps, and other governance issues, remain as obstacles to the improvement of Indian capital market efficiency.

Stock Market

**PRIMARY MARKET**

Since 1991/92, the primary market has grown fast as a result of the removal of investment restrictions in the overall economy and a repeal of the restrictions imposed by the Capital Issues Control Act. In 1991/92, Rs62.15 billion was raised in the primary market. This figure rose to Rs276.21 billion in 1994/95. Since 1995/1996, however, smaller amounts have been raised due to the overall downturn in the market and tighter entry barriers introduced by SEBI for investor protection (Table 1).

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Number</th>
<th>Public Amount (Rs billion)</th>
<th>Rights Number</th>
<th>Rights Amount (Rs billion)</th>
<th>Total Number</th>
<th>Total Amount (Rs billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>1,342</td>
<td>210.44</td>
<td>350</td>
<td>65.88</td>
<td>1,692</td>
<td>276.32</td>
</tr>
<tr>
<td>1995/96</td>
<td>1,426</td>
<td>142.39</td>
<td>299</td>
<td>65.64</td>
<td>1,725</td>
<td>208.03</td>
</tr>
<tr>
<td>1996/97</td>
<td>753</td>
<td>115.65</td>
<td>131</td>
<td>27.19</td>
<td>884</td>
<td>142.84</td>
</tr>
<tr>
<td>Dec 1997</td>
<td>59</td>
<td>21.99</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India.
Total market capitalization as of 1997/98 was Rs5,898 billion (Table 2), equivalent to about half of India’s annual gross domestic product (GDP) for the same fiscal year. India compares favorably with other emerging markets in this respect. The market capitalization-GDP ratio at end-1995 was 22.4 percent for Brazil; 12.6 percent for Hong Kong, China; 40 percent for Indonesia; 41 percent for Korea; and 37.1 percent for Mexico. It was higher however, in Malaysia (281.9 percent), Philippines (81.3), Singapore (233 percent), and Thailand (152.9 percent).

**Table 2:** Number of Listed Companies and Market Capitalization

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Listed Companies</th>
<th>Amount of Capitalization (Rs billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995/96</td>
<td>9,100</td>
<td>5,723</td>
</tr>
<tr>
<td>1996/97</td>
<td>9,890</td>
<td>4,883</td>
</tr>
<tr>
<td>1997/98</td>
<td>9,833</td>
<td>5,898</td>
</tr>
<tr>
<td>1999a</td>
<td>9,877</td>
<td>5,741</td>
</tr>
</tbody>
</table>

*As of March.*


**EQUITY PRICE**

For the past 12 years, equity prices have seen two extended periods of declining prices and two periods of rising prices. Between April 1986 and March 1988, Sensex decreased from 589 to 398, or by 32 percent. Prices also fell between March 1992, when the monthly closing level of Sensex was 4,258, and April 1993, when the level was 2,122, a decline of 50.5 percent. Prices generally rose for extended periods from March 1988 to March 1992 and from May 1993 to August 1994. The monthly closing level of Sensex climbed from 398 in March 1988 to 4,285 in March 1992, an increase of more than 10 times. In the second period of extended rising equity prices, Sensex increased 1.16 times. Since 1995, it has fluctuated around the 3,000-4,000 mark (see Figure 1). In April 1998, it hovered around 3,000.

In the period of declining prices, from August 1994 to March 1998, the price-earnings (P/E) ratio fell more sharply than prices (Figure 1). In March 1998, the monthly average Sensex P/E ratio was 15.65 while the figure for October 1993 was 38.76.

**Risk Management System**

SEBI has taken several measures to improve the integrity of the secondary market. Legislative and regulatory changes have facilitated the corporatization of stockbrokers. Capital adequacy norms have been prescribed and are being enforced. A mark-to-market margin and intraday trading limit have also been imposed. Further, the stock exchanges have put in place circuit breakers, which are applied in times of excessive volatility. The disclosure of short sales and long purchases is now required at the end of the day to reduce price volatility and further enhance the integrity of the secondary market.

**MARK-TO-MARKET MARGIN AND INTRADAY LIMIT**

Under the current clearing and settlement system, if an Indian investor buys and subsequently sells the same number of shares of stock during a settlement period, or sells and subsequently buys, it is not necessary to take or deliver the shares. The difference between the selling and buying prices can be paid or received. In other words, the squaring-off of the trading position during the same settlement period results in nondelivery of the shares that the investor traded. A short-term and speculative investment is
thus possible at a relatively low cost. FIIs and domestic institutional investors are, however, not permitted to trade without delivery, since nondelivery transactions are limited only to individual investors.

One of SEBI’s primary concerns is the risk of settlement chaos that may be caused by an increasing number of nondelivery transactions as the stock market becomes excessively speculative. Accordingly, SEBI has introduced a daily mark-to-market margin and intraday trading limit. The daily mark-to-market margin is a margin on a broker’s daily position. The intraday trading limit is the limit to a broker’s intraday trading volume. Every broker is subject to these requirements.

Each stock exchange may take any other measures to ensure the safety of the market. BSE and NSE impose on members a more stringent daily margin, including one based on concentration of business.

A daily mark-to-market margin is 100 percent of the notional loss of the stockbroker for every stock, calculated as the difference between buying or selling price and the closing price of that stock at the end of that day. However, there is a threshold limit of 25 percent of the base minimum capital plus additional capital kept with the stock exchange or Rs1 million, whichever is lower. Until the notional loss exceeds the threshold limit, the margin is not payable.

This margin is payable by a stockbroker to the stock exchange in cash or as a bank guarantee from a scheduled commercial bank, on a net basis. It will be released on the pay-in day for the settlement period. The margin money is held by the exchange for 6-12 days. This costs the broker about 0.4-1.2 percent of the notional loss, assuming that the broker’s funding cost is about 24-36 percent (Endo 1998). Thus, speculative trading without the delivery of shares is no longer cost-free.

Each broker’s trading volume during a day is not allowed to exceed the intraday trading limit. This limit is 33.3 times the base minimum capital deposited with the exchange on a gross basis, i.e., purchase plus sale. In the event of brokers wishing to exceed this limit, they have to deposit additional capital with the exchange and this cannot be withdrawn for six months.

**CIRCUIT BREAKER**

SEBI has imposed price limits for stocks whose market prices are above Rs10 up to Rs20, a daily price change limit and weekly price change limit of 25 percent. BSE imposes price limits as a circuit breaker system to maintain the orderly trading of shares on the exchange (Table 3).

BSE’s computerized trading system rejects buy or sell orders of a stock at prices outside the price limits. The daily price limit of a stock is measured from the stock’s closing price in the previous trading session. The weekly price limit is based on its closing price of the last trading in the previous week, usually its closing price on the previous Friday.

**SHORT SALES AND LONG PURCHASES**

SEBI regulates short selling in the stock market by requiring all stock exchanges to enforce reporting by members of their net short sale and long purchase positions in each stock at the end of each trading day.

<table>
<thead>
<tr>
<th>Table 3: Bombay Stock Exchange Price Limits</th>
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<table>
<thead>
<tr>
<th>Category</th>
<th>Market Price of Share</th>
<th>Price Limit (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Daily</td>
</tr>
<tr>
<td>A Group Shares</td>
<td>Over Rs20</td>
<td>10</td>
</tr>
<tr>
<td>B1 &amp; B2 Group Shares</td>
<td>Rs10 up to Rs20</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Rs1 up to Rs10</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>Up to Rs1</td>
<td>75</td>
</tr>
</tbody>
</table>

Stock Lending
A scheme for regulating stock lending was introduced in February 1997, following changes in tax regulations. Stock lending can take place through an intermediary registered for this purpose with SEBI, and which has a minimum capital of Rs500 million. Lenders and borrowers of securities have to enter into agreements with the intermediary. Stock lending facilitates the timely settlement of transactions on the stock exchanges, especially in an environment where physical delivery of certificates is required for settlement.

Introduction of Derivatives Trading
At present, there are no exchange traded derivatives or over-the-counter derivative markets in the country. However, a new law has been passed permitting the trading of derivatives. This followed recommendations for the establishment of a regulatory framework for derivatives by a committee chaired by L.C. Gupta. It is expected that derivatives trading will soon form part of the Indian securities market.

Institutional Investors

MUTUAL FUNDS
Indian investors have been able to invest through mutual funds since 1964, when UTI was established. Indian mutual funds have been organized through the Indian Trust Acts, under which they have enjoyed certain tax benefits. Between 1987 and 1992, public sector banks and insurance companies set up mutual funds. Since 1993, private sector mutual funds have been allowed, which brought competition to the mutual fund industry. This has resulted in the introduction of new products and improvement of services. The notification of the SEBI (Mutual Fund) Regulations of 1993, brought about a restructuring of the mutual fund industry. An arm’s length relationship is required between the fund sponsor, trustees, custodian, and asset management company. This is in contrast to the previous practice where all three functions, namely trusteeship, custodianship, and asset management, were often performed by one body, usually the fund sponsor or its subsidiary. The regulations prescribed disclosure and advertisement norms for mutual funds, and, for the first time, permitted the entry of private sector mutual funds. FIIs registered with SEBI may invest in domestic mutual funds, whether listed or unlisted.

The 1993 Regulations have been revised on the basis of the recommendations of the Mutual Funds 2000 Report prepared by SEBI. The revised regulations strongly emphasize the governance of mutual funds and increase the responsibility of the trustees in overseeing the functions of the asset management company. Mutual funds are now required to obtain the consent of investors for any change in the “fundamental attributes” of a scheme, on the basis of which unit holders have invested. The revised regulations require disclosures in terms of portfolio composition, transactions by schemes of mutual funds with sponsors or affiliates of sponsors, with the asset management company and trustees, and also with respect to personal transactions of key personnel of asset management companies and of trustees.

FOREIGN INSTITUTIONAL INVESTORS
FIIs have been allowed to invest in the Indian securities market since September 1992 when the Guidelines for Foreign Institutional Investment were issued by the Government. The SEBI (Foreign Institutional Investors) Regulations were enforced in November 1995, largely based on these Guidelines. The regulations require FIIs to register with SEBI and to obtain approval from the Reserve Bank of India (RBI) under the Foreign Exchange Regulation Act to buy and sell securities, open foreign currency and rupee bank accounts, and to remit and repatriate funds. Once SEBI registration has been obtained, an FII does not require any further permission to buy or sell securities or to transfer funds in and out of the country, subject to payment of applicable tax.

Foreign investors, whether registered as FIIs or not, may also invest in Indian securities outside the
FII process. Such investment requires case-by-case approval from the Foreign Investment Promotion Board (FIPB) in the Ministry of Industry and RBI, or only from RBI depending on the size of investment and the industry in which the investment is to be made. Investment in Indian securities is also possible through the purchase of GDRs. Foreign currency convertible bonds and foreign currency bonds issued by Indians that are listed, traded, and settled overseas are mainly denominated in dollars. Foreign financial service institutions have also been allowed to set up joint ventures in stockbroking, asset management companies, merchant banking, and other financial services firms along with Indian partners.

Foreign portfolio investments in Indian companies are limited to individual foreign ownership at 10 percent of the total issued capital of any one company and to aggregate foreign ownership at 30 percent of the total issued capital of any one company.

FIIs’ net investment was positive until October 1997 and their cumulative investments reached $9.1 billion in the same month. But since then, it has turned negative due to the Asian financial crisis (Table 4). As of May 1998, 496 FIIs were registered with SEBI, with a cumulative net investment of $9.2 billion in the Indian securities market.

Since 1993/94, foreign portfolio investment has so far exceeded foreign direct investment, which has also increased rapidly (Table 5). Investment through FIIs constituted the bulk of portfolio investment. Annual inflows have been about $1.5 billion-$2 billion from 1993/94 to 1996/97 through FIIs, while inflows through GDRs have declined after peaking at $1.8 billion in 1994/95. In 1996/97, India received $5.6 billion in foreign investment of which $1.9 billion was through FIIs. During 1997/98, FIIs’ investment fell while foreign direct investment rose. Improvement in inflow of foreign investment raised India’s foreign exchange reserves from $17 billion at the end of 1994/95 to $29.3 billion at the end of June 1997.

Following the changes to the 1995 SEBI (Foreign Institutional Investors) Regulations, an FII is allowed to set up an investment fund to invest in Indian bonds if it registers the fund with SEBI as a new separate FII or its new subaccount. In 1996, SEBI approved nine debt funds with a cumulative investment exposure of $1.278 billion for investment in securities.

FIIs seem to have a strong impact on equity price movements in India. Trend analysis has shown a significantly positive relationship between BSE Sensex and the lagged net investment by FIIs. Figure 2 suggests that monthly net investment has been taking

<table>
<thead>
<tr>
<th>Year/Month</th>
<th>No. of Registered FIIs (cumulative)</th>
<th>Gross Purchase Rs billion</th>
<th>Gross Sales Rs billion</th>
<th>Net Investment Rs billion</th>
<th>Cumulative Net Investment ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan–Mar 1993</td>
<td>18</td>
<td>0.17</td>
<td>0.04</td>
<td>0.13</td>
<td>4.2</td>
</tr>
<tr>
<td>1993/94</td>
<td>158</td>
<td>55.92</td>
<td>4.66</td>
<td>51.26</td>
<td>1,638.3</td>
</tr>
<tr>
<td>1994/95</td>
<td>308</td>
<td>76.31</td>
<td>28.34</td>
<td>47.96</td>
<td>1,528.3</td>
</tr>
<tr>
<td>1995/96</td>
<td>367</td>
<td>96.75</td>
<td>27.51</td>
<td>69.42</td>
<td>2,035.7</td>
</tr>
<tr>
<td>1996/97</td>
<td>439</td>
<td>154.57</td>
<td>69.73</td>
<td>84.84</td>
<td>7,609.5</td>
</tr>
<tr>
<td>1996/97 (Apr-Jan)</td>
<td>429</td>
<td>127.01</td>
<td>52.15</td>
<td>74.86</td>
<td>7,331.0</td>
</tr>
<tr>
<td>1997/98 (Apr-Jan)</td>
<td>476</td>
<td>143.82</td>
<td>102.12</td>
<td>41.69</td>
<td>8,781.5</td>
</tr>
<tr>
<td>Total (since Jan 1993)</td>
<td>476</td>
<td>527.57</td>
<td>232.43</td>
<td>295.32</td>
<td>8,781.5</td>
</tr>
</tbody>
</table>

FII = foreign institutional investor.
\* = negative values are enclosed in parentheses.
\*\* = data include debt instruments.
Source: Securities and Exchange Board of India.
**Policy Issues**

**Regulatory Framework**

**REGULATION OF INTERMEDIARIES**

Participants in the Indian capital market are required to register with SEBI to carry out their businesses. These include:

- stockbrokers, subbrokers, share transfer agents, bankers to an issue, trustees of a trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, and other such intermediaries who may be associated with the securities market in any manner;

- depositories, participants, custodians of securities, FIIs, credit rating agencies, and other such intermediaries who may be associated with the securities market in any manner; and

- venture capital funds and collective investment schemes, including mutual funds.

However, the registration system is far from complete. For some professional categories such as subbrokers, the registration system is in place, but limitations to SEBI’s enforcement power permits hundreds of thousands of unregistered subbrokers to conduct their securities businesses, while registered subbrokers are not effectively regulated. There is no registration system at all for investment advisors.

The capital adequacy requirements for registered market participants are surprisingly low. Consequently, entry barriers are also low. This is probably because the vested interest of existing market participants cannot be totally ignored since the Indian capital market would stop functioning without them. The majority are thinly capitalized. As a result, SEBI’s limited resources are spread too thinly to register many small participants and regulate them.

**Stockbrokers**

The Indian law defines a stockbroker simply as a member of a recognized stock exchange. Therefore, a registered stockbroker is a member of at least one of the recognized Indian stock exchanges.

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**Table 5: Foreign Investment Inflows ($ million)**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Direct investment</td>
<td>150</td>
<td>341</td>
<td>566</td>
<td>1314</td>
<td>2,133</td>
<td>2,696</td>
</tr>
<tr>
<td>Government (SIA/FIPB)</td>
<td>87</td>
<td>238</td>
<td>280</td>
<td>701</td>
<td>1,249</td>
<td>1,922</td>
</tr>
<tr>
<td>RBI</td>
<td>42</td>
<td>89</td>
<td>171</td>
<td>169</td>
<td>135</td>
<td></td>
</tr>
<tr>
<td>NRI</td>
<td>63</td>
<td>61</td>
<td>217</td>
<td>442</td>
<td>715</td>
<td>639</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>8</td>
<td>92</td>
<td>3,649</td>
<td>3,581</td>
<td>2,748</td>
<td>2,864</td>
</tr>
<tr>
<td>GDRs</td>
<td>86</td>
<td></td>
<td>1,602</td>
<td>1,839</td>
<td>683</td>
<td>918</td>
</tr>
<tr>
<td>FIIs</td>
<td>1</td>
<td></td>
<td>1,665</td>
<td>1,503</td>
<td>2,009</td>
<td>1,926</td>
</tr>
<tr>
<td>Offshore funds and others</td>
<td>8</td>
<td>5</td>
<td>382</td>
<td>239</td>
<td>56</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>158</strong></td>
<td><strong>433</strong></td>
<td><strong>4,215</strong></td>
<td><strong>4,895</strong></td>
<td><strong>4,881</strong></td>
<td><strong>5,560</strong></td>
</tr>
</tbody>
</table>

**Figure 2: Monthly Net FII Investment and BSE-30 Index**

BSE = Bombay Stock Exchange, FII = foreign institutional investor.


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**The lead in changing market sentiments as reflected in the market index movements.**
Stockbrokers are not allowed to buy, sell, or deal in securities, unless they hold a certificate granted by SEBI. At the end of March 1997, they numbered 8,867.

Each stockbroker is subject to capital adequacy requirements consisting of two components: basic minimum capital and additional or optional capital related to volume of business.

The basic minimum capital requirement varies from one exchange to another. A SEBI regulation requires stockbrokers of BSE or NSE to maintain a minimum of Rs500,000 (about $14,000), which is the largest requirement among the stock exchanges. However, BSE and NSE require their respective members to deposit with them larger amounts. The additional or optional capital and the basic minimum capital combined have to be maintained at 8 percent or more of the gross outstanding business in the exchange (the gross outstanding business means the cumulative amount of sales and purchases by a stockbroker in all securities at any point during the settlement period). Sales and purchases on behalf of customers may not be netted but may be included to those of the broker.

There is no mandatory qualification test for stockbrokers and other market participants in India, unlike other countries such as Japan, United Kingdom, and United States.

**Subbrokers**

Most stockbrokers in India are still relatively small. They cannot afford to directly cover every retail investor in a geographically vast country and in such a complex society. Thus, they are permitted to transact with subbrokers as the latter play an indispensable role in intermediating between investors and the stock market.

An applicant for a subbroker certificate must be affiliated with a stockbroker of a recognized stock exchange. A subbroker application may take the form of sole proprietorship, partnership, or corporation.

There are two major issues concerning subbrokers in the Indian capital market:

- majority of subbrokers are not registered with SEBI; and
- the function of the subbroker is not clearly defined.

No subbroker is supposed to buy, sell, or deal in securities, without a certificate granted by SEBI. Nevertheless, there were only about 2,593 subbrokers registered with SEBI as of end-June 1997, while the number of stock subbrokers in India was estimated in the range of 50,000 to 200,000 (Endo, 1998).

The Indian law defines a subbroker as any person, not being a member of a stock exchange, who acts on behalf of a stockbroker as an agent, or otherwise, to assist the investors in buying, selling, or dealing securities through such a stockbroker. Based on this definition, the subbroker is either a stockbroker’s agent or an arranger for the investor. Thus, legally speaking, the stockbroker as a principal will be responsible to the investor for a subbroker’s conduct if a subbroker acts as his or her agent. However, the market practice is different from this legally defined relationship. In reality, the stockbroker, in general, issues a contract note of a transaction even to a registered subbroker, thus treating the latter as a counterparty. This implicitly denies the stockbroker’s privity with the investor.

NSE does not officially allow its members to transact with end-investors through a subbroker. This is probably because NSE has liberal membership criteria and its computerized trading network can easily provide geographically scattered stockbrokers with direct access to trading on NSE. Nevertheless, many trading members of NSE have been using registered and unregistered subbrokers.

To sort out this confusion, SEBI enforced the following measures in March 1997:

- initiation of criminal actions on complaints received against unregistered sub-brokers in suitable cases;
- revival of the institution of “remisier” under rules and bylaws of the stock exchanges; and
prohibition of stockbrokers in dealing with unregistered subbrokers or unregistered remisiers after 1 June 1997 (this deadline was later extended to 1 July 1997).

In spite of these actions, the confusion has remained. There is a need to address the basic issue of clarifying the role of the subbroker and to operationally define its relationship with the stockbrokers.

Merchant Bankers

Under the old regulations, there were four categories of registered merchant bankers with different minimum net worth requirements (Table 6). Under the new regulations, the categories were abolished. Among other provisions, a merchant banker applicant is required to have a minimum net worth of Rs50 million.

The new regulations have drawn a clear-cut line between the merchant banker and the nonbanking finance company (NBFC). Under the old regulations, a merchant banker is permitted to carry out fund-based activities such as deposit-taking, leasing, bill discounting and hire-purchasing. The new regulations no longer allow a merchant banker to engage in these fund-based activities except for those related exclusively to the capital market such as underwriting. The merchant banker is required to cease such activities within two years. Correspondingly, an existing NBFC performing merchant banking activities is required to relinquish such activities after a certain period of time.

The merchant banking industry in India has many problems, the main ones being that there are too many merchant bankers, and that they are considered to be relatively incompetent.

Only 20 merchant bankers account for 60-85 percent of the merchant banking business, while 148 of them are in business only on paper. In May 1997, a substantial number of merchant bankers were found to be professionally imprudent or negligent (Endo 1998). SEBI listed 134 merchant bankers of Categories I, II, and III who broke their underwriting commitments for possible disciplinary actions. Of this number, 95 were in Category I. Furthermore, there have been records of listing delay or rejection of initial public offerings (IPOs) in the recent past.

FRAGMENTATION OF REGULATORY AUTHORITIES

The present functions and powers of regulatory agencies for the securities market seem to be fragmented. SEBI is the primary body responsible for regulation of the securities market, deriving its powers of registration and enforcement primarily from the SEBI Act. There was an existing regulatory framework for the securities market, provided by the Securities Contract Regulation (SCR) Act and the Companies Act, administered by the Ministry of Finance and the Department of Company Affairs (DCA) of the Ministry of Law, respectively. SEBI has been delegated most of the functions and powers under the SCR Act, and shares the rest with the Ministry of Finance. It has also been delegated certain powers under the Companies Act. RBI also has regulatory involvement in the capital market regarding foreign exchange control liquidity support to market participants and debt management through primary dealers. It is RBI and not SEBI that regulates primary dealers in the Government securities market. However, securities transactions that involve a foreign exchange transaction need the permission of RBI.

So far, fragmentation of the regulatory authorities has not been a major obstacle to effective regulation.

<table>
<thead>
<tr>
<th>Category</th>
<th>Minimum Amount of Net Worth (Rs million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>50</td>
</tr>
<tr>
<td>II</td>
<td>5</td>
</tr>
<tr>
<td>III</td>
<td>2</td>
</tr>
<tr>
<td>IV</td>
<td>..</td>
</tr>
</tbody>
</table>

.. = nil

A STUDY OF FINANCIAL MARKETS

A STUDY OF FINANCIAL MARKETS

of the securities market. Rather, lack of enforce-
ment capacity by SEBI has been a more significant
cause of poor regulation. But since the Indian stock
markets are rapidly being integrated, the authorities
may follow the global trend of consolidation of regu-
lation authorities or better coordination among them.

SELF-REGULATORY BODY
Self-regulatory organizations (SROs) have been
adopted in many countries to regulate various par-
ticipants in the securities market. Members are bound
by the SRO’s bylaws and codes of conduct. Through
the SEBI Act of 1992, SROs were introduced in the
Indian capital market, but they are not yet opera-
tional. A clear regulatory framework has yet to be
set up, and relevant market participants are not ready
to regulate themselves for professional purposes. The
only securities-related SROs in India whose regula-
tory frameworks have been well established and
which are actually functioning are the recognized
stock exchanges. Participants in the Indian capital
market seem to have successfully preserved the spirit
and practice of self-regulation or self-governance in
the old stock exchanges such as BSE. However, it is
ture that the old stock exchanges have been rife with
vested interests of member brokers who are not fully
friendly to investors.

Stock Market

FRAGMENTED MARKET
Of the 22 stock exchanges in the country, 17 have
introduced screen-based trading. With the expansion
of trading networks of BSE and other stock
exchanges beyond their original jurisdictions, an in-
creasing number of investors in different parts of
the country are within the reach of a national mar-
tket system. This has raised informational efficiency
and helped rapid market integration.

NSE, which provides a screen-based order driven
system, has already extended its network to more
than 100 centers in the country that are connected to
its central computer via its satellite network. The

Over-the-Counter Exchange of India (OTCEI) also
provides a nationwide electronic system for trading
relatively smaller stocks. BSE has introduced its own
screen-based quote-driven trading system. However,
the market is still fragmented and needs further inte-
gration.

The international trend is to consolidate and merge
existing stock exchanges rather than to set up new
ones. In the UK, there were about 20 stock ex-
changes in the late 1960s, which were reduced to
about half a dozen in 1972 and further down to one,
i.e., the London Stock Exchange, in 1986. NSE has
already provided connectivity to more than 100 cit-
ies, and other major stock exchanges are in the pro-
cess of extending their trading terminals outside their
places of operation. Thus, it is questionable whether
India needs as many as 22 stock exchanges, even
taking into account the vastness of the country.

SPECULATIVE INVESTMENT
Turnover in the Indian stock exchanges is high, im-
plying that they are dominated by speculative invest-
ments, which is not unusual in emerging markets.
However, trading volumes in the Indian capital mar-
tket are fairly large compared to those in other emerg-
ing markets. While price levels have been depressed,
the total turnover on BSE and NSE has been increas-
ing. The combined turnover for 1996/97 was almost
three times the level of the previous year. Figure 3
shows the total turnover of stock trading on all 22
stock exchanges in India. The annual average growth
rate from 1994/95 to 1996/97 was 56 percent in nomi-
nal terms.

Table 7 compares the dollar turnovers and liquid-
ity ratios on BSE and NSE with stock exchanges in
other economies in 1996. The combined turnover on
BSE and NSE, which are both located in Mumbai,
exceeded that of some other stock markets in Asia.
This is because of the remarkably high liquidity ratio
on NSE. Considering that the majority of about 6,000
stocks listed on BSE have low liquidity, it can be in-
ferrered that a group of the 1,500 most traded stocks

of the securities market. Rather, lack of enforce-
m
on BSE would also have a considerably high liquidity ratio (Endo 1998). The substantial increase in turnover may be attributed primarily to the recent expansion of the NSE’s trading network. But this also reflects the fact that the Indian stock market is dominated by speculative investments for short-term capital gains, rather than long-term investment.

**BARRIERS TO INITIAL PUBLIC OFFERINGS**

In April 1996, SEBI announced a policy initiative that makes access to the primary market more restrictive. SEBI requires that a firm that wishes to go public should have a three-year track record of dividends. If this is not satisfied, it should at least have a project with investment from a financial institution of at least 5 percent of the total project cost. There has been a debate on whether this entry condition is too restrictive. But the measure seems necessary to help recover investor confidence in the corporate sector.

The process of public subscription in the Indian market is lengthy and fraught with uncertainty. For domestic equity issues, the process requires compulsory fallback underwriting, setting up of 30 mandatory collection centers across the country for collecting subscriptions from investors, and price determination of at least 45 days before the date of issue. Once an issue has been subscribed, postsubscription procedures require 60 days to elapse before the securities are listed. Investors are forced to remain illiquid during that period, or resort to the gray market to meet liquidity needs. The cost of delay is likely to be incorporated by investors in the price at which they are prepared to subscribe to an issue. This raises costs to an issuer, besides encouraging clandestine activities such as gray markets.

**Transaction Costs in the Secondary Market**

Screen-based trading introduces a greater degree of transparency and reduces spreads. Market manipulation becomes more difficult with screen-based trading and easier to investigate on account of the

**Table 7: Turnovers and Liquidity Ratios of Indian and Foreign Stock Exchanges, 1996**

<table>
<thead>
<tr>
<th>Item</th>
<th>Turnover ($ billion)</th>
<th>Liquidity Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indian Stock Exchanges</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bombay</td>
<td>26.5</td>
<td>0.22</td>
</tr>
<tr>
<td>National</td>
<td>69.1</td>
<td>0.65</td>
</tr>
<tr>
<td><strong>Foreign Stock Exchanges</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>182.6</td>
<td>0.48</td>
</tr>
<tr>
<td>Jakarta</td>
<td>32.6</td>
<td>0.41</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>183.0</td>
<td>0.68</td>
</tr>
<tr>
<td>London</td>
<td>390.1</td>
<td>0.25</td>
</tr>
<tr>
<td>New York</td>
<td>3,728.4</td>
<td>0.58</td>
</tr>
<tr>
<td>Singapore</td>
<td>51.9</td>
<td>0.27</td>
</tr>
<tr>
<td>Thailand</td>
<td>51.3</td>
<td>0.43</td>
</tr>
<tr>
<td>Tokyo</td>
<td>885.7</td>
<td>0.28</td>
</tr>
</tbody>
</table>

a Converted into dollar amounts, using the simple averages of the year-end rates in 1995 and 1996; foreign companies and investment funds are excluded.

b Turnover/average market capitalization.

c Stocks listed and permitted to trade.

d The first section only. The second section was not included.

Source: Bombay Stock Exchange, National Stock Exchange, and Nikko Research Center.
transparent audit trails that are established. As estimated by Shah and Thomas (1997), the total transaction costs in India’s equity market have been reduced by half, i.e., from 5 to 2.5 percent since the introduction of screen-based trading (Table 8). But this is still high compared to advanced markets.

When depository, derivatives, and indexation are fully in place, the transaction costs of the Indian equity market could be even lower than those of most advanced countries.

CLEARING, SETTLEMENT, AND DEPOSITORIES

Account settlement period of stock exchanges that earlier had a 14-day trading cycle has been shortened to seven days (effectively five days because of two intervening no trading days on Saturday and Sunday). Both BSE and NSE process net obligations over a five-day account period and complete the settlement on the 15th day from the commencement of trading for an account period. Other stock exchanges are also moving into this cycle. In the case of NSE, the National Securities Clearing Corporation, Ltd., its wholly owned subsidiary, provides a settlement guarantee. In the case of BSE, the clearing house is operated by Bank of India Shareholding Ltd., which is jointly owned by BSE and the Bank of India.

In India, certificates of securities are registered with the issuer. For Government securities, the record of ownership is kept by RBI, which maintains a Subsidiary General Ledger in its Public Debt Office. Transfer of ownership takes place through book entry transfer in this ledger. In the case of corporate securities, the issuer maintains a register of members or holders of securities, and the issuers or their register or transfer agents have to physically receive the securities from a transferee accompanied by a transfer deed signed by the transferor before a transfer is effected. There are no bearer securities in India. The majority of the settlement of transactions in the securities market continues to be based on physical movement of certificates. This results in delays, bottlenecks, and an increase in transaction costs besides creating various risks for market participants such as bad delivery, fraud, and theft. Because the clearing and settlement infrastructure in the stock exchanges cannot keep up with the flow of paper, especially as trading expands to different parts of the country, the exchanges have been unable to shorten settlement cycles or move to rolling settlement, which are essential to reduce settlement risk.

The Depositories Act of 1996 allows for dematerialization of securities in depositories and the transfer of securities through electronic book entry. As the depository network expands and the proportion of dematerialized securities in depositories increases, the benefits are expected to extend to the vast majority of market participants. The National Securities Depository, Ltd. (NSDL) has been granted a certifi-

<p>| Table 8: Comparison of Transaction Costs Between Indian and New York Equity Markets (percent) |</p>
<table>
<thead>
<tr>
<th>Component</th>
<th>India Mid-1993</th>
<th>India Todaya</th>
<th>India Future Scenario</th>
<th>New York Todaya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading</td>
<td>3.75</td>
<td>0.75</td>
<td>0.40</td>
<td>1.23</td>
</tr>
<tr>
<td>Brokerage</td>
<td>3.00</td>
<td>0.50</td>
<td>0.25</td>
<td>1.00</td>
</tr>
<tr>
<td>Market impact cost</td>
<td>0.75</td>
<td>0.25</td>
<td>0.15</td>
<td>0.23</td>
</tr>
<tr>
<td>Clearing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Counterparty risk</td>
<td>Present</td>
<td>In part</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Settlement</td>
<td>1.25</td>
<td>1.75</td>
<td>0.10</td>
<td>0.05</td>
</tr>
<tr>
<td>Paperwork cost</td>
<td>0.75</td>
<td>0.75</td>
<td>0.10</td>
<td>0.05</td>
</tr>
<tr>
<td>Bad paper risk</td>
<td>0.50</td>
<td>1.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Total</td>
<td>5.00 (+ risk)</td>
<td>2.50</td>
<td>0.50</td>
<td>1.28</td>
</tr>
</tbody>
</table>

a 1996-1997
Source: Shah and Thomas (1997).
cate of commencement of business by SEBI. As of May 1998, 197 issues (about 50 percent of market capitalization) have applied for dematerialization and about 10 percent of them have been dematerialized. In contrast, only three issues had signed for the same as of November 1996. If about 300 to 400 issues apply for dematerialization, they will cover about 90 percent of trading volume. As of May 1998, there were 52 depository participants, which include brokers, banks, and custodians—an increase from 22 participants in 1996. Thus, it is expected that dematerialization of trade will proceed quickly although its completion may still take some time.

**Debt Market**

**HIGH STATUTORY LIQUIDITY REQUIREMENT**

The debt market is not well developed in India. Even though the volume of Government bonds outstanding is large, banks and other financial institutions hold a substantial part of these bonds as liquidity requirement. The statutory liquidity requirement (on top of cash requirement of 10 percent) has been reduced from 25 to 23 percent. But this is still high and should be further decreased to activate the private debt market.

**MARK-TO-MARKET**

Banks tend to hold Government securities to maturity to avoid a capital loss on the balance sheet. Until 1996, only 40 percent of the portfolio of Government securities had to be marked-to-market. Starting fiscal year 1996/97, the requirement has been raised to 50 percent for existing banks and 100 percent for the new private sector banks.

The pattern of ownership of Government securities is shown in Table 9. The biggest holders of both central and state Government securities are commercial banks, with more than two thirds of the total. Life insurance companies have also increased their holdings of Government securities. Banks and life insurance companies are captive markets for Government securities due to the portfolio restrictions imposed on them. Meanwhile, the market for private companies’ debentures is not yet well developed.

**PRIMARY DEALERS**

Table 10 shows the market borrowings of the central and state Governments. The total issue of Government securities and net borrowing of the Government have increased.

---

### Table 9: Pattern of Ownership of Gilt-edged Securities (percent)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Central Government Securities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve Bank of India</td>
<td>37.5</td>
<td>20.3</td>
<td>22.6</td>
<td>24.8</td>
<td>22.3</td>
<td>10.6</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>20.4</td>
<td>44.9</td>
<td>53.4</td>
<td>55.1</td>
<td>59.9</td>
<td>64.6</td>
<td>71.9</td>
<td>68.0</td>
</tr>
<tr>
<td>LIC</td>
<td>11.5</td>
<td>11.8</td>
<td>12.9</td>
<td>13.4</td>
<td>na</td>
<td>16.3</td>
<td>16.9</td>
<td>17.2</td>
</tr>
<tr>
<td>PPF</td>
<td>23.3</td>
<td>15.3</td>
<td>1.1</td>
<td>0.0</td>
<td>1.1</td>
<td>0.8</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Others</td>
<td>7.3</td>
<td>7.7</td>
<td>10.0</td>
<td>6.7</td>
<td>na</td>
<td>5.2</td>
<td>0.4</td>
<td>3.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>State Government Securities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve Bank of India</td>
<td>0.3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>37.9</td>
<td>56.5</td>
<td>79.5</td>
<td>78.6</td>
<td>79.1</td>
<td>72.7</td>
<td>74.8</td>
<td>73.0</td>
</tr>
<tr>
<td>LIC</td>
<td>24.0</td>
<td>19.1</td>
<td>6.0</td>
<td>6.9</td>
<td>7.8</td>
<td>9</td>
<td>11.1</td>
<td>11.8</td>
</tr>
<tr>
<td>PPF</td>
<td>3.1</td>
<td>21.0</td>
<td>21.0</td>
<td>3.4</td>
<td>2.9</td>
<td>2.8</td>
<td>2.8</td>
<td>4.0</td>
</tr>
<tr>
<td>Others</td>
<td>34.7</td>
<td>3.4</td>
<td>11.8</td>
<td>6.0</td>
<td>9</td>
<td>15.5</td>
<td>11.2</td>
<td>12.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

na = not available.
LIC = Life Insurance Corporation of India, PPF = Public Provident Funds.
A primary auction market for Government securities has been created and six primary dealers have been authorized by RBI. However, the auctions still do not seem to take place fully on a market basis, mainly because Government securities are not issued at completely market rates.

Other factors seem to be inhibiting the market clearing mechanism in the primary auction market. First, there is yet no preannounced notification amount in 364-day and 14-day auctions. This procedure enables RBI to determine in a flexible manner either the cutoff price or the amounts to be accepted. Removing uncertainty by notifying auction volumes will bring about more transparency in the auction procedure. Second, noncompetitive bids are allowed in 91-day and 14-day Treasury bill auctions. Since state Governments are major noncompetitive bidders in India, their participation in Treasury bill auctions causes further uncertainty in auction volumes.

### PRIVATE PLACEMENT

The number of private placements has risen in recent years. It is estimated that about 40 percent of total resources mobilized by public and private companies in the Indian capital market in 1995/96 was through private placement, and this increased further to close to 50 percent in 1996/97 (Table 11). The share of the public sector in total private placements was about 70 percent in 1995/96, which rose to about 84 percent in 1996/1997. There are several advantages to tapping private placements instead of resorting to public issues. However, certain problems need to be addressed for the well-directed and efficient functioning of the market. At present, there is no transparency in this market and virtually little information. In developed markets, the regulatory authorities indicate the framework within which private placements have to function.

### Table 10: Market Borrowings of the Government of India (Rs billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Issues</th>
<th>Cash</th>
<th>Conversion</th>
<th>Total</th>
<th>Central Government</th>
<th>Subscription</th>
<th>Net Borrowing</th>
<th>State Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970/71</td>
<td>4.0</td>
<td>2.3</td>
<td>2.0</td>
<td>4.3</td>
<td>1.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975/76</td>
<td>6.0</td>
<td>4.7</td>
<td>1.9</td>
<td>6.6</td>
<td>4.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980/81</td>
<td>26.3</td>
<td>27.3</td>
<td>1.4</td>
<td>28.7</td>
<td>26.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985/86</td>
<td>53.3</td>
<td>55.5</td>
<td>2.1</td>
<td>57.6</td>
<td>50.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990/91</td>
<td>89.9</td>
<td>85.3</td>
<td>4.6</td>
<td>89.9</td>
<td>80.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991/92</td>
<td>89.1</td>
<td>78.4</td>
<td>10.7</td>
<td>89.1</td>
<td>75.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992/93</td>
<td>138.9</td>
<td>137.4</td>
<td>1.5</td>
<td>138.9</td>
<td>47.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993/94</td>
<td>490.1</td>
<td>490.1</td>
<td></td>
<td>490.1</td>
<td>261.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994/95</td>
<td>381.1</td>
<td>381.1</td>
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<td>381.1</td>
<td>200.7</td>
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<td>405.1</td>
<td>405.1</td>
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<td>405.1</td>
<td>267.9</td>
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<td>1996/97</td>
<td>296.2</td>
<td>296.2</td>
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<td>296.2</td>
<td>200.0</td>
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DEVELOPMENT OF SECONDARY MARKET
While there has been increased activity in primary debt issues, the secondary market for debt is yet to become active. The entry of FIIs into the debt market and the launching of fixed income schemes and money market schemes by mutual funds are expected to activate the debt market. Several technical impediments that prevented more active secondary market trading in Government securities have been removed over the past few years. But still there are significant barriers to the active development of the secondary market for fixed income assets.

Investors

MUTUAL FUNDS
Table 12 shows increasing resource mobilization by mutual funds. However, over the last few years, the performance of mutual funds has not been encouraging. Investor confidence in mutual funds, which ideally should be the most preferred investment vehicles for the lay investor, has been low and the lukewarm response seen in 1995/96 continued in 1996/97 (Table 13). This could be attributed partly to market conditions, which have affected the perception of investors. With the revised SEBI (Mutual Fund) Regulations of 1996, mutual funds have been given greater flexibility to operate schemes. It is expected that as a result of this liberalization, mutual funds will introduce innovative products to attract investors. The revised regulations have also introduced greater transparency and accountability, which is anticipated to boost investor confidence.

FOREIGN INSTITUTIONAL INVESTORS
Accumulated net investment of FIIs contribute less than 7 percent of total market capitalization of the Indian capital market and less than 10 percent of the outstanding external debt of the country. India’s external debt position has shown considerable improvement in the recent past. The debt-GDP ratio fell from 41 percent in March 1992 to 25.9 percent in March 1997. Short-term debt and the volatility of FIIs may well affect the performance of India’s stock markets, but would not yet pose a significant threat to cause a foreign exchange crisis. However, if these were coupled with an increase in nonresident Indian (NRI) deposits, there
may well be the potential for a currency crisis if India fails to carefully manage its macroeconomic environment.

Policy Recommendations

Over the last few years, there have been substantial reforms in the Indian capital market. But there are still many issues to be addressed to make it more efficient in mobilizing and allocating capital.

Investor confidence in stock investment is low. This must be regained in order to encourage capital mobilization through primary market issues. Further strengthening of investor protection, and improvements in transparency, corporate governance, and monitoring will be necessary. The capital market infrastructure, such as accounting standards and legal mechanisms, should also be improved to this end.

On the supply side, to encourage corporate firms to rely more on stock markets for their source of financing, the issuing costs in terms of length of time required and administrative burden should be streamlined (Table 15).

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<td>Medium- and long-term</td>
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<tr>
<td>External assistance</td>
<td>19.31</td>
<td>32.15</td>
<td>34.28</td>
<td>38.10</td>
<td>43.71</td>
<td>48.81</td>
<td>47.29</td>
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<td>International Monetary Fund</td>
<td>3.93</td>
<td>1.50</td>
<td>2.62</td>
<td>3.45</td>
<td>5.04</td>
<td>4.30</td>
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<td>External commercial borrowing</td>
<td>5.56</td>
<td>13.74</td>
<td>14.78</td>
<td>16.08</td>
<td>17.57</td>
<td>19.62</td>
<td>18.27</td>
<td>18.85</td>
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<tr>
<td>Nonresident Indian deposits</td>
<td>3.08</td>
<td>10.36</td>
<td>10.58</td>
<td>7.85</td>
<td>12.67</td>
<td>12.38</td>
<td>11.01</td>
<td>11.13</td>
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<tr>
<td>Short-term</td>
<td>na</td>
<td>na</td>
<td>4.80</td>
<td>3.19</td>
<td>3.63</td>
<td>4.27</td>
<td>5.03</td>
<td>6.73</td>
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<tr>
<th>Issues</th>
<th>Policy Recommendation</th>
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<tbody>
<tr>
<td>A. Market infrastructure</td>
<td>• Improve accounting principles, make them consistent with international practice.</td>
</tr>
<tr>
<td>1. Accounting principles</td>
<td>• Strictly enforce punitive measures for inaccurate accounting practice.</td>
</tr>
<tr>
<td>2. Legal mechanism</td>
<td>• Establish prompt and effective settlement of disputes to protect small investors’ interests.</td>
</tr>
<tr>
<td>B. Corporate governance</td>
<td>• Grant institutional investors voting power.</td>
</tr>
<tr>
<td>C. Cost of capital issue</td>
<td>• Allow hostile takeovers.</td>
</tr>
<tr>
<td>D. Debt market</td>
<td>• Require consolidated balance sheets for conglomerates-affiliated firms to better monitor cross-subsidization and internal transactions between affiliated firms.</td>
</tr>
<tr>
<td>1. Diversification of investors</td>
<td>• Streamline the procedure for public subscription of securities to reduce transaction costs in terms of time lag and uncertainty.</td>
</tr>
<tr>
<td>2. Stamp duty</td>
<td>• Apply fully market-based interest rates for issuing Government securities.</td>
</tr>
<tr>
<td>3. Private placement</td>
<td>• Further reduce statutory liquidity requirements.</td>
</tr>
<tr>
<td>E. Integration of stock exchanges and consolidation of intermediaries</td>
<td>• Further enhance the credibility of credit rating agencies.</td>
</tr>
<tr>
<td>F. Risk management</td>
<td>• Amend stamp duty regime by the Government of Maharashtra, where Mumbai is located, in the form of one time levy or consolidated fee payable by National Securities Depository, Ltd (NSDL).</td>
</tr>
<tr>
<td>G. Integration of the capital market with the banking sector</td>
<td>• Indicate the framework within which the private placement has to function to protect investors from risk associated with subscriptions in the private placement market.</td>
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<td>• Provide favorable environment or some incentives for establishing central trading system through interconnectivity.</td>
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<td>• Encourage the corporatization and merger of brokers and merchant bankers through tax incentives.</td>
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<td>• Securities and Exchange Board of India to more closely monitor and inspect the intermediaries and stock exchanges and, if necessary, strengthen punitive measures.</td>
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<td></td>
<td>• Banking system to establish a good electronic funds transfer (EFT) solution to enable direct payments of dividends to bank accounts, eliminate counterparty risk, and facilitate FIs.</td>
</tr>
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<td></td>
<td>• Encourage sound competition between the banking sector and the capital market through more banking liberalization.</td>
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Market Infrastructure Improvement

ACCOUNTING PRINCIPLES

The financial statements of an issuing company in its disclosure documents are prepared in accordance with India’s generally accepted accounting principles (GAAP). The increasing exposure of Indian listed firms to international investors has compelled them to adopt more internationally acceptable accounting principles. The Institute of Chartered Accountants of India has issued a note to introduce new accounting standards starting fiscal year 1995/96. Yet, Indian GAAP is considerably different from that of internationally accepted principles. To raise the credibility of corporate financial statements and transparency, accounting principles should be improved further to make them consistent with international practice. In relation to this, the credibility of the accounting profession should also be enhanced through stricter enforcement of punitive measures for inaccurate accounting practices.

LEGAL MECHANISM

The problems of the court system and legal mechanism to settle disputes in India have been frequently raised. After floating shares in the market, investors should be able to monitor corporate performance closely to protect their interests. Prompt and effective settlement of disputes is also critical. According to a recent survey by Gupta (1998), 65 percent of those who brought complaints to court indicated that the cases have not been resolved. Even though minority shareholders can now bring their complaints to the court, they are discouraged from doing so because the legal mechanism is very slow. Measures are therefore needed to expedite court decisions and protect small investors’ interests.

Improvement of Corporate Governance Environment

To boost corporate governance, the authorities may consider giving institutional investors voting power, which is prohibited now, and allow hostile takeovers, a practice not yet done in India. Furthermore, the authorities may enforce a consolidated accounting principle for conglomerate-affiliated firms in order to better monitor cross-subsidization and internal transactions between affiliated firms. These measures will greatly improve the capital market environments for corporate governance.

Reduction of Cost of Capital Issue

Transaction costs involved in the public issue of securities seem high due to the length of time required. This time-consuming process also increases issuers’ uncertainty and tends to push them towards private placements. Streamlining the procedure for public subscription of securities is necessary not only to reduce administrative burdens and transaction costs, but also to lessen firms’ uncertainty.

Activation of the Debt Market

Several policy measures have been taken to activate the debt market, such as competitive pricing of Government securities, initiation of open market operation including repo operation, and a larger percentage of mark-to-market valuation. These measures have had a beneficial impact on the system, such as greater market absorption of Government securities, lower absorption by RBI, and increased attention by investors to interest rate risk management. For instance, RBI’s absorption of primary issues was 13.3 and 16.6 percent in 1996/97 and 1997/98, respectively, as against 32.6 percent in 1995/96 and 45.6 percent in 1992/93. However, further measures have to be implemented to encourage the development of the debt market, including reduction of the 23 percent statutory liquidity requirement ratio and 100 percent mark-to-market valuation for all banks.

DIVERSIFICATION OF INVESTOR BASE

In order to increase liquidity of Government securities, diversification of the investor base with nontraditional investor groups such as individuals, firms,
trusts, and corporate entities is necessary. Diversification is also important to promote an active market in which investors’ buying and selling needs vary across time. Banks, financial institutions, and provident funds are the predominant holders of Government securities. To promote diversification of investors, mutual funds could be encouraged to establish gilt funds to invest in Government securities through tax incentives, and for primary dealers to diversify the investor base. Fully market-based interest rates for issuing Government securities are also necessary. The credibility of credit-rating companies should be further established.

**STAMP DUTY**

With the establishment of NSDL, a sizable stock of private debt instruments and Public Sector Unit (PSU) bonds was expected to be dematerialized and covered by a secured payment and settlement system. At present, NSDL is able to dematerialize only those scrips that are exempted from stamp duty and are transferable by endorsement and delivery. As most bonds and other corporate debt instruments are not exempted from stamp duty on transfer of bonds, NSDL has encountered difficulties in dematerializing them. In the automated environment of the depository, it is not possible for NSDL to keep track of them. Therefore, unless the issue of the waiver of stamp duty on transfer of debt is settled with the state governments, NSDL would not be able to extend its services to bonds and other private debt instruments. A suitable amendment to stamp duty regime by the Government of Maharashtra in the form of a one-time levy or consolidated fee payable by NSDL could resolve the issue to a significant degree.

**PRIVATE PLACEMENT MARKET**

The proportion of total resources mobilized by government and nongovernment companies through private placements has been increasing. In private placements, bonds have emerged as the most preferred instrument. The popularity of private placement could be attributed to lower issuing cost and savings on issue management time lag, apart from the fact that private placement has not been subject to the strict regulatory provisions applicable to public issues. At present, there is no transparency in this market, with virtually little information issued. In developed markets, the regulatory authorities indicate the framework within which the private placement has to function, such as the number of persons per placement, arrangements with only qualified investors and strict regulations to access certain qualified investors. The issue of extending the regulatory framework to protect investors’ interests from risks associated with subscriptions in the private placement market needs to be addressed. With a proper regulatory framework and more transparency, the private placement market can develop further as an integral and important constituent of the primary market for raising resources by corporates.

Furthermore, favorable tax treatment may be extended to institutional investors to encourage individual investment in the private placement market through professional fund managers, which can reduce asymmetric information and provide better investor protection.

**SECONDARY DEBT MARKET DEVELOPMENT**

In order to activate the secondary market for debt instruments, several measures need to be undertaken. Further deregulation of domestic interest rates, greater reliance on borrowing at market rates by the Government and other quasi-state issuers, more utilization of open market operations as a tool for monetary policy, and better procedures for trading, clearing, and settlement will facilitate secondary market development. Investor groups should be further diversified in order to provide better liquidity, and statutory liquidity requirement should be reduced. A suitable solution to stamp duty in relation to dematerialization of nongovernment securities is also necessary. In the case of Government securities, RBI provides depository, and coverage of book-entry holding is expand-
ing. With respect to PSU bonds and corporate debentures, which are held mostly in scrip form, a proper settlement system is yet to be put in place. As noted, NSDL was expected to dematerialize a sizable stock of nongovernment debt but it has been able to dematerialize only those securities that are exempt from stamp duty. Therefore, suitable amendments to the stamp duty regime are necessary to reduce transaction costs in the secondary markets for private securities. This will also encourage the development of a repo market in nongovernment securities.

Integration of Stock Exchanges and Consolidation of Intermediaries

A recent movement in India is the formation of the Federation of Indian Stock Exchanges (FISE) by 12 regional stock exchanges and the setting up of a central trading system, the Indian Stock Exchanges Services Corporation (ISESC). If this materializes, there will be three entities of national stature: NSE, BSE, and ISESC. The Government should make the environment favorable and, if necessary, provide incentives to facilitate this process.

A related aspect is the consolidation of intermediaries. The number of intermediaries in the Indian capital market has mushroomed over the last 10 years. As a result, turnover per member is quite low and transaction costs are high in most stock exchanges. Corporatization of broking, entry of foreign brokers, drying up of retail investments, and increasing overhead costs have created survival problems, particularly for the individual and small brokers. Also, the number of merchant banks (more than 1,000) seems large for the Indian capital market. The Government should consider favorable tax treatment for brokers and merchant bankers who want to engage in mergers and takeovers.

Risk Management

The rules that have been introduced during the last few years to contain market risks seem to have operated reasonably well. Strict enforcement of these rules is as important as the rules themselves to effectively manage risk. In this regard, SEBI should more closely inspect intermediaries and the stock exchanges and, if necessary, strengthen punitive measures.

Integration of the Capital Market with the Banking Sector

Capital markets cannot thrive alone—they have to be integrated with the other segments of the financial system. Effective and efficient capital markets require a stable and strong payment, settlement, and clearing systems. India’s banking system is yet to come up with good EFT solutions. EFT is important for solving problems such as those related to direct payment of dividends to bank accounts, eliminating counterparty risk, and facilitating FII investments.

Global trends in recent years have seen a blurring of borders between financial market segments. The traditional wall between banks and the securities market is being eliminated, leaving banks with greater investment flexibility. Banks are also increasingly providing long-term loans and entering the capital market to raise resources through equity capital and subordinated debt. India is experiencing the same trends and they are expected to increase the competitiveness of its capital market. However, the country should pursue further expansion of banking activities in conjunction with further efforts to liberalize the banking system, and enhance asset quality to encourage sound competition between the banking sector and the capital market.
Appendix 1

Reforms in Indian Securities Market Since 1992

The development in Indian securities market since 1992 can be summarized as follows:

• Capital Issues (Control) Act of 1947 repealed and the office of Controller of Capital Issues abolished; control over price and premium of shares removed. Companies now free to raise funds from securities markets after filing prospectus with the Securities and Exchange Board of India (SEBI).

• The power to regulate stock exchanges delegated to SEBI by the Government.

• SEBI introduces regulations for primary and other secondary market intermediaries, bringing them within the regulatory framework.

• Reforms by SEBI in the primary market include improved disclosure standards, introduction of prudential norms, and simplification of issue procedures. Companies required to disclose all material facts and specific risk factors associated with their projects while making public issues.

• Listing agreements of stock exchanges amended to require listed companies to furnish annual statement to the exchanges showing variations between financial projections and projected utilization of funds in the offer document and actual figures. This is to enable shareholders to make comparisons between performance and promises.

• SEBI introduces a code of advertisement for public issues to ensure fair and truthful disclosures.

• Disclosure norms further strengthened by introducing cash flow statements.

• New issue procedures introduced—book building for institutional investors—aimed at reducing costs of issue.

• SEBI introduces regulations governing substantial acquisition of shares and takeovers and lays down conditions under which disclosures and mandatory public offers are to be made to the shareholders. Regulations further revised and strengthened in 1996.

• SEBI reconstitutes the governing boards of the stock exchanges and introduces capital adequacy norms for broker accounts.

• Private mutual funds permitted and several such funds already set up. All mutual funds allowed to apply for firm allotment in public issues—also aimed at reducing issue costs.

• Regulations for mutual funds revised in 1996, giving more flexibility to fund managers while increasing transparency, disclosure, and accountability.

• Over-the-Counter Exchange of India formed.

• National Stock Exchange (NSE) establishment as a stock exchange with nationwide electronic trading.

• Bombay Stock Exchange (BSE) introduces screen-based trading; 15 stock exchanges now have screen-based trading. BSE granted permission to expand its trading network to other centers.

• Capital adequacy requirement for brokers enforced.

• System of mark-to-market margins introduced in the stock exchanges.

• Stock lending scheme introduced.

• Transparency brought out in short selling.

• National Securities Clearing Corporation, Ltd. set up by NSE.

• BSE in the process of implementing a trade guarantee scheme.

• SEBI strengthens surveillance mechanisms and directs all stock exchanges to have separate surveillance departments.

• SEBI strengthens enforcement of its regulations. Begins the process of prosecuting companies for misstatements and ensures refunds of application money in several issues on account of misstatements in the prospectus.
• Indian companies permitted to access international capital markets through Euro issues.
• Foreign direct investment allowed in stockbroking, asset management companies, merchant banking, and other nonbank finance companies.
• Foreign institutional investors (FIIs) allowed access to Indian capital markets on registration with SEBI.

FIIs also permitted to invest in unlisted securities and corporate and Government debt.

The Depositories Act enacted to facilitate the electronic book entry transfer of securities through depositories.

Guidelines for Offshore Venture Capital Funds announced. SEBI regulations for venture capital funds become effective.

Appendix 2
The Indian Securities Market
Before 1992

The Indian securities market before 1992 had the following characteristics:

• Fragmented regulation; multiplicity of administration.
• Primary markets not in the mainstream of the financial system.
• Poor disclosure in prospectus. Prospectus and balance sheet not made available to investors.
• Investors faced problems of delays (refund, transfer, etc.)
• Stock exchanges regulated through the Securities Contracts (Regulations) Act. No inspection of stock exchanges undertaken.

• Stock Exchanges run as brokers clubs; management dominated by brokers.
• Merchant bankers and other intermediaries unregulated.
• No concept of capital adequacy.
• Mutual funds—virtually unregulated with potential for conflicts of interest in structure.
• Poor disclosures by mutual funds; net asset value (NAV) not published; no valuation norms.
• Private sector mutual funds not permitted.
• Takeovers regulated only through listing agreement between the stock exchange and the company.
• No prohibition of insider trading, or fraudulent and unfair trade practices.
Appendix 3

Regulatory Framework

INSTITUTIONS

Securities and Exchange Board of India

Securities and Exchange Board of India (SEBI) was set up as an administrative arrangement in 1988. In 1992, the SEBI Act was enacted, which gave statutory status to SEBI. It mandates SEBI to perform a dual function: investor protection through regulation of the securities market, and fostering the development of this market. SEBI has been delegated most of the functions and powers under the Securities Contract Regulation (SCR) Act, which brought stock exchanges, their members, as well as contracts in securities which could be traded under the regulations of the Ministry of Finance (see Figure A3 for the present regulatory structure of the Indian securities market). It has also been delegated certain powers under the Companies Act. In addition to registering and regulating intermediaries, service providers, mutual funds, collective investment schemes, venture capital funds, and takeovers, SEBI is also vested with power to issue directives to any person(s) related to the securities market or to companies in areas of issue of capital, transfer of securities, and disclosures. It also has powers to inspect books and records, suspend registered entities, and cancel registration.

Reserve Bank of India

Reserve Bank of India (RBI) has regulatory involvement in the capital market, but this has been limited to debt management through primary dealers, foreign exchange control, and liquidity support to market participants. It is RBI and not SEBI that regulates primary dealers in the Government securities market. RBI instituted the primary dealership of Government securities in March 1998. Securities transactions that involve a foreign exchange transaction need the permission of RBI.

Department of Company Affairs

In 1947, the Capital Issues (Control) Act was enacted, which formalized and continued initial controls on the issue of securities that were introduced during World War II. This Act was administered by the office of the Controller of Capital Issues (CCI), which was a part of the Ministry of Finance. In line with economic reforms, it was repealed in 1992 to liberalize capital issuance and pricing. While capital issuance used to be regulated by the office of the CCI, both private and public companies were governed by the Companies Act of 1956, which was and continues to be administered by the Department of Company Affairs (DCA) under the Ministry of Law, Justice and Company Affairs. Besides governing the incorporation, management, mergers, and winding up of companies, this Act also specifies certain aspects concerning capital issuance and securities trading, particularly the issue of prospectus for public offers, contents of the prospectus, completion of allotment, issue, and trading of securities, and transfer and registration of securities.

Stock Exchanges

SEBI issued directives that require that half the members of the governing boards of the stock exchanges be nonbroker public representatives and include a SEBI nominee. To avoid conflicts of interest, stock brokers are a minority in the committees of stock exchanges set up to handle matters of discipline, default, and investor-broker disputes. The exchanges are required to appoint a professional, nonmember executive director who is accountable to SEBI for the implementation of its directives on the regulation of stock exchanges. SEBI has introduced a mechanism to remedy investor grievances against brokers.

DISCLOSURE

Similar to companies in capital markets in other countries, a company offering securities in the Indian
capital market is required to make a public disclosure of all relevant information through its offer documents. These documents are as follows:

- prospectus,
- application form and the abridged prospectus (in case of an issue to the public), or
- letter of offer (in case of a rights issue to existing shareholders or debenture holders of a company with or without the right to renounce in favor of other persons).

After a security is issued to the public and subsequently listed on a stock exchange, the issuing company is required under the listing agreement to continue to disclose in a timely manner to the exchange, to the holders of the listed securities (the shareholders or the bondholders), and to the public (through the exchange or the media), any information necessary to enable the holders of the listed securities to appraise its position and to avoid the establishment of a false market in such listed securities. Such information include:

- the date of the meeting of the board of directors for corporate actions;
- the audited financial results on an annual basis and the unaudited ones on a semiannual basis;
- any proposed change in the general character or nature of the company’s business;
- any alterations of the company’s capital; and
- any change of the company’s directorate, including managing directors and auditors.

Figure A3: Regulatory Framework of the Indian Securities Market

DCA = Department of Company Affairs, FII = foreign institutional investor, SCR = Securities Contract Regulation, SEBI = Securities and Exchange Board of India.
Notes

1Euromoney (1996).

2They are the Discount and Finance House of India Ltd. (DFHI), the Securities Trading Corporation of India (STCI), State Bank of India, Gilts Ltd., PNB Gilts Ltd., Industrial Credit and Investment Corporation of India (ICICI) Securities, and Gilt Securities Trading Corporation.

3See Endo (1998) for comparison of Indian GAAP with those of the UK and US.

4Up to August 1997.

5The one-time exemption on capital gains tax provided in the Union Budget 1997/98 should be of help to brokers for corporatizing their businesses.

References


