Jayadev Kadli
2006.07.23
17:31:18 +05'30'

ACCREDITED COLLEGE
★ ★ ★
BY **NAAC**
Autonomous Body
OF **UGC**

LALA LAJPAT RAI COLLEGE
OF COMMERCE & ECONOMICS

Mahalaxmi, Mumbai - 400 034.
Tel : 492 82 40 / 42 Fax : 492 57 99
E-mail : llcolcom@bol.net.in • Website : llim.edu

LALA LAJPAT RAI MEMORIAL LECTURE

28th SERIES - 2001

JANUARY 29, 2001

MUSING ON REFORMS OF STOCK EXCHANGES

By

M. R. MAYYA
Chairman
Inter-connected Stock Exchange of India Ltd

LALA LAJPAT RAI MEMORIAL LECTURE

28TH SERIES - 2001

JANUARY 29,2001

MUSINGS ON REFORMS OF STOCK EXCHANGES

By

M. R. MAYYA
Chairman, Inter-connected Stock Exchange of India Ltd.

PRELIMINARY

I consider it a great honour and privilege to be invited to deliver the 28th Memorial Lecture in honour of our great patriot, freedom fighter, social reformer, philanthropist and educationist, Lala Lajpat Rai. It is great men like Lala Lajpat Rai, rightly called the Lion of Punjab, who not only helped the nation to remove the shackles of alien rule but also ushered in right values in all walks of life. I join you today on his one hundred and thirty-sixth birth anniversary in reverentially offering my sincere and humble tributes to this great son of India.

INTRODUCTION

Friends, I have been a student of the Indian capital market for over a quarter century and have been watching closely the various developments that have been taking place since then. Stock exchanges, which were considered to be gambling dens even in the fifties and sixties of the century that has gone by, have emerged over years as a vital instrument for mobilisation of resources into fruitful and constructive channels of investment, distribution of corporate wealth among millions of investors and a barometer to continuously assess the ever-changing values of the listed corporate sector. Government of India, the Securities and Exchange Board of India (SEBI) and the 23 recognised stock exchanges of the country spread across the length and breadth of the country have been constantly endeavouring to reform the working of stock exchanges with a view to augmenting mobilisation of resources, improving disclosure requirements, enhancing liquidity in listed stocks, rendering the transactions fair and transparent, etc., all designed basically to protect the interests of investors.

The process of reforms of the economic system as a whole, including the financial sector of which stock exchanges constitute an integral part, received a tremendous fillip with the 'induction in June 1991 of a stable government at the Centre, which ushered in an era of deregulation, liberation and globalisation of the Indian economy. Launching of the National Stock Exchange in 1994, which resulted in emergence of keen competition among the various stock exchanges of the country, gave a further boost to the reforms process in the stock exchanges.

Reforms are normally taken for granted to result in favour of the society as a whole, while in its actual translation into practice, it may really not be so. It could end up resulting in apportionment of larger benefits to certain segments to the detriment of certain other segments who may be in the lower rungs of society. It is indeed a difficult proposition to make an assessment, qualitative or quantitative, of the impact of reforms. Yet, with all these limitations, one should venture to do so, howsoever difficult the task be. I shall, in the course of my lecture, try to cover this aspect of reforms also.

GROWTH OF THE MARKET

The market has grown by leaps and bounds during the last one decade. As against an amount of Rs. 4,312 crore raised from the new issues market in 1990-91, the figure zoomed to Rs. 28,764 crore in 1994-95, amounting to about 11.4 per cent of the gross domestic savings of the year. The new issues market has, however, received a severe setback with the amount of capital raised progressively declining to Rs. 4,570 crore in 1997-98. In 1998-99 and 1999-2000, there was some revival with the amounts of capital raised improving slightly to Rs. 5,586 crore and Rs. 7,817 crore respectively. There has been a setback again in the current year with the first half of the year registering a mobilisation of Rs. 2,484 crore only. The total estimated capital of about Rs. 5,000 crore that may be raised in the current year wilt work out to a meagre 1.1 per cent of the gross domestic savings of the country.

There is a school of thought which argues that the drop in the capital mobilisation from the new issues market is matched by a rise in private placements. This is not a tenable argument, as private placements are generally among the institutions, one institution subscribing for the capital of the other, with the general investing public being mostly out of the picture.

The total daily turnover in the secondary market in India in 1990-91 was just about Rs. 200 crore with the Bombay Stock Exchange accounting for about 70 per cent of the turnover. With the commencement of operations by the National Stock Exchange in November 1994, the daily turnover in the Indian stock exchanges rose to about Rs. 600 crore in 1994-95. Thereafter, there has been a continuous spurt in turnover with the daily turnover on any given day at present being about Rs. 15,000 crore - a rise of 25 times compared to 1994-95.

Market capitalisation, which was as low as about Rs. 85,000 crore as on March 31, 1991, rose to about Rs. 5 lakh crore as on March 31, 1995. It zoomed sharply to about Rs. 1O lakh crore on February 14, 2000 when the SENSEX touched the peak of 6151 amounting to about 50 per cent of the gross domestic product. With the SENSEX currently ruling around 4300, market capitalisation is around Rs. 7.5 lakh crore.

Investor population was relatively stagnant till the FERA dilution in the mid-'70s. FERA dilution by about 120 companies, which made public offerings of about Rs. 150 crore, generated about 1.8 million shareholders. There has been a steady growth in investor population thereafter due to expansion of stock market activities, both in the primary and secondary segments. A recent survey has revealed *that the number of investor households increased at a compounded* annual rate of growth of 22 per cent between 1985-86 and 1998-99, with the rise being sharper during the period 1991-92 and 1998-99 than the earlier period of 1985-86 and 1991-92. Rather surprisingly, the growth rate was 30 per cent in the rural sector as compared to 19 per cent in the urban sector. The sharper rise during the latter period must have occurred till 1994-95 and thereafter, the growth rate in investor population has been minimal - due to a severe setback in the mobilisation of capital. As the survey itself points out, investors generally prefer the primary market to the secondary market route to invest due to a variety of reasons, including the problem of locating the right intermediary for dealing in the secondary market and lack of proper guidance and advice.

The survey has estimated the investor households at 12.8 million or nearly 8 per cent of all-India households representing 19 million individuals as at the end of the financial year 1998-99. Out of this, 12.1 or 7 per cent of all-India households representing 18 million individual investors owned equity shares only and only 3.7 million or 1 per cent representing about 5 million investors owned debentures. The bulk of the debenture owning households are also equity investor households.

We have still a long way to go to spread the equity cult in the country. 18 million individual investors who own equity represent less than 2 per cent of the population as against over 10-12 per cent in most of the developed markets of the world. U.S.A. has an equity base of over 50 million representing over 15 per cent of the population.

QUALITY OF THE MARKET

There has been a sea change in the quality of the market compared to what it was 6 to 7 years ago.

In the primary market, we have adopted the policy of free pricing of securities, no more bridled with controls. Disclosure of information for subscription in the new issues market for initial public offerings as also for other issues is almost on par with international standards. We have launched on the book-building system for public subscription, resulting in better discovery of prices and reducing the cost of public subscription. We will soon be utilising the network of stock exchanges for distribution in the primary market. The time lag between closure of issues and listing of securities has also been reduced greatly, thereby enhancing liquidity in investment in capital market instruments.

In the secondary market, screen-based trading with on-line connectivity virtually throughout the length and breadth of the country is the order of the day. In fact, screen-based trading is a condition precedent for grant of recognition to a new stock exchange by SEBI.

It is relevant to note that the New York Stock Exchange has still floor-based trading and there seems to be no move to switch over to screen-based trading in the near future.

We have made tremendous progress in replacing the physical stock of shares straight away by the dematerialisation system, skipping the immobilisation of securities stage, which some of the countries like U.S.A. still has.

At the National Securities Depositories Ltd. (NSDL), as on December 30, 2000, demat facilities were available in respect of 2,299 companies with Rs. 2,936 crore shares having a market value of Rs. 3.75 lakh crore representing about 50 per cent of the market capitalisation. There were 178 Depository Participants offering depository services from more than 1,800 locations, spread across the length and breadth of the country. More than 3.44 million investor accounts were in operation *from all over the country and abroad.* NSDL had more than 3,641 clearing member accounts providing facilities for trading and settlement of demat shares.

As on December 15, 2000, 2062 companies had made depository services available with Central Depository Services (India) Ltd. (CDSL). There were 131 Depository Participants located in more than 50 locations across the country. More than 100 crore shares were dematerialised.

The two depositories currently account for about 99.5 per cent of the total deliveries in the market.

Thanks to the sustained efforts of SEBI, NSDL and CDSL, our achievements in dematerialisation have established a global record as we did all this in just 3 to 4 years while even advanced countries took over a decade to achieve similar comparable results. This is also due to apprehensions of receipt of bad deliveries by buyers due to a few unscrupulous elements who specialised in introduction of fake, forged and stolen documents in the market, threatening the very foundation of the functioning of stock exchanges in the country.

It is relevant, in this connection, to note that the Group 30, a Committee of 30 global experts drawn from the world's major markets, in their report submitted in March 1989 on "Clearance and Settlement Systems in the World Securities Markets" had recommended a single central securities depository for each country on the ground that a single depository entity can offer the efficiencies of immobilisation and dematerialisation of physical securities, reliable and simultaneous money and securities settlement, and the economies of scale that lead to significant cost reductions and also improve operating efficiencies in post-settlement functions.

Luckily, India chose not to accept the recommendation of Group 30 in this regard and opted for multiple depositories. The establishment of the second depository, CDSL, has led to competition among the two depositories resulting in benefits to investors by way of reductions in transaction costs and custody charges.

Operations in Indian stock exchanges have become absolutely safe with the establishment of either Clearing Corporations or Trade Guarantee Funds/Settlement Guarantee Funds, guaranteeing completely the counter-party risk in the market on the one hand and of Customer Protection Funds meeting the claims of investors in case of failure of a member broker on the other hand. In case of failure of a member broker to fulfil his pay-in liabilities, Clearing Corporations/ Trade Guarantee Funds/Settlement Guarantee Funds would provide the necessary funds and thus ensure timely completion of settlements. The corpus of these funds at all the stock exchanges stood at Rs.

3,436.79 crore as on March 31, 2000. As regards clients of the member brokers, the Customer Protection Fund of the stock exchange of which he is a member reimburses the investment losses of each of the clients upto a specified amount. At the Bombay Stock Exchange, where the corpus of the Fund was Rs. 82.2 crore as on March 31, 2000, protection to each client of a defaulting member is to the tune of Rs. 10 lakh.

Indian stock exchanges are currently experimenting with the switchover to rolling settlements on a T + 5 basis from the weekly account trading periods. There have, however, been problems of adjustment between the rolling settlements and a carry forward system either by way of badla or the facility of automated lending and borrowing of securities that most of the stock exchanges have and of not only a sharp shrinkage in volume but also a steep drop in prices in most of the cases where the switch-over is experimented. These are currently being looked into.

Derivative instruments by way of futures contracts on stock indices have also been introduced at the two leading stock exchanges of the country. This is expected to be followed soon by options on stock indices and individual stocks.

Internet trading has also been introduced at the Indian stock exchanges. Volumes in internet trading are, however, very low as Indian investors are yet to get themselves used to this type of trading.

Having indicated both the qualitative and quantitative changes that have taken place in the Indian capital market in the last one decade, let me try to analyse the benefits investors in the country have been able to ' reap due to these changes. I shall first look into the primary market.

PRIMARY MARKET

As I said earlier, there has been a sharp setback in recent years in the quantum of resources raised from the primary market. This is mainly due to the free pricing policy adopted by SEBI following repeal of the Capital Issues (Control) Act, 1947 (CIC Act) on May 29, 1992. The premium amount under the CIC Act used to be fixed on the basis of valuation guidelines issued by the Controller of Capital Issues. Fair value of a share was arrived at by taking the average of the net asset value per share of the enlarged equity capital base (including the fresh issue) of the company and of the capitalised value at 15 per cent of the average post-tax earnings per share of the last three years with the earnings per share of fresh issue reckoned at 50 per cent of the existing rate of profitability of the company being added on. The fair value so arrived at used to be compared with the average market price of the preceding three years in case of listed shares and if the latter was higher by more than 20 per cent, the profit-earning capacity value was being reworked by reducing the capitalisation rate suitably from 15 per cent upto 8 per cent. This was a straight jacket formula which invariably resulted in favouring the investors as the post-listing prices in almost all cases were higher than the offer prices. Tremendous public response to FERA issues and several others was entirely due to this formula.

IMPACT OF FREE PRICING POLICY

The relatively near complete freedom given to the issuers in pricing the issues coupled with keen competition among the merchant bankers was 'grossly misused. A study conducted by Prime data base indicated that out of the 3.872 issues made during the four year period from April 1, 1992 to March 31, 1996, as many as 205 issues were not traded at all and 2,987 issues were traded below the offer prices as on January 14, 1997. Besides, 118 companies proved to be "vanishing companies" which took public money and vanished. Prices of 562 companies only were quoted above the offer prices. The position in this regard even today is almost the same as on January 14, 1997.

Even the guidelines issued by SEBI based on Malegam Committee's recommendations, effective from May 1, 1996, requiring justification of premium on the basis of six parameters viz., (i) earnings per share (EPS) for the last three years, (ii) P/E ratio pre-issue and comparison with the industry P/E ratio, (iii) average return on networth for the last three years, (iv) minimum return on increased networth required to maintain pre-issue EPS, (v) latest net asset value per- share, and (vi) net asset value per share after issue and comparison with the issue price, generally failed to ensure that post-listing prices ruled higher than the offer prices. It is relevant to note in this connection that on the basis of same parameters, while one merchant banker can justify an offer price of Rs. 100, another would pitch the justifiable offer price at Rs. 200, tempting the issuer to choose the latter.

The decision of SEBI, effective from December 10, 1996, to give up completely vetting of offer documents and leaving the responsibility entirely on merchant bankers has also affected adversely the quality of issues. Merchant bankers in India are neither mature enough nor have adequate expertise to shoulder the responsibility. Moreover, the liability cast on them is minimal with visitation of suspension and in extreme cases cancellation of their registration with no civil or criminal liability attached for any wrong doings. The freedom given to the issuers is also not accompanied by any additional responsibility cast on them. The reported observation of the Parliamentary Standing Committee of Finance that "Policy makers either in the government or in the SEBI Board had failed to realise the ground realities of the integrity and quality of promoter issuers who were given full freedom of access to raise capital under the free pricing mechanism" and that the same has "brought havoc in the Indian capital market which is in an early stage of development and growth" needs particularly to be noted in this connection.

Book-building has been permitted by SEBI for all issues, including issues below Rs. 25 crore. Book-building has a major objective of acting as a good price discovery mechanism. Indian experience, however, has been that book-building has not proved to be a good price discovery mechanism in quite a few cases. For example, prices of Cinevesta and Cadilla Healthcare, which had fixed their offer prices at Rs. 300 and Rs. 250 on the basis of book-building, were quoted at Rs. 293 and Rs. 130 on listing. Even on January 19, 2001, prices of these scrips were quoted at Rs. 129.65 and Rs. 155.85 respectively.

It is in the above context that the question of prescription of stricter norms for public issues needs consideration. Mere publication of information relating to the various parameters as recommended by the Malegam Committee would not suffice.

Companies coming out with premium issues should be required to indicate the premium amount admissible as per the time-tested valuation guidelines prescribed under the CIC Act. The premium amount that would be admissible as per the discounted cash flow method - a concept which is now quite popular - may also be given in addition. If the offer price, even if fixed by the book-building method, is higher than warranted by these formulae, some arrangement by way of safety nets in respect of at least initial small investors upto say 200 shares for a period of one year needs also be made. The responsibility of honouring the safety nets should be borne by the promoters, merchant bankers and underwriters. Such a mandatory requirement will in actuality force the issuers and merchant bankers to be more realistic while fixing the premium amount.

It is pertinent to note in this connection that in the United States, issue of securities is also governed by separate securities laws of each of the individual States in addition to the Federal Securities Act, 1933. Kansas was the first State to come out with securities legislation way back in 1911 following a wave of highly speculative and worthless securities offerings. The Kansas statute came to be popularly know as "blue sky" law as it was to check barefaced stock swindlers who were selling "building lots in the blue sky". The Kansas experiment was followed subsequently by all the remaining States of the country in some form or the other. The common denomination of all these State level legistations took the form of rules regulating the maximum expenses of public offerings, requiring a minimum equity investment by promoters, regulating the price that insiders must pay for their stock relative to the proposed price for public investors, regulating securities offer prices in relation to earnings ratios or some other benchmarks, regulating the amount of warrants and options granted to officers, key employees and underwriters, establishing minimum shareholder voting rights, and regulating interest and dividend coverage with respect to senior securities. In order to harmonise State securities regulations, the U.S. Congress enacted the Uniform Securities Act in 1985 which has been adopted by almost all the States to a significant extent.

Government has now before it a golden opportunity to offer the PSU shares at attractive rates directly to the investors. It does not have to go abroad to the GDR market nor devise any particular vehicle for disinvestment. A straight away offer to the public in respect of nonstrategic sales at discounts of about 15 to 20 per cent of the likely postlisting prices will draw millions of investors to the market. This is precisely what U.K., France and several other countries did while privatising their public undertakings. Moreover, applicants in the lower categories should be granted weightage in allotment with none of the applicants getting more than 500 shares unless all applicants upto 500 shares are allotted in full and applicants submitting multiple applications should be awarded deterrent punishment, including imprisonment. There can then be no allegations of any malafides -of throwing away family's silverware at throw away prices.

ACTION UNDER SECTIONS 62 AND 63

Another corrective can be institution of cases under Sections 62 and 63 of the Companies Act, 1956 relating to payment of compensation and criminal liability respectively for making "any untrue statement" in a prospectus. The number of cases instituted under these Sections is few. Class action by stock exchanges and investors' associations needs also to be initiated as individual investors can hardly afford to initiate such cases. Payment of compensation for "untrue statements" in prospectuses is a regular feature in the United States with millions of dollars being paid every year and that too within about six months of the institution of cases.

FLY-BY NIGHT COMPANIES

Yet another remedy can be institution of drastic penal action against promoters and directors of fly-by night companies which vanish from the scene after tapping the capital market. SEBI deserves to be congratulated for having initiated some drastic action against quite a number of directors of some "vanishing" companies. This is, however, not enough to act as a sufficient deterrent. This needs to be supplemented by further action under Section 209-A of the Companies

Act, which reportedly is being initiated by the Department of Company Affairs. Besides, personal properties of the concerned directors need also to be confiscated by issue of an immediate ordinance in this behalf. In addition, names and addresses of these directors should be published widely in newspapers.

Investors, who have lost their savings by investing in these "vanishing" companies must be compensated. The recently set up Investors' Protection and Education Fund under Section 205C of the Companies. It is reported that this Fund will be having about Rs. 500 crore.

AUDIT

No disclosure requirements can be satisfactory unless audits are made more realistic and independent. The slackness shown by the auditors in several cases has shaken the confidence of investors. In countries like the United States, auditors are held increasingly responsible for the misdeeds of companies. We need to follow this example.

CORPORATE GOVERNANCE

An equally important factor is the quality of corporate governance. An awareness of this concept has luckily now dawned on the Indian horizon. Since enforcement of corporate governance is through the listing agreements, which companies have to execute with the stock exchanges where securities of companies are listed, it is to be seen how effective corporate governance will really be. Even in the U.K.. where initially corporate governance was introduced through the listing agreement, there is now a move to have the concept of corporate governance embodied in the statute.

MERCHANT BANKERS

Investors can also be alerted by a compulsory requirement to have Merchant Bankers rated by authorised rating agencies which will evolve its own norms, including post-listing appreciation/depreciation in prices of securities handled by the Merchant Bankers. This will, in turn, compel the Merchant Bankers to exercise greater vigil white handling public issues.

BOOK-BUILDING AND REDUCTION IN PUBLIC OFFER

Another area which needs examination is the impact of the recent twin decisions of SEBI to allow all public issues through book-building and reduction in percentage of public offer from 25 per cent of post-issue capital of a company to 10 per cent, subject to a minimum offer size of Rs. 100 crore and of Rs. 20 lakhs securities, on spread of equity cult in the country.

While reservation upto 25 per cent of the issue to individual investors applying upto 10 tradeable lots is permitted in case of companies raising capital through the 100 per cent book-building route, in case of companies opting to raise capital through the 75 per cent book-building process, reservation is made to the extent of 50 per cent of the public offer for individual investors applying upto 1,000 shares in respect of 25 per cent of the fixed price offer to the public.

There is already a diminution in the interest of small investors in the new issues market and the above decisions are likely to erode further investor interest in equities. In almost all the recent issues, which had chosen the book-building route, the number of retail investors were all below 5,000 and in some cases even below 1,000 and in a way this is not surprising as in the case of 100 per cent book-building cases (majority of the book-building cases have chosen the 100 per cent book-building route), the ordinary investor generally has neither ready access to the book runners or syndicate members procuring applications nor the expertise to participate in the bidding process. Such a diminution will also result in rendering the market less liquid.

The shrinkage in the public offer to the small investors has to be viewed in the context of 60 per cent of the issued capital of a company being required to be offered to the public under the Securities Contracts (Regulation) Rules, 1957 and grant of weightage in allotment to applicants upto 500 shares in operation wilt September 1993, to be eligible for listing. The rate of growth in the number of investor households in the country, which took place at a compounded annual rate of 22 per cent between 1985-86 and 1998-99, would have been higher but for the shrinkage in percentage of public offer.

Spread of equity cult will receive a further setback because of the recent decision of SEBI to permit all companies to offer only 10 per cent of the equity to be eligible for listing. A company with an equity base of say Rs. 1,OOO crore was earlier required to offer Rs. 600 crore to the public with weightage in allotment to smaller applicants while under the new dispensation the public offer can be just Rs. 1OO crore out of which the portion that would be earmarked to small investors would be Rs. 25 crore which works out to a miniscule of 2.5 per cent of the equity capital of the company.

The argument that reduction in public offer to 10 per cent is to induce companies, not needing additional capital, to seek listing does not seem to be based on realities, at least in respect of a majority of them. Promoters do scout for private placement on a large scale among their friends and relatives with an offer either on par or a lower premium and later offer only 25 per cent or 10 per cent of the capital to the public on a higher premium.

It is relevant to note in this connection that the Directive Principles of the Constitution ordain "that the ownership and control of material resources of the community are so distributed as best to subserve the common good" and "that the operation of the economic system does not result in concentration of wealth and means of production to the common detriment." Supreme Court of India has held that "the Fundamental Rights and the Directive Principles constitute the conscience of our Constitution."

A review of the above decisions is, therefore, called for and the questions of restricting the portion of book-building to say 50 per cent of the public offer in respect of issues upto Rs. 10 crore and 25 per cent of the public offer for issues above Rs. 10 crores, subject to a minimum of Rs. 5 crore for book-building, and of raising the percentage of public offer for a company to be eligible for listing from 25 per cent to 40 per cent of its capital, if need be in two stages of 20 per cent each, needs to be considered, in the larger interest of spreading the equity cult in the country. It is relevant to note that investors generally prefer the primary market route to the secondary market to invest due to a variety of reasons, including the problem in locating the right intermediary for dealing in the secondary market and lack of guidances and advice.

MERGING COMPANIES

A sad spectacle that has emerged in the primary market in recent years is the evasion of public offer by having recourse to merger of a large unlisted company with a small listed company. For example, a leading unlisted finance company got itself merged, effective from February 9, 1995, with a small listed company with a capital of just Rs. 25 lakh and got the benefit of listing the equity shares of the face value of Rs. 12.23 crore issued to the erstwhile shareholders of the finance company without any public offer.

In the absence of a suitable guideline from SEBI, stock exchanges do not seem to have been following any uniform set of procedures with regard to public offer of shares that are being issued to the shareholders of unlisted companies merging with listed companies. Some of the stock exchanges, however, seem to be insisting, lately, on a public offer or offloading of shares to the extent of 25 per cent of the shares of the unlisted merging company if the capital of the merging company is more than 100 per cent of the capital of the merged company prior to merger. The procedures adopted by stock exchanges, therefore, need to be streamlined to ensure that relevant percentage of shares are offered to the public in a transparent manner in the larger interest of spread of equity cult in the country.

It is relevant to note in this connection that whenever there is a hiving off of a division of a listed company into a separate company, the shares of the hived off company that are being issued to the shareholders of the original company are being listed on stock exchanges without any public offer.

The action of stock exchanges in granting the facility of listing to the shares of the spun out units when the shareholders are the same both in the original company and the spun out units is fully justified, as the facility of free marketing of shares the shareholders enjoyed earlier cannot just be denied because of re-engineering by the management. Justified as this action is, equally justified is the demand for a public offer of shares wherever an unlisted company merges with a listed company, irrespective of the size of capital of the unlisted company. At least 25 per cent of the capital of the merging company should be offered to the public, without relaxing in any way provisions of Rule 19(2)(b) of the SC(R)A Rules, either by way of a fresh issue or an offer for sale at the price on the basis of which the swap ratio for exchange of shares of the merging company with the merged company has been arrived at.

We can ill afford to neglect the primary market. Remedial measures on the lines indicated above are needed to ensure that the primary market is revived so as to become a vibrant instrument for mobilisation of resources. It is relevant to note that China raised $17 billion (i.e. about Rs. 76,500 crore) in 2000 as against a meagre amount of about $ one in India.

SECONDARY MARKET

With a daily turnover of about Rs. 15,000 crore, Indian stock markets have emerged today as the fifth biggest market in the world next only to NASDAQ, New York, London and Tokyo. With the prospect of doubling of turnover in the next one year or so, Indian stock markets is poised to become the third biggest market in the world. Several improvements are, however, needed so that the secondary markets really serve the purpose they are meant to.

LIQUIDITY

The sharp increase in the turnover is confined to a few shares with the top 10 shares accounting for about 80 per cent of the turnover and the top 100 shares for 99 per cent of the turnover. The number of companies whose shares are traded on any given day has come down drastically from about 4,000 five years ago to about 1,000 about two years ago. Currently, however, shares of about 1,500 companies are traded. Out of the total of about 10,000 shares listed on Indian stock exchanges, not more than 1,000 shares get traded continuously on a daily basis. If we apply the yardstick of a minimum of 5 trades or shares worth Rs. 5 lakh, the number of daily traded shares comes to about 100. Out of the remaining 9,000 shares, while about 3,000 shares do not get traded at all, about 6,000 shares get traded only occasionally with practically no liquidity.

All round efforts are needed to improve liquidity in the stock markets.

The recommendation made by the G. P. Gupta Committee to appoint market-makers is no doubt welcome, but that alone will not be adequate. Liquidity can also be improved by initiating a number of other measures like enhancing the minimum public offer for qualifying for listing from 25 per cent or 10 per cent to 40 per cent of the issued capital of the company, directing companies numbering about 5,000 to raise the minimum issued capital to at least Rs. 3 crore for continuing as listed companies, quarterly, half-yearly and annual reports of the companies to contain information about monthly high and low prices with volumes traded, transactions of promoters, directors and key officials to be published every month, providing for listing on at least two stock exchanges to facilitate arbitrage transactions and encouraging companies to issue rights shares at discounted prices, thereby inducing renunciation of rights which would widen the shareholding pattern, etc.

FUTURE OF REGIONAL STOCK EXCHANGES

A disturbing development has been the progressive decline in the turnover at the regional stock exchanges following the rapid expansion of the operations of National Stock Exchange and Bombay Stock Exchange to about 390 and 330 centres respectively in the country. The volume of business on the 16 regional stock exchanges of the country which accounted for 12.3 per cent of the total turnover on all the stock exchanges of the country in 1995-96 plummeted to a meagre 2.46 per cent of the total all-India turnover of Rs. 20.67 lakh crore in 19992000. Besides, trading at nine stock exchanges situated at Guwahati, Magadh, Jaipur, Bhubaneshwar, Indore, Rajkot, Mangalore, Coimbatore and Cochin has come to a halt despite the fait that trading at all these stock exchanges too have been automated.

As the regional stock exchanges individually lack the necessary depth to compete effectively with NSE and BSE, the only way of ensuring that the valuable services of the members of these stock exchanges are not lost to the securities industry is to forge a new national segment of trading open to all the members of these stock exchanges while retaining the regional segments of trading at these exchanges. This is precisely what has been done by the Inter-connected Stock Exchange of India (ISE), which was granted recognition under the Securities Contracts (Regulations) Act, 1956 by SEBI. ISE commenced its trading operations on February 26, 1999.

The 15 participating exchanges of ISE have about 4,500 members and about 3,500 securities listed on them. ISE is a stock exchange of stock exchanges, members of the participating stock exchanges being only traders on the ISE.

ISE has provided a highly automated trading system open to all the registered traders of the participating exchanges with direct access to its national-level trading platform on an equal footing regardless of the location of the participating exchanges and of the status of the exchange in terms of turnover, financial strength, etc. It has not only a professionally qualified managing director, but also a public representative as the chairman of the Exchange. Most importantly, ISE is a centralised national-level market for trading in securities with decentralised operations as the participating regional stock exchanges continue to be the centres for trading, clearing and settlement.

ISE is also enrolling about 500 dealers from 61 centres in the country other than the participating regional stock exchange centres. A major task ISE has set for itself is to ensure liquidity for the regionally listed securities by providing for a national segment of trading. Thus a truly national network for trading in securities is getting built up. This will help greatly in the spread of equity cult throughout the country.

As SEBI has permitted regional stock exchanges to float subsidiaries, which can become members of major stock exchanges and members of regional stock exchanges can trade on the major stock exchanges as sub-brokers, ISE has also become a member of NSE.

CAPITAL GAINS IN DEMAT

A presumably unintended provision that has crept into the demat system is the first-in-first-out (FIFO) method used in calculation of capital gains as per Section 45(2A) of the Income Tax Act, 1961 and the clarifications issued by the Central Board of Direct Taxes. This can, in some cases, cause a financial loss to an investor while in an identical position in the physical segment, the investor can avoid the same. For example, an investor buys 100 shares of a company ABC at Rs. 1OO per share on February 1, 2001. On March 1, 2001, he buys another 100 shares of the same company at Rs. 200 per share. Then, on April 1, 2001, he sells 100 shares at Rs. 150 per share. According to the FIFO method, the investor has made a profit of Rs. 5,000 i.e., @ Rs. 50 per share on 100 shares as the shares brought by him on February 1, 2001 at Rs. 1OO per share are sold while in the physical segment, the investor can sell the shares brought by him on March 1, 2001 at Rs. 200 per share and show a toss of Rs. 5,000 i.e., @ Rs. 50 per share on 100 shares. The investor in the demat segment is denied this facility which goes against the rudimentary principle of ordinary prudence. It is necessary to amend the statutory provisions leaving the option of working out profits or losses to the investor in the demat segment as is the case in the physical segment.

FUTURES AND OPTIONS

Both NSE and BSE have commenced trading from June 2000 in index futures. Trading in options on index futures and also on individual scrips is expected to start in the near future.

Trading in index futures is still on a low level, the average daily turnover on NSE and BSE being hardly around Rs. 30 crore as against a turnover of over Rs. 10,000 crore in the secondary market. Several factors such as absence of hedgers in the market, tax treatment of speculative losses which can be offset only against speculative profits and not treating losses and profits as business expenses and business incomes, sub-brokers being kept away from the derivatives market, absence of suitable back office software in brokers' offices, etc. have hindered the growth of the market. It is hoped that this will soon be a story of the past.

There is a school of thought which feels that there is no need for trading with badla facility once trading in futures and options starts. It is, therefore, necessary to assess the relative merits and demerits of futures, options and badla. The two principal norms for assessment can be - (i) utility as a hedge instrument, and (ii) generation of liquidity by the use of these instruments and its consequent impact on volatility.

Risk is inherent in any market economy and speculators in the fond hope of realising gains are prepared to shoulder this risk while others averse to risk would like to pass on the same to those willing to carry. The instruments that are evolved in this regard should provide near full protection, if not full protection, against the likely adverse movement of prices. The instruments should also create adequate liquidity in the market so that large orders of purchase and sale are absorbed with minimal variations in prices.

Futures contracts are only on stock indices and not on individual stocks. A perfect hedge would require the prices of basket of shares held or proposed to be bought to move in unison with the stock index. As such a movement normally does not take place, beta factors measuring the variation between the prices of concerned shares and the stock index values are worked out and purchase or sale of the number of futures contracts adjusted accordingly to provide for a perfect hedge. This assumes that the beta factor of the past will continue in the future too an assumption which may not always prove to be correct. Besides, investor's inability to buy or sell the required number of shares (when it is not an integer number), transaction costs and lack of absolute correlation between the spot and futures values of the index, margin deposits, price limits, etc. detract the futures contract from acting as a perfect hedge. Even with regard to index-based funds, there is the problem due to tracking error i.e., the difference in the performance of the fund and the underlying index on account of the time lag taken to deploy the funds in the proportion of the index, difference in prices due to ex-dividend, ex-bonus and ex-rights on different stock exchanges as also the price difference arising out of trading on these exchanges, time lag in the delivery of rights, high volume of sales on redemption as the conversion into cash cannot be done as quickly as needed, etc.

Futures contracts no doubt increase liquidity but opinions seem to be divided with regard to its impact on volatility. For example, the October 19, 1987 crash on the Wall Street, when the Dow Jones Industrial Average plummeted by 508.32 points (i.e., by 22.6 per cent) to 1738.42. was attributed to a significant extent to trading in futures contract. Portfolio insurers sold that day 3,000 Standard and Poor 500 futures contracts in the first half an hour of futures trading with the result that the price of the December, 1987 futures opened 10 to

17 points below the reported spot index and fell by the end of the day by 80.75 points, i.e., by 30 per cent. The Brady Commission set up by President Reagan observed that portfolio insurers and index arbitragers accounted for about twenty-two per cent of the stock index futures selling on October 19 and 20, 1987. Seven important committees, including the Brady Commission which made an in-depth study of the crash, targeted futures trading, in particular portfolio insurance trading, as a prime culprit.

Hedging through options is relatively a costlier proposition because of the premium the purchaser of the call or the put has to pay. In the case of a call, the premium is higher for lower strike prices while the premium is higher for higher strike prices in respect of a put. The premium amount would be detracting the instrument from acting as a perfect hedge.

Several studies have been conducted in advanced countries about the impact of options on trading in shares. There is general consensus that the turnover increases in the underlying shares of those companies in respect of which options have been launched. It is, however, not clear whether the increase in turnover has led to any decline in volatility. One generally accepted fact is that options stimulate speculation which cannot be said to be a healthy sign.

Badla is an almost perfect hedge instrument. The question of any lack of correlation between the futures and spot prices detracting the instrument from acting as a perfect hedge does not just exist as the quotation in respect of all the three types of transactions, viz., for delivery, for offsetting and for carry forward, is one and the same. There is also no question of payment of any premium amount as the market is equally balanced between the buyer and seller. Payment of contango by the buyer to the seller, short or otherwise, is only by way of interest for the amount of money the buyer would have to pay for the shares bought by him but has chosen out of his own volition not to pay and instead carried forward the transaction to the next settlement. The oft repeated argument of inequity of badla payment to the short seller emanates from an inadequate understanding of the system. The recent decision of SEBI to deny payment of contango charges is a step not in the right direction.

Liquidity in a share having badla facility is much higher than in a share without badla facility. The increase in liquidity is also accompanied by a reduction in volatility. Some studies conducted in this behalf have revealed that while the annual average range of fluctuations of some select shares in the specified group is about 50 per cent, the corresponding figure for the most active shares in the non-specified group is about 65 per cent. In addition, the spreads in specified shares are much lower being not more than 1.5 per cent while the spreads in the non-specified shares are generally much higher. In fact, the average spreads in specified shares in the Bombay Stock Exchange are less than one per cent while spreads in respect of alpha stock i.e.. the most active stocks on the London Stock Exchange, are about two per cent.

Specified shares have an inherent buoyant component ingrained in them because of the facility of carry-over. This is evident from the fact that whenever a share is transferred from the non-specified group to the specified group, its price rises instantly and vice versa. In fact, even rumours about the transfer lead to a spurt in the price.

Badla has been replaced, effective from January 22, 2001, at the BSE by Borrowing and Lending Securities Scheme (BLESS) - a scheme identical to NSE's Automated Lending and Borrowing Mechanism (ALBM). A significant difference between badla and BLESS is that in the latter, the financier would actually get the delivery of shares while in the former, the shares would be lying in the Clearing House. Another vital difference between the two systems is that in badla, there can be long purchases and short sales while in the BLESS, all outstanding positions which are carried forward to the next settlement have to result in payment of price and delivery of securities in the previous settlement.

ROLLING SETTLEMENTS AND BADLA

The decision of SEBI to introduce rolling settlements is welcome as we can ill afford to deviate from a globally adopted settlement system. It is possible at the same time to have our badla too.

Daily badla, as has already been introduced in a few scrips, is not the proper answer. Daily badla is not only complex but will also result in fragmentation of the badla market rendering the market less liquid and more volatile. Moreover, it is quite costly as squaring off a badla transaction before the period of its expiry needs an offsetting badla position to be taken.

It is relevant to note in this connection that Brussels Stock Exchange has a system like our badla system while Paris Stock Exchange had till recently a system more or less like our badla system. Brussels Stock Exchange has a forward market with a trading cycle of five days on which the most liquid financial instruments are listed and a cash market with a rolling settlement on a 1+3 basis on which all the remaining securities are listed. Securities listed on the cash market are also listed on the forward market. A transaction on the forward market not offset by an opposite transaction and not resulting in delivery can be carried forward to the next trading cycle at the account settlement price by payment of carry over charges fixed at 0.085 per cent of the value order payable. This is payable by the buyer if he desires to carry forward his position and the seller is willing to give delivery and by the seller if he wants to carry forward his transaction and the buyer is prepared to take delivery.

Paris Stock Exchange had till recently, a monthly settlement market wherein the most actively traded shares are listed and a cash market with a rolling settlement on a 1+3 basis on which the remaining securities are listed. Securities are traded either on the cash market or on the monthly settlement market. In the monthly settlement market, buyers can request for immediate settlement as in the cash market. On the last day of the monthly account, buyers and sellers who have not closed their positions by opposite transactions and who cannot deliver securities or make payment can carry their positions over to the next account period of a month at the settlement price which is equal to the opening price on the trading day preceding the carry over day through a special contango market. This market determines the rate at which buyers can obtain the cash and sellers can buy the securities needed to meet their obligations and thus carry forward their positions. The process can be repeated every month without any limit.

Instead of the daily badla, it would be better to adopt the Brussels model with two separate segments, one for cash and another for forward, in respect of badla shares. In order to render both the segments liquid, the forward segment can be for a fortnight.

Badla trading has lost its charm because of denial of contango charges to short sellers while long buyers continue to receive backwardation charges. We should, therefore, consider switching over to stock futures which has several advantages such as being a very good hedging instrument, providing an excellent opportunity for arbitrage between futures and cash, and futures and options as also between cash and options leading to not only establishment of a more competitive system of pricing but also enhancing liquidity in each of these three segments of the market, capitalising on spreads between several scrips by purchase of one scrip to be matched against a simultaneous sale of another scrip without being required to adjust cash portfolios, etc.

Sydney Futures Exchange has a thriving futures market. U.S.A., which had prohibited trading in single stock futures since 1982, has lifted the ban and trading in stock futures is expected to commence shortly. There is no reason why we should not follow suit.

MUTUAL FUNDS AND DERIVATIVES

SEBI has already amended Mutual Funds Regulations permitting them to enter into derivatives transactions for the purpose of hedging and portfolio balancing. The Regulations, however, continue to prohibit mutual funds from entering into short sales or carry forward transactions or engaging in badla finance. Prohibiting a mutual fund from effecting a short sale or a long purchase is an understandable proposition but not permitting it to operate in the carry forward system by selling against an underlying security in anticipation of a fall in price or buying against a cash flow in future against a likely rise in price goes against the principle of hedging. It is time this restriction is removed from the statute.

Not permitting mutual funds to engage in badla finance is again not fair. Badla financing in the modified carry forward system, with all the built-in checks and balance - trade guarantee funds, investor protection funds, badla shares being kept either in demat form or in safe custody in the clearing house, etc. - coupled with strict monitoring and surveillance systems SEBI and stock exchanges have evolved, is a very safe avenue of investment. By keeping away from badla financing, mutual funds, commercial banks and others are denying to themselves a lucrative avenue of business, safe and sound. The involvement of these institutions in badla financing, cushioned as they are with large funds, will also help in sobering down the badla rates which in turn will help to boster buoyancy in the market.

STOCK EXCHANGES AS SROs

SEBI has been doing an excellent job in regulating the securities industry. There is little realisation that this is an arduous task and countries like U.S.A. have experience stretching over three quarters of a century while SEBI with statutory powers is yet to complete a decade. SEBI's constitution of several committees and continuous consultation with the industry help in rendering the regulations more practical. SEBI needs, however, to develop its own expertise with a well structured cadre of its own which, however, is yet to be built. It is also a doubtful point whether SEBI has been encouraging stock exchanges to become strong self-regulatory stock exchanges.

It is relevant to note in this connection that according to a study conducted by the International Capital Markets Group - a co-operative arrangement among the Federation International des Bourses de Valeurs (FIBV), the International Bar Association on Business Law *and the International Federation of Accountants - "A securities* regulatory process which combines the strength of government regulation with the benefits of self-regulation results in the most effective and efficient overall regulatory system. Government regulation and private sector regulation working together can promote well based confidence in the integrity of national and international securities markets. Competition, duplication and jurisdictional confusion between regulators leads to lessened investor protection and lower overall regulatory standards which are not in the public interest and are adverse to the maintenance of capital markets which are attractive for investors and capital investment." The study has advanced ten solid reasons in support of self-regulation by stock exchanges. These are (i) ability to impose ethical standards which go beyond those which can be imposed by statutory laws, (ii) a built-in motivation to take the regulatory course which is most effective and least disruptive to market efficiency, (iii) a willingness to accept regulations promulgated by professional peers as the necessary and appropriate action for the common good of the group, (iv) possession of business sensitivity to know when a regulation will be workable and beneficial to the investors and users of the markets, (v) the opportunity to participate at all levels of the self regulatory process making it easier to accept new regulations, (vi) built in system of checks and balances as listed companies and members and investors are less reluctant to make their views known to the self regulatory organisation with whom they have a business relationship, (vii) ability to identify and comprehend complex problems at an early stage and to respond with a solution to the problem which can ameliorate or lessen potential problem situations before they reach a crisis stage, (viii) possession of a reservoir of expertise in the officers end staff, thus enabling the self-regulators to have closeness to, and familiarity with, the field of financial activity to be regulated, (ix) built-in incentive to minimise the cost of regulation, and (x) good business sense for both those concerned about investor protection and those who are the subject to regulation.

Narasimhan Committee on "The Financial System" has also echoed the above sentiment by recommending "that the supervision of those institutions as form an integral part of the financial system should encourage self-regulation and be generally confined to off-site supervision to ensure compliance with guidelines with on-site inspection being resorted to only where necessary."

It needs to be admitted that all stock exchanges in the country are not mature enough to develop as strong self-regulating organisations. Vested interests continue to dominate some of them with the administration headed by Executive Director being unable to exercise adequate control over regulation and supervision. The extent to which a stock exchange can really become a self-regulating organisation depends largely on the stock exchange itself.

The recent move on the part of some of the stock exchanges in the country to demutualise themselves goes against the very grain of self regulation. The case of OTC Exchange of India and NSE is different as these are owned by financial institutions and commercial banks who had set up these institutions as part of an infrastructural framework for the development of the capital market in the country and not from the motive of profits. Once a stock exchange becomes a demutualised body, it looses the raison-de-etre to develop as self-regulating organisation. In fact, the very basis of effective discharge of duties by a stock exchange can be shaken as trading, clearance and settlement on the one hand and surveillance and regulation on the other hand are closely intertwined and different entities handling them would weaken the structure of the securities market as a whole. It is all the more necessary in India that stock exchanges do not demutualise themselves as stock exchanges are held to be "an authority" within the meaning of Article 226 of the Constitution of India against which a writ can lie.

It is pertinent to note in this connection that Arthur Levitt, Chairman of Securities and Exchanges Commission of U.S.A., has recently indicated about the potential for conflicts of interest that may arise "if the SRO is enmeshed with a for-profit corporation". Richard Grasso, Chairman of the New York Stock Exchange, told a sub-committee of the US Senate that "I believe firmly that spinning the NYSE regulation into an unaffiliated regulatory entity would weaken investor protection and do irreparable harm to the NYSE brand".

It is not only that stock exchanges should themselves develop as strong self-regulating organisations, but also various other organisations like Association of Merchant Bankers of India, Association of Mutual Funds of India, etc. should also grow into effective self-regulating organisations. This would necessarily mean statutory grant of supervisory and regulatory powers to these institutions.

The question that will then arise will be about the role of SEBI. As per the study of the International Capital Markets Group itself, the regulating body should devote its resources to activities which cannot be adequately served by self-regulation such as criminal proceedings, legal action on insider trading, manipulative practices, etc. It needs to be noted that bulk of the 4,000-odd staff of SEC in the U.S.A. is looking into all these matters.

CONCLUSION

Reforms of stock exchanges are a continuous process. There is, in fact, nothing like an ideal situation where matters can rest. Problems need solutions and solutions in turn give rise to fresh problems and the process is eternal. What, however, should be central to the whole approach is protection of interests of investors, particularly smaller ones, who in the Indian context, unfortunately seem no longer to occupy any significant position. A major achievement of Arthur Levitt, who will soon be retiring as Chairman of SEC, has been the focus he has been concentrating on investor protection. Investors constitute the backbone of the market and let us strengthen the backbone.

Let me in conclusion invoke the blessings of the great Lala Lajpat Rai for engaging the services of stock exchanges of the country for higher levels of savings, investment and growth so that the goals for which he laid down his life, viz., eradication of mass poverty, illiteracy, ignorance and improvement in national efficiencies, are attained.