REFLECTIONS ON THE CHANGING SCENARIO OF THE INDIAN STOCK MARKETS

M. R. MAYYA

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Published by

THE A. D. SHROFF MEMORIAL TRUST

"Piramal Mansion", 235, Dr. D. N. Road,

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OBJECTIVES

(i) Publication of one or more books in English, Hindi, and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

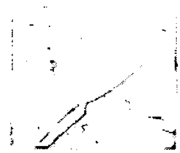
(ii) Organising one or more memorial lectures annually on subjects which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subjects to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Bombay.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits for the charitable object of education or such of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper, it being the intention of the SETTLOR that the income and/or corpus of the aforesaid charitable objects without any distinction as to caste, creed, or religion.



A. D. SHROFF (1899-1965)

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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INTRODUCTION

The A. D. Shroff Memorial Trust arranges an Annual Lecture on Insurance, Banking and Industrial Finance, by rotation. The Lecture in 1994 on the subject of Industrial Finance was delivered by Mr. M. R. Mayya, who was Executive Director of Bombay Stock Exchange for several years, and retired in 1994. Earlier he had held with distinction several important positions in various Ministries of the Central Government.

The subject of Mr. Mayya's Lecture was "Reflections on the Changing Scenario of the Indian Stock Markets". The contents are indeed highly analytical, informative and educative. He has, besides, given food for thought to us all on the subject. In the present context of new economic policies being pursued by the Central Government and Globalisation of Indian Economy, the text makes very interesting reading, not only for the layman but for those actively involved in the stock market and in the Government itself. The views of Mr. Mayya, a highly respected person in the Capital Market, carry a great deal of weight with the investing public as also the authorities.

The Trust has pleasure in placing this little booklet containing the Lecture before the public.

NANI A. PALKHIVALA
Chairman
The A. D. Shroff Memorial Trust

Bombay,
December 21, 1994

REFLECTIONS ON THE CHANGING SCENARIO OF THE INDIAN STOCK MARKETS

By

M. R. MAYYA*

Let me at the very outset express my deep sense of gratitude to the Chairman and the Board of Trustees of The A.D. Shroff Memorial Trust for conferring on me the great honour of delivering the Shroff Memorial Lecture this year. I have accepted this with a lot of trepidation as the lecture is in memory of a towering personality who strode the financial scene of the nation as a colossus for over four decades till his demise in 1965 and the persons who had delivered the series of lectures earlier were eminent men who have already left their footprints on the sands of time.

Although I had not the privilege of knowing Shri A.D. Shroff personally, I am well aware of the tremendous contribution made by Shri Shroff to the industrial development of the country, particularly industrial finance, as also to economic thinking and public education in economic affairs of the nation. In fact, if I can say so, it was indeed Shri Shroff who laid the foundation stone of what has blossomed

* The text is based on the Annual Public Lecture delivered under the auspices of the A.D. Shroff Memorial Trust in Bombay on 5th May 1994.

today into an era of liberalisation and deregulation. It is sad that the nation had to undergo the trauma of restrictions and constraints to growth for nearly half a century only to realise that that was not the proper path for progress.

Burgeoning Growth of Indian Stock Markets

The process of liberalisation, ushered in a mild way from November 1984 and more intensively and avowedly from June 1991, has had its due reflections cast on the stock market operations, leading to a pace of growth almost unparallelled in the history of any nation. The extent of growth can easily be measured by the fact that as against an annual average amount of just Rs. 900 million raised from the primary market in the seventies, Rs. 224.80 billion were raised during 1993-94 — an unbelievable rise of 250 times - amounting to 12.8 per cent of the gross domestic savings of about Rs. 1,750 billion in the year. The number of listed companies has risen from 2,265 in 1980 to about 7,500 at present catapulting this nation to the number one position in the world, overtaking the United States of America which had about 7,250 listed domestic companies at the end of 1993. The daily turnover on the Indian stock markets shot up from about Rs. 250 million in 1979-80 to about Rs. 8 billion during the year ended 1993-94. The number of shareholders and investors in mutual funds has also risen sharply from about 2 million to over 40 million during this period, rendering this nation to the position of having the second largest investor population next only to U.S.A. which has currently about 51 million investors. Market capitalisation has also increased from about Rs. 50 billion to 4,000 billion during the same period, accounting for about 60 per cent of gross national product now as against about 5 per cent earlier. The market capitalisation has thus surpassed the aggregate deposits of all scheduled banks around Rs. 3,600 billion. The number of stock exchanges has also increased from just nine in the beginning of 80s to 21 currently. Besides, there are the OTC Exchange of India and the National Stock Exchange spreading their activities right across the country like the NASDAQ of U.S.A.

India has become today an important market in the emerging markets of the world, next only to Malaysia, Mexico, Taiwan, Brazil, Korea and Thailand in terms of market capitalisation and turnover. In U.S. Dollars, the market capitalisation of India at the end of 1993 was about $ 115 billion as compared to $ 230 billion of Malaysia,$ 201 billion of Mexico, $ 193 billion of Taiwan, $ 145 billion of Brazil, $ 140 billion of Korea and $ 128 billion of Thailand. While the turnover in the Indian stock markets during the year ended December 1993 was about $ 50 billion, the turnover in Taiwan was $ 353 billion, in Korea $ 212 billion, in Malaysia $ 154 billion, in Brazil $ 99 billion, in Thailand $ 85 billion and in Mexico $ 65 billion.

Sharp as the growth has been, prospects of further growth are equally bright. With the expected new offerings pouring in at the rate of about 10 per cent of the market capitalisation, disinvestment of public sector undertakings taking place at the rate of about five per cent of the market capitalisation and prices registering an appreciation of about 20 per cent, market capitalisation of Indian stock markets can be estimated to rise by one-third every year which would mean doubling up of the market capitalisation every two and a half years. Such an optimistic outlook emanates from the rich mineral and natural resources coupled with strong agricultural, industrial and service sectors, the third largest technological, scientific and managerial pool of personnel, a growing prosperous population with about 150 million people already enjoying a life style comparable to their counterparts in the developed world, an age-old savings habit with the gross domestic savings running at the rate of about 23 per cent of the gross domestic product, a progressively deregulatory environment and the foreign investors taking increasingly greater interest in India.

A number of measures are being continuously taken by Government, the Securities and Exchange Board of India' (SEBI) and the various stock exchanges of the country not only to cope up with the rapid quantitative strides in the growth of the market but also to ensure a qualitative change in the market by rendering it fair, transparent and efficient. This is indeed a gigantic task requiring herculean efforts on the part of all concerned. I would embolden myself to offer a few comments on some of them.

Infrastructural Facilities

The burgeoning growth of the stock market activities is unfortunately not accompanied by a proportionate increase in infrastructural facilities which has, in the process, resulted in several impediments to growth.

Lack of adequate space is a major probiem. Significant portions of the space built by the stock exchanges themselves are presently occupied by others, mostly by the public sector financial institutions and banks. These spaces need to be vacated, at least on commercial terms. The rigid attitude adopted by most of them ignores the reality of the emergence of the capital market as a major source of finance in the Indian economy. Telephone and fax facilities to stock exchanges and the stockbroking community need to be stepped up on a priority basis. The process of computerisation, which is halted due partly to lethargy and partly to block transparency, has to be geared up. The working of banking and postal systems, which have acted as serious roadblocks for speeding up of the operations, particularly in the primary market, need to be toned up. The question of permitting agencies in the private sector to collect applications against public issues of capital (they are already allowed to collect applications against right issues) and also to handle refund orders and allotment letters/share certificates needs favourable consideration. The existing system will also, in the process, become more efficient.

Membership of Stock Exchange

There are at present about 6,000 active stockbrokers in the 22 recognised stock exchanges of the country. Almost all of them function at present as proprietory concerns or as partnership firms with the concept of unlimited liability being ingrained in the system.

The statute was amended in July, 1987 permitting enrolment of corporate entites as members of stock exchanges. As this amendment required a majority of the directors of the corporate entity to be also members of the stock exchange in their individual capacity with unlimited liability, the statute was further amended in November, 1992 enabling enrolment of a corporate entity directly as a member without the requirement of any individual director being a member of the stock exchange. Although a year and a half are over, very few members have got their membership cards converted into corporate entites. In the larger interest of imparting perpetuity into stockbroking operations and professionalising the stockbroking business, it is absolutely necessary that the conversion process takes place as early as possible. I would appeal to the Government to grant an one-time exemption from the requirement to pay capital gains tax on such conversion as it seems to be acting as a major hindrance to conversion.

Another matter of serious concern relating to the membership of stock exchanges is the class of sub-brokers which seems to be unique in India. In almost all the countries in the world, investors get only the contracts of a member of a stock exchange which has a readily administrable arbitration machinery in case of a dispute between them. A similar system needs to be made operative in India to sustain confidence of the investors as quite a few of the sub-brokers are callous in their attitude and the harassed investor has no arbitration machinery to approach for redressal of his grievances. Most of these investors, particularly those from areas where there are no stock exchanges, have no direct access to brokers. In fact, some of the leading sub-brokers have their own chain of sub-brokers. The question of doing away with the class of sub-brokers, lock, stock and barrel, at least over a period of ten years, needs to be given serious thought right now so that an investor gets a contract of a broker only having the arbitration machinery of a stock exchange for resolution of disputes. In the meantime, the statutory requirement by SEBI to register all the sub-brokers in the country needs not only to be expedited but a suitable arbitration machinery under the auspices of stock exchanges for settlement of disputes between sub-brokers and their clients also requires to be set up. In addition, it is desirable to permit the sub-brokers in the areas where recognised stock exchanges are located to issue contracts to clients by amending suitably the statute.

Although the amendment to the statute effected in July 1987 permitted admission of All India Financial Institutions and their subsidiaries and subsidiaries of nationalised banks and of State Bank of India as members of stock exchanges on their being so recommended by Government of India, it is rather disheartening to observe that very few of them have availed of this opportunity so far. It is unfortunate that it took a long time for the authorities to appreciate the stand taken by the stock exchanges that there has to be a level playing ground between these entities and the stockbrokers. With SEBI having subsequently conceded this point and the regulations in this behalf having been amended providing that these entities be admitted as members subject to their agreeing to observe and be bound by the rules, bye-laws and regulations of the stock exchanges as are applicable to the existing members, it is necessary for a quickened pace of action in this behalf as the stockbrokers have not been able to render adequate service to the fast growing shareholding population of the country. The investors in the mofussil areas do not have today any proper facility for entering the secondary market while the surge in activities in all these areas is unbelievable. As a result, a beehive of activities by way of investors' associations, shareholders' welfare bodies, shareshoppees, etc. is surfeiting all these areas with a daily turnover of over Rs. 1 billion in the country. A string of national networks of the stockbrokers, with proper telecommunication facilities, needs to be set up so that an investor even in a remote village is able to access any of the stock markets in the country by dealing directly with the stockbrokers. The near monopoly position enjoyed by the stockbroking community, which has led to the present unfavourable state of affairs, needs, therefore, to be changed by the entry of the public sector into this system. As all these will necessarily take time, Government should not hesitate to set up recognised stock exchanges at least at some of the important centres so that investors in these areas would have the benefit of the availability of a regulated system. In almost all the advanced countries, the number of stock exchanges had proliferated initially only to shrink later with the emergence of better telecommunication facilities. For example, in U.K. there were about 20 stock exchanges in the late 60s which later got reduced to about half a dozen in 1972 and further down to a single entity viz., The London Stock Exchange in 1986.

The move to inject the concept of capital adequacy into the stockbroking system is a step in the right direction. The stockbroking community, however, should be given a sufficiently long period say at least a year or two before it is made fully operative. The stockbroking community should also accept the directive to segregate the accounts of members from those of their clients as is the practice in most of the global markets of the world.

Governing Boards of Stock Exchanges

The question of broadbasing the governing boards of stock exchanges in the country has unfortunately got bogged down to the numerical ratios between the elected stockbroker directors and others. Happily, however, the issue has been resolved with the ratio being pegged at 50:50 with the executive director of the exchange being reckoned separately. Time alone will say as to whether this is a proper solution as except in the New York Stock Exchange, which has 12 elected stockbroker directors, 12 non-broker directors and three executives, in almost all the remaining stock exchanges of the world, stockbrokers have a majority. The debate has masked the more important issue of improvement in the quality of directors. What is, however, heartening is that progressively highly qualified and well informed stockbrokers have been entering the board rooms who can no longer be overawed by the public directors, most of whom have a rich background but unfortunately have neither adequate knowledge of the securities market nor the requisite time to devote themselves to the work of a public director. It also needs to be noted that all public directors cannot always be said to be imbued with public spirit and that it cannot equally be said that the stockbroker directors always act in private interest.

Executive Directors of Stock Exchanges

The executive directors of stock exchanges are one of the most harassed lot today. Technically appointed by the governing boards of stock exchanges subject to approval by SEBI and Central Government, the discharge of their duties engulfs a wide area spreading accross investors, companies, members and governing bodies of the stock exchanges, SEBI, Central Government, public, press, etc. He has no doubt to be a highly dedicated, an extremely faithful and a thoroughly experienced professional with expertise of a specialised nature but also has to perform adroitly the balancing act of following the rules of the game, satisfy the president, the governing board and members, keep the Central Government and SEBI on an even keel and also maintain the best of public relations in his job content. It is absolutely essential for him to be one who would work with others as a team, who is firm but courteous, who is unyielding but helpful and who is rule bound but not investor unfriendly. It is so easy to paint the picture of an ideal executive director of a stock exchange but indeed difficult, nay virtually impossible, to find one who can, with the pulls and pressures inherent in a democratically structured society like that of ours, fulfil satisfactorily the above specifications. Even a slight diminution in the discharge of duties in any segment naturally leads to discontent leading quite often to the demand for non-renewal of the term of office of the executive director, normally of five years, if not of termination. As a result, preservation of the job becomes a major obsession with the executive director, thereby rendering him not only less efficient but also inducing him to make compromise with all, denting, in the process, sharpness of the regulatory system.

It is, in the above context, that a review of the present manner of appointment of the executive director of stock exchanges is called for. In order to enable the executive director to discharge the onerous duties cast on him without fear or favour, it would be desirable to entrust this job to a Standing Committee consisting of one representative each from the Ministry of Finance, SEBI, Reserve Bank of India, and the concerned stock exchange and three eminent public figures, who will decide the appointment as also the terms and conditions of appointment, including the tenure of appointment. Termination of services of appointment should also be left to this Committee.

New Issues Market

The strident advance in the quantitative growth of the new issues market has been accompanied by the persistent efforts of SEBI to improve quality of the market. While the regulatory framework under the Securities Contracts (Regulation) Act, 1956 is confined to stock exchanges and their members, the Securities and Exchange Board of India Act, 1992 promulgated on the 30th January,' 1992 encompasses the entire gamut of the secutities industry. The SEBI Stock Brokers and Sub-brokers Rules and Regulations, 1992, SEBI (Merchant Bankers) Rules and Regulations, 1992, the SEBI (Underwriters) Rules and Regulations, 1993, SEBI (Registrars to an Issue and Share Transfer Agents) Rules and Regulations, 1993, SEBI (Insider Trading) Regulations 1992, SEBI (Mutual Fund) Regulations, 1993 and SEBI (Debenture Trustee) Rules and Regulations, 1993 are all designed to regulate the activities of various intermediaries in the primary market. Further, Schedule II of the Companies Act, 1956 relating to disclosures about public issues of capital was amended in October, 1991 to improve the standards of disclosures, particularly in the fields of company management and project, information about other listed companies in the same management, management perception of risk factors, etc. SEBI has made these disclosure requirements applicable to rights issues too. A code for advertisements of capital issues was also announced by SEBI to ensure that the gullible investing public are not misguided. Moreover, credit rating has also been made compulsory for all debt instruments, excepting fully convertible debentures providing for conversion at pre-determined prices within 18 months from the date of allotment. A new financial instrument called "Stockinvest" has also been introduced to reduce the hardship to investors through loss of interest on application money.

While the Capital Issues (Control) Act, 1947, which regulated the issue of capital rather rigidly, was repealed on the 29th May, 1992, in tune with the spirit of the time, a series of guidelines relating to disclosures and investor protection have been issued by SEBI. Investor interest is tried to be safeguarded mainly by the instrumentality of promoters' stakes varying from 20 per cent to 50 per cent of the issued capital of companies coupled with lock-in arrangements for periods from two years to five years.

Despite all the precautions taken about disclosures in the offer documents and various other safeguards, there is a general perception that the interests of investors in the era of free pricing of securities have been adversely affected as the freedom given to the issuers and the merchant bankers have been misused. In several cases, projections made have gone awry and the issues continue to be quoted well below the offer prices despite the general buoyancy in the market. Manipulation of prices in cases of further issues of capital and rigging up of prices in the "grey market" i.e., the unofficial market prior to listing, are not uncommon occurrences. It is, therefore, not only necessary to hasten framing of Rules and Regulations under the SEBI Act against manipulation of prices but also detect on a priority basis cases of manipulation of prices and launch prosecutions against the offenders. In fact, this is a major function of the regulating authorities the world over. The persistent malpractices in the "grey market", which has been more or less in continuous operation for over three decades, no longer brook any delay in action. The solution to this vexed problem is either to declare the transactions in this market as also publications of their quotations as illegal under the Securities Contracts (Regulation) Act – at present these transactions are only void under the bye-laws of the stock exchanges — or alternatively to permit this trading officially and regulate the same by suitable checks and balances by way of collection of margins, periodical clearances, etc., as is being done in some of the markets abroad. Maintenance of status quo in the matter will be of major concern to the investors.

Another safety against the relatively unbridled freedom granted in the matter of fixation of premium is to have safety net arrangements in the case of all premium issues to be made operative at least for small investors upto 200 shares and for a period of say six months. For the arrangement to be meaningful, the buy back price should be pegged at a level not below 10 to 15 per cent of the offer price.

One is tempted to offer comments on some of the recent policy decisions which have affected adversely the interest of small investors.

The amendment effected to the Securities Contracts (Regulation) Rules, 1957 in September, 1993 diluting the requirement of public offer of securities from 60 per cent to 25 per cent of the issued capital of a company for entitling the company to get its securities listed on a stock exchange will reduce greatly the direct public offer of securities to the investing public. On a rough reckoning, about 1,000 companies with a public offer of securities worth about Rs. 25 billion may be induced to go public because of this reduction while the shrinkage in public offer every year would be over Rs. 30 billion which will rise progressively because of the growing importance of the capital market. This has to be viewed also in the context of Indian companies raising increasingly higher amounts from abroad through Euro issues which in turn has led to a shrinkage of public offering to the resident Indians. In the process, the major objective of spreading widely the equity cult, particularly in the semi-urban and rural areas, will receive a setback. Shrinkage in public offer has also the effect of enhancing the scope for manipulation of prices due to lack of widespread holdings by the public. The trade off between inducement to companies to go public and enhancing the shareholding population in the country could be to reduce the minimum public offer from 60 per cent of the issued capital of the company to say 40 per cent, and not 25 per cent, with suitable provisions for relaxation in cases like Indian promoters having foreign collaborators or public sector undertaking as co-promoters.

The decision to raise the minimum number of shares for which applications can be made from 100 shares to 500 shares of the face value of Rs. 10 each will also affect adversely the small investors as annual savings of most of the small investors would not exceed Rs. 5,000. The answer that they could go to the mutual funds, where the minimum amount for applications continues to be Rs. 1,000, overlooks the restriction of freedom to the investors to choose their avenues of investment. It is pertinent to note in this connection that recently the Tokyo Stock Exchange reduced the trading lot of some of the top shares from 100 to 50 to induce small investors to have greater stake in the stock market. Taking duly into account the inflation since May 1985, when the minimum was raised from 50 shares to 100 shares and also the need to rationalise, the minimum can be pegged at 300 shares of Rs. 10 each.

The SEBI stipulation to do away with the weightage to the applicants in the lower categories and to have instead proportionate allotment is no doubt welcome as it discourages multiple applications which create a far more serious problem in the secondary market than in the primary market because of variations in signatures leading to bad deliveries. Attempts by some corporate houses and others to submit large applications have, however, resulted in a denial of justice to small applicants. A ceiling of say one per cent of the issue on allotment needs, therefore, to be imposed in the interest of small applicants.

The present method of tenders adopted by Government for disinvestment of shares by public sector units has prevented small investors to participate. In several countries, the route followed for disinvestment is by way of direct offer for sale to the public, helping thereby to widen the shareholding population. The sudden surge in the shareholding population in countries like U.K., France, etc. is because of this policy. Adoption of such a policy has also the advantage of instant creation of a broad and liquid secondary market for these shares. I would sincerely appeal to Government to consider this proposal favourably.

Attempts by managements of foreign comapanies as also Indian companies to augment their holdings by way of preferential offers at discounted prices or even at the market price are not fair to non-management shareholders. The only fair and equitable way is by way of purchases from the market or direct deals with the bulk holders as such operations in turn lead to a rise in prices, advantage of which go to the non-management shareholders.

Listing Agreement

The listing agreement comprising 42 clauses, which companies seeking listing on stock exchanges have to execute, are designed towards ensuring shareholders' democracy and orderly trading on stock exchanges.

Breaches of the provisions in the agreement, however, are visited by delisting of securities or suspension of dealings in securities for varying periods ranging from one day to until further notice, neither of which is in the interest of the shareholders resulting as it does in a denial of the market. Some of the company managements have virtually become immune to these actions. The question of empowering stock exchanges to fine companies and officers in default and also to launch prosecutions in courts of law in extreme cases merits favourable consideration. Virtual inaction in this behalf for nearly four decades has resulted in companies relegating to the background the question of redressal of grievances of investors.

Delisting of Small Companies

The number of companies Indian stock exchanges boast of really do not reflect a proper picutre. For example, at the Bombay Stock Exchange, out of about 3,500 listed companies as on March 31, 1994, companies with a paid up capital upto Rs. 5 million are 529, from Rs. 5 million to Rs. 10 million 405 and from 10 million to Rs. 30 million 805. Most of these companies are closely held investment and finance companies and hardly serve any public interest. In order to improve the quality of companies listed on stock exchanges, all these companies may be given an opportunity to increase their capital to at least Rs. 30 million and also bring about a wider distribution of holdings in a year or so and such of these companies which fail to comply with these requirements may be delisted from the stock exchanges with the option, however, to seek listing on the OTC Exchange of India.

Secondary Market Operations

The turnover in the Indian stock exchanges has increased significantly during the last ten years and particularly during the last three years. On the Bombay Stock Exchange, which currently accounts for over 50 per cent of the business in India, the daily turnover shot up from Rs. 0.13 billion in 1980-81 to Rs. 3.75 billion in 1993-94.

What is more remarkable about the Indian stock markets is the number of deals put through in a day. On an average, about 75,000 deals were executed in a day on the Bombay Stock Exchange alone in 1991-92. Although the figure came down to 63,535 in 1992-93, it rose again in 1993-94 to about 75,000. As these deals are put through in a short period of two hours, the Bombay Stock Exchange has the highest density of transactions in the world next only to that at the Taiwan Stock Exchange.

It is heartening to observe that the Bombay Stock Exchange has launched on a modernisation and computerisation programme through a four-phased programme costing over Rs. 750 million which will lead ultimately to complete automation of trade by August, 1995 with the trading ring vanishing from the scene. Other sister stock exchanges of the country have also initiated suitable steps in this behalf. OTC Exchange of India, which started its operations in October, 1992, has an automated, screen-based, quote-driven trading system which will gradually be extended to the whole country. The National Stock Exchange (NSE), which is expected to start its operations in the near future, initially for wholesale debt instruments and later for capital market instruments also, will be a country-wide, screen-based, on-line trading bourse with an order-driven trading system. NSE is committed to usher in a settlement period of T + 1 i.e., delivery of shares and payment of price to be effected on the day following the day of trade.

It is pertinent to observe in this connection that there is a school of thought which believes that trading through computers is less competitive than in a face-to-face manner as the scope for negotiation is more in the latter case. It is precisely because of this that at the New York Stock Exchange and in respect of the first section comprising 150 most active scrips on the Tokyo Stock Exchange, trading continues to be conducted openly in the trading ring.

Automation of trade is only one side of the coin, the other side being automation of the post-trade settlement process which can be done either through immobilisation or dematerialisation of securities.

The question of choosing the route was debated in great detail by a High Powered Technical Group set up by Government which recommended that given the widespread preference of Indian investors to hold physical scrips, their general concern for safety with custodians and lack of trust in market intermediaries, unfamiliarity with new technology and the need to guard against any market disruption arising from a rapid change-over, immobilisation should be attempted in the first stage with dematerialisation as the ultimate goal. The Technical Group also debated as to whether the country should have multiple depositories or a single depository as recommended by the Global Group of 30 of the securities industry and the recommendation was to have multiple depositories so as to reap the benefits of competitive service and also to ensure against any market disruption, if the sole despository were to be disabled. The prolonged debate that took place in the country on both the issues has unfortunately delayed implementation of the mechanism to have an early post-trade settlement system. Efforts to move over to a T + 3 system as recommended by the Group of 30 just cannot be achieved without having either immobilisation or dematerialisation of securities. One can appreciate the gravity of the problem by knowing that even the London Stock Exchange will be switching over to a T + 10 rolling system only in July 1994 from the current 14-day account period and at the New York Stock Exchange, the system is still T + 5, T + 3 being targetted for 1996.

As the systems that are being evolved by the existing stock exchanges and those of the OTC Exchange of India and NSE are more or less similar, it is desirable to adopt a holistic approach in the matter and not indulge in unfair competition with one another so that the markets do not get fragmented as a fragmented market is less competitive with spreads between bids and offering being wider, all to the detriment of the investors. The Indian stock markets are far too big with tremendous growth prospects and there can be room for all.

Liquidity of Securities

Contrary to the general belief, the Indian stock markets are fairly liquid. For example, at the Bombay

Stock Exchange, on any given day, about 1,900 securities are being traded daily. The securities that are infrequently traded are either of companies with a low capital base, or of loss-making companies or debt securities unrelated to equities which have yet to develop a market in India. What is, however, disturbing are the spreads between bids and offers in respect of thinly traded securities. While the spreads in respect of the most active scrips in the specified group range from 0.25 per cent to 0.5 per cent as compared to about 1.25 per cent in respect of alpa stocks, i.e., the most liquid stocks in the London Stock Exchange, the spreads keep widening in respect of less active scrips, exceeding 15 per cent in several of them as against the average spread of about 7 per cent in gamma stocks, i.e., the least liquid stocks on the London Stock Exchange. This is quite a serious situation warranting some immediate action on the part of the authorities. The guidelines issued by SEBI for market makers has unfortunately remained virtually dormant as not a single market maker has so far been registered under these guidelines.

Volatility of Indian Stock Markets

The Indian stock markets have displayed a remarkable degree of poise and stability, thanks mainly to the checks and balances in-built in the system and the various timely and effective measures taken by the Government and the stock exchange authorities from time to time. As per a study conducted by the Bombay Stock Exchange, the average annual fluctuations in the All India index number of security prices of ordinary shares compiled by the Reserve

Bank of India was only 25.0 per cent during the period 1980 to 1989 which was on par with the corresponding figures of 23.8 per cent of the London Stock Exchange and 25.2 per cent of the New York Stock Exchange and well below the average of 31.2 per cent of 15 leading countries of the world. The years 1990, 1991, 1992 and 1993 have, however, proved to be quite volatile, with the average annual fluctuations being of the order of 56.2, 55.9, 67.4 and 41.1 per cent as against the global averages of 32.9, 27.6, 24.8 and 32.0 respectively. The volatility can continue to be a major problem, particularly in the context of the entry of private mutual funds and the Foreign Institutional Investors, for both of whom stability of the market may not be a matter of consideration in their market operations. Stock Exchange authorities and well meaning financial institutions and mutual funds have, therefore, an added responsibility. A greater degree of alertness is called for on the part of stock exchange authorities to take suitable corrective measures from time to time to keep speculative excesses under check. These need to be supplemented by financial institutions and mutual funds by augmenting purchase operations at the troughs and increasing the sales at the peaks which incidentally would help them to enhance their own profits. Marking troughs and peaks is, no doubt, not an easy task but with the expertise these institutions have, spotting broad contours of the movement of prices of securities should not be a difficult proposition. In fact, in quite a few countries, special funds are set up to act as market stabilisers. In Japan, till recently, public money used to be utilised to support the stock market. There is, therefore, no reason why our financial institutions and mutual funds, who own about one-third of the equity holdings in the country, should not undertake these operations too in the larger interest of orderly and healthy growth of the capital market.

A mention needs to be made in this connection to the sharp rise of over 250 per cent followed by a sharp fall of over 40 per cent in the BSE Sensitive Index in a short span of 15 months from June, 1991 to August, 1992. The scandal that had taken at that time was not related to the dealings on the Bombay Stock Exchange but to those in government securities and public sector bonds, although, no doubt, a part of the money drawn from this market was deployed in the stock market. It needs, however, to be noted that all possible measures were taken by the Bombay Stock Exchange authorities to combat the unprecedented bullish fervour as also the subsequent crash in prices and to ensure that not a single contracted obligation remained unfulfilled. While this was a very crucial period in the history of the Exchange, more critical was the period that followed as the Exchange had to face not only a battery of investigating agencies, including the Joint Parliamentary Committee and the SEBI, but also a bomb blast out of all of which it came unscathed. I am sure history will record it.

Futures, Options and Badla

There has been recently a lot of debate about the relative merits and demerits of futures, options and badla and more particularly about the first two replacing the third as if these are easily mutually substitutable instruments and that the former is a set of perfect instruments without any blemishes and that the latter is a mixed bag with the beneful influences far out-weighing the beneficial contents. It is rather unfortunate that this debate has been taking place without a proper comprehension of what these instruments really are, what their functions are and what their relative merits and demerits are.

A financial futures contract is an agreement to buy or sell on any recognised exchange a standard quantity of a specific financial instrument or a foreign currency at a future date and at a price agreed upon between the two parties.

An option is a contract that confers upon its holder the right, but not the obligation, to buy or sell an underlying instrument at an agreed price during a specific time period. The holder (buyer) of options has rights but no obligations while the writer (seller) of options has obligations but no rights.

A contract entered into in a specified share in a settlement period in respect of which neither delivery of shares and payment of price take place nor is offset by an opposite contract in the same settlement period (a sale by a purchase and a purchase by a sale) can be carried forward to the next settlement period at the making-up price fixed by the stock exchange authorities in this regard which is generally based on the closing quotation of the share on the last trading day of the settlement period and the difference between the contract price and making-up price settled. For carrying forward the transaction from the current settlement period, the buyer normally pays to the seller a consideration amount which is called contango charge in English and popularly known as 'badla' which is fixed by the market forces in the open half-an-hour badla session held immediately before the commencement of trading in the next settlement period. It needs to be particularly noted that there is no compulsion whatsoever either on the buyer or on the seller to make 'badla'; they do it out of their own volition.

If a buyer does not want to take delivery and the seller wants to give delivery, a badla financier, who takes delivery in the current settlement and gives delivery in the next settlement receiving the difference between the purchase rate in the current settlement and the sale rate in the next settlement as 'badla' charges, emerges. If a buyer, however, insists on delivery and the seller does not have the shares, the buyer can demand consideration known as backwardation charge in English, otherwise known as 'undha badla'. Alernatively, the buyer can refuse to receive backwardation charge and insist on delivery in which case auction is effected at the risk and cost of the defaulting seller who has then to pay the difference between the making-up price and the price at which the shares are bought in auction.

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 (contractual rights and obligations in respect of which are completely frozen with the buyer having wrested from the seller all rights relating to the share including dividend, bonus, rights, etc.) but has chosen out of his own volition not to pay and instead has 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.

While both futures and options are not perfect hedge instruments, badla has proved to be an almost perfect hedge instrument. As regards the question of generation of liquidity and its consequent impact on liquidity, one is tempted to quote Alan Greenspan, Chairman of the Federal Reserve System of U.S.A., who while addressing a meeting of central bankers and economists from around the world in the latter half of August, 1993 observed that "it is by no means clear" whether the recent financial market innovations which have created a multi-trillion dollar market have "increased or decreased the inherent stability of the financial system." As against this, not only liquidity in a share having 'badla' facility is higher than in a share without 'badla' facility, but also the volatility is lower. Besides, the spreads between bids and offers are also much lower.

Instead of having a futile debate, a sane course of action would be to permit the time-tested instrument of 'badla' to continue with further checks and balances, if need be, to control speculative excesses, and introduce at the same time futures and options. Later, after all the three instruments operate simultaneously say for a year or two, there could be a review and a national debate about the desirability or otherwise of continuing the 'badla' system. The market, on which reliance is now progressively placed, will decide as to which of the instruments should be discarded. Any attempt to graft a revised version of 'badla' with restricted speculative components may prove to be abortive as the market may not accept the same.

Reforms in the Secondary Market

The Indian secondary markets in securities continue to be affected adversely by malpractices like lack of transparency, insider trading, manipulation of prices, proliferation of odd lots, inadequate protection to clients in case of defaults by stockbrokers, etc. There is an urgent need to address all these issues if the quality of the market has to be improved and the confidence of investors improved.

Lack of Transparency

With a view to injecting transparency into the operations of stockbrokers, the bye-laws and regulations of stock exchanges have been amended well over two years ago requiring stockbrokers to compulsorily issue the contracts and to show brokerage separately. Even so, a large number of stockbrokers are reportedly flouting these statutory requirements and most of the investors are not aware of the requirements. Stock exchanges and SEBI should, therefore, issue periodically press releases drawing the attention of investors in this regard. Showing the brokerages separately will not solve the problem completely as clients can be charged highest price of the day for purchases and lowest price of the day for sales. Timestamping the contracts, which, of course, can be done only after full automation of trade, is necessary. Investors should at the same time be required to be educated with regard to spreads between the bid and offer prices, their purchases being at the offer prices and the sales at the bid prices.

Insider Trading

Insider trading i.e., trading on the basis of private, confidential, non-public, price sensitive information, is a major problem in the Indian stock markets. It is rather sad that sanctions against insider trading came only on the 19th November, 1992 when the Securities & Exchange Board of India (Insider Trading) Regulations, 1992 became operative despite the fact that the various expert committees had recommeded enactment of suitable legislative measures in this behalf.

Tracking down insider trading should not prove to be a difficult proposition as it is always possible to trace the origin of transactions but what, however, is difficult is to have the requisite will and grit to track down insider trading as it is generally the stronger segments of society which are involved in bulk of the insider trading operations. It needs to be noted in this connection that even in the United States of America, which has had insider trading sanctions for quite a few decades, this menace was tackled seriously only between 1982 and 1987 when John Shad was the Chairman of the Securities and Exchange Commission, with the number of cases instituted during this period of five years exceeding those instituted in all the earlier years put together. Convictions of Ivan Boesky and Michael Milken, which have now become part and parcel of global history relating to insider trading, belong to this period. Any laxity in the matter will only jeopardise the interests of investors at whose cost the insider traders would benefit.

Manipulation of Prices

While we do now have sanctions against insider trading, we still do not have any prohibition against manipulation of prices which is an equally serious menace. There are, no doubt, some provisions in the trading bye-laws of stock exchanges against any plan or scheme for making any purchases or sales or offers of purchases or sales of securities for the purpose of upsetting the equilibrium of the market or bringing about a condition of demoralisation in which prices would not fairly reflect market values. The Bombay Stock Exchange had in the past taken action against a few members under these provisions. The real culprits were, however, not these members but company managements against whom no action was possible because of lack of provisions for action against them.

It also needs to be observed that proving manipulation of prices is rather difficult as there can never be any set of norms which can precisely delineate as to what exactly should be the correct market price of a share. The task has become all the more difficult because of free pricing when efforts to stabilise prices to ensure success of the issues need to be permitted. Even under the Forward Contracts (Regulation) Act, 1952, which has had provisions prohibiting manipulation of prices for nearly three decades, there has so far been only one case which was tried and which luckily also resulted in conviction. Be that as it may, it is absolutely necessary to have suitable legislative sanctions against manipulation of prices at the earliest and equally necessary to ensure that action against those manipulating the prices or attempting to manipulate the prices is launched as the losers against such contrivances are the gullible investing public.

Odd Lots

The problem of odd lots has hitherto not been dealt with the seriousness it deserves. The investor is a tremendous loser as sales of odd lots can generally be made only at discounts varying upto 15 per cent or beyond and purchases at premia of 15 per cent or more, the difference being pocketed by the brokers. Efforts made by quite a few organisations, both in the public and in the private sectors, by way of purchases of odd lots at reasonable discounts, have not made any serious dent into the problem mainly because of lack of publicity and also because of the barter arrangement made by some to exchange assets not capable of any significant appreciation. The problem has to be tackled in two stages, the first stage being designed to reduce substantially, if not eliminate altogether, the existing floating stock of odd lots and the second stage being aimed at ensuring that further issues do not result in odd lots. The recent decision of the Department of Company Affairs of Government of India to allow companies to set up independent trusts which could trade in their odd lot shares operating on a non-profit basis, charging only a specified service fee to meet the running expenses and pay to the investors the market price, should help to solve the problem to some extent. Companies, which are hesitant to initiate action in this behalf, as some of them would as it helps them greatly in propping up prices in the market, need to be prevailed upon to do so by the shareholders by raising this issue at the general meetings.

Arbitration

The present provisions for arbitration in respect of a dispute between a member and his client requires a reference to an arbitration committee of two persons drawn from a pool of members of the stock exchange and others having knowledge or experience in the fields of law, trade, commerce, industry, arbitration, securities market or stock exchange transactions, appointed by the governing board of the stock exchange. In case of any difference between the two arbitrators with regard to the award, the verdict of the umpire who is again drawn from this pool will prevail. The person against whom the award has been given can have the matter agitated further before the High Court. This has, in practice, proved to be time-consuming due to the protracted nature of the proceedings. The question of evolving a simplified arbitration machinery in respect of disputes upto Rs. 100,000 on the lines of provisions in respect of disputes upto $ 10,000 at the New York Stock Exchange which are handled by the Director of Arbitration of the Exchange, needs favourable consideration. This can relieve to a great extent the harassment caused to small investors.

Customers' Protection Fund

Whenever a stockbroker defaults, the claims of the clients against the assets of the defaulting stockbroker come last after meeting the claims of the stock exchange and its clearing house and the opposite contracting parties in the market. As a result, clients generally do not get anything from these assets. This has shaken the confidence of the investing public who for no fault of theirs are the losers.

The question of setting up Customers' Protection Funds to meet the claims of clients of a defaulting member has, therefore, assumed great importance. While it is quite pleasing to observe that Customers' Protection Funds have been established at almost all stock exchanges in the country, it needs to be noted that the protection granted to an individual client of a defaulting broker is rather limited. Even at the Bombay Stock Exchange, the maximum amount of coverage is Rs. 40,000 which could well be the cost of one trading lot of a high priced scrip. The Securities Investor Protection Corporation of U.S.A. grants protection upto $ 500,000.

In the larger interest of investor protection, the insurance amount needs to be raised urgently to at least Rs. 100,000. While ways and means of augmenting the flow of funds into the Customers' Protection Fund may be devised, a line of credit to this Fund from the Securities and Exchange Board of India or Investors' Protection Fund proposed to be set up by the Department of Company Affairs may be granted.

Ultimately and sooner it is done better it would be, it is desirable, nay necessary, to set up a separate Investor Protection Corporation in this country to take care of the claims of clients of defaulting members at all the stock exchanges of the country on the lines of Securities Investor Protection Corporation of U.S.A.

Investment Opportunities for Overseas Investors

When the gates for investment into the Indian securities markets were opened initially through floatation of country funds and off-shore mutual funds and later directly into the Indian stock markets by foreign institutional investors and also through Euro issues by way of foreign currency convertible bonds or ordinary shares through Global Depository Receipts, there were apprehensions as to the quantum of flow. But these apprehensions have since been belied with the flow in 1993-94 aggregating to $ 3.5 billion by way of Euro issues and direct investment by foreign institutional investors in the Indian stock markets. The inflow will continue because of the tremendous opportunities for the growth of the Indian stock markets. The annualised returns in the Bombay Stock Exchange during the period of fifteen years from September, 1977 to September, 1992, in dollar terms were 20.0 per cent as compared to 15.9 per cent of France, 14.7 per cent of U.K., 12.3 per cent of U.S.A. and Germany, 9.8 per cent of Japan and 7.8 per cent of Switzerland. As this robust rate of growth is continuing, India will be a major market of attraction for international fund operators.

As we integrate ourselves into the global markets, it is necessary to explore the possibility of having urgently cross-border trading among the SAARC nations. In fact, a small beginning was made in this behalf in October, 1992 when Sri Lanka arranged a meeting of some of the countries of South and South Asia in Colombo. This needs to be given an impetus and a beginning made to usher in the development of a more cohesive and integrated area in this part of the globe.

Securities and Exchange Board of India

Few have doubted the imperative need to have a strong and powerful watch-dog for the securities industry in the country. This was all the more necessary as the ambit of regulation under the Securities Contracts (Regulation) Act, 1956 has been confined to stock exchanges and their members while the canvas of the securities industry is a lot wider.

The main objectives of SEBI are to protect the interest of the investors and regulate and promote the development of the capital market. SEBI aims to create a systematic environment which would facilitate mobilisation of adequate resources through the securities market, its efficient allocation and consequently generate everlasting confidence of investors and industry in the capital market.

The relationships between the regulators and regulatees have not always been harmonious the world over. Wisdom, however, lies in reducing frictions and developing an everlasting and harmonious relationship as ultimately the objective of all, including the regulatees, is to develop a fair, transparent and efficient market. It is in this context that stock exchanges, which have been under regulation right from February, 1957, (in fact, the Bombay Stock Exchange was regulated for over three decades even earlier by the erstwhile Government of Bombay under the Bombay Securities Control Act, 1925) have been wanting to develop themselves as strong self-regulating organisation (SROs). It is pertinent to draw attention in this connection to a recent study 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. As per this study, "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 and 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. All these, according to the study of the Group, permit the government to devote its resources to activities which cannot be adequately served by self-regulation such as criminal proceedings, legal action on insider trading and manipulative practices by non-members, etc. Narasimham Committee on "The Financial System" has also echoed this 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". All these are not to say that SEBI should not step in to regulate the stock exchanges directly. In fact, SEBI should step in when any stock exchange fails to act as a responsible self-regulatory organisation.

There is a vast area in the securities industry which has hitherto remained totally unregulated. These include sub-brokers, registrars and transfer agents, bankers to the issues, trustees of trust deeds, merchant bankers, under writers, portfolio managers, investment advisers, financial analysts and other intermediaries. SEBI has started issuing Rules and Regulations in respect of some of them and not only Rules and Regulations in respect of the remaining intermediaries need to be set out, but also an effective regulation of all these intermediaries has to be made operative in the larger interest of investor protection so that we too in this country can achieve the objective clearly adumbrated by President Franklin D. Roosevelt when he observed while signing the Securities Act of 1933 that the goal of securities regulation is to change the law from caveat emptor (buyer beware) to caveat vendor (seller beware).

Training and Education

An area relatively neglected is training facilities for stockbrokers and various other intermediaries and education of investors. A few training institutes set up by some of the stock exchanges and financial institutions are totally inadequate to cope up with the onerous task of imparting suitable training to the vast and fast growing groups handling public funds. A string of training institutes need to be established and all intermediaries compulsorily made to undergo training regularly at least once in five years, as is generally the case in respect of employees, whether in the public sector or private sector. It is equally necessary to embark on a massive education programme for investors throughout the country as most of them are ignorant of their rights and obligations which are embodied in several statutes. Responsibility for these activities should be put on stock exchanges and other self-regulating organisations.

Conclusion

The Indian stock markets, which attained a remarkable degree of growth in the last one decade, have tremendous prospects of growth, basically because of intensification of liberalisation and deregulation of the economy, disinvestment/ privatisation of public sector undertakings and globalisation of the economy, all of which have their reflections on the stock market activities. It is expected that about 25 per cent of the gross domestic savings would be invested in corporate securities and mutual funds by the end of the current century which would be comparable to the flow of savings in such assets in the developed markets. The process of modernisation and computerisation which has already started need to be accelerated in order to render the markets not only broad and liquid but also transparent, fair and efficient and thereby allure larger flow of funds into the market. As recently observed by the World Bank, the Indian economy has not only reached the take-off stage but has also become an engine of growth for the global economy. Indeed, India is reckoned now by all to be the next economic tiger of the world. This could make the Indian stock markets the largest one between Tokyo in the east and London in the west by the end of the current century. Alongwith the growth, it should be the endeavour of all, particularly the issuers and the stock brokers, to ensure that the Indian stock markets also emerge as a model stock market to be emulated by all.

25