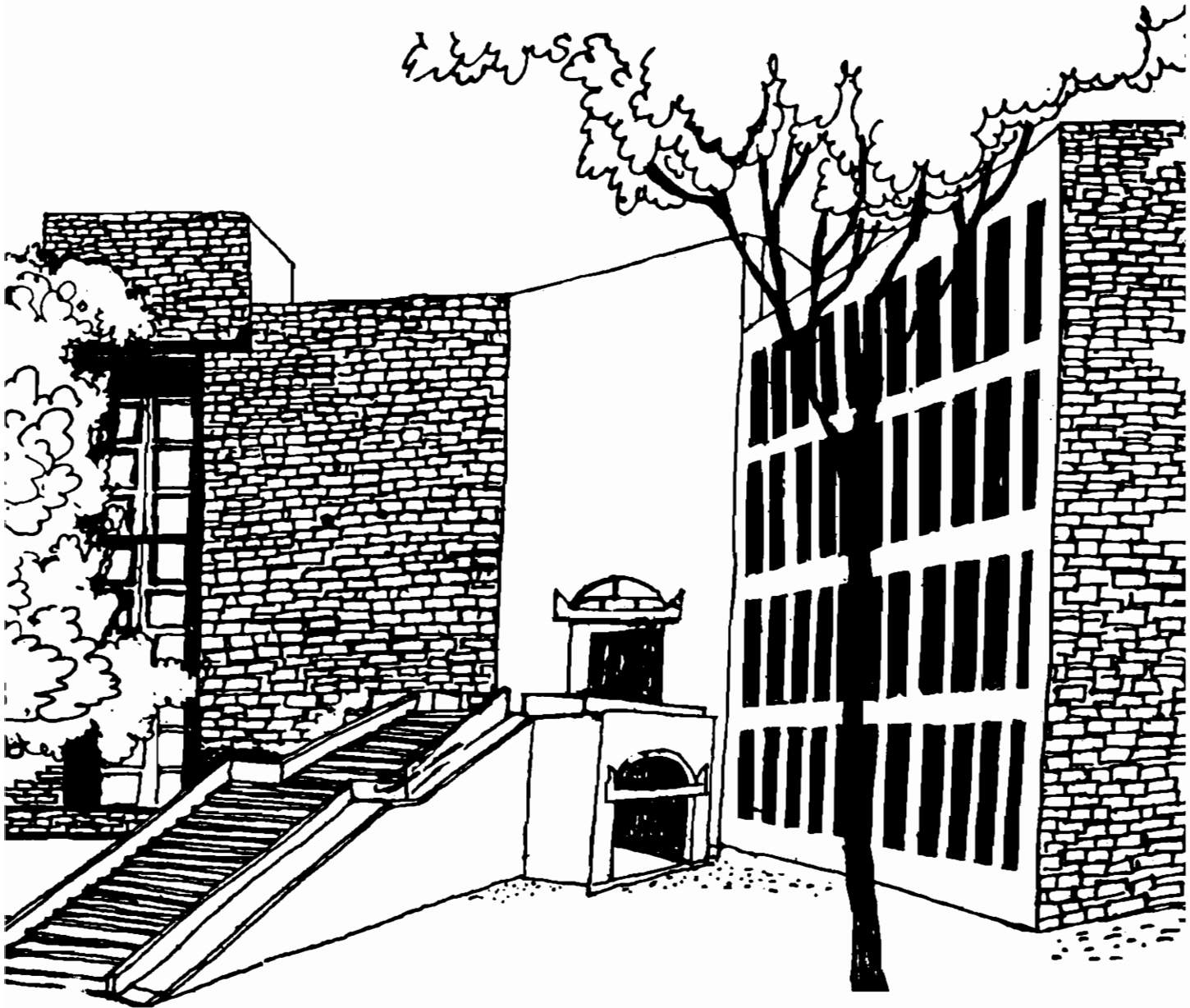





Working Paper



Development of the Capital Market in India - A Regulatory Perspective

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Development of the Capital Market in India - A Regulatory Perspective

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ABSTRACT

Capital Markets are an important mobilizer of resources for the corporate sector. Investors' confidence is key to the healthy developments of capital markets, it is necessary that comprehensive and adequate laws exist to regulate security industry to protect investors interests and rights. The laws should also provide for an effective nodal regulatory agency to ensure fair play, discipline and integrity in the investment business.

The paper reviews the current problems in working of the Indian capital markets and implementation of the security regulations. It suggests measures to improve efficiency of the markets, proposes a comprehensive regulatory framework and outlines the nature of implementing authorities. Further, it recommends a nodal regulatory authority independent of government interference which would be responsible for implementing the legislation. This agency would need to develop itself as a viable entity with its own infrastructure, trained manpower and professional work culture.

For investors' protection, some additional measures like frequent disclosure of reliable information, creation of Investors Protection Fund, setting up of Investors Protection Advisory Council and promotion of local Investors' Associations are suggested. For quick redressal of grievances, an independent quasi-judiciary machinery is proposed. Since an individual investor is unable to take action because of disproportionate expenses involved in initiating the action, the laws should also provide for public interest litigation by investors association and other agencies on behalf of investors.

Development of the Capital Market in India - A Regulatory Perspective

(Dr. Ramesh Gupta)

Vibrant capital markets are a vital and indispensable part of the national economy's financial system. They are an important mobilizer of resources for the corporate sector. During the last decade, the Indian capital markets have experienced a tremendous growth. The eighties witnessed the massive inflow of funds into the market, the introduction of mega issues, a trend towards equity issues, striking growth in market capitalization, buoyancy in share prices, etc. But the path of rapid growth was littered with the thorny problem of loss of investors confidence in the market soon after the mega issue such as Usha Rectifier, Bindal Agro etc. which appeared in late 1989. The payment crisis and prolonged closure of stock markets in the months of December 1990 and January 1991 further disturbed the encouraging trend.

Investors broadly participate in two markets- the primary market where corporations issue new securities to raise funds for investment and the secondary market where there is trading in securities issued in the primary market. Each of these markets presents its own set of problems to the investors.

Problems in Primary Markets

- a. Fixation of Premia, nature of security- terms and conditions
 - Regulations discourage innovations in instruments
 - Limited flow and variety of Security
 - Premia fixation do not take into account future prospects

b. Contents of the Prospectus

- Questionable and reliability of information
- Doubts about disclosure of true and fair information
- Variations in accounting and auditing practices

c. Questionable financial advertisement norms

- Unregulated investors conferences

d. Application and allotment procedures

- Too low stipulated cost of issue
- Too low minimum application amount
- Too many number of Collection Centers

e. Delay in Refund and issue of certificates etc.

- Non acceptance of responsibilities by the agencies involved

f. Listing Requirements are not stringent enough

- Smaller companies without a track record of earnings obtain listing
- No provision for market makers in a listed security

g. Corporate management issuing the securities

- takes a short-term view
- shows no interest in servicing investors
- provides inadequate and biased financial reporting
- supports security price particularly at the time of a new issue

Problems in Secondary Markets

a. Related to Functioning of Stock Exchanges :

- Seats controlled by member brokers
- Credibility of brokers is too low
- Sub-brokers are unregulated
- Delisting or suspension of trading in the security is the only recourse for penalizing the defaulting companies
- Board is dominated by a few brokers who are not very responsive to the investors' needs
- Enforcement of rules and regulations is not strict as
↳ often offenses are condoned or a compromise is reached

b. Related to Trading and Settlement Activities:

- Lack of transparency in transactions
- Trading activity is limited to a few securities
- For a majority of securities quotes are not available
- Jobbers' spread is too high
- Small orders are not accepted and are expensive to execute
- Transaction costs are high, particularly if jobbers' spread is included
- Speculative activity dominates the investment business
- Undercapitalization and overtrading
- Frequent market closure due to delay in settlements
- Cumbersome settlements procedures vis-a-vis delivery and transfer of shares

c. Related to Financing of Security Trading:

- At present it is financed indirectly by postponement (carrying forward) of transacted business. A business

transacted for squaring up in future with inadequate margins is highly risky and undermines the financial soundness of the system.

d. Corporate Management :

- Inadequate periodic disclosure of information
- Questionable disclosure
- Inadequacy of rules in the field of selection of accounting policies and in the treatment of various transactions in the books of accounts.
- Delay in transferring the shares
- Unresponsive to shareholders' queries.

Improving the Efficiency of Securities Markets

Following are some structural and procedural suggestions for improving the efficiency of securities markets -

a. Provide more scope for competition through deregulation of access to securities industry.

b. Automation of trading and settlement activities - advantages are :

- Transparency of transaction is enhanced
- Massive volume of trade can be handled safely
- Brokers' office work is reduced considerably
- Promotes national market integration- enhancing breadth, depth, liquidity and stability of prices
- Helps develop an effective market surveillance as each transaction leaves an audit trail.

c. Listing requirements should be made more stringent. There should be multi-tier listing. Stock Exchanges should be graded and should have different listing requirements. Every company in the first instance, need not be listed on a major stock exchange (like BSE) as it creates infrastructural and managerial problems for BSE management to monitor the activities in a listed security and its company management.

d. Too many stock exchanges in the country make it difficult to regulate them uniformly. We should have more of an up-country dealer network rather than opening more organized stock exchanges.

e. Maintain the stability and soundness of the capital markets through continuous monitoring of the market situation to facilitate timely intervention.

f. Effective regulation of financial intermediaries such as brokers and merchant bankers and other agencies is necessary.

g. The market must have strong regulations, surveillance, and discipline, so that all users know that system is fair. play.

h. Some sound and practical method has to be evolved for financing of the security trade.

Existing Security Regulations:

At present capital markets are regulated by separate legislative enactments like Companies Act, 1956, Capital Issues Control Act 1947, Securities Contracts (Regulation) Act 1956 and MRTTP Act 1969. At present, these powers are being exercised by -

the Controller of Capital Issues (CCI), the Company Law Board, and 19 Regulated Stock Exchanges located at different places in the country. Recently, the Security Exchange Board of India (SEBI) has also been authorized to issue guidelines and monitor the activities of various market functionaries. At present SEBI does not have statutory powers. The existing regulations to monitor and control the primary and secondary markets in India are as follows:

Primary Market :

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1. Companies Act : Sec. 56-81 Dealing with Prospectus and Allotment, and other matters relating to issue of shares or debentures.
2. Controller of Capital Issues: Approval of terms of issue - the kind of instrument, size, timing and premia etc.
3. Security Exchange Board of India: Approval of Prospectus Contents.
4. Stock Exchanges : Ensuring that all the requirements about issue have been complied with before listing the security.

Secondary Markets:

1. Securities Contract (Regulations) Act is administered by Stock Exchange Division. The Act provides, among other things, the procedure to be followed for recognition of stock exchanges, submission of periodical returns by stock exchanges, inquiry into the affairs of stock exchanges and their members, and require-

ments for listing of securities, regulation of contracts in securities and transfer of securities.

2. Activities on stock exchanges are governed by rules, regulations and bye-laws of each stock exchange.

3. Companies Act provide, among other things, rules for transfer of shares, preparation of accounts and its audit, disclosure of financial information to the shareholders, etc.

Deficiencies in the System

Following are the deficiencies in the existing system:

1. The legislation relating to securities is scattered in different enactments and administered by different agencies.

2. The administrative agencies do not have adequate expertise and manpower to effectively enforce the legislative provision.

3. There is not a single nodal agency to monitor all aspects of the securities business and take corrective action, including those of penalizing and/or prosecuting the defaulters.

4. There is neither an effective law nor an agency to check malpractices like price rigging, insider trading, high volatility in market prices and fraud in the system.

5. There are no laws to govern emerging financial intermediaries like mutual funds, venture capital, merchant bankers and many other functionaries in the market.

Proposed framework for Regulation

The national and international experiences suggest that financial markets need some kind of regulation to protect investors from malpractice. The ways of providing regulation and the extent to which it may be effective are matters of continuing controversy. In India, while framing the appropriate legislation for the securities industry, the aim should be to achieve healthy and orderly development of the capital markets. Ensuring the rapid growth of capital markets calls for the following measures:

1. Restoring public confidence in the capital market by safeguarding investors' interest;
2. Ensuring minimum cost of intermediation for transferring funds;
3. Facilitating the issuers task of raising funds in an easy and efficient manner;
4. Opening the markets to new entrants and encouraging competition among market players for effective working;
5. Automation of trading and settlement activities on stock exchanges including simplification of procedures in recording of transactions and share transfers and transactions;
6. Evolving uniform accounting standards would have far reaching beneficial effects on corporate practices;

7. Encouraging innovations in financial instrument which would meet market requirements. Guidelines should be developed in advance for each new instrument with regard to accounting, tax and legal matters.

The proposed legislation should seek to create an environment which would facilitate mobilization of adequate resources through the securities market as well as its efficient allocation. This environment which would include rules and regulations, institutions and their inter-relationships, instruments, practices, infrastructure, within an appropriate policy framework, should have an overall focus of fairness. The market must inspire confidence all round.

In framing a new Act for a nodal agency, care should be taken to ensure that there are comprehensive and adequate laws to regulate the securities industry. At present, laws related to the securities industry in India are scattered and there is a need to bring them together in one legislation. The main purpose of the proposed Act should be to ensure :

1. effective regulation of securities business both in primary and secondary market
2. effective regulation of functioning of stock exchanges and other financial intermediaries
3. prohibition of carrying on of securities business other than by authorized persons
4. effective monitoring and surveillance of functioning of self-regulating organisations (SROs).

5. Initiating actions (civil and/or criminal) for breach of securities business related rules and regulations.

Regulatory Authorities

The aim of the proposed Act should not only be to evolve legislation but empower implementing authorities also (like SIB in U.K. and SEC in U.S.A.) to ensure fair play, discipline. integrity and a sense of sharing information for the promotion of a healthy and dynamic capital markets.

In many capital markets, there is an irresistible temptation for the governmental nodal agency to lay down rules, and regulate and monitor the markets in excessive detail to ensure efficiency. In developing countries, this role is further emphasized by pointing to the need for "developing" a growing capital market. But the nodal agency must realize that every aspect of the capital market's function cannot be controlled from outside and such external control could become arbitrary and dysfunctional.

The government should avoid direct registration and supervision of individual firms involved in the security business. It should aim at creating an effective surveillance mechanism for the securities market and encourage responsible and accountable autonomy on the part of all players in the market, who should discipline themselves and observe the rules of the game. This would be possible if the intermediaries set themselves up as effective self-regulatory bodies.

The role of the government regulator should be to ensure that self-regulatory organizations are doing their job. The self-regulating system calls for a live, healthy and balanced relationship between the central agency and the regulatory bodies under its oversight. The nodal agency should be the regulator of last resort.

For recognition of the self-regulating organization (SROs), the following should be the minimum requirements :

- a. Ability to enforce its own rules and securities law and rules
- b. Ability to prevent manipulative acts and practices and promote fair and open markets
- c. Development and maintenance of high standard of professional conduct and integrity
- d. Rules ensuring fairness and due process in disciplinary proceedings.

The nodal agency should be authorized to ensure framing of Codes of Conduct by respective SROs connected with investment business, to abide by the provisions of such codes of conduct for respective business, to develop a mechanism to ensure compliance, failing which the nodal agency itself should draft a model code of conduct of each of these businesses to be mandatory for the respective SROs. The primary purpose of a regulatory agency should be "the guidance and supervision of the industry as a whole" rather than to play the simpler role of a policeman.

Nature of Nodal Agency

Now, the question needs to be asked : what should be the characteristics of this nodal agency. Should it be

A. only an administrative agency having expertise to enforce compliance with rules and regulations and make rules and issue guidelines consistent with administrative needs ?

or B. a statutory body having administrative, rule making and investigating powers ?

or C. a statutory body having in addition to all the powers specified in B above, the quasi-judicial powers to grant reliefs to the aggrieved parties and take injunctive actions against defaulters ?

In India, the suitable model would be B, a statutory autonomous body having administrative, rule making and investigating powers. A mere administrative agency (Model A) would not be suitable because without rule-making and investigating powers, the proposed agency would remain a 'toothless tiger' and it would be impossible to bring discipline in the market place. 'Grievance prevention' is as important as 'grievance redressal', and prevention would be possible only if the nodal agency has powers to investigate and initiate action on its own against violators and non-performers.

Model C involves concentration of power in one single authority and this will be against the interests of the long term growth of the capital markets. There is the possibility that

such a body would ultimately become bureaucratic in its nature and political in its functioning. Such tendencies of monopoly control over the complete working of markets including that of adjudication have to be combated by limiting the regulatory powers of the proposed nodal agency.

Organization and Personnel

Before taking all these responsibilities an organization should evolve as a viable entity with its own infrastructure, trained manpower and a professional work culture. Development of professional culture in an organization is most important for success of any regulatory reform. With the increasing complexity in the investment business, the need for expertise becomes a dominant, for the art of regulating an industry requires detailed knowledge of its operations.

Additional Measures to Enhance Investors' Protection :

Since investors' confidence is key to the healthy development of capital markets, following are some additional measures suggested to enhance investors' protection :

1. Reliable and Frequent Information

The new provisions where companies are obliged to send only abridged form of annual reports, requires data mostly of a statutory nature explaining very little about the financial working of a company. The statutory information like particulars with respect to conservation of energy, technology absorption; adaption and innovation; foreign exchange earnings and outgo under Section 217(1)(e) of Companies Act, 1956 is of very little use to an

average investor and need not be circulated among shareholders. What shareholders need most is the profitability, liquidity and other financial data to forecast the future financial working of the company. It would be useful if the relevant financial performance data on each segment of the business can be provided in detail. Further, the proposed nodal agency in consultation with the Institute of Chartered Accountants of India, must evolve uniform accounting standards as it would have a far reaching beneficial effect on corporate practice including their performance reporting.

2. Guidelines for Issue of New Instruments:

Unscrupulous fund raisers often devise a whole set of new complex instruments which are meant to lure the investors but which are devoid of any economic substance.

Guidelines for the promotion of new financial instruments need to consider the conceptual basis of financial instruments, their attraction for different classes of investors, and the framework under which new instruments could gain acceptability and succeed.

Regulatory authorities should encourage the development of new instruments, but proper standards of accounting, taxation and laws must be pre established. At present, companies issue fixed income securities (a pure debt security or in combination of warrants or some other synthetic variation - an example is recently proposed issue of SPN by Tisco) offering capital gains benefits if an investor so chooses. One fails to understand how

the investors choice can alter the tax treatment for exactly the same security issued with the same terms and conditions. Should not opinion of the Central Board of Direct Taxes (CBDT) be sought before allowing such dual tax treatment of a prior fixed return received from an investment. It may have serious revenue implications for the government. Similarly, can a company choose any accounting treatment of the interest expenses without regard to the Generally Accepted Accounting Principles (GAAP) ?

As suggested by the Pherwani Committee, a permanent Financial Instrument Review Committee should be set up to study in advance the tax, accounting and legal aspect of each kind of new instrument and issue the standards to be practiced by the issuers and advertised accordingly to the investors. This committee should include outside experts on valuation of securities, accounting, legal and tax issues and experts who can provide the conceptual framework.

3. Investors Protection Fund

There is an urgent need to create an Investors Protection Fund on the lines of the Securities Investors Protection Corporation (SIPC) in U.S.A. and Investors Compensation Fund in U.K. Such funds should ensure that the investors are compensated for any loss due to negligence, fraud or insolvency of any investment firm with whom he has been dealing in the course of his securities business. Such a fund should be financed by a levy on each transacted business in the secondary markets and a small fixed percentage of the funds raised in the primary markets. Investment agencies should be required to contribute money to the

Investors Protection Fund consistent with the nature, extent and volume of their operations.

4. Investor Protection Advisory Council

Further, the proposed act should provide for the constitution of an Investor Protection Advisory Council on the model of the Central Consumer Protection Council under the Consumer Protection Act. Its members should represent various interests such as agencies connected with the business of investment, investors, Parliament, Government, professional bodies and local investors associations. The Council should periodically review the operations of the Act, need for changes and programmes for education and research on the subject of the healthy development of Capital Market and Investor Protection.

5. Promotion of Local Investors' Associations

It is necessary that genuine local investors associations are formed and strengthened for providing investor guidance, creating investors awareness and promoting a meaningful relationship between companies and their shareholders and between stock exchanges, intermediaries and investors. These investors associations should be equipped to handle investors' grievances and strive for investors' continuing education.

Since an individual investor is unable to take action because of the disproportionate expense in initiating the action and because they are scattered all over the country, it is essential that proposed legislation specifically provide for **public**

interest litigation which can be initiated by investors' associations on behalf of member investors.

6. Provision for Quick Redressal of Grievances

Redressal of grievance and compensation for damages to the investors are not easily available in our regular courts. From past experience it can be said that investors rarely go to the courts for remedial action in case of default in receiving the financial services. The reasons are many of which the important ones are as follows:

- a) an individual investor is unable to take action because of disproportionate expenses involved in taking the action.
- b) our courts are overburdened and there is considerable delay in settling the disputes. In the investment business, time is money and therefore quick justice is required.
- c) the judges of our regular courts are not familiar with the complexities of investment business in to-day's world and cannot do justice to the case.

Therefore, it is suggested that a separate quasi-judicial authority like Consumer Disputes Redressal Forums or MRTP Commission should be appointed to determine disputes between the aggrieved party and various agencies connected with investment business and to provide quick and inexpensive remedy. The authority should have the following powers :

1. to direct specific performance of the contracts, transactions, promises, or provisions of Acts, Rules, Regulations by agencies