5
The Capital Market

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1 *Functions of the capital market*
2 *Primary capital market and secondary capital market*
3 *History of the Indian capital market*
4 *Capital market scams*
5 *Reforms in the capital market*

INTRODUCTION

The capital market is an important constituent of the financial system. It is a market for long-term funds—both equity and debt—and funds raised within and outside the country.

The capital market aids economic growth by mobilizing the savings of the economic sectors and directing the same towards channels of productive use. This is facilitated through the following measures:

- Issue of 'primary securities' in the 'primary market,' *i.e.*, directing cash flow from the surplus sector to the deficit sectors such as the government and the corporate sector.
- Issue of 'secondary securities' in the primary market, *i.e.*, directing cash flow from the surplus sector to financial intermediaries such as banking and non-banking financial institutions.
- 'Secondary market' transactions in outstanding securities which facilitate liquidity. The liquidity of the stock market is an important factor affecting growth. Many profitable projects require long-term finance and investment which means locking up funds for a long period. Investors do not like to relinquish control over their savings for such a long time. Hence, they are reluctant to invest in long gestation projects. It is the presence of the liquid secondary market that attracts investors because it ensures a quick exit without heavy losses or costs.

Hence, the development of an efficient capital market is necessary for creating a climate conducive to investment and economic growth.

Functions of a Capital Market

The functions of an efficient capital market are as follows:

- Mobilize long-term savings to finance long-term investments.
- Provide risk capital in the form of equity or quasi-equity to entrepreneurs.
- Encourage broader ownership of productive assets.
- Provide liquidity with a mechanism enabling the investor to sell financial assets.
- Lower the costs of transactions and information.
- Improve the efficiency of capital allocation through a competitive pricing mechanism.
- Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular financial asset.
- Enable quick valuation of financial instruments—both equity and debt.
- Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund.
- Enable wider participation by enhancing the width of the market by encouraging participation through networking institutions and associating individuals.
- Provide operational efficiency through
  - simplified transaction procedures;
  - lowering settlement timings; and
  - lowering transaction costs.

- Develop integration among
  - real and financial sectors;
  - equity and debt instruments;
  - long-term and short-term funds;
  - long-term and short-term interest costs;
  - private and government sectors; and
  - domestic and external funds.
- Direct the flow of funds into efficient channels through investment, disinvestment, and reinvestment.

Primary Capital Market and Secondary Capital Market

The capital market comprises the primary capital market and the secondary capital market.

- The primary market is a market for new issues, while the secondary market is a market where outstanding or existing securities are traded.

Primary Market This refers to the long-term flow of funds from the surplus sector to the government and corporate sector (through primary issues) and to banks and non-bank financial intermediaries (through secondary issues). Primary issues of the corporate sector lead to capital formation (creation of net fixed assets and incremental change in inventories). The capital formation function enables companies to invest the proceeds of a primary issue in creating productive capacities, increasing efficiency, and creating jobs which, in turn, generate wealth.

The nature of fund-raising is as follows:

Domestic	
Equity issues by	— Corporates (primary issues)
	— Financial intermediaries (secondary issues)
Debt instruments by	— Government (primary issues)
	— Corporates (primary issues)
	— Financial intermediaries (secondary issues)
External	
Equity issues through issue of	— Global Depository Receipts (GDR) and American Depository Receipts (ADR)
Debt instruments through	— External Commercial Borrowings (ECB)
Other External Borrowings	
Foreign Direct Investments (FDI)	— in equity and debt form
Foreign Institutional Investments (FII)	— in the form of portfolio investments
Non-resident Indian Deposits (NRI)	— in the form of short-term and medium-term deposits

The **fund-raising in the primary market** can be classified as follows:

- Public issue by prospectus
- Private placement
- Rights issues
- Preferential issues

Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII)

FDI is an investor which picks up more than 10 per cent stake in a company's equity. India has had a long experience with FDIs, with multinational corporations being significant players in many sectors of the economy–pharmaceuticals, consumer durables, fast moving consumer goods, engineering, and financial services. The sectors which were recently opened up for FDIs are telecom, banking and insurance. These multinational corporations either set up their wholly owned subsidiary in India or enter into a joint venture with Indian entrepreneurs. FDI is a preferred route to bridge the large savings–investment gap owing to its beneficial effects such as access to modern technologies and export markets, and direct and indirect employment reaction. However, FDI crowds out domestic investment opportunities and hence some conditions in the form of minimum level of local content, export commitment, technology transfer, and compulsory listing on the local stock-exchanges are generally imposed on FDIs. FDIs are stable by nature as they usually come into the picture only for long-term projects. They also help generate employment and bring in the latest technological innovations.

The government aims to attract FDI worth \$150 billion over the next 10 years, with a thrust on infrastructure, financial services and agriculture. This will be possible only if there is a stability of policies, tax laws and incentives and a minimum of red tape and a corruption-free environment. The government has set up an investment commission to identify the problems of the potential investors and advise the government.

The government has revised FDI caps to 100 per cent in airports, power trading, petroleum marketing, distillation and brewing of potable alcohol, captive mining in coal and lignite, industrial explosives, and hazardous chemicals. Investment in these areas would no longer require the approval of the Foreign Investment Promotion Board.

Flls are in the form of portfolio investments both in the primary and secondary capital markets. They help in bridging the short-to medium-term savings–investment gap. FII flows help capital formation either by subscribing to quality issues in the primary market or by releasing the existing pool of risk capital through the secondary market. FIIs can invest only upto 24 per cent in a company. Further investments would need special approval from the company's board and in any case cannot go beyond the foreign investment cap for the sector set by the government. FIIs usually help in developing capital markets. Entrepreneurs can tap the capital market by wooing FIIs and can thereby setup new projects or use the funds for expansion. However, FII investment may not be stable as there can be sudden outflows, if capital markets perform adversely, or are expected to perform negatively.

The Secondary Market This is a market for outstanding securities. An equity instrument, being an eternal fund, provides an all-time market while a debt instrument, with a defined maturity period, is traded at the secondary market till maturity. Unlike primary issues in the primary market which result in capital formation, the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments. The secondary market contributes to economic growth by channelizing funds into the most efficient channel through the process of disinvestment to reinvestment. The secondary market also provides instant valuation of securities (equity and debt instruments) made possible by changes in the internal environment, *i.e.*, through companywide and industrywide factors. Such a valuation facilitates the measurement of the cost of capital and rate of return of economic entities at the micro level. Secondary markets reduce the cost of capital by providing liquidity, price discovery and risk transfer capability. Liquidity is the ability to buy or sell an asset readily at a low cost and without a substantial impact on its price. Price discovery is the process whereby market participants attempt to find an equilibrium price which, in turn, is useful in making economic decisions. Both the government and business firms use this information to formulate future strategies. For instance, the derivatives trading reveals expected future prices of different commodities, currencies, precious metals, securities, and interest rates. Based on this information, both the government and business firms determine particulars like pricing commitments, timing of issues and expansion of production facilities.

Secondary Market

- Facilitates liquidity and marketability of securities.
- Provides valuation of securities.
- Reduces cost of capital
- Enables price discovery
- Creates a wealth effect

The secondary market creates a wealth effect. The bull run in the stock markets adds to the market capitalization which notionally accrues to all investors–government, corporates, promoters, strategic holders of equity on listed companies, mutual funds and individual investors and it makes them feel wealthier. Investors also feel rich when they receive frequent dividend distribution from mutual funds or corporates. This stock market created wealth does influence consumption and growth of the economy. The wealth effect suggests that an addition in financial wealth boosts consumer spending in the long run.

The Indian secondary market can be segregated into two.

1. The secondary market for corporates and financial intermediaries. For trading in issues of corporates and financial intermediaries, there are the following entities:
   a. Recognized stock exchanges
   b. The National Stock Exchange of India Limited (NSE)
   c. The Over the Counter Exchange of India (OTCEI)
   d. The Interconnected Stock Exchange of India (ISE).

   The participants in this market are registered brokers—both individuals and institutions. They operate through a network of sub-brokers and sub-dealers and are connected through an electronic networking system.
2. The secondary market for government securities and public sector undertaking bonds. The trading in government securities is basically divided into the short-term money market instruments such as treasury bills and long-term government bonds ranging in maturity from 5 to 20 years.

   The main participants in the secondary market for government securities are entities like primary dealers, banks, financial institutions, and mutual funds.

   The secondary market transactions in government securities have been conducted through the subsidiary general ledger (SGL) since September 1994. Both the government securities and public sector undertaking bonds are now traded in the wholesale debt market (WDM) segment of the NSE, the BSE, and the OTCEI.

HISTORY OF THE INDIAN CAPITAL MARKET

The history of the capital market in India dates back to the eighteenth century when the East India Company securities were traded in the country. Until the end of the nineteenth century, securities trading was unorganized and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860–61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for nearly half a decade. The bubble burst on July 1, 1865, when there was a tremendous slump in share prices.

Trading was at that time limited to a dozen brokers; their trading place was under a banyan tree in front of the Town Hall in Bombay. These stock brokers organized an informal association in 1875—the Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmedabad, also industrial and trading centres, materialized later. The Bombay Stock Exchange was recognized in May 1927 under the Bombay Securities Contracts Control Act, 1925.

The capital market was not well-organized and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence era also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. Public sector undertakings were healthier than private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades.

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as the *satta bazaar*. Despite speculation, non-payment or defaults were not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 was also enacted. The decade of the 1950s was also characterized by the establishment of a network for the development of financial institutions and state financial corporations.

The 1960s was characterized by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969 on forward trading and *badla,* technically called 'contracts for clearing'. *Badla* provided a mechanism for carrying forward positions as well as for borrowing funds. Financial institutions such as LIC and GIC helped revive the sentiment by emerging as the most important group of investors. The first mutual fund of India, the Unit Trust of India (UTI) came into existence in 1964.

In the 1970s, *badla* trading was resumed under the guise of 'hand-delivery contracts—a group.' This revived the market. However, the capital market received another severe setback on July 6, 1974, when the government promulgated the Dividend Restriction Ordinance, restricting the payment of dividend by companies to 12 per cent of the face value or one-third of the profits of the companies that can be distributed as computed under Section 369 of the Companies Act, whichever was lower. This led to a slump in market capitalization at the BSE by about 20 per cent overnight and the stock market did not open for nearly a fortnight. Later came a buoyancy in the stock markets when the multinational companies (MNCs) were forced to dilute their majority stocks in their Indian ventures in favour of the Indian public under FERA in 1973. Several MNCs opted out of India. One hundred and twenty-three MNCs offered shares worth ₹150 crore, creating 1.8 million shareholders within four years. The offer prices of FERA shares were lower than their intrinsic worth. Hence, for the first time, FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real fillip to the Indian stock market. For the first time, many investors got an opportunity to invest in the stocks of such MNCs as Colgate, and Hindustan Lever Limited. Then, in 1977, a little-known entrepreneur, Dhirubhai Ambani, tapped the capital market. The scrip, Reliance Textiles, is still a hot favourite and dominates trading at all stock exchanges.

The 1980s witnessed an explosive growth of the securities market in India, with millions of investors suddenly discovering lucrative opportunities. Many investors jumped into the stock markets for the first time. The government's liberalization process initiated during the mid-1980s, spurred this growth. Participation by small investors, speculation, defaults, ban on *badla,* and resumption *of badla* continued. Convertible debentures emerged as a popular instrument of resource mobilization in the primary market. The introduction of public sector bonds and the successful mega issues of Reliance Petrochemicals and Larsen and Toubro gave a new lease of life to the primary market. This, in turn, enlarged volumes in the secondary market. The decade of the 1980s was characterized by an increase in the number of stock exchanges, listed companies, paid-up capital, and market capitalization.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalization and globalization were the new terms coined and marketed during this decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterized by a new industrial policy, emergence of the SEBI as a regulator of the capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing, many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to an erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

The 1991–92 securities scam revealed the inadequacies of and inefficiencies in the financial system. It was the scam which prompted a reform of the equity market. The Indian stock market witnessed a sea change in terms of technology and market prices. Technology brought radical changes in the trading mechanism. The Bombay Stock Exchange was subject to nationwide competition by two new stock exchanges—the National Stock Exchange, set up in 1994, and the Over the Counter Exchange of India, set up in 1992. The National Securities Clearing Corporation (NSCC) and the National Securities Depository Limited (NSDL) were set up in April 1995 and November 1996 respectively for improved clearing and settlement and dematerialized trading. The Securities Contracts (Regulation) Act, 1956 was amended in 1995–96 for introduction of options trading. Moreover, rolling settlement was introduced in January 1998 for the dematerialized segment of all companies. With automation and geographical spread, stock market participation increased.

In the late-1990s, Information Technology (IT) scrips dominated the Indian bourses. These scrips included Infosys, Wipro, and Satyam. They were a part of the favourite scrips of the period, also known as 'new economy' scrips, along with telecommunications and media scrips. The new economy companies were knowledge intensive unlike the old economy companies that were asset intensive.

The Indian capital market entered the twenty-first century with the Ketan Parekh scam. As a result of this scam, *badla* was discontinued from July 2001 and rolling settlement was introduced in all scrips. Trading of futures commenced from June 2000, and Internet trading was permitted in February 2000. On July 2, 2001, the Unit Trust of India announced suspension of the sale and repurchase of its flagship US-64 scheme due to heavy redemption leading to a panic on the bourses. The government's decision to privatise oil PSUs in 2003 fueled stock prices. One big divestment of international telephony major VSNL took place in early February 2002. Foreign institutional investors have emerged as major players on the Indian bourses. NSE has an upper hand over its rival BSE in terms of volumes not only in the equity markets but also in the derivatives market.

It has been a long journey for the Indian capital market. Now the capital market is organized, fairly integrated, mature, more global and modernized. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology, coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. Indian stock markets are now getting integrated with global markets.

A Brief History of the Rise of Equity Trading in India

July 9, 1875: Native brokers form the Native Share and Stock Brokers' Association in Bombay. Membership fee is Re. 1. The association has 318 members.

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1899: The Bombay Stock Exchange acquires own premises.

1921: Clearing houses are established for settlement of trades as volumes increase.

1923: K. R. P. Shroff becomes the honorary president of the BSE.

1925: The Bombay Securities Contract Control Act (BSCCA) comes into force.

December 1, 1939: Stock exchange building is acquired.

1943: Forward trading banned till 1946. Only ready to deliver and hand delivery contracts permitted.

1956: The Securities Contract Regulation Act drafted on the lines of the BSCCA comes into force.

1957:	The BSE becomes the first exchange in India to get permanent recognition.
1964:	Unit Trust of India (UTI) is born.
April 1, 1966:	K. R. P. Shroff retires and Phiroze J. Jeejeebhoy becomes new chairman.
June 29, 1969:	Morarji Desai bans forward trading.
1973:	Construction of P J Towers, named after late Phiroze Jamshedji Jeejeebhoy, starts.
January 2, 1986:	The BSE Sensex launched as the first stock market index with 1978–79 as the base year.
November 1987:	SBI Mutual Fund launches Magnum Regular Income Scheme.
April 1988:	The Securities and Exchange Board of India (SEBI) set up.
January 1992:	The SEBI given statutory powers.
May 1992:	Harshad Mehta securities scam breaks.
May 27, 1992:	Reliance is the first Indian company to make a GDR issue.
May 30, 1992:	The Capital Issues Control Act, 1947 is repealed.
September 1992:	Foreign institutional investors (FIIs) are permitted to invest in the Indian securities market.
November 1992:	Finance Minister Manmohan Singh inaugurates the Over the Counter Exchange of India.
October 30, 1993:	The first private sector mutual fund, Kothari Pioneer Mutual Fund, begins operations.
1993:	The SEBI bans *badla* trading on the BSE.
June 1994:	NSE commences operations in wholesale debt market segment.
November 1994:	The capital market segment of the NSE goes on stream. Trading is screen-based for the first time in India.
March 1995:	The BSE on-line trading system (BOLT) replaces the open outcry system.
April 1995:	The National Securities Clearing Corporation Limited, India's first clearing corporation is set up.
October 1995:	The NSE overtakes the BSE as the largest stock exchange in terms of volume of trading.
April 1996:	Nifty is born. The National Securities Clearing Corporation Limited commences operations.
November 1996:	The National Securities Depository Limited is created.
February 1997:	The SEBI releases norms for takeovers and acquisitions.
May 1997:	The BSE introduces screen-based trading.
February 1998:	Launch of automated lending and borrowing mechanism (ALBM) on the NSE.
November 1998:	The SEBI recognizes the Interconnected Stock Exchange founded by 15 regional stock exchanges. This exchange starts functioning in February 1999.
March 11, 1999:	Infosys Technologies is the first company to be listed on the NASDAQ through a public offering of American Depository Receipts (ADRs).
March 22, 1999:	Central Depository Services (India) promoted by the BSE commences operations.
September 1999:	ICICI is the first Indian company to be listed on the New York Stock Exchange (NYSE).
October 11, 1999:	For the first time in the BSE's history, the Sensex closes above the 5,000 mark at 5,031.78.
January 2000:	The BSE creates a 'Z' category of scrips in addition to A, B1, and B2 comprising scrips that breached or failed to comply with the listing agreement.
February 2000:	Internet trading commences on the NSE. On February 14, 2000, the BSE Sensex hits an all-time high of 6,150. On February 21, the NSE records peak market capitalization of ₹11,94,282 crore.
April 10, 2000:	The Sensex is revamped to include Dr Reddy's Lab, Reliance Petroleum, Satyam Computers, and Zee Telefilms replacing Indian Hotels, Tata Chemicals, Tata Power, and IDBI.
June 2000:	The BSE and the NSE introduce derivatives trading in the form of index futures.
July 9, 2000:	The BSE turns 125.

October 19, 2000:	Wipro lists on the NYSE.
January 22, 2001:	The Borrowing and Lending Securities Scheme (BLESS) launched on the BSE to promote securities lending and borrowing activities.
March 2001:	Ketan Parekh scam breaks. The SEBI suspends all the broker directors of the BSE in relation to the KP scam.
May 2001:	The BSE advises compulsory demat for B2 scrips.
June 2001:	Index options start trading on the NSE.
July 2001:	A SEBI directive bans carry forward. All major securities are moved to rolling settlement. Options of individual scrips start trading on the NSE.
November 9, 2001:	The BSE and the NSE launch futures in individual stocks.
September 28, 2015:	The historic merger of the erstwhile commodities futures regulator, forward markets commission with SEBI.
January 23, 2017:	The BSE was the first stock exchange to issue an IPO and the IPO was listed on NSE.

Source: Business Today, January 20, 2002, pp. 62–63.

CAPITAL MARKET SCAMS

Introduction

The post-economic liberalization era witnessed scams with cyclical regularity in the Indian capital market. The series of scams in the capital market may lead someone to believe that scams and liberalization are correlated phenomena.

The most infamous scam, known as the 1992 securities scam, was masterminded by Harshad Mehta and other bull operators, not without the connivance and collusion of banks. The consequences were so serious that the BSE remained closed for a month. This was followed by scams by unscrupulous promoters mostly of finance companies who took advantage of free pricing to raise money by price rigging. Such fly-by-night operators jolted both the stock exchange and investors. Besides price rigging, grey market activities were common where the share prices were quoted at a premium before they were listed on the stock exchanges. For instance, a Morgan Stanley Mutual Fund unit worth ₹10 was commanding a premium of ₹18, *i.e.*, it was quoted at ₹28 during the subscription period. In March 1995, another scam known as the M. S. Shoes scam masterminded by an exporter, Pavan Sachdeva, who rigged up prices of shares, leading eventually to a crash. Once again the market had to be closed for three days. In December 1995, the Reliance shares issue—share switching scam—sprung up in which Fair Growth Financial Services, Reliance Industries, and the stock exchange itself were involved. The Bombay Stock Exchange suspended trading in the famous RIL scrip for three days.

C. R. Bhansali, a chartered accountant, shook the country's financial system in May 1997. He identified weaknesses in the regulatory framework of the country's financial system. By trimming the balance sheets of CRB capital markets, he positioned his company as a unique financial organization with excellent prospects. This created for him an almost unlimited supply of deposits with high interest rates on the one hand, and provided him leverage to rig prices in the market on the other. The investors were lured to part with their money and risk their future.

Price rigging became a recurring ailment of the Indian capital market. This is clearly evident from the fact that, in 1998, the technique of price rigging was successfully applied in case of the BPL,Videocon, and Sterlite scrips, which created a payment crisis. Brokers, who acted in concert with Harshad Mehta, had taken large positions in these scrips. As a consequence, these scrips had to be debarred from the market for a couple of years. J. C. Parekh, the then president, and other key members on the board of the BSE were sacked by the SEBI for price rigging and insider trading in this case. The history of insider trading was repeated in March 2001 when Anand Rathi, the then president of the BSE, was caught red-handed and thereafter sacked by the SEBI alongwith six other broker directors. Ketan Parekh, the new big bull, once again exploited the loopholes and the Anand Rathi bear cartel hammered the market. The hammering rocked the stock market once again.

All the scamsters employed common ploys like price manipulation, price rigging, insider trading, cartels, collusion, and nexus among the bankers, brokers, politicians, and promoters. These ploys were successfully engineered and implemented particularly around public issues or mergers. The regulators were so ineffective that actions were undertaken only after the investors were looted of their hard-earned money. The ignorance of investors and greed for quick money made the scamsters' job all the more easy. Post-scam inquiries are still being carried on.

In this chapter, the first scam in the post-liberalization era, the 1991–92 securities scam, also known as the Harshad Mehta scam and the 2001 scam, *i.e.*, the Ketan Parekh scam are discussed in detail.

The 1991–92 Securities Scam (The Harshad Mehta Scam)

In 1991, major changes in the government policy led to the emergence of a market-oriented private enterprise economy through the removal of controls.

The economic liberalization package compelled banks to improve their profitability. With liberalization, entered the free interest rate regime, which meant that banks had to face interest rate uncertainty. Coupled with this was strict enforcement of the SLR requirements for banks to keep the money supply under control. Hence, public sector banks were forced to undertake more trading in government securities. The increase in interest rates on government securities with a longer period of maturity meant capital loss (depreciation) on the holding of old securities. To partly offset this loss, banks began trading of a new instrument—repos or ready forward. Repo is a means of funding by selling a security held on spot (ready) basis and repurchasing it on a forward basis.

Several banks, including foreign banks, were unwilling to purchase securities for maintaining the SLR because of the risk of depreciation. They preferred ready forward contracts with other banks, which were surplus in securities. These ready forward contracts were turned around every fortnight depending on the banks' deposit figures. Moreover, many banks had purchased public sector bonds which they could not sell due to the coupon rate hike. Many banks then violated the Reserve Bank advice and entered into ready forward deals in PSU bonds.

Repos are legal and versatile instruments but the inter-bank repos in 1991–92 were based on some inside information obtained illegally. This was confirmed by the interim report of the RBI panel on securities, which stated, 'Towards the end of March 1992, the State Bank of India (SBI) had purchased a large quantity of government securities on a ready forward basis one day prior to the date on which the coupon rate of government securities was raised.'

Besides obtaining information illegally, most of the ready forward deals were dubious and facilities like bank receipts (BRs) and SGL forms were misused. Bank receipts which were working smoothly as a mechanism (acknowledgement) for transfer of government securities amongst banks were highly misused. There were fake bank receipts in circulation and there was double counting of BRs, which led to an accelerated growth in money supply. For example, the Bank of Karad, which had an equity base of less than ₹1 crore, issued BRs worth more than ₹1,000 crore. Standard Chartered Bank, a foreign bank, accepted BRs worth ₹200 crore from this bank. These transactions, which were far out of proportion of the banks' own resources, were handled by a handful of brokers. All this was pointed out in the interim report, together with statistics. Of the 57,980 transactions of over ₹9,00,000 crore in securities entered into by banks in 14 months from April 1, 1991, a mere 5.26 per cent was made up of outright purchases. More than two-thirds of these transactions were done by four foreign banks. Over 60 per cent of the transactions were carried out through brokers. Nearly 95 per cent of these transactions—worth ₹8,58,511 crore, constituted commitments to repurchase or resell securities. In more than 40 per cent of these transactions, the commitments were not documented, but were a mere matter of understanding.

Most banks, with a view to increasing their profits, employed their clients' funds in stocks through their brokers. This they did by offering higher returns through portfolio management.

The stock market index the BSE Sensex—rose by leaps and bounds. Harshad Mehta, by injecting the banks' money into share trading, pushed up prices of selected scrips. Besides the banks' funds, he tapped another source of money—mutual funds. The government was encouraging the creation of mutual funds. These mutual funds, in order to increase their popularity, assured higher returns which led to sizable flow of money to the stock market. Moreover, certain industrialists engaged themselves in 'insider trading' to raise the prices of their shares to prevent hostile takeovers. Brokers, with so much money in their hands, were successful in raising the Sensex by 1,500 points in 15 days.

The boom, which began in July 1991, peaked in April 1992, before the bubble burst. Prices of many scrips such as Apollo Tyres, ACC, Castrol India, East India Hotels, GE Shipping, GNFC, Deepak Fertilisers, and Tata Chemicals shot up three times their usual value in just a year's time. National Housing Bank, Bank of Karad, Metropolitan Cooperative Bank, Standard Chartered Bank, Citibank, Bank of America, ANZ Grindlays Bank, Canbank Financial Services, and many other institutions were involved in the boom.

Between March 1991 and March 1992, the BSE sensitive index rose by more than three-and-a-half times—from 1,168 to 4,285. At the peak level, the market capitalization of ₹3 lakh crore was about half of the GDP as compared to hardly one-fifth of the GDP in the previous year. The market price–earning (P/E) ratio at 55 was not only higher than what it was in many other developing and developed countries but was far in excess of the fundamentals. The monetary size of the securities fraud was estimated to be ₹3,542 crore. The Sensex dropped to 3,000 and the BSE was closed for a month when the scam came to light.

The scam highlighted the loopholes in the financial system, unfair trade practices in various instruments, widespread corruption, and wrong policies. The Reserve Bank banned inter-bank repos after the scam and the pace of reforms in the financial sector also increased.

In June 1992, the government had constituted a special court through an ordinance for trial of offences in the case and provided for disbursement of dues to banks and the IT department. The assets were identified, attached and auctioned by a court appointed custodian and disbursements were made.

Banks had an exposure of ₹2000 crore in the Harshad Mehta Security Scam. Standard Chartered Bank and State Bank of India had the maximum exposure among all banks in this scam. The banks have claimed dues of more than ₹4000 crore along with interest. The custodian has so far disbursed ₹2000 crore to various banks (including ₹1000 crore to the SBI group) towards their exposure and losses and ₹6310 crore to the IT department.

The 2001 Scam (Ketan Parekh Scam)

All over the world, investment in ICE (Information Technology, Communication and Entertainment) shares was the trend. Ketan Parekh colluded with promoters of the new economy (ICE) shares and changed the complexion of the market by buying stock known as K-10 scrips. He succeeded in lifting scrips such as HFCL, Satyam, and Global to international P/E levels.

Parekh's modus operandi was to route orders through his three broking outfits and 40 satellite brokers. He had contacts with brokers in Kolkata and Ahmedabad, who were rewarded with *badla* payments. His source of funds was non-resident Indians and the new private sector banks who accepted shares as collateral. He would pledge shares with banks as collaterals when the share prices were high. Mutual funds and foreign institutional investors, by investing heavily in technology stocks, helped KP scrips to rise high. He placed shares of Satyam at a premium of ₹1,000 with UTI and the shares of HFCL for ₹1,400 with mutual funds and foreign institutional investors. Parekh would increase the liquidity of stock when there was a strong demand or buy aggressively if one of the portfolio stocks fell.

The bull run started in May–November 1999 when Parekh started his first major round of trading aggressively in HFCL, Global, Satyam, and Zee scrips. The Sensex rose from 3,378.4 to 4,491 points. The Sensex peaked at 6,100 points before it started falling due to a global meltdown in ICE shares. There was a sharp decline in prices due to factors such as the global economic slowdown, significant market capitalization erosion at NASDAQ and other leading stock exchanges, and bear hammering on the Indian stock exchanges in sectors such as telecommunication, media, and information technology. The sudden, sharp fall in prices of these scrips resulted in a huge depletion in the margins on shares that were placed as securities with the banks. Consequently, the banks were, on the one hand, obliged to ask Parekh and his associates to either pledge more shares as collateral or return some of the borrowed money, and on the other, they were driven to prop the prices by pumping more money into the capital market. This resulted in a financial crunch for some major bull operators, which led to disputes in the Kolkata Stock Exchange (CSE). The crisis snowballed as the Kolkata brokers took more long positions than Parekh. Trading at Kolkata is 90 per cent unofficial. It is a cash *badla* market where ₹1,500–2,000 crore is rolled over every month at 21–30 per cent. As the circumstances developed, *badla* rates shot up to 80 per cent at the Kolkata stock exchange. So, Parekh defaulted on payment to Kolkata brokers which resulted in a payment crisis between March 12–17, 2001.

Seventy CSE brokers defaulted as the exchange plunged into crisis. The bear cartel on the BSE, which was bear hammering the market with inside information, was caught red-handed by the SEBI which suspended all seven broker members from the BSE governing board.

Ketan Parekh desperately borrowed huge sums from the Ahmedabad-based Madhavpura Mercantile Cooperative Bank (MMCB). The bank issued pay orders running into crores of rupees without receiving cash payment or collateral from Parekh. Pay orders are instruments issued between branches of a bank in one place. They are issued after the issuing bank collects the cash or has significant collateral. Hence, the discounting bank is sure of collection. As Parekh colluded with Ramesh Parekh, the chairman of MMCB, the latter issued pay orders without having a sufficient balance in the bank's accounts. The Bank of India (BOI) discounted ₹137 crore worth of pay orders which bounced. Ketan Parekh paid only ₹7 crore and the BOI went to a criminal court against him. The Reserve Bank specifically prohibits cooperative banks to invest in the stock market or to lend to stockbrokers. However, the latter are free to lend to individuals against a pledge of shares upto ₹10 lakh per borrower if the shares are in a physical form and upto ₹20 lakh if they are in a dematerialized form. MMCB flouted the norms of the Reserve Bank to earn higher rates of return.

The Crime Branch of India arrested Ketan Parekh on the charge of defrauding the BOI. The BSE Sensex plummeted from a peak of 6,100 points to 3,788.2 on March 30, 2001. The SEBI banned all deferral products, including *badla,* from all stock exchanges.

Comparison of the Harshad Mehta Scam and the Ketan Parekh Scam

The Ketan Parekh scam appears to resemble the Harshad Mehta scam. Both adopted price rigging practices involving banks and mutual funds. Both took advantage of the loopholes and inadequacies in the financial system.

However, both scams are different and the difference lies in the instruments, securities, and the cause. While it was the old economy stocks, bank receipts, and SGL ledger accounts in the Harshad Mehta case, it was new economy stocks and misuse of pay orders in the Ketan Parekh scam. Harshad Mehta exploited public sector banks while Ketan Parekh misused the new private sector and cooperative bank funds. The Harshad Mehta scam indicated that capital market was free from checks and controls while the Ketan Parekh scam indicated that scams could and would occur inspite of checks and controls. The major cause of the crisis in the Ketan Parekh scam was the financial crunch resulting from bear hammering which caused a sharp fall in prices, while in 1992 crisis, the fall was an effect, not the cause of the crisis.

The Harshad Mehta scam was thought to be a bank scam rather than a securities scam as banks and institutions lost several thousand crores of rupees. It was the Harshad Mehta scam that prompted reform of the equity markets whereas the Ketan Parekh scam occurred when equity markets had radically transformed. Repos were banned by the Reserve Bank after the Harshad Mehta scam whereas in case of the Ketan Parekh scam, *badla* transactions were banned along with other deferral products.

Conclusion

This cycle of scams needs to be broken if an orderly development of the capital market for higher economic growth is to take place. It has been observed that regulators, instead of taking corrective measures, precipitate crisis. They have to be proactive instead of reactive. Regulators should develop a market intelligence system, which will give them early warning signals. The real culprits should be given deterrent punishment and there should be strict enforcement of directives and law. The capital market cannot function without the support of the banking system. If both are to survive, remain healthy and vibrant, both should develop an extra measure of self-discipline in the first instance.

REFORMS IN THE CAPITAL MARKET

The 1991–92 securities scam prompted the government to increase the pace of reforms in the capital market. Several reform measures have been undertaken since then in both the primary and secondary segments of the equity market.

The Primary Capital Market

- The Securities and Exchange Board of India (SEBI) was set up in early 1988 as a non-statutory body under an administrative arrangement. It was given statutory powers in January 1992 through the enactment of the SEBI Act, 1992 for regulating the securities market. The two objectives mandated in the SEBI Act are investor protection and orderly development of the capital market.
- The Capital Issues (Control) Act, 1947 was repealed in May 1992, allowing issuers of securities to raise capital from the market without requiring the consent of any authority either for floating an issue or pricing it. Restrictions on right and bonus issues were also removed. The interest rate on debentures was freed. However, the new issue of capital has now been brought under the SEBI's purview and issuers are required to meet the SEBI guidelines for disclosure and investor protection, which are being strengthened from time to time to protect investor interest.
- The infrastructure of the primary capital market has been fairly diversified over the years with the setting up of a large number of merchant bankers, investment and consulting agencies, and registrars to the issue.
- The primary capital market has widened and deepened with public sector banks, financial institutions, and public sector enterprises in the infrastructure and power sectors increasingly raising resources from the market both by way of debt and equity.
- Although the process of institutionalization of the market on the supply side started in 1987–88 when many mutual funds sponsored by banks and financial institutions were set up, it gained considerable

momentum in the early 1990s when many mutual funds were set up in the private sector. There are now 37 mutual funds operating in the country with a total asset base of over ₹1 lakh crore.

- The requirement to issue shares at a par value of ₹10 and ₹100 was withdrawn. This gave companies the freedom to determine a fixed value per share. This facility is available to companies which have dematerialized their shares. Moreover, the shares cannot be issued in the decimal of a rupee. The companies which have already issued shares at ₹10 or ₹100 per value are also eligible for splitting and consolidating the share values.
- Improved disclosure standards, prudential norms, and simplified issue procedures have been prescribed. Companies are required to disclose all material facts, specific risk factors associated with their projects while launching public issues and give justification for pricing on their prospectus. The offer document is not vetted by the SEBI but a code of advertisement for public issues, for ensuring fair and truthful disclosures has been introduced.
- To reduce the cost of the issue, underwriting by the issuer was made optional, subject to the condition that if an issue was not underwritten and in case it failed to secure 90 per cent of the amount offered to the public, the entire amount so collected would be refunded.
- One of the significant steps towards integrating the Indian capital market with the international capital markets was the permission given to foreign institutional investors such as mutual funds, pension funds, and country funds, to operate in the Indian market. Foreign institutional investors were initially allowed to invest only in equity shares; later, they were allowed to invest in the debt market, including dated government securities and treasury bills. The ceiling for investment by foreign institutional investors was increased from 40 per cent to 49 per cent in 2000–01. This increase can be made with the approval of shareholders through a special resolution in the general body meeting.
- Indian companies have also been allowed to raise capital from the international capital markets through issues of Global Depository Receipts, American Depository Receipts, Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Companies were permitted to invest all ADR/GDR proceeds abroad. Two-way fungibility was announced for ADRs/GDRs in 2000–01 for persons residing outside India. Converted local shares could be reconverted into ADRs/GDRs while being subject to sectoral caps wherever applicable.
  - Various bottlenecks on the floatation of new capital issues, particularly for infrastructure projects, were removed. Requirements such as making a minimum public offer of 25 per cent of the issue, five shareholders per ₹1 lakh of offer, and a minimum subscription of 90 per cent are no longer mandatory for infrastructure companies.
  - With a view to helping infrastructure companies raise funds for their projects, their debt instruments are allowed to be listed on the stock exchanges without prior listing of equity. Corporates with infrastructure projects and municipal corporations are exempted from the requirements of Rule 19(2)(b) of the Securities (Contracts) (Regulation) Act, 1956 to facilitate the public offer and listing of its pure debt instruments as well as debt instruments fully or partly convertible into equity without requirement of prior listing of equity but are subject to conditions such as investment grade rating. The freedom to issue debt security without listing security granted to infrastructure companies and municipal corporations has been extended to all companies. This is subject to certain conditions. Issues below ₹100 crore shall carry an investment grade credit rating, issues above ₹100 crore shall carry an investment grade credit rating from two credit rating agencies; the issues shall comply with the provisions of Rule 19(2)(b) of the Securities Contracts (Regulation) Act, 1956 regarding the size of the public offer and the promoters shall bring in the equity contribution of 20 per cent and lock in the same for three years.
  - In respect of unlisted companies, the existing requirement of a track record of dividend payment in at least three of the preceding five years for asking an initial public offer (IPO) has been relaxed. Under the new norms, the companies will have to demonstrate an ability to pay dividend instead of showing an actual dividend paying record.
- Merchant bankers are prohibited from carrying on fund-based activities other than those related exclusively to the capital market. Multiple categories of merchant bankers have been abolished and there is only one entity, the merchant banker.
- Besides merchant bankers, various other intermediaries such as mutual funds, portfolio managers, registrars to an issue, share transfer agents, underwriters, debenture trustees, bankers to an issue, custodian of securities, venture capital funds and issues have also been brought under the purview of the SEBI.
- Since 1998–99, banks are permitted within the ceiling of 5 per cent of incremental deposits of the previous year prescribed for banks' investment in shares to (a) sanction bridge loans to companies against expected equity flows/issues for periods not exceeding one year and (b) extend loans to

corporates against shares held by them to enable them to meet promoters' contribution to the equity of new companies in anticipation of raising resources. The approval of the bank's board is necessary. The prescription of the minimum margin of 50 per cent of loans to individuals against preference shares and debentures/bonds of corporate bodies is withdrawn. However, the margin of 50 per cent prescribed in respect of equity shares has been retained. Subsequently, the ceiling amount on advances against shares to individuals was increased from ₹10 lakh to ₹20 lakh against dematerialized securities while the minimum margin prescription was reduced from 50 per cent to 25 per cent for dematerialized shares.

- A code of conduct on advertisement has been issued for mutual funds, banning them from making any assurance or claims that might mislead the public.
- The entry norms for IPOs have been tightened by modifying the Disclosure and Investor Protection (DIP) guidelines. According to the new guidelines, IPOs five times the size of the pre-issue net worth are allowed only if the company has had a record of profitability and a net worth of ₹1 crore in three of the past 15 years. Companies without such a track record or a issue size beyond five times the pre-issue net worth are allowed to make IPOs only through the book-building route, with 60 per cent of the issue to be allotted to qualified institutional borrowers (QIBs). For shares issued on a preferential basis to any person by listing companies, a lock-in period of one year has been stipulated. Infrastructure companies are exempt from the requirement of eligibility norms if the project has been appraised by a public financial institution and not less than 5 per cent of the project cost is being financed by any of the institutions jointly or severally, by way of loans and/or subscription to equity.
- The SEBI DIP (Disclosure and Investor Protection) Guidelines, 2000 have been amended. Permission has been granted to foreign venture capital investors (FVCIs) registered with the SEBI and State Industrial Development Corporations (SIDCs) to participate in public issues through the book-building route as qualified institutional buyers (QIBs). There is no lock-in requirements for the pre-issue capital of an unlisted company held by venture capital funds (VCFs) and FVCIs. Exemption from the public offer requirement in view of a reduction in quantum from 25 per cent to 10 per cent and restriction of a minimum public issue size of ₹25 crore in respect of an IPO through the book-building issue have been removed.
- Companies in the IT, telecom, media, and entertainment sectors are allowed to tap the market with a minimum offering of 10 per cent of their equity. All public issues through this route have to satisfy the criterion of a minimum ₹100 crore issue size, follow the book-building route with an allocation of 60 per cent to QIBs, and maintain a minimum floating post-listing stock on a continuous basis.
- The issuer can make a public or rights offer of shares in demat form only. Investors have the option of subscribing to securities in either the physical or the dematerialized form.
- Every public-listed company making an IPO of any security for ₹10 crore or more is required to make an offer only in a dematerialized form.
- The SEBI prescribed new guidelines for regulating private placement of debt securities issued by the corporates. These guidelines aim to enhance transparency and protect the interest of investors in the debt securities.
- The SEBI introduced the green-shoe option facility in IPOs as a stabilization tool for the post listing price of newly issued shares.
- The Central Listing Authority was set-up to ensure uniform and standard practices for listing the securities on stock exchanges.
- In 2001, the SEBI guidelines mandated a minimum level of public holding at 25 per cent for companies carrying out with fresh IPOs. Companies in infotech, media, and telecom sector were allowed to go public with a 10 per cent public stake. In order to ensure availability of floating stocks on a continuous basis and maintain uniformity for the purpose of continuous listing, a minimum public share-holding of 25 per cent was prescribed. This minimum 25 per cent public float would not only lead to an increase in the floating stock, but also to a higher public holding or control of shares with investors other than promoters which would make manipulation of stock prices difficult and boost liquidity in the market. According to a capital market study, there are over 136 companies in 'A' group alone with less than 25 per cent public float. According to the data provided by the National Stock Exchange, the average public holding in listed companies in India is only 13 per cent. Holding of Indian promoters in contrast is on an average as high as 48 per cent. Companies like Wipro whose public holding is just 6.74 per cent, Bharti Airtel (1.17 per cent), TCS (5.19 per cent), and several state-owned companies such as MMTC (0.02 per cent), ONGC (1.82 per cent), SAIL (2.08 per cent), BHEL (2.23 per cent), and NTPC (2.57 per cent) will be impacted by this move. This fall in public float was on account of a substantial rise in open offers arising from hostile takeover bids and mergers and acquisitions in the last few years; SEBI gave a time frame of two years to

maintain this minimum level. Hence, to increase public stakes, promoters can either offload their existing equity shares in the open market through an offer for sale or issue fresh shares. This move failed to yield results as promoters resisted. In 2008, the government has made it mandatory for all listed firms, which do not have a public shareholding of 25 per cent, to increase their shareholding annually by 3–5 per cent.

- In March 2003, the SEBI introduced sweeping changes in IPO norms to boost investor confidence. It changed the eligibility criteria for IPOs—a track record of distributable profits was replaced by net tangible assets as it felt that profit figures could be fudged. According to the new norms, companies floating IPOs should have net tangible assets of ₹3 crore in each of the two preceding two years. Of this, not more than 50 per cent should be held in monetary assets–cash or its equivalent such as securities. It is now mandatory for companies changing their names to ensure that a minimum 50 per cent of the total revenues are derived from the business activity suggested by the new name.
- On March 29, 2005, the SEBI redefined the retail individual investor as one who applies or bids for securities of or for a value not exceeding ₹1 lakh. It hiked allocation for retail investors in a book-built issue from 25 per cent to 35 per cent and reduced allocation to high networth individuals (non-institutional) category. The allocation to high net-worth individuals was reduced to 15 per cent from 25 per cent. The market regulator also reduced the bidding period for a book-built issue. The SEBI reduced the bidding period from the current 5–10 days (including holidays) to 3–7 working days. It has given an option to listed issuers to either disclose price band in a red-herring prospectus/ an application form/an abridged prospectus or to disclose the price band/floor price atleast one day before opening of the bid. In order to improve contents and ensure uniformity in data display on the websites of the stock exchanges, the data will be made available for a further period of 3 days after the closure of the bid/issue. The new norms are applicable to all public issues whose offer documents are filed with the SEBI on or after April 4, 2005.
- For issues priced below ₹500 per share, the face value of the share should mandatorily be ₹10 per share. But if the issue price is ₹500 or more, the minimum face value should not go below ₹1.
- Shares will now be allotted on a proportionate basis within the specified categories, with the predetermined minimum allotment being equal to the minimum application size.
- During 2005–06 SEBI Disclosure and Investor Protection (DIP) Guidelines, 2000 relating to bookbuilding issues were amended to introduce a specific allocation of 5 per cent for mutual funds, proportionate allotment to Qualified Institutional Buyers (QIBs) and margin requirement for QIBs.
- In order to ensure availability of floating stocks on a continuous basis and maintain uniformity for the purpose of continuous listing, a minimum public shareholding of 25 per cent was prescribed by SEBI in case of all listed companies barring a few exceptions.
- To assist the retail investors, SEBI gave in-principle approval for grading of IPOs by the rating agencies at the option of the issuers. SEBI will not certify the assessment made by the rating agencies.
- The disclosure requirements were rationalized during the year. Listed companies which have a satisfactory track record of filing periodic returns with the stock exchanges are exempted from repititive disclosures in case of rights and public issues by them. An issuer company is permitted to make a rights issue by dispatching an abridged letter of offer which shall contain disclosures as required to be given in the case of an abridged prospectus. A listed company can fix and disclose the issue price in case of a rights issue, any time prior to fixing of the record date in consultation with the designated stock exchange and in case of public issue through fixed price rate, at anytime prior to filing of the prospectus with the Registrar of Companies. In order to facilitate additional resource mobilization, a company is permitted to issue further shares after filing a draft offer document with SEBI, provided full disclosures as regards the total capital to be raised from such further issues are made in the draft offer document.
- The facility of electronic clearing services (ECS) was extended to refunds arising out of public issue so as to ensure faster and hassle free refunds.
- Companies are permitted to take multiple routes to raise capital at the same time, even after a prospectus for an IPO or public offer is filed with the regulator. Companies are now only required to update their prospectus with details about the additional capital being raised through other routes. This new relaxation will help corporates to efficiently plan their capital-raising programmes.
- Venture Capital and private equity forms are barred to sell their stake in a company after its IPO. Now, only those firms that have invested more than a year before the company goes public can sell their shares on listing.
- For public/rights issues of debt instruments, credit rating from one credit rating agency would be sufficient now which had to be done from at least two agencies before. This was done to reduce the cost of issuance of debt instruments.

- Issuance of bonds which are below investment grade will be allowed to the public to suit the risk/return appetite of investors. This was previously required to be of, at least, investment grade.
- In order to enable listed companies to raise equity through rights and follow-on issues in a short span of time, SEBI amended the DIP guidelines. The issues by listed companies are known as fast track issues and there are guidelines for the same which are covered in the next chapter.
- SEBI has allowed companies to give discount of upto 10 per cent to retail investors in public offers. This move would enable companies to obtain a more diversified shareholding and a good response from retail shareholders in a period of dull primary market scenario.
- All investors, including retail investors are allowed to invest in Indian Depository Receipts (IDRs). The minimum investment limit has been reduced from ₹2,00,000 to ₹20,000.
- SEBI launched an alternate payment system called Applications Supported by Blocked Amount (ASBA) for public and rights issues in August 2008.
- PAN has been mandatory in all public and rights issues irrespective of the application amount. SEBI exempted investors residing in the state of Sikkim from the mandatory requirement of PAN for the purpose of opening/operating Beneficial Owner (BO) accounts with depository participants and trading in cash market, respectively.
- In order to make regulatory requirements consistent across companies irrespective of post-issue capitalization and to facilitate mid-size issuers who may not be in need of large funds, norms on minimum offer to public were revised.
- Minimum public shareholding requirement in case of public companies was enhanced to at least 25 percent within a period of three years, i.e., by August 22, 2017.

Secondary Capital Market

- The open outcry trading system, prevalent till 1995, was replaced by the on-line screen-based electronic trading. In all, 23 stock exchanges have approximately 8,000 trading terminals spread all over the country.
- Three new stock exchanges at the national level were set up in the 1990s. These were: the Over the Counter Exchange of India (1992), the National Stock Exchange of India (1994), and the Interconnected Stock Exchange of India (1999).
- Trading and settlement cycles were uniformly trimmed from 14 days to 7 days in all stock exchanges in August 1996. Rolling settlement (T+5) was introduced in January 1998 for the dematerialized segment of all companies. With effect from December 31, 2001, all scrips have come under rolling settlement. The settlement cycle for all securities was shortened from T+5 to T+3, with effect from April 1, 2002.
- With a view to maintaining integrity and ensuring safety of the market, various risk containment measures have been initiated or strengthened, such as the mark to market margin system, intra-day trading limit, exposure limit, and setting up of trade/settlement guarantee fund. Stock exchanges are allowed, subject to conditions, to use the settlement guarantee funds (SGFs) for meting shortfalls caused by non-fulfillment/partial fulfillment of the obligations by members, before declaring them defaulters. The NSE set up a separate clearing corporation—The National Securities Clearing Corporation—to act as a counter-party to all trades executed in the capital market segment of the exchange.
- To enhance the level of investor protection, the process of dematerialization of securities through the depository system and their transfer through electronic book entry is pursued vigorously. To enable this, the National Securities Depository Limited was set up in November 1996 and the Central Depository Service Limited in February 1999. All actively traded securities are held, traded, and settled in demat form.
- *Badla*–the carry forward trading mechanism was reinstated in January 1996, with safeguards in line with the recommendations of the Patel Committee (1995) and the Varma Committee (1996). The cash segment was strengthened with measures such as mandatory delivery under negotiated deals, securities lending, and continuous net settlement. All deferral products including *badla* have been discontinued from July 2001 following the scam of March 2001.
- Issuing companies are required to make continuing disclosures under the listing agreement. All listed companies are required to furnish to stock exchanges and also publish unaudited financial results on a quarterly basis. Disclosure of material information, which may have a bearing on the performance/operations of a company, is also required to be made available to the public.
- One of the most significant reforms in the secondary market is the measure to improve corporate governance. Corporate governance is a set of systems and processes designed to protect the interests of stakeholders. It is about commitment to values, ethical business conduct, and a high degree of transparency. It is about creating and enhancing shareholder wealth while protecting the interests

of all other stakeholders. The SEBI had appointed a committee under the chairmanship of Kumar Mangalam Birla on corporate governance in India. The committee framed the codes for corporate governance and suggested the implementation of the code through stock exchanges.

- Stock exchanges have also undergone some major structural reforms. The boards of various stock exchanges have been made broad-based so that they represent different interests and not just the interests of their members. Stock exchanges, brokers, and sub-brokers have been brought under the regulatory purview of the SEBI.
- Companies are allowed to buy back their own shares for capital restructuring, subject to the condition that the buy back does not exceed 25 per cent of the paid-up capital and free reserves of the concerned company. This buy back has been allowed to improve liquidity and enhance wealth of the shareholder.
- The insider trading regulations have been formulated prohibiting insider trading and making it a criminal offence, punishable in accordance with the provisions under the SEBI Act, 1992.
- Regulations are also in place for take over and substantial acquisition of shares to make the take over process more transparent and mindful of the interests of small shareholders. In September 2002, the SEBI amended the Takeover Code by accepting the Bhagwati Committee recommendations on takeovers. As per the new code, if an acquirer gains control of over 15 per cent in a company which already owns 15 per cent in another company, the acquirer has to declare open offers for shareholders of both the companies. Also, any change in management control will result in an open offer, even though the equity stake is below 15 per cent. Shareholders can withdraw shares already tendered in an open offer and sell them in the open market or to another acquirer at a higher price. Acquirers now have to disclose their holdings in companies at various levels of acquisitions such as 5 per cent, 10 per cent, and 14 per cent. Once the holding touches the 15 per cent mark, the acquirer then has to make disclosures at every 2 per cent acquisition, thereby ensuring full transparency in acquisition.
- An index-based market wide 'circuit breaker' system has also been introduced to check a sudden rise in security price, in speculation and over-trading. This system becomes active at three stages of the index movements either way, at 10 per cent,15 per cent and 20 per cent. As an additional measure of safety, individual scrips-wise bands of 20 per cent either way can be imposed for all securities except those available for stock options.
- In February 1999, trading terminals were allowed to be set up abroad for facilitating market participation by non-residents. Internet trading was permitted in February 2000.
- For ensuring greater market transparency, SEBI, in 1999, banned negotiated and cross deals (where both the seller and buyer operate through the same broker). Moreover, all private off-market deals in both shares as well as listed corporate debts were banned. So these deals are routed only through trading screens.
- Since June 2000, trading of futures has begun. Both the NSE and the BSE have created proper facilities for derivatives trading, including conducting of regular training programmes for the same. The Securities Contracts (Regulation) Act, 1956 has been amended for introduction of options trading. Trading of index-based and stock-based options started in June and July 2001 respectively while trading of stock-based futures began in November 2001.
- It is mandatory for listed companies to announce quarterly results. This enables investors to keep a close track of the scrips in their portfolios. The declaration of quarterly results is in line with the practice prevailing in the stock markets in developed countries.
- To check price manipulation, mandatory client code and minimum floating stock for continuous listing were stipulated in November 2001.
- The government amended the Securities Contracts (Regulation) Rules, 1957 to standardise listing requirements at stock exchanges.
- A 99 per cent value at risk (VaR) based margin system for all scrips in rolling settlement was introduced from July 2, 2001.
- The central government has notified the establishment of the Investor Education and Protection Fund (IEPF) with effect from October 1, 2001. The IEPF will be utilised for the promotion of awareness amongst investors and protection of their interests.
- The restriction on short sales announced in March 7, 2001, was withdrawn with effect from July 2, 2001, as all deferral products stand banned after that date.
- It is mandatory for all brokers to disclose all details of block deals. Block deals include trading which accounts for more than 0.5 per cent of the equity shares of that listed company.
- With a view to providing greater liquidity in the secondary securities market, the SEBI allowed corporate brokers with a net worth of atleast ₹3 crore to extend margin trading facility to their clients in the cash segment of stock exchanges.

- A clearing corporation/clearing house, after registration with the SEBI, under the SEBI scheme for Securities Lending and Borrowing, as an approved intermediary may borrow securities for meeting shortfalls in settlement on behalf of the member.
- The SEBI has made it mandatory for every intermediary, to make an application for allotment of unique identification numbers for itself and for its related persons, under the SEBI (Central Data Base of Market Participants) Regulations, 2003. This move aims to promote up-to-date information about all market participants. This will be made mandatory for investors and companies at a later date.
- Stock exchanges were advised to amend Clause 41 of the Listing Agreement to make it mandatory for listed companies to publish the number of investor complaints received, disposed of, unresolved along with quarterly results.
- Clearing and settlement cycle time was further contracted to T+2 with effect from April 1, 2003.
- With a view to strengthening the position, specifying accountability and protecting the interest of investors, the SEBI defined the roles of the chief executive officer and fund manager of mutual funds. It prescribed a uniform cut-off time for calculating and applying NAVs, both for subscriptions and redemptions. It also prescribed the minimum number of investors in a scheme. Further, it specified that no single investor should hold more than 25 per cent of the corpus of any scheme/plan.
- SEBI allowed mutual funds to invest in derivative securities. They were also permitted to invest upto 10 per cent of the net assets as on January 31 of each year in foreign securities with the limit of minimum US $5 million and maximum of US $50 million.
- Interest rate futures contracts were introduced in June 2003 and futures and options contracts on sectoral indices were introduced in August 2003.
- FIIs and NRIs were permitted to invest in all exchange-traded derivative contracts.
- Stock brokers were allowed to trade in commodity derivatives.
- FIIs were allowed to participate in delisting offers, sponsored ADR/GDR programmes and disinvestment by the government in listed companies.
- In order to facilitate execution of large trades without impacting the market, the stock exchanges were permitted to provide a separate trading window for block deals subject to certain conditions. The BSE and the NSE activated this window with effect from November 14, 2005.
- In order to prevent off-market trades prior to the commencement of trading, the International Securities Identification Numbers (ISINs) of IPOs will be activated by the depositories only on the date of commencement of trading on the stock exchanges.
- The Depositories/DPs cannot levy any charges when a BO transfers all securities lying in his/her account to another branch of the same depository participant (DP) or to another DP of the same depository or another depository, provided the BO accounts at the transferee DP and at transferor DP are one and the same
- In order to protect the interest of minority shareholder, the Securities Contracts (Regulation) Act was amended in 2004 to recognize delisting. The draft delisting rules notified by the department of economic affairs on October 30, 2006 state that stock exchanges will have to compulsorily delist a company if
  - it has suffered losses during the preceding three consecutive years and its net worth has turned negative.
  - trading in its securities has remained suspended for more than six months, or if the securities have been ‘infrequently traded’ during the preceding three years.
  - it violates SCR Act or Sebi Act or the Depositories Act or rules and regulations thereunder, that warrant a penalty of ₹1 crore or less than three years punishment.
  - it vanishes or furnishes false addresses or there is an unauthorized change of registered office.
  - the public shareholding in the company shrinks to below the minimum level prescribed in the listing agreement.

These apart, a company can opt for delisting if it has been listed in a recognized exchange for a minimum period of three years or the delisting has been approved by three-fourth of the shareholders in a general body meeting or the promoters commit to buy the outstanding securities of the minority and non-promoter holders.

SEBI amended the listing agreement in December 2007 to improve the transparency with regard to utilization of issue proceeds. Any company making a public offer or rights issue of more than ₹500 crores has to appoint a monitoring agency to monitor the utilization of issue proceeds.

From April 21, 2008, all institutional trades in the cash market are margined on a T+1 basis with margin being collected from the custodian upon confirmation of the trade. Subsequently, with effect from June 16, 2008, the collection of margins moved to an upfront basis.

In April 2008, SEBI allowed all classes of investors to short sell subject to a broad framework. SEBI also set up a full-fledged securities lending and borrowing (SLB) scheme for all participants in the market under the overall framework of 'Securities Lending Scheme, 1997'. Naked short selling is not allowed and FIIs are prohibited from day trading.

Comprehensive risk management for the cash market and margining of institutional trades in the cash market have been specified by SEBI. In September 2008, SEBI introduced trading in rights entitlements.

Brokers can offer to their clients an electronic facility known as Direct Market Access Facility (DMA), which enables their clients to place orders directly into an exchange-traded system.

Mutual fund distributors have been allowed to use stock exchange infrastructure for mutual fund distribution

Elements of Market Design in Indian Securities Market, 1992 and 2003

Features *1*	*1992* *2*	*2003* *3*
Regulator	No specific regulator, but central government oversight.	A specialized regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. The SROs strengthened.
Intermediaries	Some of the intermediaries (stock brokers, authorized clerks and remisiers) regulated by the SROs.	A variety of specialized intermediaries emerged. They are registered and regulated by the SEBI (Also by the SROs). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances.
Access to Market	Granted by central government.	Eligible issuers access the market after complying with the issue requirements.
Pricing of Securities	Determined by central government.	Determined by market, either by the issuer through fixed price or by the investors through book building.
Access to International Market	No access.	Corporates allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two-way fungibility. FIIs allowed to trade in indian market. MFs also allowed to invest overseas.
Corporate Compliance	Very little emphasis.	Emphasis on disclosures, accounting standards and corporate governance.
Mutual Funds	Restricted to public sector.	Open to private sector and emergence of a variety of funds and schemes.
Trading Mechanism	Open outcry, available at the trading rings of the exchanges, opaque, auction/negotiated deals.	Screen-based trading system, orders are matched on price–time priority, transparent, trading platform accessible from all over country.
Aggregation Order Flow	Fragmented market through geographical distance. Order flow unobserved.	Order flow observed. The exchanges have Open Electronic Consolidated Limit Order Book (OECLOB).
Anonymity in Trading	Absent.	Complete.
Settlement System	Bilateral.	Clearing house of the exchange or the clearing corporation is the central counter-party.
Settlement Cycle	14-Day account period settlement, but not adhered to always.	Rolling settlement on a T+2 basis.
Counter-party Risk	Present.	Absent.
Form of Settlement	Physical.	Mostly electronic.
Basis of Settlement	Bilateral netting.	Multilateral netting.
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer.	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management.	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR based margining client-level gross margining, and on-line position monitoring.
Derivatives Trading	Absent.	Exchange-traded futures and options available on two indices and select securities.

Source: Chartered Secretary, April 2004, p. 485.

KEY TERMS

Capital Market
Primary Securities
Secondary Securities
Primary Market
Secondary Market

SUMMARY

1. The capital market is a market for long-term funds— both equity and debt—and funds raised within and outside the country.
2. The primary market refers to the long-term flow of funds from the surplus sector to the government and corporate sector (through primary issues) and to banks and non-bank financial intermediaries (through secondary issues). Primary issues of the corporate sector lead to capital formation (creation of net fixed assets and incremental change in inventories).
3. The secondary market is a market for outstanding securities. Unlike primary issues in the primary market which result in capital formation, the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments.
4. The history of the capital market in India dates back to the eighteenth century when East India Company securities were traded in the country. It has been a long journey for the Indian capital market. Now the capital market is organized, fairly integrated, mature, more global and modernized. The Indian equity market is one of the best in the world in terms of technology.

REVIEW QUESTIONS

1. What is a capital market? How does it aid economic growth? What are the functions of the capital market?
2. Compare and contrast the Harshad Mehta and Ketan Parekh scams.
3. List down the major reforms in the primary and secondary capital market.
4. State the differences between FDI and FII?
5. What is primary market? State the nature of fund raising in primary market?
6. How do primary and secondary markets contribute to economic growth?

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