

Evolution of the Capital Markets and their Regulations in India*

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Ladies and Gentlemen,

I am honoured to be here amongst you to deliver the Rao Bahadur Kale Memorial Lecture 2009. Considering that the lectures have been annually delivered since 1937 and that illustrious personalities have delivered this lecture over the years, it is indeed an honour for me to be invited to deliver this lecture. I am thankful to the Gokhale Institute of Politics and Economics for this invitation.

During the course of my talk, I intend to share with you my understanding of the evolution of the capital markets and the regulation of the capital markets in India and what lies ahead of us. I do not intend to go too far into history. Let us take the year 1947 as the cut-off point.

As you all are aware, at its most basic level, the capital market is required first to enable issuers to get a diverse set of investors to invest in their projects by offering the investors a part ownership of the enterprise. This is called the primary market where the issuer is able to get investments from the investors in return for part ownership represented by the equity stock allotted to them. This in common parlance is called shares. The shares allotted to the investors may yield returns to them over a period of time, depending on the ability of the issuer to make a success of the enterprise he has undertaken. However, investors need not only returns on their investment but liquidity as well. They need to be able to get out of this investment if they spot a better opportunity or if they simply need the money to fulfil some other obligations. This would need a market for the shares issued by the issuers. This is called the secondary market in the capital market parlance. Thus, at the most basic level, the capital market will have a primary market and a secondary market.

In 1947, our primary market was subject to extensive controls under the Defense of India Rules. This might sound improbable that the defense of the country had anything to do with the primary market. The link, however, is fairly straightforward. During the Second World War, while India was still under the British rule, the colonial Government needed to raise money in order to support the war effort. The Government did not want to be crowded out by the private sector and, therefore, under the Defense of India Rules had put restrictions, requiring the issuers to obtain the prior permission of the then Government

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before going to the market. In keeping with the philosophy adopted by the Government, after independence the control of the primary market continued and the Capital Issues Control Act, 1955 was passed by the Parliament. Between 1955 and 1992, issuers in India needed to get the Government's permission with regard to: (i) the timing of the issue; (ii) the size of the issue; and, (iii) the price at which the securities were issued. This led to an environment where the Government would invariably ask the issuers to issue their securities at a discount to the market clearing price, on the safer side. The investors were quick to see this and primary issues invariably were over-subscribed. In the course of time a notion got established that there were sure shot profits if an investor won a lottery of the primary market allotment.

The Government also passed the Securities Contract (Regulation) Act in 1956 which exists even now. Though this Act gave power to the Government to regulate the stock markets, the actual regulation of the stock markets was what could be described as a mere "light touch" regulation. It was left entirely to the stock exchanges to discipline their members and the Government rarely looked into the affairs of the stock exchanges. India had a highly controlled primary market and a substantially free secondary market. In this controlled environment our market grew in a limited manner.

It was in 1992 that the Government of India decided that the regulation of the capital markets needed to be handled by a separate statutory authority, namely, Securities and Exchange Board of India (SEBI). Simultaneously, the Government of India repealed the Controller of Capital Issues Act and the corporates were given freedom in terms of price, size and timing of their issues. Thus, when SEBI was given the responsibility of regulating markets it faced two diametrically opposite situations *vis-à-vis* the primary market and the secondary market.

As SEBI got on with its job of regulation, it appeared to the corporate world that it heralded freedom from detailed rules and control, while in the secondary market the brokers and the stock exchanges felt that it meant more rules and regulations for them to follow. Thus regulation can result in both enhancing freedom and restricting it. Regulation is like setting and enforcing the rules subject to which a game is played. It does not seek to interfere with team selection or the strategy of a team. It seeks to lay down rules and enforce them. If you are used to a regime where some central authority chose your team, you will enjoy the freedom of regulation. However, if you were playing the game without proper rules, you will resent the restriction of regulations.

In the year 1991, the Government of India ushered in reforms in the areas of trade and industrial policies. The Indian economy has since been growing at a much higher rate than in the past and has picked up even greater speed in the last 10 years as compared to 1990s. A rapidly growing economy requires capital markets that are deep, wide and reliable. Some statistics would be useful here in understanding the growth of the market in the last 17 years. Our market capitalization at that time was ₹ 1,23,000 crore. Now the market capitalization is

₹ 61,00,000 crore. In 1992-1993 the total turnover of all the stock exchanges in India was ₹ 92,461 crore. Last year, i.e., calendar year 2009, the turnover of the cash segments of BSE and NSE was ₹ 50,86,098 crore. In 1992 Derivatives Market did not exist. Last year the turnover in the Equity Derivatives Market was ₹ 1,55,65,799 crore. Additionally, in 2009 the exchange-traded currency futures and interest rate futures clocked turnover of ₹ 21,53,859 crore and ₹ 2,686 crore respectively. There were nine Mutual Funds in 1992, while total assets under management were ₹ 47,004 crore at the end of 1993. Today there are 46 Mutual Funds with assets under management of ₹ 6,65,146 crore. The Foreign Institutional Investors (FIIs) were allowed in late 1992 to invest in the Indian market. In the last 17 years more than 1,700 FIIs have registered with SEBI to invest in the Indian market and the market value of their total investment exceeds ₹ 8 lakh crore.

In 1992 our settlement systems were outdated and extremely inefficient. It used to take anywhere between 35 and 45 days to settle the trades at a stock exchange. Defaults by brokers were chronic and would result in losses to the clients time and again. Today the settlement of trades is done within two working days of the trade and the stock exchanges have built up trade guarantee funds as well as investor compensation mechanisms to ensure that investors are compensated if brokers default.

The improvement in efficiency in trading and settlement, wide range of products available today and depth of the market are a testimony to what our governance systems, entrepreneurial skills and trading instincts are capable of delivering. We often find that we are good at conceptualizing problems and prescribing solutions, but just in implementing and executing them. The last seventeen years in the capital markets have witnessed an excellent combination of conceptualization and execution. The automation of exchange trading, creation of depositories, clearing corporations with trade guarantee and introduction of derivatives have earned respect of the rest of the world for India.

The concepts were implemented so smoothly that we at times underestimate their importance. Few of us know or remember that NSE was successful not merely because automated trading was a great concept but also because we had the courage to experiment with V-SAT technology which had not been tried anywhere else in the world for exchange trading. Similarly, little do we realize that dematerialization was successful because it was implemented in an unconventional manner – which had not been done elsewhere in the world.

The number of products that are available in the equity market have undergone a significant change. There was a time when all one could trade in the stock exchange was the shares of companies. Now derivative contracts like futures and options, index futures and index options, currency futures and interest rate futures are traded in the Indian market. The secondary market in corporate bonds and Government securities is not as vibrant as the equity market. This has been a matter of concern for the Government and the regulator alike.

Efforts are on the way to see if these markets can be developed. As a first step, the settlement of corporate bonds is being attempted through clearing corporations.

While we have displayed a good measure of execution capability in the area of capital market infrastructure, we have to be conscious of not letting this lull us into complacency. We still have some distance to go. Technology changes are very rapidly presenting opportunities to improve all the time. We can ignore them only at our own peril.

When brokers trade in an exchange they deal with each other. No broker can individually know whether his counterpart broker will be in a position to settle the trade. The exchange can create this confidence in the system if they have a proper margining mechanism and have guarantee funds that act as a back stop. In 1992, we had no guarantee funds with any exchange. When SEBI mooted this idea, people thought that this cannot be implemented in India because we are a poor country and such western concepts are not practical here. SEBI persisted that we can start in small way and that we need to have a clear growth path. Today, the settlement guarantee funds in the cash markets are of the order of ₹10,000 crore and the derivatives market of ₹ 31,000 crore.

The scale of growth and gains in efficiency in a span of 17 years are unprecedented. All this would not have been possible without SEBI taking proactive role not merely in regulating markets, but in the development of the markets as well. Given the fact that we have seen dramatic improvement in the last 17 years in terms of the growth of the market, the question that arises is where do we go from here and what are the challenges that are thrown up for regulation of the capital markets in India?

I think a major challenge any regulator faces is to make sure that the focus remains on the investors. The intermediaries should be seen as only a means to an end. The agenda of the regulator ought to have investors' interest as the prime mover and the interest of the institutions or the intermediaries must only be secondary. While this principle is easy to state, perhaps easy to understand as well, it is not easy to practice. By the very nature of their economic power, the intermediaries have a greater ability to influence policies and make seemingly persuasive arguments. In the very early stages, when SEBI insisted that brokers must show brokerage and price of shares separately on the contract note, the brokers told us that SEBI will unnecessarily confuse investors! The investors after all need to know only the net amount payable. The brokers even went to the extent of arguing that just as the *Kirana* shopowner doesn't reveal his profit margin while selling goods, so it was unfair to ask brokers to reveal their brokerage! It is important for the regulator to realize that there is a natural tendency for intermediary bias to creep into their organizations and this bias needs to be corrected from time to time.

Let me give you another example. You may be aware that when you apply for allotment of shares in a public issue, you are asked to pay up but there is no assurance of allotment. This gives rise to a large number of refunds to those who

receive partial or no allotment. Using modern technology, it is possible to block money in an investor's account and take only what is needed to allot shares. When we broached this subject, we were given all possible arguments as to why this cannot be done. It was even said that the idea was impractical. The real issue, of course, was that investor's money would be in the bank for 30 – 35 days and the banks enjoyed the float. It is necessary to see through such arguments. Even in the developed world, issues of regulatory capture are being debated.

One of the early methods adopted by SEBI to keep its focus on investors' interest was to introduce more transparency in its processes. All major policy decisions of SEBI are referred to its Advisory Committees and are invariably put out for public discussion in the form of a consultative paper. On receipt of the public comments, the matter is taken up to the SEBI Board for their approval. Last year SEBI took one more step in the direction of transparency by making the agenda notes submitted to the Board available to the public. On its Advisory Committees, SEBI has representatives of investors so that the Advisory Committees are not dominated by intermediaries' alone. This is not to say that one should always discount the intermediaries' viewpoint. It is necessary to arrive at a proper balance and that will remain a challenge for all times to come.

A second challenge that regulators, especially in the developing jurisdictions, would face is the extent to which they intervene in the development of the market. Again, there are no readymade answers here and it is really a question of judgment. SEBI intervened directly in promoting automation of stock exchanges, dematerialization and derivatives trading. These were useful interventions. In a globalized world, regulators in emerging markets face the question of competition between domestic entities which may not be exposed to the sophistication that the overseas entities may have in terms of different financial products and practices in more advanced countries. In such a situation, the introduction of new practices has to be carefully calibrated in order to ensure a smooth transition from the state of relative under-development to sophistication.

Apart from the development of the markets, SEBI is entrusted with the job of regulation. Regulation involves setting the rules of the game and meeting out punishment when these rules are not followed. New institutions take time to develop the investigation skills to be able to bring the culprits to book. SEBI has been on this journey since 1992 and some of the important developments in this journey are noteworthy. With the advent of technology and increasing sophistication of investigation, SEBI is now able to detect cases of violation with its own surveillance efforts and does not have to depend on a complaint from outside. The punishment meted out by SEBI needs to stand the test of law and an appellate mechanism in the form of Securities Appellate Tribunal has been created for this purpose. Increasingly SEBI's orders are being upheld in this Tribunal and SEBI's confidence in being able to investigate cases appropriately and meeting out punishment in an unbiased manner is increasing. Any violation

of law or rules is required to be discouraged in order to get a majority of the people to follow the law.

Our judicial process of appeals and the follow-up tends to be time consuming. In the capital markets the entities very often commit violations in order to gain some undue profits. If these profits are taken away and a suitable penalty imposed, it is possible to discourage entities from indulging in violations of rules. SEBI has, therefore, set up a consent mechanism in which an entity can enter into an agreement with SEBI to pay a certain amount of money and sometimes to undergo voluntary restraint from trading. This procedure is vetted by a Committee headed by a retired High Court Judge. In a consent proceeding, the litigations arising out of appeals are avoided and one is able to dispose off the cases expeditiously without losing sight of the original goal. This mechanism is being used extensively in the last couple of years and has stood the test of law. Some of the cases that were pending before different Courts, the Securities Appellate Tribunal as well as the Supreme Court have been settled and closed in this manner.

When the violation of rules is committed by the financial intermediaries, there are three things that need to be done in order to ensure that the ends of justice are fully met. First and foremost, such entities should not be allowed to retain the profits made by them. Merely taking away the profits is not enough. It is necessary that punishments are given to the intermediaries for violating the rules. In other words, a penalty should be more than a mere recovery of illegal gains. In addition wherever possible, the innocent victims of such violations of law by the entities should be identified and paid compensation for the losses suffered by them. This is a difficult area. It is not always possible to pinpoint the victims of the violation of law by the entities. However, it is necessary to continue to make an effort to see if it is possible to take this step. SEBI is at present engaged in a proceeding in which an attempt is being made to identify innocent victims and reallocate to them some monies from the money recovered from the perpetrators of the fraud. Success in this area will encourage us to make our regulatory apparatus even more robust.

A modern capital market and the variety of products it offers is a fairly complex subject. I have tried to keep it simple by focusing on issues rather than getting lost in complexity. Ladies and gentlemen, India is standing today at the threshold of a great decade in terms of a historic growth opportunity. But growth is not ordained by history. It is for one of us to contribute our mite for realizing this potential. SEBI is committed to play its role in the process. As young economists, you have a great opportunity to set this unfold. I wish you success in your lives.