Report of the Advisory Group on Securities Market Regulation

Chapter I
Background to the Report
Chapter II
Securities Market Regulation in India - An Overview
1. Introduction
2. Equity market
    - 2.1 Nature of market prior to reforms
    - 2.2 Equity market reforms since 1992
    - 2.3 Results
3. Debt market
    - 3.1 Nature of market prior to reforms
    - 3.2 Reforms since early 1990s
    - 3.3 Results

Chapter III
Adherence to Best Practices: Status and Future Agenda
1. Introduction
2. Regulatory Issues
    - 2.1 The regulator
    - 2.2 Enforcement of securities regulation
    - 2.3 Cooperation in regulation
    - 2.4 Self-regulation
    - 2.5 Prudential issues
3. Legal Issues
    - 3.1 Institution-specific regulations
    - 3.2 Multiplicity of Acts
4. Market issues
    - 4.1 Market infrastructure
    - 4.2 Primary issues and transparency
5. Mutual Funds

Annexure I

Annexure II

Chapter I [*]
Background to the Report

The Southeast Asian crisis underlined the need for the availability of strong institutions in addition to sound macroeconomic policies. Recognizing this, the international standards-setting bodies have moved in a significant way in making available the respective standards and codes for financial markets and identifying principles for sound and stable policies. While the International Monetary Fund has prescribed the standards and codes for monetary and financial policies and fiscal transparency and the Bank for International Settlements has prescribed the Basle Core Principles for strengthening bank supervision, the IOSCO has outlined the standards and codes for securities markets.

Following these measures by the international bodies, the Reserve Bank of India, in consultation with the Government of India, constituted a Standing Committee on International Financial Standards and Codes in December 1999. The mandate of the Standing Committee includes the identification and monitoring of the developments in global financial standards and codes, assessment of their applicability to the Indian financial system and outlining a road map for aligning India's practices with international best practices. In view of the enormity of the task as well as its varied nature, the Standing Committee considered it useful to constitute ten Advisory Groups in different specialized areas. The Advisory Group on Securities Market Regulation, under the chairmanship of Shri Deepak Parekh was one such group. The SEBI and the RBI, being regulatory bodies, were made permanent special invitees. The RBI provided the secretariat and infrastructure support. The list of members of the Group is given in Annexure I.

The Group would like to place on record its sincere thanks for all the guidance received from Shri. S. S. Tarapore and Prof. Ajay Shah and also to Dr. R. Kannan, Convenor and Shri. A. K. Mitra, co-convenor, Dr. Urjit Patel, Shri. Nirmal Mohanty and Smt. Usha Thorat for their contributions in finalizing the draft. The Group very much enjoyed working together with this team.

The terms of reference of the Advisory Group are as follows:

- To study the present status of applicability and relevance and compliance in India of the relevant standards and codes,
- To review the feasibility of compliance and the time frame within which this can be achieved, given the prevailing legal and institutional practices in India,
- To compare the levels of adherence in India *vis-à-vis* in industrialized countries and also emerging economies, particularly to understand India's

[*] The Report is subject to comments from SEBI.

position and promote actions on some of the more important codes and standards, and,

- To chalk out a course of action to achieve the best practices.

After a few deliberations, the Group decided to limit the agenda to a review of the securities market regulations in India and to identify the important lacunae and issues in the light of IOSCO objectives and principles, which could provide a basis for charting out future reforms. While Section-II provides an overview of the securities market regulation with emphasis on reform measures introduced in the past decade, Section-III outlines the extent to which the Indian securities market adheres to the IOSCO principles and also sets out an agenda for getting the Indian market more in line with IOSCO standards.

Chapter II

Securities Market Regulation in India - An Overview

1. Introduction

A stable and efficient financial system provides the foundation for implementation of effective stabilization policies, more accurate pricing of risk and more efficient use of capital. Efficiency of the financial system is governed by the role of markets in mobilizing and allocating financial resources, in providing liquidity and payment services and in gathering information on which to base investment decisions. Stability, on the other hand, is concerned with safeguarding the value of liabilities of financial intermediaries that serve as stores of wealth. This also involves questions relating to prudential supervision, financial regulation and good governance. It needs to be added here that as financial systems get increasingly globalized, capital moves not only in response to competing monetary policies, but also to competing financial systems. Inefficient and unstable financial systems are therefore likely to be increasingly penalized.

In India, as in other parts of the world, securities regulations have evolved in the face of two apparently diverging trends. One relates to a move toward liberalization of financial markets, which entails elimination of measures of financial repression such as direct controls on interest rates, mandatory investment in government securities, administrative pricing of securities and so on. The other force is toward stronger regulation. The need for stronger regulation comes to the fore since financial markets are characterized by significant asymmetries of information, which contribute to moral hazard and in extreme cases leads to market failure. In sum, an unregulated market can entail high systemic risk. This section briefly discusses the problems faced by the market prior to reforms and outlines the major reform initiatives of the 1990s with what results.

2. Equity market

2.1 Nature of market prior to reforms

As compared to other developing countries, the Indian stock markets have a fairly long history.[1] However, the volume of transactions in these markets remained limited until the late 1970s, but grew rapidly during the 1980s as the corporate sector turned increasingly to the equity market. Although the volume of transactions increased, the market remained primitive, insulated from foreign investment and continued to suffer from several problems. Most importantly, to access capital markets, companies needed to have prior permission from the government, which had to approve the price at which new equity could be raised. The aim was ostensibly to control flow of funds to the private corporate sector in view of the requirements of public finance and also to provide a "fair value" to investors. However, the practice effectively penalized firms raising capital from the market: the Initial Public Offerings (IPOs) of equity were typically under-priced in relation to the price upon listing, and the new issues by listed companies were at a substantial discount to the prevailing price. While the new issue market was overly regulated, there were inadequate regulations of secondary market activities. The domestic

[1] The Bombay Stock Exchange is over a hundred years old.

capital market had no global link. Information and transparency were limited, reflecting the individual, dealer-based trading system. All these contributed to high transaction costs.

In addition, public sector financial institutions such as the Unit Trust of India (UTI), the insurance companies and the Development Finance Institutions (DFIs) were dominant players in the stock market. This had two significant effects. First, the government had major influence on the domestic financial markets. [2] Second, it allowed promoters of public companies to run their companies with relatively small holdings of their own, because public sector financial institutions generally supported the status quo ownership and management position, unless something drastic happened.

2.2 Equity market reforms since 1992

As part of a broad set of reforms, the Securities and Exchange Board of India (SEBI) was given the legal powers in 1992 to regulate and reform the capital market, including new issues. The equity market reforms since then can be divided into two broad categories: one that increases the level of competition in the market and the other that deals with problems of information and transaction cost. The most important initiative to enhance competition was the free pricing of IPO and formulation of guidelines concerning new issues. The new regulatory framework sought to strengthen investor protection by ensuring disclosure and transparency rather than through direct control. Secondly, the National Stock Exchange (NSE) was set up, which competed with the Bombay Stock Exchange (BSE). The NSE introduced an automated screen-based trading system, known as the National Exchange for Automated Trading (NEAT) system, which allowed members from across the country to trade simultaneously with enormous ease and efficiency. Faced with stiff competition, the BSE adopted similar technology. Competition was also enhanced through an increased number of participants—foreign institutional investors (FIIs) were permitted to trade and private sector mutual funds came on the scene. To deal with market imperfection such as information asymmetry and high transaction costs, a number of measures were taken. At the trading level, transparency was facilitated by the new technology (NEAT system), which operated on a strict price/time priority. [3] At the investor level, transparency was augmented by the regulation that required listed companies to increase the frequency of their account announcements. To ensure transferability of securities with speed, accuracy and security, the Depositories Act was passed in 1996, which provided for the establishment of securities depositories and allowed securities to be dematerialized. Following the legislation, National Securities Depository Limited—India's first depository--was launched. Other measures to reduce transaction costs included: a) a movement toward electronic trading and settlement, and b) streamlining of procedures with respect to clearance of new issues.

2.3 Results

Following these measures, the Indian equity market has modernized rapidly and its ability to serve investors has increased considerably. Competition among stock

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[2] During the 1990s, this meant that public sector mutual funds and other financial entities supported the government's divestment program.

[3] A member places an order on the computer stating the quantities of securities and the price at which he wants to transact and the order is executed when it finds a matching sale or buy order from a counter-party. It is possible for market participants to see the full market, which has made the market more transparent.

exchanges has intensified. With all stock exchanges introducing screen-based trading, trading has become more transparent.[4] With the option of settling through depository now available to investors in case of most of the liquid stocks, it is possible to eliminate risks of bad delivery and counterfeit shares. The two depositories that are in operation now ensure faster, cleaner and cheaper settlement. Dematerialized settlement now accounts for about 90 percent of settlement settled by delivery. Disclosure standards by companies and financial intermediaries are higher. Following the introduction of prudential regulations, stock exchanges have become safer and more dependable. One area where there has been only limited progress is in reducing the dominance of public sector financial institutions.

3. Debt Market

The Indian debt market can be classified into three segments: (i) the government securities market; (ii) the public sector units (PSU) bond market; and (iii) the corporate bond market. Each segment has its own distinctive practices, procedures, institutional framework and regulatory structure. The focus of debt market reforms has been on government securities market, because not only does it dominate the debt market, [5] but also plays an important role in establishing benchmarks for the rest of the market.

3.1 Nature of market prior to reforms

Until the early 1990s, the debt market received very little attention. The government securities market, which constituted the bulk of the debt market, remained dormant. The reason for this was simple. Since the government could borrow at pre-announced coupon rates at below market rates from a set of captive institutions, there was no need for the government to directly place its securities on the market. The captive institutions largely held on to government paper until maturity; whatever little trading existed, was aimed at adjusting the maturity structure of the portfolio, rather than at profit making. As a result, the market did not develop.

3.2 Reforms since early 1990s

Debt market reforms began with the establishment of a primary market for government securities. It was followed by the strengthening of the legal, regulatory and payments infrastructure which contributed to the development of a secondary market. Some of the important reform initiatives undertaken since the early 1990s are given below.

- There have been **progressive restrictions on on-demand government borrowing** from the RBI. The earlier system of issuing ad hoc treasury bills has been replaced by a system of ways and means advances, which are being made increasingly restrictive.
- **Auction for treasury bills** of varying maturity—14-day, 91-day, 182-day and 364-day—have been introduced. To encourage aggressive bidding, uniform price auctions have been introduced for 91-day treasury bills. Also, to foster competition, non-competitive bids are now kept outside the notified amount.

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[4] Earlier, brokers routinely inflated (deflated) the prices at which they bought (sold) shares for their clients, thus earning a hidden margin.

[5] Government debt constitutes about three-fourth of the total outstanding debt.

- To widen the investor base, **foreign institutional investors have been allowed to invest in government securities** including treasury bills in both primary and secondary markets.
- The RBI has introduced a **Delivery versus Payments (DVP) system**, which ensures settlement by synchronizing transfer of securities with cash payments, thereby accelerating settlement, enhancing transparency and eliminating settlement risk. (Earlier, settlements in securities transactions between any two parties were recorded without any direct link with cash settlement between buyers and sellers, which entailed delays in settlement and counterparty risk.)
- A **primary dealer system** has been developed to channel securities from primary auctions to ultimate investors. Primary dealers facilitate debt trading through committed participation in primary market auctions and by creating an active secondary market in securities by giving two-way quotes.
- The RBI is actively **promoting retailing of government securities** by providing liquidity support to satellite dealers and dedicated gilt funds to help them sustain their retail activities. Gilt funds also benefit from special tax incentives.
- An **active interbank repo market** has been developed, which has helped to boost liquidity in government securities. To provide depth to the interbank repo market, a number of measures have been taken, including permission for all government securities to be eligible for interbank repos.

3.3 Results

These initiatives have resulted in a significant transformation of the debt market. The size of the market has grown rapidly in the past four years. Activity in the secondary debt market has also accelerated during recent years as reflected by the turnover of traded securities rising from 3.3 percent of GDP in 1996/97 to 6.7 percent in 1998/99. The market has not only grown in size, but has become more efficient too. Prices for government securities are increasingly market-determined. The government, like any other issuer, has to come to the market to raise its resources. The ability of the market to signal changes in interest rate structure has been augmented through regular auction of treasury bills of different maturity. The market has been broadened through primary dealers and the FIIs. Introduction of DVP has enhanced transparency. The move toward price discovery through a price-based auction system has contributed to the development of bidding skills among market participants. Although reforms have clearly achieved some success in the development of a modern, well-functioning market, the overall progress toward modernization has been smoother and more substantial in the case of the primary market in government securities than in the secondary market.

Chapter III

Adherence to best practices:

Status and Future Agenda

1. Introduction

The IOSCO has set out three objectives--protection of investors, ensuring fair, transparent and efficient market and reduction of systemic risk--which securities regulations need to address.[6] Further, to enhance the ability of the regulatory system to attain these objectives, the IOSCO has also laid down a set of guiding principles. (see Annexure II). As we have discussed in the last section, the reform initiatives taken in the past decade have addressed these objectives in varying degrees, which have resulted in the emergence of a more modern and competitive securities market. In this section, we attempt to evaluate the existing regulatory framework broadly using the IOSCO principles as criteria and to identify problem areas, which call for future reform initiatives to strengthen the current system. This chapter is divided into five sections. The second section deals with regulatory issues: the regulators' mandate, their autonomy, powers and capacity to enforce regulation and their coordination to make regulations effective. Self-regulation as well as prudential issues are also discussed under this section. The third section outlines the legal issues concerning the securities market. The fourth section deals with crosscutting themes relating to the regulated market, namely, market infrastructure, and issues relating to primary market and transparency. The challenges facing the mutual fund industry are discussed in the fifth section. The discussion in this chapter provides some examples of current practices, recognizing that these practices will and should change as the markets change and as technology and improved coordination among regulators make other strategies available.

2. Regulatory Issues

2.1 The Regulator

The regulatory responsibility of the securities market is vested in the SEBI, the RBI, and two government departments--Department of Company Affairs and Department of Economic Affairs. Investigative agencies such as Economic Offences Wing of the government and consumer grievance redressal forums also play a role. The SEBI, established under the SEBI Act, is the apex regulatory body for the securities market. Besides regulation, the SEBI's mandate includes responsibilities for ensuring investor protection and promoting orderly growth of the securities market. The RBI, on the other hand, is responsible for regulation of a certain well-defined segment of the securities market. As the manager of public debt, the RBI is responsible for primary issues of Government Securities. The RBI's mandate also includes the regulation of all contracts in government securities, gold related securities, money market securities and in securities derived from these securities. To foster consistency of the regulatory processes, the SEBI is mandated to regulate the trading of these securities on recognized stock exchanges in line with the guidelines issued by RBI. Although there is a clear division of regulatory responsibilities between RBI and SEBI, and efforts have been made to make

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[6] International Organization of Securities Commissions, 1998, *Objectives and Principles of Securities Regulation,* September.

the regulatory process consistent, the distribution of regulatory responsibilities among a number of institutions can potentially create confusion among the regulated as to which body is responsible for a particular area of regulation.

To ensure operational independence and accountability in the exercise of functions and powers by the regulators, SEBI and RBI have been constituted as autonomous bodies and are established under separate acts of the Parliament. Both regulators are accountable to the Parliament through Central Government and the regulations framed by them are required to be laid before Parliament by the Central Government.[7] There is also a system of independent judicial review of the decisions of SEBI and RBI. Although the SEBI and the RBI are operationally independent, the government can issue directions to both in policy matters.

2.2 Enforcement of Securities Regulation

The SEBI has powers to carry out routine inspections of market intermediaries to ensure compliance with prescribed standards. It also has investigation powers similar to that of a civil court in terms of summoning persons and obtaining information relevant to its enquiry. Action is taken on the basis of investigation. The enforcement powers of SEBI include issuance of directions, imposition of monetary penalties, cancellation of registration and even prosecution of market intermediaries. To ensure effective and credible use of enforcement powers, the SEBI has adopted measures such as development of a stock watch system, uniform price bands and establishment of a Market Surveillance Division. [8]

While SEBI has powers of direct surveillance of the stock exchanges, members of stock exchanges and other market intermediaries registered with it, SEBI has no powers over listed companies. Further, the present penalty levels in many cases are not high enough to effectively deter market players from regulatory violations. In particular, the amount of monetary penalty for non-compliance with respect to disclosure, information requirements, insider trading and market manipulation is very inadequate. To cite an example, a maximum monetary penalty of only Rs.1, 000/- can be imposed in case of failure to comply with the provisions of listing agreement. Similarly, under the SEBI Act the penalty for insider trading and non-disclosure of acquisition of shares and takeovers is only Rs.5 lakh. The Group believes that there is a need to allow SEBI enhanced authority * and powers to impose penalty commensurate with the gravity of the violation (i.e., disgorgement powers). [9]

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[7] For example, the regulations framed by the SEBI under the SEBI Act are required to be laid before each house of the Parliament, and consequently published in the Gazette of India, thereby facilitating a clear and consistent regulatory process.

[8] This division oversees the surveillance activities of the stock exchanges.

* *Under implementation: The Finance Minister has announced on March 13, 2001 in the Parliament that the Government intends to propose legislative changes to "further strengthen the provisions in the SEBI Act, 1992 to ensure investor protection".*

[9] To give an example of powers of disgorgement, the US Securities Exchange Commission can penalize the guilty by up to three times its profit made or loss avoided through a regulatory violation. Incidentally, the RBI has disgorgement powers.

An additional problem relates to delays in taking action against those who commit frauds. A number of companies, which had collected funds in the past through public issues, cannot even be traced. To take action against such companies and bring their Directors to book, a number of initiatives have been taken including the establishment of Central Coordination and Monitoring Committee (CCMC), with Secretary, DCA and Chairman, SEBI as its co-chairmen. However, only limited success has been achieved. Clearly, the enforcement procedures are cumbersome, time-consuming and involve too many agencies. There is a need to streamline the procedures to quickly detect frauds and take appropriate remedial measures.

In addition to the problem stated above, the slow response in case of frauds results from long delays arising from the obligation to follow due process. As a regulatory body has to be accountable for its action, by implication, it gives the alleged institution an opportunity to show cause why action should not be taken. There is a need to streamline the procedures relating to due process. Also, dealing with cases of suspected fraud often requires freezing the situation, while the legal process is being pursued. This happens in India, but the decision to freeze the situation often takes time.

2.3 Cooperation in Regulation

Various segments of the domestic financial market are getting increasingly integrated. There have also been progressive linkages between the domestic and international capital markets. As a result, the regulatory interventions or their absence in one market tend to have repercussions in other markets that are more serious and more widespread than in the past. Further, with the emergence of more and more financial supermarkets and

growing complexity of financial transactions, there are increasing instances of the same market intermediary coming under the purview of multiple regulatory bodies. These factors have raised the potential for regulatory gaps as well as overlaps, thereby underlining the need for greater cooperation among various regulators.

Currently, coordination among domestic regulators is occurring through the High Level Group on Capital Markets (HLGCM) comprising the RBI, SEBI, the IRDA and Finance Ministry. The HLGCM has set up two Standing Committees: one for regulatory coordination and the other for coordination in matters relating to the development of debt markets. The Committee meets periodically to exchange information and views. Besides, to address specific issues such as DvP system or asset securitization, the RBI and SEBI have been coordinating through the institution of working groups. The Group observes that there is scope to further strengthen the coordination efforts. There may be merit in formalizing the HLGCM by giving it a legal status. Besides, the HLGCM needs to meet more frequently and its functioning needs to be made more transparent. Also, a system needs to be devised to allow designated functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis.

As regards coordination with regulators in other countries, the RBI has put in place a system of exchange of need-based information in respect of international operations. However, the powers of SEBI to assist foreign regulators or to enter into MOUs or other cooperation arrangements are not explicitly provided by legislation, although SEBI has signed a MoU with the Securities Exchange Commission of the USA. Hence, the Group

is of view that necessary legislative changes need to be made to enhance SEBI's scope in this regard.

2.4 Self-Regulation

The SEBI Act provides for promotion and regulation of SROs (i.e., stock exchanges). The stock exchanges are empowered to make rules and regulations for their members and for regulating the conduct of respective members. However, self-regulation is not always effective, because the current ownership and governance structures of many stock exchanges allow scope for conflict of interest. [10] These exchanges are owned and managed by members who enjoy exclusive trading rights. In the broker-owned exchanges, brokers elect their representatives to regulate activities of the exchange, including those of the brokers themselves. This raises fairness issues, because the members of stock exchange governing boards have access to valuable information about market participants. Elimination of such conflict of interest through demutualization, which implies separation of ownership of exchange from the right to trade on it, can promote fairness and reinforce investor protection.[*]

Further, the slow evolution of the Association of Mutual Funds of India (AMFI) as a SRO has meant continuation of substantial regulatory burden on SEBI. In this regard, the Group suggests that SEBI assist the AMFI to develop into a full-fledged SRO. Similarly, in money and government securities markets, Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) are operating as industry level associations, who are gradually taking on the role of SROs. There is as yet no regulatory oversight of the RBI over these emerging SROs. However, to facilitate these associations to emerge as full-fledged SROs, the RBI is engaging them in a consultative process, which needs to be further intensified. On their part, to promote integrity of the markets, FIMMDA and PDAI need to establish a comprehensive code of conduct and best practices in securities transactions and also have a mechanism to enforce such codes. The RBI can play a supportive role here.

2.5 Prudential issues

With a view to contain risk, secure market integrity and protect the interest of investors, the regulators have prescribed elaborate margining and capital adequacy standards. In addition, intra-day trading limit and exposure limits have been prescribed. Brokers are subject to various types of margins, viz., daily margins, marked-to-market margin, ad hoc margin and volatility margin. In case of excessive volatility or perceived higher risk, exchanges have been given the flexibility of imposing higher margins. [11] However, one lacuna that continues relates to the absence of margin requirement for institutional trades. The Group recommends that this lacuna be addressed.

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[10] Most of the exchanges are incorporated as "Association of Persons", possibly because of the tax benefits and ease of compliance that such a form entails.

[*] *Under implementation: On March 13, 2001 the Finance Minister announced in the Parliament that administrative steps would be taken, and legislative changes would be proposed, if required, in order to corporatize stock exchanges by which ownership, management and trading membership would be segregated from each other. The process is currently under way.*

[11] In case of primary and satellite dealers in government securities, the RBI has prescribed detailed prudential guidelines.

3. Legal Issues

3.1 Institution-specific regulations

The legal framework constrains the RBI from exercising uniform powers vis-a-vis different groups of players, even though the activity regulated is the same because of a peculiar legal arrangement. The amended Securities Contract Regulation Act (SCRA) has conferred on the RBI the responsibility of regulation of Government securities and money markets, but not the necessary enforcement powers to regulate these markets. To regulate these markets, the RBI therefore resorts to its regulatory authority over the major participants in these markets such as banks, financial institutions and primary dealers through separate institution-specific legislation. With respect to banks, the RBI has statutory powers of inspection, investigation, surveillance and enforcement under Banking Regulation Act, 1949. As regards financial institutions, the regulatory powers are available to the RBI under the RBI Act 1934. The RBI's regulatory powers over FIs are not as comprehensive as over banks. With regard to Primary Dealers, the RBI exercises regulatory powers on the basis of guidelines issued by RBI and MOUs signed between PDs and RBI on a contractual basis. This underlines the need for (a) the same legislation to include both regulatory responsibilities and the authority to carry them out and (b) the focus to shift from institution-specific regulation to market-specific regulation.

3.2 Multiplicity of Acts

The problem of multiplicity of regulators, as referred to earlier, emerges from the existence of multiplicity of Acts governing securities market regulation. The legal framework comprises inter alia the SEBI Act, Securities Contract Regulation Act (SCRA), Indian Contracts Act, Companies Act, Public Debt Act, the RBI Act and the Banking Regulation Act. Some acts came into being to create regulatory institutions (SEBI Act and RBI Act), some to regulate contracts (SCRA and Indian Contracts Act) and yet others to regulate issue of government securities (Public Debt Act). Although the scope of the Acts is well defined, problems of interpretation have led to confusion. There is therefore a need to simplify and streamline the legal framework. In this context, the Group believes that consolidating the SCRA and the SEBI Act in line with the recommendations of the Dhanuka Committee, will be very helpful.

4. Market issues

It is important to recognize the trade-off between over-regulation and high cost of compliance. Over-regulation may minimize market friction, but can potentially kill a market. To dilute this tradeoff, it is important to modernize the microstructure. (Microstructure relates to the manner in which a market is organized and the trading and post-trading technology the market adopts.) As regulations become more and more complex, certain regulatory objectives can be more easily attained through changes in microstructure rather than further addition to regulatory law.

4.1 Market Infrastructure

4.1.1 Screen-Based Trading System

As enunciated in Chapter II, the equities market has witnessed a quantum improvement in trading technology during the 1990s as it moved away from the open-outcry system of

trading to a computer screen-based trading. The new technology has not only increased transparency in trading, but also facilitated the integration of different trading centers into a single trading platform. Permitting of internet trading has enabled investors across the globe to route orders through the internet for execution on the Indian stock exchanges. In contrast to the equities market, the government securities market and the market for money market instruments are largely negotiated markets. Although the NSE established a wholesale debt market segment for exchange trading, members generally use this segment only for reporting trades undertaken by them in the negotiated market, rather than trading on the exchange.

4.1.2 Rolling Settlement

The stock exchanges in India have traditionally followed account period settlement system, which tends to distort the price discovery process since it combines the features of cash as well as futures markets. In contrast, the current international practice is predominantly rolling settlement on a T+3 basis, which introduces certainty of trades and reduces risk and delay in settlement. Beginning last year, compulsory rolling settlement has been introduced in a limited number of scrips on a T+5 basis. The slow progress toward the introduction of rolling settlement is on account of (a) lack of availability of electronic funds transfer across the country and (b) a general apprehension that such a move will reduce liquidity in the market. Even though a more effective payment and clearing system through a wider availability of EFT is important for switch-over to rolling settlement [12], the Group is of the view that even the current payment infrastructure can support a faster phasing-in.* Further, the view that rolling settlement per se will drain liquidity from the market is not borne out by international experience. The Group also suggests that RBI and SEBI expedite their scrutiny of the recent recommendations made by the joint task force of IOSCO and BIS on securities settlement systems, for early implementation.

4.1.3 Depositories and dematerialization

To ensure transferability of securities with speed, accuracy and security, the Depositories Act was passed in 1996, which provided for the establishment of securities depositories and allowed securities to be dematerialized. Following the legislation, two depositories (NSDL and CDSL) have so far been established. Further, the compulsory dematerialization of shares for trading purpose has been introduced in a phased manner with the aim of synchronizing the settlement of trade and transfer of securities

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[12] Unless the funds move quickly--that is on the same day or at best the next day--traders will face liquidity problem. Hence electronic funds transfer is critical to the introduction of rolling settlement. Currently, EFT facility is available in 14 centers. The RBI is mandated to facilitate electronic movement of funds through the entire banking system within a year.

* *Under implementation: SEBI has since decided to extend rolling settlement to more than 200 stocks with relatively high liquidity on a nationwide basis from July 2, 2001. These shares, which account for over 95 percent of daily market transactions, are to be traded only in rolling settlement mode. Meanwhile, on April 26, 2001 a Sebi group on rolling settlement has recommended that from July 2, 2001 the approved deferral products including Automated Lending and Borrowing Mechanism, Borrowing and Lending of Securities System and Continuous Net Settlement cease to be available for all the scrips and that Sebi and the exchanges should work towards introduction of individual stock derivatives--such as options and futures of selected stocks--which would substitute the hedging functions currently being performed by the above deferral products.*

irrespective of geographical locations, and eliminating the ills associated with paper-based securities system such as delay in transfer, bad delivery, theft and forgery. Although the process of compulsory dematerialization is nearing completion, its full benefits have not been reaped because of slow progress in introduction of rolling settlement.

With the appropriate infrastructure in place, there is now scope for taking further advantage of depositories to promote retailing of government securities. The RBI has taken a step in the right direction by allowing NSDL and CDSL to have a second SGL account for depository participants who in turn can hold in custody government securities on behalf of the final investors. This will facilitate holding of government securities in demat form.

4.1.4 Clearing Corporations

The stock exchanges supervise the buying and selling activities of brokers, but financial settlements are guaranteed by a clearing corporation, which creates a settlement guarantee fund to ensure settlement of trades irrespective of default by trading members. This arrangement, by nearly eliminating counterparty risk, has given a tremendous boost to investor confidence in India.

Further, in contrast to the current Indian system of each stock exchange having its own clearing corporation or clearing bank, it may be appropriate to have perhaps only two clearing corporations in line with international practice, which would support many stock exchanges. Such an arrangement would allow the clearing agency to have an overall view of gross exposures of traders across the stock exchanges and would be much better geared to manage risks.

4.1.5 Delivery vs. Payment

In the government securities market, DvP was introduced in 1994 for transactions put through the SGL accounts maintained in RBI's Public Debt Office (PDO), which has greatly helped in reducing the principal risk. The Special Fund Facility introduced last year has to a certain extent reduced risk of non-settlement due to gridlock. The Advisory Group on Payments and Settlement Systems (Headed by Shri M.G. Bhide) has made some suggestions for improving the payments and settlement systems and this Group would concur with these suggestions.

In the equity market there is currently no DvP. The Group notes that SEBI and RBI are jointly trying to evolve a mechanism, which would seamlessly link the depositories with the payment system through the clearing corporation/ clearing agency to ensure DvP. The Group recommends that establishment of such a mechanism is expedited.

4.1.6 Straight-through Processing:

Straight-through Processing (STP) involves verification through Internet of (i) the selling client's DP account for security balances following a sell order; and (ii) the buying clients' bank accounts for cash balances following a buy order. This system can eliminate nearly all settlement and payment risk. The significant changes taking place in technological and trading environment worldwide are driving the global securities industry towards STP. However, at present, all the pre-requisites for STP are not yet

available in India. While automated trading and dematerialization have been largely achieved, the limited availability of EFT and absence of RTGS have constrained the introduction of STP. These constraints are likely to be eliminated in the near future.

4.2 Primary Issues and Transparency

4.2.1 Private Placement Market

High costs of regulatory compliance associated with public issues of debt have made issuers prefer the private placement market. The private placement market has registered tremendous growth in the last few years. In 1999/2000, private placements accounted for 84 percent of total resources mobilized by the corporate sector. Preponderance of private placement can potentially strip the market of its ability to discipline issuers and thereby enhance systemic risk. Once investors have used the private placement route, they cannot signal their changing evaluation of the business prospects of the issuers, because there is no market in which they can sell. The dominance of private placement in primary issue market possibly reflects an absence of regulatory level playing field in the sense that public issues may be over-regulated while private placements could be under-regulated. Some recent initiatives such as the amendment to the Companies Act, making it mandatory for companies issuing debentures through private placement route to set up debenture redemption reserves as in the case of public issues, can partially restore the balance. [13] These initiatives need to be complemented by simultaneous efforts to ease some of the regulations governing public issues.

4.2.2 Corporate disclosure

With a view to enabling investors to take informed decisions as well as to promote transparency, regulations have over the years become more stringent by requiring disclosure to be more frequent and wider in scope. Currently, disclosure in India extends to material having a bearing on the price of a security, and entities who either have significant interest in a company or seek management control. A company offering securities is required to make a public disclosure of all relevant information through its offer documents. After a security is issued to the public and subsequently listed on a stock exchange, the issuing company is required to make continuous disclosures, including through publication of yearly audited balance sheets and quarterly un-audited financial results. Moreover, the disclosure of material information, which could have a bearing on the performance of the company, has to be made available to the public immediately.

Among the drawbacks, the ‘timing’ and ‘contents’ of disclosure of material events that impact prices are not unambiguously specified and followed. Recently, it has been decided that companies would be required to make decisions regarding dividend bonus and rights announcements or any other material event within 15 minutes of the conclusion of the board meeting where the decisions are taken. In terms of contents of disclosure, the following initiatives are necessary: (i) group company disclosures may be limited to top 5 companies by market capitalization or turnover, to avoid cumbersome exercise of gathering information from all companies falling under the definition of

[13] Further, issuance to more than 50 individuals will now deemed to be a public issue. With this, it has become more difficult to disguise public issues as private placement.

promoter group; and (ii) risk factors need to be given in greater detail as per international practices, although management perceptions of risks need not be given.

4.2.3 Transparency in the debt market

As regards transparency in trading, the debt market is lagging behind the equity market. The cash market in debt securities throughout the world prefers to operate through negotiated deals either through telephone or an electronic dealing system like Bloomberg. This is because unlike the equity market, the bond market participants are generally wholesale institutional investors who put in large deals at a time, which may not always be possible through the screen based order driven system. It is only in the futures market that the principles of anonymity, price time priority, nationwide market and settlement guarantee are known to work. As stated earlier, wholesale institutional investors have yet to show adequate inclination to use the anonymous order matching system for executing their debt securities transactions. Under the circumstances, SEBI has taken initiatives to foster transparency through regulatory fiat by prohibiting negotiated deals on the exchanges in respect of listed corporate debt securities and prescribing that all such trades would be executed on the basis of price and order matching mechanism of stock exchanges as in the case of equities. However, negotiated deals are still continuing, albeit outside the exchange, and there is no market dissemination of information on such transactions.

Since almost all deals in the government securities market are settled through the Subsidiary General Ledger (SGL), the daily dissemination of such information (albeit with a one day lag) has proved to be important in the price discovery process.) This, together with the data available from the NSE's Wholesale Debt Market (WDM) segment has contributed to greater transparency in the secondary market for government securities. Transparency will be further boosted by the current initiative to put in place an electronic negotiated dealing system for the SGL participants, which will disseminate information on a near real time basis.

5. Mutual Funds

SEBI is the principal regulator of the mutual fund industry. Mutual funds in India are constituted in the form of trusts. The fund's sponsor executes the trust deed, which outlines the liabilities and obligations of the trustees in relation to the unitholders. The day-to-day operations of the fund are carried out by the asset management company (AMC). [14] The board of trustees oversees the fund's activities and enters into a management agreement with the AMC.

SEBI has put in place standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme. Eligibility criteria have been set in terms of net worth, track record and internal management procedure. The regulations lay down disclosure requirements, procedures for calculating and declaring net asset values (NAV) of mutual fund schemes, accounting standards and a code for advertisements. Regulations are also prescribed to ensure arms-length relationship between the trustees and the AMC. SEBI is responsible not only for registration and authorization of schemes,

[14] The fund's sponsor must contribute at least 40 percent of the net worth of the AMC.

but also for inspection of registered mutual funds and remedial action against any regulatory infraction.

Disclosure standards of mutual funds have been under regulatory focus. SEBI requires disclosure to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme. Regulations have prescribed specified format for offer documents as well as a disclosed basis for asset valuation and the pricing and the redemption of units in a mutual fund. With a view to make unitholders aware of the securities in which the funds have been invested by the mutual fund, it has been made mandatory for mutual funds to send to all unitholders a complete statement of the scheme portfolio on a half-yearly basis.

The mutual fund industry has played a significant role in mobilization of domestic savings. Substantial progress has been made in strengthening regulation and improving transparency in the mutual fund industry through the Mutual Funds Regulations of 1996 and subsequent amendments. However, a number of challenges still remain, which are outlined below.

The UTI is the largest mutual fund in India, which was set up by an Act of the Parliament (the UTI Act, 1963). As such it is bound by the UTI Act and not by mutual funds regulations, although under a voluntary arrangement, SEBI oversees all the investment schemes launched by UTI since 1994. The organizational structure of the UTI differs from other mutual funds in two additional ways. First, there is no separate AMC with an independent Board of Directors. Second, there has been no separation of management groups managing schemes launched prior to 1994; regulations apply only to schemes established after 1994. Currently, there are four UTI schemes--US-64, ULIP-71, CRTS-81 and CCCF-93--which do not comply with SEBI regulations. The US-64, the flagship scheme of the UTI and the largest scheme in India, does not have a disclosed basis for asset valuation or pricing of units although it has plans to move towards this. [15] Bringing the UTI under SEBI's purview as well as the introduction and implementation of international accounting principles across the mutual fund industry will help promote fairness and stability of the sector.

Currently, regulations appropriately require that the sale and redemption of funds should be based on their NAVs, which have to be computed according to specified rules. However, there is scope for further improvement in one significant area: AMCs still have considerable room for discretion in adopting valuation of thinly traded or non-traded securities, as regulations specify only broad guidelines. There is a need to reduce the AMCs' discretion in this regard.

Finally, a couple of issues relating to prudential norms and corporate governance need to be examined. Regulations provide that a fund's ownership in any single company should not exceed 10 percent of a company's voting shares, although there is no upper limit on

[15] The US-64 has a corpus of about Rs.20, 000 crore, about a fifth of the total assets under management of all mutual funds. Following financial trouble in the scheme, the UTI constituted a committee (the Deepak Parekh Committee). The recommendations of the committee are being implemented to restructure the US-64.

the total holdings of voting and non-voting shares of any single company. Further, there appears to be no restriction on corporate investment in a mutual fund's units.

Annexure I

Advisory Group on Securities Market Regulation
List of Members

Sr. No.	Name	Designation	
1	Mr. Deepak Parekh	Chairman Housing Development Finance Corporation Limited	Chairman
2	Mr. Shitin Desai	Vice Chairman & Managing Director DSP Merill Lynch Limited	Member
3	Mr. I. C. Jain	Chairman KJMC Financial Services Limited	Member
4	Mr. Nimesh Kampani	Chairman J.M. Morgan Stanley Limited	Member
5	Mr. Anand Rathi	President The Stock Exchange, Mumbai	Member
6	Mr. Uday S. Kotak	Vice Chairman Kotak Mahindra Finance Limited	Member
7	Mr. Ravi Narain	Managing Director & CEO National Stock Exchange of India Limited	Member
8	Mr. Pratip Kar	Executive Director Securities and Exchange Board of India	Permanent Special Invitee
9	Dr. R. Kannan	Adviser, DEAP Reserve Bank of India	Convenor
10	Shri A.K. Mitra	Assistant Adviser, DEAP Reserve Bank of India	Co-Convenor

Annexure II

IOSCO Guiding Principles

This annexure sets out 30 principles of securities regulation, which are based upon three objectives of securities regulation. These are:

- The protection of investors;[16]
- Ensuring that markets are fair, efficient and transparent;
- The reduction of systemic risk.

The 30 principles need to be practically implemented under the relevant legal framework to achieve the objectives of regulation described above. The principles are grouped into eight categories.

A. Principles Relating to the Regulator

1 The responsibilities of the regulator should be clear and objectively stated.
2 The regulator should be operationally independent and accountable in the exercise of its functions and powers
3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4 The regulator should adopt clear and consistent regulatory processes.
5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

8 The regulator should have comprehensive inspection, investigation and surveillance powers.
9 The regulator should have comprehensive enforcement powers.
10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

[16] The term "investor" is intended to include customers or other consumers of financial services.

12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

13 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers

14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

15 Holders of securities in a company should be treated in a fair and equitable manner.

16 Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries.

23 Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients and under which management of the intermediary accepts primary responsibility for these matters.

24 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
30 The system for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that it is fair, effective and efficient and that it reduces systemic risk.