

# Perambulating through the Years of Reforms in the Indian Securities Market



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## A fiction or a fairy tale or a true tale

A fiction could perhaps begin with a description of an incident, or of a character. A fiction based on an historical event could begin with a factual or philosophical presentation of the prevailing environment as Dickens did in his "Tale of Two Cities", "It was the best of times, it was the worst of times" and so on. A grandmother's fairy tale would begin with

"Once upon a time there lived in a country..." and mostly end with the words "... and they lived happily thereafter". But how would one begin a real life story, an on going saga, which in retrospect would call for a suspension of disbelief and appear to be nothing less than a fairy tale. Most aptly it should begin as any fairy tale would - "once upon there was a..." The Tale of the Transformation Indian Capital Market aptly begins as ..

## Once upon a time .. the market then

Once upon a time, not so long ago, a decade and four years to be nearly accurate, the Indian stock market had earned a reputation of a casino (some persons of great erudition and scholarship even today are inclined to believe that electronic trading has helped in the preservation of that reputation of the stock exchanges). Once upon a time the stock exchanges in the country were closed clubs and the Bombay Stock Exchange (BSE) in Mumbai, the biggest of them all. The stock exchanges were then run and controlled by a few cliques or cartels of large brokers hailing mainly from Mumbai and Kolkata, to which rest of the broking community necessarily paid obeisance and acknowledged their suzerainty for securing their business and livelihood. There were some sultanates in Ahmedabad and Delhi too, which worked in their own jurisdictions. A strong sense of "biradiri" in the community provided a multipurpose bulwark. It allowed flow of insider information, about exposure on the books of some of the brokers. Second, large business houses had house-brokers, just as they had a house dhobi, house jewelers, house saree suppliers. In other words these brokers were loyal to their masters and would do business only on their behalf and for the sake of business efficiency, had to be privy to inside information. Third, two books of accounts could be easily maintained by the brokers. Fourth, cases

of individual default in both the books could easily be hushed up and settled in a manner befitting and upholding the dignity of the biradiri - "*apas mein salta lengey*" was the acceptable parlance.

## Trading on the stock exchanges

Trading in the stock exchanges was thin and the stock prices were largely manipulated and the closing price of the BSE Sensex depended on the price which some of the key brokers thought should be the last traded price of heavy weighted securities in the index. Kerb trading swayed the prices on the secondary market. In fact to learn about the next day's opening price of a scrip or learn about the market gossip, one had to sit with a glass of beer in the evenings in the coffee shop of Ambassador Hotel or sit in the lobby of the erstwhile Natraj Hotel in Mumbai or have vada pav and "cutting chai" in the tea shacks in Dalal Street and listen to what the "tarvaniwallas" and their employees discuss about the market.

Trading took place in the pit and amid sound and fury, which unlike Shakespeare fortunately signified something meaningful only to those in the pit who understood them. In the absence of speedy communication systems, rumours had a field day and could not be easily checked. (Not that it is any less now, the only difference being it could be easily verified) The settlement took place every fourteen days, but the fourteenth day of the account period varied from exchange to exchange. As a result a broker could easily transfer his position across exchanges. The varied settlement calendar which was the USP of the exchanges and absence of quick communication system together resulted in high arbitrage opportunities. But the settlement period of fourteen days however often existed on paper, because if the broker cliques decided (depending whether bull cliques were in control or the bear cliques) that settlements should be postponed, the stock exchanges readily had to agree to aggregate settlement cycles. Stock exchanges levied margins in consultation with the players who would congregate in the President's room and collectively decide the extent of the margin, which will be sufficient to alter the direction of the market.

## The badla system

This was also the time when the ubiquitous and omnipotent "badla" system - an ingenious Indian variant of contango and backwardation mechanism prevailing in the London Stock Exchange - dominated the firmament of the Indian stock market. And indeed what a domination it was, far far overwhelming than Cleopatra's over Mark Anthony. So complete was the reign that even the slightest attempt to wean away the market from it met with stiffest resistance from almost every quarter in the market. The reign of badla could end only six years back.

### *The primary market*

If this was the state of the secondary market, the primary market was no different. Companies issued IPOs with prospectuses which were written in the smallest of fonts. These were not meant to be read by the investors. The valuation was determined by the government but the real price discovery happened in the grey market and shrewd investors tracked the market. The market would have been happy if it raised Rs 5000 crore in a year. There was hardly any regulation for taking over a company and investors and shareholders would wake up one fine morning and learn that the company which was manufacturing widgets has been sold off to another company which manufactures safety pins and they had no say in the matter. There were very few mutual funds – in fact seven of them, all set up by the public sector banks and there was the UTI. But UTI was known as UTI to the lay household and not as a mutual fund and to the market it was the big bull. It could stand in the market and hold the sway or change the direction of the market, especially when the government required it to do so.

### *The hapless investor*

What was the plight of the investors? By the early eighties equity cult was growing firmly in the country, thanks largely to Reliance Industries and investors were getting into investing in the equity market. By the late eighties some of the companies ventured to access the market to raise capital – the amounts being relatively large (above Rs 100 crore) to coin the term “mega issues” for the first time. The apathy of the investors was appalling, much like the passengers in a Virar local or those hanging like iron filings in the private buses in Kolkata. Mere subscription and allotment to an IPO was no guarantee that the investors will receive the shares on time, for the share certificates may be lost in transit. Besides if an investor is lucky, he would receive the certificate in three months, during which his liquidity would have been blocked. If he was not lucky to get allotment, he may not receive the refund within six months. If he has traded in the secondary market, he would not know when his order was executed and what price; he may have paid the money or shares to the broker or the subbroker, but that was no guarantee that he will receive his shares or money after settlement, in any event not before a month after the trade. If he bought shares and got share certificates and sent these to the company for transfer, more often he would find that the company's share transfer agents would return the shares after several months saying the shares are forged or fake or the signatures didn't tally. Shares might also have been lost in transit.

### *The establishment of SEBI*

It was under these circumstances that the Government decided that an independent regulatory body was required for growing the security market; investors would have to be encouraged to invest their savings in the securities market and their rights would have to be protected. The

Securities and Exchange Board of India (SEBI) was thus set up in 1998 as a non statutory body, a precursor to a statutory body. Four years later and after protracted deliberations with the Government, on what should be its appropriate functions and powers, given that such a regulatory body was being set up for the first time, SEBI became a statutory body through an ordinance issued by the Government on January 30, 1992. The Act was passed by the Parliament in April 1992. The establishment of SEBI as a statutory body, was milestone in the history of India's financial system. Indeed SEBI itself becoming a statutory body in 1992 was a product of India's economic reforms. Government took two other measures almost simultaneously. One it abolished the office of Controller of Capital Issues and allowed private sector companies to raise capital freely. It also opened up the Indian stock markets to foreign institutional investors, who could freely buy and sell Indian securities, bring in foreign capital and repatriate it freely at market rates.

### *The 1992 market irregularity and the impact*

In 1992, before SEBI could assume charge, irregularities in the government securities market, the effects of which spilled over to the stock exchanges as well, shook the foundations of the financial system of the country. Though the irregularities were in the banking system and concerned trading in government securities which did not fall under the regulatory purview of SEBI, SEBI had an indirect role in bringing out the irregularities. As regulation is a service, SEBI like securities market regulators had levied fees on intermediaries who will be registered with SEBI under the SEBI Act. Brokers refused to be registered with SEBI or pay registration fees as that will mean that they accepted their new master. In protest they went on strike and shut down the stock exchanges. This broke an important link in the cycle of fund flow which was sustaining the irregularities. The market misdemeanor surfaced almost as soon as the brokers went on strike.

### *The establishment of NSE.*

Government responded to broker recalcitrance in a manner which was bound to have long term implication for Indian stock market. The government proposed the establishment of a new, modern nationwide securities exchange with the financial support of institutions like the Industrial Development Bank of India and other all India financial institutions. The National Stock Exchange of India Limited (NSE) was set up in 1994 as a corporatised, demutualised, for profit exchange, which was subject to payment of Income Tax. The NSE offered modern trading facilities across the breadth of the country, using satellite communication network technology to make modern trading systems available to individual investors as well as large institutions. Investors loved the new system. For the first time, an investor anywhere in the country could see their order inputted into a computer and the transaction completed on screen. The price was transparent and the broker commission was a fraction of that paid in the past. This drove BSE, though after a lot

doubt, persuasion and debate to give up its open outcry system and launch electronic trading, a year later. In the next few years, SEBI cajoled all the remaining stock exchanges operated as screen-based trading systems. In February 2000, the NSE launched internet trading, which gave investors direct access to the cash market, and the BSE followed in March 2001.

### **And they lived happily thereafter – the market now**

#### *Electronic trading*

As electronic trading picked up, speed of transactions increased and foreign portfolio investments flowed in, trading volumes soared and other exchanges felt the effect. But new risks emerged. Settlement of trades was still done with paper securities and this posed a huge risk to the new exchanges. Settlement guarantee funds were mandated by SEBI in all exchanges. The screen-based, order-driven system aggregated securities from sellers from all over the country to meet a large buy orders. But trades being settled once a fortnight (and later on once a week) weeding out forged paper and authenticating share certificates from the company became a nightmare for the clearing houses. To allow electronic book entry and move to paperless trading the depositories were set up. The National Securities Depository (NSDL) was set up in 1996. A second depository, the Central Depository Services, was set up by the Bombay Stock Exchange a few years later.

#### *Dematerialisation*

Dematerialization began in phases when SEBI mandated that trading in eight stocks in 1996 (a step considered by most as a small, inconsequential and meaningless at that time) will be settled dematerialized securities. In the next two years, when the market realised the advantages of dematerialized settlement, the entire trading was covered. The transaction charges and the cost of ownership of securities collapsed almost overnight. More importantly, bad paper was weeded out of the market and delays in transfer, fake and forged shares were nightmares of the past.

#### *Change over to rolling settlement*

The main business at India's regional exchanges emanated from a system in which trades were settled on an account period basis – once a fortnight (and later once a week), with different account settlement days for each exchange. This coupled with badla had allowed speculators a free hand, as they could shift open positions from one exchange to another without settling them. Market misconducts, have a positive role to play. It helps in heralding reforms which were difficult to implement earlier. There was a major market misconduct in 2000 which necessitated the setting up of Joint Parliamentary Committee by the Parliament.

This crisis forced several regulatory responses, which were hitherto difficult to adopt due to the obduracy of the exchanges and brokers. In July 2001 all exchanges adopted rolling settlement. Initially, the settlement of

equity trades was shortened to T+5, and then to T+3 in April 2002 and finally to T+2 in April 2003. The transition was smooth and contrary to the naysayers opinion, market flourished. **At** about the same time (July 2001) the age old indigenous product, the badla, which embedded the features of futures, margin trading and stock lending, and was the cause of a number of market misconduct, was abolished and derivatives introduced by SEBI.

#### *Regional exchanges*

If the spread of terminals of the NSE and BSE had threatened the existence of the regional exchanges, rolling settlement rendered them economically irrelevant. The only survival kit available to them was the subsidiary route through which brokers of these exchanges could trade on the two national exchanges. But a survival kit only helps to survive and not to grow and develop. Survival kits in the financial world outlive their utilities, over a period of time as the regional exchanges were soon to find out.

#### *Risk management system, counterparty risk and margins*

The stock market was prone to price manipulation and the new rules introduced by SEBI sought to make manipulation difficult, costly and punishable, thereby improving the integrity of the market. Margining norms and risk management systems introduced by SEBI were predicated on scientific foundations and replaced ad hocism and subjectivity. The BSE and the clearing corporation of NSE now monitor the exposure limits of trading members online in real time and an automatic disablement of broker terminal's in case there is breach of margins. An index-based, market-wide, circuit breaker system applies when the index moves either way by 10%, 15% and 20%. These circuit breakers bring trading in all equity and equity derivatives markets in India to a halt. A movement in either of the two benchmark indices, the S&P CNX Nifty or the BSE Sensex can trigger the circuit breakers. On May 17, 2004, when the country was in a state of political uncertainty, the market fell by a record of more than 10% in one hour and 15 minutes of trading. The risk management systems of the stock exchanges successfully went through one of the severest of stress tests and there were no broker default. These measures put the Indian securities markets ahead of the G30 recommendations which prescribe that final settlement for all trades should occur no later than T+3.

#### *Mutual funds, takeovers*

The perambulations have so far traversed the secondary market. This is not as if to say that the reforms have not been all pervasive and not touched other segments of the market. There is now a well regulated, transparent and growing market for corporate control. Investors have benefited through participation in takeover offers. The number of mutual funds has multiplied and foreign mutual funds have also been established. Investors now have a choice of over 400 schemes to invest in.

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### *Disclosures and accounting standards*

Significant changes have been made in the disclosure standards for public issues and continuing disclosures have improved by leaps and bounds; from virtually non-existent prospectuses, the prospectuses today have become dull bulky documents with a surfeit of information about the project, promoters, financing requirements, information on the financial position of the company and its associates, risk factors, details of litigations. Continuous disclosures have been introduced through the listing agreement. Quarterly reports are now mandatory for any listed company and consolidated accounts, segment reporting, related party disclosures, and deferred tax treatment found a place in annual and half yearly results. More importantly these disclosures were made available to all investors.

### *Corporate governance*

SEBI set out the corporate governance standards through the listing agreements of the stock exchanges, not in response to any crisis but as a reform measure by itself. Indeed in terms of disclosures, and corporate governance, the Indian standards compare with the very best in world. These have been commented upon internationally. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, in their working paper titled "What works in Securities Laws?" appearing in NBER Working paper series states that "India scores 100% as far as disclosure standards are concerned". Reena Aggarwal, Leora Klapper, Peter D. Wysocki of the CALPERS write in their article titled "Disclosure Quality and Emerging Market Mutual Fund Investment" that *Indian Accounting Standards scores a maximum of 3, according to CALPERS' Permissible Equity Market Analysis.*

### *Exchange governance*

The exercise of improving the exchange governance which began by empowering the office of the executive director of the exchange and having 50 % non broker representative on the governing boards of the exchanges, was carried to its logical conclusion by corporatising and demutualising the stock exchanges.

### *Compliance with international standards of IOSCO*

Notwithstanding the three episodes of major market misconduct in the last thirteen years, in 1992, 1998 and 2000, each of which evoked suitable policy responses, the economic benefits of reform to the securities market have been enormous. The IOSCO sets out three core objectives of securities regulation. Although there would be local differences in market structures in countries, these objectives form the basis for an effective system of securities regulation. These objectives are:

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

The three objectives are closely related and, in some respects, overlap. Many of the requirements that help to

ensure fair, efficient and transparent markets also provide investor protection and help to reduce systemic risk. Similarly, many of the measures that reduce systemic risk provide protection for investors. Further, matters such as thorough surveillance and compliance programs, effective enforcement and close cooperation with other regulators are necessary to give effect to all three objectives. The reforms in India's securities market and the regulatory framework established by SEBI, have to a large extent been able to meet these objectives.

### **The epilogue**

Prof Amartya Sen while speaking on the subject of economic reforms at a recent conference identified three factors which should be of major concern in the task of initiating and implementing a major reform. These are: reach, range and reason. In terms of reach, it is important to always keep in mind what the proposed reform does for the people it affects; one must pay attention, specifically, to the reach of reform. As far as range is concerned, reforms must recognize that the means to pursue the ends of reform involve a variety of institutions, not just a few magic bullets. Finally, the reformers must constantly be willing to ask themselves why they are pursuing a particular course of reform or choosing a certain policy instrument over another. If the conceptual framework outlined by Prof Sen is adopted to evaluate the reforms in the Indian securities market, then the reforms could be said to have done well for themselves. The reforms have reached out to every participant of the securities market – the investor, the issuer and the intermediary. The range of the reforms has been wide – affecting every segment of the securities market, introducing new markets for new products, spawning new institutions, while making the existing ones more transparent and efficient and transforming the existing market structure into a modern, transparent and efficient one. The reforms have also been under constant scrutiny and carefully crafted through a process of constant review and evaluation.

Reforms in the securities market have been an integral part of the financial sector reforms and indeed of the wide ranging economic reforms initiated in India in 1991. Since the economic reforms were designed to create a more competitive economy, with a larger role for the private sector and market forces, the reforms in the securities market were needed to support a greater role of the market in the efficient allocation of capital in the economy. The approach to reforming the securities market was comprehensive; covering every aspect of the market. While the economic reforms were set in the broad perspective of large fiscal deficit being identified as a major factor of macroeconomic imbalance, the securities market reforms were set in the broad framework of investor protection, market transparency, efficiency, and integrity. The reforms have been comprehensive in scope and gradualist in implementation. Besides what was important was the sequencing of the reforms; all the pieces fitted together to complete the puzzle; for example,

introducing dematerialization without electronic trading, would not have optimised the results. Similarly, rolling settlement could not have been introduced without dematerialization or electronic trading. Policy changes were typically implemented through a consultative process taking on board the views of various market participants. This approach had obvious advantages most notably the wide acceptance of reforms which allowed their easy adaptation and firm implementation.

Reforms in the securities market could not have been totally successful, or its benefits fully realized unless there are accompanying reforms in the banking sector, because of their role in the payment and fund settlement system and as well as their dominance in the intermediation of household saving. The efficiency with which these savings are mobilized and allocated is clearly an important determinant of total factor productivity and therefore of growth in the real economy.

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The main area where India's approach to securities market reforms differed significantly from current international perceptions relates to the reforms being driven and catalysed by the market regulator. Regulation became like laying the railway track on a virgin territory, converting from meter gauge to broad gauge and then to electrification and modernization of tracks for swifter transportation and locomotion. The railway tracks have been now been laid down and most of the virgin terrain explored. Exploration of the remaining ones is now dependent on market demand and less on the market regulator.. It need not be driven necessarily by the regulator. The task for the regulator is now more towards monitoring the running of the trains, their maintenance, safety of the passengers, tracks and the trains, provide appropriate tracks and signals so that if there is demand for a shinkashen, it can run freely. This is by no means an easy task and it is here that the regulatory efficiency will be, measured.

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