Stock Markets Need to be Widened and Deepened

M.R.Mayya
Former Executive Director
Bombay Stock Exchange

Introduction

Indian stock markets are presently among the most advanced markets of the world in terms of automation, dematerialization, settlement, etc. We have screen-based trading granting simultaneously to all investors located anywhere in India and elsewhere the same opportunity to trade. Over 90 percent of our securities are in demat mode, achieved in a very short time, setting a model to the global markets. Rolling settlements are in T + 2 mode, while most of advanced markets of the world, including the United States, still have T + 3 cycle.

Growth of the Market

Market has witnessed phenomenal growth during the period of five years from 2003-04 to 2007-08. Capital raised from the primary market which was just Rs.23,272 crore in 2003 - 04 zoomed to Rs.87,029 crore in 2007 – 08 amounting to 4.5 percent of the gross domestic savings of Rs.20.46 lakh crore. With the net inflow of Rs.1,53,802 crore into mutual funds in 2007-08, aggregate mobilization by the stock markets and mutual funds amounted to Rs.2,40,931 crore working out to 11.8 percent of the gross domestic savings.

In the cash segment, the volume of turnover registered a more than five fold increase from Rs.12.16 lakh crore in 2003-04 to Rs.51.30 lakh crore in 2007-08.

Although a late entrant into the derivatives market, the progress of the Indian markets has been fantastic. From a low level of Rs.21.75 lakh crore in 2003-04, the turnover in the derivatives market has been fantastic, rising to Rs.130.91 lakh crore in 2007-08. In stock futures, progress of Indian stock markets has been amazing. In 2007-08, the turnover touched Rs.75.49 lakh crores occupying the top position in the world.

Success in the derivatives market has to be viewed in the background of a thriving 'badla' market India had for over a century till 2001 when it was banned by the Securities and Exchange Board of India.

What, however, is disturbing is the monopolistic position occupied by the National Stock Exchange, as there is virtually no trading whatever in derivatives on the Bombay Stock Exchange. With the MCX, Stock Exchange likely to commence trading in equity derivatives in the near future and the revamping of trading on BSE by enabling trading in derivatives on the BSE Online Trading platform, the picture is likely to change.

Market capitalization of Indian stocks also witnessed a phenomenal growth in the half decade ended March 2008. Market capitalization rose by about eight times from about Rs. 6.5 lakh crore in March 2003 to about Rs.55 lakh crore in March 2008 which was 117 percent of the gross domestic product of about Rs. 47 lakh crore which is on par with several of the developed countries of he world.

The bell weather index, SENSEX, recorded an unprecedented rise of 592.52 percent from 3048.72 on March 31, 2003 to 21,113.13 on January 9, 2008 when it peaked before declining to 15,644.44 on March 31, 2008.

The global meltdown which started towards the close of 2007 has had its reflections cast on the Indian stock markets, although the robustness of the domestic market moderated the impact.

Capital raised from the primary market plummeted sharply by 83.1 percent to Rs.14,720 crore during 2008-09. Turnover in the secondary market declined by 24.0 percent to Rs.38.53 lakh crore. Turnover in the derivatives segment also fell by 15.9 percent to Rs.110.10 lakh crore.

Trading in currency futures, which commenced in August 2008, showed a robust trend with a total volume of turnover of Rs.3.12 lakh crore by March 2009.

Rather surprisingly, market has staged a dramatic recovery since March 2009. SENSEX, which touched the low of 7697.39 on October 27, 2008 and virtually stagnated till March 2009 staged a sharp rise thereafter. SENSEX closed at 14,870.90 on June 3, 2009 which is a little less than double of the low level of October 27, 2008.

Need to Widen and Deepen the Market

The growth of the market needs to be widened so that the benefits of a fast growing market percolates to small investors located all over the country, including the semi-urban and rural areas. It is equally necessary to deepen the market in order to increase liquidity and reduce volatility.

The four major areas of concern of Indian securities market are low retail individual investors' shareholding, lack of adequate liquidity, high volatility and frequent manipulation of prices, apart from problems like insider trading, bucket shop operations, etc.

Low Retail Individual Investor Shareholding

Retail individual shareholding population of India has not grown commensurate with the growth of the market. In fact, according to a SEBI – NCAER survey, the number of equity investor households in India actually halved from 12.1 million in 1998-99 to 6.1 million in 2000-01, representing just 3.7 percent of Indian households. As on March 31, 2001, 20.1 million had invested in equities, debentures and mutual funds, representing a meager two percent of the population as against over 20-25 percent in several developed countries. Number of demat beneficial owner accounts as on April 30, 2009 was 15.28 million.

There are several companies where holding by RIIs are less than 10 percent of the equity capital, and out of them a lot less than even 5 percent. It is ridiculous that a company like MMTC quoted at Rs.28,267.50 on June 1, 2009 is having a public float of a negligible percentage of 0.67 percent with government holding the balance of 99.33 percent of the capital.

Low Liquidity

While the most popular scrips get traded heavily, often a sizeable portion of the issued capital of the company in a single day, the less popular ones do not get adequately traded to provide for easy entry or exit with the gap between bids and offers being quite wide, not to speak of a majority of listed scrips either being thinly traded or not being traded all, all because of low floating stocks.

In 2008-09, out of 7,729 scrips listed on BSE, only 2,559 scrips i.e. 31.1 percent of the listed scrips were traded. While top 100 scrips accounted for 44.55 percent of trading during 2005-06, in March 2009, the share of the top 100 scrips rose to 86.44 percent.

With the National Stock Exchange listing mostly large cap companies, and trading on all the regional stock exchanges having ground to a halt, BSE is the only stock exchange at present where trading in mid-cap and small-cap companies are taking place.

High Volatility

Indian stock markets used to be among the most volatile markets of the world while advanced markets like USA, U.K., used to be less volatile. The year 2008-09, however, saw most of the global markets, including the advanced markets, turn more volatile.

While the average daily volatility of SENSEX and S&PCNX Nifty during 2008-09 was 2.79 and 2.66 respectively, daily volatility of Dow Jones of USA was 2.55, FTSE of UK was 2.40, and Nekkei of Japan was 2.94. The average daily volatility of IBOV of Brazil and HSI of Hong Kong was higher still at 3.35 and 3.01 respectively. A major cause of volatility in the Indian stock markets is the operations of Foreign Institutional Investors (FIIs). FIIs, who had pumped in a net investment of Rs.74,595 crore during 2007, made a net disinvestment of Rs.53,673 crore during the period of 15 months from January 2008 to March 2009.

Manipulation of Prices

Indian stock markets are also subject to manipulation of prices, rigging up of prices, creating a false market, etc. Prior to abolition of wealth tax, to see the prices of SME shares hammered by interested parties to pay less wealth tax was a common feature. However, stock exchanges took no effective action, although they had ample powers to do so under their bye-laws.

Manipulation of prices by interested parties continued to be a common feature till SEBI started penal action from 1996 under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations1995. Instances of manipulation of prices have come down partly also due to close surveillance by both stock exchanges and SEBI. Yet, it is quite a common occurrence that takes place in several cases prior to the announcement of quarterly results by the listed companies. Price rise or price fall that takes place a few days before the announcements of the results are broadly in tune with the actual results. How can one explain this except due to insider trading?

Manipulation of prices on a large scale by FIIs also continues as most of them act in concert. Scale of operations are so widespread that it has become very difficult to track them down. Here is a challenge for stock exchanges and SEBI which needs greater attention.

Root Cause of the Problem

The root cause of the problem relating to low holding by RIIs, lack of adequate liquidity, high volatility and manipulation of prices can be traced to a singular decision taken by SEBI in June 1992 to reduce drastically the public offer of securities to a meagre 20 per cent of the issued capital of a company from 60 per cent stipulated by the Government earlier. Government of India, however, raised the percentage of public offer to 25 percent while amending the Securities Contracts (Regulation) Rules, 1957 in September 1993.

After a series of alterations, Government amended the SC (R) Rules in 2001 providing for a minimum public offer of 25 per cent for all companies except Government companies where stock exchanges can relax the requirement, and further provided for a public offer of 10 per cent subject to a minimum public offer of Rs.100 crore and 20 lakh shares and through book building with 60 per cent being allotted to Qualified Institutional Buyers (QIBs). This meant that a company with a capital of Rs.1,000 crore could offer only Rs.100 crore and RIIs would get 30 per cent of the same i.e. Rs.30 crore, with Non-Institutional Investors getting 10 per cent and QIBs 60 per cent. In other words, a company with a capital of Rs.1,000 crore would offer only 3 per cent of the public offer of the issued capital to the RIIs. Needless to say that this mutilated against the concept of spreading equity cult in the country preached by all.

Continuous Listing Requirements at Present

The listing agreement as amended in May 2006 provides for a continuous maintenance of at least 25 per cent. However, if a company had offered in the past less than 25 per cent but not less than 10 per cent, or where the number of outstanding listed shares is at least two crore and the market capitalization is at least Rs.1,000 crore, it shall maintain the minimum level of public shareholding of 10 per cent. Wherever there is a short fall, a period of two years is given for raising the shareholding to the relevant level. In practice, however, this has hardly been enforced.

Proposal of Ministry of Finance

It was against the background set out above that the Ministry of Finance came out with a Discussion paper on the "Requirement of Public Holding for Listing" in March 2008. Ministry of Finance put for public debate a proposal to amend Rule 19(2) (b) of the S.C. (R) Rules to provide for a public shareholding of 25 per cent of each and every class of issued capital of a company, both initial and continuous, seeking listing on a stock exchange.

While the investing public and the institutions associated with the investing public wholeheartedly welcomed the proposal, Chambers of Commerce and Industry representing the corporate world opposed the proposal mainly on the grounds that all companies may not need all the cash that would be raised by the public offer of 25 per cent and fears of market depression following public offer.

The deep erosion that took in equity prices presumably prompted the government to postponed implementation of the proposal.

Rise In Promoters' Holdings

Company promoters of several corporate utilized the opportunity of depression in the market to augment their holdings. A study of S&PCNX 500 companies indicates that two out of every five companies have witnessed an increase in promoters' holdings over the year ended March 2009. Startling examples where promoters have increased holdings over the year 2008-09 are those of UTV Software (from 32.54 percent to 83.25 percent), Essar Shipping (from 47.25 percent to 83.71 percent), Era Infra Engineering (from 24.23 percent to 58.17 percent), Zandu Pharmaceuticals (from 41.99 percent to 72.80 percent) and Ranbaxy Laboratories (from 34.82 percent to 63.92 percent).

The principal route taken to augment the promoters' holding particularly by foreign promoters, was through open offers. Another major route was through rights offers where promoters ended up subscribing to shares of entitlements surrendered by other shareholders.

As a result, the situation at present is much more wore than what it was in March 2008 when Ministry of Finance mooted the proposal to increase public shareholding to 25 percent of the issued capital of a company.

Revival of the Market

Markets are no longer in a bearish phase. In fact, a bull phase seems to have started. SENSEX, which touched a low of 8160.40 on March 9, 2009 has been progressively rising, closing at 14,870.90 on June 3, 2009.

SEBI should not delay implementation of the proposal of Ministry of Finance mooted in March 2008 to provide for a public shareholding of 25 percent of issued capital of a company, both initial and continuous, seeking listing on a stock exchange.

Share of RIIs

At present share of Resident Individual Shareholders (RIIs) is 30 percent with 60 percent being allotted to Qualified Institutional Buyers (QIBs) and 10 percent to Non-Institutional Investors (NIIs). In some cases RIIs get 35 percent, QIBs 50 percent and NIIs 15 percent. RIIs must get at least 40 percent with QIBs getting 45 percent and NIIs 15 percent respectively.

If initially there is an allotment of less than 40 percent to RIIs, there can then be an interchange among the three groups and also vice versa. Once the listing is over, while QIBs and NIIs holdings may be reduced to 45 percent and 15 percent respectively, RIIs holdings may be permitted to be raised to 40 percent.

Period for Compliance

In case of a shortfall below 25 percent at present, the company may be permitted to bring about the public shareholding to 25 percent within a period of one year as against the proposed period of three month as according to one estimate, 1,200 companies would be required to offer shares worth Rs.10 trillion as against the market capitalization of about Rs.50 trillion i.e. about 20 percent of market capitalization. It is not as though this is a unique experiment. New York, London and Hong Kong Stock Exchanges have 25 percent as the requirement both for initial and continuous listing while NASDAQ has 1.1 million publicly held shares for initial listing and 0.75 million publicly held shares for continuous listing.

Augment the Domestic Supply of Capital

With political hurdles removed, Government should hasten the disinvestment of Public Sector Undertakings. In order to attract RIIs, who have been frustrated by the sharp erosion in prices, offers to them may be made at a discount of 5 – 10 percent.

Foreign stock exchanges have launched an intensive campaign to induce Indian companies to float GDRs and ADRs. Although Government has permitted floatation of IDRs on Indian stock exchanges over 3 years ago, it is surprising that not a single company has floated its IDRs. It is time domestic stock exchanges launch a campaign to attract foreign companies to float IDRs on Indian stock exchanges.

Conclusion

Widening and deepening the stock markets of the country meets several objectives like inclusive growth by increase in the shareholding population, moderation in movement of prices, reducing the scope for manipulation of prices, increasing the efficiency of capital due to disintermediation, injection of greater accountability of management on account of wider focus of the company, etc. Let all the parties concerned like SEBI, stock exchanges and stock brokers, depositories and depository participants, investors' associations, etc. fix a target of raising the shareholding population three fold to at least 60 million in the next five years of an expected stable government rule at the Centre. This would be just about five percent of the population.