Chapter Two

LITERATURE REVIEW

This chapter presents the various literature reviews of already conducted studies in India and abroad. The review of books, journals, committee reports, company reports, SEBI bulletins and research papers on the Securities and Exchange Board of India have been presented in this chapter.

Chandra (1991), in a study on the proper functioning of the securities markets, examined the government policy of favouring the small shareholders in terms of allotment of shares. The study argued that, such a policy suffered from several lacunae such as higher issue and servicing costs and lesser vigilance about the functioning of companies, because of inadequate knowledge. The study suggested that there was a need to eliminate the bias as that would lead to a better functioning of the Capital Market and would strengthen investors’ protection. With proportional allocation being advocated by SEBI, a shift in the policy was evident. However, there appeared to be some re-thinking on the proportional allocation after the recent experiences which clearly demonstrate that such a policy could result in a highly skewed ownership patterns.

Pandya (1992), in a study, “SEBI: Its Role, Powers, Functions and Activities”, observed that as a regulatory and development body, SEBI's efforts in the direction of investor protection are varied and unlimited. The measures brought in by SEBI broadly cover measures for allocation efficiency in the primary market with a fair degree of transparency. It was found out that reforms in the secondary market institutions, mutual funds and regulation of various market intermediaries and above all for the protection of the investing public, were necessary.

Barua and Varma (1993), in a study on the activities of the scams reported that press reports first appeared in April 1992, indicating that there was a shortfall in Government Securities held by the State Bank of India (SBI). Investigations revealed that it was just the tip of an iceberg which came to be called the securities scam. It involved the
misappropriation of funds to the tune of over Rs. 3500 crore (about $ 1.2 billion). The scam had engulfed top executives of large nationalized banks, foreign banks, financial institutions, brokers, bureaucrats and politicians. The functioning of the money market and the stock market had been thrown into disarray. The scam had generated such immense public interest that it had become a permanent feature on the front pages of newspapers. A large number of agencies, namely, the Reserve Bank of India (RBI), the Central Bureau of Investigation (Indian CBI), the Income Tax Department, the Directorate of Enforcement and the Joint Parliamentary Committee (JPC) all set out to investigate the various aspects of the scam. The government set up the Janakiraman Committee to probe the scam, which broke out between April, 1991, and June, 1992. At least 10 commercial banks were involved, including the Standard Chartered Bank, the SBI and National Housing Bank (an RBI subsidiary).

Barua and Varma (1993), in another study, stated the modus operandi used in the scam. It found out that in form, the brokers used the Ready Forward (RF) deal, which was not a loan at all. The borrowing bank (Bank 2) actually sold the securities to the lending bank (Bank 1) and bought them back at the end of the period of the deal at (typically) a slightly higher price. The price difference represented the profit on the deal. It was found out that the RF instrument was used in other countries, known as a repurchase (or repo) agreement. It was a very safe and secured form of lending and it was very common throughout the world. The US repo market, for example, is about a hundred times larger than the Indian RF market. It found out that the RF in India served two main purposes: (a) it provided much needed liquidity to the government securities markets and (b) it was an important tool in the hands of the banks to manage their Statutory Liquidity Ratio (SLR) requirements. Banks in India were required to maintain 38.5% of their Demand and Time Liabilities (DTL) in government securities and certain approved securities which were collectively known as SLR securities.

Barua and Varma (1993), in a study, examined the impact of the scam and found out that it resulted in a sharp fall in the share prices. The index fell from 4500 to 2500, representing a loss of Rs. 100,000 crores in market capitalization. Though one may be tempted to blame the steep decline in prices on the scam, but they think that the reason for this fall was not the scam directly. It found out that the scam resulted in the withdrawal of about Rs. 3,500 crore from the market, which for a market of the size of Rs. 250,000 crores (at an index level of
(4500) was a very small amount, and therefore should have had little impact on the prices. The study found out that there were however, two major reasons for the fall, both related to the government's knee jerk response to the scam. First was the phenomenon of tainted shares which created panic in the market and second was the perceived slowdown of the reform process which destroyed the very foundation on which the boom was based. It was found out that Harshad Mehta and others were being described as the products of the situation, this was as a result of political pressures and the bad press it received during the scam. The study revealed that it was the liberalization policies of the government which did not function properly and which were later on put on hold for a while. The Securities Exchange Board of India (SEBI) postponed sanctioning of the private sector mutual funds. Some question marks arose regarding privatization as the chairman of the committee looking into this ended up in jail on charges of involvement in the scam.

Dhillon (1993), in a doctoral dissertation examined the regulatory policies of the Bombay Stock Exchange (BSE) over a four year period (July 1986 - June 1990). The findings showed that regulatory authorities decided changes in their margin policy on the basis of market activity. It found out that the margins were prompted by changes in settlement returns, price volatility, trading volume and open positions. The Granger causality results showed that there was limited causality in the reverse direction: margin changes did not affect returns, and had only a limited impact on price volatility, trading volume and open positions. The event study methodology applied to daily margins showed similar results, except that daily margin on sellers did not appear to be affected by the market variables. Further, there was also evidence of under margining leading to excessively levered positions, thereby increasing the insolvency risk. The results revealed that regulations through this instrument had only a marginal impact on the dual objectives of controlling market activities and insolvency risk.

Barua and Varma (1993), in a related study of the scam, defined the term "securities scam" as a diversion of funds to the tune of over Rs. 3500 crore from the banking system to various stockbrokers in a series of transactions (primarily in Government securities) during the period April 1991 to May 1992. It found out that in April 1992, the first press report appeared indicating that there was a shortfall in the Government Securities held by the State Bank of India. In a little over a month, investigations revealed that this was just the tip of an
iceberg which came to be called the securities scam, involving misappropriation of funds to
the tune of over Rs. 3500 crores. The scam engulfed top executives of large nationalized
banks, foreign banks and financial institutions, brokers, bureaucrats and politicians. The
functioning of the money market and the stock market was thrown in disarray. The scam
generated such immense public interest that it became a permanent feature on the front pages
of newspapers. A large number of agencies, namely, the Reserve Bank of India (RBI), the
Central Bureau of Investigation (CBI), the Income Tax Department, the Directorate of
Enforcement and the Joint Parliamentary Committee (JPC) were all set to investigating the
various aspects of the scam.

Varma (1996), in a study of the weaknesses of the Securities Market, found out that
investors were being treated unfairly. Thus, investors were being misled with impunity.
Using two examples, the study pointed out how easily issuers and merchant bankers got
away with grossly misleading advertisements for public issues. The first example was the
reported decision of the Ministry of Finance to rescind the penalty imposed by the Securities
and Exchange Board of India (SEBI) on SBI Caps for its role as lead manager of the
infamous MS Shoes public issue. The second was the issue advertisements of the IDBI deep
discount bonds which failed to mention that the IDBI had a call option to redeem the bond at
various dates at various prices. This was necessary information that was not made available
to the investors. On the basis of such information investors could decide whether to invest or
not, since the bond without call options were worth Rs 5,300. With call options it was worth
only about Rs 4,800. This showed how significant the concealed information really distorted
the deal in favour of the issuers. The found out that, as the Indian Capital Markets became
more developed, the most important element of investor protection was to ensure that the
information given to investors was true, fair and adequate to enable the investors to make
well informed investment decisions. It found out that it was a matter of grave concern that
issue advertisements in India flout such a requirement with impunity.

Varma (1996), stated that, it was necessary to distinguish between the role of SEBI as a
market regulator and the role of Government as the formulator of national economic policy.
The study found out that it was not the function of the market regulator to manipulate the
micro structure of the market in order to nudge stock prices up or down. Any such attempt is
unreasonable and amounted to rigging stock prices. The study stated that the job of the market regulator was to create a market environment which was efficient and transparent. It stated that such an environment should allow the direction of price movements to the free play of the market forces rather than force in manipulations. It stated that the government as the formulator of economic policy had a very different role to play, that is, the role of controlling the economic fundamentals which were the ultimate determinants of stock prices.

Varma and Barua (1996), also stated that, investors must be protected in all deals, whether they are rights issue, script issue or merger. The study stated that, the right to protection of the investor was of paramount importance. Thus, it lamented that “Under the proposed merger of Hindustan Lever Limited (HLL) and Brooke Bond Lipton India Limited (BBLIL), shareholders of BBLIL were to receive 9 shares of HLL for every 20 shares of BBLIL held by them. Minority shareholders of BBLIL were unhappy because the 20:9 or 2.222222:1 ratio was worse than the ratio of 2:1 (or more accurately 1.9:1) implicit in the market prices at the time of the announcement. It stated that, the awkward ratio of 2.222222:1 left the small shareholders of BBLIL with a large percentage of odd lots after the merger. It found out that the swap ratio was decided on the basis of the advice of two respected firms of accountants and two well-known merchant bankers. This brought to the surface the question of how so many experts could together come up with such an unreasonable conclusion. It found out that the answer was that though the government abolished the office of the Controller of Capital Issues long ago, the ghost of its formula continued haunting Indian companies as well as their accountants and merchant bankers. It was argued that, such a ghost must be exorcised, if dealings in the Indian capital market were to be done at fair and reasonable valuations.

Varma and Barua (1996), in a study, “SEBI Comes down on Bulls to Punish the Bears”, pointed out the reasons which were often given for introducing circuit breakers in the Securities Markets as follow:

a). they prevented a sudden collapse of confidence,

b). they provided time for payment and thereby reduced the risk of default,
c). they provided time for market operators to think through and to decide the stance they found necessary to take in the market.

The study found out that the first reason was extremely erroneous, since it mixed up cause and effect. The last reason given was even more erroneous. It stated that an open market provided an opportunity to trade, but did not create a compulsion to trade. Finally, the argument about default risk was also not valid, because Stock Exchanges could and should use margin requirements to deal with such a risk. It should be borne in mind that this does not at all render the Securities Market a risk free investment environment.

The study advanced several valid arguments against circuit breakers which were as follows:

a). they did not allow the markets to self-correct themselves,

b). they in fact exacerbated the trend by inducing higher volumes as the prices moved close to the band limit, and traders became desperate executing the trade before the circuit breaker took effect,

c). they created illiquidity precisely at times when liquidity was most needed by the market,

d). when applied to only one market, they created arbitrage opportunities.

It stated that, such arguments indicated that regulators must allow a free play of market forces to determine prices of securities in the Market. It pointed out that everything should be done to ensure that reliable information which was the biggest facilitator of proper free markets should be made available simultaneously and easily to all operators for informed decision making purposes.

**Varma and Raghunathan (1996)**, in a study, stated that, the new takeover code by the Bhagwati committee was comprehensive and well drafted. The study pointed out that the code added little value over the existing code of SEBI. It pointed out that some provisions of the code were retrograde, while others lacked rigour. It revealed that the new code was seen as:
(1). A useful tool in the capital market. In one of the most pernicious steps, the new code blocked acquisitions through an exchange of shares.

(2). The stipulation of the Minimum Offer Price was discordant with the spirit of free pricing, and was a needless obstacle in the emergence of an orderly market for corporate control.

(3) While it appeared to allow conditional offers, the code effectively made them unconditional by stipulating that even if the conditions were not met, the acquirer must acquire at least 20 per cent of the shares. This norm was unwarranted and could make transparent takeovers difficult.

(4) The committee had shown excessive concern for incumbent managements by legitimising a creeping takeover.

(5) Together with the effective ban on stock offers, the requirement for an escrow account prevented takeovers by successful, but cash strapped companies. Furthermore, the stipulated 10 per cent was too low to achieve the desired objective.

(6) The code also contained many drafting errors and ambiguities and made understanding rather difficult.

Drucker (1999), identified systemic risk as risk that was inherent in the Capital Market and could not be avoided. The study pointed out that, the only way to avoid it was to abandon the Capital Market investment business. Furthermore, it pointed out that, the Capital Market risks were concerned with volatility in prices and also some poor market conditions which affected demand, in the case of futures and options. It pointed out that SEBI was helping the investors in reducing the Capital Market risks by carefully educating them, bringing in careful rules and regulations which should reduce risks and also the imposition of margin trading.

Varma (2002), with a view on Corporate Governance, stated that from the days of Adam Smith, those who have placed their faith in the free markets had done so in the full knowledge of the greed that permeated human society. It pointed out that, the breakdown of
market discipline may be attributed to State interventions in the free market that fatally weakened its ability to correct itself. However, the arguments were that:

(i). Corporate Governance was compromised by weakening corporate pillars of etiquette and internal control,

(ii). Capital Market discipline was weakened by regulatory restrictions on short sales and inefficient banking regulations,

(iii). the contract enforcement mechanism that was critical for free market capitalism was weakened by restricting private securities litigation,

(iv). the private sector watchdogs failed, because they operated as cosy oligopolies that had no incentive to succeed.

The study stated that, the massive regulatory failures represented by the Enron case and other corporate frauds in the USA are evidence of lack of good Corporate Governance. Failures in market discipline are equally evident, leaving the markets vulnerable and distressing the Investors. The study pointed out that, Corporate Governance checks and balances had not been carefully implemented as they should in corporate and market environment. It concluded that in a nutshell, an infectious greed seemed to have gripped much of the business community and helped to destroy it, at the detriment of the investors.

**Dubey (2007),** examined the risk management of companies and pointed out that, the management of companies dealing in the Capital Market must make sure that all risks taking activities were carefully identified and disclosures made. Such activities as the increased use of derivatives, which possessed a potentially indomitable and preposterous nature, were fuelling the systemic risk in the Indian Capital Market.

**Gaggav (2007),** in a study of risk assessment, pointed out that, risk assessment and management was fast becoming an area of disclosure in the report of Board of directors, and therefore the Capital Market should not be an exception. It pointed out that, the era of demutualization in the Capital Market meant that careful disclosure of risk management
activities, put in place by management, minimized the losses that resulted both to the company and the investors.

**Hyderabad (2007),** in a study of risk management measures, pointed out that risk management measures should be a continuous process. Stating that, the process should help in identifying all risk factors, analyzing risks factors and deciding upon good measures of effective risks handling and control. It found out that, risks handling and control therefore involved such activities as risks identification, risks quantification, risks mitigation and risk insurance. It pointed out that, like other parameters used in taking the temperature of the Capital Market and reporting to investors when to buy and when to sell, there should be a risk measurement parameter that should be reporting the risky level of the Capital Market, so that investors should know when to invest and when not to invest. A risk measurement index was very necessary in the Capital Market. This could help to inform investors when to expect low returns.

**Hyderabad (2007),** in a study of business decision making, found out that, business decision making involved the consideration of risk and return, because higher risks generally entailed higher returns. However, it concluded that, this was not true in the Capital Market, where higher risks led to low returns and even losses.

**Kansara (2007),** in a study of the capital market, pointed out that, the primary market in India had earlier witnessed two major boom periods. The current one was the third and most sustained. There was a fundamental difference in the state of the primary market then and what it was on the earlier two occasions. The first bull phase was during the period of 1986-88, following the Rajiv Gandhi-led government taking charge at the Centre. It was then that the market witnessed a slew of public issues hitting the market. The second boom was during 1994-96, which saw all kinds of entities – from the well-run to the fly-by-night (*next day house to let*), tapping the Capital Market without any substantial fund-raising programme in sight. The Securities & Exchange Board of India (SEBI),(the Capital Market regulator), learnt its lessons from these two experiences and came out with the Comprehensive Disclosure and Investor Protection (DIP) Guidelines, for the first time in the year 2000. These regulations made a vast change in the Indian Primary Market and were a key factor in
the sustainable Bull Run that had been witnessed in the IPO market, since June 2003. The study pointed out that, on the earlier two occasions of the IPO boom, investors were provided with very little information by companies raising funds through the IPO market, to take informed decisions on whether to subscribe to an issue or not. Based on the poor information provided, in the prospectus (all issues were fixed price issues then), decision making was a difficult task. This was because, Companies and merchant bankers hardly used to disclose information about the company’s past, present and future performance. Following SEBI’s decision to move to a disclosure-based process in the fund-raising exercise, the quality of the issuers’ information provision improved, and it has helped in the raising of larger amounts of capital from the domestic market. The situation in the earlier days was that very little information was provided, making investment decisions difficult. The study found out that, the full size of a prospectus, then, was not more than 50 pages, but today due to the comprehensive disclosure requirements, every Draft Red Herring Prospectus (DRHP) for the book built issues), runs into nothing less than 400 pages. The study concluded that, following the Disclosure and Investor Protection (DIP) Guidelines, in the year 2000, the disclosure-based regime in the fund-raising process had attained a maturity level.

Reddy (2007), in a study on corporate governance in the financial sector, pointed out that, in India, as in the case of many other countries, there are several agencies entrusted with the task of regulation and supervision of different institutions and market participants in the financial sector. It pointed out that, the RBI regulated and supervised the major part of the financial system through its various departments under the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. Its supervisory domain covers Commercial Banks, Non- Banking Financial Companies (NBFCs), Urban Cooperative Banks (UCBs) and some of the All-India Financial Institutions (AIFIs). Some of these AIFIs, in turn, regulated and/or supervised other institutions in the financial sector. Thus, the Regional Rural Banks (RRBs) and Central and State Cooperative Banks were supervised by the Reserve Bank of India through National Bank for Agriculture and Rural Development (NABARD); State Financial Corporations (SFCs) through the Industrial Development Bank of India (IDBI) (since transferred to SIDBI) and the Housing Finance Companies through National Housing Bank (NHB). It pointed out that, since 1992, the
Securities and Exchange Board of India (SEBI) has regulated the Capital Markets and supervised several institutions such as the Stock Exchanges, Mutual Funds, Asset Management Companies, securities dealers and brokers, Merchant Bankers and Credit Rating Agencies. SEBI regulated venture capital funds also. The entities in the insurance sector were regulated by the Insurance Regulatory and Development Authority (IRDA), since 1999.

*Economic Times of India (2007)*, reported that the Securities and Exchange Board of India (SEBI) created a database of all participants in the bourses, a move that helped the regulator to keep a watch on traders, investors and intermediaries operating in the market.

It stated that the National Institute of Securities Market (NISM) was coordinating certification in the country's Securities Markets and engaged agencies to administer computer-based tests across the country, (SEBI release). NISM, established by SEBI, also put in place a comprehensive continuing professional education framework involving reputed institutions. SEBI had always organised workshops for market participants on `Certification of associated persons in the Securities Markets. It pointed out that, certification had been mandated in the US, UK and Singapore among other countries. In India, certification was mandated for distributors of mutual funds, traders in derivatives segment and depository participants. The regulations introduced in the year 2007, had enlarged the scope of mandated certification to a number of new segments of intermediaries and their associated persons. It pointed out that, all persons handling investors' money, investor complaints, dealing with operational risk, attending to compliance and persons responsible for management of intermediates must have to demonstrate minimum proficiency standards in order to maintain their registration with SEBI. The certificate was to be obtained by passing an examination approved by SEBI and was valid for three years.

The above reviews fall short of quantifying the risks in the Capital Market. This research project should be able to quantify the risks and examine the functions of SEBI as regulator of the Indian Capital Market. This should be able to guide investors to invest wisely, avoiding losses.

*Varma (2009)*, in a study, Risk Management Lessons from the Global Financial Crisis for Derivative Exchanges, stated that during the global financial turmoil of 2007 and 2008, no
major derivative clearing house in the world encountered distress, while many banks were pushed to the brink and beyond. An important reason for this was that derivative exchanges have avoided using value at risk, normal distributions and linear correlations. The study stated that this was an important lesson. Pointing out that the global financial crisis has also taught the public that in risk management, robustness was more important than sophistication and that it was dangerous to use models that are over calibrated to short time series of market prices. The study applied these lessons to the important exchange traded derivatives in India and recommended major changes to the current margining systems to improve their robustness. It also discussed directions in which global best practices in exchange risk management could be improved to take advantage of recent advances in computing power and finance theory. The study argued that risk management should evolve towards explicit models based on coherent risk measures (like expected shortfall), fat tailed distributions and non-linear dependence structures.

Varma (2009), in a study, Indian Financial Sector and the Global Financial Crisis, stated that though the Indian financial sector had very limited exposure to the toxic assets at the heart of the global financial crisis, it suffered a severe liquidity crisis after the Lehman bankruptcy. The study stated that the liquidity crisis could have been averted with timely injection of liquidity into the system by the Reserve Bank of India. Apart from the liquidity crisis, India also had to deal with the collapse of global trade finance; deflation of an asset market bubble; demand contraction for exports; and corporate losses on currency derivatives. Looking ahead, the paper argued that the crisis was a wake-up call for the Indian banks and financial system for better managing their liquidity and credit risks, re-examining the international expansion policies of banks, and reviewing risk management models and stress test methodologies. The study rejected the widely held notion that financial innovation caused the global crisis and offered examples from the bond markets and securitization to establish the necessity of continuing with the financial reforms. It pointed out that, while India had a high growth potential, the growth was not inevitable. It pointed out that, only the right economic and financial policies and a favourable global environment could make rapid growth a sustainable phenomenon.
Varma (2009), in a study, Satyam Fraud: The Regulatory Response stated that a major fraud was an opportunity to push through important reforms which would otherwise be resisted by powerful vested interests. It stated that this opportunity was missed in India. Point out that the initial regulatory response to the Satyam fraud was swift and appropriate, but this momentum was lost very quickly. Those who hoped for comprehensive and decisive reforms had been disappointed. This means the Corporate Governance principles only rely mainly on the SEBI clause 49 for enforcement.

Varma (2009), in a study Corporate Governance in India: Disciplining the Dominant Shareholder stated that, the nascent debate on corporate governance in India had tended to draw heavily on the large Anglo-American literature on the subject. This paper argued, however, that the corporate governance problems in India were very different. The governance issue in the US or the UK was essentially that of disciplining the management who had ceased to be effectively accountable to the owners. The paper stated that the problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) was that of disciplining the dominant shareholder and protecting the minority shareholders. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself. The paper discussed the role of two such forces - the regulator and the capital market. Regulators face a difficult dilemma in that correction of governance abuses perpetrated by a dominant shareholder. This often implied that a micro-management of routine business decisions which lied beyond the regulators’ mandate or competence existed. The paper discussed the increasing power of the capital market to discipline the dominant shareholder by denying him access to the capital market. The newly unleashed forces of deregulation, disintermediation, institutionalization, globalization and tax reforms are making the minority shareholder more powerful and are forcing the companies to adopt healthier governance practices. These trends are expected to become even stronger in future. The study pointed out that, the Regulators could facilitate the process by measures such as: enhancing the scope, frequency, quality and reliability of information disclosures; promoting an efficient market for corporate control; restructuring or privatizing the large public sector institutional investors; and reforming bankruptcy and related laws. In short, the key to better corporate governance in India today lies in a more efficient and vibrant capital market. The study pointed out that, things could change in the
future, if the Indian corporate structures also approach the Anglo-American pattern of near complete separation of management and ownership.

**Literature Gaps**

(1) The Indian Capital Market listed companies have not monitored their performance in any form, for a very long time. It necessary to examine performance trends between the period 1992 to 2006 (15 years) to see the significant difference between the market returns performance and company returns performance.

(2) The risks present in the Indian Capital Market, has never been quantified to let the investors know how much risks they have to bear as investors of the Capital Market.

(3) Brokers, sub-brokers and investors’ perception about SEBI has never been studied. There is a need to study their perception, in order to fine out their problems. This leads us to part two, the Regulatory and Empirical Framework of SEBI.

Chapter two has carefully provided the literature review of this project. The literature review has revealed the reasons why this research work was necessary. This literature review has helped to bring out the gaps (as mentioned above) which this research would help to close up.