THE CAPITAL MARKET REFORMS IN INDIA

CHAPTER – 3

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Since independence, a number of steps have been taken by the Government of India to ensure the organized growth of capital market. The Capital Issues (control) Act 1948, The Companies Act 1956 and, The Securities Contracts (Regulation) Act 1956 are prominent among them. The Capital Issues (control) act 1948 was initiated to prevent, regulate and control investment by companies to protect the interests of the investors by examining the terms of capital issues, capital reorganization plans including mergers and amalgamations and foreign investment. The Companies Act 1956 envisaged an integrated pattern of relationship between the various components of corporate business. The main object of the Securities Contracts (Regulation) Act 1956 was to have a strong and healthy investment market and ensure investor confidence. The Monopolies and Restrictive Trade Practices Act (MRTP) which came into existence with effect from June 1, 1970 was to prevent concentration of economic power in private hands and to control restrictive trade practices. Moreover, a number of specialized financial and development corporations were established to finance large scale industrial development. Finally, the Reserve Bank of India and the government have been taken steps for the integration of organized and unorganized sectors of the capital market, development of rural credit, financial inclusion and the diversification of the functions of the commercial banks.

In this section we summarize briefly the capital market reforms initiated since 1980s.

Capital Market Reforms at a Glance

1980 – 2005

- In 1981-82, the ceiling on payment of dividend on preference shares and interest on debentures were raised.
- In April 1982, different rates of interest for CDs and NCDs and premium on the face value of debentures were permitted.

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1 This part is largely taken from various volumes of; (1) The Report on Currency and Finance, RBI, (2) Economic Survey, Ministry of Finance, Government of India.
In 1982-83, Non-Resident Indians were allowed to invest with repatriation rights up to 40% of the capital issue.

The exemption limit of income tax and wealth tax for investments in government securities, UTI, bank deposits and shares of Companies raised.

1982, it has been designated as the “Productivity Year”.

In 1984-85, interest on debentures and dividend on shares up to Rs. 1000 has been allowed without deduction of income tax to encourage small investors.

On May 17, 1984, Patel Committee was appointed to review the smooth working and the expansion of stock exchanges in India.

On September 15, 1984, Government issued revised guidelines for the issue of debentures by public limited companies.

In 1985-86, two stock option schemes were introduced such as; (1) Employees Stock Option Scheme (ESOs) and (2) the preferential allotment of 5% of any further issue for their employees.

In 1985-86 Government announced liberalization measures to certain specific industries such as;

(1) liberal export-import policy for three years,
(2) exemption of 18 additional categories of industries from Sec. 21 and 22 of MRTP Act for a period of 5 years,
(3) new textile policy for harmonious growth of all sectors of the textile industry, (4) de-licensing of additional 82 bulk drugs, and,
(5) broad banning of certain products of the engineering industry into 14 categories for the purpose of licensing, affording flexibility to product-mix.

In January 1987, companies are allowed to offer issues to financial institutions or on rights basis to existing shareholders based on certain conditions.

In 1987-88 Government proposed to set up a separate board for the regulation and orderly functioning of stock exchanges and security industry.

In 1988, the ceiling on inter-corporate investments and loans were raised from 10% to 25% and 10% to 20%.

In October 1988, foreign investment norms were relaxed to allow foreign equity participation in selective basis subject to a ceiling of Rs. 10 Crores.
Foreign companies were allowed to apply for the grant of industrial licenses for establishing new undertakings in India.

In this period, three more financial instruments were introduced:
1. India Growth Fund launched by UTI in USA and other countries in August 1988,
2. SBI issued 7 year US dollar denominated Non-Repatriable NRI bonds in November 1988, and,
3. CCI approved Partly Convertible Debenture has launched in January 1989.

In June 1989, government granted recognition to 3 new stock exchanges (Total 18) and it permitted multiple memberships of stock exchanges.

Instead of trading in lots of 100 share of Rs. 10 each, the government revert the policy to trade in lots of 50 shares of Rs. 10 each and 5 shares of Rs. 100 each.

The listing guidelines were revised w.e.f. February 13, 1989. The minimum capital limit and minimum offer to public for subscription raised.

SEBI introduced National Equity Index with 1983-84 as the base year and include 100 scrips.

To ensure participation of small investors, Equity Linked Saving Scheme by UTI, and loans to employees for purchasing shares of their own companies were announced.

In 1989, SEBI submitted a draft framework for comprehensive legislation dealing with capital market.

The government approved the creation of Over the Counter Exchange of India (OCTEI) under the Securities Regulation Act, in August 1989.

In January 1990, the government reduced the minimum period between two bonus issues from 24 months to 12 months.

In April 1990, the government issued a set of guidelines for share transactions by FIs or debentures more transparent.

In July 1990, the government released guidelines to public for valuation of shares and fixation of premia.

The SEBI has been entrusted for the supervision of MFs, transactions or sales of shares by FIs, and takeover of companies through acquisition of shares on the stock exchanges.
All mutual funds except those established by a statute would require the approval of CCI and SEBI. Existing mutual funds are to get registered with SEBI.

The accounting and disclosure requirements of mutual funds would be prescribed by SEBI.

Capital Market Reforms in the Post 1990 Period

During 1990-91, the government set up 4 committees to look into the problems of capital market. They are; (1) Pherwani Committee (Feb 1991), (2) Ajit Dey Committee (Feb 1991), (3) Dave Committee (Feb 1991) and (4) Pherwani Committee (April 1991).

A committee was appointed in August 1991 under the chairmanship of Shri. M. Narasimham, to examine all aspects of the structures, organization, function and procedures of the financial system.

OTCEI accorded recognition by the Ministry of Finance as a stock exchange under Securities Contracts (Regulation) Act, 1956.

A number of reform proposals relating to financial sector, SEBI, stock exchanges, mutual funds, public sector and foreign investments, were announced in the Union Budget for 1991-92.

A Presidential Ordinance promulgated on January 31, 1992, accorded statutory status as an autonomous body to SEBI- to protect investor's interest in securities, to promote the development of the capital market and to regulate the working of the market including the stock exchanges.

Parliament passed SEBI Bill on April 4, 1992.

SEBI has been given substantial powers under the SEBI Act 1992 to regulate the activities of various players in the capital market and give direction to the developments in the capital market.


In 1992-93, reputed foreign investors (FIIs) were allowed to invest in capital market such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies, and incorporated portfolio managers.

FIIs started investing in India in January 1993.
Investment norms for NRIs liberalized, so that NRIs and overseas corporate bodies can buy shares and debentures with prior permission of RBI.

Indian Companies permitted to access international capital markets through Euro-equity shares.

SEBI's autonomy reinforced and allowed it to issue regulations and file suits without prior approval of the Central Government.


Regulations pertaining to stock brokers and sub brokers In October 12, and in November 1992, it has given instructions relating to "insider trading".

Over-the-Counter Exchange of India (OTCEI) and the National Stock Exchange of India (NSE) with nation wide stock trading and electronic display, clearing and settlement facilities, commenced operations.

Private mutual funds permitted and several have already been set up. All mutual funds allowed to apply for firm allotment in public issues.

Companies with good track record permitted to issue Convertible Debentures (CD) or equity to investors abroad (One company entered the international capital market during May 1992)

In OTCEI, the first public issue was made in July 1992. Trading commenced in September 1992.

In April 1993, RBI formed Securities Trading Corporation of India (STCI) to promote and develop secondary market in government securities and public sector bonds.

In April 1993Rangarajan Committee submitted its report on Disinvestment of Shares in Public Sector Enterprises.

In March 1994, Government of India invited tenders for selling equity shares of 7 Central Public Sector Enterprises (CPSEs).

UTI brought under the regulatory jurisdiction of SEBI.

In May 1994, RBI, given complete flexibility to the banks for the investment and underwriting of shares and debentures of corporate bodies.

SEBI has prescribed improved disclosure standards, introduction of prudential norms and simplification of issue procedures.
Companies required to disclose all material facts and specific risk factors associated with their projects while making public issues.

Stock exchanges advised to amend the listing agreement to show the variations between financial projections and projected utilization of funds made in the offer documents and actuals.

SEBI introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.

In January 1995, Securities Contracts (Regulation) Act 1956 amended to allow trading of options in securities and to establish additional trading floors.

In March 1995, the GoI amended SEBI Act, 1992 to give more powers to SEBI.

In July 1995, an Expert Committee appointed by Shri Y.H. Malegam as the chairman, to review the existing disclosure requirements and issue procedures.

In September 1995, Depositories Ordinance was promulgated which empowers SEBI to make regulations.

In October 1995, SEBI issued guidelines for a ‘carry forward’ trading in a revised form.

SEBI to vet the draft prospectus within 21 days and mandatory period between the date of approval of the prospectus by the Registrar of Companies and the opening of the issue to be reduced to 14 days.

SEBI reconstituted governing boards of the stock exchange, introduced capital adequacy norms for brokers and made rules for making the client/broker relationship more transparent, in particular, segregating client and broker accounts.

In 1996-97, Housing Finance Companies considered to be registered for issue purposes provided they were eligible for refinance from the National Housing Bank.

Stock Exchanges asked to modify the listing agreement to provide for payment of interest by companies to investors from the 30th day after the closure of a public issue.

Uniform good-bad delivery norms and procedure for time bound resolution of bad deliveries through Bad Delivery Cells prescribed.

All exchanges are directed to institute the buy-in or auction procedure being followed by the National Stock Exchange.
- The Stock Exchange, Mumbai and other exchanges with screen based trading systems allowed to expand their trading terminals.

- Several restrictions OTCEI removed, and listing criteria for OTCEI, relaxed.

- In 1997-98, the disclosure standards have been strengthened with corporate entities being required to publish their unaudited financial results on a quarterly basis.

- On November 13, 1997, SEBI allowed institutional investors, stock brokers, stock exchanges etc. to make use of ‘warehousing’ (execution of firm client order with one contract note) of trades, subject to certain conditions.

- On December 5, 1997, SEBI (Merchant Bankers) Regulations 1992 directed non-banking financial companies (NBFCs) operating as merchant bankers to segregate their Capital market related activities from the NBFC activities.

- On March 6, 1998, SEBI signed a Memorandum of Understanding (MoU) with the United States Securities and Exchange Commission regarding co-operation, consultation, and provision of technical assistance.

- On October 31, 1998, the Companies (Amendment) Ordinance promulgated empowering companies to purchase their own shares or other specified securities (referred to as “buy back”).

- In June 1998, as per provisions of the Companies (Amendment) Ordinance, companies are allowed to issue sweat equity shares subject to authorization by a resolution passed by a general meeting

- On July 6, 1998, SEBI prescribed Additional Volatility Measures (AVM) to curb volatility in share price. It includes; (1) The daily price band was reduced from 10% to 8%. (2) Weekly price band of 25% was removed and a graded margin was prescribed.

- From 15, 1998, SEBI introduced compulsory trading of shares in dematerialized form in specified scrips by institutional investors (FIIs, MFs, Banks, and FIs).

- More over SEBI took the following the steps;
  
  (1) Rolling settlement on T+5 basis introduced in the dematerialized segment and delivery of dematerialized shares permitted in the physical segment.

  (2) The list for compulsory demat trading expanded to 103 and to increase it to 304 by Feb 15, 1999.
(3) From February 15, 1999, delivery of shares in dematerialized form has been made compulsory for all investors in 31 scrips.

- The Central Depository Services (India) (CDL), the second depository in the country has been granted certificate of registration.
- In December 1999, Insurance Regulatory and Development Authority (IRDA) Bill passed by the Parliament, open up the insurance sector to the private providers, allowed foreign equity in domestic insurance companies subject to a maximum of 26% of the total paid up capital.
- In December 1999, the Securities Laws (Amendment) Bill, 1999 proposing expanded definition of securities including derivatives has been passed by the Parliament.
- Rolling settlement was introduced by SEBI for the first time in 1998 by making it optional for demat scrips.
- SEBI has selected 10 scrips for rolling settlement on a T+5 basis with effect from January 10, 2000.
- SEBI has proposed internet trading in a limited way under Order Routing System (ORS) through registered stock brokers on behalf of clients for execution of trades on stock exchanges.
- In July 1999, as per the recommendations of Shri. K.B. Chandrasekhar on Venture Capital, the guidelines for overseas Foreign Currency Investment in India dated September 20, 1995 repealed.
- Mutual Funds, banks, insurance companies should be permitted to invest in SEBI-registered Venture Capital Funds.
- During the period 2000-01, SEBI guidelines (Disclosure and Investor Protection) revised in terms of the offering of post issue capital to public, book-building, the promoter's lock-in provision, and time limit for allotment.
- The Companies (Amendment) Act 2000 passed.
- On June 9, 2000, derivatives trading commenced at the NSE based on Sensex and on June 12, it started based on S&P CNX Nifty.
It has been decided to setup an Investor Grievance Redressal Cell (IGRC) in the Department of Company Affairs (DCA) which includes RBI, SEBI, and DCA.

On March 2001 the Union Finance Minister proposed the following steps;

1. Computerization of stock exchanges involving segregation of ownership, management and trading membership from each other.

2. Extension of rolling settlement to 200 ‘A’ category stocks in Modified Carry Forward Scheme (MCFS),

3. Automated Lending and Borrowing Mechanism (ALBM),

4. Borrowing and Lending Securities Scheme (BLESS) by July 2, 2001 and,

5. Legislative changes aimed at further strengthening the provisions in the SEBI Act, 1992 to ensure investor protection.

With effect from July 2, 2001, SEBI extended rolling settlement to all scrips included in the ALBM/BLESS/ MCFS.

From December 31, 2001, all stocks are under rolling settlement in all stock exchanges. This constitutes one of the most far-reaching reforms in the history of India’s capital market.

The freedom to issue debt security without listing equity has been granted to all companies, subject to a credit rating of issues.

SEBI’s Disclosure and Investor Protection (DIP) Guidelines 2000 were amended; include Foreign Venture Capital Investors (FVCIs) and SIDCs to participate in public issues through the book building route.

In June 2001, RBI issues guidelines to banks related to prudential limits on investments, due diligence, and internal ratings in respect of unrated issues.

In the secondary market, all scrips have been brought under the rolling settlement mode, replacing “account period settlement” by “T+5 rolling settlement”.

In March 2001, the Finance Minister announced to introduce rolling settlement in 200 scrips.

On July 2, 2001, SEBI announced a list of 251 scrips for compulsory rolling settlement on all exchanges.

On December 31, 2001, rolling settlement was extended to all scrips on all exchanges.
In December 2001, SEBI announced that from April 1, 2002, the settlement cycle for all securities would be shortened to T+3 basis. With this Indian securities market would be complying with the standard of the Bank for International Settlements and the International Organization of Securities Commissions.

Restrictions on short sales were withdrawn w.e.f. July 2, 2001.

Stock exchanges were allowed to use the Settlement Guarantee Funds (SGFs) for meeting shortfalls caused by non-fulfillment/partial fulfillment of obligations of members, before declaring them defaulters.

Government amended Securities Contracts (Regulation) Rules 1957, to standardize listing requirements on stock exchanges.

On October 1, 2001, the central government notified the establishment of the Investor Education and Protection Fund (IEPF).

A committee under the chairmanship of Dr. N.L. Mithra submitted its study report on Investor Protection to SEBI and Government.

In July 2001, trading in stock options and in November 2001, futures trading on individual stocks were commenced.

In November 2002, SEBI announced modified rules governing the choice of stocks on derivatives trading.

On 31st January 2002, the list of firms for derivatives trading rose to 41.

In July 2002, SEBI set up Electronic Data Information Filling and Retrieval (EDIFAR). This mechanism offers electronically disclosures to SEBI, and to individuals across the country over the internet with a near zero delay.

In 2001, the Clearing Corporation of India (CCIL) established to perform clearing functions for the debt market like the National Securities Clearing Corporation (NSCC) (1996) in the equity market.

In March 2002, guidelines were issued to enable mutual funds to invest in rated securities in countries with fully convertible currencies. This marks an important milestone, through which mutual funds will be able to trade internationally.

On 28th October 2002, an ordinance was promulgated which repealed the UTI Act, and created two entities, UTI-1 and UTI-2.
On 28th October 2002, an ordinance was promulgated which seeks to strengthen SEBI and better empower it.

On April 1, 2003, government issued a notification rescinding all previous notifications which prohibited futures trading in a large number of commodities. These have set the stage for commodity futures trading in the country.

Based on the recommendations of the Forward Market Commission (FMC), granted recognition to –

- National Multi Commodity Exchange, Ahmedabad (NMCE),
- Multi Commodity Exchange, Mumbai (MCX),
- National Commodity and Derivative Exchange (NCDEX) Mumbai,

– as nation-wide multi-commodity exchanges.

MCX commenced operations in November 2003, NCDEX in December 2003. NCDEX has set up 505 terminals in 138 centers, MCX has set up 763 terminals in 132 centers and NMCE has set up 346 terminals in 90 centers across the country.

FMC initiated trading in gold and silver futures in 2003-04. Turnover has grown dramatically from 223 kg of gold in October 2003 to 21413 kg of gold in March 2004. Similarly, silver turnover grew from 3.6 metric tones in October 2003 to 395 metric tones in March 2004.

Demat settlement for commodities; the first commodity electronic dematerialization, transfer and delivery were undertaken for one kilogram of gold on February 24, 2003. This was the first electronic transfer of commodities in the country.

On the application of sectoral FDI limits upon FII investments, a committee chaired by the Chief Economic Advisor with the representatives from the Department of Economic Affairs and Department of Industrial Policy and Promotion was formed. The committee submitted its report in June 2004.

Its recommendations include;
- Simplification of registration and renewal of FII status.
- FII investment ceilings should be reckoned over and above FDI sectoral caps.
- A provision for raising FII investment beyond 24% up to the FDI limit in a company should be dispensed with by amending the relevant SEBI–FII regulations.
In order to provide dispersed investments, the present cap of 10% by an FII in a single company should be retained.

Apart from the above in 4 sectors the composite cap on FDI and FII may be enhanced to: Telecom – 74%, Defence – 49%, PSU banks – 20%, Insurance – 49%.

The prohibition on FII investment in print media and gambling may continue.


The major recommendations include:

- Ensure primary issuance process on a T+6 basis.
- Provide differential weightage to applications received earlier.
- Receipt of electronic forms with electronic remittances and use of digital signatures.
- To consider encouraging mutual funds to go through either the depositories model or a distributor model.
- SEBI should review the current procedure of giving the NAV to investors before the funds are actually received by the mutual fund.

Formation of SEBI

The most significant development during this period was the emergence of Securities and Exchange Board of India (SEBI). It was set up by government of India on April 12, 1988 on the recommendation of high powered Committee on Stock Exchange reforms headed by G.S. Patel. It was given a statutory status on April 30, 1992 by promulgation of SEBI ordinance which has since become an Act of parliament. SEBI has been given substantial powers under the SEBI Act 1992 to regulate the activities of various players in the capital market and give direction to the developments in the capital market. Some of the important powers of SEBI are:

1. Regulation of securities market,

2. Registration and regulation of stock brokers, merchant banks, underwriters, portfolio managers, and such other intermediaries who may be associated with the securities market in any manner whatsoever,
prohibition of fraudulent and unfair trade practices relating to securities market,
prohibition of insider trading in securities market,
regulation of substantial acquisition of shares and takeovers of companies,
promotion of investors' education and training of securities markets,
promotion and regulation of self regulatory organization and
calling information from, conducting inquires and audit of stock exchanges,
intermediaries and self regulatory organizations in the securities market.

After the emergence of SEBI on the Indian Capital market, major reforms in the capital market have been carried out. Capital Issues (Control) Act, 1947 repealed on May 29, 1992. Office of the Controller of Capital Issues abolished and share pricing decontrolled. SEBI became the regulatory authority. The companies can approach capital market after clearance by SEBI. Operational guidelines for investments by Foreign Institutional Investors (FIIs) were issued by the Government of India in September 1992. Foreign Institutional Investors (FIIs) allowed access to Indian capital markets on registration with SEBI. Investment norms for NRIs liberalized, so that NRIs and overseas corporate bodies can buy shares and debentures with prior permission of RBI. Indian Companies permitted to access international capital markets through Euro-equity shares. SEBI's autonomy reinforced and allowed it to issue regulations and file suits without prior approval of the Central Government. SEBI issued guidelines for development financial institutions in September 1992. Regulations pertaining to stock brokers and sub brokers In October 12, and in November 1992, it has given instructions relating to "insider trading". Over-the-Counter Exchange of India (OTCEI) and the National Stock Exchange of India (NSE) with nation wide stock trading and electronic display, clearing and settlement facilities, commenced operations.
Banking Sector Reforms

Before 1991, we had an unprofitable, inefficient and financially unsound banking sector. The profitability of Indian banks was extremely low. The average return on assets in the second half of the 1980's was 0.15%, an extremely low figure by world standards. Capital and reserves averaged about 1.5% of assets compared to 4 – 6% in other Asian countries. Not only were they unprofitable but also provided an abysmal quality of service. There are external and internal causes behind this. The external causes pertaining to the regulatory framework such as pre-emption of bank resources, directed credit, administered interest rates, port-folio quality and lax regulation and supervision.

The pre-emption of bank resources by way of CRR and SLR has steeply increased over the period. In 1960's and 70's CRR was around 5% which increased to its legal upper limit of 15% in early 1991. SLR at the same time grew up from 25% to 38.5%. Thus, more than 50% of the resources of banks were taken away from its commercial activities. Further, the tool of directed credit to certain priority sectors at concessional rate of interest enhanced from 33% in the 60's to 40% in 1991. Interest rates were administered by the government. Bank's portfolio quality was poor due to the weak accounting rules, high quantitative targets, political influence and inadequate legal support. Finally, lax regulation and supervision because of vague accounting norms and financial discipline was responsible. The internal factors are low organizational efficiency, lack of competition, and political interference. Organizational inefficiency was due to rampant over manning, bad industrial relations, and inadequate incentives for managerial competence. The public sector banks had no incentive to compete. Lending to large borrowers was subject to consortium arrangements in which banks shared in inflexible proportions. Moreover, bank credit that was subject to political manipulation, reduced the ability to manage portfolio risks.

Certain important banking sector regulations are mentioned below.
A new committee on financial system under the chairmanship of M. Narasimham was appointed in August 1991. In April 1992, RBI issued guidelines for income recognition, asset classification and provisioning and adopted the Basle Accord capital adequacy standards. These norms began to be applied in the accounts of the year ending 31st March 1993. Banks were expected to reach a 4% capital to risk-assets ratio by 31st March 1993 and 8% by 31st March 1996. At the end of March 1995, 13 banks had achieved a capital adequacy ratio of at least 8%, another 11 between 4 and 8%. On pre-emption of bank resources, the government reduced SLR. By March 1995, the incremental SLR was 25% and average SLR was down to 29.5% compared to 38.5% in 1991. In 1991, the CRR was 15% with an incremental 10% on top. By mid 1993, it had reduced to 14% and the increment abolished. It further rose to 15% in 1994. On interest rates, coupon rates on government bonds were increased from 9.5% in 1984/85 to 11.5% in 1989/90. Rates in the call money market were freed in 1989. In April 1992, a 364 day Treasury Bill was replaced the 182 day Bill, sold by auction and was not rediscountable with RBI. In January 1993, a 91 day Treasury Bill sold by auction, was introduced. In April 1992, the commercial bank deposit and loan rates structure has been made much freer and simpler. In 1974, the directed credit to priority sectors was 33%, increased to 40% in 1985; of which the share of agriculture was 18%. By March 1995, credit to agriculture and directed credit as a whole fell to 13% and 33% of bank credit. In January 1993, the RBI announced guidelines for the entry of new banks.