# CHAPTER: 1

## INTRODUCTION

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CHAPTER: 1

INTRODUCTION

Forms of business organization are varied like, sole proprietorship, partnership, joint stock company and co-operative society. The main objective of each form is to carry out economic activities in the form of manufacture, trade and providing ancillary services. The joint stock company form of business is unique among all of them. Many persons can become its owner by contributing capital according to their own choice with a limited liability to the extent of capital contribution only. A company form of business has its own existence apart from its owners and therefore the existence of company does not depend on the existence of its owners. These features ensure perpetual succession of the company as well as collection of huge amount of capital involving many fund providers. On the other part, regulations for managing the affairs of company is also very important because it involves the interest of many stakeholders, who directly do not have control over management of the company. Hence, the company form of business is more regulated then any other form of business organization. Consequently, the regulations have considerable impact on decision of financing required capital for companies.

1.1 HISTORICAL BACKGROUND OF DEVELOPMENT OF REGULATORY FRAMEWORK REGARDING JOINT STOCK COMPANIES IN INDIA

Joint stock companies in India were under direct control of the British authorities without any separate legislation until 1850. An act for registration of companies was enacted in 1850 as English Companies Act 1844. In India the Supreme Courts of Calcutta, Madras and Bombay were authorized to order the registration of joint stock companies under this act. This act did not confer the privilege of limited liability to members. The Joint Stock Companies Act, 1856 consolidated the law and allowed greater freedom of incorporation and limited liability to members. It was also provided in this act that those who deal with such companies should be informed that the liability of members was limited. In 1857, the act was further revised and the registration was extended with or without limited liability. Insurance and banking companies were not allowed limited liability of members by this act. In 1862 the British parliament enacted the “Companies Act, 1862” consolidating all previous acts and amendments (web source).
A comprehensive act was passed in India in 1866 as "The Laws relating to incorporation, regulation and winding-up of trading companies and other associations". This act was amended in 1882 to incorporate the changes made in Companies Act in England. Between the years, 1882 and 1910 five acts were passed in England. Following these acts, The Companies Act VII of 1913 was passed in 1913. This act was amended in 1914, 1932, 1936 and thereafter every year until 1946. The main provisions made in this act were regarding objects, branch, payment of interest out of capital, issue of debentures etc. All powers of implementing the act were conferred to supreme courts in India (web source). After independence, Ministry of finance of Government of India was governing the matters of joint stock companies. The first consolidated act governing all matters of joint stock companies after independence was enacted in 1956 by the act of parliament called as "Indian Companies Act, 1956". This act was amended by inserting and omitting many clauses from time to time by the government on the recommendations of regulatory authorities like Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), Ministry of Finance, Industry Ministry and Central Board of Direct Taxes (CBDT).

1.2 HISTORICAL BACKGROUND OF REGULATORY FRAMEWORK RELATED TO CAPITAL MARKET IN INDIA

The capital market is the place from where long-term funds are raised by companies for meeting their requirement of capital for new projects, modernization and expansion programmes, long-term working capital requirements, repayment of loans and for various other purposes. The capital market mobilizes the long-term savings of individuals for investment in shares, debentures, units of mutual funds and other financial instruments, which are ultimately deployed for productive purposes in various sectors of the economy. Capital market thus plays a vital role in channelizing the savings of individuals for investment in the economic development of the country.

Broadly, capital market comprises two segments—the new issue market which is commonly known as the primary market and the stock market which is known as the secondary market.
1.2.1 Historical background of regulatory framework related to primary market

Regulatory framework of primary market represents the policy of the government regarding capital issues, whether the capital issues are highly controlled and regulated or supervised under liberalized policy. Under the policy of control, capital issues in primary market are highly regulated and controlled by the government and avenues of raising funds by private companies are restricted and therefore market oriented sources of fund can not develop. Under the liberalized policy the scope of raising funds from the primary market is widened, regulations are streamlined and companies are encouraged to use any source of fund available to them without any restriction by satisfying the underlying regulatory conditions. Indian primary market has gone through the process of both, control based regulations from independence until 1991 and disclosure based regulations under liberalized policy from the year 1992 onwards.

Capital issues control was first introduced under Rule 94-A of the Defence of India Rules which was promulgated on 17th May 1943 under the Defence of India Act, 1939. It was designed to prevent the establishment of those industries which did not assist in the production of war goods. The act was also aimed to restrict the growth of those companies, which had little chance of survival in normal times. After the World War II, capital issues control was retained and Rule 94-A of the Defence of India Rules was replaced by Capital Issues (Continuance of Control) Act, 1947. The said Act was passed to secure a balanced investment of the country's resources in industry, agriculture and the social services. The Act was enacted for a period of 3 years and was successively extended in 1950 and 1952. Subsequently, the term "Continuance" was omitted in 1956 and the Act came to be known as "The Capital Issues Control (CIC) Act, 1947". Office of Controller of Capital Issues (CCI) was established under this act to implement the CIC Act in 1947. Indian Companies Act, 1956 was the comprehensive act, promulgated in 1956. Many rules and regulations were added to CIC Act and Companies Act. Amendments were also made from time to time to these acts. As a part of reform process, the major development towards changing the entire scenario of Indian capital market took place when Securities and Exchange Board of India (SEBI) was enacted by repealing the office of CCI in 1992 (Sekhar, 1994).
The regulatory powers of the SEBI were increased through the Securities Laws (Amendment) Ordinance of January 1995, which was subsequently replaced by an Act of Parliament. SEBI under the overall control of the Ministry of Finance has become a very important constituent of the financial regulatory framework in India.

Other regulatory authorities like Reserve Bank of India, Central Board of Direct Taxes, Ministry of Finance and Industry ministry also govern matters of the capital issues under their jurisdiction.

All these regulatory authorities brought phenomenal change in the Indian capital market to bring full transparency, ensuring investors' protection, developing more avenues of domestic and foreign capital for Indian companies, evolving new routes of capital issues and making the Indian capital market global.

1.2.2 Historical background of regulatory framework related to secondary market

Secondary market is a place, where securities issued in primary market are traded in stock markets. Secondary market provides liquidity to investors of primary market. Thus primary market and secondary markets are two sides of one coin, i.e. capital market.

The history of secondary market in India is 135 years old.

Associations to trade in securities were formed in India in 1875 for the first time in Mumbai and then in 1894 in Ahmedabad and in 1908 in Kolkata before independence. However, these associations were not recognized by any statutory body of the government. The first Act regulating the activities of trading in securities was enacted in 1925 in India as Bombay Securities Contract Control Regulation Act (BSCCRA), 1925. However the impact of this act was insignificant because these associations were not recognized and regulated under this act. In 1954 a committee was formed under the chairmanship of Mr. A. D. Gorwala to scrutinize the draft on formulation of stock exchange in India and on recommendations of this committee, Securities Contract Regulation Act (SCRA), 1956 was enacted. The SCRA provided a broad framework of present structure of stock exchanges regulations in India (Khan, 2007).

Securities Contract Regulation Act, 1956 came into force from 16-02-1957 and it was amended from time to time. The main objective of the act was to prevent undesirable
transactions in securities and other matters concerning it. Provisions enacted under this act from time to time are regarding recognition, corporatization and demutualization of stock exchanges, annual report to be furnished by stock exchanges, clearing corporation, power of recognized stock exchanges to make bye-laws, power of Central Government to supersede governing body of a recognized stock exchange, suspend business of recognized stock exchanges, to issue directions, to prohibit contracts in certain cases, listing conditions etc. Finance Ministry of Government of India was in charge of implementing the SCRA, 1957 till 1992 and thereafter SEBI was conferred powers to implement and amended the act for regulating Indian capital market.

1.3 SIGNIFICANCE OF CAPITAL STRUCTURE FOR THE JOINT STOCK COMPANIES

Capital structure has its own significance for the corporate sector because it comprises of varieties of sources of equity and debt fund provided by many stakeholders in the role of fund providers as shareholders or moneylenders. Most of them remain passive in decision-making process regarding financial and business matters. Moreover, the capital structure is a blend of long term capital in the form of equity and debt, which affect the monetary interest of fund providers whether they are shareholders or money lenders. The equity and debt have their own features distinct from each other. This feature of capital structure has consumed a lot of energy and time of various experts to decide the optimum blend of equity and debt to safe guard interest of all fund providers and maximize the value of the firm by creating synergy effect of financing decision. Moreover, capital structure of a corporate entity is a mirror, which reflects the financial health of the company in terms of long-term financial soundness, size of the firm and scope for expansion and development of the business.

These unique features of capital structure of the corporate sector has contributed to the development of regulated capital market to mobilize funds form financial institutions and micro savings of individuals. As it involves the interest the passive stakeholders, regulations governing the different sources of equity and debt funds have become inevitable. Consequently, regulatory framework has been developed to regulate capital market and activities of raising funds by corporate sector across the glob.

In the post liberalized era the capital structure of Indian companies have become more complex as Indian companies were allowed to raise funds from international capital market also in the form of equity and debt. Scope of raising funds from international capital market has many fold impact on capital structure of a company which domestic
capital market does not have. A huge amount of funds at low cost can be raised from international capital market. However, the risk of foreign exchange attached to foreign funds creates vital impact on the cost of capital and book value of capital, which affects capital structure of the company. Fluctuation in exchange rate and redemption conditions of foreign debt affects the cash out flow. Cash out flow at the time of redemption at prevailing market rate as per the terms of redemption results into abnormal profit or loss for the company, which affects the profitability of the company considerably. Thus foreign sources of funds have advantage of ease in raising more amount of funds at low cost but at the same time the problem of its deployment in the project and increased risk due to exchange rate fluctuation adds more significance to the capital structure of a company.

1.4 DEVELOPMENT OF SOURCES OF FUNDS AND ROUTES OF CAPITAL ISSUES IN INDIA

Before enactment of SEBI the sources of capital which were practically available to Indian companies were very limited. Equity shares, preference shares, debentures and loan were the main sources of raising capital for Indian companies. During SEBI regime, many new instruments of capital market were introduced based on the recommendations of Abid Hussain Committee (1989) and Pherwani Committee (1991). Different types of equity shares, preference shares, debentures, bonds and warrants were introduces in domestic capital market. Many new routes of capital issues like preferential allotment, Qualified Institutional Placement (QIP), book-building offer, Employees Stock Option Plan (ESOP) etc. were introduced in domestic capital market to facilitate the use of different new sources of funds to raise capital from domestic capital market (Sekhar, 1994).

Indian companies were also allowed to raise funds from foreign capital market during post reform period, which increased further the scope of raising funds for Indian companies. New international sources of foreign equity like American Depository Receipts (ADR), Global Depository Receipts (GDR), European Depository Receipts (EDR), Singapore Depository Receipts (SDR) etc. and foreign debt like External Commercial Borrowing (ECB), Foreign Currency Commercial Borrowing (FCCB), External Non-Convertible Bonds (ENCB), foreign currency loan etc were made available for Indian companies. Thus, Indian companies have wide scope of choice
among various sources of funds and routes of capital issues to raise funds during post reform period.

1.5 SELECTION OF RESEARCH PROBLEM

Due to the reform process in capital market in India, new avenues for raising funds through different sources via different routes opened for Indian companies in domestic as well as international capital market during post reform period. The reform process has now become a continuous process, as regulatory authorities like Government of India, SEBI, RBI, CBDT etc. have been active in governing the matters of capital issues after 1992 to implement the reform process in Indian capital market. Indian companies have also adopted new sources of domestic and international equity and debt fund in their capital structure. Thus, the capital structure of Indian companies is affected by policy changes to a considerable extent during post reform period. These changes opened new challenges for determining the optimum capital structure due to impact of regulatory policy changes on capital structure of Indian companies.

Capital structure has been a focus of continuous research but most of it directed towards analyzing and comparing cost of various components capital of a company with a view to arrive at the optimum capital structure. The significance of capital structure, the survival, profitability and liquidity aspect of the company has also been focused in intensive research. These researchers assumed either an absence of regulations in the capital market thereby indirectly assigning a free market perfectly competitive type of characteristics to the capital markets or in other cases the regulation and control of capital market was not perceived to have any impact on the cost of capital and there from the capita structure of a company. Both these assumptions may be erroneous in the present market situation where the regulatory focus has been shifted from control based to disclosure based. The frequent changes in policies whether proactive or reactive has led to equally fast changes in the capital structure of companies. This type of small and large proactive and reactive regulatory changes is likely to continue in the future also. Therefore, the regulators must know weather a change would have desired impact or not, the companies must know how to take best advantage of these regulatory changes and the academicians must also have better understanding of the impact of regulatory changes. Hence, the need of the hour is to understand the impact of various regulatory
changes on the capital structure of companies, especially for an emerging market economy like that of India. Therefore the topic selected for this study was,

“STUDY OF IMPACT OF ECONOMIC POLICY CHANGES ON CAPITAL STRUCTURE OF INDIAN CORPORATES: ANALYSIS OF SELECTED COMPANIES IN POST REFORM PERIOD”.

1.6 SIGNIFICANCE OF THE STUDY

All theories of capital structure focus only on cost of capital, which is relevant in free market situation. In capital market of developing countries, regulations regarding different sources of funds and routes of capital issues may affect the capital structure of companies in terms of debt-equity mix, cost of capital, flexibility and inducting additional capital through new sources of funds. In India, earlier the regulations were in primitive in nature and control oriented, which discouraged private sector to raise funds from capital market. The impact of intention of the Government to liberalize Indian capital market was seen for the first time during 1985 to 1990. During this period, regulatory rules regarding acquisition of domestic capital through various sources of funds were streamlined and consequently, the secondary market became very active. But the sources of funds were limited and restricted to domestic capital market only. Indian companies were not allowed to raise funds from international capital market, foreign investment was also not allowed in Indian capital market. Even permission of government was required to allot shares to Non-Resident Indians (NRIs).

During post reform period, foreign capital market was opened for Indian companies under new market regulations. Under the disclosure based behavioral market regulations, Indian companies can easily raise huge amount of funds through euro issues speedily and at low cost. On the other hand, liberal regulations create problems of timely and efficient use of funds and risk of abnormal loss due to fluctuation in exchange rate. Thus the liberal and market driven regulations have governed the capital structure of Indian companies largely. Even after liberalization, regulations have not reduced but they have rather increased to regulate the varieties of domestic and international sources of funds and their routes of capital issues and protect the interest of all stakeholders. Therefore the bearing regulations are bound to have a significant impact on the capital structure of Indian companies but weather it is really so or not needs a full
understanding. Hence, the study is significant from the viewpoint of companies, regulators, stakeholders and researchers.

1.7 OBJECTIVES OF THE STUDY

To analyze the whole process of impact of regulatory policy changes on capital structure of Indian companies, following objectives were set:

(i) To study the theories of capital structure propounded by various experts.

(ii) To study the changes in regulations made by prevailing regulatory authorities in India from time to time regarding domestic and international sources of equity and debt fund and their routes of capital issues for Indian companies since 1947 to 2008-09.

(iii) To study the scope of availability of equity funds for Indian companies through various domestic sources and routes of equity issue as a consequence of changes in economic policy and regulatory norms at all India level from 1970 to 2008-09 and for selected Indian companies in the post reform period, i.e.1991-92 to 2008-09.

(iv) To study the scope of availability of debt funds for Indian companies through various domestic sources and routes of debt issue as a consequence of changes in economic policy and regulatory norms at all India level from 1970 to 2008-09 and for selected Indian companies in the post reform period, i.e.1991-92 to 2008-09.

(v) To study the scope of availability of equity and debt funds for Indian companies through various international sources and routes of equity debt issue as a consequence of changes in economic policy and regulatory norms at all India level from 1992-93 to 2008-09 and for selected Indian companies in the post reform period, i.e.1992-93 to 2008-09.

(vi) To study the overall impact of change in economic policy and regulatory norms on capital structure of selected companies and analyze the changes in capital structure of the selected companies due to regulatory changes and other factors.

(vii) To identify the most crucial regulatory changes for improving the capital structure and further direction of required policy changes.
1.8 SCOPE OF THE STUDY

In view of the objectives of the study, the scope of the study was outlined as under:

(i) Study of various theories of capital structure propounded by different experts
(ii) Study of regulatory policy changes made in India by various regulatory authorities in regulations relating to domestic and international sources of funds and various routes of capital issues for Indian companies since independence
(iii) Study of development of various sources of equity and debt funds and their routes of capital issues in domestic and international capital market since independence.
(iv) Analysis of impact of regulatory policy changes on various capital issues of equity and debt fund made in India and abroad by non-government public limited companies at all India level and for the selected companies during post reform period
(v) Analysis of impact of regulatory policy changes on different ratios of various components of capital structure of selected companies during post reform period
(vi) Identification of most crucial regulatory changes causing considerable change in the exercise of capital issue by Indian companies

1.9 LIMITATIONS OF THE STUDY

Following limitations apply to this study:

(i) The study was related to the analysis of impact of regulatory policy changes made by Indian regulatory authorities on capital structure of Indian companies only.

(ii) Government companies and financial companies were outside the perview of the study, hence the analysis, conclusions and suggestions of this study do not apply to the government companies and financial companies.

(iii) Secondary data used for the study were collected from outside sources and drawback of the formation in data base of secondary data also apply to the data analysis.

(iv) The period of the analysis of impact of regulatory policy changes on different components of capital structure was not homogenous for all companies at all India level and for the selected companies during post reform period due to following two factors:
(a) Non availability of company wise secondary data for the selected companies before 1989, as the data base is maintained by the respective agency for a specific period.

(b) The different period of introduction of respective source of fund or route of capital issue by regulatory authorities.

(v) Only impact of regulatory changes on capital structure was studied. Many other factors do affect the capital structure, which were outside the perview of the study.

(vi) The impact of regulatory changes on selected companies was studied during post reform period only.

1.10 CONTRIBUTION OF THE STUDY

The study will be helpful to academicians, researchers, regulatory authorities, financing institutions and Indian corporate sector for various purpose. The contributions of the study is outlined as under:

(i) Academicians will be able to acquire the knowledge of capital structure regarding historical background, development and latest trend regarding theories of capital structure, new sources of funds, new routes of capital issues, regulatory framework, Indian capital market, determinants of capital structure, debt-equity mix and capital structure practices by Indian corporate.

(ii) Researchers will be able to know the determinants of capital structure, historical as well as latest development in theories of capital structure, sources of funds, routes of capital issue and regulatory framework.

They will a get new dimension of research on capital structure which is hardly pursued in past. A new area of research is thrown open by this study for researchers by studying the impact of regulatory changes on capital structure practices by Indian corporate.

(iii) Regulatory authorities will be able to assess the impact of their regulatory framework on the financing decision taken by Indian corporate based on the change in regulations. They will also be able to evaluate their role in fulfilling the broad objective of developing practice capital structure among Indian corporate to safeguard the interest of all stake holders and develop the sound capital market in India. The study will be also helpful to them in formulating future policies.
(iv) Financing institutions will be able to know the prevailing financing pattern of Indian companies, which will be helpful to them in formulating their business policies in future.

(v) Indian companies will be able to know the prevailing practices of capital structure among other companies in India and impact of regulatory framework on capital structure of Indian companies. This information will helpful to Indian companies in formulating their capital structure.

1.11 CHAPTER PLAN

The entire thesis is divided in total twelve chapters. All these chapters are planned as under.

Chapter 1 : The main reason behind the selection of research problem, its significance, the objectives, scope and limitations are outlined in chapter 1. The chapter plan is also provided in this chapter.

Chapter 2 : In this chapter the literature review regarding research done on different aspects of capital structure in India and abroad is presented.

Chapter 3 : The research design of the study is discussed in this chapter. Different research methods used for the study are explained in detail.

Chapter 4 : Different theories of capital structure propounded by various experts over the time and latest development in this regard is discussed in this chapter.

Chapter 5 : Different sources of domestic equity fund and regulatory Policy changes made by prevailing regulatory authorities since independence regarding issue of domestic equity capital through various routes of capital issues are discussed in this chapter.

Chapter 6 : Different sources of domestic debt fund and regulatory Policy changes made by prevailing regulatory authorities since independence regarding issue of domestic debt through various routes of capital issues are discussed in this chapter.
Chapter 7 : Different sources of international equity and debt fund and regulatory Policy changes made by prevailing regulatory authorities since independence regarding issue of international equity and debt fund through various route of capital issues are discussed in this chapter.

Chapter 8 : In this chapter the impact of regulatory policy changes on amount of domestic equity capital issues made by non-government Indian companies at all India level and by the selected companies during post reform period is analyzed.

Chapter 9 : In this chapter the impact of regulatory policy changes on amount of domestic debt issues made by non-government Indian companies at all India level and by the selected companies during post reform period is analyzed.

Chapter 10 : In this chapter the impact of regulatory policy changes on amount of international equity and debt issues made by non-government Indian companies at all India level and by the selected companies during post reform period is analyzed.

Chapter 11 : In this chapter the impact of regulatory policy changes on different ratios of capital structure of selected companies during post reform period is analyzed.

Chapter 12 : Observations, findings and conclusions of the study are mentioned in this chapter. Suggestions are offered for regulatory authorities and scope for the further research is mentioned.