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Chapter 3: **ONLINE TRADING IN INDIAN CAPITAL MARKET AND REGULATORY ISSUES**

03.01 **Origin of Online Trading**

A result of rev-up in information and communication technology as stated by tech – visionaries and forecast groups over the last decade, the Internet has indeed opened up new avenues for conducting business. Stock exchanges across the world are now conducting a bulk of its business online through its brokers and partners, a major shift from the traditional method. In developed countries, almost all exchange transactions are conducted online. Internet, the new medium that has emerged as a result of convergence between telecommunication and computers, is revolutionizing the way business is done and is making inroads into every conceivable area of business activity. The potential of e-commerce is no longer a matter of controversy. In fact, every forecast has been proved wrong, with actual figures far exceeding the forecast. The natural extension of e-commerce in the securities market is Internet based trading and securities services and it has
made a great impact on the securities trading business. Issuers of securities, intermediaries, service providers and investors are increasingly selling and dealing or providing securities services on the Internet.

Online trading allows investors to buy and sell shares/stocks on the exchange through Internet. Investors can use revolutionary Internet Client-Server technology to buy and sell stocks nearly anywhere, anytime. Online investing is the term used to conjure up images of risk-taking individuals hunched over home computers, navigating mysterious byways of the stock market. Online investing has reached mainstream proportions. With Internet transmission time of less than a second to anywhere in the world, dealing over the Internet is faster and cheaper as compared to the traditional transaction modes.

The trend of online trading has slowly picked up in India and two of the largest exchanges, the National Stock Exchange (NSE)
and the Bombay Stock Exchange (BSE) have been conducting online trading successfully since a decade. Indian exchanges and broking houses have been slow to move their transactions online. This has been mainly due to Government regulations. There was initial delay in laying down specifications for creating Closed User Groups (CUGs). The issue was resolved between the Department of Telecommunication (DoT) and the Finance Ministry around 1998 and soon trade portals like ICICIDirect.com, motilaloswal.com, and smartjones.com, etc. came into existence.

Connectivity was perhaps the most important technological factor. The cost of leased lines and VSAT links has been traditionally very high and the reliability of the links has been low. It also took a long time to commission the links as one had to make an application and wait for a few weeks for the link to be up and running. Other issues like security, backup and recovery procedural costs were also deterrents.
Along with the resolution of regulatory issues, India no longer has any pressing connectivity and bandwidth issues. With the entry of private players into the broadband scenario and the government opening up the telecom sector, these issues are almost non-existent. Security solutions and services available in the market have matured and it doesn't cost a pretty packet anymore to put a simple backup solution in place.

SEBI being the Capital Market Regulator in India has twin objectives i.e. of regulating as well as developing the capital market. Although, the Internet based trading and securities services are at a nascent stage in India, the pace of growth predicted brings in an urgency to address legal and policy issues that are associated with it.
03.02 Internet Based Trading through Order Routing System

Internet based trading on conventional exchanges, uses the Internet as a medium for communicating client orders to the exchanges, through broker websites. Brokers’ websites may serve a variety of functions. These may include:

- allow the clients to directly trade through internet;
- advertise the broker-dealers' services to potential investors;
- offer market information and investment tools similar to those offered by information vendor or SRO websites;
- offer real-time or delayed quote information, continuously update quotes while the user visits other sites, or allow investors to create a personal stock ticker;
- provide market summaries and commentaries, analyst reports and trading strategies and market data on currencies, mutual funds, options, market indices and news;
- offer investors access to portfolio management tools and analytical programs;
• information on commissions and fees; and

• Account information and research reports.

In an Order Routing System, a broker offering Internet trading facility provides an electronic template for the customer to enter the name of the security, whether it is to be bought or sold, the quantity and whether the order is a market or limit order. Once the broker’s system receives this information, it is checked electronically against the customer's account and is routed out by the broker to the appropriate exchange for execution. After the order is executed, the customer receives a message confirming the order. The customer's portfolio and ledger account may also be updated on-line to reflect the transaction.
03.03 Use of Internet as Alternative Trading Systems (Provision for price discovery and matching outside conventional exchanges)

In foreign jurisdictions, alternative trading systems have been developing outside conventional securities markets which provide investors with additional proprietary electronic trading facilities for securities that are traded principally on securities exchanges, or other organized markets. They have price discovery functions, matching systems and crossing systems. The systems that are currently in use in outside jurisdictions are closed systems and are not accessible to the general public through the Internet.

The securities markets regulators abroad have maintained flexible and open policies designed to encourage innovation in the secondary securities markets. As a result, a number of market participants, usually broker-dealers, have developed computerized alternative trading system by which the system is centralized and it displays, matches, cross or otherwise executes trading interest.
03.04 Use of Internet for making Initial Public Offerings

Issuers of securities are using the Internet to communicate directly with their shareholders, potential investors and analysts by disseminating corporate information. In foreign jurisdictions, they are also using the Internet to communicate to the public for the following:

- public offering;
- private offering; and
- Disclosure and communication.

Issuers are using the Internet to market themselves to potential investors. The Internet is also being used for fulfilling necessary disclosure requirements, for disseminating the prospectus in electronic form and even for receiving share applications in public issues electronically. In India, SEBI has taken initiative in permitting use of the network of stock exchanges for collection of investor applications in public offerings by the issuer companies.
03.05 Investment Advisory Services

Brokers as well as other service providers such as investment firms, research outfits etc. are using the Internet for marketing and advertising purposes, for presenting information on portfolio analysis market information, and for communicating with and receiving orders from potential investors. The services offered by the service providers to the investors are generally as follows:

- advertising;
- providing investment information and investment advice;
- underwriting;
- communicating with the investors;
- customer orders; and
- Record keeping.
03.06 Indian Exchanges

The NSE and BSE are among the largest exchanges in the country. They handle very large daily trading volumes, support large amounts of data traffic, and have a very large nationwide network. The trading volume figures in both the exchanges are huge. The average daily turnover in the capital markets segment at NSE is around Rs 2300 crore and in the derivatives segment around Rs 1300 crore. The average daily traffic volume is around one million trades per day in the capital markets segment and around 50,000 trades per day in the derivatives segment. There are around 13,000 registered users in aforesaid segments and an average of around 9500 users are logged in at a time¹.

At BSE the average daily turnover in 2008-2009 (April-March) was Rs. 1244.10 crore and the number of average daily trades was 5,17,000².
03.06.01 Network Design

It is impertinent that any online exchange needs to be always-on, secure, redundant, and have adequate backup and recovery processes. G.M Shenoy, VP, NSE-IT, states about the design philosophy of his online exchange. "The basic design objective was to provide fair, equal, and transparent access across all our nationwide locations. An important aspect was to provide connectivity to our trading members as soon as possible."

"The telecom sector is fairly liberal today. Back in 1993, the technology was maturing and was costly. Leased lines cost almost ten times as much as it does today. Satellite technology was a boon since it allowed quicker deployment than leased lines. NSE now has the country's largest VSAT network with over 3000 VSATs and expects to grow to more than 4000 VSATs soon."
03.06.02 Network Elements

A look at the massive trading volumes and traffic bulk is enough proof of the critical nature of systems. It makes one shudder to think of the expected losses in case of a ten minute downtime when daily trade crosses Rs 3000 crore. Network elements like storage, security, backup and recovery processes, availability, and the different applications must be carefully planned and commissioned. Then one has to follow stringent RBI regulations to store at least 7 years of transactional and financial data.

Storage for such high amounts of critical data it's natural to deploy network-based storage like NAS or SAN. NSE is implementing a SAN as it feels that its data volumes have grown 'phenomenally'.

03.06.03 Security

This should be a vital and integral part of the design architecture. The hardware and software elements should be built
around a layered security architecture. It should be held in place with a well-documented security policy.

Shenoy states "Security is the most crucial element in the network. All applications have been built with a conscious approach towards security. The security policies are tightly integrated and regularly scrutinized to leave no room for compromise. All the applications and OSs are hardened periodically for safety."\(^4\)

03.06.04 Backup and Recovery

This has emerged as one of the vital aspects of business continuity. When online exchanges were designed a few years ago, perhaps a lot of emphasis was not placed on this aspect of backup and retrieval system as it is today. However it's not difficult to add business continuity processes to an existing network.

Shenoy further states on this aspect "As a backup to our VSAT network, a terrestrial-based trading network was deployed in the middle of 2000. We have more than 850 leased lines connecting our
nationwide locations. We are the only stock exchange in the country to have a fully-redundant business continuity site in Chennai."

03.06.05 Availability of 'five-nines'

Ideally online exchanges should have 'five-nines' availability. Exchanges usually prefer to host its infrastructure in-house and not use the services of an external data center. ‘Five – nines’ refers to 99.999% uptime of server during and after trading hours for dissemination of information.

NSE claims to achieve uptime greater than 99.9%. Shenoy states further, "This is mostly due to internally formulated procedures and continuous review of SLAs with hardware vendors.

03.06.06 Applications

It's difficult to deploy out-of-the-box applications at exchanges as each has a unique architecture based on factors like operations flow, trading volumes, number of members, number of users, and number of locations. The applications like trading,
clearing, risk-management, surveillance, index computation, listing, membership, and accounts may be developed in-house or by external software developers.

**The 'big two' architectures**

NSE and BSE, the 'big two' exchanges believe in updating and upgrading their technology systems to keep delivering according to commitments and promises made to its members, partners, and customers.
03.07 NEAT Technology of National Stock Exchange

In an ongoing effort to improve NSE's infrastructure, a corporate network has been implemented, connecting all the offices at Mumbai, Delhi, Calcutta and Chennai. This corporate network enables speedy inter-office communications and data and voice connectivity between offices.

Across the globe, developments in information, communication and network technologies have created paradigm shifts in the securities market operations. Technology has enabled organizations to build new sources of competitive advantage, to bring about innovations in products and services, and to provide for new business opportunities. Stock exchanges all over the world have realized the potential of IT and have moved over to electronic trading systems, which are cheaper, have wider reach and provide a better mechanism for trade and post trade execution.

NSE believes that technology will continue to provide the
necessary impetus for the organization to retain its competitive edge and ensure timeliness and satisfaction in customer service. In recognition of the fact that technology will continue to redefine the shape of the securities industry, NSE stresses on innovation and sustained investment in technology to remain ahead of competition. NSE’s IT set-up is the largest by any company in India. It uses satellite communication technology to energize participation from around 200 cities spread all over the country. In the recent past, capacity enhancement measures were taken up in regard to the trading systems so as to effectively meet the requirements of increased users and associated trading loads. With upgradation of trading hardware, NSE today can handle up to 15 million trades per day in Capital Market segment. In order to capitalize on in-house expertise in technology, NSE set up a separate company, NSE Technology Services Ltd. which is expected to provide a platform for taking up all IT related assignments of NSE.

NEAT is a state-of-the-art client server based application. At the server end, all trading information is stored in an in-memory
database to achieve minimum response time and maximum system availability for users. The trading server software runs on a fault tolerant STRATUS main frame computer while the client software runs under Windows on PCs.

The telecommunications network which was using X.25 protocol and is the backbone of the automated trading system is being upgraded to use the more popular and modern IP Protocol. This is a major project involving use of X.25 and IP in parallel and ensuring smooth transition to IP. Each trading member trades on the NSE with other members through a PC located in the trading member's office, anywhere in India. The trading members on the various market segments such as CM / F&O, WDM are linked to the central computer at the NSE through dedicated leased lines and VSAT terminals. The Exchange uses powerful RISC -based UNIX servers, procured from HP for the back office processing. The latest software platforms like ORACLE 10g RDBMS, SQL/ORACLE FORMS Front - Ends, etc. have been used for the Exchange applications. The Exchange currently manages its data centre
operations, system and database administration, design and development of in-house systems and design and implementation of telecommunication solutions.

NSE is one of the largest interactive VSAT based stock exchanges in the world. Today it supports more than 2000 VSATs and 3000 leased lines across the country. The NSE network is the largest private wide area network in the country and the first extended C- Band VSAT network in the world. Currently more than 9000 users are trading on the real time-online NSE application. There are over 15 large computer systems which include non-stop fault-tolerant computers and high end UNIX servers, operational under one roof to support the NSE applications. This coupled with the nation wide VSAT network makes NSE the country's largest Information Technology user. In keeping with the current trend, NSE has gone online on the Internet. Apart from having multiple internet links and own domain for internal browsing and e-mail purposes, it has also set up it’s own web site. Currently, NSE is
displaying its live stock quotes on the web site (www.nseindia.com) which are updated online.

NSE today allows members to provide internet trading facility to their clients through the use of NOW (NSE On Web), a shared web infrastructure.
Figure: 03.01

NEAT System Architecture

National Stock Exchange - Systems Architecture

[Diagram of NEAT System Architecture]

Source: http://www.networkmagazineindia.com/200211/nse.shtml
BSE has deployed an On Line Trading system (BOLT) on March 14, 1995. It works on a Tandem S74016 platform running on 16 CPUs. The Tandem Himalaya S74016 machines act as the backend to more than 8000 Trader Workstations networked on Ethernet, VSAT and Managed Leased Data Network (MLDN). The systems claim to handle up to two million trades a day.

BOLT has a two-tier architecture. The trader workstations are connected directly to the backend server which acts as a communication server and a Central Trading Engine (CTE). Other services like information dissemination, index computation, and position monitoring are also provided by the system. A transaction monitoring facility in the Tandem architecture helps keep data integrity through non-stop SQL.

With the help of MTNL, BSE has setup a MLDN Network comprising 300 2 Mbps lines and 1500 64 Kbps lines which connect
all regional stock exchanges and offices in Mumbai. Access to market related information through the trader workstations is essential for the market participants to act on real-time basis and take instantaneous decisions. BOLT has been interfaced with various information vendors like Bloomberg, Bridge, and Reuters. Market information is fed to news agencies in real time. The exchange plans to enhance the capabilities further to have an integrated two-way information flow.
03.09 Performance and Major Issues of Regulatory Framework in Indian Capital Market

The wave of economic reforms initiated by the government has influenced the functioning and governance of the capital market. The Indian capital market is also undergoing structural transformation since liberalisation. The chief aim of the reforms exercise is to improve market efficiency, make stock market transactions more transparent, curb unfair trade practices and to bring our financial markets up to international standards. Further, the consistent reforms in Indian capital market, especially in the secondary market resulting in modern technology and online trading have revolutionized the stock exchanges. The number of listed companies increased from 5,968 in March 1990 to about 10,000 by 1999 and market capitalization has grown almost 11 times during the same period. The debt market, however, is almost non-existent in India even though there has been a large volume of Government bonds trading. Banks and financial institutions have been holding a substantial part of these bonds as a statutory liquidity requirement. A
primary auction market for Government securities has been created and a primary dealer system was introduced in 1995. Currently, there are 31 mutual funds, out of which 21 are in the private sector. Mutual funds were opened to the private sector in 1992. Earlier, in 1987, banks were allowed to enter this business, breaking the monopoly of the Unit Trust of India (UTI), which maintains a dominant position. Recognizing the importance of increasing investor protection, several measures were enacted to improve the fairness of the capital market. There have been significant reforms in the regulation of the securities market since 1992 in conjunction with overall economic and financial reforms. In 1992, the SEBI Act was enacted giving SEBI statutory powers as an apex regulator. And a series of reforms were introduced to improve investor protection, automation of stock trading, integration of national markets and efficiency of market operations. SEBI in 1993 initiated a significant move which involved the shift of all exchanges to screen-based trading being motivated primarily by the need for greater transparency. The first exchange to be based on an open electronic
limit order book was the National Stock Exchange (NSE), which started trading debt instruments in June 1994 and equity in November 1994. In March 1995, Bombay Stock Exchange (BSE) shifted from open outcry to a limit order book market.

03.09.01. REVIEW OF REGULATORY ENVIRONMENT

SEBI: Securities and Exchange Board of India (SEBI) was set up as an administrative arrangement in 1988. In 1992, the SEBI Act was enacted, which gave statutory status to SEBI. It mandates SEBI to perform a dual function: investor protection through regulation of the securities market and fostering the development of this market. SEBI has been vested most of the functions and powers under the Securities Contract Regulation (SCR) Act, which brought stock exchanges, their members, as well as contracts in securities which could be traded under the regulations of the Ministry of Finance. It has also been delegated certain powers under the Companies Act. In addition to registering and regulating intermediaries, service providers, mutual funds, collective investment schemes, venture
capital funds and takeovers, SEBI is also vested with the power to issue directives to any person(s) related to the securities market or to companies in areas of issue of capital, transfer of securities and disclosures. It also has powers to inspect books and records, suspend registered entities and cancel registration.

**RBI :** Reserve Bank of India (RBI) has regulatory involvement in the capital market, but this has been limited to debt management through primary dealers, foreign exchange control and liquidity support to market participants. It is RBI and not SEBI that regulates primary dealers in the Government securities market. RBI instituted the primary dealership of Government securities in March 1998. Securities transactions that involve a foreign exchange transactions need the permission of RBI.

**Stock Exchanges :** SEBI issued directives that require that half the members of the governing boards of the stock exchanges should be non broker public representatives and include a SEBI nominee. To
avoid conflicts of interest, stock brokers are a minority in the committees of stock exchanges set up to handle matters of discipline, default and investor-broker disputes. The exchanges are required to appoint a professional, non member executive director who is accountable to SEBI for the implementation of its directives on the regulation of stock exchanges. SEBI has introduced a mechanism to redress investor grievances against brokers. Further, all issues are regulated through a series of disclosure norms as prescribed by SEBI and respective stock exchanges through their listing agreement. After a security is issued to the public and subsequently listed on a stock exchange, the issuing company is required under the listing agreement to continue to disclose in a timely manner to the exchange, to the holders of the listed securities and to the public any information necessary to enable the holders of the listed securities to appraise its position and to avoid the establishment of a false market in such listed securities.

The powers and functions of regulatory authorities for the securities market seem to be diverse in nature. SEBI is the
primary body responsible for regulation of the securities market, deriving its powers of registration and enforcement from the SEBI Act. There was an existing regulatory framework for the securities market provided by the Securities Contract Regulation (SCR) Act and the Companies Act, administered by the Ministry of Finance and the Department of Company Affairs (DCA) under the Ministry of Law, respectively. SEBI has been delegated most of the functions and powers under the SCR Act and shares the rest with the Ministry of Finance. It has also been delegated certain powers under the Companies Act. RBI also has regulatory involvement in the capital markets regarding foreign exchange control, liquidity support to market participants and debt management through primary dealers. It is RBI and not SEBI that regulates primary dealers in the Government securities market. However, securities transactions that involve a foreign exchange transaction need the permission of RBI. So far, fragmentation of the regulatory authorities has not been a major obstacle to effective regulation of the securities market. Rather, lack of enforcement capacity by SEBI has been a more
significant cause of poor regulation. But since the Indian stock markets are rapidly being integrated, the authorities may follow the global trend of consolidation of regulatory authorities or better coordination among them.

After introduction of SEBI Act, participants in the Indian capital market are required to register with SEBI to carry out their businesses. These include: stock brokers, sub brokers, share transfer agents, bankers to an issue, trustees of a trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, and investment advisers. Stockbrokers are not allowed to buy, sell, or deal in securities, unless they hold a certificate granted by SEBI. Each stockbroker is subject to capital adequacy requirements consisting of two components: basic minimum capital and additional or optional capital relating to volume of business. The basic minimum capital requirements varies from one exchange to another. The additional or optional capital and the basic minimum capital combined have to be maintained at 8 percent or more of the gross outstanding business in the exchange (the gross outstanding
business means the cumulative amount of sales and purchases by a stock broker in all securities at any point during the settlement period). Sales and purchases on behalf of customers may not be netted but may be included to those of the broker.

Most stockbrokers in India are still relatively small. They cannot afford to directly cover every retail investor in a geographically vast country and in such a complex society. Thus, they are permitted to transact with sub brokers as the latter play an indispensable role in intermediating between investors and the stock market. An applicant for a sub broker certificate must be affiliated with a stockbroker of a recognized stock exchange. There are two major issues which need to be addressed concerning sub brokers in the Indian capital market; majority of sub brokers are not registered with SEBI; and the function of the sub broker is not clearly defined. No sub broker is permitted to buy, sell, or deal in securities, without a certificate granted by SEBI. SEBI enforced the following measures in March 1997 to regulate unregistered sub brokers:
[a] initiation of criminal actions on complaints received against unregistered sub-brokers in suitable cases;

[b] prohibition of stockbrokers in dealing with unregistered subbrokers.

In spite of these actions, the problem is still at large. There is a need to address the basic issue of clarifying the role of the sub brokers and to educate the investors about their role.

SEBI Act of 1992 has introduced self-regulatory organizations [SROs] for regulating various participants in the securities market. But they are not yet operational. A clear regulatory framework has yet to be set up, and relevant market participants are not ready to regulate themselves for professional purposes. The only market related SROs in India whose regulatory frameworks have been well established and which are actually functioning are the recognized stock exchanges.
03.09.02. Recent Developments & Performance

In brief the major reforms which have taken place in Indian markets include screen based trading, electronic transfer of securities, dematerialization, rolling settlement, risk management practices and introduction of derivative trading and so on. The net result of these initiatives can be seen in the form of efficient and transparent trading & settlement processes in our exchanges. If we compare Indian markets today with some of the internationally developed markets we find that we are not lagging behind. This judgment is primarily based on the comparative study of two important ratios, that is market capitalisation ratio and the turnover ratio. [Table – No.03.01]

Table No.03.01

Comparative View of Market Capitalization & Turnover Ratios

<table>
<thead>
<tr>
<th>RATIO</th>
<th>USA</th>
<th>UK</th>
<th>CHINA</th>
<th>JAPAN</th>
<th>INDIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Capitalisation</td>
<td>358.8</td>
<td>130.7</td>
<td>73.6</td>
<td>66.4</td>
<td>54.5</td>
</tr>
<tr>
<td>Turnover</td>
<td>200.8</td>
<td>66.6</td>
<td>158.3</td>
<td>69.9</td>
<td>374.7</td>
</tr>
</tbody>
</table>

The above figure in fact looks quite impressive. Further, India has been placed 23rd in world ranking in terms of market capitalization and 14th in terms of value of trades on stock exchanges by standard.

Performance of Primary Market: Primary market is a market where fresh securities are issued whether debt or equity. Primary market for equities are further divided in public issues and rights issues. Public issues can be from existing listed companies or those companies which are approaching public for the first time which are popularly known as IPOs. Since 1991/92, the primary market has grown fast as a result of the removal of investment restrictions in the overall economy and a repeal of the restrictions imposed by the Capital Issues Control Act. In 1991/92, Rs.62.15 billion was raised in the primary market. This figure rose to Rs.276.21 billion in 1994/95. Since 1995/1996, however, smaller amounts have been raised due to the overall downtrend in the market and tighter entry barriers introduced by SEBI for investor protection. More recently, the number of companies that approached public
through IPOs have almost vanished in the first quarter of 2007-2008. The declining trend of IPOs continued in 2008-2009 and also in 2009-2010 only after the success of DLF IPO, a number of IPOs are scheduled for the current financial year.

Some research studies have shown the performance of the primary market for equities is very often linked to the performance of equities on secondary markets. If the stocks in the market are booming there will be a rush to issue fresh shares in primary market and vice versa. The impact of the fall in stock markets on primary issues can be clearly seen on the listing price of the IPOs from April 2009 to March 2010. During this period the statistics revealed that as many as 15 issues [out of total of 25] listed on NSE traded during the same period, were well below its issue price on the first day of listing. Even some mega issues are no exception during the same period. This result can be interpreted that the Corporate enterprises started using the private placement market for tapping their resources.
Private Placement: The private placement of funds which has been dominated by debt issues has grown in popularity over the years. From a mere Rs. 10,000 crores in 1995-96, the private placements have grown to Rs. 1,12,434 crores in 2010-2011. The rapid growth in private placement of debt can be attributed to its advantages like, these can be tailor made to suit the needs of the investor and issuer. Further, the issue is usually exempt from certain legal requirements and public disclosures, tremendous savings in terms of time and costs of issue and finally the not so good response of the primary equity market. The most active segment which is constantly tapping the private placement market are the banks, PSUs and FIs which accounted for 82.5% of resources mobilized in 2009-2010. The private sector on the other hand raised 9169 crores in 2009-2010 which was 17.49% of total private placement of debt.
### Table No. 03.02

**Comparison of Debt raised through Private Placement and Public Issue**

<table>
<thead>
<tr>
<th>Year</th>
<th>Private debt through placement (Rs. Crores)</th>
<th>Debt through public issue (Rs. Crores)</th>
<th>Total corporate debt (Rs. Crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-06</td>
<td>20,035</td>
<td>2,940</td>
<td>22,975</td>
</tr>
<tr>
<td>06-07</td>
<td>28,391</td>
<td>6,977</td>
<td>35,368</td>
</tr>
<tr>
<td>07-08</td>
<td>43,981</td>
<td>1,929</td>
<td>45,910</td>
</tr>
<tr>
<td>08-09</td>
<td>58,748</td>
<td>7,407</td>
<td>66,155</td>
</tr>
<tr>
<td>09-10</td>
<td>84,701</td>
<td>4,698</td>
<td>89,399</td>
</tr>
<tr>
<td>10-11</td>
<td>1,12,434</td>
<td>4,144</td>
<td>1,16,578</td>
</tr>
</tbody>
</table>


Development of Mutual funds: Three distinct phases in the mutual funds industry are clearly visible. First, is the pre-1987 phase when UTI was the only player and the industry as such had not developed. As a result only 4500 crores funds were mobilized in 23 years, i.e., from 1964-87. Then it came the second phase which started with the entry of public sector mutual funds in 1987-88. This phase lasted for five years and total funds mobilized from
1982-1992 had risen up to Rs. 33000 crores. Then came the third phase when we saw entry of few private players. The private players managed to capture a good clientele through initiatives like, daily declaring of NAVs, 100% disclosure of portfolios etc. The result was that the resource mobilized by all mutual funds during the period 1992-96 arose to Rs. 43,000 crores. Resources mobilized by all MFs have shown strong correlation with movements in secondary markets. If we compare the movement in stock market index with resource mobilized by mutual funds, it was found that from 1.4.1998 to 31.3.1999 when change in the index was negligible, the net resources mobilized by mutual funds were negligible. From 1.4.2009 to 31.3.2010 the BSE Sensex arose by 34% and there was substantial rise in net resources raised by all MFs. Thereafter, from 1.4.2010 to 31.3.2011, when BSE Sensex fell by 28%, there was a fall in the net resources raised by all MFs by 50% for the same period.
### Table No. 03.03

**Resources Mobilized by all Mutual Funds**

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales [Rs crores]</th>
<th>Purchases [Rs. crores]</th>
<th>Net Resource Mobilized</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>18701</td>
<td>15227</td>
<td>3474</td>
</tr>
<tr>
<td>2008-09</td>
<td>21377</td>
<td>21032</td>
<td>345</td>
</tr>
<tr>
<td>2009-10</td>
<td>59739</td>
<td>41204</td>
<td>18545</td>
</tr>
<tr>
<td>2010-11</td>
<td>92957</td>
<td>83829</td>
<td>9128</td>
</tr>
</tbody>
</table>


Developments in Secondary Market: The primary and secondary segments of the capital market expanded rapidly, with greater institutionalization and wider participation of individual investors accompanying this growth. However, many problems, including lack of confidence in stock investments, institutional overlaps, and other governance issues, remain as obstacles to the improvement of Indian capital markets' efficiency.

SEBI has taken several measures to improve the integrity of the secondary market. Legislative and regulatory changes have facilitated the corporatization of stockbrokers. Capital adequacy norms have been prescribed and are being enforced. A mark-to-market margin and intra-day trading limit have also been
imposed. Further, the stock exchanges have put in place circuit breakers, which are applied in times of excessive volatility. The disclosure of short sales and long purchases is now required at the end of the day to reduce price volatility and further enhance the integrity of the secondary market. Another barrier to volatility has been the introduction of futures trading as a future hedge does not give a clear signal to the day traders about the direction of the market.

Further, there has been introduction of derivative trading in the stock exchanges, this followed recommendations for the establishment of a regulatory framework for derivatives by a committee chaired by L.C. Gupta. If we look at some initial statistics on derivative trading, we find that the instruments seem to have adopted very well in Indian financial markets. This becomes clear when we look at the figures of trading volumes of those stocks which have been selected for derivatives trading vis-à-vis their volumes in the cash market.
Table No.03.04

**Derivative & Cash Trading** (Rs. ‘Crores)

<table>
<thead>
<tr>
<th>Month</th>
<th>Cash</th>
<th>Derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>January-2009</td>
<td>1155</td>
<td>798</td>
</tr>
<tr>
<td>February-2009</td>
<td>956</td>
<td>923</td>
</tr>
<tr>
<td>March-2009</td>
<td>758</td>
<td>944</td>
</tr>
<tr>
<td>April-2009</td>
<td>686</td>
<td>912</td>
</tr>
</tbody>
</table>


**03.09.03. EMERGING CHALLENGES & ISSUES**

Despite these significant developments, the Indian capital market has been in decline in the recent past. However, currently the market has recovered substantially and hopefully, the upward trend is expected to remain. The Indian security market still faces many challenges and issues that need to be resolved.

Market infrastructure and investor awareness has to be improved as it obstructs the efficient flow of information and effective corporate governance.
The legal mechanism should be activated to protect small shareholders by giving them speedy grievance redressal mechanism.

The trading system has to be made more transparent. Market information is a crucial public good that should be made available to all participants to achieve market efficiency.

Further, SEBI need to monitor more closely cases of insider trading and price manipulation and to meet the challenges of possible roles of market makers.

There is a need for integration of the security market through consolidation of stock exchanges. The trend all over the world is to consolidate and merge existing stock exchanges.

Need for integration of security markets with banks so as to improve the payment situation and to reduce the risks of scams.

Issues relating to market performance: Over the years the turnover of big exchanges has increased but only at the cost of small exchange. The turnover of NSE and BSE were Rs.1339510 crores and Rs.1000032 crores respectively for the year 2010-2011.
Further, the top six exchanges of India out of a total of 23 accounted for over 99% of the total turnover of all exchanges.

Another important issue is that turnover in our exchanges are dominated mainly by few securities. This is clear because top 100 traded securities on BSE had a share of 95% in the total turnover on BSE for the year 2010-2001, while the listed securities on BSE are approximately 10000. So this brings us to the conclusion that most of the securities on Indian Stock Exchanges are either not traded or very thinly traded. This also indicates that there is a problem of liquidity in our exchanges.

Further, on the one hand the object of circuit breaker is to prevent volatility but on the other hand many feel that the breaker distorts the basic price discovery process of scrip. This is again a matter of debate and whether the breaker should stay or be done away with depends upon what is more important for stock exchange, i.e. price discovery which should be independent or controlled volatility.
Issues relating to regional stock exchanges: Regional stock exchanges of late have witnessed shrinking volumes and are thus in poor financial health. Their inability to attract business is clear if we look at the total incomes of the various exchanges as split between business and non business incomes. Business incomes include membership fees, transaction based service charges and other miscellaneous income whereas non business income includes listing fees, interest and rent. With the government initiating further reforms like, central listing authority to avoid multiplicity problems of listing for companies and centralized monitoring and compliance of obligations, it seems the end of regional exchanges is not very far and it is only a matter of time when these regional exchanges close their shops.

Attempts can however be made to revive the regional exchanges through mergers & acquisitions, consolidations, diversification of the business of stock exchanges to areas like, investment banking, insurance etc. Some attempts are already made when Inter connected stock exchange of India was launched which
was to provide a separate market among member exchanges.

However, the exchange could not do much business in 2010-2011.

Table No. 03.05

Income Source of Stock Exchanges During 2009-10 [in %]

<table>
<thead>
<tr>
<th>Name of Exchange</th>
<th>Percent of Business Income</th>
<th>Percent of Non-Business Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>1. Ahmedabad</td>
<td>14.12</td>
<td>85.88</td>
</tr>
<tr>
<td>2. Bangalore</td>
<td>36.75</td>
<td>63.25</td>
</tr>
<tr>
<td>3. Bhubaneshwar</td>
<td>8.65</td>
<td>91.35</td>
</tr>
<tr>
<td>4. Calcutta</td>
<td>62.93</td>
<td>37.07</td>
</tr>
<tr>
<td>5. Cochin</td>
<td>45.26</td>
<td>54.74</td>
</tr>
<tr>
<td>6. Coimbatore</td>
<td>3.33</td>
<td>96.77</td>
</tr>
<tr>
<td>8. Gauhati</td>
<td>9.83</td>
<td>86.17</td>
</tr>
<tr>
<td>9. Hyderabad</td>
<td>22.25</td>
<td>77.75</td>
</tr>
<tr>
<td>10. Jaipur</td>
<td>9.02</td>
<td>91.98</td>
</tr>
<tr>
<td>11. Ludhiana</td>
<td>23.61</td>
<td>76.39</td>
</tr>
<tr>
<td>12. Madhyapradesh</td>
<td>41.36</td>
<td>58.64</td>
</tr>
<tr>
<td>13. Madras</td>
<td>16.77</td>
<td>83.23</td>
</tr>
<tr>
<td>14. Magadh</td>
<td>30.01</td>
<td>69.99</td>
</tr>
<tr>
<td>15. Mangalore</td>
<td>20.48</td>
<td>79.52</td>
</tr>
<tr>
<td>16. OTCEI</td>
<td>21.57</td>
<td>78.43</td>
</tr>
<tr>
<td>17. PUNE</td>
<td>10.36</td>
<td>89.64</td>
</tr>
<tr>
<td>18. SKSE</td>
<td>23.58</td>
<td>76.42</td>
</tr>
<tr>
<td>19. UP</td>
<td>28.76</td>
<td>71.24</td>
</tr>
<tr>
<td>20. Vadodra</td>
<td>5.51</td>
<td>94.49</td>
</tr>
<tr>
<td>21. ICSE</td>
<td>49.01</td>
<td>50.49</td>
</tr>
<tr>
<td>22. BSE</td>
<td>52.25</td>
<td>47.75</td>
</tr>
</tbody>
</table>
Issues relating to regulatory framework: It is more than a decade since SEBI started to put in place a regulatory framework for the capital market. Despite a plethora of disclosure requirements, there are still key areas where investors get precious little information of value. This relates to mergers and acquisitions, asset sell-off, intra-company, intra-group transactions and intercorporate investments. In these cases the minimum legal requirement under Companies Act is met. Though, we have a full fledged market for corporate control yet the disclosure levels are not up to the mark. A lot of information is also made available on financial performance and other synergistic areas of mergers and acquisitions. However, the manner in which the swap ratio is fixed, pricing of offers and the managerial perception is largely missing. The valuations of two companies and swap ratio are key aspects in any merger no doubt valuation reports are available for inspection however, access is not easy for investors. A comprehensive and
mandated list of disclosures like, the ones that accompanies IPO’s or a rights offer, should be made available to all investors.

The effectiveness of any regulatory body is judged by the quality of implementation in general and the rate of convictions in particular achieved in cases where there are violations. What is worrying is the poor rate of conviction in major cases. The judgments of SEBI involving Sterlite, BPL, Videocon, Anand Rathi and Hindustan Liver have been overruled by SAT [Securities Appellate Tribunal]. There is something seriously amiss if the SAT can overturn SEBI orders by pointing to lacunas on almost every possible ground, ranging from technical aspects to substantive issues involving the regulator’s subjective judgment.

Controversies regarding offer pricing: An acquirer is expected to bid for control if he sees the prospect of value that can be unlocked by taking control. This value and the need to buy a sizeable stake that would provide for control over management are reasons why an acquirer is willing to pay a sizable premium over the market price. If the bid price is in the range of normal prices, quite
clearly the acquirer is at an advantage. The acquirer does not pay anything extra for the expected value to be uncovered as well as the value for control. From research literature it was found that the premium for corporate control has been anywhere between 100 to 150 percent of the market prices of shares in important deals. However, the recent offer of Rs. 190 by Grasim for L&T has again given importance to pricing issues. The shareholders of L&T have every reason to upset as Grasim had acquired a 10 percent stake at Rs. 306 per share from Reliance in November 2010. In this case, the SEBI takeover code, designed to protect the interests of shareholders in a takeover situation has failed in spirit. Particularly in this case several other contentious issues and fresh offers are expected to come in near future.

The SEBI takeover code allows the board of directors to offer an independent view on the pricing. A company board can come out and tell their shareholders that the price is unattractive and not to take the offer unless it is improved. This is routinely done in United States. In the recent past also, there were controversies
regarding pricing of BSES scrips acquired by Reliance and Sterlite buy back schemes. Until recently, valuations have been the prerogative of a few management experts having expertise in M&A deals. There have been no overall guidelines or specific directives on this subject, which gives ample scope for subjectivity and manipulation to the advantage of vested interest players. The department of company affairs has taken note of these allegations and has come up with directives to reduce the subjectivity within some parameters.

Hostile takeover bids: Hostile corporate raids are those attempted takeovers without promoters’ consent. Other takeover techniques could be undertaken with the promoters’ consent. The raiders usually target those companies for takeovers which are undervalued and whose replacement costs are high. In simple words, there is difference between market value of assets and their replacement costs. However, in the prevailing situation in the market, the market capitalization of many companies is lower than book value of their assets, forget about replacement costs. In this
situation, if a company wants to add to capacity in producing a particular product, it could acquire the additional capacity more cheaply by buying a company that produces the product rather than building brick and mortar from scratch. Rock-bottom share prices of many companies have made many of them attractive takeover targets. Besides, horizontal and vertical takeovers, it is also tempting for the raider to diversify his portfolios of business by adding new companies of different business lines through this route. However, the issues before the corporate raider are to analyze the strategic considerations for taking a decision. In the recent past, acquisitions of large blocks of shares in Bombay Dyeing and Ballarpur Industries by Arun Bajoria has given credence to the stated facts. Further, the attempted raid on Gesco Corporation by Utkal Investments and Renaissance Estate Ltd has proved that hostile M&A front prevailing in the Indian corporate front. There are many complex issues confronting this front, which need immediate attention for better corporate governance. According to the takeover regulations, the raider has to inform the stock exchanges once his holdings cross
five percent in a particular targeted company. Further, when holdings cross ten percent, the buyer has to make an offer to buy another twenty percent of the shares from the public. When the raider starts the initial moves in the market, usually, share price of that company goes up. Further, if the promoter makes a counter offer in defence, the prices will go up again. Operators in the stock market could exploit this situation to their own advantage.

Problematic areas in Buy-Back of shares: In a simple way buyback offer meant at enhancing the share value in the long run, enhancing the share prices and to give an honorable exit option to the shareholders who want to exit from the company at a premium price. However, if we analyze recent buy-backs in the corporate front, one would find that shareholders have given a raw deal. First of all, in majority of such offers promoters and persons in control do not participate. The ultimate out come of the offer is that the total shareholding of promoters rises without spending anything from their pocket. The ordinary shareholders who are interested in the dividend and the capital appreciation will fall for the offer seeing the
offer made at a premium vis-à-vis the average market price and will go for it. However, little does he know that the future values of shares are more than what is offered to him for his exit? Recently, Abbott India made a buy-back offer at Rs 350 per share, whereas the average price for the last six months was hovering around Rs 275 - Rs 300. In that offer the promoters did not participate and it was evident that the promoters holding would increase to 61% post buy-back. Considering the growth potential of Abbot India, the price offered is less for an honorable exit for shareholders.

In the recent past, share prices have depreciated a lot despite Govt’s and regulators effort to bring back buoyancy in the markets. Further, SEBI had relaxed the limit of creeping acquisition from 5% to 10% for a year. This also did not bring any relieve to the depreciating markets. However, this has helped the promoters as they saw an opportunity to increase their shareholding in the companies by making buy back offers at a price, which is much lower than its intrinsic value in the long term. In this context, companies like Great Eastern Shipping, Kesoram Industries, Finolex
Cables, Indian Rayon, Finolex Industries and Jay Shree Tea have announced buyback programmes worth Rs 400 crores. Further, Finolex Cables and Indian Rayon have also gone for their second buyback. In fact, company like, MICO made three offers in last three years and each subsequent offer at a lower price than earlier price.

Stringent regulation for quality accounting & auditing information in several instances in the recent past in the US, like, Enron, Worldcom, Global Crossing, Merck etc, put out blatantly false numbers and auditors went along with this charade. Many companies in India also give poor quality audit information. Some authors suggest SEBI should act proactively with the government to have special audits done for the top 100 or 200 companies that account for more than 90% of market capitalization and trading.

The structure and pattern of securities markets in India and around the world is undergoing many changes. The current trading environment is characterized by frequent regulatory interventions
and competitive pressures. Further, the proliferation of the Indian capital market, the market players, the trading pattern and the emerging market for corporate control, brings to the forefront abovementioned issues which need immediate attention. As these issues have implications for the trading strategies employed by investors, the behaviour of specialists, liquidity in the market, the informational efficiency of prices, and ultimately the valuation of listed companies and welfare of their shareholders.

03.10 Concluding Observations:

On the basis of afore stated facts it may be observed that online trading in the Indian Capital Market being still in it’s nascent stage, has started gaining impetus with multitude of key corporate connoisseurs coming forward to participate in smooth and steady growth of market. With latest technological advancements acting as a catalyst for reinforcement of enhanced outreach in terms of consumer base, investor’s confidence, online trading in India is growing at a rapid pace to keep up with global counterparts.
List of References: