CHAPTER I

INTRODUCTION
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Indian Capital Market - History and Developments

The financial system of a country plays a significant role in the growth and development of its business. The system helps in mobilizing funds and provides the needed financial support to industries. The intermediaries are banks, financial institutions, mutual funds and merchant bankers. The Government of a country also relies on such intermediaries for financing the business activities. From the business perspective, the place from where the funds are raised is the Capital Market. A capital market is a place where securities are bought and sold. This is a market where the investors’ park their funds in the securities issued by the companies. The companies appoint intermediaries to raise funds from the investors. Such intermediaries are called merchant bankers. The structure of the Indian Capital Market is shown in Figure 1.1. The regulator of the capital market prior to 1992 was the Controller of Capital Issues (CCI). This body was under the Department of Economics, Ministry of Finance, Government of India. The CCI was monitoring all the activities in the capital market including fixing the price of shares in the primary market. In order to have a separate professional body to regulate the activities of the capital market, Securities and Exchange Board of India (SEBI) was established in the year 1988 and received its statutory power in the year 1992. Under the SEBI Act, 1992, a lot of power is vested on the hands of SEBI. SEBI has the power to regulate the functioning of stock exchanges, other securities market and mutual funds. Registration and regulation of market intermediaries are also carried out by SEBI. It has the major responsibility of
prohibiting unfair trade practices and insider dealings. Stock exchanges will have to submit periodic returns to SEBI. Its major duty is to develop healthy practices in the capital market and protect the interests of the investors.

**Figure 1.1**

**Structure of Indian Capital Market**

The equity market is categorized into two – primary and secondary market. Figure 1.2 shows the structure of the equity market. Barring the derivatives market, the debt market has also primary and secondary markets. Derivatives market consists of futures and options market. The operations of futures and options market are discussed in detail under the title ‘Introduction to Derivatives in India’ in the ensuing pages.

Primary market is a place where new securities are issued to the investors and is known as ‘Initial Public Offering’ (IPO). It is also called New Issue Market (NIM). In this market, the retail investors, Qualified Institutional Buyers (Banks, Financial Institutions, Mutual Funds, Insurance Companies etc.), underwriters participate for investing in new issues of companies. The investors apply for the shares and once the shares are allotted to the investors, it is listed in the stock exchanges. Stock exchanges are called the secondary market. There are various forms of issues in the primary market. An issue of shares to investors by a public company that is already listed on an exchange is called a Follow on Public Offer (FPO). An FPO is essentially a stock issue of supplementary shares made by a company that is already publicly listed and has gone through the IPO process. In India, a company can go for an FPO only after three years from the date of its last IPO.


**Figure 1.2**

**Classification of Equity Market**
Companies issue shares to the existing share holders in order to raise long term capital for their needs. Such issues are called Rights Issue. Private placement is another source of raising long term funds where shares are sold to a relatively small number of select investors as a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale in the open market. A company which does not want to go public for issuing shares may provide preference to some people say its employees to subscribe to the company’s share. Such a process is called preferential allotment of shares.

Secondary market is a market where securities are listed in a stock exchange after the shares are allotted in the primary market. The shares are either listed in Bombay Stock Exchange (BSE) or National Stock Exchange (NSE). The Bombay Stock Exchange was established in the year 1875 and is one of the oldest stock exchanges in Asia. Earlier the exchange was an Association of Persons (AOP) and now the exchange is a demutualised one, where in the management is different from the membership to trade. SENSEX is the index which is tracked worldwide as the index of BSE. The sensex comprises of thirty scripts and is a value weighted index. The base value of the sensex is 100 with 1979 as the base year. In March, 1995, BSE introduced an online trading system called BOLT. The BOLT is designed to get the best bids and offers from jobbers as well as the best buy and sell orders from the order book. In the year 2003, the sensex calculation moved from total float to free float methodology. Free float methodology of shares refers to that part of the shares which are freely available for trading in the public.
According to BSE, the holdings by the following are not considered to be part of free float of shares—holdings by promoters/directors who have controlling interest, Government holdings as a promoter, equity held by group companies, locked in shares, equity held by employees and equity held through Foreign Direct Investment (FDI) route.

The BSE has classified the companies into various categories such as A, B, T, F and G. The categorization is done on the basis of factors such as market capitalization, trading volume, equity capital, dividend and profits. Group A shares are selected on the basis of market capitalization. Companies with a market capitalization of Rs.300 Crs. Group B shares are those companies with an equity capital ranging between Rs. 3 Crs and 30 Crs. Group T shares are the companies where the dealing is done on trade to trade basis, i.e, buying and selling of shares are settled through delivery of shares. Group F consists of fixed income securities and Group G consists of Government Securities.

The National Stock Exchange Ltd. (NSE) was incorporated in the year 1994. NSE came into existence based on the recommendations of a committee formed by SEBI. The committee wanted to create a separate exchange for removal of certain deficiencies prevalent in the existing system. Some of them were outdated settlement cycle, lack of transparency in capital market operations, inadequate infrastructural facilities etc. This exchange was formed by leading banking financial institutions like State Bank of India and was the first exchange to use information technology in stock trading. The major objectives of the exchange were to meet the current international standards of securities market, to shorten the settlement cycle, to enable investors across the country to participate in the
capital market etc. The software used in NSE for trading is called National Exchange for Automated Trading (NEAT). It is a fully automated screen based trading. It uses a modern, fully computerised trading system designed to offer investors across the length and breadth of the country a safe and easy way to invest. NEAT is a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs. The trading takes place through computers and the trading members’ computers are connected to a central computer in NSE through leased lines and VSAT and communication is carried through satellites. NIFTY is the index and it comprises of fifty scripts and is also a value weighted index which was introduced in the year 1995. The base value is 1000 and 1995 as the base year. In this market, buyers and sellers include mutual funds, financial institutions, and Foreign Institutional Investors and retail investors. The transactions are performed through intermediaries whose memberships are approved by the respective stock exchanges and SEBI.

Government securities market is a market where the government raises funds through issue of bonds. The Reserve Bank of India (RBI) is the authorized agency to issue bonds to the participants. Major participants in the market are commercial banks, insurance companies and provident funds. Such securities are deemed to be listed and eligible for trading in the National Stock Exchange (NSE). The NSE has a Wholesale Debt Market (WDM) segment which is a fully automated screen
based trading system meant primarily for banks, corporates etc., which do high value transactions in debt securities. The Reserve Bank of India is the main monetary authority of India besides acting as the bank for the national and state governments. It formulates, implements and monitors the monetary policy and has to ensure an adequate flow of credit to productive sectors. The objectives are maintaining price stability and ensuring adequate flow of credit to productive sectors. The RBI is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. The objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

Corporate debt market is a place where companies listed on a stock exchange raise debt from the participants. The instrument through which the debt is raised is a debenture. The instrument is issued for a fixed period and carries a fixed rate of interest during the tenure. The participants of debenture issues are banks, financial institutions, retail investors etc. Mostly in India, debenture issues are redeemable debentures where the debentures are redeemed after the maturity period. A perpetual hybrid instrument is another innovation of raising long term debt from the market. Perpetual hybrid securities have equity characteristics and have the highest pecking order (to share capital) in the capital structure. It is just like an equity instrument and the returns are not certain as the company retains the right to defer interest payment. In case of liquidation of the company, the perpetual bondholders precede equity share investors. The unique features of the securities are that they are perpetual in nature with no maturity or redemption and are
callable only at the option of the company. This innovative long term funding with equity features helps a company to diversify the financing options of a company. In these securities, the interest rate is fixed for a certain period with an option to raise it after some years. The funds raised through this instrument are cost effective as the interest rate is fixed and in an inflationary condition where the interest rates climb, such securities will be very handy for companies in India.

A segment of the financial market in which financial instruments with high liquidity and very short maturities are traded is money market. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money market securities consist of negotiable certificates of deposit (CDs), bankers acceptances, Treasury bills, commercial papers. The participants of the market are banks, companies and government. The money market is typically seen as a safe place to invest money due the highly liquid nature of the securities and short maturities. Commercial papers are short-term debt instrument issued by companies, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. Maturities on commercial paper rarely range from 14 days to 270 days. The debt is usually issued at a discount, reflecting prevailing market interest rates. Commercial paper is not backed by any form of collateral and hence only companies with high-quality debt ratings use this instrument to raise funds from the investors. Such instruments are issued at a discount and on maturity the money is repaid at par to the investors. A certificate of deposit is a promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand. The term of a certificate of deposit ranges from one month to five years.
The Indian Capital Market has witnessed a plethora of developments in the last two decades thanks to the liberalized policies of the Government and the regulator SEBI’s (Securities Exchange Board of India) vision to see the capital market of India at par with that of developed countries. The abundant usage of information, communication and technology along with liberalized policies has seen an increase in volume of trade, number of participants investing in the capital market etc. The volume of trade in the secondary market has also significantly increased from a mere Rs. 550 crores in 1992 to close to Rs. 16000 crores in 2011. The net investment of Foreign Institutional Investors has also increased from Rs.100 crores to a whopping Rs. 1,14,901.12 crores in 2010. The application of information technology in the capital market operations has seen a lot of developments benefitting the investing fraternity. The Indian Capital Market was once a physical market where securities were traded and since early 2000 it has become a screen based trading where the markets and the intermediaries are connected through a network and investors can transact with ease from their respective places rather than visiting the stock exchange in person. Some of the developments witnessed are introduction of dematerialization / rematerialization of shares, online trading, rolling settlement, book building, derivatives trading and investment in foreign companies by Indian investors. The developments have brought in greater transparencies in transactions, improved quality of services and also have provided multiple opportunities for the investors to park their resources. In the year 1999, the Government and the regulatory authority allowed companies to split their shares and buyback of shares.
The following are some of the developments witnessed in the Indian capital market-

I. Book Building

II. Online Trading

III. Margin Trading

IV. Dematerialisation/Rematerialisation of shares

V. Rolling Settlement

VI. Issue of ADR/GDR

VII. IDR (Indian Depository Receipt)

VIII. Introduction of Derivatives in India

IX. Buyback of Shares

X. Introduction to Innovative Debt Instruments

XI. Foreign Currency Convertible Bonds

I. **Book building**

The process of fixing the price of a security in an IPO is a book building process. This method is more scientific compared to the conventional method of pricing. Under the conventional method, the price of a security is fixed and the investors will have to subscribe at the price fixed by the company in consultation with the merchant bankers. The basis of arriving at the fixed price was not clearly known to the investors. Fixed price offerings are made to uninformed investors. Moreover, there is a long time gap in the date of pricing, in the date the issue
opens, and in the date when trading commences. This raises the possibility of price fluctuations in the intervening period. Empirical evidence supports the view that fixed price offering results in high cost of capital for companies due to under pricing of shares for attracting subscription. Also the fixed pricing regime was characterized with unrealistic pricing structure and most of the investors burnt their fingers as the shares purchased by them at a premium were quoting below the par value.

In the book building process, the price for a security is determined by the demand for the securities from the investors. The company will appoint a book runner, a merchant banker and the book runner will submit all the necessary documents to the SEBI. The book runner will submit the draft prospectus which does not mention the price at which the shares will be issued to the public. It contains all the details about the company and the issue other than the price. The book runner along with the company will fix the price range within which the shares are to be bid. The offers of various investors are received along with their prices which are within the minimum and the maximum range. Once the different prices are received, the book runner will decide the price at which the shares will be allotted to the public and other investors. Therefore, the price of the share is known only after the bidding is completed. The advantage of book building process is that the entire process is completed within five days and procedural delays are reduced. From the investors’ point of view, book building is beneficial as they can trust the price at which the syndicate members have purchased shares. Due to this, the possibility of price falling below par after listing is remote. There are different investors who participate in the book building process. Among them are the
Qualified Institutional Buyers (QIB), retail investors etc. SEBI has fixed quotas for different categories of investors. For instance, QIBs’ quota is 35%, retail investors 50% and others 15%. The lead manager and the book runner should take into consideration the quotas while allotting shares to the investors. The maximum amount a retail investor can invest was earlier fixed at Rs. 100000/- which has been increased to Rs. 200000/- since April 2011.

II. Online Trading

Internet trading is trading through net which otherwise is known as online/E-broking. The web site of a registered broker is used as a medium to trade in the securities listed on National Stock Exchange and Bombay Stock Exchange Under this method, a client enters his/her requirements in the brokers site which are referred electronically to the appropriate exchange for execution by the broker. The client receives a confirmation on the execution of the order. At the same time, the customer’s portfolio and ledger account gets updated to reflect the transaction. From security point of view, it is fully protected as most sites use encryption technology to ensure that transmitted information is safe and cannot be accessed by any outsider. Online trading offers a lot of benefits to investors as the transaction costs are reduced when compared to the conventional method. The trading can be done from the investors’ place and they can also place orders during the non trading hours which are executed on the next earliest trading day. Since all the procedures are electronically done in online trading, the settlement cycle has reduced from 5 days to 2 days. The regulator has recently permitted usage of sms (short message service)/ text messages through cell phones to place
orders. Therefore, the investors need not necessarily be at the brokers place to trade in the stock market. The introduction of online trading has expanded the base of traders as working professionals, house wives have all started to invest in capital market due to the convenience and flexibility in operations.

III. Margin Trading

This trading mechanism was one of the biggest developments in the Indian Capital Market in April 2004. It is a mechanism that allows the investors to buy stocks by paying a part of the transaction value with the rest financed by the broker. It is basically a deal between the member brokers of stock exchanges and their clients. The money the investor contributes is the ‘margin’ and the stocks purchased form the ‘collateral security’ for the funds advanced by the broker. This kind of trading system was introduced in order to facilitate retail traders to trade more in the market.

In the case of margin trading, an investor can buy shares taking a marginal loan, say up to 50% of the total amount from the broker. If the value of shares purchased goes down, the investor is required to maintain a ‘maintenance margin’ at 40% of the market value of the shares. If the margin goes below 40%, the broker makes a margin call to the investor to pay the amount falling short of this 40%.

There are a few advantages for investors indulging in margin trading as they can buy more shares than that can be purchased using own funds provided for by cash. It also leverages the transaction and gives an investor a much higher return as compared to the cost of raising funds for investment.
IV. Dematerialization and Rematerialization of shares

Dematerialization (DEMAT) is a process by which an investor gets to convert the
physical share certificates in electronic form. Prior to this development, the
settlements (buying and selling of shares) were done in physical form. A lot of
complaints were received by the regulatory body relating to transfer of shares.
Some of the complaints were fake and bad deliveries, loss due to theft etc and
hence SEBI decided to introduce ‘paperless transfer’ of shares and hence
dematerialization happened.

The dematerialized shares are held with an organization, namely ‘depository’.
There are two major depositories in India – NSDL (National Securities Depository
Limited) and CSDL (Central Securities Depository Limited). The investors will
have to route their physical share certificates through an intermediary called
‘Depository Participant’.

The investing fraternity has benefited from this process as no stamp duty is
required for transfer of securities, bad deliveries are completely eliminated and all
risks associated with physical certificates such as loss, theft and mutilation etc are
removed. This also facilitates the investors to pledge and hypothecate securities.

In case the investors want to hold share certificates in physical form, they have the
option of getting the shares physically converted from electronic form. Such a
process is known as ‘rematerialization of shares’.

In case of IPO investments by retailers, the shares are directly credited to the
DEMAT account of the investors. Also, the investors have an option for
requesting shares in physical form. Dematerialisation improves volume of trade in
the market as the transaction cost is low and the settlement time is two days. Companies splitting stocks can easily credit the shares with new face value to the investors demat account.

V. Rolling Settlement

Rolling settlement was first introduced by SEBI on 10\(^{th}\) January 2000. This mechanism was brought in to reduce the settlement period which was earlier T+5 days, i.e., a trade entered in on Monday was to be settled on Friday. The current rolling settlement is T+2, i.e., a trade entered in on Monday has to be settled on Wednesday. Rolling settlement is compulsory for all dematerialized shares. Under this settlement cycle, both the buyer and seller are given the pay in and payout dates. This is usually T+2 working days, i.e., a trade entered in on Monday will have to be settled on Wednesday.

Rolling settlement has brought in certain advantages for the investors as transactions take place quickly, speculation is curbed and price volatility is reduced. The introduction of rolling settlement was possible because of the introduction of online trading and dematerialization of shares. Efforts are made by the regulator to settle the transactions within T+1 day(s).

VI. Issue of ADR/GDR

The Indian companies were permitted to raise money from overseas markets and list their securities in overseas stock exchanges. Companies were allowed to raise money through issue of American Depository Receipts (ADR) and Global Depository Receipts (GDR). ADRs enable investors based in USA to invest in stocks of non- US companies/Indian companies. Such securities are listed in New
York Stock Exchange (NYSE) or NASDAQ (National Association of Security Dealers Automated Quotation). The Indian companies benefit from raising funds from the US markets. It will allow companies to access the US market. ADRs are denominated in dollars. Some of the blue chip Indian companies which have raised funds through ADR route are Grasim Industries, Dr. Reddy’s Laboratories, ICICI Bank, Sterlite Industries etc. An ADR is issued by a depository bank and each ADR represents one or more shares. In other words, US brokers purchase shares of a foreign company. The shares are delivered to a custodian bank which in turn brings the depository banks into the picture. The depository bank then issues a certificate called ADR, each ADR representing a fixed number of shares. There are three levels of ADR issues, namely, level I, level II and level III. Level I and level II issues do not have strict regulations. Level III ADRs’ should strictly comply with US GAAP as far as reporting of financial statements are concerned and should strictly comply with listing norms of U.S Securities Exchange Commission (SEC), the regulator of capital market in U.S. Earlier in India, there were restrictions in using the proceeds of ADR issues. The proceeds of the ADR issues were to be deposited in a dollar denominated account with a bank in India. The RBI (Reserve Bank of India) permission had to be sought for releasing the funds from the account. The rules are now relaxed and the entire proceeds from an ADR issue can be used by the companies to create assets in the foreign countries as India is moving towards full convertibility of rupee on capital account.

Global Depository Receipts (GDR) is issued by Indian companies to non-US investors. GDRs can be denominated in dollars or euros and are commonly listed
on European Stock Exchanges. Companies like Reliance Industries, Gas Authority of India Ltd (GAIL) etc have raised money through issue of GDR.

VII. IDR (Indian Depository Receipts)

The Government of India is moving towards full convertibility of Indian rupee. There are basically two sets of transactions namely current account and capital account transactions. The current account transactions are exports and imports and there are no restrictions laid down by the Government in converting the foreign currency. The capital account transactions include Foreign Direct Investments like joint ventures and issue of depository receipts which have restrictions in converting rupee into a foreign currency and vice versa. The Indian Government is moving towards full convertibility of rupee on capital account and the result is the introduction of Indian Depository Receipts. The Government recently (2009) permitted foreign companies to raise money from the Indian market. The medium through which the money is raised from Indian investors is known as an Indian Depository Receipt. Standard Chartered Bank was the first company to use this instrument to raise money from the Indian market. Each depository receipt will be equivalent to certain number of shares of the issuing company. The shares are traded in the stock exchanges of India. The IDRs are at their nascent stage and currently the depository receipts are not two way fungible, i.e., they cannot be converted into shares and vice versa. From the investors’ point of view, they have a choice of investing in multinational companies and the maximum of Rs.2 lakhs investment holds good similar to domestic investments (IPO). The introduction of IDRs brings some benefits to the Indian investors as they can invest in foreign
companies without coming under a foreign exchange regulation. The regulation states that no resident individual should hold more than $200000 in foreign capital markets.

VIII. Introduction of Derivatives in India

Derivatives are financial contracts whose values are derived from the value of underlying financial instruments. The International Monetary Fund defines derivatives as ‘Financial instruments that are linked to a specific indicator or commodity and through which specific financial risks can be traded in financial markets in their own right. The value of a financial derivative derives from the price of an underlying item, such as an asset or index. Unlike debt securities, no principal is advanced to be repaid and no investment income accrues. The first step towards introduction of derivatives trading in India was the setting up of a committee by SEBI to develop regulatory framework for derivatives trading in India in 1996. The committee suggested the induction of derivatives within the meaning of ‘securities’ in the Securities Contract Regulation Act, 1956 and necessary amendment was made in the year 1999. Derivatives were formally defined to include: a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract or any other form of security, and b) a contract which derives its value from the prices, or index of prices or underlying securities. The Act also made it very clear that derivatives are legal and valid, but only if such contracts are traded on a recognized stock exchange. The committee also worked out the operational details of margining
system, methodology for charging initial margins, brokers’ net worth, deposit and real time monitoring requirements.

Derivatives trading commenced in India after SEBI granted the final approval to commence trading and settlement in approved derivatives on BSE and NSE. Derivative contracts have several variants such as forward contracts, futures, Option and Swaps. Forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today’s pre-agreed price. Futures contract is an agreement between two parties to buy and sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange traded contracts. Options contract is of two types - calls and puts. Call option gives the buyer the right to buy an asset but not an obligation to buy a given quantity at a given price on or before a given future date, whereas a put option gives the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before the future date. Swaps are private agreements between two parties to exchange cash flows in the future according to a pre arranged formula. Also there are three broad categories of participants who trade in the derivatives market such as hedgers, speculators and arbitrageurs. Hedgers use futures or option markets to reduce or eliminate the risk associated with the price of an asset. Speculators use futures and options contracts to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and potential losses by usage of derivatives in a speculative venture. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If for example, they see the
future price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Index futures were introduced in June 2000, followed by index options in June 2001, and options and futures on individual securities in July 2001 and November 2001, respectively. As of 2011, the NSE trades futures and options on 200 individual stocks and 3 stock indices. All these derivative contracts are settled by cash payment and do not involve physical delivery of the underlying product.

There has been tremendous growth in futures and options segment as far as number of contracts and turnover are concerned. The turnover in index futures tremendously increased from Rs.2365 crs in 2001 to Rs.174000 crs in 2011. Similarly in stock futures the turnover increased from Rs.51515 crs to Rs 190000crs in 2011. The use of derivatives varies according to the type of institution. Financial institutions, such as banks, have assets and liabilities of different maturities and in different currencies, and are exposed to different risks of default from their borrowers. Thus, they are likely to use derivatives on interest rates and currencies, and derivatives to manage credit risk. Non-financial institutions are regulated differently from financial institutions, and this affects their incentives to use derivatives. Indian insurance regulators, for example, are yet to issue guidelines relating to the use of derivatives by insurance companies.

Foreign Institutional Investors (FIIs) were allowed to operate in the derivatives market from 2004 onwards. There were restrictions on FIIs exposure in the derivatives market. For instance, their exposure in equity index derivatives were subject to the following - a) for short positions in index derivatives (short futures, short calls and long puts) will not exceed the FIII holdings in the stock market.
b) For long position in index derivatives (long futures, long calls and short puts) will not exceed the FIIs holdings of cash, government securities, T-bills (treasury bills) and similar instruments. In the year 2004, two new exchanges were set up namely, MCX (Multi Commodity Exchange of India Ltd) and NCDX (National Commodity and Derivatives Exchange Ltd) for trading in commodities.

The developments witnessed in the Indian Capital Market in the last decade has resulted in more volume of trade, reduced transaction costs and has provided an opportunity for the companies in India to raise funds from overseas markets thus reducing the burden on the financial institutions in India to lend money to the business segment. The introduction of derivatives has led to a mechanism of discovering price for the stocks and commodities. The developments have opened up opportunities for Indian investors to invest in foreign companies.

**IX. Buyback of Shares**

In India, companies were permitted to buy back their own shares in the year 1999. Buyback of shares refers to repurchase of their own shares by companies in India. There are two different methods of share buyback viz., through authorized brokers and tender offer. The repurchase of shares in the open market through authorized brokers is a method to buy back shares and in the tender method, the company will specify the purchase price, the total amount and the period within which shares will be bought back. Some leading companies like Reliance Industries, Ashok Leyland, Bajaj Auto etc., have opted to buy back their own shares. The common reason cited by these leading companies is to return surplus cash to shareholders and in turn improve the EPS and enhance shareholders value. Most
of the companies have used tender offer method to buyback shares from their shareholders. The most plausible reasons for buyback of shares could be any of the following -

a) To return the surplus cash to the shareholders as the general reserves of companies buying back shares will be huge and also may not have profitable avenues for investing such surplus reserves. Hence, a decision will be taken to return the surplus to the shareholders.

b) To increase the share value and also the earnings per share. By repurchasing the shares, the earnings per share will increase as the number of shares outstanding will be reduced.

c) To increase the share prices of undervalued shares. The companies may use buyback of shares as a reason to increase the share prices. Companies buy back shares at higher prices to move up the current share prices.

d) To achieve a target capital structure. The companies may use buyback of shares if there is high proportion of equity in the capital structure. Buying back of shares reduces the equity capital of a company.

e) The promoters of the company benefit by consolidating their ownership and control over companies through the buyback arrangement.

f) To protect against hostile takeovers. In a hostile takeover, a company may buyback its shares to reduce the availability of shares and make takeover difficult.
There are certain guidelines to be followed for buyback of shares by companies in India namely-

a) The buyback of shares should not exceed twenty five percent of the equity and paid up capital of a company in the respective financial year in which buyback is planned.

b) The shares to be bought should be free from lock in period and non-transferability. A special resolution should be passed in the general meeting authorizing buyback of shares. The buyback can be made by a board resolution if the buyback of shares is less than ten percent of the paid up capital and free reserves.

c) The buyback should be authorized by the Articles of Association of the Company.

d) The debt owed by the company should not be twice the equity capital and free reserves after the buyback of shares.

e) The companies should not have defaulted in payment of interest on debentures, redemption of debentures/preference shares, payment of dividend to the shareholders within the stipulated time before buyback of shares.

f) All the shares meant for buyback should be fully paid up.

g) The companies opting for buyback should have filed the annual accounts of the company regularly and should not have defaulted in submission of accounts and returns to the concerned authorities.
h) The buyback of shares of any listed company on a stock exchange should be according to the regulations stipulated by Securities and Exchange Board of India (SEBI).

X. Introduction of Innovative Debt Instruments

Perpetual Hybrid securities are an innovative means of raising funds from the capital market. They have equity characteristics and have the highest pecking order (to share capital) in the capital structure. It is similar to an equity instrument and the returns are not certain as the company retains the right to defer interest payment. In case of liquidation of the company, the perpetual bondholders precede equity share investors. The unique features of the securities are that they are perpetual in nature with no maturity or redemption and are callable only at the option of the company. This innovative long term funding with equity features helps a company to diversify its financing options. In these securities, the interest rate is fixed for a certain period with an option to raise it after some years. The funds raised through this instrument are cost effective as the interest rate is fixed and in an inflationary condition where the interest rates climb, such securities will be very handy for companies in India. Such bonds can also be listed in the stock exchanges. For instance, in March 2011, Tata Steel was the first Indian company to raise Rs.1500crs through this instrument with a coupon rate of 11.8% fixed for 10 years with an option to revise the interest rates at the end of 10th year. This issue was privately placed and the company has got plans to list this security in NSE and BSE. The important feature of this instrument is that it has an option to defer payment of interest on the bond. From the investors’ point of view, such
issues will be attractive because of an attractive interest rate and security of the investments.

XI. Foreign Currency Convertible Bonds

These are the bonds which are issued in a currency other than the home country’s currency. It is a quasi debt instrument which is issued in a foreign currency and during the tenure the bond holders will be paid the interests at regular intervals with an option to convert the bonds into shares after some point of time during the period. The price at which the bonds are to be converted is fixed at the time of issue. The bond holders have the option to convert into equity shares or redeem the bonds at the end of the maturity period. The companies benefit from the issuance of such securities as the cost of raising funds through this mode is less when compared to the conventional sources. It is said that FCCBs could be raised at 70% of the conventional source of borrowing. The conversion of bonds into shares takes place at a premium price which is fixed at the time of raising the money and as the conversion happens at a higher price, there will be less dilution of equity. The regulatory process is also very simple and the FCCBs are basically issued to suit the companies’ needs. From the investors’ perspective, the capital is guaranteed just like any other debt instrument. If the company does well in the post conversion period, the converted bond holders can enjoy the capital appreciation. It is also an option for the investors to convert into equity shares and if an investor is not in favour of converting it into equity, the bonds could be redeemed immediately on maturity.
Introduction to Stock Splits

Liquidity is one of the major factors affecting investment in the capital market. Liquidity refers to how easy it is to buy and sell shares without seeing a change in the prices. It is important as increase in liquidity increases the volume of trade in the capital market. The important factors affecting liquidity are the percentage of shares available for trade in the market and the price of stocks quoted in the market. The indices in India are constructed on the basis of free float system. A system where that part of the shares that are freely available for trade in the market. In other words the shares held by the promoters and financial institutions are not considered for calculating the indices. The price of a stock refers to say a company with Rs 100 as a face value is quoting at Rs 10000/- in the secondary market. The investors mostly retail investors will be discouraged to buy stocks with such high values. There are many ways to improve liquidity of shares like issue of bonus shares and another tool the corporate world witnessed to improve liquidity is stock split. A stock split is the division of a share into two or more parts. Stock split adds no value but increases the number of shares in the ratio of the split. By splitting the share, the value of the company will not increase, but the capital is only redistributed by the increased number of shares. Lamoureux et al., (1987) “Splits are only cosmetic change, slicing the same pie into smaller pieces but not changing the fractional ownership of the equity interest and votes in the company”. The earnings per share will be diluted and the market price per share will fall proportionately with the share split. The total value of the holdings of the share holder remains unaffected with the stock split. It was Fama et al., (1969) paper which gave the signaling and trading range hypotheses
as possible reasons for companies opting for stock splits. There are other plausible reasons for stock splits in the financial literature, which are discussed in the following pages.

**Trading Range Hypothesis**

Companies with stock price ranging higher in the market try to attract the investors by reducing the price of the stock and bring them to the popular trading range (*McNichols et al., 1990*). Stocks with very high price would not be considered by the common investors, as they would get lesser number of shares for the given amount. New investors entering into the market always prefer those stocks which are in the trading range or with lesser share price (*Satyajit Dhar et al., 2006*). Stock split is one of the techniques in which the corporate brings the stock price to the trading range.

**Signaling Hypothesis**

Companies would always like to see their share prices soaring high and it is veridical that a stock split signals better prospects for the companies in future and can also be interpreted as a vote of confidence by the management (*Grinblatt et al., 1984*). Firms that split their shares have a higher short term earnings growth in the future than firms that do not. The market share of high growth firms increases very fast. If the shares are not split periodically, they fall outside the popular trading range. Therefore these companies resort to stock splits from time to time (*Lakonishok et al., 1987*).
The stock split thus is the informational value that the company is expected to perform efficiently and profitably and that the shares have been split to avoid future high price per share. *Brennan and Copeland (1988)* have assumed that managers use stock split announcements to communicate their private information about the future prospects to investors.

**Liquidity Hypothesis**

A stock split lowers the share price, which in turn makes stocks more attractive to retail investors and culminates in driving the share price higher and in turn improve the market capitalization of the companies. Most of the CFOs’ have opined that an exercise of splitting stocks could remove the psychological problem or block of having to pay a higher price for stocks (*Baker and Philips, 1994*). Stocks are split to improve liquidity or increase trading in a company’s share (*Muscarella et al., 1996*). For instance, Infosys, Wipro, Hindustan Unilever, LMW (Lakshmi Machine Works Ltd), Rajesh Exports etc., were highly priced before the stock splits and were out of reach for retail investors, while after the stock split, investments in these shares have become more viable. With the reduction in the market price of the share, the shares of the company are placed in a more popular trading range. Thus, reduction in the share price caused by the share split motivates more investors, particularly those with small savings, to purchase the shares. This helps in increasing the marketability and liquidity of the company’s shares.
**Neglected Firm Hypothesis**

*Arbel and Swanson (1993)*, predominantly in the context of stock splits have proposed the Neglected Firm Hypothesis. According to them, if there is little information about a firm, its shares trade at a discount. Thus, a firm’s manager uses the split to draw attention of the investors to ensure that information about the company is recognized widely than before. The companies opt for stock splits, if it feels that the shares are undervalued and also neglected by the investing community in the stock market. The idea is, when a split is effected, the analysts will reexamine the company and if the management is right, the analysts will find its prospects more favorable and in turn improve the ratings of the stock. The stock splits strategy across the globe other than in India is to send an optimistic signal about the future prospects of companies, which was researched and found to be correct. In India, empirical studies have shown that corporates split stocks to gain the attention of retail investors (i.e., a penchant for attention) *(Gupta Amitabh et al., 2007)*.

**Stock Split in India**

In India, SEBI (Securities Exchange Board of India) permitted stock splits in the year 1999 and this was followed by a majority of the companies starting to split stock frequently in a short period of time. In the late 90s’, institutional investors such as Foreign Institutional Investors, mutual funds and financial institutions started to actively participate in the stock market and the volatile movement in stock prices was attributed to them. To reduce volatile movement in the stock prices and encourage retail investors to invest more, companies started to use
stock split as a strategy to stabilize the price. A Split is expected to create a psychological block in the minds of institutional investors that their stake in companies are undermined and retail investors are given more importance by the companies. Therefore, the institutional investors may either retain their stake or sell their holdings in companies and withdraw from the market. *(Mason et al., 1998)*, have found that companies with more institutional ownership as a percentage of total capital tend to have larger stock splits than those with low institutional ownership.

The fundamental analysts assess the performance of companies using parameters such as E.P.S (Earnings Per Share), P/E (Price to Earnings) ratio etc. and as a result of stock splits, they may revise the valuation of the companies and may start using other parameters to judge the performance like RoA (Return on Assets), Leverage ratios and economic profit models. This is because E.P.S and P/E ratio will be adjusted for the stock split and using the parameters will not bring out any quantitative reasons for splits. But, *(Kalay et al., 2007)* have found in their study that analysts revise E.P.S forecasts upwards by approximately 1.2% around the split declaration date. Hence, their empirical study has stressed on the fact that ‘stock split’ announcement is taken as positive information enabling fundamental analysts to revise the valuations of the companies.

The earlier studies were centered on technical factors such as daily price movements and comparison of stock prices before and after the split date (usually called event day) to assess the impact of stock split decisions on the companies’ performance. *(Amitabh Gupta et al., 2007)*, in their study have found that stock
splits are associated with positive abnormal returns around the announcement day or the event day.

The returns for 30 days prior to the split and 30 post split returns were studied in their research. (Asquinth Paul et al., 1989), in their study have indicated that companies splitting stocks have significant increase in earnings and have found that price response to splits is positively related to pre split but not to post split earnings changes. The investors assume that incidence of increase in earnings before the split is permanent in nature and will continue to hold good in the future.

The assumption seems to be true, but the authors could not attribute earnings increase to stock splits. From the shareholders/investors perspective, stock split is considered as a positive signal about the performance of companies. But there are a few intricacies which investors face regarding stock splits in India, namely:

1. Investors were totally confused as to whether the market price was based on the pre-split value or post split value. Also, for the research analysts, comparison between companies in the same industry became difficult because of frequent changes in the face value of shares.

2. The frequent changes in the face value of shares made it difficult for investors to determine the dividend rate and also to calculate the return from a company. For instance, a dividend rate of 100% on a Re. 1/- per share or a dividend rate of 10% on a Rs.10/- per share made no difference. This is because investors will be entitled to a dividend of Re 1/- in either of the cases. But, a 100% dividend will create apprehension about the performance of the company. Such psychological games were resorted to
by the companies and created unhealthy practices in the market. This was also contradictory to the SEBI circular in the year July 1999 which stated that dividend should be declared on per share basis.

3. The purpose of stock split is to reduce the face value of the share (proportionately the market value also reduces) and also to encourage retail investors to trade more in the stock market. The investors had the tendency to invest more in shares, which had opted for stock splits. Keeping this psychological factor in mind, many of the unscrupulous promoters started to split their shares, when they were already trading at a nominal price.

In India, even companies which were trading in a nominal price range, were resorting to stock splits. This was contrary to the primary purpose of splitting stocks (Fama et al., 1969), which was to bring the shares to a nominal trading range. The issues discussed above have led to the following questions being raised on stock splits:

1. Are companies opting for stock splits in a financially profitable situation prior to the splits?
2. Do companies split stocks because they are undervalued in the market?
3. Is a high split ratio an indicator of higher earnings potential in the future for companies?
4. Are earnings the determinant factor for stock splits?

The questions raised above are developed into Statement of the Problem for the present study which is defined at the end of this chapter.
The following pages will discuss on SEBI regulations on stock splits and also the revised regulations brought out in the year 2003.

SEBI Guidelines on Stock Split

The equity shares of the listed companies were originally required to be offered to the public in the denominations with face value of Rs. 10 or Rs. 100. Before SEBI took over the control of the capital market in 1992 as the securities regulator, it was Controller of the Capital Issue (CCI) that controlled the issue of shares by listed companies. The CCI, under the Ministry of Finance had stipulated that equity shares which are in denominations other than those of Rs. 10 or Rs. 100 need to be converted into those of Rs. 10 or Rs. 100.

SEBI has provided the following guidelines:

a. The companies are given the freedom to issue the shares in any denomination to be determined by them in accordance with section 13(4) of the Companies Act, 1956. However, these shares would not be issued in decimal of rupee.

b. The companies that seek to change the standard may do so after amending the Memorandum and,

c. The existing companies which have issued shares of face value Rs 10 and Rs 100 may also change the standard denomination other than decimal of the rupee by splitting or consolidating the existing shares after amending their Memorandum and Articles of Association.
d. Only those companies whose shares are dematerialized shall be eligible to alter the standard denomination.

e. At any given time there shall be only one denomination for the shares of the company.

The company shall adhere to the disclosure and the accounting norms specified by SEBI from time to time.

SEBI, after several instances, issued advisories to curb abuse of stock splits. A committee named Secondary Market Advisory Committee (SMAC) was set by SEBI in the year 2003 and the following are the modifications and suggestions to the earlier directive in 1999:

- No listed company whose market price in the previous six months is less than Rs.500 per share can split the value of its equity share.

- If the company goes in for split or consolidation, it will not be permitted to do so again for a period of three years from the date of the last split / consolidation.

- The change in the par value will have to be disseminated through the websites of the stock exchanges for a continuous period of one year from the date of last split / consolidation.

- This should be in addition to the condition stated in SEBI circular dated June 14, 1999 which is discussed earlier.
In the year 2005, the Primary Market Advisory Committee (PMAC) of SEBI rejected the guidelines laid down by the SMAC in the year 2003. The PMAC was of the opinion that all companies should have a uniform face value of Re.1 which would make the investors in comparing the performance of stocks with ease. However in May 2010, a special advisory committee of SEBI rejected the idea of having a uniform face value of Rs. 1 for all the companies. The committee opined that all the dividend announcements of companies were currently on per share basis as against the announcements on percentage basis. Also the companies were already resorting to stock splits and would soon reach the Re1 level mark. Hence, there are no clear guidelines for allowing companies to split stocks in India.

**Statement of the Problem**

Stock splits in India were on the rise during the period of study (2000-2008). The shareholders were unaware of the reasons as to why companies were splitting shares in India and consequent market reaction to split announcements by companies were not clearly known. The reasons might have been to increase the volume of trade, reduce the share prices and also might be to get a fair valuation of shares in case of undervalued companies and to follow those companies which have split stocks in the peer group. Mystery looms large on the purpose, process, expectations and objectives behind the stock splits. The present study is therefore to identify factors as to why companies split stocks and explore whether the reasons for splitting stocks are the same across the different categories of companies in Bombay Stock Exchange (BSE) India.
Chapter Scheme

The chapters for the research work are sequenced in the following manner:

Chapter I  INTRODUCTION

This chapter is subdivided into two sections. The first section gives an overview of Indian Capital Market and its constituents. The growth and evolution of stock exchanges in India is discussed which is followed by discussion on the recent developments which the Indian Capital Market has been witnessing since liberalization. The second part is about the study on stock splits. A theoretical explanation on why stock splits happen is followed by statement of problem relating to splits. At the end of the chapter, SEBI regulations on stock splits and the present status of stock splits in India are discussed.

Chapter II  REVIEW OF LITERATURE

This chapter is a collection of earlier studies done relating to stock splits. Reviews consist of studies conducted in U.S, U.K, Europe, China and India. A gist of the earlier studies is highlighted and also the various variable used by the earlier researchers in their study are also analysed. The review is done from 1985 to 2011.

Chapter III  METHODOLOGY

This chapter discusses the research design, objectives and hypotheses developed for the purpose of study. This chapter also explains the method and source of data collection, data analysis undertaken and the statistical tools adopted for the study.
Chapter IV  DATA ANALYSIS AND INTERPRETATION

This chapter provides the descriptive statistics of the data collected and the number of companies split according to year wise, split ratio wise and economic activity performed by the companies. The results of various statistical tools used in the study are also analysed and interpreted.

Chapter V  FINDINGS AND SUGGESTIONS

This chapter discusses the findings based on the objectives of the study. This chapter compares the findings of the present study with those from earlier studies and the implications of the present study on stock splits are discussed. The study also provides certain suggestions for conducting further research in stock splits.

Chapter VI  CONCLUSION

This chapter discusses the concluding aspects of stock splits and provides certain directions for pursuing research in future relating to stock splits.