

The

**"The best book ... (on)
India's securities
industry"**

*Ajay Shah,
Indira Gandhi Institute of
Development Research*

Indian SECURITIES MARKET



**A GUIDE FOR
FOREIGN
& DOMESTIC
INVESTORS**

TADASHI ENDO

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The Indian Securities Market

A Guide for Foreign and Domestic Investors

Tadashi Endo



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TADASHI ENDO

Preface

The Indian capital markets may appear mysterious and puzzling to many foreign investors and even to domestic Indian investors. To my knowledge, however, there is no current information material which comprehensively addresses investors' concerns about this rapidly-growing market. I have no power to solve its inherent problems; but what I have tried to do is shed some light on practices and rules in the Indian market, including the problematic ones, so that foreign as well as Indian investors can look at the market more rationally for their portfolio investments in Indian securities.

The Indian financial system is a vast universe, as shown in Figure 1.1. This universe is regulated and supervised by two government agencies under the Ministry of Finance:

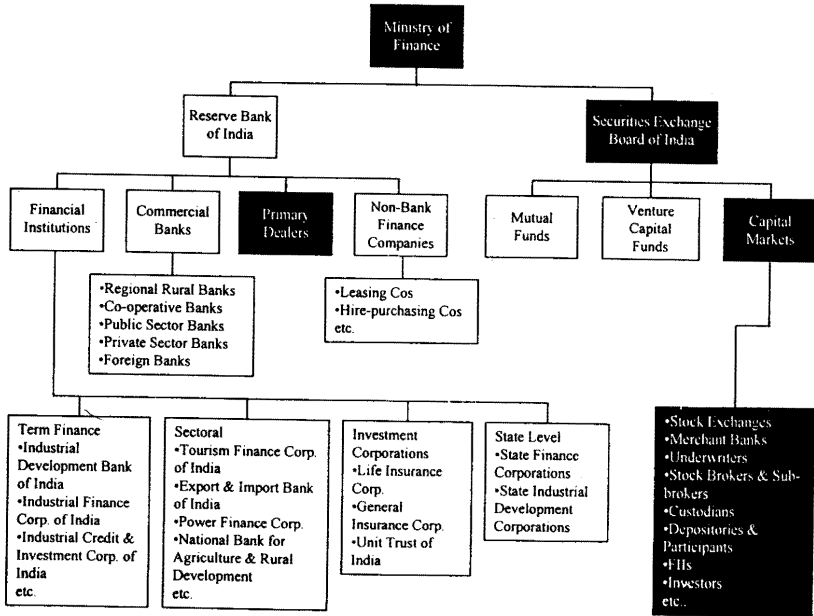
- (i) The Reserve Bank of India, India's Central Bank, and
- (ii) The Securities Exchange Board of India, the country's capital market regulator.

All parts of the system are interconnected with one another, and the jurisdictions of the central bank and the capital market regulator overlap in some fields of Indian financial activities. This book focuses on the capital markets of India under the latter, and primarily covers the areas involving the regulator and the market participants, as highlighted in the chart.

The Indian capital markets change amazingly quickly. Some parts of this publication may well be out-of-date by the time it reaches your desk. Indian people in the securities industry attribute the lack of comprehensive information material about their market to the rapid and incessant changing of rules and regulations. Yet, I believe that investors, foreign and Indian alike, need something like a benchmark from which they can develop their knowledge and understanding of this market.

Therefore, please do not assume that the information in this book continues to be correct or remains unchanged. This book is intended to be a tool to help you ask educated questions and make unbiased judgments about the Indian capital market. Though this publication is originally designed for foreign investors, Indian investors and students will also find

Figure 1.1
An Overview of Indian Financial System



Compiled from *The Emerging Asian Bond Market: India*, The World Bank, 1995, and other sources.

Note: This book covers primarily the regulators and market participants in the highlighted boxes.

it useful if they wish to build up knowledge and understanding of their own capital market.

Given the limitations of this publication, I would greatly appreciate it if you would mail, call, fax or e-mail me your comments, suggestions and more accurate information if you have any, and they will be incorporated in the next edition.

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Introduction

1.1 Wild Dreams?

Has India been changing since 1991? Yes, definitely. But, how can one tell that?

In November 1995, I landed in Mumbai from Singapore, twenty-three years after I had last visited the city. Facilities at the airport still seemed far behind those of major Southeast Asian countries. On the way downtown from the airport, I saw signboards advertising cellular phone services. The names Ericsson, Panasonic and Sanyo also caught my eye. Generally speaking, most passenger cars on the road were Marutis, which are Indian-made versions of the Suzuki 800. But, so what? All these things can be found everywhere in East and Southeast Asia.

The Indian commercial capital still looked like the East German cities, East Berlin and Potsdam, which I had visited soon after the Berlin Wall was torn down. Buildings were just as shabby as they were twenty-three years ago. Even the office buildings of major Indian corporations, many of which had been built in the British colonial times, were poorly maintained. I could not notice any tower cranes on the skyline. There were fewer stray cows on the city streets than before, but professional beggars still waited for me at almost every traffic junction.

I had last left India in early 1976. So many things had happened in my life in the intervening twenty years since then. I had worked on a building project in Pakistan. I had gotten married and had kids. I had worked in the midst of the jungles of Borneo and then in Hong Kong. I had gone to the United States to study business administration. I had worked on Wall Street and had enjoyed crossing swords with American investment bankers. Now, I was back in Asia. As I expected in the late seventies, Asian economies had made drastic changes. Nevertheless, India seemed much the same.

Coming back to India made me wonder if my life for the past twenty-three years had been just a series of wild dreams. Despite some

conspicuous changes in the Indian urban life, I could not help feeling uneasy about the economic reforms in India.

I had another chance to visit India in May 1996. Thanks to my current profession as an investment banker, I was able to meet the Finance Secretary, the Chief Economic Advisor to the Finance Minister, and other government officials. To be honest, all I did was accompany my boss. I mostly listened to his discussion with the Indian officials. Only occasionally did I participate. I was pleasantly surprised to find that Indian intellectuals were very different from how they used to be. Their discussion about the Indian economy were animated, and their concerns genuine. They were trying hard to apply their intelligence, knowledge and judgment to their own economy.

More than twenty years ago I was amidst Indian intellectuals — professors and graduate students — on a university campus in New Delhi. They were terribly sharp and smart. I was overwhelmed. Quite a few of them had been educated in the United Kingdom or the United States, or both. They seemed to know everything and, in fact, they could argue and debate about almost any subject.

Nevertheless, they had a common weakness. They were, in general, poor at relating their academic knowledge to the reality of the Indian economy or society. How do you apply it? That question was often effective enough in heading off their intellectual aggressiveness. They did not have a politico-economic platform on which they could practice their academic knowledge. They seemed to be intellectually caged.

But today, the way India's best and brightest analyze their own economy and present macro-economic prescriptions for it convinces me of the viability of the country's economic reforms. I am not talking about the validity of their economic policies. The point is that their intellectual ability is finally shaping India's development, and that they appear to be willing to accept this responsibility. So, my life in the past twenty years was real, and India's reforms are real, too. India is indeed changing.

1.2 Ancient History in Two Years

You may be hesitant to invest in Indian securities, because you have heard that the Indian stock market is rife with a myriad of paperwork and messy settlements.

The Bombay Stock Exchange used to open for only two hours a day from 12 noon on weekdays till early 1995. A two-hour trading session

generated a whole day's worth of paperwork. All shares were traded and transferred literally in a physical form from one investor to another. But investors did not trust their brokers to safe-keep their securities in a street-name, that is, in the name of brokers; there were no depository systems in the country, either. Share certificates and accompanying documents had to have verification of both significant and trivial natures cleared by brokers, custodians, exchange officials and registrars, each of whom often applied different criteria in accepting or rejecting the share certificate and accompanying documents. Their settlements were prone to errors, mistakes, delays and, in extreme cases, unethical or criminal practices at each step of the process. There were few rigid time-frames in which each settlement procedure had to be completed and fully complied with¹.

Testimonies of such inefficiencies abounded: overwhelmed by settlement delays, sometimes many months long, the exchange periodically had to close to clean up house; after filling its vaults to the brim, an Indian custodial bank started storing share certificates in a trailer parked in an alley; and messengers queued up outside banks, each bearing one or more boxes stuffed with shares².

However, today this is all ancient history. The exchange's regular trading hours are five-and-a-half hours (from 10:00 a.m. ³ to 3:30 p.m.) a day. Do people in the market have to carry out 16.50 to 19.25 hours (= 6 or 7 hours / 2 hours x 5.5 hours) of paperwork before they go home? No, they do not need to work overnight. They can go home at normal hours every evening. Trades settle every week and shares are delivered every week.

What custodial banks in Bombay would like you to today first take a look at is their "factory": a neatly organized and restricted dispatch room, a spacious vault which smells fresh painted, complete with bar-coded plastic pouches and security guards in uniform.

Until May 1995, the Bombay Stock Exchange operated as an open outcry market with thousands of traders on the floor who communicated

¹ For an interesting description of the working of the Bombay Stock Exchange at that time, see an internet article, Richard Todd, "The Good, the Badla, & the Ugly", *Worth OnLine*, February 1995, <http://www.worth.com/articles/Z9502F03.html>.

² Michael R. Sesit, "Global Investors Depend on Invisible Force: the Custodian", *The Wall Street Journal*, June 26, 1997.

³ Changed to 9:30 a.m. with effect from Monday, November 17, 1997.

with each other by shouting in the Gujarati language⁴ and by using hand signals. One good thing about an open outcry system is that you can intuitively feel the mood of the market that is continuously changing. To a layman, however, it is just chaos. In fact, open outcry trading is prone to errors and mistakes. While an outsider can see an open outcry market, but he or she cannot tell exactly what is going on there. No collusive transactions may be noticed unless a highly trained and adequately staffed surveillance team is in place. The Indian trading floor was always, therefore, viewed with some suspicion.

Today, the trading floor at the exchange is no more. It was replaced by a computerized trading system in May 1995. The area which used to be the trading floor is now a majestic hall that the exchange uses for in-house seminars or functions. By contrast, you can see much more spectacular and “chaotic” theater at the stock exchanges of Tokyo and New York as well as at the Chicago Mercantile Exchange and the Chicago Board of Trade. The Bombay Stock Exchange, the National Stock Exchange and the other 14 exchanges in India⁵, on the other hand have been completely computerized. Of these, 11 stock exchanges went on line in 1996-97 alone. In a few years, Indian business students may take overseas tours to the Tokyo Stock Exchange or New York Stock Exchange to see floor trading in its old-fashioned glory.

1.3 Persistent Misconception

Why do some foreigners persistently refuse to trust the Indian securities markets? I can think of two reasons: the appearance of Mumbai, and Indian English.

Let's assume you are the representative of a foreign institutional investor, and you are not an Indian. You visit India for the first time to meet local stockbrokers and custodial banks in Mumbai before you begin to trade in Indian securities. How would you sense the potential and the trading reliability of this emerging capital market? Through intensive interviews with the market participants? Probably not. You're likely to be more influenced by what happens at airport immigration and customs,

⁴ A vernacular language of India which is generally spoken in the Gujarat State and in the trading communities in the city of Bombay.

⁵ Out of 22 stock exchanges in India, 15 stock exchanges had been computerized as at the end of March 1997.

and by what you see as you drive into the city. You arrive in Mumbai at night. The next morning, you reflect on your experience at the airport, and continue to observe, out of the window of your car, everything that catches your eye on the way to your first appointment. You quickly start comparing the Indian commercial capital with Bangkok, Kuala Lumpur, Jakarta and Singapore. The chances are that you would already unconsciously have built up 50-70% of your "objective" view about the potential and the trading reliability of the Indian market by the time you arrive for your first meeting.

India is really unfortunate in this respect. She does not have many of the symbols of an emerging capital market, normally, a forest of tower cranes or shining plate-glass skyscrapers in her commercial capital. It is ironical that Mumbai saw a combination of real estate and stock market booms as early as the 1860s. Yet, there are few redevelopment sites in the city today. There is little contrast between the new and the old.

Why is this so? There is a good reason for it. A holdover from the pre-independence era still impedes the redevelopment of Mumbai. The rent control act, a Maharashtra state law applicable only to Mumbai city, solidly protects tenants, and does not allow landlords of residential and commercial buildings to raise rents. The rent for a 3,500 square feet residential flat in downtown Mumbai can be as low as US \$10 a month if the tenant has been leasing the flat for decades. Neither tenants nor landlords are financially motivated to renovate their buildings, especially the commonly-used areas including the facades. It is almost impossible for a landlord to kick out tenants from his or her building in order to tear it down and construct a modern and economically-efficient building. This is because the majority of electoral constituents are tenants, and law makers do not want to lose their jobs by taking the initiative in amending or repealing the current law. It is said that 50-60% of apartment residents in Mumbai are living under these conditions. (*Note: about 40% of residents are homeless or stay in slums.*)

Instead, urban developments are under way in Navi Mumbai or New Bombay outside Mumbai island, New Delhi and other cities. Construction sites there would probably excite foreign investors more, and convince them of the growing potential of the nation. Therefore, you should not be disproportionally influenced by Mumbai's stagnant and disorderly surface when making a judgment about the Indian capital market.

Another factor that may mislead you in India is the English language that Indians speak and write. This can be a hidden source of mistrust and

may play a part in making Indians misunderstood by foreigners, including foreign investors.

English is widely spoken in India. Most subjects in higher education are taught in English. Indians in the south of the subcontinent can effectively communicate with Indians in the north only in English. A substantial part of business is done in English. There are lots of Indian professors of English in the United States and England. Cab drivers can speak English. Therefore, Indians and many foreigners feel it is easy to communicate with each other and both are no doubt benefit from English being used in India. It's very convenient. However, some foreigners often get frustrated in communicating with Indians and, consequently, some mistrust develops between Indians and their foreign counterparts.

It is important to realize that Indian English is virtually an Indian vernacular language. It is not just a matter of accent. Indian people may use some English words in a different sense from what those words would normally mean to a native English speaker. Many Indians master English in an Indian environment which is a world away from England or America. They speak English fluently but in an Indian context. Your "promise" may not be their "promise". Some Indians may use English in an Indian context on one occasion, and in a British context on another. Others may speak it only in the context of international business.

The great fluency with which Indians use English often makes foreigners, as well as Indians themselves, drop their guard against cultural differences. Unfortunately, this, may present some pitfalls. An average international business person is well aware of how critical it is to know and respect the cultural differences of the countries they deal with. Upon arrival in Japan, or even before that, a foreign business person will be aware that very few Japanese speak English, and therefore prepares himself or herself for a limited scope of communication in English and/or possible misunderstandings arising from the cultural differences. You would not study the Japanese language without studying Japanese culture and history. Similarly, you would not study an Indian vernacular language without studying more about Indian culture and history.

The lack of awareness of the indigenouness of Indian English seems significantly responsible for much of the unnecessary mistrust between sincere Indians and sincere foreigners. Nevertheless, once you can recognize Indian English for what it is — a vernacular language of India — you can be more careful about discerning the actual meanings of English expressions used by the Indians. Furthermore, you will also be

able to prevent mistrust and thereby evaluate more objectively the potential of the Indian capital market.

1.4 Confirmation, Confirmation and Confirmation!

It is said that the secret of success in the real estate business is location, location and location. The secret of safety in the Indian securities business is confirmation, confirmation and confirmation.

I am loath to say this, but information available in, or from India, is unfortunately more often inaccurate or imprecise than that available in or from developed countries. The way Indian people give you information tends to be decisive, but the information itself may be incorrect. The contrast between the decisiveness and the incorrectness is sometimes perplexing. You would often be confused by sharply conflicting answers to the same question.

Indian people never intend to mislead you. However, the reality is that the quality consciousness or quality control in respect of information in India is generally poor by international standards, even though the country has a large population of highly educated people. Firstly, information may not be sufficient or carefully prepared at the source. For instance, some of SEBI's⁶ regulations and announcements are loosely worded. Some rules of stock exchanges are not readily available and this lacuna can confuse and misguide people. Secondly, information may be damaged in the communication process. It is fragile and perishable like an egg and its handling requires some skill and care. There are still many people in the Indian capital market who are not adequately qualified or trained according to international standards. Thirdly, as I discussed earlier, perception gaps between Indians and foreigners only serve to blur the picture further.

When I was in India more than twenty years ago, I made it a rule to ask three different people the direction to the railway station or the post office in a town even though their locations had remained unchanged for many years. Information on a capital market including rules and practices is much more complex and unstable than a railway station or a post office. In gathering information, make sure you have made yourself understood fully and accurately, and also make sure you have understood your counterpart fully and accurately.

⁶ SEBI stands for Securities Exchange Board of India.

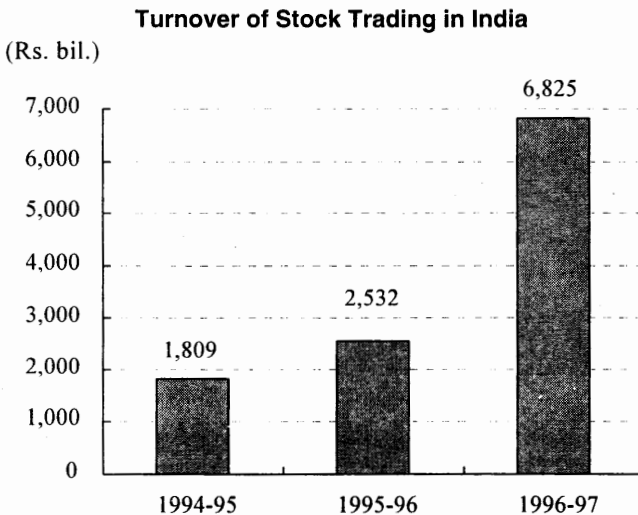
Portfolio Investment by Foreign Investors

2.1 Improving Regulatory Framework

2.1.1 Controlled Opening-Up Process

The Indian capital market has been growing by leaps and bounds. Figure 2.1 below shows the total turnover of stock trading on all 22 stock exchanges in India. The annual growth rate from the fiscal year 1994-95 to the fiscal year 1996-97 was 56% in nominal Rupee terms.

Figure 2.1



Source: SEBI Annual Reports 1995-96 & 1996-97.

Trading volumes in the Indian capital market are fairly large compared to those in other emerging markets. Table 2.1 shows the turnovers in terms of the US dollar and the liquidity ratios on the two major stock

exchanges in India as well as various stock exchanges in other countries in 1996. The combined turnover on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), which are both located in Bombay (Mumbai), exceeded that of some booming stock markets in Southeast Asian countries. This is because of the remarkably high liquidity ratio on the NSE. Considering the fact that the majority of about 6,000 stocks listed on the BSE have little liquidity, it can be inferred that a group of the 1,500 most traded stocks on the BSE would also have a considerably high liquidity ratio.

Table 2.1
Turnovers & Liquidity Ratios
of Indian & Foreign Stock Exchanges in 1996

	Turnover (in US\$ bil.) ^c	Liquidity Ratio ^d
Bombay Stock Exchange ^a	26.5	0.22
National Stock Exchange ^a	69.1	0.65
New York Stock Exchange	3,728.4	0.58
London Stock Exchange	390.1	0.25
Tokyo Stock Exchange ^b	885.7	0.28
Stock Exchange of Singapore	51.9	0.27
Hong Kong Stock Exchange	182.6	0.48
Kuala Lumpur Stock Exchange	183.0	0.68
Jakarta Stock Exchange	32.6	0.41
Stock Exchange of Thailand	51.3	0.43

Source: BSE, NSE & Nikko Research Center.

a Stocks listed and permitted to trade.

b The first section only. The second section was not included.

c Converted into US\$ amounts with the simple averages of the year-end rates in 1995 and 1996; Foreign companies and investment funds are excluded.

d Turnover/average market capitalization.

Nevertheless, as is often the case in many other developing countries, a foreigner's investment in Indian companies is still restricted. Besides an uncontrollable impact on India's macro-economy of foreign fund flows, the restriction may be attributed to the two major policy concerns that the Indian Government presumably has:

- (1) excessive dominance of foreign capital in the Indian domestic market, and

(2) abuse of preferential facilities by inappropriate investors.

The Indian Rupee-denominated assets are relatively cheap, and the country's economy is vulnerable to an exogenous shock. India's capital market is not large enough. Its total capitalization was only Rs. 4,883 billion (approximately US\$ 138 billion) at the end of March 1997. Table 2.2 shows the two largest exchanges in India relative to exchanges in other countries.

India has a bitter modern history of British rule and exploitation. No matter how badly India needs foreign capital to catalyze her economic development, a reasonably controlled process of opening up her economy to foreigners is politically essential. Otherwise, the objective of economic liberalization would be unnecessarily defeated by some political elements. The more confidence the Indian people build up in their economy and competitiveness by capitalizing on the country's comparative advantages, the less restricted will become foreign investment in Indian companies. That is what is actually happening.

Table 2.2
Market Capitalization
(at the end of 1996)

	<i>Market Cap.^c</i> (in US\$ bil.)	<i># of Listed</i> <i>Companies</i>	<i>Market Cap.</i> <i>per Co.</i> (in US\$ mil.)
Bombay Stock Exchange^a	\$127.8	5,969	\$21
National Stock Exchange^a	\$109.1	1,478	\$74
New York Stock Exchange	\$6,800.0	2,907	\$2,339
London Stock Exchange	\$1,712.0	913	\$1,875
Tokyo Stock Exchange ^b	\$2,902.6	1,771	\$1,744
Stock Exchange of Singapore	\$184.0	274	\$810
Hong Kong Stock Exchange	\$455.6	583	\$782
Kuala Lumpur Stock Exchange	\$318.8	621	\$513
Jakarta Stock Exchange	\$90.3	253	\$357
Stock Exchange of Thailand	\$101.0	253	\$222

Source: BSE, NSE & Nikko Research Center.

a includes both listed and permitted stocks.

b includes the 1st section, but not the 2nd section.

c converted in US\$ using exchange rates as at the end of 1996; Foreign companies and investment funds are excluded; The NYSE figure is approximate.

The Government of India grants foreigners some preferential facilities in order to encourage them into investing in India. The status of Foreign Institutional Investor (FII), for instance, simplifies formalities for foreign exchange clearance, and lowers tax rates on income arising from securities investments. These are special incentives provided to qualified foreigners. More importantly though, these are preferential allocations of the country's limited economic resources at the expense of the Indian public in the short run. Unfortunately, India has been notorious for her sizable underground economy. Some of the restrictions are intended to avoid the problem of "round-tripping" when Indian residents or corporates take money out through an informal route and re-invest in India through the FII route.

2.1.2 A Sharp Learning Curve

There are a great number of investment opportunities in India. However, it is also true that the rules and regulations in Indian capital markets are somewhat confusing. The rapid and incessant changing of rules and regulations may bewilder market participants. Less sophisticated draftsmanship of rules and regulations may cause unexpected problems rather than bring about an intended solution to an already identified problem. Officials at the regulatory authorities may take time to accommodate your "rational" request or proposal. All this is true.

On the other hand, India has realized that she badly needs both domestic and foreign capital to improve her nation's living standards in today's global economy. The regulatory authorities have been remarkably diligent and flexible in upgrading the regulatory framework of Indian capital markets as quickly as possible to meet such needs. The market participants in India have, as long as I have observed, little doubt about the commitment of their regulatory authorities to that end. All these are no more than positive indications of the reborn capital markets in India going through a sharp learning curve.

2.2 Portfolio Investment by Foreign Investors

Foreign investors, individual or institutional, who wish to invest in Indian companies, can do so by investing in global depository receipts (GDRs) for Indian stocks or Euro convertible bonds issued by Indian companies.

Once GDRs or Euro convertible bonds are issued outside India, investments in these are generally not subject to Indian regulations.

However, their availability is limited. Not every Indian company can issue GDRs¹ or Euro convertible bonds. Generally, only large and resourceful corporations can afford to do so. As of 10 May 1997, only 58 Indian companies had issued GDRs and only 10 companies Euro convertible bonds². Their liquidity is restricted. GDRs or Euro convertible bonds are deemed as direct foreign investment and they, together with other types of direct foreign investment, cannot exceed 51% of the outstanding shares of an Indian company on a diluted basis, unless it is specially permitted by the Foreign Investment Promotion Board (FIPB)³. They change hands only outside India; in other words, they cannot be sold to Indian domestic investors in an ordinary way.

Besides GDRs and Euro convertible bonds, the following three categories of foreign investors are allowed to invest directly in Indian securities:

- Foreign Institutional Investor (FII)
- Non-Resident Indian (NRI)
- Overseas Corporate Body (OCB).

By way of any one of the above three, foreign investors can have direct access to securities traded on the Indian domestic markets. They are permitted to make portfolio investments in thousands of listed and unlisted companies, though there are some restrictions. They can buy shares from, and sell them to, any Indian domestic investor as well as to each other. The Government of India, through its central bank and the Securities Exchange Board of India (SEBI), grants them some preferential facilities.

¹ To be precise, GDRs are issued by an overseas depository bank against underlying shares or bonds of a company held with a domestic custodian bank; therefore, the issuer of GDRs is the foreign depository bank but not the company. Usually, a company arranges for a foreign depository bank to issue GDRs for its shares.

² There are 21 GDR issues and 9 Euro CB issues outstanding. 2 GDR issues have been converted from Euro CBs, and Reliance has 2 GDR issues.

³ Section 4 of Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, SEBI Notification No. SO 1032(E), dated 24th December, 1993, and Guidelines for Euro-Issues, Press Note F. No. S 11(25)/CCI-II/89/NRI, dated 25-11-1995, issued by the Department of Economic Affairs, Foreign Trade and Investment Division, Ministry of Finance.

The FII status and its sub-accounts will be discussed in detail later in Section 2.3. Since detailed discussion of NRIs and OCBs lies outside the scope of this book, only their definitions are touched upon here.

An NRI is defined as:

- (1) an Indian citizen who stays abroad for employment/carrying on business or vocation outside India or stays abroad under circumstances indicating an intention for an uncertain duration of stay abroad, including persons posted in UN organizations and officials deputed abroad by Central/State Governments and Public Sector undertakings on temporary assignments; or
- (2) a non-resident foreign citizen of Indian origin (excluding a citizen of Pakistan or Bangladesh)⁴.

OCBs are:

- (1) bodies at least 60% owned by individuals of Indian nationality or origin resident outside India including overseas companies, partnership firms, societies and other bodies corporate; and
- (2) overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons, provided that such ownership interest should be actually held by them and not in the capacity as nominees⁵.

2.3 Foreign Institutional Investors

2.3.1 Introduction of FII

The Government of India, narrowly saved from a foreign currency reserve crisis in 1991, finally determined to open up her capital markets to foreign investors. In September 1992⁶, the Government of India, through the SEBI, introduced the concept of Foreign Institutional Investor (FII), which essentially permits reputed foreign institutional investors to invest in Indian primary and secondary markets. FIIs are permitted to invest in:

- securities in the primary and secondary markets, including shares, debentures, warrants of companies listed or unlisted on a

⁴ FAQs, RBI web site.

⁵ *Ibid.*

⁶ The Ministry of Finance, Press Note dated September 14, 1992.

recognized stock exchange in India (including the OTC Exchange of India); and

- specific schemes floated by domestic mutual funds for institutional investors and such other securities as may be approved by the SEBI from time to time⁷.

Unlisted securities were added to the scope of investments in which FIIs are allowed to invest in October 1996⁸. In addition, a special category of FII was introduced for debt investments in November 1996.

SEBI is authorized to grant qualified foreign institutional investors the FII status⁹.

This scheme of foreigners' portfolio investments has significantly simplified the formalities that overseas investors have to go through in order to build up their portfolio investments in India. Such investments in Indian securities also require foreigners to obtain various permission from the Reserve Bank of India (RBI) for foreign exchange control purposes. The scheme allows FII applicants to obtain such RBI permission for all proposed activities at one time, under a single window approach, since an approval from SEBI includes such RBI permissions.

2.3.2 Investment by FIIs

FIIs' net investment in Indian securities have been positive since the outset in November 1992 as shown in Figure 2.2, and their cumulative investments had reached US\$ 8,673 million as of 11 August 1997. Figure 2.3 and Figure 2.4 show their monthly net investment and new entrants relative to the BSE-30 Index. From the charts, it follows that FIIs' investment has been not only correlated with the market index movement, but it has been taking the lead in changing the market sentiment.

Of the 426 FIIs registered as at the end of December 1996, an average of 130 FIIs were active in 1996-97. Only 25 FIIs accounted for 60-65% of

⁷ Section 15. (1) of Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995, SEBI/LE/918(E), dated 14-11-95 (hereinafter referred to as "SEBI (FIIs) Regulations, 1995").

⁸ Securities and Exchange Board of India (Foreign Institutional Investors) Amendment Regulations, 1996 (hereinafter referred to as "SEBI (FIIs) Amendment Regulations, 1996"), by SEBI Notification dated October 9, 1997, F. No. SEBI/LE/10/0130/96.

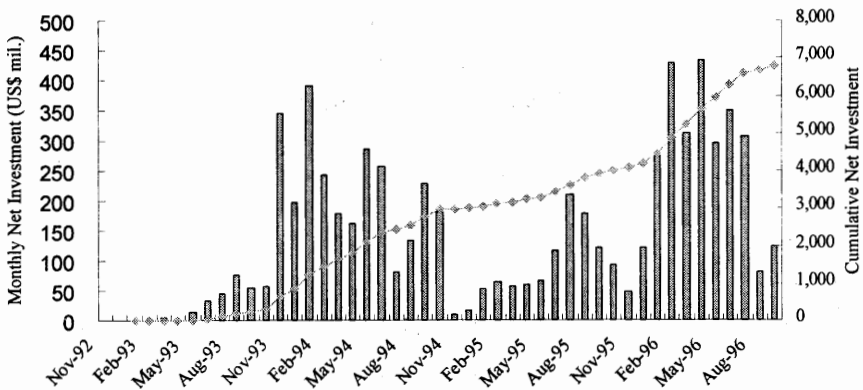
⁹ Section 3.(1) of SEBI (FIIs) Regulations, 1995.

all the FII trading. FIIs' investment was spread over 600 stocks through more than 140 stockbrokers¹⁰. Among the most active FIIs are:

- Morgan Stanley Asset Management
- Jardine Fleming
- Capital International
- J. Henry Schroder
- Templeton
- Warburg Pinkers
- International Alliance
- Quantum Fund¹¹.

The BSE and the NSE accounted for 60-70% and 25-40% of the FIIs' trading, respectively. Conversely, the FIIs' trading amounted to only 2-3% of the BSE and the NSE's trading volume; however, that is estimated to amount to 15-25%¹² of the trading on a delivery basis¹³.

Figure 2.2
Monthly Net & Cumulative Investment by FIIs



Source: SEBI Annual Report 1995-96.

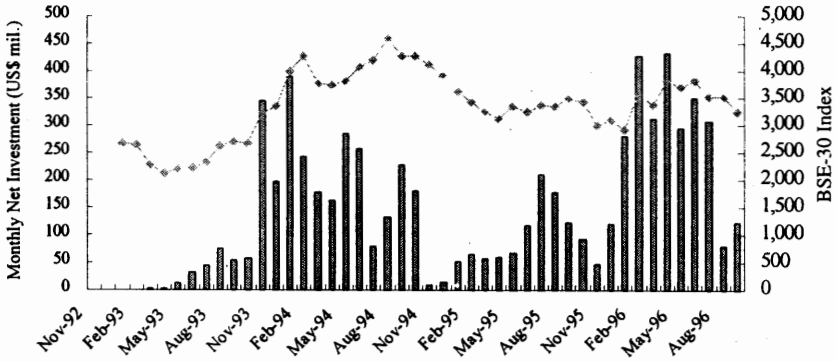
¹⁰ Paragraph 28 of Capital and Money Markets, *Economic Survey of India 1997*, The Ministry of Finance, The Government of India, (<http://www.expressindia.com/fe/iweek/SURVEY4.HTM>).

¹¹ "SEBI-registered FIIs figure touches 453", *The Financial Express*, June 28, 1997.

¹² Estimated from the delivery trade rate of approx. 10-20% on the both exchanges.

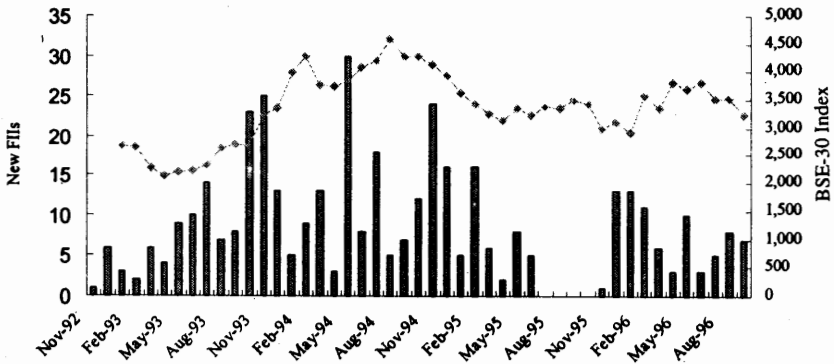
¹³ Paragraph 28 of Capital and Money Markets, *Economic Survey of India 1997*, The Ministry of Finance, The Government of India, (<http://www.expressindia.com/fe/iweek/SURVEY4.HTM>).

Figure 2.3
Net FII Investment & BSE-30 Index



Source: SEBI Annual Report 1995-96.

Figure 2.4
New FIIs & BSE-30 Index



Source: SEBI Annual Report 1995-96.

2.3.3 FII Registration

FII

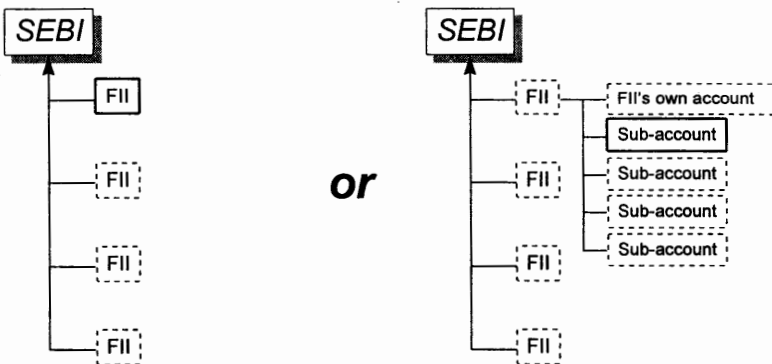
When a foreign institutional investor wishes to invest in the Indian primary or secondary market, he or she has two choices: to do so as a registered FII, or as a sub-account of a registered FII (see Figure 2.5). In either case, the foreign institutional investor is required to register with SEBI prior to the commencement of such investment.

There were over 453 FIIs registered with the SEBI as at the end of June 1997¹⁴.

A foreign institutional investor who wishes to make a portfolio investment has to apply to SEBI for the FII status. Not every foreign institution can apply for this status to qualify for which an FII applicant, established or incorporated outside India, has to be:

1. A pension fund or mutual fund or investment trust;
2. An asset management company or nominee company or bank or institutional portfolio manager, proposing to make investments in India on behalf of a broad based fund;
3. A trustee or a power of attorney holder, proposing to make investments in India on behalf of a broad based fund; or,

Figure 2.5
FII Registration



¹⁴ "SEBI-registered FIIs figure touches 453", *The Financial Express*, June 28, 1997.

4. University funds, endowments, foundations or charitable trusts or charitable societies¹⁵.

The addition of university fund and others to the list of applicants was cleared by SEBI in July 1996 after a custodian bank, on behalf of a US university fund, negotiated with the SEBI. It was finally implemented in October 1996¹⁶.

An FII applicant, in general, must furnish SEBI with the following data¹⁷:

1. Name, address, etc. of the FII applicant.
2. The category to which the FII applicant belongs: pension fund, mutual fund, investment trust, asset management company, nominee company, incorporated/institutional portfolio manager or their power of attorney holder (providing discretionary and non-discretionary portfolio management services), university funds, endowments, foundations or charitable trusts or charitable societies.
3.
 - a) Date and place of incorporation.
 - b) Brief description of the Group.
 - c) Principal activities.
4. The name, address, etc. of the regulatory agency of the FII applicant; material violation or non-adherence records (if any).
5.
 - a) The names of the clients on whose behalf the FII applicant proposes to invest in India.
 - b) Details regarding the clients:
 - i. Date and place of incorporation and constitution (i.e. partnership firms, private company, public company, holding company, subsidiary, etc.).

¹⁵ *Ibid.*, Section 6.(d).

¹⁶ SEBI (FIIs) Amendment Regulations, 1996, by SEBI Notification dated October 9, 1997, F. No. SEBI/LE/10/0130/96.

¹⁷ Application for Registration of Foreign Institutional Investor with Securities and Exchange Board of India and for Permission of Reserve Bank of India under the Foreign Exchange Regulations Act, 1973, issued under the Guidelines for Foreign Institutional Investment, by the Government of India (Ministry of Finance, Department of Economic Affairs), dated 14-9-1992.

- ii. Whether the sub-account is registered with any regulatory agency; if so, the name and address of the regulatory agency, registration number and date of registration.
 - iii. Objectives and principal activities of the sub-accounts (investment/fund management, finance company, investment company, mutual fund, pension fund, etc.).
 - iv. Number and types of shareholders (i.e. individuals, institutions, etc.), etc.
 - v. Volume of assets.
6. The manner of investments: through an establishment in India or through any other office outside India; the name of a contact person.
 7. Name and address of the designated bank branch in India through which the investment is proposed to be made.
 8. a) Name, address, etc. of the domestic custodian.
b) Whether or not the FII applicant has entered into an agreement with the domestic custodian.

An applicant who falls under the category of university funds, endowments, foundations or charitable trusts or charitable societies is required to provide SEBI with some additional information¹⁸.

This registration as an FII is valid for a period of five years with a one-time fee of US \$10,000¹⁹. Tax-exempted foreign aid organizations like the World Bank and the Asian Development Bank may be exempted from the fee²⁰.

Clearance for a fresh FII registration usually takes a month; earlier, it could take up to several months in extreme cases. To cope with complaints about delays in clearances, SEBI and RBI will reportedly form a joint committee on the lines of the Foreign Investment Promotion Board to speed up the FII registration process. The registration is then expected to take only 15 days²¹.

¹⁸ SEBI (FIIs) Amendment Regulations, 1996, by SEBI Notification dated October 9, 1997, F. No. SEBI/LE/10/0130/96.

¹⁹ Section 7 and Second Schedule of SEBI (FIIs) Regulations, 1995.

²⁰ SEBI (FIIs) Amendment Regulations, 1996, by SEBI Notification dated October 9, 1997, F. No. SEBI/LE/10/0130/96.

²¹ "SEBI, RBI to form team for speedy FII registrations", *The Economic Times*, January 6, 1997.

Sub-account

A registered FII who intends to invest in Indian securities on behalf of another institution, fund or portfolio established or incorporated outside India is required to seek from SEBI registration of a sub-account for such an investor prior to the commencement of investments for the sub-account²². Obviously, a sub-account applicant makes an application for sub-account registration to SEBI through the registered FII with whom the applicant wishes to open a sub-account²³.

As a matter of practice, SEBI currently allows an asset management company or a portfolio manager to register as a sub-account, but does not allow a pension fund, a mutual trust, an investment fund, a university trust, an endowment foundations or charitable trust or society to do so.

For application purposes, an FII is required to furnish SEBI with the following data regarding the sub-account applicant²⁴:

1. Names of the sub-account applicant
2. Date and place of incorporation and constitution of the sub-account applicant (i.e. partnership firm, private company, public company, pension fund, mutual fund investment trust, etc.);
3. Whether the sub-account applicant is a holding or subsidiary company or any other company;
4. Whether the sub-account is registered with any regulatory agency; if so, the name and address of the regulatory agency, registration number and date of registration;
5. Objectives and principal activities of the sub-account applicant (investment/fund management, finance company, investment company, mutual fund, pension fund, etc.);
6. Number and types of shareholders of the sub-account applicant (i.e. individuals, institutions, etc.) — percentage distribution of assets between groups of shareholders may also be provided, along with details of the number of beneficiaries on whose behalf the institutional shareholders of the sub-account applicant are investing;
7. Volume of assets of the sub-account applicant

²² Section 12.(1) of SEBI (FIIs) Regulations, 1995.

²³ *Ibid.*, Section 13.(1) (c) & (d).

²⁴ *Ibid.*, Section 12.(3) & para 5 of Form A. There are no significant changes from “Details Pertaining to Sub-Accounts”, Annexure II to SEBI’s FII approval letter dated April 25, 1994.

A foreign investor is not permitted to open a sub-account with an FII if he or she has already opened a sub-account with another FII, or is already registered as an FII.

While an FII registration could be given to the fund itself, since the SEBI registration process involves scrutiny of the past record of the sponsored group, it is considered advantageous to register an asset management company as the FII and to introduce its newly-established funds as its sub-accounts. When the sub-account status is obtained, the benefits of the RBI approval (see “RBI Approval” sub-section below) and the FII registration are extended to the beneficiaries of the sub-account.

Proprietary Funds, Pilot Funds or Seed Funds

An FII’s proprietary fund is permitted to invest in Indian securities through an FII account if the following conditions are satisfied:

- the proprietary fund belongs to the FII; and,
- the FII is regulated by its home regulator or registered with its tax authority²⁵.

FIIs or their sub-accounts were required to be “broad based” until January, 1997. This requirement has since been removed to facilitate investment in Indian securities by pilot funds or seed funds which aim to establish a track record prior to their wide distribution²⁶.

RBI Approval

The one-time approval from RBI permits FIIs to do the following:

1. Open a foreign currency denominated account with a designated bank;
2. Open a special non-resident rupee account for credit of all capital inflow receipts, sales proceeds of shares and other securities, dividends and interests;
3. Transfer sums from the foreign currency account to the rupee account and *vice versa* at market rates of exchange;

²⁵ SEBI Press Release Ref. No. PR 16/97, January 30, 1997.

²⁶ *Ibid*.

4. Make investments in securities of Indian companies out of the balance in the rupee account;
5. Transfer repatriable (after tax) proceeds from the rupee account to the foreign currency account; and
6. Repatriate the capital, capital-gains, dividends, interest income etc., and sales proceeds of rights from the foreign currency account²⁷.

2.3.4 Procedure for FII Registration

In order to obtain preliminary information on the procedures for registration, a foreign institutional investor who intends to make a portfolio investment in Indian securities may wish to approach some banks which provide FIIs with custodial services in India (see Section 7.1). A local custodian plays a key role in the whole process. Investors who have registered with SEBI as FIIs may also be a good source of information. Custodial banks in India can easily provide you with a list of the registered FIIs and sub-accounts with their addresses. The list is public information.

An investor who chooses to trade Indian securities through a sub-account with one of FIIs should first approach the FII for the SEBI registration and opening of accounts.

The procedures for the FII registration are now well established. Table 2.3 summarizes the sequential steps for the registration process.

2.3.5 Foreign Ownership Limits

The Government of India, through the SEBI regulations, currently limits foreign portfolio investments in Indian companies in the following two ways:

- Individual foreign ownership at 10% of the total issued capital of any one company; and,

²⁷ RBI Permission under the Foreign Exchange Regulation Act, 1973 for purchase/sale of shares/debentures, etc. of Indian companies through stock exchanges with repatriation benefits - A/c. The Nikko Merchant Bank (Singapore) Limited, Singapore, dated April 15, 1994.

- Aggregate foreign ownership at 24% or 30%²⁸ of the total issued capital of any one company.

Table 2.3
Sequential Steps for FII Registration

<i>Steps</i>	<i>Actions</i>
1	The investor designates a local custodial bank
2	If necessary, the custodial bank makes an informal inquiry to the SEBI about the eligibility of the investor as an FII.
3	The investor prepares an application for the FII status on its letterhead in the format prescribed in the SEBI (FII) Regulation.
4	The investor submits the completed application in duplicate to SEBI through its custodian, along with a copy of the custody agreement between the investor and the custodian and other supporting documents.
5	SEBI may require clarification from the investor about the contents of the application.
6	SEBI grants an in-principle approval, and forwards a copy of the application to the RBI for approval for opening cash accounts with the custodian.
7	RBI issues an approval to the custodian.
8	SEBI instructs the investor to pay a registration fee of US\$ 10,000.
9	SEBI issues a certificate of FII registration to the investor.
10	The custodian opens cash accounts (a foreign currency-denominated account and a special non-resident rupee account) and a security account for the investor (now a registered FII).
11	The trading starts.
12	The investor appoints a tax consultant, and informs the custodian of the appointment of the tax consultant.

Source: Deutsche Bank, Mumbai Branch.

²⁸ The limit was increased to 30% from 24% on April 4, 1997. "Govt notifies higher FII ceiling", *The Financial Express*, April 5, 1997.

Individual Foreign Ownership Limit — 10%

An FII investing in Indian equity shares on its own behalf is not permitted to hold more than 10%²⁹ of the total issued capital of any one company³⁰. An FII's investment in Indian equity shares on behalf of a sub-account is not allowed to exceed 10% of the total issued capital of any one company, either³¹.

This does not mean that an FII can, in an extreme case, hold 10% of the total issued capital of an Indian company for its own account and another 10% of the same company for one of its sub-accounts. For the purpose of the 10% individual foreign ownership limit, the holdings of an FII group, including its sub-accounts, is counted as the holdings of a single FII³².

It is the duty of the custodian to monitor an FII's investments with regard to the 10% ceiling, and advise SEBI about its FIIs' daily positions³³.

In this connection, it is worthwhile to note that there is no restriction on the total amount of investments, minimum or maximum, that an FII can make in the Indian primary and secondary markets³⁴.

Aggregate Foreign Ownership Limit — 24% or 30%

In addition to the 10% individual foreign ownership limit, an FII's portfolio investments in Indian securities are generally subject to an overall ceiling of 24% or 30% of issued share capital for the total aggregate holdings of all registered FIIs and all NRI/OCBs³⁵, in any one company³⁶. This ceiling applies to all holdings, including shares to be converted out of the full and partly-convertible debentures issued by the company³⁷.

²⁹ By SEBI (FIIs) Amendment Regulations, 1996 notified by SEBI Notification dated October 9, 1997, F. No. SEBI/LE/10/0130/96, the ceiling was increased to 10% from 5%.

³⁰ Section 15(5) of SEBI (FIIs) Regulations, 1995.

³¹ *Ibid.*, Section 15(6).

³² *Ibid.*, Section 11.

³³ *Ibid.*, Section 16(2) (a) & (b).

³⁴ *Ibid.*, Section 10.

³⁵ See Section 2.2.

³⁶ Sections 11 & 12 of Press Note, Department of Economic Affairs, Ministry of Finance, dated September 1992.

³⁷ *Ibid.*, Section 11.

Until April 1997 the aggregate foreign ownership limit of all Indian companies, except for the State Bank of India as discussed below, was just 24%. An increase of the ceiling to 30% was made possible in that month. The enhancement of the limit requires an approval by the board of directors of the company and a special resolution by the general shareholders meeting, and then an approval from RBI. The aggregate foreign ownership limit for Indian companies remain at 24% of the issued share capital unless an individual company takes the special measures stated above³⁸. Only three Indian companies had applied for the increase of the limit as of 13 August 1997.

The maximum holding of 24% or 30% for all non-resident portfolio investments exclude the following:

- (a) Direct investments
- (b) Investments by FIIs through the following alternative routes:
 - (i) Offshore single/regional funds
 - (ii) Global depository receipts
 - (iii) Euro convertible bonds³⁹.

Even before the aggregate foreign ownership reaches 24%, an FII's further investment in an Indian company is substantially restricted. Once the aggregate foreign ownership reaches 20%, any further purchases of that company's equity have to be first approved by RBI before purchase orders can be executed. The RBI approval is given on a first-come-first-served basis. RBI regularly issues notification when the aggregate foreign ownership of an Indian company has reached 20%. The FII's custodian usually obtains the restricted list of such stocks from RBI and advises the FII accordingly. When an FII wishes to purchase shares of a company on the restricted list, the FII has first to advise its custodian so that the custodian can apply for approval from RBI. For companies with 30% limit, the threshold at which RBI issues notification will be raised to 26% from 20%⁴⁰.

RBI regularly announces the list of companies whose foreign ownership has reached the 24% limit and the 20% threshold. The central bank's announcement is released on the Reuters screen and the central

³⁸ Press Note No. F. 14/11/96-NRI, Investment Division, Department of Economic Affairs, Ministry of Finance, April 4, 1997 (<http://www.nic.in/finmin/press/040597.HTM>).

³⁹ *Ibid.*, Section 12.

⁴⁰ A telephone inquiry with the RBI.

bank's website on the internet (address: <http://www.reservebank.com/pressrel/>)⁴¹. Appendix I given at the end of the book lists the Indian companies according to their aggregate foreign ownership status. The number of restricted companies is growing rapidly.

Although the foreign ownership of SBI shares with the exception of GDRs has not reached the 24% limit, no further of its shares purchase by FIIs is currently allowed in view of the conditions that the Central Government attached to its approval of SBI's GDR issue in October 1996⁴². The issue was approved on the condition that the foreign ownership of SBI shares, with the exception of GDRs, should be kept at 20% or below.

Even if the aggregate foreign ownership of an Indian company has reached 24% or 30%, as the case may be, it is still possible for an FII to purchase the shares of that company from other FIIs within the overall limit of 24% or 30%. The FII's custodian applies for approval of such a purchase on behalf of the FII.

2.3.6 Other Requirements & Restrictions

Besides the ownership limits, there are some other requirements and restrictions on FIIs' investment activities and the cash management activities incidental to them.

An FII is required to:

- Buy and/or sell securities either through local brokers registered with SEBI or a Foreign Broker (as defined in Section 2.4), except where specially permitted by the RBI⁴³;
- Register purchased securities in the registered FII's name where the FII may be acting for itself or for the funds managed by it, or in its name for any of its sub-accounts⁴⁴;
- Disclose to SEBI the names of the sub-accounts and the funds to be managed by it, along with some other particulars⁴⁵;
- Appoint one or more domestic custodians; one domestic custodian for a sub-account⁴⁶; and,

⁴¹ "Firms with 24 pc FII stake on RBI list", *The Economic Times*, March 23, 1997.

⁴² *Ibid.*

⁴³ Section 15(1)(c) of SEBI (FIIs) Regulations, 1995.

⁴⁴ *Ibid.*, Section 15(4).

⁴⁵ *Ibid.*, Section 15(4)(b).

- Buy or sell only for delivery (An FII is not permitted to offset a deal without delivery)⁴⁷.

An FII is not permitted to:

- Engage in carry-forward transactions⁴⁸ (*Badla* transactions, as will be discussed later in Section 4.3.8);
- Engage in short selling⁴⁹;
- Offset a deal without delivery⁵⁰;
- Invest in debt more than 30% of the fund⁵¹; and
- Invest in Indian Government's Treasury Bills.⁵²

For cash management purposes, FIIs are not permitted to:

- Overdraw their non-resident Rupee accounts; and
- Earn interest on their securities cash accounts.

The overdraft facility, if permitted, would defeat the policy objective of inducing hard currency investments into India. These restrictions on FIIs' cash management are also presumably aimed at curbing either possible arbitrage activities on an interest differential between the Indian Rupee and foreign currencies or any other currency speculations, disguised as cash management incidental to the permitted portfolio investments.

2.3.7 Special FII Status for Debt Investment

As mentioned earlier, an FII is allowed to invest in Indian bonds only up to 30% of the fund that it actually invests in Indian securities. This restrictive rule holds true in a fund investing in equities and bonds together.

In November 1996 and January 1997, however, the SEBI relaxed its restriction on FIIs' investment in Indian bonds, both corporate and

⁴⁶ *Ibid.*, Section 16(3).

⁴⁷ Indian institutions and mutual funds are not permitted to square off trades without delivery, either.

⁴⁸ Section 15(3) (b) of SEBI (FIIs) Regulations, 1995

⁴⁹ *Ibid.*, Section 15(3) (a).

⁵⁰ *Ibid.*

⁵¹ *Ibid.*, Section 15(2); RBI, Section 17(m) (v) of "Monetary and Credit Policy for the Second Half of 1997-98", Ref. No CPC.BC.165/07.01.279/97-98, dated October 21, 1997

⁵² The Securities Exchange Board of India (Foreign Institutional Investors) Regulations 1995.

government bonds⁵³, by creating a special FII status⁵⁴. This was probably because the Indian Government had realized that the development of full-scaled debt markets was imminently needed for infrastructure investments⁵⁵. A registered FII is now allowed to set up an investment fund to invest 100% of the fund in Indian bonds if it registers the fund with SEBI as a new separate FII or its new sub-account. It is to be noted, however, that if an FII invests in Indian equities and bonds, its investment in bonds remains limited to a maximum 30% of the fund.

SEBI may, while granting approval for the investments, impose conditions with respect to the maximum amount that can be so invested. Though the SEBI did not specify such conditions in its new regulation of 100% debt fund, the IIMARP Department⁵⁶ of SEBI issued a press release which prescribed following conditions:

1. Overall debt cap of US \$1.0-1.5 billion for investment by all FIIs investing in the 100% debt route.
2. Individual ceiling on each individual fund or sub-account. Such a ceiling will be based on the track record of the FII and its experience in managing debt funds in emerging markets and other objective criteria. An individual debt fund would be informed of its ceiling at the time of the SEBI approval.
3. No restriction on maturity of debt securities invested in.
4. No limit on the amount of investment in debt securities of any particular issuer⁵⁷.

FIIs' investments in government securities are somewhat restricted. FIIs are permitted to invest in dated government securities which include dated securities of both Government of India and State Governments of

⁵³ The Press Release issued by the IIMARP Department of the SEBI on November 29, 1996 allowed FIIs to invest in corporate bonds but not government bonds. However, this restriction was removed in the SEBI Boad Meeting. SEBI Press Release Ref. No. PR 16/97, January 30, 1997.

⁵⁴ SEBI (FIIs) (Second Amendment) Regulations, 1996 notified by SEBI Notification dated November 19, 1997, F. No. SEBI/LE-V(2)/254/96.

⁵⁵ The Expert Group of the Commercialisation of Infrastructure Projects, *The India Infrastructure Report*, New Delhi, 1996.

⁵⁶ Institutional Investors, Mergers & Acquisitions, Research & Publication Department.

⁵⁷ Press Release issued by IIMARP Department of the SEBI, dated November 9, 1996, Ref. No. PR 112/96 (The notification was dated November 19, 1996 but the press release November 9, 1996).

all maturities, excluding Treasury Bills. FIIs are permitted to purchase dated government securities either in the primary market at the auctions or floatation, or in the secondary market. FIIs can purchase dated government securities through a broker registered for dealing in debt securities on a recognized stock exchange or over the counter from a bank, and must settle through the delivery versus payment system of the RBI⁵⁸. For clearing purposes, FIIs are required to open an SGL sub-account and a current account with a bank which has a Subsidiary General Ledger (SGL) account with the RBI (see Section 9.2.1).

Until August 1997, the RBI banned FIIs from entering into foreign exchange forward contracts. However, the central bank lifted the ban in respect of FIIs' investments in debt instruments⁵⁹. FIIs can cover their Indian rupee-denominated positions in Indian fixed income securities and determine yields on their investments in terms of a foreign currency like US dollar. The Indian Government is also considering allowing FIIs to cover their equity position with a forward contract⁶⁰.

FIIs' investments in Indian government have yet to clear one more obstacle: FIIs' interest income is subject to the withholding tax.

In response to the regulatory relaxation, 13 FIIs have already obtained approvals from the SEBI for seven 100% debt funds amounting to US \$1.778 billion as of 11 August 1997. The total amount has almost reached

Table 2.4
FIIs & SEBI-approved Debt Investment Limits

<i>FIIs</i>	<i>Limits (US\$ mil)</i>
Peregrine Capital India Pvt. Ltd.	100
Credit Suisse Asset Management	3
Chescor International	50
J Henry Schroder Bank	150
HSBC Asset Management	200
Citicorp Investment Bank (Singapore)	50
Union Bank of Switzerland	350
Buchanan Capital Management	200
Templeton Fund	90

Source: p. 107, *Business India*, 22 May 1997

⁵⁸ RBI Guidelines for FII investment in dated Government Securities, RBI Press Release: 1996-97/533, March 8, 1997.

⁵⁹ RBI Press Release No. 1997-98/121, August 11, 1997.

⁶⁰ "FIIs may get forward \$ cover on equity mkt pump-ins", *The Economic Times*, October 27, 1997.

the overall debt cap of US\$ 1.5 billion for the fiscal year ending March 1997. In the fiscal year 1997-98, the SEBI is expected to increase the ceiling, and the total amount of such funds is anticipated to exceed US\$ 2.5 billion⁶¹. Those FIIs which obtained approvals as of May 1997 and their approved investment limits are shown in Table 2.5.

However, the actual investment by the FIIs is marginal in size. FIIs' net investment in Indian debt securities reached only US\$ 105.2 million as of 11 August 1997⁶².

2.4 Foreign Brokers

As at the end of March 1997, 36 foreign brokers had registered with SEBI as Foreign Brokers (FBs). However, the FB status is not workable in a business sense due to the cumbersome duplication of FB's administrative requirements over those of the FII. The FB status was originally meant to allow non-Indian brokers to provide assistance to the FIIs in their dealings in securities in India.

Under the "Operational Guidelines for Dealings by Foreign Brokers on the Indian Stock Exchanges on Behalf of Registered Foreign Institutional Investors" issued by the SEBI on 5 November 1993:

1. An FB should first obtain registration from the SEBI and thereafter obtain the permission of the RBI to open foreign currency and rupee denominated accounts with a designated bank in India;
2. The FB is required to open custodian accounts with the approved custodians of all the registered FII whom he or she may be assisting or on whose behalf he or she may be placing orders with members of Indian stock exchanges; as such, a registered FB will have to open multiple custodian accounts depending upon the number of FIIs assisted by him;
3. The FB is allowed to secure orders only from FIIs and transmit them only to members of Indian stock exchanges;

⁶¹ "FIIs can invest in dated govt securities only", *The Economic Times*, March 9, 1997, and "\$1.2 bn foreign debt funds to track PSUs", *The Financial Express*, April 4, 1997. Templeton Investment Counsel Inc., a Franklin Templeton Group company, has applied for the special FII status. "Templeton arm to increase exposure in debt market", *The Financial Express*, February 13, 1997, and "SEBI to clear \$500-mn FIIs proposals", *The Financial Express*, March 20, 1997.

⁶² SEBI Press Release Ref. No. PR 91/97, August 12, 1997.

4. The FB is required to bring inward remittances in foreign currency for the initial payment against the purchase contracts while his or her FII customer, who placed an order with him, has to do the same;
5. The FB must make the payment for the purchase contract from his or her rupee account and take the delivery at his or her own custodian from an Indian broker who, in turn, must ensure the delivery to the FII's custodian; and,
6. The FB must ensure that, at no point in time, the rupee value of the total value of purchases made on behalf of the FIIs shall exceed the rupee equivalent of remittances into the FB's foreign currency account.

The benefits of the FB status include the following:

- (1) the identity of an FII can be withheld from the Indian broker with whom the FII's orders are placed; and
- (2) the brokerage income earned by an FB in India can be repatriated in foreign currency.

However, the disadvantages of the status are almost overwhelming:

- (1) the redundancy of forex operations leads to additional forex risks and costs; and
- (2) the brokerage income is taxable at source at 45%.

2.5 Practical Approaches to the Indian Market

2.5.1 Foreign Investor's Approach

Given the various restrictions discussed earlier, would an individual or corporate investor be able to invest in Indian securities except through an investment fund registered as an FII or a sub-account of a registered FII? There is no clear answer to this question. The SEBI regulations and its guidance do not allow an individual or corporate investor to register with it as an FII or a sub-account of a registered FII. For example, in response to an inquiry, the SEBI replied that a manufacturing company investing out of its surpluses would be considered as proprietary investors and would not qualify for the sub-account of an FII.

This does not necessarily mean that a foreign individual or corporate investor cannot directly invest in Indian stocks in the Indian domestic

markets. What if a legitimately registered FII that has a brokerage license in a country outside India receives an order for Indian shares from an individual or corporate investor who agrees to keep his or her shares registered in the street name (the broker's name)? For an investor to keep his or her shares in the street name is a common practice in many countries. Should the FII reject the order? The conditions incidental to the approval of FII status do not explicitly prohibit an FII from receiving an order for Indian shares from an individual or corporate investor abroad. The relationship between the broker and the investor is governed by the local laws under which the FII has been licensed or registered as a securities broker. The FII may not have any reasonable ground under the local laws to reject the order. The investor may feel comfortable to claim his or her beneficiary ownership of the Indian shares under the local laws even if the shares are registered in the street name.

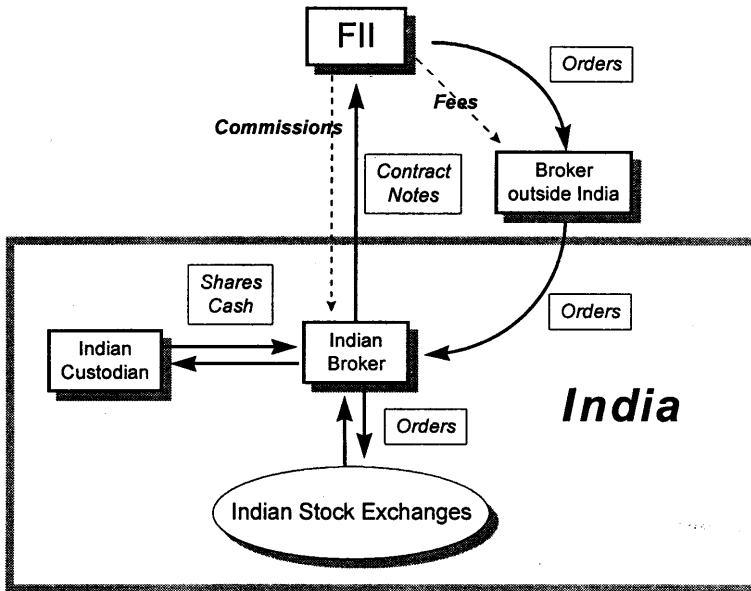
2.5.2 Foreign Broker's Approach

Many foreign brokers (non-Indian brokers outside India) have adopted a practical approach to the Indian market. At times, FIIs may wish to place their orders with Indian brokers through foreign brokers outside India, instead of dealing directly with Indian brokers. In such cases, however, as we have already discussed above, the official FB status is not operationally practical for foreign brokers who wish to place their FII customers' orders with Indian brokers or assist their FII customers in placing orders directly with Indian brokers for a fee. Therefore, the arrangement depicted in Figure 2.6 has become an increasingly common practice among foreign brokers, Indian brokers and FIIs.

The arrangement is outlined as follows:

1. A foreign broker outside India does not register with the SEBI as an FB;
2. An FII places orders with the foreign broker;
3. The foreign broker places the orders in the FII's name, with an Indian broker who is a member of an Indian stock exchange;
4. The Indian broker executes the orders on the Indian stock exchange;
5. The Indian broker produces and mails contact notes of the executed orders to the FII (but not the foreign broker);
6. The Indian broker delivers the shares to or receives the shares from the FII;

Figure 2.6
Practical Approach of Indian Market



7. The Indian broker charges the FII a commission for the order execution at a discount, say, 70% of a normal commission rate; and,
8. The foreign broker charges the FII a fee for placing the orders with the Indian broker at, say, 30% of the normal commission rate.

2.6 Brokerage

The maximum permissible brokerage is 2.50%. Brokerage charged to FIIs is generally 1.00% or less. As will be discussed later in Section 7.3.2, Indian brokers differentiate brokerage, depending on the mode of settlement an investor chooses, due to the funding costs involved. A typical range of brokerage charged by reputable brokers in Mumbai is shown in Table 2.5. The actual brokerage is negotiable. There are some brokers who quote their brokerage alternatives: a cost plus a margin, and a flat rate only.

Other factors that favorably affect the brokerage rate are the involvement of the NSE's clearing house and a depository in settlement

Table 2.5
Brokerage per Transaction

<i>Mode of Settlement</i>	<i>Case A</i>	<i>Case B</i>
DVP	0.75 to 1.00%	(1) 0.90% + Service Tax + NSE/BSE transaction charges; or (2) 1.00%
Clearing House	0.25 to 0.75%	(1) 0.40% + Service Tax + NSE/BSE transaction charges; or (2) 0.50%

of a trade. The NSE's clearing house guarantees timely settlement of all trades in the normal market segment of the NSE (see Section 7.4.6). The depository system frees a trade from a bad delivery and an objection of transfer that have long been a pain in the neck for the Indian capital market (see Section 7.6.1). These factors reduce the degree of risks that the broker has to take, and lowers the brokerage rate accordingly. The combination of the NSE's clearing house and depository, *i.e.* a trade in the book entry segment, can offer as low a brokerage as 0.20% to a retail investor.

Market Regulations

3.1 Legal Framework

3.1.1 New Wine in New Bottles

The nearly two hundred years of British rule resulted a comprehensive legal system in India. However, today's capital markets in India cannot live only on the British legacy. New wine needs new bottles. After she initiated economic reform in 1991, India quickly repealed or revised old laws, rules and regulations, and legislated new ones in order to align herself with global capital market standards.

The Indian securities laws, rules and regulations that were amended or newly enacted for the development of the reborn capital markets include:

1. The Companies Act, 1956
2. The Securities and Exchange Board of India Act, 1992
3. The Securities Contracts (Regulation) Act, 1956
4. Delegation of Powers to SEBI under Securities Contracts (Regulation) Act, 1956
5. The Securities Contracts (Regulation) Rules, 1957
6. Depositories Act, 1996
7. The SEBI (Depositories and Participants) Regulations, 1996
8. The SEBI (Bankers to an Issue) Rules, 1994
9. The SEBI (Bankers to an Issue) Regulations, 1994
10. The SEBI (Custodian) Regulations, 1996
11. The SEBI (Debenture Trustees) Rules, 1993
12. The SEBI (Debenture Trustees) Regulations, 1993
13. The SEBI (Foreign Institutional Investors) Regulations, 1995
14. The SEBI (Insider Trading) Regulations, 1992
15. The SEBI (Merchant Bankers) Rules, 1992
16. The SEBI (Merchant Bankers) Regulations, 1992
17. The SEBI (Mutual Funds) Regulations, 1996
18. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations, 1995

19. The SEBI (Portfolio Managers) Rules, 1993
20. The SEBI (Portfolio Managers) Regulations, 1993
21. The SEBI (Registrars to Issue and Share Transfer Agents) Rules, 1993
22. The SEBI (Registrars to Issue and Share Transfer Agents) Regulations, 1993
23. The SEBI (Stock Brokers and Sub-Brokers) Rules, 1992
24. The SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992
25. The SEBI (Substantial Acquisition of Shares and Take Over) Regulations, 1994
26. The SEBI (Underwriters) Rules, 1993
27. The SEBI (Underwriters) Regulations, 1993
28. The SEBI (Venture Capital Funds) Regulation 1996
29. The SEBI (Appeal to Central Government) Rules, 1993
30. The SEBI Appellate Tribunal (Procedure) Rules, 1994
31. The SEBI (Substantial Acquisition of Shares and Takeover) Regulation, 1997.

The texts of these laws, rules and regulations, except for the Company Act, 1956, are readily available at the SEBI's web site, <http://www.sebi.com>.

3.1.2 Acts, Rules & Regulations

The legal framework of the Indian capital markets is constituted by acts, ordinances, rules, regulations, guidelines, clarifications, press releases and bye-laws of self-regulatory organizations.

Acts

The Companies Act, 1956, the Securities and Exchange Board of India Act, 1992 and The Securities Contracts (Regulation) Act, 1956, are statutory laws. The three acts will be briefly discussed later.

Ordinances

These are promulgated by the President of the Republic of India in accordance with the Constitution when the Parliament is not in session and it is necessary for the President to take immediate action. For example, both the Depositories Ordinance, 1995 and the Depositories Ordinance, 1996 were promulgated before the Depositories Act, 1996 was enacted into legislation.

Rules and Regulations

Rules are made by the Central Government and regulations by the SEBI, under the provisions of the relevant act, for carrying out the purposes of that act. These are required to be laid before the Parliament for a total period of thirty days for possible modification or annulment¹. Such rules have the force of the act.

Guidelines and Clarifications

The SEBI issues guidelines and their clarifications on specific and technical subjects, such as “Disclosure and Investor Protection”, “Development Financial Institutions”, “Flexibility on Pricing of the Issue”, “Bonus Issue”, “Preferential Issue”, “Outstanding Financial Instruments”, and “Firm Allotments, Transfer”. For example, seventeen clarifications have been issued on “Disclosure and Investor Protection” since 1992 in response to inquiries, complaints, comments from market participants, as at the end of March 1997.

They are no doubt practical and effectual, but there may be some confusion in their legal enforceability. Their authority is based on Section 11(1) of the Securities and Exchange Board of India Act, 1992. They are not required to be laid before the Parliament, because they are neither rules nor regulations. However, the SEBI once claimed that any violation of the guidelines will be punishable by prosecution by SEBI under the SEBI Act, 1992². The provisions of Section 11(1) only say, “.... it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measure as it thinks fit.”

Non-compliance of the guidelines may well give SEBI reasonable grounds for disqualifying an issue of securities or taking necessary administrative actions. Yet, it is questionable whether such non-compliance of guidelines would be punishable directly under the Act³.

¹ Section 31 of the SEBI Act, 1992.

² Section P (i) of Guidelines for Disclosure & Investor Protection, Press Release dated 11-6-1992 (PMD Circular 4545/92, dated 11-6-1992).

³ Section 24 of the SEBI Act, 1992, provides “Whoever contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any *rules or regulations* made thereunder, shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.” (underscored by the author)

Press Releases

Press releases are also frequently used as a means of informing the public of SEBI's tentative administrative stance towards, or criteria for, a particular subject. These are also practical and effectual.

When the SEBI issued the regulations for 100% debt fund in November 1996, for instance, it did not specify such conditions as may be attached to an approval of the fund, but the Institutional Investors, Mergers & Acquisitions, Research & Publication (IIMARP) Department of SEBI simultaneously issued a press release which prescribed the conditions in detail. One of the conditions prescribed in the press release restricted FIIs' investments only to corporate bonds. There were some arguments within the Indian government as to whether or not FIIs' investments in government securities should be allowed. On 31 January 1997 — after less than three months of the previous announcement — the government announced that it would allow FIIs to invest in government securities. The policy became immediately effective without any further legal formality.

Bye-laws of Stock Exchanges

These set forth details of the administration of stock exchanges. They cover the hours of trade, clearing house operations, the collection and publication of market data, trading rules, listing rules, the scale of brokerage and other matters. SEBI has the authority under the SEBI Act, 1992 to approve, make or amend the bye-laws of recognized stock exchanges⁴. In fact, SEBI exercised its power to amend the bye-laws of the Bombay, Delhi, Hyderabad, Madras and Cochin Stock Exchanges in implementing the segregation between clients accounts and member broker's accounts between November 1994 and January 1995⁵ after the exchanges had failed to comply with the SEBI's direction issued in November 1993. Bye-laws have to be published in the Gazette of India, and also in the Official Gazette of the State, before these can take effect⁶.

⁴ Sections 9 & 10 of the SC(R) Act, 1956.

⁵ SEBI Press Release (PR 115/94) dated 26-9-1994, Notification No. SO 855(E), dated 29-11-1994, Circular No. 5/95, dated 16-1-1995, issued by Delhi Stock Exchange, (1995) 84 Comp. Cas. 109., Notification No. 34(E), dated 11-1-1995.

⁶ Section 9(4) of the SC(R) Act, 1956.

3.1.3 The Companies Act, 1956

This Act governs public offerings of shares and debentures, in addition to subjects generally common in company laws of other countries such as the incorporation of a company, share capital and debentures, the registration of charges, the management and administration, and winding up, etc. Part III of the Act, which pertains to public offerings of shares and debentures provides, in particular, for the prospectus, allotment, commission on discounts, issue of shares at a premium and discount, issue and redemption of preference shares, and further issue of capital.

Recently, a revamp of the entire Companies Act has been proposed. While the provisions of the current Act have been amended from time to time to accommodate the needs of the changing corporate and economic world, as a result of the economic liberalization program started in 1991, however, the new India has not been able to function effectively within the anachronistic legal framework that was established in an era of planned economy. In August 1996, a working group was constituted to drastically restructure and streamline the Act. The working group published its recommendations on 3 March, 1997 for discussion and debate, and subsequently completed the codification of the new Companies Bill, 1997⁷.

The recommended amendments are conceptually characterized by:

- (1) a remodeling of companies to today's economic realities,
- (2) the explicit incorporation of existing or desirable corporate practices,
- (3) the shifting of some company law powers to SEBI,
- (4) more freedom and flexibility to corporate governance,
- (5) user-friendly and more disclosures of corporate activities, and
- (6) a simplification of the company law procedures.

They specifically include, among other things, the new classification of companies, freedom to transfer and acquire shares, the SEBI's sole authority for listed companies, the introduction of a shelf prospectus (shelf registration), book building, hybrids, derivatives and options, Indian depository receipts, employee stock options, the buyback of shares (see Section 5.3), the chief financial officer (CFO), the establishment of a

⁷ *The Financial Express, The Economic Times, The Hindu, and The Hindustan Times*, March 4, 1997.

company law tribunal, optional consolidation of group accounts, disclosures of interest by directors, loans to directors, segment information, foreign exchange information, and the time-bound winding up of companies.

3.1.4 The Securities Contracts (Regulation) Act, 1956

This Act is meant to prevent undesirable transactions in securities by regulating the business of dealing in securities, and by providing for certain other matters connected with securities dealing. The Act governs mainly the following areas:

- recognized stock exchanges;
- contracts and options in securities; and
- listing of securities by public companies.

It is this Act which defines 'securities' in the Indian context. The SEBI Act, 1992 refers to this Act for the definition of 'securities'⁸. Section 2 (h) of this act stipulates that 'securities' include:

1. Shares, scripts, stocks, bonds, debentures, debenture stock or marketable securities of a like nature in or of any incorporated company or other body corporate,
2. Government securities⁹;
3. Such other instruments as may be declared by the Central Government to be securities; and
4. Rights or interest in securities.

The Indian definition of a security is narrower and less specific than that of the Securities Act of 1933 of the United States. The Indian scope of a security is roughly the same as that under the Japanese securities law. Like the Japanese securities laws, the Indian act does not categorically include investment contracts in its definition of a security. Without some remedy, the narrow definition would become a drag both on the development of investment activities in India and on their future regulation. Nonetheless, the definition of securities has not been modified, nor has it been explicitly expanded. Instead, "registering and regulating the working of *collective investment schemes*" was

⁸ Section 2. (1) (h) of the SEBI Act, 1992.

⁹ "Government security" means a security created and issued by the Central Government or a State Government. Section 2. (b) of the SC(R) Act, 1956.

added to the list of the items that the SEBI may take 'to protect the interests of investors in *securities* and"¹⁰. This approach nevertheless is somewhat illogical, but is a practical solution to the problem for the time being.

The Act earlier prohibited options. Section 20. (1) of the act provided that "all options in securities entered into after the commencement of this Act shall be illegal." This section, together with its sub-section (2), was omitted by the Securities Laws (Amendment) Act, 1995, to accommodate the introduction of futures and options contracts of NSE-50, a National Stock Exchange index (see Section 4.4.7).

This Act is also being reviewed for further amendments to keep up with the changing Indian capital market. The SEBI, in March 1997, appointed the D. R. Dhanuka Committee to review the Act, together with the SEBI Act, the Depositories Act and relevant provisions of the Companies Act¹¹.

3.1.5 The Securities and Exchange Board of India Act, 1992

This Act is pivotal to the regulatory framework of the Indian capital markets today. It was enacted in 1992 in line with the economic reforms initiated in 1991.

This administrative law provides for the establishment of the Securities and Exchange Board of India, commonly known as SEBI, to protect the interests of investors in securities and to promote the development of and to regulate the securities market and for matters connected with or incidental to them. It delegates to SEBI the rule-making power, the licensing power, the investigating power and the directing power. It prescribes the powers and functions of the Board, and the registration of capital market participants such as stock brokers, sub-brokers, share transfer agents, etc. It also empowers the Central Government to make rules and SEBI to make regulations for carrying out the purposes of the Act.

¹⁰ Section 2(1) (c) of the SEBI Act, 1992. The Ministry of Finance decided to expand the definition of the term 'securities' to include collective investment schemes, and to regulate them under the SEBI's jurisdiction. ("Finance Ministry redefines securities to bring plantation companies under market regulator SEBI", *Business Standard*, November 19, 1997)

¹¹ "Dhanuka picked to oversee review of SCRA, SEBI Acts", *The Economic Times*, March 4, 1997.

This Act will be considerably affected by the proposed Companies Bill, 1997. Consequently, it has been reviewed for necessary amendments by the Dhanuka Committee appointed by SEBI.

3.2 Market Participants

In accordance with the wording of the law, most participants in the Indian capital markets are supposed to register with SEBI in order to carry out their businesses. Such participants are:

1. Stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and other such intermediaries who may be associated with securities markets in any manner;
2. Depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and other such intermediaries who may be associated with securities markets in any manner; and,
3. Venture capital funds and collective investment schemes including mutual funds¹².

However, the ambitious registration system is far from complete. For some professional categories such as sub-brokers, the registration system is nominally in place, but the lack of SEBI's enforcement power permits hundreds of thousands of unregistered sub-brokers to conduct their securities businesses, while registered sub-brokers are not effectively regulated (see Section 3.2.2). There is also no registration system at all for investment advisers.

Getting all the existing market participants registered with SEBI and regulating them tightly cannot be the Indian regulator's single policy goal. As expressed in the preamble of the SEBI Act, 1992, the regulator's policy goals are:

- To protect the interests of investors in securities;
- To promote the development of the securities market; and
- To regulate the securities market.

¹² Sections 11. (2) (b), (ba) & (c), and 12 (1) , (1A) & (1B) of the SEBI Act, 1992.

The development of the securities market will be another important key to protect the interests of investors in securities (and to ultimately mobilize and allocate domestic as well as foreign capital for the development of the Indian economy). As will be shown later in this section, the capital adequacy requirements of registered market participants are surprisingly low. Consequently, entry barriers are also low.

This is probably because the vested interests of existing market participants cannot be totally ignored since the Indian capital market would stop functioning without the existing market participants. The majority of them are very thinly capitalized. As a result, SEBI is compelled to register many small participants and to regulate them. The regulator's limited resources are thus spread too thin.

This dilemma is reflected in a recent statement by Mr. D.R. Mehta, the SEBI Chairman, who said that "India needs big players"¹³. In not a few cases, being small is not efficient either. Efficiency tends to be achieved through competition and competition is likely to lead to a market of big players. The development of the securities market will presumably be in that direction.

3.2.1 Stockbrokers¹⁴

The Indian law defines a stockbroker simply as a member of a recognized stock exchange¹⁵. Therefore, a registered stockbroker holds the membership of at least one of the recognized Indian stock exchanges¹⁶. No stockbroker is allowed to buy, sell or deal in securities, unless he or she holds a certificate granted by SEBI¹⁷. There were 5,698 stockbrokers registered with SEBI in the 1994-95 period; at the end of March 1997 they numbered 8,867.

A stockbroker applicant applies for registration to SEBI through a stock exchange or stock exchanges of which he or she is admitted as a

¹³ "Indian markets need to be cleaned: Sebi chief", *The Financial Express*, December 28, 1996.

¹⁴ The term "stockbroker" is spelled "stock broker" in Indian laws, rules and regulations.

¹⁵ Section 2 (e) of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992.

¹⁶ *Ibid.*, Section 4 (a).

¹⁷ *Ibid.*, Section 3.

member¹⁸. The registration then remains valid unless it is suspended or canceled¹⁹. A stockbroker may take the form of sole proprietorship, partnership, or corporation. Although the official statistics of registered stockbrokers by form of ownership is not available, sole proprietorships, partnerships and corporations are estimated to account for 70-75%, 5-10% and 15-20% of the registered stockbrokers, respectively.

Table 3.1
Stockbrokers Registered with SEBI

<i>Sr.Stock No.Exchange</i>	<i>Total Members</i>	<i>Corporate Members</i>	<i>Corporate Members % of Total</i>	
1	NSE	873	736	84.31
2	Calcutta	861	78	9.06
3	OTCEI	785	544	69.30
4	Mumbai	608	71	11.68
5	Jaipur	587	0	0.00
6	Uttar Pradesh	507	13	22.56
7	Cochin	488	38	7.79
8	Saurashtra Kutch	437	38	8.70
9	Delhi	379	65	17.16
10	Vadodara	312	25	8.01
11	Hyderabad	304	23	7.57
12	Ahmedabad	285	49	17.19
13	Ludhiana	275	48	17.45
14	Bangalore	230	51	22.17
15	Bhubaneshwar	222	8	3.60
16	Guwahati	206	0	0.00
17	Madras	200	49	24.50
18	Pune	197	23	11.68
19	Magadh	193	3	1.55
20	Coimbatore	192	42	21.88
21	Madhya Pradesh	188	11	5.85
22	Mangalore	147	2	1.60
TOTAL	8,476	1,917	22.00	

As on March 31, 1996.

Source: SEBI Annual Report 1995-96

¹⁸ Section 3 (1) of the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992.

¹⁹ *Ibid.*, Form D Certificate of registration.

Table 3.1 lists the number of stockbrokers of different recognized stock exchanges in India who were registered with SEBI as at the end of March 1996. Though the statistics in the table are slightly out of date, they still clearly reveal a historical trend; a majority of the members of new stock exchanges like the NSE and the OCTEI are corporate while those of old exchanges are individuals. The statistics are a little misleading; the percentage of corporate members of the exchanges is 22%, which is higher than the above estimate of 15-20%; and the total number of stockbrokers registered with the SEBI is 8,476, which is much larger than the above estimate of 6,400-6,500 at the end of March, 1997. The distortion is accounted for by multiple membership of some brokers. Such brokers have membership of more than one stock exchange and are double-counted. More specially, a host of members of stock exchanges located in Mumbai (Bombay) are more likely to be double-counted. Furthermore, it is more likely that corporate members can afford to own membership of more than one stock exchange. This is an example of the low quality consciousness of information in India²⁰.

Each stockbroker is subject to capital adequacy requirements consisting of two components:

- (a) basic minimum capital, and
- (b) additional or optional capital related to volume of business.

The amount of basic minimum capital varies from exchange to exchange. A SEBI regulation requires stockbrokers of the Bombay Stock Exchange or the National Stock Exchange to maintain an absolute minimum of Rs. 500,000 (approximately US \$14,000), which is the largest of all the stock exchanges. However, the BSE require its members to deposit with it a larger amount, Rs. 1 million²¹. The NSE also requires its members to deposit with it larger amounts (see Section 4.4.2). The additional or optional capital, including the basic minimum capital, has to be maintained at 8% or more of the gross outstanding business in the exchange. The gross outstanding business means the cumulative amount of sales and purchases by a stockbroker in all securities at any point of time during the ongoing settlement period. Sales and purchases made on behalf

²⁰ See Section 1.4 In fact, another SEBI statistics also reports the number of stockbrokers with the SEBI as 8,476, along with other categories of market intermediaries registered with the SEBI. ("Intermediaries Registered with SEBI", SEBI Annual Report 1995-96, <http://www.sebi.com/invest/extract8.html>).

²¹ "BSE directive to members", *The Financial Express*, January 9, 1997.

of customers may be not netted but those on the broker's own behalf may be. The capital is defined as the sum of capital and free reserve less non-allowable assets, namely, fixed assets, pledged securities, member's card, non-allowable securities, bad deliveries, doubtful debts and advances, prepaid expenses, intangible assets, and 30% of marketable securities²².

Every registered stockbroker is entitled to act as an underwriter without any separate registration other than his or her own²³.

There is no mandatory qualification test for stockbrokers and other market participants in India, unlike in the United States, the United Kingdom, Japan and many other countries. SEBI recently proposed the introduction of a system of testing and certification for capital market participants. The test is intended for stockbrokers, their employees and sub-brokers. It will be voluntary and not mandatory, at least for the time being²⁴.

3.2.2 Sub-brokers

Most stockbrokers in India are still relatively small. They cannot afford to directly cover every retail investor in a gigantic country with such a complex society like India. Sub-brokers play an indispensable role in intermediating between investors and stock markets. Stockbrokers of Indian stock exchanges are permitted to transact with sub-brokers.

In applying for a sub-broker certificate, a sub-broker applicant must be affiliated with a stockbroker of a recognized stock exchange. His or her application must be accompanied by a recommendation letter from the sponsoring stockbroker and two references, including one from his or her banker. It must also be submitted to SEBI through a stock exchange of which the sponsoring stockbroker is a member²⁵. The registration then remains valid unless it is suspended or canceled²⁶. A sub-broker may take the form of sole proprietorship, partnership, or corporation.

²² "Capital Adequacy Norms for Stock-Brokers", Press Release dated 21-10-1993, issued by the Secondary Market Department of the SEB.

²³ Section 3 (2) of the SEBI (Underwriters) Rules, 1993.

²⁴ Primary Market Department, SEBI, *Draft Consultative Paper on Testing and Certification of Persons Joining Capital Market Intermediaries*, Ref No. PR 03/97, January 8, 1997;"SEBI certification system for capital market functionaries".

²⁵ Sections 11 (1) - (3) of the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992.

²⁶ *Ibid.*, Form D Certificate of registration.

A sub-broker is, however, a controversial issue in the Indian capital markets. The issue is twofold:

- (i) the majority of sub-brokers are not registered with SEBI; and
- (ii) the function of a sub-broker is not meaningfully defined.

No sub-broker is supposed to buy, sell or deal in securities, unless he or she holds a certificate granted by the SEBI²⁷. Nevertheless, the reality is that there were only about 2,593 sub-brokers registered with SEBI as at the end of June 1997²⁸, while the number of stock sub-brokers in India was estimated in the range of 50,000 to 200,000²⁹.

The Indian law defines a sub-broker as any person, not being a member of a stock exchange, who acts on behalf of a stockbroker as an agent, or otherwise, for assisting the investors in buying, selling or dealing securities through such stockbrokers³⁰. Based on this definition, the sub-broker is either a stockbroker's agent, or an arranger for the investor. Thus, legally speaking, the stockbroker as a principal will be responsible to the investor for a sub-broker's conduct if a sub-broker acts as his or her agent. On the other hand, there will be no question of the stockbroker's responsibility to the investor if a sub-broker is merely an arranger of the transaction for the investor. If this legal relationship between the stockbroker, the sub-broker and the investor holds true, the sub-broker's financial standing matters little, but the stockbroker's one matters a lot so far as protecting the interests of the investor is concerned.

However, the market practice is totally different from this legally-defined relationship. In reality, the stockbroker in general issues a contract note of a transaction even to a registered sub-broker, and not just an unregistered sub-broker. He or she treats the sub-broker as his or her counter-party, implicitly denying his or her privity with the investor. Without the privity between the stockbroker and the investor, the sub-broker's financial strength would hold more weight in the protection of the investor's interests.

²⁷ *Ibid.*, Section 3.

²⁸ "Sub-brokers' registration norm takes effect today", *The Financial Express*, July 1, 1997. Another 170 sub-brokers were applying for registration at the end of June 30.

²⁹ "Price Waterhouse to suggest sub-broker regulations", *The Economic Times*, January 6, 1997.

³⁰ Section 2 (f) of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992.

Then, what if a sub-broker causes the investor a material loss fraudulently or with gross negligence, and he or she is financially fragile? Can the investor hold the stockbroker responsible for the loss? Furthermore, what if a stockbroker's fraudulent or grossly negligent act results in a material loss to the investor? Should the sub-broker be held responsible to the investor? It is clear from these questions that the applicability of the current rules and regulations with regard to the sub-broker would, in this case, be highly questionable.

The NSE did not officially allow its members to transact with end-investors through sub-brokers until June 1997³¹. Besides the legal ambiguity of a sub-broker, this is probably because the NSE has generous membership criteria; and its computerized trading network can easily provide geographically scattered stockbrokers with a direct access to the trading on the NSE. Nevertheless, the reality is that many trading members of the NSE have been using registered and unregistered sub-brokers.

The need for proper regulation of sub-brokers is now being increasingly voiced and recognized. Price Waterhouse, which has been contracted to administer the Financial Institutions Reform and Expansion (FIRE), a joint project of USAID and the Government of India, submitted a proposal to SEBI for setting up an Indian Association of Securities Intermediaries, a self-regulatory organization of sub-brokers to bring sub-brokers into the formal capital market system³².

To sort out this confusing situation, SEBI decided to take some measures in March 1997:

- (1) SEBI will initiate criminal actions on complaints received against unregistered sub-brokers in suitable cases;
- (2) The institution of 'remisier' under rules and bye laws of the stock exchanges will be revived; and
- (3) No stockbroker shall deal with unregistered sub-brokers or unregistered remisiers after 1 June 1997 (this deadline was later extended to 1 July 1997).

A remisier is an agent of a broker and is registered with the stock exchange. However, he or she is not authorized to issue a contract note or confirmation note of a transaction to his or her investor; instead,

³¹ "NSE issues guidelines for sub-brokers", *The Financial Express*, June 12, 1997.

³² *Ibid*, *The Economic Times*, January 6, 1997, "Lack of initiatives hinders sub-broke certification", *The Financial Express*, April 3, 1997.

the broker issues the note and takes full responsibility in respect of that transaction³³. The remisier has been provided for in the rules of the BSE³⁴, but not utilized³⁵. These regulations took effect on 1 July 1997.

SEBI's recent decision makes sense in that it expressed SEBI's will not to tolerate unregistered sub-brokers. However, it is probably far from solving the confusion with regard to the sub-broker. In technical aspects, the role of the sub-broker should be redefined; and the relationship between the broker and the sub-broker should be meaningfully and realistically defined. A fundamental problem is the gap between the coverage of registered stockbrokers and sub-brokers and the fast-expanding investment community all over the sub-continental country. Registered brokers and sub-brokers should grow operationally and financially, and be large enough to serve Indian investors across the country.

3.2.3 Merchant Bankers

A merchant banker is defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities, or acting as manager, consultant, advisor or rendering corporate advisory services in relation to issue management³⁶. No person is allowed to carry out any activity as a merchant banker unless he or she holds a certificate granted by SEBI³⁷. As of 31 March 1997 there were 1,163 merchant bankers registered with SEBI.

Major amendments were made to the SEBI regulations regarding merchant bankers in September 1997. Both the old and new regulatory frameworks for merchant bankers are presently in force. The duration of this transition period has not officially been announced.

³³ SEBI Press Release Ref. No. PR 37/97, March 19, 1997.

³⁴ Section 216 of the Rules of The Stock Exchange, Bombay, 1957, defines remisier as "a person who is engaged by a member primarily to solicit commission business in securities".

³⁵ "SEBI bars unregistered sub-brokers, plans criminal action", *The Financial Express*, March 20, 1997.

³⁶ Section 2 (e) of the SEBI (Merchant Bankers) Rules, 1992.

³⁷ *Ibid.*, Section 3.

A merchant banker applicant applies for registration directly to SEBI³⁸. The registration is valid for three years and has then to be renewed³⁹. The merchant banker's status may be a public or private limited company, an unlimited company, a partnership, proprietary or some others under the old regulations⁴⁰, but the new regulations allow only body corporates to operate as merchant bankers⁴¹. The information that a merchant banker applicant is required to furnish to SEBI in the application form is much more extensive and comprehensive than that for a stockbroker applicant.

There are four categories of registered merchant bankers under the old regulations, but under the new regulations, there is only one, namely "merchant banker". This corresponds to Category I under the old regulations. Each category has a different scope of activities that the registered merchant bank is permitted to carry out⁴². The four categories under the old regulations are shown in Table 3.2. Merchant bankers presently functioning in Category II, III or IV, will be given the option to either upgrade themselves as merchant bankers in the new category, or seek separate registrations as underwriters or portfolio managers under the respective regulations. Otherwise, their present registrations will lapse at the end of the current period of registration⁴³.

A merchant banker applicant must satisfy, among other things, the capital adequacy requirement. Under the old regulations there were different capital adequacy requirements for the various categories. Table 3.3 summarizes the minimum amount of net worth that the applicant had to have at the time of application⁴⁴, and had to maintain after registration under the old regulations⁴⁵. Net worth is defined as the sum of the capital contributed to the business (in the case of a partnership) or the paid-up capital (in the case of a corporation) plus free reserves. Only the requirement for the present Category I applies under the new regulations.

³⁸ Section 3 (1) of the SEBI (Merchant Bankers) Regulations, 1992.

³⁹ Section 6 of the SEBI (Merchant Bankers) Rules, 1992.

⁴⁰ Section 2.3 of Form A, the SEBI (Merchant Bankers) Regulations, 1992

⁴¹ Section 5. a. of the SEBI Press Release Ref. PR/100/97, dated September 5, 1997.

⁴² The activities or functions set forth in Section 3 of the Regulations do not exactly match those in Form B (Certificate of Registration). "Investment Advisor" is included in Form B but not in Section 3 of the Regulations.

⁴³ Section 5. b. of the SEBI Press Release Ref. PR/100/97, dated September 5, 1997.

⁴⁴ Section 7 of the SEBI (Merchant Bankers) Rules, 1992.

⁴⁵ *Ibid.*, Section 36(1) (vi).

Table 3.2
Four Categories of Merchant Banker Registration (Old Regulations)

<i>Category</i>	<i>I</i>	<i>II</i>	<i>III</i>	<i>IV</i>
Any activity of the issue management consisting of preparation of prospectus and other information relating to the issue, determining financial structure, tie-up of financiers and final allotment and refund of the subscriptions	✓			
Manager	✓			
Co-Manager	✓*	✓		
Underwriter	✓	✓	✓	
Portfolio Manager	✓	✓		
Adviser or Consultant to an issue	✓	✓	✓	✓
Number of Registrants (as of March 31, '97)	440	107	172	444

Legend: ✓ Permitted to be carried out
* Not explicit in letters of the regulations

Source: SEBI Annual Report 1996-97.

Table 3.3
Capital Adequacy Requirement
for Merchant Banker Applicant (Old Regulations)

<i>Category</i>	<i>Minimum Amount of Net Worth</i>
I	Rs. 50,000,000 ⁴⁶
II	Rs. 5,000,000
III	Rs. 2,000,000
IV	Nil.

Under the old regulations, a merchant banker in Category I is allowed to undertake underwriting and portfolio management activities in addition to issue management, as shown in Table 3.2. Though the new category of the merchant banker generally takes over the present Category I, a merchant banker under the new regulation undertakes issue management and underwriting activities, but has to seek a separate registration to act as a portfolio manager under the relevant regulations⁴⁷.

⁴⁶ Increased from Rs. 10,000,000 by Notification No. SEBI/CE/1/94-95, dated 7-9-1995.

⁴⁷ Section 5. c. of the SEBI Press Release Ref. PR/100/97, dated September 5, 1997.

The new regulations have drawn a clear-cut line between the merchant banker and the non-banking finance company (NBFC). Under the old regulations, a merchant banker is allowed to carry out fund-based activities such as deposit-taking, leasing, bill discounting and hire-purchasing. However, the new regulations no longer allow a merchant banker to engage in these fund-based activities except for those related exclusively to the capital market such as underwriting. The merchant banker is required to break away such activities in a period of two years. Correspondingly, an existing NBFC performing merchant banking activities is required to relinquish such activities after a certain period of time⁴⁸.

The merchant banking industry in India has been rife with problems, which have recently led SEBI to make drastic changes to the merchant banking regulations. The problems are twofold:

- (i) nominal registration as merchant bankers; and
- (ii) incompetence of many merchant bankers.

From Table 3.2 above, it is obvious that there are too many merchant bankers. The majority of them have conducted few significant activities in such capacity. Only 20 merchant bankers of Category I reportedly account for 60-85% of the merchant banking business⁴⁹, while 148 of them are in business only on paper⁵⁰. In May 1997⁵¹, a substantial number of merchant bankers were found to be professionally imprudent or negligent in their practices. SEBI listed 134 merchant bankers of Categories I, II and III who broke their underwriting commitments for possible disciplinary actions. 95 Category I merchant bankers were included in the list⁵². More evidence of the problem is the dishonorable track record of listing delay or rejection of initial public offerings (IPOs) (see "Listing Delay or Rejection" in Section 8.1.5). The incompetence of

⁴⁸ *Ibid.*, Section 5. d.

⁴⁹ "Capital market must be competition friendly: Mehta", *The Economic Times*, March 19, 1997; "Market forces will determine fate of merchant bankers, say Kar", *The Financial Express*, September 11, 1997.

⁵⁰ "SEBI plans to triple merchant bankers' net worth criteria", *The Economic Times*, June 25, 1997.

⁵¹ "SEBI raps merchant bankers for lapses in due diligence", *The Economic Times*, May 8, 1997.

⁵² "SEBI lists 120 errant merchant bankers list", *The Financial Express*, May 24, 1997 and "SEBI plans to triple merchant bankers' net worth criteria", *The Economic Times*, June 25, 1997.

the merchant bankers who managed such IPOs was materially responsible for the troubled deals.

3.2.4 Underwriters

The underwriter is defined as a person who engages in the business of underwriting of an issue of securities of a body corporate, where underwriting means an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such a body corporate or the public do not subscribe to the securities offered to them⁵³. No person is allowed to act as an underwriter unless he or she holds a certificate granted by SEBI⁵⁴. There were 34 underwriters registered with SEBI as of 31 March 1997, in addition to 719 merchant bankers of categories I, II and III who can also act as underwriters.

An underwriter applicant applies for registration directly to SEBI⁵⁵. The registration is valid for three years and has to be renewed⁵⁶ thereafter. The underwriter's status may be a public or private limited company, an association of persons, a body of individuals, a partnership, a proprietary or others⁵⁷. Every registered stockbroker or registered category I, II and III merchant banker is entitled to act as an underwriter without any separate registration⁵⁸.

An underwriter applicant must satisfy, among other things, the capital adequacy requirement; the applicant must have a net worth of Rs. 2,000,000 (approximately US \$57,000) at the time of application⁵⁹ and must maintain this even after registration⁶⁰. The net worth is defined as the sum of the capital contributed to the business (in the case of a partnership) or the paid-up capital (in the case of a corporation) plus free reserve.

⁵³ Section 2 (f) & (g) of the SEBI (Underwriters) Rules, 1993

⁵⁴ *Ibid.*, Section 3

⁵⁵ Section 3 (1) of the SEBI (Underwriters) Regulations, 1993

⁵⁶ Section 5 of the SEBI (Underwriters) Rules, 1993

⁵⁷ Section 2.3 of Form A, the SEBI (Underwriters) Regulations, 1993

⁵⁸ Section 3 (2) of the SEBI (Underwriters) Rules, 1993

⁵⁹ *Ibid.*, Section 7 (1).

⁶⁰ *Ibid.*, Section 26. (1) (vi)

3.2.5 Primary Dealers

It is the Reserve Bank of India (RBI) and not SEBI which regulates primary dealers in the government securities market. The RBI instituted the primary dealership of government securities in March 1995 through RBI's Guidelines for Primary Dealers in Government Securities Market.

Those eligible to apply for the primary dealership are:

- (a) subsidiaries of commercial banks and all Indian financial institutions dedicated predominantly to the securities business and, in particular, to the government securities market; and
- (b) companies incorporated under the Companies Act, 1956 and engaged predominantly in the securities business and, in particular, in the government securities market⁶¹.

There were 6 primary dealers registered with RBI at the end of July, 1997. Those stockbrokers and merchant bankers who are authorized as primary dealers subject to RBI's supervision.

The six primary dealers are:

- The Discount and Finance House of India Ltd. (DFHI)
- The Securities Trading Corporation of India (STCI)
- SBI Gilts Limited
- PNB Gilts Limited
- ICICI Securities Limited
- Gilts Securities Trading Corporation.

In addition to the six primary dealers, RBI appointed 17 satellite dealers from all over the country in April 1997, in order to broaden the distribution of government securities.

A primary dealer applicant must have net owned funds of Rs. 500 million (approximately US \$14 million) at the time of application. The net owned funds are defined as the sum of 'paid-up equity capital, free reserves, balance in share premium account and capital reserves representing a surplus arising out of sales proceeds of assets but not reserves created by revaluation of assets'⁶². In addition, an authorized

⁶¹ Section 3 of RBI's Guidelines for Primary Dealers in Government Securities Market, Press Release (Ref. IDMC No. 1931/03.02.00/94-95), dated 20-3-1995, issued by Internal Debt Management Cell, RBI.

⁶² *Ibid.*, Section 4.

primary dealer is required to maintain the capital adequacy standards prescribed by RBI⁶³.

The regulation by the RBI additionally includes the bank's inspection of the dealer's books, the dealer's daily and monthly reporting to the bank on its securities transactions, risk position and performance in auctions, and the dealer's reporting on its annual performance together with its annual audited accounts⁶⁴.

3.2.6 Depositories and Participants

Until December 1996, there was no depository in India. A depository is a central location for keeping securities on deposit and makes scripless trading possible. There are two methods for holding securities in a depository:

- (i) immobilization, and
- (ii) dematerialization.

Under immobilization, the securities are held by the depository in a physical form in its own vaults, but the transfer of securities takes place through book entries. Under dematerialization, the securities in a physical form are destroyed (*i.e.* dematerialized) and corresponding balances are electronically credited to the book at the depository; the securities are transferred electronically through book entries. India has adopted the latter method.

It is the Government of India's policy to allow multiple depositories to operate rather than have a single central depository in the country. The government promulgated the Depositories Ordinance in September 1995. Subsequently, SEBI notified the SEBI (Depositories and Participants) Regulations, 1996 in May 1996, and National Securities Depository Limited (NSDL) was registered with SEBI in June 1996. The Depositories Act, 1996 came into effect in August 1996. At present, the NSDL is the only depository in India, while the BSE intends to set up, jointly with BoI Shareholding Ltd., the clearing house of the BSE (see Section 7.6).

The sponsor of a depository applies for registration to SEBI⁶⁵. The net worth of a depository has to be at least Rs. 1 billion⁶⁶ (approx. US\$ 28

⁶³ *Ibid.*, Section 5 (vi) & 6.

⁶⁴ *Ibid.*, Sections 10.

⁶⁵ Section 3 (1) of the SEBI (Depositories and Participants) Regulations, 1996.

million). A depository which has been granted a certificate of registration has to apply to SEBI for commencement of business within one year from the date of the issue of such a certificate.

A depository is required to appoint depository participants as its agent to reach out to investors⁶⁷. Depository participants have to be registered with SEBI⁶⁸, and the registration holds good for a period of five years⁶⁹. An applicant for a depository participant has to belong to one of the following categories:

1. A public financial institution
2. A scheduled bank
3. An RBI-approved foreign bank operating in India
4. A state financial institution
5. A financial service institution promoted by any of institutions in Categories 1 to 4 above
6. A registered custodian of securities
7. A registered clearing corporation of a stock exchange
8. A registered stockbroker (subject to net worth and other financial criteria)
9. A non-banking financial company (only on behalf of itself and subject to a net worth criterion)⁷⁰.

A depository interfaces with investors through depository participants. It gathers information on each beneficiary owner's holdings of securities in an electric book entry form through depository participants, and provides it to the issuing companies, their registrars and transfer agents on a regular basis. This enables them to ascertain each beneficiary owner's entitlements on the record date, and to distribute them to beneficiary owners accordingly.

Under the regulation, a wide variety of securities, money market instruments and rights in collective investment schemes⁷¹ is eligible for being held in dematerialized form in a depository. Every depository is

⁶⁶ *Ibid.*, Section 13 (1) (a).

⁶⁷ Section 4 (1) of the Depositories Act, 1996.

⁶⁸ Section 16 (1) of the SEBI (Depositories and Participants) Regulations, 1996.

⁶⁹ *Ibid.*, Section 21.

⁷⁰ *Ibid.*, Section 27.

⁷¹ *Ibid.*, Section 28.

required to state the specific securities which are eligible to be held in dematerialized form in the depository⁷².

3.2.7 Other Market Participants

Besides those market participants whose registration requirements have been individually discussed earlier, there are some other market participants who are required to register with SEBI and are regulated by it under the relevant SEBI rules and regulations. Such market participants include:

- Bankers to an issue⁷³
- Custodians⁷⁴
- Debenture trustees⁷⁵
- Mutual funds⁷⁶
- Portfolio managers⁷⁷
- Registrars to issue and share transfer agents⁷⁸
- Venture capital funds⁷⁹.

Unlike other types of mutual funds, money market mutual funds which invest exclusively in money market instruments are regulated by RBI and must be registered with it⁸⁰.

⁷² *Ibid.*, Section 19 (a).

⁷³ The SEBI (Bankers to an Issue) Rules, 1994, and the SEBI (Bankers to an Issue) Regulations, 1994.

⁷⁴ The SEBI (Custodian) Regulations, 1996.

⁷⁵ The SEBI (Debenture Trustees) Rules, 1993, and the SEBI (Debenture Trustees) Regulations, 1993.

⁷⁶ The SEBI (Mutual Funds) Regulations, 1996.

⁷⁷ The SEBI (Portfolio Managers) Rules, 1993, and the SEBI (Portfolio Managers) Regulations, 1993.

⁷⁸ The SEBI (Registrars to Issue and Share Transfer Agents) Rules, 1993, and the SEBI (Registrars to Issue and Share Transfer Agents) Regulations, 1993.

⁷⁹ The SEBI (Venture Capital Funds) Regulation 1996.

⁸⁰ Section 15 of RBI's Guidelines for Money Market Mutual Funds, Press Release: 1995-96/372, dated 23-11-1995, issued by Press Relations Division, Reserve Bank of India, and Section 1. (3) (I) of the SEBI (Mutual Funds) Regulations, 1993.

3.3 Regulatory Bodies

3.3.1 The Securities Exchange Board of India (SEBI)

Functions of SEBI

There are two Indian laws that substantially empower SEBI to carry out various regulatory functions and duties relating to the capital markets namely, the Securities and Exchange Board of India Act, 1992 (the SEBI Act, 1992) and the Securities Contracts (Regulation) Act, 1956.

SEBI was in fact set up by the Indian Government in 1988. However, its power to regulate the capital markets was limited until the Securities and Exchange Board of India Act, 1992 (the SEBI Act, 1992) was legislated. Apparently, the Great Indian Scam in 1991-92⁸¹ prompted the Government of India and the Indian Parliament to enact the SEBI Act, 1992. To discharge its duty, SEBI is authorized under Section 11 of the Act to take measures providing for:

- regulating the business in stock exchanges and any other securities market;
- registering and regulating the working of stockbrokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner;
- registering and regulating the working of collective investment schemes including mutual funds;
- promoting and regulating self-regulatory organizations;
- prohibiting fraudulent and unfair trade practices in securities market;
- promoting investors' education and training of intermediaries in the securities market;
- prohibiting insider trading in securities;
- regulating the substantial acquisition of shares and take-over of companies;

⁸¹ For the details of the scam, see S. K. Barua & J. R. Varma, 1993, *The Great Indian Scam: Story of the missing Rs 4,000 crore*, New Delhi: Vision Books.

- calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges and intermediaries and self-regulatory organizations in the securities market;
- performing such functions and exercising such powers under the provisions at the Securities Contracts (Regulations) Act, 1956, as may be delegated to it by the Central Government;
- levying fees or other charges for carrying out the purposes of Section 11 of the Act;
- conducting research for the above purpose; and,
- performing such other functions as may be prescribed by the government⁸².

The functions and powers that have been or may be delegated to SEBI under the provisions of the Securities Contracts (Regulations) Act, 1956 extensively pertain to:

- (i) recognized stock exchanges;
- (ii) contracts and options in securities; and
- (iii) listing of securities by public companies.

SEBI is autonomous in principle but not independent of the central government. Besides the appointment of its board members and the grants by the central government, SEBI is bound by directions issued by the central government on policy matters; and it may be superseded by the central government for a period of six months or less in case the central government finds SEBI unable to discharge its functions and duties, or in other extraordinary cases⁸³.

Members of the Board

The Act sets down the composition of SEBI's Board as follows:

- a Chairman;
- two members from amongst the officials of the Ministries of the Central Government dealing with Finance and Law;
- one member from amongst the officials of the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934;

⁸² Section 11 of The Securities and Exchange Board of India Act, 1992.

⁸³ *Ibid.*, Section 17.

- two other members⁸⁴ to be appointed by the central government, who shall be professionals and *inter alia* have experience or special knowledge relating to securities market.

Head Office, Regional Offices

The SEBI has its Head Office in Mumbai and three regional offices in New Delhi, Calcutta and Madras, respectively. It has been trying to delegate more and more power to its regional offices and decentralize its administrative functions in the sub-continental country. The jurisdiction of the Head Office and each regional offices of SEBI is shown in Table 3.4. Each regional office is to carry out, among other things, the following duties:

- to oversee stock exchanges and their brokers, and attend to complaints against them⁸⁵;
- to accept offer documents of new issues of Rs. 200 million or less⁸⁶ (approximately US\$ 5.7 million or less); and,
- to accept applications for the registration of merchant bankers in Categories II, III and IV⁸⁷.

Table 3.4
SEBI Head Office & Regional Offices

Office	Address	Stock Exchanges & States Covered
Head Office (Western Region)	Mittal Court, Wing 'B' 224, Nariman Point Mumbai - 400021 Phone: 285-0451 to 0456, 288-0962 to 0970 Fax: 202-1073, 204-5633	Bombay Stock Exchange Pune Stock Exchange Vadodara Stock Exchange Ahmedabad Stock Exchange Madhya Pradesh Stock Exchange Saurashtra Kutch Stock Exchange OTCEI National Stock Exchange Vadodara Stock Exchange

⁸⁴ *Ibid.*, Section 4.

⁸⁵ SEBI Press Release dated 17-8-1994.

⁸⁶ Increased to Rs. 200 million from Rs. 100 million effective September 16, 1996; SEBI Press Release Ref. No. PR/84.96, dated 29-8-1996, issued by Primary Market Department.

⁸⁷ *Ibid.*

Table 3.4 (Contd.)

		Maharashtra, Gujarat, Madhya Pradesh and Goa, and Union Territories of Damman, Diu, Dadra and Nagar Haveli
Northern Regional Office	4 th Floor, Kailash Building 26, Kasturba Gandhi Marg New Delhi -110001 Phone: 332-9266, 332-9277	Delhi Stock Exchange Jaipur Stock Exchange Uttar Pradesh Stock Exchange Ludhiana Stock Exchange
		Delhi, Punjab, Haryana, Jammu and Kashmir, Himachal Pradesh, Uttar Pradesh, Rajasthan and Union Territory of Chandigarh
Eastern Regional Office	FMC Fortuna, 5 th Floor 234/3-A, AJC Bose Road Calcutta - 700020 Phone: 40-2435, 40-4307, 40-6105	Calcutta Stock Exchange Guwahati Stock Exchange Magadh Stock Exchange Bhubaneshwar Stock Exchange
		West Bengal, Bihar, Orissa, Assam, Sikkim, Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Tripura and Union Territories of Andaman and Nicobar Island
Southern Regional Office	3 rd Floor, D'Monte Building 32, D'Monte Colony TTK Road, Alwarpet Chennai 600 018 Phone: 497-1791 to 95 Fax 497-1796	Madras Stock Exchange Hyderabad Stock Exchange Bangalore Stock Exchange Cochin Stock Exchange Mangalore Stock Exchange Coimbatore Stock Exchange
		Tamil Nadu, Kerala, Pondicherry, Andhra Pradesh, Kamataka and Union Territories of Lakshadweep and Minicoy Islands

Departments

The SEBI currently consists of the following departments:

- the primary market department

- the secondary market department
 - institutional investors, mergers & acquisitions, research & publication department (IIMARP department)
 - legal department
 - investigation department.
- FII's registration is dealt with by IIMARP Department.

3.3.2 The Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) is the central bank of the Republic of India. It has its head office in Mumbai. The RBI's regulatory involvement in the Indian capital market has so far been limited, and is primarily threefold:

- (i) debt management through primary dealers;
- (ii) foreign exchange control; and
- (iii) liquidity support to market participants.

The RBI's regulatory authority over the primary dealers has been discussed earlier in Section 3.2.5.

The RBI also regulates participants in the securities markets when a foreign exchange transaction is involved, under the provisions of the Foreign Exchange Regulation Act, 1973. The securities transactions that involve a foreign exchange transaction need the permission of RBI. Such transactions include Indian issuer's issuance of securities outside India; and, FII's or Foreign Broker's selling, buying or dealing in Indian securities⁸⁸.

SEBI has introduced the concept of market making in some stock exchanges. Under the scheme laid out by SEBI, the SEBI-approved market makers may avail themselves of special credit lines from commercial banks. The RBI regulates such lending by banks to the market makers through standards which are more flexible than those applicable in ordinary cases⁸⁹.

3.3.3 Ministry of Finance

The Ministry of Finance of the Government of India has three departments:

⁸⁸ Section 19(1) of the Foreign Exchange Regulations Act, 1973.

⁸⁹ RBI's Guidelines for Bank Finance to Market Makers, RBI Circular, dated 5-8-1993.

Department of Economic Affairs,
Department of Revenue, and
Department of Expenditure.

Capital markets and securities transactions are regulated by the Capital Market Division of Department of Economic Affairs.

3.3.4 Self-Regulatory Organizations (SROs)

What is an SRO?

The SEBI is authorized to promote and regulate self-regulatory organizations (SROs) to carry out its functions⁹⁰. SROs are a practical and effectual tool for regulating various kinds of participants in the securities markets, and are commonly used in many countries. They have bye-laws and codes of conduct that bind their members. Indian SROs are incorporated as associations under Section 25 of the Companies Act, 1956, and are basically non-profit organizations.

Though the SEBI Act, 1992 refers to them, SROs have yet to be clearly defined under Indian laws. The Financial Services Act 1986 of the United Kingdom defines an SRO as a body (whether a body corporate or an unincorporated association) which regulates the carrying on of investment business of any kind by enforcing rules which are binding on persons carrying on such business either because they are members of that body or because they are otherwise subject to its control⁹¹.

Stock Exchanges, AMBI & AMFI

Currently, the only securities-related SROs in India whose regulatory framework has been well established and which have actually been functioning are the recognized stock exchanges. Stock exchanges, once recognized by the central government, have the authority, as well as the obligation, under the Securities Contracts (Regulation) Act, 1956, to fine, expel, suspend or otherwise penalize their member stockbrokers⁹².

The SEBI has so far designated (i) the Association of Merchant Bankers of India (AMBI) and (ii) the Association of Mutual Funds of India (AMFI) for these promotion and regulation of SROs⁹³. Though

⁹⁰ Section 11. (2) (d) of the SEBI Act, 1992.

⁹¹ Section 8 (1) of the Financial Services Act 1986.

⁹² Sections 9. (1) (o) & (3) (b) of the SC(R) Act, 1956.

⁹³ The SEBI Annual Report 1995-96, (<http://www.webi.com/report/pt3d.html>).

some Indian market participants perceive these professional associations as SROs, the two associations have yet to function as SROs, at least in full capacity. SEBI's announcement in this regard is too ambiguous and misleading⁹⁴, and SEBI does not seem to have established a definite regulatory framework for SROs other than that of the recognized stock exchanges.

The AMBI has not been granted an SRO status⁹⁵. Furthermore, it does not have as strong a disciplinary authority as recognized stock exchanges do. Nevertheless, the SEBI's other policy objectives have been definitely incorporated into the workings of the Association of Merchant Bankers of India. One of the association's objectives is to encourage and promote the observance of securities laws, including regulations and directives issued by SEBI⁹⁶; its membership is limited only to SEBI-registered merchant bankers⁹⁷; the board's co-optation of one director is subject to the consent of the SEBI⁹⁸; the SEBI has the right to nominate three directors to the board of 15 directors or less in total⁹⁹; and, no alterations to the memorandum of associations or the articles of association may be made without consent of the SEBI¹⁰⁰.

It has been reported that the AMFI itself is not desirous of an SRO status at the moment¹⁰¹.

Other SROs

The Registrars' Association of India (RAIN), among others, is on its way to becoming an SRO. The SEBI has been also in a dialogue with the Association of Custodial Agencies of India (ACAI). Outside the SEBI's jurisdiction, there is another securities-related SRO, namely, the

⁹⁴ *Ibid.*

⁹⁵ "SEBI begins review of regulations for merchant bankers", *The Financial Express*, May 8, 1997.

⁹⁶ Article III. A. (2) of Memorandum of Association of Association of Merchant Bankers of India, dated July 29, 1993.

⁹⁷ Article (3) (b) of Articles of Association of Association of Merchant Bankers of India, dated July 29, 1993.

⁹⁸ *Ibid.*, Article (54).

⁹⁹ *Ibid.*, Article (45) (2).

¹⁰⁰ Article VI of the Memorandum, Article (101) of the Articles.

¹⁰¹ "SRO a distant goal, says AMFI chief chairman", *The Financial Express*, June 15, 1997.

Association of Authorized Primary Dealers of India registered with the RBI¹⁰².

An Effective Counterbalance to Top-down Reforms

The concept of an SRO presents a new dimension of the capital market reforms in India.

An SRO has been conceptually introduced in the Indian capital market, but it has not yet been well established or accepted. A clear regulatory framework has yet to be set up, and relevant market participants are not necessarily ready to regulate themselves for professional purposes. Only recognized stock exchanges have so far been functioning as SROs in the capital market. At the same time, the BSE and other traditional stock exchanges have been one of the main targets of the capital market reforms initiated by the Government of India through SEBI. The reforms have been carried out primarily by a top-down approach. The establishment and management style of the NSE symbolizes the top-down approach.

A tradition prevalent in the older stock exchanges is now needed to administer the Indian capital market in an efficient manner, namely that of self-regulation or self-governance. If the Indian capital market is reformed and regulated solely by a top-down approach, the regulatory machinery will quickly grow into a mammoth organization which will be highly centralized and bureaucratic. The Indian economy suffered a great deal during more than forty years of a socialistic and centralized regime after independence. However, participants in the Indian capital market have successfully preserved the spirit and practice of self-regulation or self-governance at the older stock exchanges such as the BSE. It is true that the older stock exchanges have been rife with vested interests of member brokers that are not necessarily friendly to investors, but the SRO tradition of the older stock exchanges should be recognized as a necessary counter-balance to the successful top-down approach in order to keep the whole system efficient.

¹⁰² Section 12 of RBI's Guidelines for Primary Dealers in Government Securities Market.

Stock Exchanges

4.1 Early Days of Indian Stock Markets¹

Everything in India has a history to tell, her stock business being on of the best examples. It is said that the capital market in India dates back to the eighteenth century. At that time, the East India Company was ruling its Indian territories out of Calcutta, and a Mughal Emperor was sitting in Delhi. Stock exchanges were organized much later. From the Mughals and the East Indian Company, the British Government took over India in 1858 after the Indian War of Independence (the Mutiny) (1857-58). The Bombay Stock Exchange was formed in 1875, the Ahmedabad Stock Exchange in 1894, Calcutta in 1908, Madras in 1920 (the current stock exchange in 1937), the Indore Stock Exchange in 1930, the Hyderabad Stock Exchange in 1943, Bangalore in 1963, and Vadodara in 1990.

Calcutta and Bombay were the two business centers in India of the nineteenth century where securities were traded. Trading was concentrated in bank shares. In 1836, the Calcutta newspaper *Englishman* quoted share prices of the Bank of Bengal (bid/offer: Rs. 5,000/7,500), the Commercial Bank, and the Chartered Mercantile Bank. Similarly, bank stocks like Commercial Bank, Chartered Mercantile Bank, Chartered Bank, Agra Bank, and Oriental Bank were traded in Bombay.

India saw her first boom in stocks during 1861-65 and her first bubble bursting in 1865. A group of stockbrokers in Bombay had already come into prominence by 1865. Furthermore, 125 new companies went public during 1863-65. The boom was a windfall of the American Civil War (1860-65) as the war brought about an upsurge of Indian cotton exports to Europe in place of American cotton.

¹ Most of the information in this section is derived from Chapter III 'History and Institutional Aspects of Indian Stock Markets' of Jandhya L. Sharma, *The Theory of Random Walk and Stock Price Behavior of the Bombay Stock Exchange: A Time Series Analysis*, a Ph.D. dissertation, the University of Arkansas, 1976. The author digested and related them to historical events.

Between 1850 and 1860, stocks of reclamation companies were extremely active in Bombay. It was during this period that today's Bombay was formed by filling the shallow sea waters between seven small islands and expanding outwards through further reclamation. Bombay underwent intense development. Public buildings, roads and public gardens were built in the city. During the first stock boom from 1861-65, stocks of all companies that were floated commanded a premium. Banks and financial associations also attracted investors. Once the American Civil War ended, the Indian stock market crashed on 1 July 1865. Table 4.1 shows peak prices that some stocks reached during the boom period and the prices at which they were traded after the crash.

Table 4.1
Boom & Crash of Indian Stocks from 1861-65

	<i>Paid-up amount per share</i>	<i>Peak price from 1861-65</i>	<i>Post-boom price</i>
The Backbay Reclamation	Rs. 5,000	Rs. 50,000	Rs. 1,750
The Port Canning	Rs. 1,000	Rs. 11,000	N.A.
The Mazgaon Land	Rs. 1,000	Rs. 9,000	Rs. 515
The Elphinstone Land	N.A.	More than 500%	Rs. 450
Asiatic Bank	Rs. 200	Rs. 460	N.A.
The Bank of Bombay	Rs. 500	Rs. 2,850	Rs. 87

Compiled from *Share mania, 50 Years of Indian Capital Market, Capital Market*.

After this first boom, Indian stock markets went through several ups and downs, reflecting the two World Wars, the Great Depressions, and her own Independence movement. Interestingly, the excitement of the Non-Cooperative Movement (1920-22) correlated with a leap in stock prices. The share price index (1914=100) shot up to 294 by 1921. The buoyant market collapsed by the end of 1922 as Mahatma Gandhi called off the campaign and was arrested soon thereafter.

The repeated collapses of the market left casualties, together with a clamor for reforms of speculative markets and manipulative practices, in 1923, 1936 and 1947. Stock exchanges were just associations of brokers. Naturally, recommendations for reform encountered resistance from stockbrokers. The first reform attempt ended with the legislation of the Bombay Securities Contract Act of 1925. The second one was almost squashed. The third reform attempt was made after the collapse of the World War II boom of 1942-46. The company law then in force overlooked manipulating and rigging of share prices. The reform took a

long time. In 1947, India finally got independence, but it was not until nine years later that. The Companies Act, 1956 was enacted to plug the loop holes of the previous company law.

4.2 Recognized Stock Exchanges

There are 22 stock exchanges in India (Table 4.2). These were founded at different times, in different places, under different laws. However, all of them have now been recognized and regulated under a single law, namely, the Securities Contracts (Regulation) Act, 1956. No person is, in principle, allowed to organize stock exchanges other than the recognized ones².

Table 4.2
Recognized Stock Exchanges in India

<i>Exchange</i>	<i>State (City)</i>	<i>Exchange</i>	<i>State (City)</i>
Ahmedabad	Gujarat	Uttar Pradesh	Uttar Pradesh (Kanpur)
Bangalore	Karnataka	Ludhiana	Punjab
Bhubaneshwar	Orissa	Madras	Tamil Nadu
Calcutta	West Bengal	Mangalore	Kerala
Cochin	Kerala	Magadh	Bihar (Patna)
Coimbatore	Tamil Nadu	Mumbai	Maharashtra
Delhi	Delhi	National Stock Exchange	Maharashtra (Mumbai)
Guwahati	Assam	Pune	Maharashtra
Hyderabad	Andhra Pradesh	Saurashtra Kutch	Gujarat (Rajkot)
Madhya Pradesh	Madhya Pradesh (Indore)	Vadodara (Baroda)	Gujarat
Jaipur	Rajasthan	OTCEI	Maharashtra (Mumbai)

The stock exchanges are tightly regulated as self-regulatory organizations (SROs) under the act. In addition to ordinary regulatory powers over the stock exchanges, the Central Government and/or SEBI may nominate up to three members to the board of each stock exchange³. The government and/or the agency have the authority to make, approve and amend the bye-laws of the stock exchanges⁴. In return, the stock

² Section 19 (1) of the SC(R) Act, 1956.

³ Section 4. (2) (iii) of the SC(R) Act, 1956, and Section 10 of the SC(R) Rules, 1957.

⁴ Section 4. (1) (a) & 8 of the SC(R) Act, 1956.

exchanges have been granted a strong disciplinary authority (as well as obligations) over their member stockbrokers.

In December 1995, SEBI set up the Inter-Exchange Coordination Group, consisting of heads of all major stock exchanges and representations from regional stock exchanges, to help improve the compliance process among stock exchanges⁵.

Table 4.3
Turnover on Stock Exchanges in India

	Stock Exchange	Turnover (Rs. bil.)			% of Total Turnover			Change in Turnover	
		94-95	95-96	96-97	94-95	95-96	96-97	95-96	96-97
1	NSEI	17	681	2,945	1.1%	30.0%	45.6%	3843%	332%
2	Mumbai	677	501	1,243	41.6%	22.0%	19.2%	-26%	148%
3	Calcutta	529	621	1,057	32.5%	27.3%	16.4%	18%	70%
4	Delhi	91	101	486	5.6%	4.4%	7.5%	11%	383%
5	Ahmedabad	57	88	205	3.5%	3.9%	3.2%	55%	134%
6	Uttar Pradesh	78	24	161	4.8%	1.0%	2.5%	-70%	577%
7	Pune	37	71	99	2.3%	3.1%	1.5%	93%	40%
8	Ludhiana	25	48	53	1.5%	2.1%	0.8%	95%	9%
9	Bangalore	7	9	44	0.4%	0.4%	0.7%	25%	394%
10	Vadodara	16	13	43	1.0%	0.6%	0.7%	-22%	239%
11	Magadh	8	16	28	0.5%	0.7%	0.4%	104%	69%
12	Coimbatore	13	25	24	0.8%	1.1%	0.4%	91%	-4%
13	Madras	30	16	23	1.9%	0.7%	0.4%	-47%	45%
14	Jaipur	9	10	15	0.5%	0.5%	0.2%	19%	45%
15	Cochin	6	18	14	0.4%	0.8%	0.2%	202%	-22%
16	Guwahati	3	6	5	0.2%	0.3%	0.1%	117%	-22%
17	Hyderabad	14	13	5	0.8%	0.6%	0.1%	-7%	-63%
18	Saurashtra Kutch	5	6	4	0.3%	0.2%	0.1%	4%	-29%
19	Mangalore	1	0	4	0.0%	0.0%	0.1%	-37%	856%
20	Bhubaneshwar	1	2	2	0.1%	0.1%	0.0%	58%	2%
21	OTCEI	4	2	2	0.2%	0.1%	0.0%	-40%	1%
22	Madhya Pradesh	1	2	0	0.1%	0.1%	0.0%	73%	-94%
TOTAL		1,629	2,274	6,461	100.0%	100.0%	100.0%	40%	184%

Source: SEBI Annual Reports 1995-96 & 1996-97.

⁵ SEBI Press Release, PR No. 142/95, dated 21-12-95.

Table 4.3 summarizes the turnover of the 22 stock exchanges in India. The top 5 stock exchanges, namely, the NSE, the BSE, the Calcutta Stock Exchange, the Delhi Stock Exchange, and the Ahmedabad Stock Exchange accounted for 84.3%, 87.6% and 91.6% of trading volume in the fiscal years 1994-95, 1995-96 and 1996-97, respectively. There has been a steady trend toward a concentration of trading in those major stock exchanges. The trend is especially clear in the case of NSE and BSE, in Mumbai. The combined market share of these two stock exchanges was 42.6%, 52.0% and 64.8% in the fiscal years 1994-95, 1995-96 and 1996-97, respectively. The NSE grew remarkably in trading volume in the second and the third years of its operation. Rather than eating away at the BSE's share, it contributed toward an expansion of the whole pie. It is also interesting to note that securities trading is predominant in Mumbai, Calcutta and Delhi which have all been political and/or commercial capitals since the British colonial time.

4.3 Bombay Stock Exchange

4.3.1 Organization

The Bombay Stock Exchange (BSE) is not the official name of the stock exchange. Its official name is 'The Stock Exchange, Mumbai', previously called 'The Stock Exchange, Bombay'. Its prestige stems from the fact that it is the oldest stock exchange in India. It was formally established as the Native Share & Stock Brokers' Association in 1875, and is still an association of persons. The BSE was modeled on the London Stock Exchange which is an independent institution not subject to government regulation. It is located on Dalal Street⁶, in down town Bombay.

The board of directors of the exchange is composed of 19 directors: nine elected member brokers, five public representatives, three nominees of the SEBI, one nominee of the RBI, and the executive director. The president, the vice-president and the honorable treasurer were elected from among member brokers. The executive director is a professional, having been seconded from the State Bank of India.

⁶ The Indian version of Wall Street, down town New York, means 'Brokers Street' in Hindi. '*Dalâl*' derives from an Arabic work '*dallâl*' or a broker, a salesman.

4.3.2 Membership

As at the end of 1996, the BSE had a total of 641 members, consisting of 557 individual members, 5 corporate members with unlimited liability, and 79 corporate members with limited liability. Until recently the category of corporate members with limited liability was confined to closely-held companies. The exchange has no financial institutions as members. The BSE members are grouped into two types: Type 1 members who are allowed to carry forward their positions and Type 2 members who are not allowed to do so, under the *badla* system (see Section 4.3.8).

The predominance of individual members is often blamed for impeding the modernization of this prestigious exchange. That is not necessarily true. Membership of the New York Exchange too is limited to individuals. The truth of the modernization issue probably lies in the size of operations and the ownership structure of brokerage houses which are often too small and under-capitalized to cope with the rapidly changing needs of investors in the expanding capital market. Furthermore, they are not suited to raise capital from the public.

Many brokers used to cite a 20% capital gains tax on any gain arising from revaluation of their membership card as a hindrance to corporatization of individual members of the BSE. Many individual brokers have been engaged in the broking business for generations, and have inherited the membership from their fathers or relatives. Others purchased their membership cards decades ago. The BSE made a successful plea to the Indian government to grant brokers a one-time exemption from tax on the capital gains on corporatizing their privately-owned firms⁷. In early March 1997, the central government announced in its 1997-98 budget bill an exemption for individual brokers from the capital gains tax. The tax-exempt corporatization was expected to help members raise capital and/or merge with other brokerage houses to survive through economies of scale. Corporatization was, in turn, expected to help make broker's operations more transparent, since the Companies Act requires corporatized brokers to disclose more

⁷ 'Brokers seek exemption from capital gains tax', *The Financial Express*, December 24, 1996.

information. There are expectations that mass corporatization of more than 200 individual members⁸ may take place.

Membership cards are transferable. Their market price fluctuates with demand and supply. Goodwill such as the status of a designated broker of a large institutional investors also affects the price of a particular membership card. The open market price of a membership card has ranged between Rs. 35.0 million (approx. US\$ 1.00 million) and Rs. 11.5 million (approx. US\$ 0.32 million) since 1992 (Table 4.4). Baring Securities reportedly paid Rs. 40.0 million (approx. US\$ 1.14 million) at an auction early 1996.

However, at least 50 membership cards were reportedly for sale and an offered price was Rs. 9.0 million (approx. US\$ 0.25 million) in early fall 1996. Besides the sluggish market conditions, a structural change of the securities industry has been taking place: foreign brokerage houses have entered the market; powerful Indian financial institutions have also commenced brokerage businesses; and the recent computerization of Indian securities trading has cut down transaction costs, squeezed jobbing spreads and driven some jobbers out of the market⁹. The announcement of the capital gains tax exemption in March 1997 and the proposed

Table 4.4

Open Market Price of BSE Membership Card

Year	(Rs. mil.)
1992	30.0
1993	25.0
1994	25.0
1995	35.0
1996	11.5
1997	13.5

Source; *The Economic Times*, Sep. 5, 1996,

The Financial Express, Apr. 13, 1997.

⁸ "Broker keen on corporatisation", *The Financial Express*, March 2, 1997. Mr. Damani, the BSE President, personally expects approximately 85% of the BSE members to get corporatized by the end of 1997. As a result of last minute applications for corporatization by brokers before the 31st December 1997 deadline, however, the BSE appears to have achieved a corporatization rate of 65% (Corporatization new mantra as BSE brokers utilise sops", *The Economic Times*, January 1, 1998).

⁹ 'Broking business on the slow track', *The Economic Times*, Sep. 5, 1996.

expansion of the BSE on-line trading system (BOLT) have driven up the membership price to Rs. 13.5 million¹⁰.

4.3.3 Trading Mechanism

Trading Days & Hours

Regular trading on the BSE takes place on all days except Saturdays, Sundays and other notified holidays. The BSE's notified holidays may be different from those of other stock exchanges like the NSE.

The regular trading hours of the BSE are from 10:00 a.m.¹¹ to 3:30 p.m. Earlier there used to be an opening session, which was discontinued in July 1997¹². The market close phase is from 3:30 p.m. to 3:40 p.m., during which the closing prices of each listed stock are determined. The post-closing phase is from 3:40 p.m. to 4:05 p.m., during which transactions can be made only at the closing prices, and negotiated and cross deals are entered into the system. However, it is very common that BSE as well as the NSE often change their trading hours¹³.

Carried-forward (*Badla*) sessions are held on Saturdays as follows: from 11:00 a.m. to 1:00 p.m., and from 1:30 p.m. to 2:30 p.m.

The stock exchange also has extra trading sessions on special occasions. The uniform post-budget trading session of the BSE, along with other stock exchanges, is held in the evening of the day the Indian Government announces its annual budget. In 1997, the special session

¹⁰ 'BSE card value goes up to Rs. 1.3 crore', *The Financial Express*, April 13, 1997.

¹¹ Changed to 9:30 a.m. with effective from Monday, November 17, 1997.

¹² "BSE bids goodbye to daily opening sessions", *The Financial Express*, July 16, 1997. Prior to the trading hours, there were the pre-open and the open phases. The pre-open phase was from 9:30 a.m. to 9:50 a.m. During that phase, the trading member could enter, modify or cancel orders in the BSE's on-line trading system. The open phase was from 9:50 a.m. to 10:00 a.m. During the 10-minute session before the opening, the trading member could inquire, through his/her computer terminal, about the orders entered during the pre-open and the open phases, but could not enter, modify or cancel those orders.

¹³ With effect from December 29, 1997, the regular trading session was extended to 4:00 p.m. Post closing session is from 4:00 p.m. to 4:10 p.m. while normal break-up session is from 4:50 p.m. to 6:20 p.m. The log-in session commences at 8:30 a.m. and ends at 9:00 a.m. The *badla* session starts at 10:00 a.m. and continues till 12:00 p.m. while the break-up session is from 1:40 p.m. to 3:00 p.m. (Bombay Stock Exchange revises timings of BOLT session from trading, *badla*, auction, and objection auction from December Monday, *Business Standard*, December 29, 1997.

was held from 6:00 p.m. to 8:00 p.m. on Friday, February 28¹⁴. After the no-confidence vote against the United Front government led by then Prime Minister H. D. Deve Gowda at midnight of Friday, 11 April 1997, the BSE and all other exchanges had a session from 9:30 a.m. to 2:30 p.m.

Trading System

Trading on the BSE is carried out by member brokers and their authorized assistants from their trading work stations (TWS) in their offices through a screen-based on-line system called the Bombay Stock Exchange On-Line Trading system (BOLT). BOLT was introduced in March 1995 and had completely replaced the open outcry system of trading on the trading floor by June 1995. The BOLT system accepts two-way quotes from jobbers¹⁵, and market and limit orders from brokers who have received such orders from their investors. Then, it matches them according to the matching logic specified for this system¹⁶.

The BOLT displays the touchline and the market view on the screen. The touchline for a particular stock shows the best bid and offer prices that are currently available in the market, along with the depths (number of shares placed for sale or purchase) at those prices. The market view window provides more information about each stock listed, including the best five sell and buy prices, the quantities available at each of those prices, the opening, high, low and previous day's closing prices, the last traded price and quantity, the total number of trades, the total number of and value of shares traded¹⁷.

A jobber's two-way quote has a spread of four ticks. The jobber book (an on-line record file of jobbers' quotes) has a priority over the order book (an on-line record file of customers' orders) for matching orders that enter BOLT. Standing orders in the order book are executed in order of price, and then in order of time for the same price¹⁸.

¹⁴ Secondary Market Department, SEBI, "Inter Exchange Coordination Group Meeting", Press Release Ref. No. PR 18/97, February 4, 1997.

¹⁵ A jobber transacts business on the floor of an exchange (on the platform of the BOLT at the BSE) and serves only as a principal, buying and selling for his own account and dealing only with brokers or other jobbers.

¹⁶ The BSE, The Leaflet *The Stock Exchange, Mumbai*, Mumbai, 1996.

¹⁷ The BSE, The Leaflet *Screen-based Trading: An Overview*, Mumbai, 1996.

¹⁸ *Ibid.*

The BSE accepts and executes limit orders, market orders, “hit” orders and “take” orders. “Hit” and “take” orders are a hybrid of limit and market orders. The BOLT trading work station allows a broker to instantly place a limit order at the current touchline. Such a buy order is called a “hit” order and such a sell order a “take” order¹⁹.

The introduction of BOLT has made surveillance and monitoring of market transactions far easier and more effective in curbing and containing price manipulations. Previously, the task was assigned to the Floor Committee which was responsible for keeping a watch on the gross and net positions of the trading members. The new system enables BSE to continuously detect suspicious price movements and automatically activates the circuit-breaker²⁰.

Daily & Weekly Price Limits

Effective January 1997, BSE imposed price limits as a circuit breaker system to maintain the orderly trading of shares on the exchange. Daily and weekly price limits are in force for each stock. The daily price limit of a stock is measured from the stock’s closing price in the previous trading session. The weekly price limit of a stock is based on its closing price on the last trading day in the previous week, usually its closing price on the previous Friday.

The BSE’s computerized trading system rejects buy or sell orders of a stock at prices outside the price limits, but does not stop trading itself.

Daily price limits have been set for A Group and four sub-categories of B1 & B2 Groups. These are 10%, 25%, 50% and 75% from the closing price of the previous trading day, depending on the category to which each stock belongs. The weekly price limit of 25% is in force for A Group

Table 4.5
Daily Price Limits on BSE

Category	Market Price of the Share	Daily Price Limit	Weekly Price Limit
A Group Shares	Over Rs. 20	10%	25%
B1 & B2 Group	Rs. 10 up to 20	25%	
Shares	Rs. 1 up to 10	50%	No limit
	Up to Rs. 1	75%	No limit

¹⁹ *Ibid.*

²⁰ The Stock Exchange, *REFORMS*, Mumbai (BSE), 1997, p. 11.

stocks and B1 & B2 Group stocks whose market prices are over Rs. 10. No weekly price limits are set for B1 & B2 Group stocks whose market prices are Rs. 10 or less²¹ (see Table 4.5).

In fact, it is SEBI which has determined and imposed the price limits for stocks whose market prices are above Rs. 20, namely, the daily price limit of 10% and the weekly price limit of 25%. The BSE has set the other price limits and may, at its own initiative, vary such price limits in a highly volatile market situation²².

4.3.4 Equity Segment

Market Cap & Turnover

As at the end of 1996, the total market capitalization of the 5,999 BSE-listed companies was Rs. 4,392 billion (US\$ 122 billion). Out of that, however, only about 1,500 stocks were liquid, the rest illiquid. During the calendar year 1996, the BSE recorded an annual turnover of 790 billion shares with a value totaling Rs. 941 billion (US\$ 26 billion). The BSE currently accounts for about 12.5% of the total annual market turnover and about 92% of the total market capitalization in India. These two numbers do not necessarily add up to the BSE's sole predominance in the Indian securities market, because most of large cap stocks are also listed on the NSE due to the multiple listing system (see Section 4.3.5).

Table 4.6
BSE Annual Turnover & Market Cap.

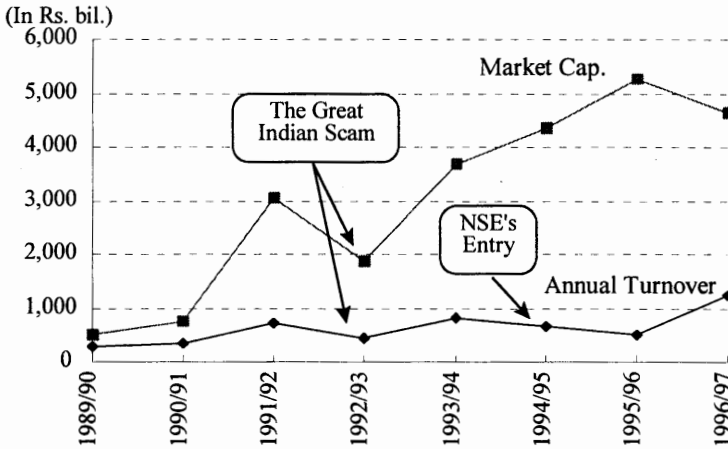
Fiscal Year (Apr.-Mar.)	Annual Turnover		Market Capitalization (at end of March)	
	(In Rs. bil.)	(In US\$ bil.)	(In Rs. bil.)	(In US\$ bil.)
1991/92	717.77	22.78	3,059.87	97.13
1992/93	456.96	14.50	1,881.46	59.72
1993/94	836.29	26.55	3,680.71	116.85
1994/95	677.49	21.51	4,354.81	138.37
1995/96	500.64	14.57	5,264.76	153.27
1996/97	1,242.84	34.41	4,639.15	129.22

Source: BSE.

²¹ BSE's letter dated April 15, 1997.

²² 'Intra-settlement price filters from tomorrow', *The Financial Express*, January 19, 1997, 'BSE to impose price band from Feb 10', *The Financial Express*, February 9, 1997, and BSE's letter dated February 28, 1997.

Figure 4.1
BSE Turnover & Market Capitalization



Source: BSE

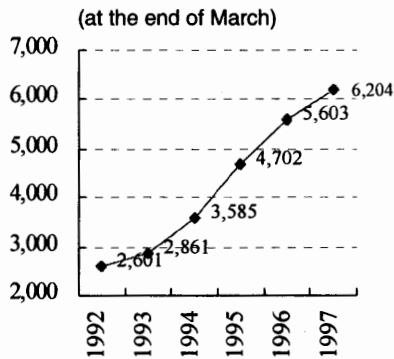
The annual turnover and market capitalization of the BSE from the fiscal year 1991/92 to 1996/97 is shown in Table 4.6, and those from the fiscal year 1989/90 to 1996/97 in Figure 4.1. The impact of the Great Indian Scam in 1991-92 and the NSE's entry were obvious in 1992-93 and 1994-95 and 1995-96 respectively. While market capitalization swelled drastically, the annual turnover declined. This phenomenon, which looks contradictory, was made possible by the multiple-listing requirement (see Section 4.4.5). The parallel listings of companies on the BSE inflated BSE's market capitalization, but large cap stocks were traded more on the NSE than the BSE (see Section 4.5.5).

Too Many Small Companies Listed

The number of companies listed on the BSE has increased geometrically over the years — from 992 in 1982 to 6,224 at the end of June 1997. Figure 4.2 shows the number of companies listed on the BSE at the end of March from 1992 to 1997. The pace of listing from 1993 to 1996 was astronomical by global standards. Obviously, there are too many small companies listed on the BSE. According to statistics, in 1996, the number of companies listed on BSE with a paid-up capital of Rs. 30 million (approx. US\$ 0.84 million) or less amounted to 1,204. Ownership of such small companies tends to be concentrated in the hands of a few

shareholders, and their shares are illiquid. As a result, stocks of small companies are prone to price-rigging²³.

Figure 4.2
Number of BSE-listed Companies



Two factors contributed to the large number of companies listed on the BSE:

- (i) it includes not only listed stocks but also permitted stocks; and
- (ii) the listing criteria used to be very easy.

What are customarily called “listed companies” or “listed stocks” in India is a broader concept than in other countries. “Listed companies” or “listed stocks” on an Indian stock exchange include:

- Companies or stocks which were originally listed on that stock exchange;
- Companies which were originally listed on one of other stock exchanges and secondarily listed on that stock exchange to meet the multiple-listing requirement (see “Multiple-listing” of Section 4.3.5); and,
- Companies which were originally listed on one or more of other stock exchanges and later permitted to trade on that stock exchange.

Those in the third category were known as permitted stocks (see “Permitted Stocks” of Section 4.4.5). Of 6,204 companies listed on BSE

²³ The BSE, *op. cit.*, p. 13.

as at the end of March 1997, only 1,810 companies²⁴ were originally listed on that exchange. The rest were either secondarily listed or permitted stocks.

It is probably fair to say that the BSE's listing criteria, which used to be too moderate, also accounted for the unrealistically large number of companies on the BSE. For a long time in the past, there were either no thresholds for listing on the BSE or the thresholds were too low. The eligibility criteria for an initial public offering that SEBI had laid down in its guidelines, and which were in force until 1996, were very moderate (see Section 8.1.5). A large number of joint stock companies with a very low issued capital were promoted for tax reasons and listed on the BSE in the late 1960s and early 1970s²⁵. Now many companies are being delisted on account of non-payment of listing fees. 216 companies were delisted in 1994-95, 87 in 1995-96, and 181 in 1996-97²⁶. This large number of companies delisted for non-payment of listing fees is further evidence of the listing criteria having been problematic in the past compared to today's standards.

In order to contend with the too many small companies listed on the BSE, it has been proposed that these be weeded out from the BSE and moved to the Over-the-Counter Exchange of India (OTCEI). The settlement on the OTCEI is not on a batch basis but on a delivery-against-payment basis²⁷, and every trade on OTCEI settles with delivery. There is thus less room for price-rigging of small cap stocks on the OCTEI.

Classification of Group A, B1 & B2 Shares

The BSE classifies its listed shares as Groups A, B1 or B2, as shown in Table 4.7. Group A scrips are eligible for *badla* transaction (see Section 4.3.8). The classification is made on the basis of attributes described in the table. The attributes are taken as guiding factors and their totality is taken into account. No single factor is considered in isolation. The BSE continuously reviews the scrips for reclassification. Therefore, the number of stocks in each group is subject to change. The stock exchange has a tendency to expand Groups A and B1.

Settlement procedures on the BSE follow a unique "settlement period" where trades are settled on a weekly basis. The clearing house of the

²⁴ The SEBI Annual Report 1996-97, p. 39

²⁵ *Ibid.*, p. 11

²⁶ BSE's letter dated April 25, 1997

²⁷ The BSE, *op. cit.*, p. 13

exchange clears and performs the cash settlement, while the member brokers often carry out hand-to-hand delivery settlements among themselves. Settlement and clearing of BSE-listed stocks will be discussed in detail in Section 7.2.3.

It should be noted that this classification does not hold for transactions on the National Stock Exchange.

Table 4.7
Classification & Number of Stocks Listed on BSE

Group	# of Stocks ²⁸			Characteristics
	Dec.31, 1996	Mar.31, 1997	Jun. 30, 1997	
A	60	80	100	<ul style="list-style-type: none"> • Scrips having very high liquidity • Company having large equity base and large public holding • Company having consistently good performance over the years
B1	468	645	799	<ul style="list-style-type: none"> • Scrips having high liquidity • Company having an equity above Rs. 30 million • Company having fundamentals and financial parameters in line with the industry
B2	5,471	5,479	5,325	<ul style="list-style-type: none"> • Scrips having low trading volume at the BSE indicating low investor interest • Scrips trading below par value at the BSE • Company having an equity below Rs. 30 million • Company's shares being not widely held • Company having surveillance measure initiated against it by the BSE for suspected price manipulations
Total	5,999	6,204	6,224	

Source: BSE.

²⁸ As of July 31, 1996, "Key Statistics on the Stock Exchange, Mumbai for the Year 1996". The number of BSE-listed companies is over 6,000 at the end of September, 1996.

4.3.5 Listing on BSE

Listing Criteria

Under current Indian laws²⁹, securities offered to the public for subscription have to be listed. Therefore, an applicant company for listing on the BSE has to first satisfy the eligibility criteria for an initial public offering (IPO). Additionally, the applicant company is required to make disclosure in accordance with the stipulated rules and regulations. Such criteria and disclosure requirements are virtually the conditions precedent to listing on the BSE, and will be discussed later in Section 6.2 and Section 8.1.5, respectively. The discussion in this section will be limited pertaining to requirements to listing on the BSE.

The following summarizes major requirements which need to be fulfilled by an unlisted company for being listed on BSE:

1. *Issued capital*: The issued and subscribed equity capital of the applicant company, including that proposed to be issued before listing, shall not be less than Rs. 100 million³⁰ (approximately US\$ 2.78 million).
2. *Minimum public offer of capital*: At least 25% of each class of securities issued by a company has to be offered to the public for subscription³¹. The central government may relax this minimum public offer of capital for government companies³². (The public shareholdings should not be reduced to less than 20% of the voting capital of the company³³.) (see Section 8.1.3).

²⁹ Section 73 of the Companies Act, 1956.

³⁰ The threshold limit of paid-up capital for listing was raised to Rs. 100 million from Rs. 50 million with effect from February 27, 1996. BSE Press Release dated February 26, 1996.

³¹ Section 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957, as amended by the Notification F. No. 1/33/SE/92, dated September 20, 1993, issued by the Ministry of Finance, Department of Economic Affairs, Investment Division. The minimum public offer of capital was 60% or other percentage, prior to the amendment.

³² Proviso to Section 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957. Listing of debt securities issued by Public Sector Undertakings (PSUs) is exempted from the provisions of the section. Notification F. No. 1/10/SE/94, issued by the Ministry of Finance, Department of Economic Affairs, ESB & Investment Division.

³³ Section 40B (9) of the BSE Listing Agreement Form.

3. *Public shareholders*: As a result of a public issue, a company has to have at least 5 public shareholders for every Rs. 100,000 of net capital offered to the public. In the case of an offer for sale, the company has to have at least 10 public shareholders for every Rs. 100,000 of net capital offered to the public. "Public shareholder" means a person who is neither a promoter nor a holder of more than 1% equity capital of the company³⁴.

A different set of listing criteria applies to an applicant company which has already been listed on another recognized stock exchange in India and seeks listing on BSE. The criteria are as follows:

1. Issued capital: Rs. 50 million (approximately US\$ 1.39 million) or more;
2. Net worth: Rs. 100 million (approximately US\$ 2.78 million) or more; and,
3. Market capitalization: Rs. 150 million (approximately US\$ 4.18 million) or more

Multiple-listing

Multiple-listing is compulsory. A company with a paid-up capital of more than Rs. 50 million has to list its securities, or have its securities permitted to trade, on at least one more stock exchange, in addition to the regional stock exchange³⁵. The Ministry of Finance of India issued a direction to that effect in September 1985. Thereafter, all BSE-listed companies with a paid-up capital of more than Rs. 50 million³⁶ listed their shares on at least one more exchange. After the NSE came into operation in November 1994, the new stock exchange was a logical choice for the second listing of such companies. This is one of the reasons why many Indian companies are double-listed on the BSE and the NSE.

The multiple-listing system also creates arbitrage opportunities between different exchanges. If a stock is listed on two stock exchanges whose settlement days differ, a smart investor may be able to make a profit on the disparity in prices of stock on the two exchanges at a minimal risk. In fact, such arbitrage activities are very popular in India.

³⁴ Section 45 of BSE Listing Agreement, as amended by BSE notification Ref. No. JJB/ALL LISTED COMPANIES/96, dated June 5, 1996.

³⁵ Ministry of Finance F. No. 14 (2)/SE/85, dated September 23, 1985.

³⁶ There are many BSE-listed companies that were admitted to trading on the BSE before the threshold paid-up capital was raised to Rs. 50 million in July 1995, and which still have a paid-up capital of less than Rs. 50 million or less.

Tightening of Listing Criteria

The Government of India has been guiding BSE to improve the quality of the portfolio of companies listed on the exchange. Accordingly, BSE has rapidly tightened its listing criteria in terms of the size of companies. The threshold paid-up capital of a company being listed on the BSE was raised to Rs. 50 million from Rs. 30 million in July 1995, and to Rs. 100 million from Rs. 50 million in February 1996.

The next target of the government appears to be the business sustainability of BSE-listed companies. The current listing criteria of the BSE have some salient features as compared to those of the NSE that will be discussed later in Section 4.4.5. One of them is that the BSE does not require an applicant company to have a track record of commercial operations. The BSE's listing criteria are relatively moderate, even though the exchange raised the threshold limit of paid-up capital for listing to Rs. 100 million from Rs. 50 million in February 1996. Yet, many small and medium-sized companies have reportedly deceived the exchange and SEBI in order to satisfy the criteria by inflating their project costs and thereby raising the issue size.

Furthermore, SEBI has stopped vetting the prospectus of an issuing company since December 1996. This has increased the BSE's responsibility towards introducing genuinely qualified companies to the investment community by allowing them to list on the BSE. The exchange is expected to institute additional requirements for listing in terms of promoters' track records, promoters' contributions, project appraisals by banks or financial institutions and companies' financial performances³⁷.

4.3.6 BSE Indices

The BSE publishes four stock price indices:

BSE Sensitive Index,
BSE 100 Index,
BSE-200, and
DOLLEX.

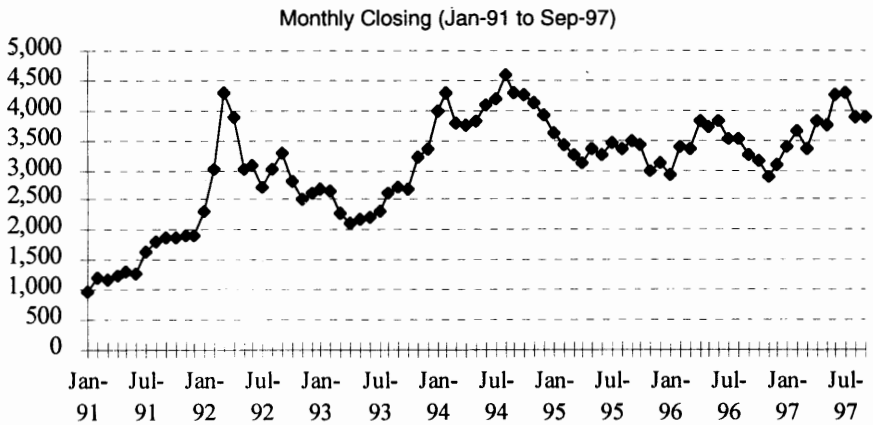
In addition, the BSE-500 Index has been proposed.

³⁷ "BSE's stiff listing norms to ward off poor issues", *The Financial Express*, April 26, 1997.

The BSE Sensitive Index

The BSE Sensitive Index is also known as the BSE Sensex or the BSE 30 Index, and is the most widely used and extensively quoted stock price average in India. BSE started publishing the index on 2 January 1986³⁸, and currently calculates and updates it every two minutes³⁹ (Figure 4.3).

Figure 4.3
BSE Sensitive Index



Source: BSE.

The BSE Sensitive Index is a market capitalization-weighted index composed of 30 stocks with the base April 1979=100, accounting for approximately 30% of the total market capitalization of the exchange. In arriving at an index figure, the BSE starts by multiplying the price of each share by the number of shares outstanding in that stock. These market value figures are then added, giving the aggregate market value of the stocks covered (the current market value). This aggregate is expressed as a percentage of the average market value using the fiscal year 1978-79 as a base (the base market value)⁴⁰. Other stock price indices like the NSE-50, the S&P 500 Composite Index, NYSE Common Stock Index, FTSE-100, and the Tokyo Stock Price Index (TOPIX) are also market capitalization-weighted.

³⁸ The BSE, *BSE Index Numbers*, 1997, p. 3.

³⁹ *Ibid.*, p. 4.

⁴⁰ *Ibid.*, p.3.

Table 4.8
30 Component Stocks of BSE Sensitive Index
 (as of August 19, 1996)

<i>Stock</i>	<i>Industry</i>	<i>Market Cap.</i> <i>(In Rs. bil.)</i>	<i>Weight</i>
1 Arvind Mills Ltd.	Textile	11.18	0.71%
2 Associated Cement Co. Ltd.	Cement	27.95	1.79%
3 Bajaj Auto Ltd.	Automobile	77.41	4.95%
4 Bharat Heavy Electrical Ltd.	Engineering	37.63	2.40%
5 BSES Ltd.	Power	24.38	1.56%
6 Colgate Palmolive India Ltd.	Consumer	33.34	2.13%
7 Glaxco (India) Ltd.	Pharmaceutical	14.14	0.90%
8 Grasim Industries Ltd.	Diversified	30.28	1.93%
9 Great Eastern Shipping Co. Ltd.	Shipping	12.1	0.77%
10 Gujarat Ambuja Cement Ltd.	Cement	22.17	1.42%
11 Hindalco Industries Ltd.	Aluminum	46.57	2.98%
12 Hindustan Lever Ltd.	Consumer	119.41	7.63%
13 Hindustan Petroleum Corporation Ltd.	Petroleum/Refinery	67.88	4.34%
14 Indian Hotels Co. Ltd.	Hotels	34.19	2.18%
15 Indian Petrochemical Corporation Ltd.	Petroleum	30.89	1.97%
16 Industrial Credit and Investment Corporation	Service	21.55	1.38%
17 Industrial Development Bank of India Ltd.	Service	76.73	4.90%
18 ITC Ltd.	Diversified	69.21	4.42%
19 Larsen & Toubro Ltd.	Diversified	59.56	3.81%
20 Mahanagar Telephone Nigam Ltd.	Telecom	112.2	7.17%
21 Mahindra & Mahindra Ltd.	Automobile	34.2	2.19%
22 Nestle India Ltd.	Food Products	25.55	1.63%
23 Ranbaxy Laboratories Ltd.	Pharmaceutical	28.91	1.85%
24 Reliance Industries Ltd.	Diversified	91.72	5.86%
25 State Bank of India	Service	125.29	8.01%
26 Steel Authority of India Ltd.	Iron & Steel	103.26	6.60%
27 Tata Chemicals Ltd.	Chemical	34.97	2.23%
28 Tata Engineering and Locomotive Co. Ltd.	Automobile	1,10.06	7.03%
29 Tata Iron and Steel Co. Ltd.	Iron & Steel	66.45	4.25%
30 Tata Power Co. Ltd.	Power	15.79	1.01%
Total Market Cap.		1,564.97	100.00%

Compiled from *The Stock Exchange, Mumbai, BSE Index Numbers, Mumbai, 1997, p. 8*

To maintain the continuity of the index in order that it indicates only stock price movements, the base market value is adjusted for a change of a component stock (if any) and new share issues through share offerings, rights issues, the conversion of convertible bonds or the exercise of warrants. Stock split-ups or split-downs, bonus issues, stock dividends or a reduction of paid-up capital do not change the base market value because these do not affect the net worth of a company, and consequently, by themselves do not alter the current market value of a component stock.

The 30 component stocks of the index are shown in Table 4.8. These were selected on the basis of liquidity, depth, floating-stock-adjusted depth and industry representation. All of them are included in the 100 stocks of the A Group (specified stocks eligible for *badla* trading). The 30 stocks were originally chosen from the specified and the non-specified groups. Only Zenith Ltd. was replaced by Bharat Forge Ltd. in August 1992 before the overhaul of the component stocks in August 1996. Effective 19 August 1996, 15 of the 30 component stocks were replaced by new component stocks, and the aggregate market value of the index increased 76% to Rs. 1,565 billion (approx. US\$ 44 billion) from Rs. 891 (approx. US\$ 25 billion)⁴¹. Its representation of the exchange's market capitalization increased to 31% from 18%.

BSE 100 Index

The BSE 100 Index, formerly known as the BSE National Index, is also a market value weighted index, composed of 100 stocks, accounting for approximately 43% of the total market capitalization of the exchange. It uses the fiscal year 1983-84 as a base. The BSE started publishing the index on 3 January 1989⁴².

The index was initially intended to reflect stock price movements on a national scale, wider than the BSE Sensitive Index which was limited only to the 30 component stocks listed on the BSE. That is why the index was called the BSE National Index. The 100 stocks were selected from the specified and non-specified stocks listed on the five major stock exchanges, namely, Mumbai, Calcutta, Delhi, Ahmedabad, and Madras. For the purpose of quoting prices to calculate the index, they were divided into two groups: local stocks and inter-exchange stocks. For the local stocks that were listed on a single stock exchange, prices were those quoted on the relevant stock exchanges. For the inter-exchange stocks

⁴¹ The BSE, *op. cit.*, 1997, pp. 6-8.

⁴² *Ibid.*, p.9.

that were listed on more than one stock exchange, prices were the averages of the prices quoted on those stock exchanges⁴³.

However, the fast advance in communication as well as trading technologies quickly diminished price differences among stock exchanges, and taking stock prices from the regional stock exchanges became meaningless. Consequently, the BSE redesigned the index based only on prices quoted on the BSE, and renamed it the BSE 100 Index instead of the BSE National Index, effective 14 October 1996⁴⁴. As a result, the aggregate market value of the index increased 45% to Rs. 1,960 billion (approx. US\$ 55 billion) from Rs. 1,350 billion (approx. US\$ 38 billion)⁴⁵. Its representation of the exchange's market capitalization increased to 43% from 30%.

It is interesting to note that as late as in 1989 that India felt it necessary to create what was called a national index because inefficiencies evidently existed in the market places across the country. Seven years later, in 1996, it became meaningless to have such an index because different parts of the country had become so integrated that significant inefficiencies no longer existed in the market places.

BSE-200 Index

The BSE 200 Index is another market value weighted index, composed of 200 stocks, accounting for approximately 55% of the total market capitalization of the exchange. It uses the fiscal year 1989-90 as a base. The BSE started publishing the index on 27 May 1994⁴⁶.

Effective 14 October 1996, 10 of the 200 component stocks were replaced by new component stocks, and the aggregate market value of the index increased slightly more than 1% to Rs. 2,502 billion (approx. US\$ 70 billion) from Rs. 2,471 billion (approx. US\$ 69 billion)⁴⁷. Its representation of the exchange's market capitalization crept up to 55% from 54%.

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*, pp. 10-15.

⁴⁶ *Ibid.*, p.16.

⁴⁷ *Ibid.*, pp. 6-8.

DOLLEX

DOLLEX is the US\$ version of the BSE-200 Index. The US dollar-linked index was launched to facilitate investment evaluation in US dollar terms for foreign investors.

The base year of DOLLEX is the fiscal year of 1989-90. The base market value was converted from the rupee-denominated base market value of the BSE-200 Index at the average rupee-dollar conversion rate in the base year. The current market value is translated from the rupee-denominated current market value at the current exchange rate⁴⁸.

4.3.7 Debt Segments

Synchronizing with the Indian government's decision to open corporate and government debt investments to FIIs, BSE has recently re-activated corporate debt securities trading, and plans to re-activate trading in government securities through a rolling settlement on the BOLT system⁴⁹.

The BSE commenced trading in corporate bonds in September 1996. Currently, 350 issues of corporate bonds with maturity ranging from 1 to 9 years are listed on the BSE⁵⁰. They have now little liquidity, though they used to have some⁵¹. The market segment for corporate debt securities listed on the BSE is called 'F' Group. 'F' obviously stands for fixed income securities. Remember that equity stocks listed on the BSE are classified as A, B1 and B2 Groups.

There is no trading of government securities on the BSE at this moment. The exchange has a plan to start electronic trading in them under 'G' Group. The securities proposed to be traded in 'G' Group segment include government securities, government-guaranteed bonds, financial institution bonds, and public sector undertaking (PSU) bonds⁵², and money market instruments including treasury bills, commercial papers and certificates of deposit. All trades of 'G' Group securities are planned to be settled through a central clearing house.

48 *Ibid.*, p.17.

49 'BSE to re-activate trading in Govt securities', *The Financial Express*, December 15 1996

50 BSE's letter dated February 28, 1997 in response to the author's inquiry

51 *Ibid.*

52 *Ibid.*

4.3.8 Badla System

What is 'badla'?

The *badla* system, which is also known as carry-over trading system or forward trading system, is currently allowed only on the BSE in India. It is a speculative system which allows an investor to carry over his or her transaction of a particular stock to the next settlement cycle without cash settlement in the current settlement cycle. It provides a great deal of liquidity to the securities market.

The *badla* system is available only to domestic non-institutional investors in respect of Group A shares (specified shares) listed on the BSE. FIIs do not have access to this system since they are prohibited from trading without actual deliveries.

On the BSE, a batch of securities traded during a period of 7 calendar days settle *en masse* on days after the end of such a period, which is known as a settlement period (see "Standardized Settlement Period" of Section 7.2.3). At the end of a settlement period, an Indian investor has three choices:

- Square off his or her position by a contra-transaction.
- Deliver or pay as contracted for; or,
- Carry forward his or her position to the next settlement.

The third option is called a *badla*, a Hindi noun meaning substitution or exchange. When an investor wants to carry forward his or her position without effecting the delivery or payment on the pay-in day, he or she instructs his or her broker to arrange a *badla* in a *badla* session on a Saturday before the next settlement period starts. The buying investor carries forward his or her long position by matching it with a short position of a bearish investor, or is financed by a financier or *badliwala* for which he or she is normally charged a *badla* rate for the carry-forward. The *badla* rate usually ranges between 18% and 20% per annum at the current short-term interest level of 6-7%. The rate is then incorporated either in the new settlement price or paid to the *badliwala*.

The selling investor, on the other hand, carries over his or her short position by matching it with the long position of a bullish investor⁵³. If the particular stock is oversold in the market and there are more people who want to deliver the shares than those who are willing to receive them,

⁵³ Securities lending that would facilitate short sales is not currently available in the Indian market. See Section 5.4.

the selling investor will be charged for not taking delivery of the shares (*Undha Badla*)⁵⁴. A newspaper article in Table 4.9 illustrates how the system is used and priced.

The *badla* system divides the BSE member brokers into two groups: Type 1 members who are qualified to carry forward their positions on a settlement date; and Type 2 members who are not.

The *badla* system is not totally unique to India. Carry-over trading systems similar to it exist or used to exist in some other parts of the world where a batch settlement system (see Section 7.2.1) is or used to be in operation. The *badla* system itself is said to have been modeled after the carry-over trading system on the London Stock Exchange, which was abolished in June 1995 when the exchange adopted a daily rolling settlement system. Furthermore, the *badla* system is conceptually similar to margin trading under a daily rolling system, where a settlement period (trading period) is only one day instead of seven days. The margin trading allows the investor to roll over his or her trading position beyond the original settlement day up to a certain period of time, such as three or six months, using the stock lending system (see Section 5.4).

Table 4.9

Badla Charges Shoot Up on BSE

The Financial Express, Sunday, January 19, 1997

Vivek Law & Nalini D'Souza

MUMBAI, January 18: The rates of financing on badla transactions hit the peak on the Bombay Stock Exchange on Saturday reflecting a highly overbought state of the market.

The carry-over transactions in several scrips were placed at rates upward of 45 per cent per annum, described by brokers as an 'astronomical' one.

At the close of the two-hour hectic badla session, 3.59 lakh Reliance shares were carried forward at a closing interest rate of 43.45 per cent per annum (or a weighted average badla rate of Rs 1.81 per week) and 4.53 lakh State Bank of India shares were carried forward commanding an annual yield of 42 per cent at the close.

The badla charges on several scrips including Reliance and State Bank of India however scaled over an annual yield rate of 47 per cent during the day. According to a technical analyst, the market is already in an overbought state with the bulls having an edge over the bears.

Contd...

⁵⁴ The BSE, *Welcome to the Stock Exchange Bombay*, p. 17.

"However, the bulls do not have the funds to take the deliveries due to the shallow financial state in spite of high optimism for the future," said an analyst. The net outstanding value at the Badla session conducted on Saturday, January 18 stands at Rs 81.52 crore up by 16.57 per cent over the previous week's value of Rs 69.94 crore recorded on January 11.

In contrast to this week's high badla transaction charges last week had seen undha badla in as many as 12 scrips. This week only two scrips witnessed undha badla.

"I have never witnessed such high rates of badla financing. The market seems to be in an extremely overbought state. Members willing to pay such exorbitant sums of interest for financing just shows the extent of speculative buying that has taken place during the week," said an analyst with a leading broking outfit.

.....(omitted).....

KBS Capital Management Ltd vice-president Vimesh Jhaveri said that the reason for the high badla financing rate can be attributed to the fact that investors are keen to take long positions in anticipation of the prime minister announcing his much awaited market revival package.

"This just shows that the speculators and retail investors both have been more active buyers during the past week as institutional investors don't usually resort to badla transactions," he said.

.(omitted).....

Source: The Financial Express, January 19, 1997. By courtesy of The Financial Express.

Badla Blamed for Excessive Speculation

In the past, *badla* trading was almost always singled out for criticism for the excessive speculation in the Indian stock market. Accordingly, there were numerous attempts to ban *badla* trading. The Indian Government finally banned badla trading in stocks in June 1969⁵⁵. Since then, forward trading has been revived and banned repeatedly. The ban on *badla* trading dislocated the market for some time, and slowly the market evolved a system similar to *badla* trading, although it is not called by that name⁵⁶. On 12 December 1993⁵⁷, SEBI banned *badla* trading on the BSE and the Calcutta, Delhi and Ahmedabad stock exchanges. Taking advantage of this ban, some statistical researches were conducted to assess the impact

⁵⁵ Sharma Jandhyalal, *op. cit.*, p. 70.

⁵⁶ *Ibid.*

⁵⁷ The ban was officially confirmed in March 1994.

of *badla* trading on volatility and market efficiency⁵⁸. It was revealed that *badla* trading had no impact on stock price volatility, and that it was, in fact, slightly beneficial for short-horizon market efficiency. One of the researches concluded that “the banning of the *badla* system by the regulators (SEBI), on the grounds that it causes ‘excessive’ speculation, is clearly unwarranted and not justified on economic grounds.”⁵⁹

Yet, people continue to blame the *badla* system for any drastic market crash. This is mainly because they fail to distinguish between speculation and excessive leverage. Speculation is a must in today’s market mechanism. As many scientific researches have proved, speculation itself is not responsible for stock price volatility. Speculators take advantage of the financial leverage embedded in the *badla* system. The more heavily a speculator gets financially leveraged, the more vulnerable to financial insolvency he or she becomes. What has been responsible for market disruptions after overly-heated markets is the excessive financial leverage that speculators employed; some speculators, brokers and others to the point of abuse. The bankers and the market regulators either overlooked this and/or had no effective control over it. Market manipulations were also an issue. There is basically nothing wrong with the *badla* system if an effective monitoring and surveillance system were in place and preemptive measures, including those against excessive leverage such as a reasonably strict margin system, were ready to be taken. Therefore, discussions among experts center around the effectiveness of these systems and measures, and the balance between their effects and counter-effects.

Revised Badla System

In October 1995, SEBI introduced a modified *badla* trading system which began on the BSE in January 1996. This new system is commonly referred to as the revised *badla* system or revised carry forward system (RCFS). Under the new system, *badla* trading had to be identified and

⁵⁸ Ajay Shah, “The impact of speculation upon volatility and market efficiency: The *badla* experience on the BSE”, <http://www.cmie.ernet.in/~ajayshah/PROSE/ARTICLES/badla.ps.gz>. Centre for Monitoring Indian Economy, Bombay; Venkat Eleswarapu and Chandrasekar Krishnamurti, “Do ‘speculative traders’ increase Stock Price Volatility? Empirical evidence from the Bombay Stock Exchange”, Technical report, University of Auckland, New Zealand and Indian Institute of Science, Bangalore.

⁵⁹ Venkat Eleswarapu and Chandrasekar Krishnamurti, *op. cit.*, p. 16.

segregated from delivery and jobbing trading, and was subject to some restrictions: flat margins of 15%; compulsory on-line trading (the system is allowed only on a computerized stock exchange); a maximum 90-day period for carry-over of transactions; the net exposure trading limit of Rs. 75 million for each member; and capital adequacy norms of 3% for individual brokers and 6% for corporate brokers⁶⁰.

Some market participants considered the revised *badla* trading system to be too restrictive. In fact, the zeal for non-restricted *badla* trading appears furious among speculative investors. Illegal *badla* transactions are, reportedly, very rampant on stock exchanges all over the country, especially in Calcutta and Ahmedabad. Off-market deals on the BOLT were until recently used to circumvent the 90-day limit of the currently permitted *badla* system. Under the disguised *badla* system, a pair of brokers falsely told the BSE at the end of each settlement that the deal had been closed off-market, and re-entered into the same deal at the opening of the next settlement after adding the *badla* charge. The volume of this illegal *badla* trading was estimated at one-and-a-half times the official *badla* volume.

To curb this practice, SEBI made it compulsory for all negotiated deals to be settled with delivery effective from 1 June 1997. However, some BSE members believe that illegal *badla* transactions will be driven further underground⁶¹.

Modified Badla System

The revised *badla* system was further modified in October 1997. This latest system is now known as the modified *badla* system or modified carry forward system (MCRS). There was a camp lobbying for the re-introduction of the old *badla* trading system⁶². The BSE and its members were strong proponents of the revival of the old system in view of the proposed introduction of futures and options trading on the NSE. An expected surge in the trading volume of the exchange that would result from a less restricted *badla* trading undoubtedly motivated BSE brokers to lobby for reviving the old *badla* system.

⁶⁰ SEBI Letter No. SMD/SED/3703/95 to all stock exchanges, dated October 16, 1995

⁶¹ "Negotiated deals to end in delivery form June", *The Financial Express*, March 20, 1997, and "A requiem for illegal badla", Tuesday, June 3, 1997

⁶² "Brokers seek exemption from capital gains tax", *The Financial Express*, December 24 1996

As a result, SEBI set up the J.R. Varma Committee to review the *badla* trading system in March 1997⁶³, and the committee recommended in July 1997 to remove some of the restrictions. After a lot of heated debates among different camps in the market and an intervention by the Ministry of Finance, SEBI finally decided on the following modifications to be made to the revised *badla* system:

- Daily margin on *badla* transactions to be reduced to a minimum of 10% from 15%; 50% of the daily margin is collected up-front either in cash or in the form of a bank guarantee; the current 7.5% daily margin on Type I members' transactions for delivery is no longer imposed;
- Overall *badla* limit would be raised to Rs. 200 million from Rs. 75 million per broker per settlement; the existing sub-limit on the sale and purchase of individual stocks be lifted; and,
- A limit of Rs. 100 million on financier funding to be lifted.

Despite the Varma Committee's recommendations, some restrictions have been retained, including:

- The twin track system whereby *badla* transactions are segregated from transactions for delivery at the time of trade; and
- The 90-day time-limit.

The BSE was scheduled to start *badla* trading under the modified system in early November 1997.

4.4 The National Stock Exchange

4.4.1 Organization

The official name of the National Stock Exchange (NSE) is 'The National Stock Exchange of India Limited', a public limited company under the Companies Act, 1956. It is located in Worli, in the heart of Mumbai.

The NSE was incorporated in November 1992 on the initiative of the Indian Government. Its promoters include the Industrial Development Bank of India, Life Insurance Corporation of India, General Insurance Corporation of India, Industrial Finance Corporation of India Ltd., Industrial Credit and Investment Corporation of India Ltd., the State Bank

⁶³ "More reforms to liven primary market", *The Economic Times*, March 27, 1997.

of India and several other highly reputed financial institutions in India. They represent major and important participants in the Indian fixed income and equity markets. Most of them are directly or indirectly and partially or wholly owned by the Government.

The NSE appears to be the “antithesis” of the BSE from the point of view of Indian policy makers. The policy makers tried in vain to modernize the working of the BSE in order to synchronize it with the economic reforms. Since the BSE is an association of its members, BSE members who make a living on securities transactions on the exchange are owners as well as managers of the oldest and largest exchange. Given the fact that Mumbai has long been the commercial capital of India, it is no exaggeration to say that the BSE members used to practically monopolize India’s securities market. They were not collectively motivated to give up their vested interests. Accordingly, the policy makers took the approach of “new wine in new bottles”.

The NSE’s brochure says, “while India has had a long history of securities trading, the markets have not always kept pace with the changing trends and requirements for this industry to reach its full potential. Particular issues of concern in the securities industry have been lack of transparency, lack of trading facilities which are fair and accessible to all, undercapitalized trading members, dated procedures and practices and uncertain settlement cycles. NSE emerged as an endeavor by some of the institutional investors within the country to address these issues.”⁶⁴ In a country which was, until very recently, socialistic and which nationalized her major financial institutions, it is reasonable to say that “an endeavor by some of the financial institutions” was no more than the policy makers’ will.

The NSE primarily operates two market segments:

- (i) the wholesale debt market (WDM) segment, where fixed income instruments such as government bonds, treasury bills, commercial papers, corporate debentures are traded among institutional investors; and
- (ii) the capital market (CM) segment, which facilitates trade in equities and retail trade in convertible and non-convertible debentures and hybrid instruments.

Trading of the debt market segment began in June 1994 and that of its capital market segment, in November 1994. The futures and options (F &

⁶⁴ The brochure of the National Stock Exchange, p. 4.

O)segment was scheduled to start in December 1996 but is not yet in operation.

The ownership and management of the NSE is completely separated from its members' right to trade on the exchange. It is owned by the promoters and other financial institutions and not by its trading members. Hence the management has no trading interest. It is managed by a board of directors which delegates decisions on market operations to the executive committee⁶⁵.

The board of directors of the exchange has 15 directors: no elected member brokers, no public representatives, 3 nominees of the SEBI, no nominee of the RBI, 2 eminent persons, 2 directors from the NSE management, and 8 nominees of the shareholder institutions. It is worth noting that the composition of the NSE's board is significantly different from that of the BSE's board. The majority of the NSE's board is represented by institutions affiliated to or under material influence of the central government, while that of the BSE board is comprised by non-governmental members.

The executive committee consists of 14 members: 4 from trading members, 3 from the public, 3 other nominees, 2 from the SEBI or the central government and 2 from the management as at the end of August 1997. Unlike the president and the vice-president of the BSE who are elected from member brokers, the managing director and the deputy managing director are professionals hired from financial institutions.

4.4.2 Membership

As at the end of 1996, there were about 115 members on the WDM segment of the NSE. These were all corporate members. The NSE had 1,024 members on the CM segment, comprising 867 corporate members, 80 individual members and 77 registered firms⁶⁶. Many of the NSE members have access to other stock exchanges. 219 trading members of the NSE, and 862 promoters and/or directors of the NSE trading members are members of other stock exchanges.

One of the NSE's objectives is to upgrade the professional standards of market intermediaries. The exchange's admission standards stress capital adequacy, corporate structure, track record, educational qualifications and

⁶⁵ *Ibid.*, p. 6.

⁶⁶ Partnership firms registered under the Indian Partnership Act, 1932.

experience of an individual applicant or directors of a corporate applicant⁶⁷.

The eligibility criteria for the NSE's trading members are summarized in Table 4.10. The capital adequacy requirements for the capital market segment are far higher than the minimum statutory requirements of Rs. 500,000 (approximately US \$14,000). As you see in the table, the legal status and the officials' qualification and experience for the F&O Segment is currently stipulated to be the same as those of the CM Segment. However, the L. C. Gupta Committee appointed by SEBI in March 1997 to review the regulations and rules of futures and options transactions in India is expected to propose new and more stringent criteria for the F&O Segment.

Table 4.10
NSE Membership Eligibility

	Wholesale Debt Market (WDM) Segment	Capital Market (CM) Segment	Futures & Options (F&O) Segment
Legal constitution	Bodies corporate, banks and financial institutions and their subsidiaries	Individuals, registered firms, bodies corporate and institutions	The same as that of CM Segment
Officials' qualification & experience	Full-time directors or dealers must have at least two years' experience in banking or financial services.	The minimum prescribed educational qualification and two-year experience must be fulfilled by: <ul style="list-style-type: none"> • at least two directors for a body corporate; • at least two partners for a partnership; and, • the individual for an individual or sole proprietary. 	The same as that of CM Segment
Capital adequacy	Rs. 20 million	<ul style="list-style-type: none"> • Rs. 7.5 million for individuals and registered firms • Rs. 10 million for bodies corporate 	<ul style="list-style-type: none"> • Rs. 30 million for brokers • Rs. 50 million for option writers
For common membership			
WDM & CM segments	<ul style="list-style-type: none"> • Full-time engagement in securities business • The minimum paid-up capital of Rs. 3 million 		
WDM, CM & F&O segments	<ul style="list-style-type: none"> • Full-time engagement in securities business • The minimum networth of Rs. 30 million (Rs. 50 million for an option writer) 		

Compiled from *The NSE Brochure*, pp. 8-9.

⁶⁷ *Ibid.*, p. 7.

The membership of NSE is transferable under certain terms and conditions, though it was not transferable in principle until August 1997⁶⁸. A new member of the NSE does not pay any membership fee or entrance fees but is required to deposit cash and security with the exchange and pay annual subscription fee and other dues. The amounts of the cash and security deposit vary, depending on the member's legal constitution; be it an individual, a partnership firm or a body corporate. Table 4.11 below shows those amounts for the membership of the NSE's capital market segment.

Table 4.11

Cash & Security Deposit for Membership of NSE's CM Segment

	(In million)		
<i>Legal Constitution of Trading Member</i>	<i>Cash</i>	<i>Bank Guarantee or Securities</i>	<i>Total</i>
Individual or Partnership	Rs. 3.75	Rs. 1.25	Rs. 5.00
Body Corporate	Rs. 5.00	Rs. 2.50	Rs. 7.50

Source: NSE

4.4.3 Trading Mechanism

Trading Days and Hours

The NSE trades on all days except Saturdays, Sundays and notified holidays. The notified holidays of the NSE are not necessarily the same as those of other stock exchanges, such as the BSE.

The regular trading hours of NSE are 10:00 a.m. to 3:30 p.m. A trading member can log into the NSE's screen-based trading system from 8:30 a.m.. Prior to the trading hours, there is the pre-open phase from 9:30 a.m. to 10:00 a.m. during which a trading member can enter, modify or cancel orders in the trading system. The system figures out by single-price auction and displays the potential opening price, based on orders entered into the system, but does not trade till the end of the pre-open phase. At the end of the pre-open period, the system conducts a single price auction to establish the opening price and execute all orders that can be matched by the single price auction. At this price, all the orders are matched. After this, the system is placed in the continuous trading mode. The orders are matched on a continuous basis on price time priority. The market closes at 3:30 p.m. Around 4.30 p.m., trading members receive the official

⁶⁸ "NSE allows broker card transfer", *Business Standard*, August 7, 1997

quotation lists, end-of-the-day reports covering trades done during the day, outstanding orders, orders canceled, and so on. On Tuesday, the special closing session is held from 3:45 p.m. to 4:00 p.m. to facilitate squaring off on the last day of the trading cycle.

However, the above trading hours including the pre-opening and closing sessions have been temporarily suspended since early August 1997 due to the problems in the VSAT network caused by the drift of the communication satellite, and the current trading hours are from 9:30 a.m. to 3:00 p.m. on all days except auction days.

There are some exceptions. The stock exchange, in concert with other stock exchanges, holds extra trading sessions off the regular trading hours or days on special occasions like the announcement of the uniform post-budget and the no-confidence vote against the cabinet.

Trading System

Like BSE, the NSE operates a sophisticated screen-based trading system which is called the National Exchange for Automated Trading (NEAT). From the very beginning, the NSE commenced its trading as a fully computerized exchange in 1994 and was the first stock exchange in India to do so. The trading system that the exchange uses was initially developed by TCAM Systems Inc. in New York for the Vancouver Stock Exchange in Canada and later adapted for Indian requirements.

The NSE's trading is order driven and it has no trading intermediaries such as jobbers or specialists who quote buy and sell prices of stocks to induce orders. Orders received through the system are matched and executed on a price time priority basis in a systematic manner.

A trading member can enter various types of orders, combining time-, price- and quantity-related conditions. Order types by time conditions are: a day order (DAY order), a good till canceled order (GTC order), a good till days order (GTD order), and an immediate or cancel order (IOC order). Order types by price conditions are: a market order, a limit order, and a stop loss or on-stop order (SL order), though a stop loss order has not been activated. Order types by quantity conditions are: a disclosed quantity order (DQ order), a minimum fill order (MF order), and an-all-or-none order (AON order)⁶⁹.

Orders are entered and processed in five different books, depending on the type of order. The five books: are regular lot book, negotiated trade book, special terms book, spot order book and stop loss book. Special

⁶⁹ The National Stock Exchange, *A Guide to the Trading System*, pp. 3-4.

terms refer to the quantity conditions of orders, namely, minimum fill and all-or-none conditions, and MF orders and AON orders are registered in a special terms book. The spot order book is for transactions that settle within 48 hours.

A trading member accesses the NSE's trading system from the trader workstation located in his or her office anywhere in India (see Section 4.6.2). The computer terminal screen of the trading members displays, among other things, the ticker window, the market watch window, the inquiry window, and the order entry window.

The market watch window allows the trading member to watch, on a real time basis, market information of particular securities that he or she has selected. The information that the market watch window displays includes the best order value, the best buy price, the best sell price, the best sell order value and the last traded price. The inquiry window enables the trading member to view market by order, market by price, previous trade, order log, outstanding order and snap quotes. The information regarding market by order is retrieved from the board lot trading book or special terms book, and that regarding market by price from the board lot trading book at different prices. The order entry window enables the trading member to place orders in the trading system.

Daily & Weekly Price Limits

The NSE also has a circuit breaker system to maintain orderly trading of shares on the exchange. However, it does not have a temporary trading halt of 30 minutes as can be found on the BSE. Price limits on the NSE are two-fold. Trading on the exchange is bound by the stock's daily price limit and weekly price limit. For this purpose, a week corresponds to a trading period on the NSE⁷⁰, which starts on Wednesday and ends on Tuesday. The daily and weekly price limits above or below which the market may not trade during a given trading session or trading period have been set, according to three categories of stocks based on each stock's liquidity⁷¹ on NSE. The daily and weekly price limits are, respectively, 10%, 7% and 15% from the previous closing price of the day and 25%, 20% and 30% from the previous closing price of the trading

⁷⁰ For a trading period, see Section 7.2.1.

⁷¹ For price limit purposes, there used to be three categories based on each stock's volatility, instead of liquidity, until September 9, 1997. The three categories were the Green Group (less volatile), the Yellow Group (moderately volatile) and the Red Group (highly volatile).

period, depending on the category to which each stock belongs, as shown in Table 4.12⁷².

Table 4.12
Daily & Weekly Price Limits on NSE

Liquidity of stocks	# of stocks	Price limit	
		Daily	Weekly
NSE-50 & NSE-50 mid-cap stocks	100	10%	25%
Stocks with reasonable liquidity	491	7%	20%
Others	903	15%	30%

4.4.4 Capital Market Segment

Market Cap and Turnover

The capital market (CM) segment is one of the two major segments that the NSE operates. It facilitates trade in equities and retail trade in convertible and non-convertible debentures and hybrid instruments. The segment started trading with just over 200 securities in November 1994.

The total market capitalization of companies whose shares are eligible to trade on the CM Segment of the NSE was Rs. 3,911 billion (US\$ 110 billion) as at the end of 1996. There were 1,478 companies traded on the NSE, of which 535 companies were listed, and 943 companies permitted to trade. During 1996, the NSE recorded an annual turnover of 12,099 million shares with a value totaling Rs. 2,458 billion (approximately US\$ 69 billion). The NSE currently accounts for about 98% of the total Indian market capitalization.

As has been discussed in Section 4.3.5. (Too Many Small Companies Listed), what are customarily called "listed stocks" or "listed companies" on an Indian stock exchange include those (i) originally listed, (ii) secondarily listed, and (iii) permitted to trade. Only 2 companies and 7 companies were originally listed on the NSE at the end of March 1996 and 1997⁷³, respectively. Most listed companies on the NSE are secondarily listed. It is interesting to note that NSE started trading without any companies listed on it. At the beginning, over 200 stocks

⁷² With effective from Sep. 10, 1997 ("NSE revise listing norms, introduces new price bands", *The Financial Express*, September 4, 1997).

⁷³ The SEBI, *Annual Report 1996-97*, Bombay, 1997, p. 39.

listed on another recognized stock exchange were permitted to trade on the NSE.

Concentration of Turnover on Several Stocks

The trading on the NSE's CM Segment, like that on other exchanges, tends to be concentrated on a limited number of stocks. The following top five stocks traded during May 1997 contributed 80% of the traded value:

- ITC Ltd.
- State Bank of India (SBI).
- Reliance Industries Ltd.
- Telco Ltd. (Tata Engineering and Locomotive Co., Ltd.).
- Tisco Ltd. (Tata Iron and Steel Co., Ltd.)⁷⁴.

In addition to the above five, ACC (Associated Cement Co., Ltd.) and L & T (Larsen & Toubro Ltd.) are other heavily traded stocks. The top 25 stocks contributed approximately 95% of traded value during April and May 1997 as shown in Table 4.13.

Table 4.13
NSE Top 'N' Stocks' Contribution

Top 'N' Stocks	Contribution	
	May 1997	April 1997
5	80%	N.A.
10	87%	92%
25	94%	96%
50	96%	97%
100	98%	99%

Source: NSE News, Volume III No. 4, May 1997.

Odd Lots

An odd lot trading facility is currently not available on the NSE. As far as odd lots of securities listed or permitted to trade on the exchange are concerned, however, the NSE allows its members to trade these outside the exchange, whether on a principal or agency basis. The members are required to report such trades to the exchange as off-market trades within 24 hours of the issue of the contract notes. These trades are settled outside

⁷⁴ The NSE, *NSE News*, Volume III No. 4, May 1997.

the clearing system. In addition, the NSE dispensed with market lots in dematerialized stocks in May 1997 and odd lots can be traded on the book entry segment of the NSE (see “Account Transfer” of Section 7.6.1).

4.4.5 Listing on NSE

Stocks and bonds are both listed on the NSE. However, our discussion here will be limited to stocks. Furthermore, as has been mentioned in the preceding section, permitted stocks are also traded on the exchange. Therefore, the introduction of stocks for trading on the NSE either as listed stocks or as permitted stocks will be discussed in this section.

Listed Stocks

To distinguish listed stocks from permitted stocks, it is worthwhile to define the word “listing” here. “Listing” means the admission of a stock to a stock exchange for trading on the exchange under a listing agreement between the exchange and the issuer of the stock. Companies whose stocks are listed on the exchange are obliged to comply with the various conditions set forth in the listing agreement, regarding administration of share certificates, registration of transfers of shares, new issue and continuing disclosures, and other subjects.

As has been mentioned earlier in Section 4.3.5 (Listing on BSE), the IPO eligibility criteria and disclosure requirements incidental to it are conditions virtually precedent to listing on the NSE, too.

A company applying for the listing of its stock has to satisfy NSE’s listing guidelines which are the following summarized below:

1. *Issued capital or market capitalization:* The issued and subscribed equity capital, of the applicant company including that proposed to be issued before listing, shall not be less than Rs. 200 million⁷⁵ (approximately US\$ 5.56 million); or the market capitalization of the existing equity of the applicant company shall not be less than Rs. 250 million (approximately US\$ 6.96 million).
2. *Minimum public offer of capital:* At least 25% of each class of securities issued by a company must be offered to public for

⁷⁵ The NSE raised the minimum paid-up capital for listing to Rs. 200 million from Rs. 100 million on Sep. 3, 1997 (“NSE revise listing norms, introduces new price bands”, *The Financial Express*, September 4, 1997).

- subscription⁷⁶. The central government may relax this minimum public offer of capital for government companies⁷⁷.
3. *Track record*: One of the following three parties must have a track record of at least 3 years:
 - (i) the aspirant company seeking listing;
 - (ii) the promoting company; or
 - (iii) another company of the same core promoters provided that the company is listed on another recognized stock exchange in India for at least 3 years.
 4. If the applicant company has not been listed on another recognized stock exchange in India for at least the last 3 years, its project or activity plan must have been appraised by a financial institution under Section 4A of the Companies Act, 1956⁷⁸, or a state finance corporation, or a scheduled commercial bank with a paid-up capital exceeding Rs. 500 million (US\$ 13.93 million), or a merchant banker of Category I with a net worth of at least Rs. 100 million (US\$ 2.78 million)⁷⁹.

In reference to Item 1 above, the SEBI guidelines provide for a profitability criterion for going public or a special criterion for a project company⁸⁰. To sum up the various provisions and criteria regarding listing, Indian companies applying for the NSE listing, other than project companies and certain finance companies, must have:

-
- ⁷⁶ Section 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957, as amended by the Notification F. No. 1/33/SE/92, dated September 21, 1993, issued by the Ministry of Finance, Department of Economic Affairs, Investment Division. The minimum public offer of capital was 60% or other percentage, prior to the amendment.
 - ⁷⁷ Proviso to Section 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957. Listing of debt securities issued by Public Sector Undertakings (PSUs) is exempted from the provisions of the section. Notification F. No. 1/10/SE/94, issued by the Ministry of Finance, Department of Economic Affairs, ESB & Investment Division.
 - ⁷⁸ Financial institutions under Section 4A of the Companies Act, 1956 include: Industrial Development Bank of India, Industrial Credit and Corporation of India, Industrial Finance Corporation of India, Life Insurance Corporation of India, Unit Trust of India, and others.
 - ⁷⁹ Listing, NSE Internet home-page, <http://www.nseindia.com>.
 - ⁸⁰ Part A of Clarification Nos. XV and Part A of Clarification Nos. XVI of the SEBI Guidelines.

- (i) a track record of dividend payment for at least three years out of the immediate preceding five years⁸¹; and
- (ii) a post-issue paid-up capital of Rs. 200 million (approximately US\$ 5.56 million) or more, or a market capitalization of at Rs. 250 million (approximately US\$ 6.96 million) or more.

For more details of IPO requirements, see Section 8.1.1.

Permitted Stocks

Besides its listed stocks, stocks listed on another recognized stock exchange in India may also be permitted to trade on the NSE. This system, together with multiple listing, is common on other stock exchanges in India (see “Too Many Small Companies Listed” of Section 4.3.4), and is aimed at increasing the liquidity of stocks for wider investor participation.

The exchange, from time to time, selects stocks suitable for trading on it, and introduces them for trading under the permitted-to-trade category without a listing agreement executed. The selection criteria of permitted stocks are similar to those for the listing.

Issuing companies of permitted stocks are not bound by a listing agreement with the exchange. However, the companies are expected to undertake their obligations under listing agreements with the other stock exchanges. Since the SEBI laid down a standard form of listing agreement to be essentially adopted by all the recognized stock exchanges, a listed company’s obligations under a listing agreement with any Indian stock exchange are almost the same.

Multiple-listing

As has been discussed in Section 4.3.5, multiple-listing is compulsory. If a company has a paid-up capital of more than Rs. 50 million, the company is required to list its securities on more than one stock exchange⁸². This is one of the reasons why many Indian companies are double-listed on the BSE and the NSE. This, combined with the expansion of the NEAT, presumably made it possible to increase the trading volume on the NSE in such a short period of time.

⁸¹ This requirement is expected to be changed to “the immediately preceding three years”, since the SEBI’s eligibility criteria for an IPO was changed to this effect in August 1997. (SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997; see Section 8.1.5)

⁸² Ministry of Finance F. No. 14 (2)/SE/85, dated September 23, 1985

4.4.6 Wholesale Debt Market Segment

Another major segment at the NSE is the wholesale debt market (WDM) segment, where fixed income instruments such as government bonds, treasury bills, commercial papers, certificates of deposits, public sector bonds, corporate debentures are traded among institutional investors. Trading of the debt market began in June 1994.

The WDM segment has “trading members” and “participants”. A trading member is one who has satisfied the admission criteria set forth for the WDM Segment, and can place and execute orders for debt securities on the trading system on its own behalf or on the behalf of its clients. Participants are large investors, including banks and other financial institutions registered with the NSE, but which are not members of the NSE. They bear the responsibility for direct settlement of trades that were executed on their behalf by an NSE WDM trading member. They can effect their trades only through a member. They are given access to the NSE’s trading system to view the market through an on-line screen and their counter-party exposure limits⁸³.

As at the end of 1996, the WDM Segment had 107 trading members, and 71 participants. The break-down of the trading members and the participants is shown in Table 4.14.

Table 4.14
**Break-down of Trading Members & Participants
on WDM Segment, NSE**

	<i>Trading Members</i>	<i>Participants</i>
Foreign and private banks	18	30
Indian nationalized banks	3	24
Financial institutions	3	4
Corporates or mutual funds	83	4
Mutual funds		5
Primary dealers	-	4
Total	107	71

Source: NSE, as at the end of 1996.

In addition to publicly issued bonds, privately issued ones with an investment grade rating can be listed on the NSE. All government securities and treasury bills are deemed listed upon their issuance. Other debt securities are traded on the NSE either as “admitted to dealings”

⁸³ The NSE, *A Brochure*, 1996 Cp. 19.

securities or as listed securities⁸⁴. Until recently, only debt securities issued by companies whose stocks were listed on an exchange were permitted to be listed on an exchange. However, SEBI permitted the listing of a debt instrument prior to equity on stock exchanges in October 1996. This amendment of the rule was aimed at facilitating debt issues by infrastructure projects⁸⁵.

The total amount of debt securities outstanding in India has been increasing. As at the end of December 1996, there were 607 debt securities listed or permitted on the NSE with an outstanding amount of Rs. 3,030 billion (approx. US\$ 84 billion). The total outstanding amount as at the end of June 1997 was Rs. 3,184.73 (approx. US\$ 89 billion). Approximately 54.2% of the securities were listed on the NSE and the rest are permitted to trade. The trading volume of the WDM segment in 1996 was Rs. 277.5 billion (approx. US\$ 7.7 billion)⁸⁶.

However, debt trading activities on the exchange are very low relative to the total outstanding amount of Indian debt securities, and active trading of debt securities centers around government securities (see Section 9.1.2). Indian debt securities are also traded over the counter. This is often the case with debt securities in other countries, too. The average daily trading volume on the WDM segment is only about Rs. 1 billion (approx. US\$ 28 million)⁸⁷. The reasons for the low level of debt trading activities on the exchange are mainly twofold:

- (i) debt securities transactions of a significant lot tend to be carried out over the telephone among established banks and financial institutions, and
- (ii) many Indian institutional investors buy and hold debt securities until maturity.

The concentration of debt securities trading on government securities is attributable to their relatively high level of liquidity due to large issue sizes, and their "risk-free" nature. Government securities and treasury bills account for about 75% of the total debt trading activities⁸⁸.

Trades on the WDM Segment of debt securities are settled in Mumbai and directly between the buyer and the seller or through their custodians.

⁸⁴ The NSE, *op. cit.*, pp. 19-20.

⁸⁵ SEBI Press Release, Ref. No. PR 108/96, October 29, 1996.

⁸⁶ The NSE.

⁸⁷ The NSE, *op. cit.*, p. 23.

⁸⁸ The NSE, *op. cit.*, p. 21.

They do not settle through the NSE's clearing house, and neither the NSE nor its clearing house guarantees their settlement. Settlements are made on a daily rolling basis between the same day (T+0) and the fifth day from the trade date (T+5). The seller and the buyer determine an actual settlement date at the time of trade. T+2 is most popular. Government securities are settled through the RBI (see Section 9.2.1).

4.4.7 NSE-50 Index

The NSE-50 Index, commonly known as 'Nifty', is a market capitalization weighted index like the BSE Sensitive Index and S&P 500. It was introduced in April 1996, replacing the earlier NSE-100. The objectives of the NSE-50 index are:

- to reflect the market movements more accurately;
- to provide fund managers with a benchmark for measuring portfolio performance; and
- to establish a basis for introducing index-based derivative products.

To ensure the effectiveness of the index, the constituent stocks were carefully selected by the Index Committee, based on two criteria: (i) market capitalization and (ii) liquidity. As for market capitalization, a constituent stock must have a market capitalization of Rs. 5 billion (approx. US\$ 142 million); and each constituent stock bears a weight in the index proportional to its market capitalization. A high level of liquidity is required to be included in the index in terms of trading frequency and an impact cost⁸⁹. A constituent stock should be able to be executed on 85% of the trading days at an impact cost of less than 1.5%. The impact cost of the index portfolio worth approximately Rs. 20 million, Rs. 10 million and Rs. 5 million (approx. US\$ 571 thousand, US\$ 285 thousand and US\$ 142 thousand) is, on an average, 0.488%, 0.310% and 0.234%⁹⁰.

The base for the NSE-50 index is the close prices on 3 November 1995, and is set at 1,000. The component stocks of the index are periodically reviewed and modified by the Index Committee to reflect the

⁸⁹ The impact cost for a stock is defined as the percentage mark-up suffered in buying or selling the stock from the mid-price between the best bid and offer prices.

⁹⁰ The NSE, *NSE-50*, Mumbai, p. 3

changes in the Indian capital market. For instance, Bharat Heavy Electrical Ltd., Hindustan Petroleum Corporation Ltd. and Mahanagar Telephone Nigam Ltd. replaced Dr. Reddy's Laboratories Ltd., SCICI Ltd., and Brooke Bond India Ltd. in May 1997. The current list of the index stocks is shown in Table 4.15. The NSE has a copy right to the index and intends to permit a third party to use it with a prior consent for no fee.

Table 4.15
50 Component Stocks of NSE-50 Index
 (as of July 31, 1997)

	<i>Stock</i>	<i>Industry</i>	<i>Market Cap. (Rs. bil)</i>	<i>Weightage</i>
1	Andhra Valley Power Supply Co. Ltd.	Power	6.30	0.26%
2	* Arvind Mills Ltd.	Textile	13.85	0.57%
3	Asea Brown Boveri Ltd.	Engineering	25.00	1.02%
4	Ashok Leyland Ltd.	Automobile	10.23	0.42%
5	Asian Paints India Ltd.	Paints	14.60	0.60%
6	* Associated Cement Co. Ltd.	Cement	20.80	0.85%
7	* Bajaj Auto Ltd.	Automobile	71.62	2.93%
8	* Bharat Heavy Electrical Ltd.	Engineering	104.43	4.28%
9	* BSES Ltd.	Power	32.97	1.35%
10	Castrol India Ltd.	Refinery & Petrochem	42.74	1.75%
11	Cochin Refineries Ltd.	Refinery & Petrochem	9.92	0.41%
12	* Colgate Palmolive India Ltd.	Personal Care	44.26	1.81%
13	East India Hotels Ltd.	Hotels	20.97	0.86%
14	Essar Steel Ltd.	Iron & Steel	9.81	0.40%
15	* Glaxco (India) Ltd.	Pharmaceutical	28.41	1.16%
16	* Grasim Industries Ltd.	Diversified	27.02	1.11%
17	* Great Eastern Shipping Co. Ltd.	Shipping	13.95	0.57%
18	* Gujarat Ambuja Cement Ltd.	Cement	23.61	0.97%
19	HDFC Bank Ltd.	Banking	14.81	0.61%
20	* Hindalco Industries Ltd.	Metals & Minerals	85.83	3.52%
21	* Hindustan Lever Ltd.	Diversified	284.40	11.65%
22	* Hindustan Petroleum Corporation Ltd.	Refinery & Petrochem	110.98	4.55%
23	Housing Development Finance Corporation	Term Lending	44.36	1.82%
24	* Indian Hotels Co. Ltd.	Hotels	28.16	1.15%
25	* Indian Petrochemical Corporation Ltd.	Refinery & Petrochem	34.22	1.40%

Contd...

Table 4.15 (Contd.)

26	Indian Rayon & Industries Ltd.	Diversified	17.89	0.73%
27	Indo Gulf Fertilizers & Chemicals Corp. Ltd.	Fertilizers	8.41	0.34%
28	* Industrial Credit and Investment Corporation	Term Lending	51.34	2.10%
29	* Industrial Development Bank of India Ltd.	Term Lending	68.82	2.82%
30	Industrial Finance Corporation of India Ltd.	Term Lending	13.39	0.55%
31	* ITC Ltd.	Diversified	123.98	5.08%
32	* Larsen & Toubro Ltd.	Diversified	67.19	2.75%
33	* Mahanagar Telephone Nigam Ltd.	Telecom	173.88	7.12%
34	* Mahindra & Mahindra Ltd.	Automobile	45.02	1.84%
35	Mangalore Refinery and Petrochemicals Ltd.	Refinery & Petrochem	9.69	0.40%
36	* Nestle India Ltd.	Food Products	27.93	1.14%
37	Oriental Bank of Commerce	Banking	13.75	0.56%
38	Ponds India Ltd.	Personal Care	28.06	1.15%
39	* Ranbaxy Laboratories Ltd.	Pharmaceutical	31.55	1.29%
40	Reliance Capital Limited	Finance	9.85	0.40%
41	* Reliance Industries Ltd.	Diversified	165.73	6.79%
42	Reliance Petroleum Ltd.	Refinery & Petrochem	18.92	0.78%
43	* State Bank of India	Banking	171.05	7.01%
44	* Tata Chemicals Ltd.	Chemical	33.80	1.38%
45	* Tata Engineering and Locomotive Co. Ltd.	Automobile	100.55	4.12%
46	* Tata Iron and Steel Co. Ltd.	Iron & Steel	81.25	3.33%
47	* Tata Power Co. Ltd.	Power	15.75	0.65%
48	Tata Tea Ltd.	Tee & Coffee	20.04	0.82%
49	Thermax Ltd.	Engineering	8.88	0.36%
50	TVS Suzuki Ltd.	Automobile	11.32	0.46%
Total			2441.29	100.00%

Source: The NSE.

* Also included in the BSE Sensitive Index.

The first fund linked to the NSE-50 was launched in February 1997. The US\$ 55-70 million index fund was set up on Guernsey Island, managed by the Unit Trust of India, and placed by SBC Warburg with investors outside India⁹¹. Recently, IDBI Investment Management Co. Ltd. announced its plan to launch another NSE-50 Index fund.

The selection criteria for the constituent stocks of the NSE-50 Midcap Index are basically the same as those for the NSE-50 index: (i) market capitalization and (ii) liquidity. However, the constituent stocks of the NSE-

⁹¹ "India Index Fund opens, UTI targets \$ 150 mn", *The Financial Express*, December 4, 1996.

50 Midcap Index exclude those of the NSE-50 index. As for market capitalization, a constituent stock must have a market capitalization of Rs. 2 billion (approx. US\$ 57 million); and each constituent stock bears a weight in the index proportional to its market capitalization. A high level of liquidity is required to be included in the index in terms of trading frequency and an impact cost. A constituent stock should be able to be executed on 85% of the trading days at an impact cost of less than 2.5%. The impact cost of the index portfolio worth approximately Rs. 5 million, and Rs. 2.5 million (approx. US\$ 142 thousand and US\$ 71 thousand) is, on an average, 1.07% and 0.83%⁹².

The base for the NSE-50 Midcap index is the close prices on 4 November 1996, and is set at 1,000. The market capitalization of the NSE-50 Midcap index was Rs. 328.42 billion (approx. US\$ 9.2 billion) as of 31 July 1997, which was 13.45% of the market capitalization of the NSE-50 index.

4.4.8 Futures and Options

The NSE drafted out plans to start trading in futures and options of NSE-50 by December 1996, and the stock exchange has been ready for the commencement of the futures contracts. The proposed contract specifications are outlined in Table 4.16.

However, the exchange has not been permitted to do so as of September 1997. The delay is said to be due to some concerns over a possible negative impact of the futures trading on the currently weak stock market in India. The SEBI formed the L.C. Gupta Committee to deliberate the viability of derivatives in the Indian capital market⁹³. The BSE is a determined opponent of an introduction of derivatives in the Indian capital market in general, and of futures and options of NSE-50 in NSE in particular. The BSE President's favorite argument against derivatives in the current Indian environment is "Derivatives will be like driving a Ferrari on Indian roads — riskier for both the driver and others using the road as well. Wise are those who learn from the mistakes of others."⁹⁴

⁹² NSE website, <http://www.nseindia.com/htdocs/market/midcap.htm>.

⁹³ "SEBI to clear \$500-mn FIIs proposals", *The Financial Express*, March 20, 1997, "Finance ministry caveat on futures trading", *The Financial Express*, April 1, 1997.

⁹⁴ "Derivatives not investors' interest, says Damani", *The Financial Express*, May 29, 1997, and "In tangles with derivatives", *The Financial Express*, June 20, 1997

Table 4.16
Proposed NSE-50 Futures Contract

Contract size	In the range of Rs. 50,000 (Approx. US \$1,500) per contract
Contract months	Every month. Contracts listed on a 3-month cycle.
Trading hours	10:00 a.m. to 3:30 p.m.
Minimum price fluctuations	Rs. 0.05
Daily price limit	Not decided yet. Expectedly no more than 7%.
Last trading day	The day before the last Friday of the contract month
Initial margin	Around 15%
Mark to market	Daily and settled on T+1

Source: NSE.

The BSE is the most energetic proponent of a revival of the old *badla* system on the ground that it will increase liquidity of the market (see Section 4.3.8). From this, some market participants assert that the BSE's opposition to derivatives is no more than political bargaining for winning the revival of the old *badla* system.

The Securities Contracts (Regulation) Act, 1956 used to prohibit options. Section 20 (1) of the act provided that "all options in securities entered into after the commencement of this Act shall be illegal." This section, together with its sub-section (2), was omitted by the Securities Laws (Amendment) Act, 1995, to accommodate the introduction of futures and options contracts of NSE-50, a National Stock Exchange index (see Section 4.4.7)

Officially, the Futures & Options segment will be the only options market in the country at least for the time being. In reality, however, the segment is not the only market of options but there exist some unregulated markets of option contracts for Indian stocks (see Section 5.5).

4.5 BSE versus NSE

4.5.1 Two Camps

Foreign investors may wonder which member brokers of which stock exchange, the BSE or the NSE, should they use for their trading of Indian securities. Both are located in Mumbai. But how are they different from each other?

There are two camps of thought with regard to preference of either the BSE or the NSE: (i) one which had brokers highly recommending the NSE and (ii) the other which had brokers taking a neutral stance.

Essentially, those brokers who have started businesses over the past few years tend to enthusiastically praise the NSE for its transparency, decent risk controls and simple settlement mechanism. They also claim that since the NSE is newer and not bound by 'traditions' or 'vested interests', it has brighter prospects for the future, especially with regard to quicker and further technological advancements.

4.5.2 Disappearing Advantages of the NSE

The reality is that brokers, in fact, use both exchanges to meet the diversified investment requirements of their clients, and, at least for the time being, will continue to do so. Though only 70 brokers have dual membership of both stock exchanges in strictly identical names⁹⁵, many brokers have practical arrangements for ready access to both stock exchanges. For instance, a family may have the BSE membership in the name of one family member and the NSE membership in the name of another; similarly, the same person may own controlling shares in both a BSE corporate member and an NSE corporate member.

In addition, the BSE has been working very hard to catch up with the NSE by improving its operations. The technical advantages of the NSE over the BSE used to be obvious. Such advantages included counter-party guarantee, on-line trading, trade monitoring, and the time-framed bad delivery clearance systems. However, the BSE instituted all these systems in a one-year period from 1996 to 1997. The operational advantages of the NSE have thus been quickly disappearing.

The trading volume of the NSE has greatly exceeded that of the BSE since November 1995 (see Table 4.17 and Figure 4.4). Is the NSE's predominance now decisive? Not necessarily. This visible outperformance of the NSE over the BSE is definitely attributed to a series of rational measures that the new stock exchange has taken and which the investment community, both domestic and foreign alike, has unquestionably welcomed. Besides, some policy measures taken by the

⁹⁵ "Only 70 brokers hold dual membership, claims NSE", *The Financial Express*, June 14, 1997.

Government of India have also presumably contributed to on NSE's impressive performance. Such policy measures include:

- (i) the monopolistic expansion of its on-line trading system (NEAT) on a national scale, and
- (ii) the multiple listing requirement.

Table 4.17
Average Daily Turnover: BSE vs. NSE

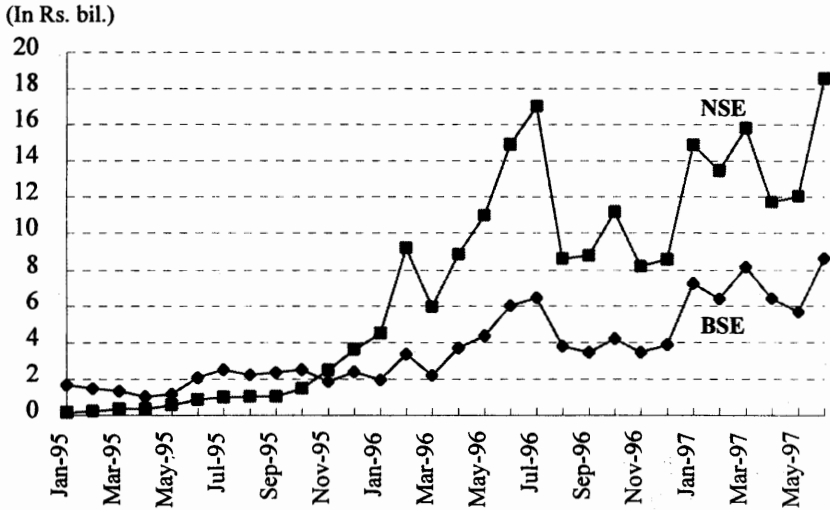
<i>(Rs. billion)</i>								
<i>Month</i>	<i>BSE</i>	<i>NSE</i>	<i>Month</i>	<i>BSE</i>	<i>NSE</i>	<i>Month</i>	<i>BSE</i>	<i>NSE</i>
Jan-95	1.69	0.15	Jan-96	1.97	4.48	Jan-97	7.27	14.88
Feb-95	1.51	0.23	Feb-96	3.38	9.21	Feb-97	6.41	13.48
Mar-95	1.34	0.35	Mar-96	2.23	5.95	Mar-97	8.19	15.81
Apr-95	1.03	0.34	Apr-96	3.71	8.87	Apr-97	6.43	11.74
May-95	1.20	0.57	May-96	4.36	10.99	May-97	5.69	12.07
Jun-95	2.08	0.87	Jun-96	6.02	14.92	Jun-97	8.63	18.58
Jul-95	2.53	0.99	Jul-96	6.46	17.01	Jul-97		
Aug-95	2.25	1.03	Aug-96	3.80	8.62	Aug-97		
Sep-95	2.38	1.04	Sep-96	3.47	8.80	Sep-97		
Oct-95	2.54	1.50	Oct-96	4.22	11.17	Oct-97		
Nov-95	1.87	2.50	Nov-96	3.47	8.22	Nov-97		
Dec-95	2.39	3.63	Dec-96	3.86	8.58	Dec-97		

Source: BSE and NSE .

The NEAT in cities other than Mumbai contributes approximately two thirds of trade volume on the NSE. Apparently, the national network of the NSE's on-line trading system has resulted in the NSE quickly overtaking BSE as the number one stock exchange in India. The NSE's on-line trading network went national from the outset, while SEBI did not permit BSE's on-line trading system to go national until October 1996. Some technical problems with the Department of Telecommunications and a delay in setting up the trade guarantee fund were still holding back its expansion outside Mumbai as of June 1997 (see Sections 4.6.1 & 4.6.2).

Secondly, India's Ministry of Finance issued a directive in September 1995, requiring all listed companies with a paid-up capital of more than Rs. 50 million to list their shares (or have their shares permitted to trade) on another additional recognized stock exchange in India. This ministerial direction of multiple listing evidently helped the NSE increase its trading volume in October 1995 (see Section 4.4.5).

Figure 4.4
Average Daily Turnover: BSE vs. NSE



These governmental steps, that were ostensibly biased against the oldest stock exchange in India (BSE), have proven to be effective in achieving their intended policy goals. In NSE, Indian investors across the country have been afforded access to an efficient and transparent market place. The deliberately created competition has successfully motivated the oldest exchange to improve and quickly overcome its operational disadvantages.

4.5.3 Which Exchange is More Speculative?

It is often said that Indian stock exchanges are speculative. Is that true?

Some market participants in India point their fingers at one particular stock exchange as being more speculative than another. Of the two main stock exchanges, which is more speculative, the BSE or the NSE?

As will be discussed later in Section 7.2.1, the Indian stock markets operate mostly under the batch settlement system. A batch of shares traded during a period of 7 calendar days, known as a settlement period or a trading period, are settled *en masse* through the clearing house on a predetermined day after the end of such a period. If an investor buys and sells the same number of shares of the same stock during a settlement period, he or she can square off his or her orders, and does not need to

deliver the shares on the settlement day. In other words, the squaring-off of the trading position during the same settlement period results in non-delivery of the shares that the investor has traded. The investor settles only the net amount of purchase and sale of shares. This method of trading (turnaround trading) is very popular among individual investors in the Indian stock markets for speculative purposes, though Indian institutions, mutual funds and FIIs are not permitted to conduct such transactions (see Section 2.3.6).

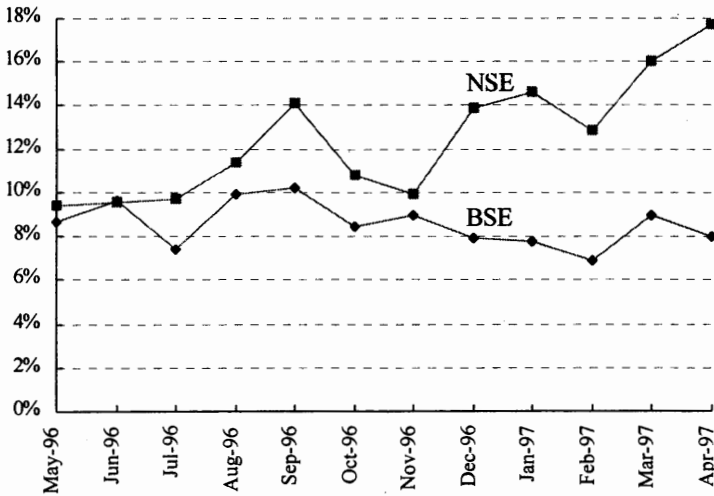
Table 4.18 shows the delivery rates of the two stock exchanges over a period of about one year from May 1996 to April 1997. The delivery rate is the ratio of the value of shares delivered to the value of shares traded during a certain period. The rates during the one-year period range from 7% to 18%. Approximately 80-90% of the trades in the two stock exchanges were thus turnaround trades. During roughly the same period from April 1996 to March 1997, the monthly margin trading ratios of the Tokyo Stock Exchange were in the range of 12-20%. The non-delivery rates (turnaround trading rates) of the Indian stock exchanges and the Tokyo Stock Exchange's margin trading ratios cannot be directly

Table 4.18
Monthly Delivery Rates on BSE & NSE

	Period on BSE		Period on NSE		BSE		NSE		Delivery Rate	
	from	to	from	to	Traded	Delivered	Traded	Delivered	BSE	NSE
'96	13-May	7-Jun	15-May	11-Jun	98.10	8.53	238.61	22.47	8.7%	9.4%
	10-Jun	5-Jul	12-Jun	9-Jul	122.21	11.75	324.06	30.98	9.6%	9.6%
	8-Jul	2-Aug	10-Jul	6-Aug	126.98	9.42	312.29	30.31	7.4%	9.7%
	5-Aug	30-Aug	7-Aug	3-Sep	63.17	6.25	152.29	17.32	9.9%	11.4%
	2-Sep	29-Sep	4-Sep	1-Oct	57.62	5.89	223.97	31.55	10.2%	14.1%
	30-Sep	3-Nov	2-Oct	5-Nov	92.95	7.88	228.95	24.80	8.5%	10.8%
	4-Nov	1-Dec	6-Nov	3-Dec	59.19	5.30	157.10	15.59	9.0%	9.9%
'97	2-Dec	5-Jan	4-Dec	7-Jan	78.85	6.24	199.19	27.61	7.9%	13.9%
	6-Jan	2-Feb	8-Jan	4-Feb	142.07	11.10	305.18	44.53	7.8%	14.6%
	3-Feb	27-Feb	5-Feb	25-Feb	114.89	7.92	195.55	25.21	6.9%	12.9%
	28-Feb	30-Mar	26-Feb	1-Apr	167.40	15.03	353.40	56.68	9.0%	16.0%
	31-Mar	2-May	2-Apr	29-Apr	137.60	11.01	195.43	34.61	8.0%	17.7%
				1,261.05	106.33	2,885.99	361.67	8.4%	12.5%	

Source: SEBI.

Figure 4.5
Monthly Delivery Rates on BSE & NSE



compared with each other, because there are other types of speculative activities that involve stocks in the two countries such as the *badla* system in India and the futures and stock options market in Japan. However, it appears reasonable to conclude that stock trading activities in India are substantially speculative.

The statistics show another interesting aspect of stock trading activities in India. The average monthly delivery rates of the BSE and the NSE over the one-year period were 8.4% and 12.5%, respectively. The contrast between these numbers alone may not be significant enough to conclude that the BSE is more speculative than the NSE. However, Figure 4.5 clearly depicts the trend that the delivery rate on the NSE has been evidently rising relative to that on the BSE. From this one could infer that the NSE has been becoming “less speculative”.

What has been making such a difference between the two stock exchanges? It could well be because different groups of investors have been increasingly differentiating between the exchanges; the BSE tends to be preferred by individual investors and the NSE by institutional investors. This differentiating trend is likely to intensify in the future. In most capital markets, individual investors are much more speculative than institutional ones. It is the participation of these speculators in the stock market that generally makes the price movement less volatile.

4.5.4 Advantages of NSE

There are some arguments in favor of the NSE and these are as follows:

1. **Unconditional counter-party guarantee:** The NSE's clearing house guarantees the timely settlement of trades executed in its normal market segment against short and bad deliveries. Though the BSE has also instituted a trade guarantee fund since May 1997 to guarantee settlement of trades, the guarantee is subject to a review and decision on each default case by the Defaulters' Committee of the exchange (see Section 7.4.6).
2. **Depository:** The NSE introduced the first depository system in India, and began to trade securities in a book-entry form in December 1996. The system has freed trades from some persistent problems of the Indian securities markets, such as paper work, bad delivery, and stamp duty. Therefore, it has made a daily rolling settlement system possible and will also prepare the ground for arbitrage trading between cash and futures markets. The BSE is contemplating its own depository system, but it will take months to put the system in operation (see Section 7.6).
3. **Options and futures trading:** The NSE is ready to launch options and futures trading, pending the Government of India's approval. The derivative trading is expected to add more liquidity and also a hedging tool to the current system (see Section 4.4.8).
4. **Professionalism:** The NSE is a body corporate run by professionals and has no representations of brokers on its board. The NSE also has a dedicated, trained, technologically-literate staff with a responsive attitude on a full-time basis. This has enabled NSE to quickly develop a stock exchange that is efficient and fair to investors.
5. **Public relations:** The NSE has established various programs for public relations. It is well prepared to disseminate information on the exchange's rules and regulations and activities to the public through printed and internet publications.

Until July 1997, the greatest advantage of the NSE over BSE was the settlement guarantee that the NSE's clearing house provided not only against bad-deliveries up to the pay-out, but also against objections of transfer. However, the NSE's clearing house subsequently withdrew the guarantee against objections of transfer (see Section 7.5.3).

4.5.5 Advantages of BSE

There are also some arguments in favor of the BSE as follows:

1. **Badla System:** Only the BSE has been allowed to have the *badla* system. The *badla* system provides the market with additional liquidity and the investor with a certain hedging tool for each of the 100 stocks, which are known as the specified stocks or Group A stocks (see Section 4.3.8).
2. **Broader market:** Nearly 6,000 stocks are listed on the BSE while the NSE has approximately 1,500 listed or permitted stocks. BSE thus provides investors with a broader choice of Indian companies to invest in.
3. **Odd lots trading:** The BSE's trading system facilitates trading odd lots of shares and such transactions settle through the exchange's clearing house. The NSE allows its members to trade odd lots outside the exchange (see "Account Transfer" of Section 7.6.1).
4. **Realistic approach:** The BSE is an association of people and is run by people who are primarily brokers and who have years of on-hand experience in securities business. Under such management, professionals have been recruited to key administrative positions of the exchange. Therefore, the exchange's approach to problems tends to be more realistic and practical and does not upset the whole brokers' community. This is a double-edged sword which may work against investors' interest, too.
5. **More time for settlement:** The BSE gives an investor's broker or custodian more time to make payments and effect deliveries.

4.5.6 Summary of Comparison

The BSE has been quickly catching up with the NSE in terms of modernization of the workings of the stock exchange. The functional comparison of the both stock exchanges in India is summarized in Table 4.19.

4.6 Trading in Regional Cities

4.6.1 BOLT

The BSE's on-line trading system (BOLT) network began to expand outside Mumbai in September 1997. The exchange had applied long ago

Table 4.19
Quick Comparison of BSE & NSE

	<i>BSE</i>	<i>NSE</i>
Secrecy	Disclosure to the identity of counter-party is optional (effective from Sep. 29, '97).	Identity of counter-party is not known until delivery
Trading system	Quote driven	Order driven
Speed of execution	Average speed	Usually very fast. Slow-down towards the end of the session.
Choice of stocks	Wide choice and range with over 6,000 listed companies	Choice is limited with only 1500 listed and permitted stocks.
Short delivery	Auction on the pay-out day.	Auction on the pay-out day.
Bad delivery	Rectified within 4 days of the pay-out day; otherwise auctioned off or closed out within 10 days of the pay-out day.	Rectified within 5 days of the pay-out day; otherwise auctioned off or closed out within 10 days of the pay-out day. Guaranteed.
Objection of transfer	Rectified with 21 days; otherwise auctioned off or closed out within 45 days through the bad delivery cess (BDC).	Rectified with 21 days; otherwise auctioned off or closed out within 45 days (The counter-party guarantee was withdrawn in July 1997)
Ease of trading	Strong contacts among brokers makes it easier to source huge lots faster.	It is possible to trade in big lots in only selected stocks.
Depository	BSE's own depository is being contemplated, while the BSE is joining the NSE's depository.	Started in December 1996
Settlement Period	7 calendar days	7 calendar days
Percentage of delivery- based business	7-10%	9-18%
National coverage	Used to be limited to Mumbai only. However, the BOLT has started since Sep. 1997	The NEAT covers more than 150 cities.
Counter-party risk coverage	Introduced in May 1997	Introduced since inception.
Management	Largely elected by brokers	Independent of brokers

to SEBI for permission to expand the BOLT network to stockbrokers in cities other than Mumbai. In October 1996, the SEBI cleared the expansion of the BOLT network, along with that of on-line trading

networks of any other stock exchanges⁹⁶, subject to the setting up of a trade guarantee fund to eliminate the counter-party risk of trades on the trading system. In September 1997, the BOLT finally went national with the first three trading centers being inaugurated in the suburbs of New Delhi⁹⁷, and is expected to expand to 99 centers by the first week of October 1997⁹⁸.

The BOLT expansion will potentially provide investors across the country with the facility to trade in the 6,000 stocks listed on the BSE. BSE, therefore, believes that at least 50 per cent of the 4,575 stocks that are currently not much traded just now would be traded⁹⁹. However, it would be more logical to assume that about 1,500 stocks that are traded will become more active thanks to incremental demand generated through the far-reaching on-line trading network. The actual contribution of the NSE's on-line trading system to the trading volume on the NSE, as will be discussed in the following section, indicates that the national network of the BOLT is expected to easily double and probably triple the trade volume of the BSE.

Stock exchanges are free to expand their on-line trading network to cities where there is no stock exchange. However, the SEBI has imposed an "invitation clause" on the network expansion to protect smaller exchanges from such expansion. When a stock exchange intends to expand its network into a city where another stock exchange exists, the former is required to obtain prior consent from the latter in order to do so. Both the stock exchanges have to reach an agreement on adequate arrangements for resolving the investor's grievances and timely settlement of arbitration cases arising from trades executed through the trading network¹⁰⁰.

The BSE has already signed a memo of understanding on the expansion of the BOLT with the Ahmedabad and Calcutta Stock

⁹⁶ Press Release, "Permission for the Expansion of BOLT Terminals to Cities Other Than Mumbai and Policy Regarding Such Other Proposals", Ref. No. PR 108/96, October 29, 1996.

⁹⁷ "BOLT dots Delhi borders", *The Financial Express*, September 5, 1997.

⁹⁸ The BSE's letter to the author, dated September 16, 1997.

⁹⁹ "SEBI allows BOLT expansion", *The Financial Express*, October 31, 1996.

¹⁰⁰ Press Release, "Permission for the Expansion of BOLT Terminals to Cities Other Than Mumbai and Policy Regarding Such Other Proposals", Ref. No. PR 108/96, October 29, 1996; and, "SEBI allows BOLT expansion", *The Financial Express*, October 31, 1996.

Exchanges, and is expected to do so with the Pune, Coimbatore and Indore Stock Exchanges soon. As at the end of February 1997, the BOLT had expanded to centers within Mumbai, and would be able to expand to 200 by the end of 1997¹⁰¹. The new centers include New Mumbai, Nasik, Jalagaon, Akola, Nagpur, Raipur, Bhopal, Kolhapur, Sholapur, Chandigarh, Jodhpur, Vijaywada, Mysore, Davangere, Hubli, Dharwad¹⁰². The BSE plans to increase the number of BOLT-linked trading work stations to 5,000 in two years from 1,400 in March 1997, and consequently connect the whole country with the BSE¹⁰³.

4.6.2 NEAT

The NSE is the largest stock exchange in the world that is based on interactive 'very small aperture terminals' (VSATs). Through a total of 1,502 VSATs installed in 151 cities as at the end of May 1997, stockbrokers or their agents have access to the NSE's on-line trading system (NEAT). 1,351 terminals have been installed in cities where one or more stock exchanges are located, and 151 more sites in non-exchange cities. Mumbai has 463 sites and Delhi 294¹⁰⁴. The total number of VSATs is expected to grow to more than 2,000 in 1997¹⁰⁵.

The on-line trading network has been so far strikingly effective in generating trade volume on the NSE. The geographical distributions of NSE's VSATs and traded value during April and May 1997 are summarized in Table 4.20, and the relationship between the number of VSATs and average monthly traded value during April and May 1997 is graphed in Figure 4.6. The table and the figure indicate that:

- NSE derives twice as much as of its trade volume from cities other than Mumbai, thanks to its on-line trading network; and,
- the trade volume in major cities is positively correlated with the number of trading terminals.

In fact, NSE has been expanding the network of on-line trading terminals mainly in cities served by existing stock exchanges. All the top

¹⁰¹ BSE Handout distributed in Tokyo, March 1997.

¹⁰² "BSE to expand B1 group, delist 600 companies", *The Financial Express*, October 31, 1996.

¹⁰³ BSE Handout distributed in Tokyo, March 1997.

¹⁰⁴ *NSE News*, Vol. III No. 4, May 1997.

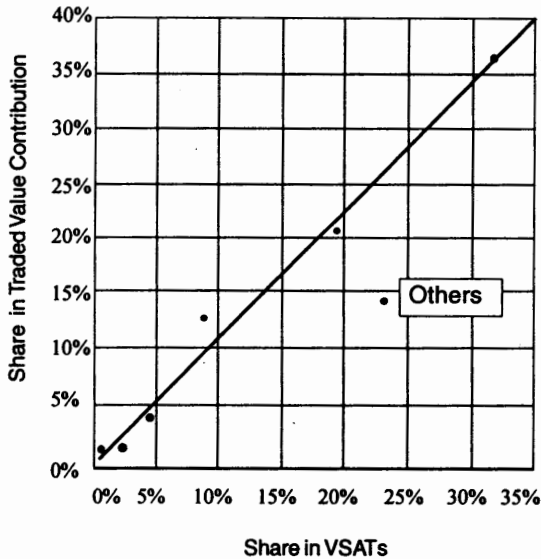
¹⁰⁵ "NSE plan 21 new centres", *The Financial Express*, February 1, 1997.

Table 4.20
NSE VSATs & Traded Value Contribution

Cities	VSATs		Traded Value Contribution	
	# of Terminals	%	May '97	Apr '97
Mumbai	463	30.83%	33.94%	37.33%
Delhi	294	19.57%	21.25%	19.88%
Calcutta	136	9.06%	12.71%	13.16%
Ahmedabad	72	4.79%	4.61%	4.64%
Chennai	71	4.73%	4.58%	4.41%
Bangalore	29	1.93%	2.04%	1.88%
Hyderabad	39	2.60%	1.77%	1.70%
Pune	31	2.06%	1.59%	1.57%
Coimbatore	14	0.93%	1.54%	1.15%
Kanpur	8	0.53%	1.39%	1.09%
Others	345	22.97%	14.58%	13.37%
Total	1,502	100.00%	100.00%	100.00%

Source: NSE News, Vol. III No. 4, May 1997.

Figure 4.6
% Shares of VSATs & Traded Value Contribution
During April & Nat 1997



13 cities in terms of the number of VSATs installed as at the end of May 1997 had a stock exchange or stock exchanges when the installation of VSATs began. They account for 81% of the total number of VSATs¹⁰⁶. The NSE's national expansion of the VSAT network has presumably been eating away at local investment demand cultivated by the regional stock exchanges and their brokers. The scatter diagram in Figure 4.6 reasonably supports this hypothetical view. Not only is a direct linear relationship evident between the percentage share of VSATs installed in such a city and that of the city's traded value contribution, but the point representing 'Others' which includes cities without any stock exchanges also lies significantly below the straight line along which the points representing the major cities fall. This suggests that the installation of the on-line trading terminals in a city where a regional stock exchange has been present is more effective in generating trades on the NSE than in a city without any stock exchange.

4.6.3 Other Exchanges

In addition to the BSE and the NSE, there are 22 other stock exchanges in India recognized under the Securities Contracts (Regulation) Act, 1956. Indian brokers seldom orders from institutional investors, including FIIs, for stocks listed on exchanges other than BSE, NSE or the OTC Exchange of India. The locations of such exchanges are shown in Table 4.2. They form the Federation of Indian Stock Exchanges (FISE).

While the regional stock exchanges have, in general, been benefiting from India's economic reform which has increased demand for securities investments in the regional cities, they have been threatened by the national expansion of on-line trading networks like the NEAT of the NSE and the BOLT of the BSE, and are struggling for survival. The threat is real as analyzed in the preceding section. Their survival strategy mainly centers around the computerization of their operations or the on-line trading system.

Besides the NSE and the BSE, 13 regional exchanges were computerized as at the end of March 1997. These were OTCEI, Pune, Delhi, Bangalore, Vadodara, Mangalore, Madras, Coimbatore, Ludhiana,

¹⁰⁶ NSE NEWS Volume II No. 12, December 1996. The statistics of VSATs in the news are apparently erroneous. Yet, it is reasonable to assume as described in the above text.

Ahmedabad, Bhubaneshwar, Hyderabad¹⁰⁷ and Madhya Pradesh (Indore)¹⁰⁸ Stock Exchanges. Cochin and Calcutta Stock Exchanges are expected to go on-line shortly¹⁰⁹. Computerization allows stock exchanges to expand their trading operations into other cities in their regions.

The other measure that has been considered to cope with the threats from the expansion of the on-line trading networks of major stock exchanges is the inter-connectivity of all stock exchanges. The regional exchanges will set up a company to develop a national market system¹¹⁰. The system is called the interconnected market system (ICMS) and is being thrashed out by FISE¹¹¹.

The regional exchanges have also been trying to follow NSE with regard to the establishment of a clearing house and a trade guarantee fund. All the stock exchanges, except Calcutta, Madras and Magadh, have either a clearing house or a clearing corporation. Calcutta and Madras Stock Exchanges were expected to set up their respective clearing houses by the end of February and April 1997 respectively. Magadh Stock Exchange was expected to be able to establish a clearing house by the end of April 1997¹¹².

4.7 Marketable Lot

4.7.1 Normal Marketable Lot

The marketable lot (or the round lot or tradable lot) is company specific. The normal marketable lot is:

- 50 or 100 shares for Rs. 10/ paid-up shares, and
- 5 or 10 shares for Rs. 100/ paid-up shares.

¹⁰⁷ "Hyderabad exchange goes on-line", *The Hindu*, February 21, 1997.

¹⁰⁸ "MP stock exchange to go online", *The Financial Express*, February 26, 1997.

¹⁰⁹ SEBI Press Release, "Inter Exchange Coordination Group Meeting", Ref. No. PR 18/97, February 4, 1997.

¹¹⁰ "Regional SEs to press for connectivity", *The Financial Express*, October 29, 1996.

¹¹¹ "ICMS will be operational by September", *The Financial Express*, March 22, 1997.

¹¹² SEBI Press Release, "Inter Exchange Coordination Group Meeting", Ref. No. PR 18/97, February 4, 1997.

Market participants tend to prefer a lot of 5 or 50 shares over a lot of 10 or 100 shares probably due to the former's higher marketability. Such small marketable lots, combined with the paper-based transactions, gave rise to a terrible settlement nightmare in the Indian markets in the years 1993 to 1994 as FIIs suddenly poured a huge amount of funds into the markets. The problem still persists in the markets to this day.

Assuming that an FII buys 82,500 XYZ shares in a physical form (but not in a depository form) of a Rs. 10 face value at Rs. 200 per share for US \$ 0.47 million (at Rs. 35 for US \$1.00), as many as 1,650 lots of 50 XYZ shares each have to be physically processed, along with 1,650 completed transfer deeds. US \$0.5 million worth of shares purchased at one time is not an unusually large transaction at all considering the sizes of FII portfolios.

Besides, the marketable lot of a new issue is regulated in order to encourage participation of small investors in highly priced public issues or offers of sale. Issuers or offerors of shares are given the option to fix the minimum marketable lot on the basis of its specified offer prices, provided that the maximum marketable one in any case shall not exceed 100 shares¹¹³. Table 4.21 shows the ranges of the marketable lot for the different offer price ranges.

Table 4.21
Ranges of Marketable Lot

Offer Price (p)	Marketable Lot
$p \leq \text{Rs. } 100$	100 shares
$\text{Rs. } 100 < p \leq \text{Rs. } 400$	50-100 shares
$\text{Rs. } 400 < p$	10-100 shares

Compiled from SEBI Clarification No. 20.

4.7.2 Institutional Board Lot (Jumbo Lot)

The NSE "temporarily" suspended trading of institutional board lots since 11 September 1996. However, it may be interesting to take a glimpse at how the stock exchange unsuccessfully struggled to lessen the intolerable burden arising from the physical nature of the Indian settlement system.

¹¹³ SEBI Clarification No. 20, dated July 29, 1997.

To alleviate the problem discussed in the preceding section, the NSE once introduced “institutional board lots” of 1,000 shares as a trading unit in its institutional lot segment as will be discussed in Section 7.2.4. An institutional board lot was also commonly known as a ‘jumbo lot’. A share certificate for such a lot was called a ‘jumbo certificate’. There were no jumbo lots on the BSE.

According to market participants, jumbo certificates have proven to be very illiquid at the time of sale, and are often traded at a discount. At one time, Jumbo certificates were very popular with a number of custodians since those did not require large vault space and were easy to process. However, at the time of sale, many FIIs suffered from extensive delays before they were actually able to sell their shares in the market. The delays were caused by the fact the jumbo certificates had to be sent to the registrar for splitting which usually took more than 3 to 4 weeks. Some custodians used to advise their clients to allow them to immediately send any jumbo certificate they receive for splitting, or to obtain confirmation from the registrar that future splitting would be done upon demand within a few days.

Trading Rules & Practice

5.1 Mark-to-Market Margin

5.1.1 SEBI-imposed Margins

Rationale for Margins

Under the current clearing and settlement system in India (see Section 7.2.1), if an Indian investor buys and subsequently sells, or sells and subsequently buys, the same number of shares of a stock during a settlement period, he or she does not need to take or make delivery of the shares and can pay or receive the difference between the sell and buy prices. In other words, the squaring-off of the trading position during the same settlement period results in non-delivery of the shares that the investor traded. A very short-term and speculative investment is thus possible at a relatively low cost. FIIs and domestic institutional investors are, however, not permitted to trade without delivery (see Section 2.3.6), since non-delivery transactions are limited only to individual investors.

One of SEBI's primary concerns is the risk of settlement chaos that may be caused by an increasing number of non-delivery transactions as the stock market gets excessively speculative¹. Accordingly, SEBI introduced

- (1) a concentration ratio margin,
- (2) a daily mark to market margin, and
- (3) an intra-day trading limit,

in July 1996 to curb excessive speculation, but later postponed the enforcement of the concentration ratio margin².

The concentration margin is an initial margin on a broker's historical position, while the daily mark-to-market margin is a margin on a broker's

¹ SEBI Press Releases, "Secondary Market Reforms", Ref No. PR 65/96, July 11, 1996, and "Reforms in the Secondary Market", Ref No. PR 78/96, August 9, 1996.

² The BSE's letter to the author, dated September 19, 1997; In fact, the SEBI Annual Report 1996-97 refers to the mark-to-market margin and the intra-day trading limits, but not to the concentration ratio margin (p. 9 of the annual report).

daily position. The intra-day trading limit is the limit to a broker's intra-day trading volume. Each broker is subject to the margins and the trading limit. Under the new system, speculative trading without the delivery of shares is no longer 'cost-free' or inexpensive.

However, the restrictive measures do not apply to those transactions:

- (i) whose physical deliveries to the stock exchange take place within 48 hours of the transactions, or
- (ii) whose principals are institutional investors, namely, financial institutions, banks, mutual funds and FIIs.

Such transactions are excluded when calculating the margins. The former exemption is intended to encourage transactions with delivery³. The latter one is due to the fact that the institutional investors are required to only buy and sell for delivery.

Each stock exchange may take any other additional measures to ensure the safety of the market⁴. The BSE and the NSE both impose on its members a more stringent daily margin.

Concentration Ratio Margin

As has been mentioned above, SEBI has suspended the enforcement of the concentration ratio margin. As a result, the BSE's clearing house does not impose it on the exchange's members, but instead imposes special margin, ad hoc margin and special ad hoc margin (see Section 5.1.1). The NSE's clearing house, however, applies it to its clearing members.

A concentration ratio margin applies if the gross turnover (purchases plus sales) of a broker for the previous quarter in any 3 stocks is greater than 70% of his or her total turnover in all the stocks. It is payable as an initial margin, and will be kept with the exchange for one quarter. The initial margin amount is determined quarterly, depending on the total turnover for the previous quarter, as is shown in Table 5.1⁵.

Daily Mark-to-market Margin

A daily mark-to-market margin is 100% of the notional loss of the stockbroker for every stock, calculated as the difference between his or

³ SEBI Press Release, Ref No. PR 78/96, August 9, 1996.

⁴ SEBI Press Releases, Ref No. PR 65/96, July 11, 1996, and Ref No. PR 78/96, August 9, 1996.

⁵ *Ibid.*

Table 5.1
Concentration Ratio Margin

Total gross turnover for the previous quarter (<i>t</i>)	Initial margin
$t < \text{Rs. } 600 \text{ million}$	nil
$\text{Rs. } 600 \text{ million} \leq t < \text{Rs. } 1,200 \text{ million}$	Rs. 1 million
$\text{Rs. } 1,200 \text{ million} \leq t$	Rs. 2 million

her buying or selling price and the closing price of that stock at the end of that day. However, there is a threshold limit of 25% of the base minimum capital plus additional capital kept with the stock exchange or Rs. 1 million, whichever is lower⁶. Until the notional loss exceeds the threshold limit, the margin is not payable.

This margin is payable by a stockbroker to his or her stock exchange in cash or bank guarantee from a scheduled commercial bank, on a net basis. It will be released on the pay-in day for the settlement period⁷. The margin money is held by the exchange for 6-12 days. This costs the broker approximately 0.40-1.20% of the notional loss, assuming that the broker's funding cost is at 24-36%.

Intra-day Trading Limit

Each broker's trading volume during a day is not allowed to exceed the intra-day trading limit. This limit is $33 \frac{1}{3}$ times his or her base minimum capital deposited with the exchange on a gross basis i.e. purchase plus sale. In case a broker wishes to exceed this limit, he or she has to deposit additional capital with the exchange which would not be permitted to be withdrawn for a period of 6 months⁸.

5.1.2 BSE-imposed Margins

In addition to the intra-day trading limit imposed by SEBI, the BSE members are subject to the stock exchange's own daily margin. The BSE's daily margin rate varies with the stock classification (A, B1 or B2 Groups), the broker type (Type I or Type II brokers) and the trade type

⁶ SEBI Press Release, Ref No. PR 78/96, August 9, 1996.

⁷ SEBI Press Releases, Ref No. PR 65/96, July 11, 1996, and Ref No. PR 78/96, August 9, 1996.

⁸ *Ibid.*

Table 5.2
Daily Margin of BSE

Stock Classification & Trade Type		Type I		Type II
A Group Stocks	Delivery trades	Nil ⁹	The mark-to-market margin is applicable if the amount of the mark-to-market exceeds that of the day margin.	The highest of (i) the mark-to-market margin, (ii) the gross exposure margin, and (iii) the net exposure margin
	Badla trades	10% ¹⁰ on badla trades from Rs. 15 million but less than Rs. 50 million.		
B1 & B2 Group Stocks				

Source: BSE.

(delivery or *badla* trades). Hence there are two types of daily margin calculation:

- (1) the one applicable to Type I brokers in respect of A Group stocks; and
- (2) the other one applicable to the rest, as shown in Table 5.2.

The daily margin for the rest, namely, Type I brokers in respect of B1 and B2 Group stocks and Type II brokers in respect of A, B1 and B2 Group stocks, is computed at the highest of the three types of margins: (i) the mark-to-market margin, (ii) the gross exposure margin, and (iii) the net exposure margin. The first one was prescribed by SEBI, and the second and third ones by the BSE's clearing house. Each of the three types of margins is calculated as follows:

- (i) *Mark-to-market margin*: A mark-to-market margin is 100% of the notional loss of the stockbroker for every stock, calculated as the difference between his or her buying or selling price and the closing price of that stock at the end of that day. Only if the notional loss exceeds the Rs. 1 million threshold limit, however, the margin becomes payable.

⁹ SEBI Press Release Ref: PR No. 115/97, dated October 15; the margin rate used to be 7.5%.

¹⁰ *Ibid.*; the margin rate used to be 15%.

- (ii) **Gross exposure margin:** The gross exposure is an aggregate of the net cumulative outstanding positions (outstanding net purchases plus net sales) in each security of the broker member, and the gross exposure margin amount is computed on the gross exposure, as shown in Table 5.3 below.

Table 5.3
Gross Exposure Margin

Gross Exposure (t)	Gross Exposure margin
$t \leq$ Rs. 30 million	nil
Rs. 30 million $< t \leq$ Rs. 70 million	10% in excess of Rs. 30 million
Rs. 70 million $< t \leq$ Rs. 150 million	Rs. 4 million plus 10% in excess of Rs. 70 million
Rs. 150 million $< t$	Rs. 160 million plus 20% in excess of Rs. 150 million

Source: BSE.

- (iii) **Net exposure margin:** The net exposure is the net of purchases minus sales, or *vice versa* in each security of the member broker for a settlement period, and the net exposure margin is computed on the net exposure, as shown in Table 5.4.

Table 5.4
Net Exposure Margin of BSE

Net Exposure (t)	Net Exposure margin
$t \leq$ Rs. 15 million	nil
Rs. 15 million $< t \leq$ Rs. 50 million	10% in excess of Rs. 1.5 million
Rs. 50 million $< t \leq$ Rs. 100 million	Rs. 3.5 million plus 20% in excess of Rs. 50 million
Rs. 100 million $< t$	Rs. 13.5 million plus 30% in excess of Rs. 100 million

Source: BSE.

The stock exchange reviews and revises these margin rates from time to time in consideration of market conditions such as market volatility.

Besides the daily margin above, the BSE may impose: (a) special margin, (b) *ad hoc* margin, and (c) special *ad hoc* margin in place of the concentration ratio margin.

- (a) **Special margin:** this margin is imposed on a net purchase of B1 and B2 Groups of stocks when there is an abnormal variation in price or volume. The margin rate is 25% or more. This margin, if imposed, is payable in addition to the daily mark-to-market

- margin. If B1 or B2 shares that are subject to a special margin are short-delivered, the special margin is imposed on the seller of the short-delivered shares, instead of the purchaser and is retained by the exchange for a period of 90 days.
- (b) *Ad hoc margin*: this margin is imposed on a member broker if S/he has a substantial outstanding position in a particular stock or all stocks combined. The imposition of the adhoc margin and the margin rate are determined by taking into account various factors including risk to the market as a whole, the member's financial soundness and track record¹¹.
- (c) *Special ad hoc margin*: this margin is imposed on a member broker's position in B2 Group shares that exceeds certain limits. The exchange currently restricts its member's trading of B2 shares: the net outstanding balance per B2 stock up to Rs. 2 million and the aggregate net outstanding balance of B2 stocks up to Rs. 10 million per settlement. Any trade in excess of these limits is subject to the prior permission of the exchange and a special adhoc margin. The margin rate ranges from 25% to 100% and is determined in consideration of various factors, including the nature of the stock or stocks and the member's track record¹².

It is clear that these margins are designed to curb trading manipulation of or an excessively risky exposure to illiquid stocks.

5.1.3 NSE-imposed Margins

The NSE's clearing house imposes on its clearing members the same concentration margin (initial or up front margin) and the same intra-day trading limit as those laid down by SEBI. In addition, it imposes a gross exposure limit.

The daily margin that the NSE's clearing house requires its clearing member to pay is computed at the highest of three types of margins, namely:

- (i) the mark-to-market margin,

¹¹ The SEBI's letter issued in connection with the resumption of the *badla* system provides "the exchanges may impose ad hoc margins also in cases of individual brokers or scrips if the situation so demands". (The SEBI Letter No. SMD/SED/3703/95 to the exchanges, dated October 16, 1995).

¹² BSE's letters to the author dated April 25, 1997, and September 19, 1997.

- (ii) the gross exposure margin, and
 (iii) the net exposure margin¹³.

The first one is prescribed by the SEBI, and the second and third ones by the NSE's clearing house. Each of the three types of margins is calculated as follows:

- (i) *Mark-to-market margin*: A mark-to-market margin is 100% of the notional loss of the stockbroker for every stock, calculated as the difference between his or her buying or selling price and the closing price of that stock at the end of that day. Only if the notional loss exceeds the Rs. 1 million threshold limit, however, the margin becomes payable.
- (ii) *Gross exposure margin*: A gross exposure is an aggregate of the net cumulative outstanding positions in each security of the clearing member, and a gross exposure margin amount is computed on the gross exposure, as shown in Table 5.5 below.

Table 5.5
Gross Exposure Margin

Gross Exposure (<i>t</i>)	Gross Exposure margin
$t \leq \text{Rs. } 40 \text{ million}$	nil
$\text{Rs. } 40 \text{ million} < t \leq \text{Rs. } 70 \text{ million}$	10% in excess of Rs. 40 million
$\text{Rs. } 70 \text{ million} < t$	Rs. 3 million plus 20% in excess of Rs. 70 million

Source: NSE web site

- (iii) *Net exposure margin*: A net exposure is the net cumulative outstanding purchase (but not sale) position in each security of the clearing member, and a net exposure margin amount is computed on the net exposure, as shown in Table 5.6 below.

Table 5.6
Net Exposure Margin

Net Exposure (<i>t</i>)	Gross Exposure margin
$t \leq \text{Rs. } 20 \text{ million}$	nil
$\text{Rs. } 20 \text{ million} < t \leq \text{Rs. } 50 \text{ million}$	10% in excess of Rs. 20 million
$\text{Rs. } 50 \text{ million} < t \leq \text{Rs. } 200 \text{ million}$	Rs. 3 million plus 20% in excess of Rs. 50 million
$\text{Rs. } 200 \text{ million} < t$	Rs. 33 million plus 30% in excess of Rs. 200 million

Source: NSE web site.

¹³ NSE web site: <http://www.nseindia.com/htdocs/nscl/margin.htm>. The rest of this section is also based on the same source of information.

A gross exposure limit is also imposed by the NSE's clearing house on its clearing member's cumulative gross exposure. The cumulative gross exposure may not exceed 7 times¹⁴ the clearing member's base capital. A member is permitted to raise the limit as well as the intra-day turnover limit by providing the clearing house with an additional capital base up-front.

5.2 Short Sales

It is a well accepted practice in many countries for an investor to sell shares that he or she does not currently own in the expectation that the price of the shares will fall, and subsequently he or she can buy back such shares at a lower price and net the difference between the sell and buy prices as trading profit. This trading practice is known as a short sale or short selling and is an integral part of margin trading.

The settlement system in India makes short selling possible, even though the Indian capital market does not have a stock lending scheme in place.

As the Indian stock market had been generally trading downward between September 1994 and January 1997, the blame for the depressed market conditions was put on short sales as is the case with the *badla* system. The SEBI reportedly considered imposing a ban on short sales in a falling market¹⁵. However, the board did not impose such a ban. Instead, it appointed the B. D. Shah Committee in November 1996 to examine and recommend the suitable modalities for the proper regulation of short-selling in Indian stock market¹⁶. As a result, SEBI successfully made short selling transactions transparent to all market participants, and unified the margin rate for the short selling position on all the Indian stock exchanges. Yet, the measures that the SEBI has taken are biased against short sales.

The committee defined a short sale in the Indian context as the selling of shares without having the physical possession of such shares, unless it is either for squaring-up of an earlier purchase in the same settlement and in the same stock exchange, or against the pending deliveries from the

¹⁴ The limit used to be 10 times until April 1997.

¹⁵ "SEBI considers ban on short sales", *The Business Standard*, August 23, 1996.

¹⁶ SEBI Press Release, B. D. Shah Committee Report, Ref. No. PR 128/96, December 20, 1996, Section 1.

same stock exchange pertaining to previous settlements¹⁷. A transaction in which the client or broker sells shares on one stock exchange against his or her outstanding purchase position on another stock exchange(s) (an exchange spread transaction) is also technically considered as a short sale¹⁸. In this connection, the committee also defined a long purchase as the purchase of shares with the intention of not taking the deliveries and squaring off the transaction¹⁹.

In November 1996, even before the B. D. Shah Committee completed its deliberation and submitted a report, SEBI took the first step to regulate short selling in the Indian stock market by requiring all stock exchanges to enforce the reporting by their members of their net short sale position in each stock at the end of each trading day²⁰. In December 1996, the committee submitted its report to SEBI with the following major recommendations:

- mandatory declaration by member brokers of their cumulative stock-wise net short positions and cumulative stock-wise net long purchase positions of the 60 designated stocks at the end of each trading day²¹;
- publication by the stock exchanges of the information on the short sales as well as the long purchases by means of the notice board, the trading terminal screen and the press media²²;
- imposition of a penalty of 2% of the weighted average auction price or close-out price of a stock on a broker who declares a transaction of the stock as a sale for delivery and subsequently fails to give deliveries or square off his or her transaction, for the quantity squared-off and undelivered²³; and
- imposition of a differential margin of 15% on the aggregate short sales position of the 15 high volume stocks on cumulative basis of each stockbroker over the margin rate for the long purchase position, in addition to the mark-to-market margin²⁴.

¹⁷ *Ibid*, Section 3.2.

¹⁸ *Ibid.*, Section 3.5.

¹⁹ *Ibid.*, Section 3.2.

²⁰ SEBI Press Release, Ref No. 117/96, November 27, 1996.

²¹ SEBI Press Release, Ref. No. PR 128/96, December 20, 1996, Section 3.2.

²² *Ibid.*, SEBI Press Release Ref. No. PR 16/97, January 30, 1997, and SEBI Press Release Ref. No. PR 18/97, February 4, 1997.

²³ *Ibid.*, Section 3.4.

²⁴ *Ibid.*, Section 3.6.

The 60 stocks designated for the short sales position reporting were originally the A Group stocks of the BSE, plus UTI Master Share. As the universe of the A Group stocks of the BSE has been expanding (see Section 4.3.4), the number of stocks designated for reporting the short sales position accordingly has been increasing.

The 15 high volume stocks for the differential margin on the aggregate short sales position are as follows:

- State Bank of India
- ITC Ltd.
- Reliance Industries Ltd.
- Tata Iron & Steel Co. Ltd.
- Mahanagar Telephone Nigam Ltd.
- Larsen & Toubro Ltd.
- Tata Engineering & Locomotive Co., Ltd.
- BSES Ltd.
- Bajaj Auto Ltd.
- Associated Cement Co. Ltd.
- Gujarat Ambuja Cements Ltd.
- Indian Petrochemicals Corporation Ltd.
- Tata Power Co. Ltd.
- Hindustan Lever Ltd.
- Oriental Bank of Commerce²⁵.

5.3 Share Buyback

In some developed countries, companies are granted the right to purchase their own shares under certain conditions. Share buybacks are, however, cumbersome and difficult in India. As corporate takeover bids increase in the Indian capital market, however, the industry has demanded the provisions of the Companies Act, 1956 to be amended to facilitate share buybacks to tackle any potential threat of a takeover. An undervalued stock is an attractive target of a corporate raid. The reacquisition of the shares of a stock helps raise the share price and makes a takeover expensive.

Section 77 of the Companies Act, 1956, in principle, prohibits an Indian company from buying back its own shares. Currently, a company

²⁵ *Ibid.*, Section 3.7.

threatened a corporate raider has to go through lengthy court procedures to legitimately buy back its shares. The applicable procedure is one for a reduction of share capital as prescribed by Sections 100 to 105 of the Act. The procedure in brief is as follows:

- the company should be empowered by its Articles of Association to effect such a reduction;
- a special resolution is required to be passed by the shareholders of the company;
- the company then has to apply to the relevant High Court (“the Court”) by way of a petition for confirmation of the reduction;
- where the proposed reduction involves diminution of liability in respect of unpaid capital or payment to the shareholder of any paid up capital or if the Court deems fit, the creditors of the company are entitled to object and there are further procedures prescribed regarding the hearing and disposition by the Court of such objections;
- on satisfaction of the procedures, the Court may make an order confirming the reductions on such terms and conditions as it thinks fit which includes directing the company to add the words “and reduced” to its name for such period as may be prescribed and requiring the company to publish the reasons for the reduction or such other information as the Court thinks fit; and,
- thereafter, the company has to give notice of the Court’s order to the Registrar of Companies (ROC) within 30 days of receipt of the order. The company has to then file a copy of the Court’s order and minutes with the ROC and upon such registration only the reduction becomes effective.

The current provisions of the Companies Act for a reduction of share capital apparently supposes that the company has been in a somewhat financially difficult position. Therefore, the procedures are stringent enough to protect the creditors’ claim. The court has power to administer the company reducing its share capital as if the company’s management were no longer competent. That is not necessarily the case in a takeover situation.

The SEBI, the Finance Minister and the Prime Minister approved a proposal to amend the Companies Act to accommodate share buybacks in

July 1996, but the Finance Secretary blocked the proposal²⁶. The argument against the proposal was that share buybacks would be misused by companies and would lead to stock price manipulation and insider trading.

As has been discussed earlier in Section 3.1.3, however, the draft Companies Bill reintroduced the share buyback provision, and provides for the circumstances and conditions under which companies are permitted to buy back their shares, as follows:

- a prior approval of the shareholders is obtained which clearly states the amount allocated for the buyback, the time period for concluding the buyback operations and that the funds allocated for buyback are from free reserves and share premium account;
- in the event of buyback, the company cannot issue any new shares for a period of 12 twelve months after the buyback is completed; this includes rights issues but excludes bonus shares;
- the buyback should not result in an increase in the debt-equity ratio beyond 2:1;
- if the buyback is for treasury operations, such shares are not to be reissued for 24 months following the last date of buyback and are subject to certain further restrictions depending on the nature of the shares; and,
- the buyback is to be accompanied by a “declaration of solvency” by the board of directors of the company concerned.

The above provisions are still in a proposal stage, and are subject to a lot of discussion, debate and controversy. They may be substantially modified before the Indian parliament passes the bill.²⁷

dissolution of the lower house of India parliament and the position will be only after the general elections in 1998.

²⁶ “SEBI approves share buyback proposal”, *The Business Standard*, July 8, 1996, and “Finance ministry blocks share buyback proposal”, *The Business Standard*, August 23, 1996.

²⁷ The bill has now been delayed, if not jeopardised by the dissolution of the lower house of Indian Parliament and the position will be clear only after the general elections in 1998.

5.4 Stock Lending

The Indian capital market does not have a stock lending scheme in place. A short sale or short selling would be much easier and less troublesome if stock lending schemes were available in India because it would reduce the likelihood of short deliveries²⁸. A stock lending scheme would enable a seller to borrow shares for a specific period for a fee under a share lending contract, and deliver them to a buyer to settle a transaction. At a later date, and at the expiry of the contract, the seller acquires the shares by purchasing them from the market or by further borrowing, and returns them to the lender. The system would make margin trading possible and facilitate arbitrage activities using stock index futures and options. Margin trading would possibly replace the *badla* system, and would further enhance the liquidity of stocks (see “A Pitfall & A Solution” of Section 7.6.1)

The Indian capital market is now in the process of introducing a stock lending scheme. The B. D. Shah Committee, appointed by SEBI, deliberated issues involved in share lending to formulate guidelines and capital adequacy requirements for borrowers and lenders²⁹. Sale of securities against share lending is expected to be exempt from being termed as short selling. This is because the sale will be backed by physical delivery of shares³⁰.

However, a capital gains tax issue earlier impeded the introduction of a share lending scheme in India. The Law Ministry ruled in December 1996 that the same shares which were lent out, would have to be returned in order to ensure that the lender did not attract the provisions of capital gains tax³¹. Obviously, that was impractical. The levy of capital gains tax on a share lending transaction would hike the cost of share borrowings prohibitively.

The Central Board of Direct Taxes has worked out a solution to this impediment. It first treats shares as fungible assets. Lending and borrowing of shares under the stock lending scheme, therefore, would not be regarded as a ‘transfer’ or even an ‘exchange’ under the Income Tax

²⁸ A short delivery takes place when a broker, a custodian or the clearing house delivers fewer securities than what were contracted for to either another broker, a custodian or the clearing house. See Section 7.4.2.

²⁹ SEBI Press Release, Ref. No. PR 128/96, December 20, 1996, Section 3.8.

³⁰ “Stock Lending Scheme cleared”, *The Financial Express*, October 16, 1996.

³¹ “Stock lending comes a cropper”, *The Financial Express*, December 27, 1996.

Act. Consequently, capital gains tax would not be levied on lending and borrowing of shares under the stock lending scheme³².

Once a definitive scheme of share lending is in place, lenders are expected to be large institutional investors, FIIs, mutual funds and high net worth individuals with a large inventory of shares³³. Major borrowers will be stockbrokers and corporates. According to the schematic plan approved by SEBI, the lenders will deposit the securities with an approved intermediary under an agreement for a specified period not exceeding 3 months, and the agreement shall provide that the beneficial interest would continue to remain with the lender and all the corporate benefits would also continue to accrue to the lender. Intermediaries of share lending should have a minimum networth of Rs. 500 million³⁴.

The Stock Holding Corporation of India (SCHIL) is the first institution that has applied for registration as a stock lending intermediary. Its stock lending scheme is expected to be operational by October 1997³⁵. Reliance Capital is also aspiring for registration³⁶. Some custodian banks too see a great deal of business opportunity in the share lending brokerage.

5.5 Unregulated Market of Options

Derivatives are not entirely a modern invention in Europe or America. Just as futures trading has historical roots in the rice exchange of Japan in the early eighteenth century, options trading may date back to the medieval times of India. The concept of options is not new to the Indian stock market as it follows from the fact that the definition of "option in securities" in the Securities Contracts (Regulation) Act, 1956 includes such terms as *teji*, *mandi*, *teji mandi*, and *galli*³⁷. These Hindi terms suggest that option contracts existed in the local marketplaces of some commodities. Trading of these options is illegal under current laws. The futures & options segment of the NSE, whose launch has been blocked for some time, is the only legally permitted option market in India.

³² "Stock lending free of capital gains tax", *The Economic Times*, February 3, 1997.

³³ "Stock lending comes a cropper", *The Financial Express*, December 27, 1996.

³⁴ SEBI Press Release, Ref. No. PR 16/97, January 20, 1997.

³⁵ "SHCL to get into stock lending by October", *The Financial Express*, August 9, 1997.

³⁶ "Three-month cap on stock lending", *The Financial Express*, April 14, 1997.

³⁷ Section 2. (d) of the Securities Contracts (Regulation) Act, 1956.

However, an interesting study illustrates unregulated options trading in the country today³⁸. According to the study, such illegal trading, such as *badla* trading, has been popular for a long time in places like Ahmedabad, Mumbai, Calcutta and Delhi.

Table 5.7 below shows the Indian terminology of options in such unregulated markets.

Table 5.7
Indian Terminology of Options

Call Option	<i>Teji</i>
Put option	<i>Mandi</i>
The seller or writer of a call	<i>Teji khaii-wal, Teji Khane-wala or Teji bookie</i>
The holder of a call	<i>Teji lagaii-wal</i>
The seller or writer of a put	<i>Mandi khaii-wal, Mandi Khane-wala or Mandi punter</i>
The holder of a put	<i>Mandi lagaii-wal</i>
Straddle	<i>Nazrana or Bhav-bhav</i>
Top vertical combination	<i>Fatak or Jhota</i>

Compiled from Pavan Kumar Vijay, "Options and Futures in India".

Both *teji* and *mandi* are always out-of-the-money options. The time to the expiration of these indigenous options is very short due to the limited mutual faith among players in an unregulated options market. A *teji* or a *mandi* expires at the stroke of 15 minutes before the trading close of the following trading day. Sometimes they are event-based and expire on the day following the announcement of the Union Budget or the day following the annual general shareholders meeting of a company whose stock underlies the option contracts. The premium on an ordinary *teji* or *mandi* is fixed at 25 paise (Rs. 0.25) per share. The premium on an event-based *teji* or *mandi* is double that on an ordinary *teji* or *mandi*. The strike price is negotiable. *Teji* and *mandi* transactions account for 35-40% of the unregulated market.

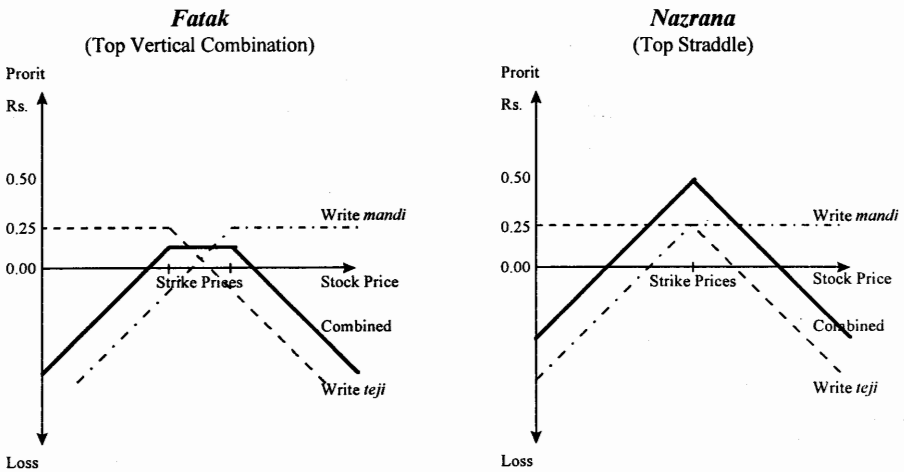
The most popular option strategy is a top vertical combination³⁹, known as *fatak* or *jhota*, in which an investor simultaneously writes a *teji* of a stock with a higher strike price and a *mandi* of the same stock at a lower strike price. *Fatak* transactions account for 50-60% of the

³⁸ Pavan Kumar Vijay, "Options and Futures in India", an undated and unpublished paper. The description in this section is heavily dependent on Mr. Vijay's paper.

³⁹ A combination is the purchase (or sale) of calls and puts on the same underlying stock that do not have the same expiration date and/or strike price.

unregulated market. Another option strategy available in the unregulated markets is a straddle⁴⁰, known as *nazrana* or *bhav-bhav*, in which an investor simultaneously writes a *teji* and a *mandi* of a stock with the same strike price. Figure 5.1 is the pay-off diagrams for a *fatak* and a *nazrana*.

Figure 5.1
Fatak & Narzana



The premium on a *fatak* is typically double that on a *teji* or *mandi*, because it has two-sided risks. The premium on a *nazrana* is roughly one half of the gap between the current price of the underlying stock and the strike price of a *fatak* of the same stock. For instance, assuming that a stock currently trade at Rs. 66 and its *fatak* strike prices are Rs. 69 and Rs. 63, the premium is set around Rs. 1.50, a half of Rs. 3.00 (= Rs. 69 - Rs. 66).

⁴⁰ A straddle consists of the purchase of a call and the purchase of a put on the same underlying stock with the same expiration date and the same strike price (a bottom or long straddle), or the sale of a call and the sale of a put on the same underlying stock with the same expiration date and the same strike price (a top or short straddle).

Disclosure

6.1 Disclosure Documents

As is the case with companies in capital markets of the other countries, a company offering securities in the Indian capital markets is required to make a public disclosure of all relevant information through its offer documents. The offer documents for an issue of securities in India are:

- (1) the prospectus, and
- (2) the application form and the abridged prospectus in case of an issue to the public, or
- (3) the letter of offer in the case of a rights issue to existing shareholders or debenture holders of a company with or without the right to renounce in favor of other persons.

6.1.1 Prospectus

An Indian company making a public issue is required to make a true, fair and adequate disclosure on the issue, the company and other relevant matters through a prospectus. In India, the lead manager for a public issue, who is a merchant banker of Category I, is responsible for preparing the prospectus of the issue. The lead manager is required to submit a draft prospectus to SEBI and the relevant stock exchange¹ at least 21 days (three weeks)² prior to the filing of the final offer documents with the Registrar of Companies (ROC) and the stock exchange for disclosure purposes³. A draft prospectus without the issue price fixed shall be at first submitted to SEBI for its comments. SEBI then issues an Observation Letter to the lead manager⁴. Once the issue is priced and the

¹ Section 5 of Clarification No. XII, dated September 29, 1995.

² Section 4 (b) of Part C of SEBI Clarification No. XIV, dated March 1, 1996.

³ Section 24 (1) and (2), SEBI (Merchant Bankers) Regulations, 1992.

⁴ Previously SEB vetted offer documents and issued an acknowledgment card for an issue it approved. The board stopped such a practice in December 1996. Part A.1 of SEBI Clarification No. XVII, December 10, 1996.

prospectus is completed, the lead manager files its copies with the stock exchange on which the issue is proposed to be listed and distributes its copies to the public as a public document⁵. The final prospectus with the pricing information included in it is filed with the ROC⁶ and the relevant stock exchange.

Unlike a prospectus of an issue in the United States and some other countries, a prospectus in India is not required to be furnished to every investor before he or she commits to investing in the issue. It is required to be furnished only upon his or her request⁷. Instead, the abridged prospectus is furnished to every investor who applies for newly-issued shares or debentures.

6.1.2 Abridged Prospectus

The abridged prospectus is an offer document attached to an application form for shares or debentures. The Companies Act, 1956 requires the application to be accompanied by “a memorandum containing such salient features of a prospectus as may be prescribed”⁸. The memorandum is conventionally called an abridged prospectus. It carries less information than the prospectus. The application form is part of the abridged prospectus, being attached to it along a perforated line⁹. This is meant not that to ensure prospective investor will miss out on an opportunity to study important information for his or her investment decision before he or she submits the application form, given the fact that the investor may fail to request of a copy of the prospectus.

6.1.3 Letter of Offer

The letter of offer is a disclosure document for a rights issue in lieu of the prospectus. Where a listed company issues shares whose value exceeds

⁵ Section 5 of Clarification No. XII of the SEBI Guidelines, dated September 29, 1995.

⁶ Section B 14 of Clarification No. XIII of the SEBI Guidelines, dated October 12, 1995.

⁷ The proviso of Section 56 (3) of the Companies Act, 1956.

⁸ Section 56 (3) of the Companies Act, 1956.

⁹ Circular No. 1 of 1992, dated January 9, 1992, issued by Department of Company Affairs, Ministry of Law, Justice and Company Affairs, and Section 5.1 of RMB (GI Series) Circular No. 1 (92-93) (RMB = registered merchant bankers, and GI = general instructions).

Rs. 5 million (approximately US\$ 140,000) by way of rights, its merchant banker, acting as the lead manager, is required to file a letter of offer with SEBI two weeks before the issue opens for subscription¹⁰. Before that, the merchant banker is required to file the draft letter of offer with SEBI for observation and comments six weeks before the issue opens for subscription. SEBI is to provide the merchant banker with its comments within three weeks. The merchant banker is required to incorporate SEBI's comments into the final letter of offer, or comply with SEBI's comments before filing the final letter of offer with SEBI¹¹.

6.2 Disclosure Requirements

The disclosure requirements for the offer documents in India are, at present, governed by the following:

1. Schedule II to the Companies Act, 1956 (Schedule II)
This schedule is stipulated under Sections 44 (2) (a) and 56 of the Companies Act, 1956, and highlights the matters to be specified in the prospectus and reports to be sent out therein.
2. Form No. 2A of the General Rules & Forms (Form No. 2A)
The salient features of the prospectus which must be incorporated in the abridged prospectus are prescribed in Form No. 2A annexed to the Companies (Central Government's) General Rules and Forms, 1956, under Section 4CC thereof.
3. Guidelines for Disclosure and Investor Protection issued by SEBI (SEBI Guidelines) and Clarifications thereto (SEBI Clarifications)
These guidelines were initially issued in June 1992, and subsequently 10 additional guidelines and 21 clarifications of the guidelines had been issued, as at the end of July 1997. These guidelines and clarifications are also referred to as DIP Series¹².
4. RMB (GI Series) Circulars issued by the SEBI (GI Series Circulars)

¹⁰ Section P of Clarification I, dated July 16, 1992, Section II 1 (D) of Clarification III, dated August 13, 1992, and Sections 3 & 4 of Clarification, No. X dated May 23, 1995, of the SEBI Guidelines for Disclosure on Investor Protection.

¹¹ Section 4 (b) & (c) of Clarification No. X of the SEBI Guidelines, dated May 23, 1995.

¹² DIP = Disclosure and Investor Protection.

The general instructions that SEBI had issued to registered merchant bankers regarding issue management and other activities were consolidated and codified into RMB (GI Series) Circulars¹³.

5. Observation letters issued by SEBI to lead managers while scrutinizing the offer documents in individual cases (Observation Letters)

SEBI examines the draft prospectus of an issue filed with it, with a view to ensuring that the important and necessary disclosures be made, and issues an observation letter to the lead manager, pointing out if there is anything which is *prima facie* misleading or incorrect. The observation letter is valid for a period of 365 days¹⁴. It is an Indian version of a “deficiency letter” or letter of comment under the US Securities Laws.

The items required to be disclosed in an abridged prospectus are stipulated in Section II of Clarification XIV of the SEBI Guidelines. Those required to be disclosed in a letter of offer are stipulated in Annexure I to Clarification X, dated May 23, 1995, and in Section II of Clarification XIV of the SEBI Guidelines. The disclosure requirements for a rights issue are simpler than those for a public issue.

6.3 Continuing Disclosure

After a security is issued to the public and subsequently listed on a stock exchange, the stock exchange requires the issuing company to make continuing disclosures under the listing agreement. The issuing company is required to continue to disclose in a timely manner to the exchange, to the holders of the listed securities (the shareholders or the bondholders), and to the public through the exchange or the media, 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.

Such information includes:

- the date of the meeting of the board of directors for corporate actions;

¹³ RMB = Registered Merchant Bankers, and GI = General Instructions.

¹⁴ Part D of SEBI Clarification No. 19, RMB (DIP Series) Circular No. 5 (96-97), dated May 14, 1997.

- the audited financial results on an annual basis and the unaudited ones on a semi-annual basis;
- any proposed change in the general character or nature of the company's business;
- any alterations of the company's capital;
- any change of the company's directorate including managing directors and auditors, etc.

6.4 Accounting Principles

The financial statements of an issuing company in its disclosure documents are prepared in accordance with India's generally accepted accounting principles (Indian GAAP).

The increasing exposure of Indian listed companies to international investment communities, through their securities issues outside the country or FIIs' investment in their stocks or debentures in the domestic markets, has compelled them to adopt more internationally acceptable accounting principles. Institutes of Chartered Accountants of India issued a note to introduce new accounting standards in the fiscal year 1995-96. The new accounting principles include the following:

- cash flow statement
- classification between long-term and current investments
- earnings per share
- recognition of a forward exchange contract hedged against a long-term commitment at the historical rate, and of the translation gain or loss from the hedged transaction over the life of the contract in the profit and loss account except for fixed assets.
- provision for such compensation for future absences of employees, wherever applicable.

Yet, Indian GAAP is considerably different from US and UK GAAPs. Table 6.1 below summarizes the significant differences of Indian GAAP from UK and US ones.

Table 6.1
Significant Differences among Indian, US & UK GAAP

	<i>Indian GAAP</i>	<i>US GAAP</i>	<i>UK GAAP</i>
88	Consolidation of subsidiaries is not required.	Consolidation of subsidiaries is required.	Consolidation of subsidiaries is required. (Applies to large and listed companies only).
2	Investments in associated companies are carried at cost.	Investments in associated companies are accounted for under the equity method.	Investments in associated companies are accounted for under the equity method. (applies to large and listed companies only)
3	For the fiscal years prior to 1996, a cash flow statement was not required. However, with effect from fiscal 1996, companies listed on Indian stock exchanges are required to furnish cash flow statements as part of listing agreement with stock exchanges.	Cash flow statement is required.	Cash flow statement is required. (Applies to large and listed companies only).
4	Unrealized and realized gains and losses arising on translation of foreign currency liabilities incurred to finance the purchase of fixed assets are adjusted against the carrying cost of the relevant assets and depreciation is provided thereon.	Unrealized and realized gains and losses arising on foreign currency liabilities must be taken to the Profit and Loss Account.	Unrealized and realized gains and losses arising on foreign currency liabilities must be taken to the Profit and Loss Account.
5	Effective from fiscal 1996, forward exchange contracts are required to be accounted for at the rates prevailing on the transaction dates and the resultant gain or loss arising out of a hedging transaction is to be recognized as income or expense over the life of the contract in the Profit and Loss Account except for fixed assets.	Forward exchange contracts to hedge future commitments or transactions are revalued at each balance sheet date and the gain or loss arising is dealt with in income for the period or deferred if identifiable to a specific foreign currency commitment. However, losses are not deferred if it is estimated that deferral would lead to recognizing losses in later periods.	Where forward exchange contracts are hedged against future commitments, the transactions are accounted for at such contracted rates.

Table 6.1 (Contd.)

6	Minimum depreciation rates are prescribed by the Companies Act. Where applicable, higher depreciation based on useful economic life is required to be provided.	Depreciation rates are derived on the basis of the useful economic life of the asset.	Depreciation rates are derived on the basis of the useful economic life of the asset.
7	Revaluation of fixed assets is permitted by creating a revaluation reserve which is not available for distribution.	Revaluation of fixed assets is not permitted.	Revaluation of fixed assets is permitted by creating a revaluation reserve which is not available for distribution.
8	Additional depreciation on revaluation of fixed assets is permitted to be credited to the Profit and Loss Account from revaluation reserve.	Revaluation of fixed assets is not permitted.	Permitted to credit the amount equal to additional depreciation from revaluation reserve to retained profit.
9	The provision for taxation is based on the estimated tax liability currently payable. No distinction is made between timing differences and permanent differences and adjustments are not made for deferred tax liability or deferred tax credit.	Timing differences are identified and provided for using the liability method for the reversal of these differences to the extent that the tax payment or receipt is expected to arise.	Timing differences are identified and provision using the liability method is made for the reversal of these differences to the extent that a tax payment for receipt is expected to arise.
10	Effect from fiscal 1996, investments are required to be classified into long-term and current investments. While long-term investments must be carried at cost less provision for permanent diminution in value (such provisions are determined and made individually for each investment). Current investments must be carried at the lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall or global basis.	Investments are segregated into (a) "held to maturity securities" carried at amortized cost and classified in accounts based on contractual maturity); (b) "trading securities" (carried at fair value, recognizing unrealized gains and losses and classified in accounts as current assets); (c) "available for sale securities" (carried at fair value, unrealized gains and losses excluded from earnings, reported in separate component of shareholders equity and classified in accounts as current or long-term based on management intentions).	Fixed asset investments are carried at cost (with provision for permanent diminution in value). Current asset investments are recorded at lower of cost and net realizable value.

Table 6.1 (Contd.)

11	Obligations for repayment of long-term debts which fall due for repayment within one year are not segregated but continue to form part of long-term debt.	Obligations for repayment of long-term debts which fall due for repayment within one year are included in current liabilities.	Obligations for repayment of long-term debts which fall due for repayment within one year are included in current liabilities.
12	Extraordinary items are disclosed separately or by way of note without adjustment for the tax effect thereof.	Extraordinary items are reported net of disclosed income tax effect thereon.	Extraordinary items (which are now extremely rare) are separately disclosed with income tax effect thereon. Items previously considered as "extraordinary" are now charged to profit before tax as exceptional items.
13	Premium on redemption of debentures and bonds can be amortized over the period of the debentures or bonds or charged to the share premium account.	Premium on redemption of debentures and bonds can be amortized over the period of the debentures or bonds, using the effective interest method.	Premium on redemption of debentures and bonds can be amortized over the period of the debentures or bonds or charged to the share premium account.
14	Changes in accounting policies and prior period items are reported on a prospective, if material, in the year of change/ incurrence with separate disclosure and with quantification of impact on profits and losses for the year and reserves as at the year end. Accounting effect of changes in accounting policies made from an earlier date is given in the year of change.	Prior period items are accounted by restating prior years and adjustment to retained profits. Except changes in certain specified accounting principles made by retroactive restatement, changes in accounting policies are not accounted by restating prior years but the effect of such changes is separately disclosed in the Profit and Loss Account. The cumulative effect of the changes is included in the Profit and Loss Account, net of income-tax effects. Correction of errors required prior period restatement.	Changes in accounting policies and prior period items are accounted by restating prior years and adjustments to retained profits.
15	For fiscal years prior to 1996, information regarding earnings per share was not required to be disclosed. With effect from fiscal 1996, such figure is required to be disclosed. However, a standard method for determining earnings per share has not yet been prescribed.	Information regarding earnings per share is disclosed. Prescribed methods are used for determining earnings per share.	Information regarding earnings per share is disclosed. (Applies to large and listed companies only).

Table 6.1 (Contd.)

16	There is no requirement to disclose information for segments of business.	Segmental disclosure must be made of turnover, net assets, and profits before interest and tax in respect of each class of business and geographical segment.	Segmental disclosure must be made of turnover, net assets, and profits before tax in respect of each class of business and geographical segment. (Applies to large and listed companies only).
17	Share and debenture issue expenses can be written off when incurred or charged to the share premium account or can be accounted for as deferred revenue expenses and amortized.	Direct costs of issuing share capital are deducted from the related proceeds and the net amount is recorded in shareholders' equity. Debt issue costs are amortized over the life of the debt.	Share and debenture issue expenses can be written off when incurred or charged to the share premium account.
18	Proposed dividends are reflected in the financial statements of the year to which they relate even though proposed or declared after the year end.	Dividends are a charge to retained earnings at the point of time that they are formally declared by the Board of Directors.	Proposed dividends are reflected in the financial statements of the year to which they relate even though proposed or declared after the year end.
19	Generally lease rentals for both operating and finance leases are recognized in the Profit and Loss Account. In the case of a finance lease, a matching annual charge is made to the Profit and Loss Account representing recovery of the net investment/fair value of the leased asset over the lease term.	Lease rentals for operating leases are recognized in the Profit and Loss Account. In respect of finance leases the present value of the minimum lease payments discounted at the interest rate implicit in the lease is capitalized and depreciated over the shorter of the lease term and its useful life. Lease rentals are apportioned between finance charges and outstanding obligations. Finance charges are recognized in the Profit and Loss Account.	Lease rentals for operating leases are recognized in the Profit and Loss Account. In respect of finance leases the present value of the minimum lease payments discounted at the interest rate implicit in the lease is capitalized and depreciated over the shorter of the lease term and its useful life. Lease rentals are apportioned between finance charges and outstanding obligations. Finance charges are recognized in the Profit and Loss Account.
20	Profit and loss arising from sale and leaseback transactions in respect of finance leases may be recognized in the financial statements in the year of the transaction, only if the sale and leaseback transaction is at fair value.	Profit or loss arising from sale and leaseback transactions in respect of finance leases should be deferred and amortized in the financial statements of the seller/lessee over the shorter of the lease term and the useful life of the assets.	Profit or loss arising from sale and leaseback transactions in respect of financial leases should be deferred and amortized in the financial statements of the seller/lessee over the shorter of the lease term and the useful life of the assets.

Table 6.1 (Contd.)

21	Effect from fiscal 1996, provision for compensation for future absences of employees to the extent earned by the employee during the period is required to be provided.	Provision for compensation for future absences of employees is necessary if the absences are earned by the employees during the period and the unused rights eventually vest or accumulate and compensation therefor is probable and can be reasonably estimated.	Compensation for future absences of employees is generally not provided for.
22	Although related party transactions are not required to be disclosed, amounts due to/from specified related parties are disclosed separately as required by the Companies Act.	All related party transactions are required to be disclosed.	Where material, related party transactions are required to be disclosed.

Source: MTN Offer Document (August 1997) of the Industrial Credit & Investment Corporation of India Limited, audited by Messrs. N. M. Rajji & Co., Chartered Accountants (By courtesy of Messrs. N. M. Rajji & Co.)

Clearing & Settlement

7.1 Custodians

An FII is required to appoint a custodian for its portfolio investments in India¹. A custodian in India generally provides FIIs with the following services:

- settlement services which include the receipt and delivery of securities and the execution of transfer deeds (share transfer forms) for securities sold;
- lodgement of securities bought with the registrar/transfer agent;
- safekeeping of securities;
- dividend collection and reporting;
- collection of withholding taxes on capital gains;
- corporate actions which involve tracking entitlements, etc.

Custodians registered with SEBI to provide the above custodial services in India include:

- ANZ Grindlays Bank
- Citibank
- Deutsche Bank
- Hong Kong & Shanghai Banking Corporation
- ICICI
- Standard Chartered Bank
- Stock Holding Corporation of India, Ltd.

SEBI has come out with a set of uniform practices to be followed by all the registered custodians. With effect from 1 October 1996, it is now mandatory for custodians to participate in the clearing houses of the stock exchanges. In addition, the registered custodians have to accept the common bad delivery norms provided for all stock exchanges and adopt

¹ Section 16 of SEBI (FIIs) Regulations, 1995.

the prescribed rectification process. The custodians must also adopt a deadline of 48 hours for brokers' payments² (see Section 7.3.2).

7.2 Settlement Procedures

7.2.1 Batch Settlement System

In the capital markets of developed countries and the Southeast Asian countries, trades commonly settle on a daily rolling basis a certain number of business days after the trade date (commonly expressed as "T"); T+4 in Japan, and T+5 in the United States. In India, daily rolling settlements are restricted only to the following segments of the market:

- (i) the Sunshine segment of the BSE,
- (ii) the book entry segment,
- (iii) the trade-for-trade segment of the NSE, and
- (iv) the OTCEI³.

Instead, in segments other than the above, a batch of securities traded during a period of 7 calendar days settle *en masse* through the clearing house on a predetermined day after the end of such a period (see Figure 7.1). This batch settlement system is necessitated by the fact that most Indian securities are in a physical form and their settlements require delivery and receipt of a great deal of documents including physical certificates of securities and transfer deeds. The recent introduction of a depository system⁴, where ownership of securities is recorded electronically and no physical certificates exist, has paved the way for switching the Indian settlement system to a daily rolling basis from a batch basis.

There are the three key words to understanding the Indian settlement system:

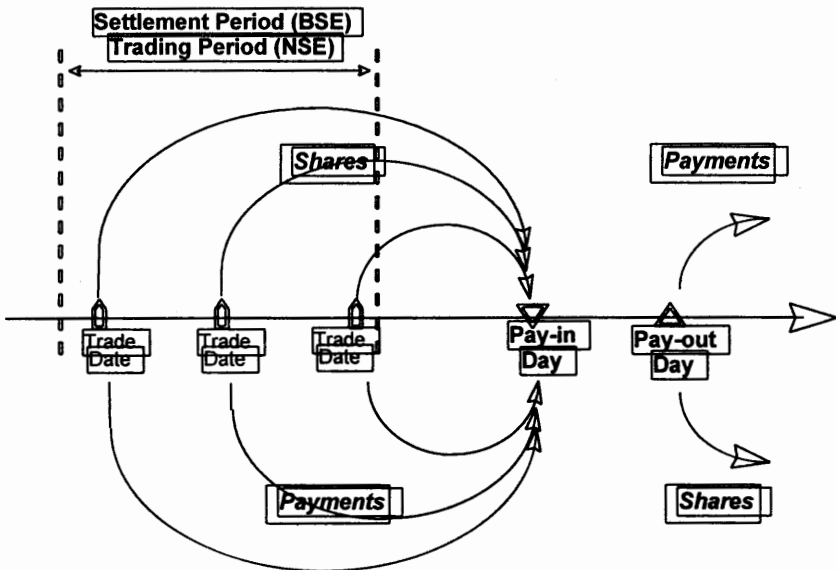
- (i) settlement period (or trading period),
- (ii) pay-in day, and
- (iii) pay-out day.

² *The Economic Times*, August 15, 1996.

³ The Dave Committee appointed by the SEBI has made several recommendations to revive the fortunes of the OTCEI. One of them calls for a T+5 settlement system for listed securities. (*The Financial Express* on September 28, 1996).

⁴ See Sections 3.2.6 and 7.6.1.

Figure 7.1
Settlement Period / Trading Period



Stock exchanges in India divide one-year periods into periods of 7 calendar days, known as a 'settlement period' or 'account period' on the BSE, or a 'trading period' on the NSE. There are usually 5 trading days during a settlement period or a trading period since typically there are no trades on Saturdays and Sundays. The transactions entered during a settlement period (or a trading period) are to be settled on a set of 'pay-in day' and 'pay-out day'.

The pay-in day is the day when brokers have to make payments to the clearing house of the exchange for all purchases made by or through them in the preceding settlement period, and to deliver security certificates, together with transfer deeds, for all sales made by or through them in the same settlement period. The pay-out day is the day on which brokers receive payments from the clearing house of the exchange for all sales made by or through them in the preceding settlement period, and to receive security certificates, together with transfer deeds, for all purchases made by or through them in the same settlement period.

To be precise, the delivery and receipt of security certificates and transfer deeds take place only for securities in a physical form. An electronic transfer of balance is made between relevant accounts for securities in a book-entry form on the pay-in and pay-out days. In case an

investor, such as an FII, has a custodial arrangement, the custodian, instead of the broker, settles funds and securities on the pay-in and pay-out days.

For securities in a physical form the pay-out day falls four working days after the pay-in day on the BSE and two working days on the NSE. This staggered arrangement of the pay-in and pay-out days is designed to facilitate the irksome handling of physical certificates and transfer deeds at a clearing house. Under a book-entry system, however, the settlement for funds and securities can take place on a single day. In the book-entry sub-segment of the NSE, funds and securities are settled simultaneously on the Tuesday following the end of the trading period (see Section 7.6.1).

What brokers pay in and pay out are their net positions on the pay-in and pay-out days. If an investor buys and sells the same quantity of the same stock during the same settlement period (trading period), he or she can square off his or her orders and does not need to deliver the shares on the pay-in day. Trades can be reversed by contra transactions entered into during the same settlement period and consequently result in no delivery. This method of trading (turnaround trading) is very popular in the Indian stock markets for speculative purposes, though Indian institutions, mutual funds and FIIs are not permitted to conduct such transactions.

In India, the terms 'settlement cycle' and 'settlement period' are often used interchangeably. However, the term 'settlement cycle' in the US stock markets, where there is no batch settlement system and therefore no 'settlement periods', conventionally means the number of days between trade and settlement dates. Therefore, the term 'settlement period' is distinguished from the term 'settlement cycle' in this book to avoid unnecessary confusion in understanding the Indian settlement mechanism.

7.2.2 Transfer Deed (Share Transfer Form)

A transfer deed is needed for the settlement of every trade on a physical delivery basis in addition to a certificate of the traded shares. This is because a transfer deed that has been duly stamped and executed, in general, has to accompany a certificate of shares to register a transfer of ownership of the shares⁵. A transfer deed is an instrument of transfer, and is officially known as share transfer form⁶.

⁵ Section 108 (1) of the Companies Act, 1956.

⁶ Section 5A (2) of the Companies (Central Government's) General Rules and Forms, and Form 7B set forth in Annexure A thereto.

A transfer deed for listed shares is valid for registration of ownership until the first book closure date, or within 12 months after the transfer deed was stamped, whichever is later⁷. As long as a transfer deed is valid for registration, therefore, a certificate of shares accompanied by the transfer deed changes hands with the delivery broker's (selling broker's) endorsement on the back of the deed for each delivery settlement.

In the event of the transfer deed becoming outdated for one reason or another, the shares will have to be sent for registration in the buyer's name and stamp duty will be paid by the buyer. Subsequently, the share will come back transferred in the buyer's name.

7.2.3 BSE-listed Stocks

Improvements in Settlement

BSE has made considerable improvements to its settlement system. The recent improvements are twofold:

- (i) the standardization of settlement periods for all classes of stocks in September 1996, and
- (ii) the introduction of a rolling settlement cycle for delivery made by institutional investors in July 1997.

Improvements on settlement will not stop here. Further improvements are expected.

Settlement and Trading Methods

As a result of these improvements, there are two segments of equity trades on the BSE from the point of view of settlement periods:

- (i) the ordinary settlement segment and
- (ii) the rolling settlement segment which is also known as "Sunshine" segment.

Trades executed in the ordinary settlement segment are settled in two ways:

- (a) settlement through the clearing house, and
- (b) hand-delivery.

There is another segment, that is, the negotiated trade segment.

⁷ Section 108 (1A) (b) (i) of the Companies Act, 1956. This provision applies to listed shares. For unlisted shares, a transfer deed is valid for 12 months after it is stamped. (Section 108 (1A) (b) (ii), *Ibid.*).

Standardized Settlement Period

As has been discussed in Section 4.3.4, BSE-listed stocks are currently classified into three groups: Group A, Group B1 and Group B2 (Table 7.1). Earlier, until March 1996, BSE-listed stocks were classified as Group A and Group B. The settlement of Group A stocks had been made through the clearing house of the stock exchange for more than a decade. In that month, all Group B stocks, along with Group A stocks, began to settle through the clearing house, and BSE-listed stocks were re-classified as Group A, Group B1 and Group B2. Group B1 stocks were different from Group B2 stocks in that Group B1 stocks, together with Group A stocks, were put on a weekly settlement period but Group B2 stocks continued to settle on a fortnightly basis. In September 1996, Group B2 stocks joined Group A and Group B1 stocks in settling on a weekly basis.

Table 7.1
Classification of Stocks on BSE

<i>Group</i>	<i>Settlement</i>	<i>Badla transaction (carry-forward trading)</i>
A	7-day settlement period.	Eligible ("specified shares" or the "forward list")
B1	Via the clearing house or via delivery versus payment (DVP)	Not eligible ("non-specified securities" or the "non-forward list")
B2		

At present, therefore, there is only a single settlement period of seven calendar days for all trades of the BSE-listed stocks in the ordinary segment, and the classification between Group B1 and B2 is made generally in terms of marketability of those stocks.

A program for each one-week settlement period, including trade, pay-in, pay-out and other relevant dates, is announced four to six months in advance. Settlement programs announced in advance have been strictly observed since April 1996. Earlier, pay-in and pay-out days would be notified by BSE from time to time; and these were often delayed or prolonged in order to accommodate some influential members of the exchange. This practice was unfair to investors and symbolized the egocentric administration of the BSE in the past by its member brokers.

Trades of all BSE-listed stocks can settle through the clearing house of the stock exchange. However, parties to a trade may settle on a delivery versus payment (DVP) if they so choose.

Settlement through the Clearing House

As shown in Table 7.1, all BSE-listed stocks follow a 7-day settlement period (Monday to Friday) in the ordinary segment and can be settled through the BSE's clearing house, that is, BOI Shareholding Ltd. All trades executed during a settlement period are then settled during the subsequent weeks. Table 7.2 gives the sequential steps of (i) the ordinary settlement, (ii) the rectification of a short delivery, and (iii) the rectification of a bad delivery.

On Monday following the settlement period, the clearing house nets members' delivery obligations and generates settlement statements for its members. Securities and funds are paid-in on the first Thursday after the settlement period ends.

The clearing house checks for short delivery. The selling broker or custodian who makes short delivery gives the clearing house a notice of short delivery, together with a cheque for a value of the short-delivered securities, on Thursday evening or on Friday morning. The selling broker or custodian is required to make up for the short delivery (if any) by 5:00 p.m. on Friday. If a make-up delivery is made, the cheque is returned to the selling broker or custodian. On the following Monday (the pay-out day), the clearing house releases securities and funds to the selling and buying brokers or custodians. The settlement process complete unless there is any bad delivery.

After the securities are paid out on the pay-out day, the buying broker or custodian examines the delivered securities for bad delivery within 48 hours of the delivery, and has to report a *prima facie* bad delivery (if any) to the BSE's clearing house by the end of the following Tuesday. The selling broker collects the bad delivery on the following Wednesday for rectification and either rectifies the delivery or gives a non-rectification notice to the BSE's clearing house by the following Thursday. The buying broker or custodian collects the rectified delivery from the clearing house on the following Friday. If the selling broker fails to rectify the bad delivery, the securities are auctioned on the following Monday (the Monday in Week 4) (Step 10 in Table 7.5). Any bad-

Table 7.2
Typical Settlement Cycle on BSE⁸

<i>Week</i>	<i>Day</i>	<i>Activities</i>
1	Monday	The Settlement Period starts.
	Friday	The Settlement Period ends.
2	Monday	The BSE issues settlement reports to its members.
	Thursday	Pay-in day <ul style="list-style-type: none"> • The first day selling brokers or custodians deliver shares to the clearing house. • Buying brokers or custodians deliver cheques to the clearing house.
	Friday	The last day selling brokers custodians deliver shares to the clearing house.
3	Monday	Pay-out day <ul style="list-style-type: none"> • The clearing house releases cheques to selling brokers or custodians. • The clearing house releases shares to buying brokers or custodians. • The clearing house, on behalf of selling brokers or custodians who have not delivered in full, puts up the short delivery for auction.
	Tuesday	The buying broker or custodian examines delivered securities, and has to report a bad delivery (if any) to the clearing house (within 48 hours). Short delivery is auctioned on the BOLT.
	Wednesday	The selling broker or custodian collects the bad delivery for rectification.
	Thursday	The selling broker or custodian rectifies the delivery or gives a non-rectification notice to the clearing house.
	Friday	The buying broker or custodian collects the rectified delivery from the clearing house.
	4	Monday

Source: BSE.

⁸ On 12 December 1997, the BSE proposed to move up the pay-in day to Wednesday from the following Thursday, and the pay-out day to Saturday from the following Monday. All other activities after the pay-out day will also be moved up by one business day. The new settlement cycle announced by BSE is given in Appendix II at the end of the book.

delivered shares that are still left unmatched after the auction are closed out at the highest price for the shares from the trade day or 20% above the closing price on the day of auction, whichever is higher.

In this connection, it is important to note that the clearing house of the BSE only uses the on-line bad-delivery monitoring system to ensure good delivery in respect of shares delivered, but does not guarantee good delivery to the buying broker or custodian. In contrast to this, the NSE's clearing house guarantees good delivery by committing its own fund. To bridge this gap, BSE is now introducing a trade guarantee fund (see Section 7.4.6).

On the pay-out day (the second Monday after the settlement period ends), unfilled short delivery is announced for auction (buy-in) through the BOLT. The auction is conducted on the BOLT on Tuesday following the pay-out day. An auctioned amount of the short delivery is debited to the selling broker or custodian. The cheque deposited against the short delivery is adjusted accordingly. Any short-delivered shares that are still left unmatched after the auction are closed out at the highest price for the shares from the trade day or 20% above the closing price on the day of auction, whichever is higher.

Once a trade duly is settled, the delivered shares can again be sold in another transaction and delivered to the next buying broker or custodian so long as their transfer deed is valid (see Section 7.2.2), or can be sent to the registrar or the transfer agent of the issuer for registration. The registrar or the transfer agent may object to the registration of the transferee as the shareholder of the shares for one reason or another (see Section 7.5.3).

Hand-delivery Trades

This type of trade is very popular among BSE members. The selling and buying member brokers mutually agree on the price at which a transaction is effected, and the delivery and payment terms (settlement terms) of the transaction. The selling broker delivers the securities directly to the buying broker in exchange for the funds on a DVP basis. Since they do not go through the clearing house, these trades are not protected by automatic buys-in, Bad Delivery Cells (see Section 7.5.3) and others facilities that the clearing house provides.

“Sunshine” Segment

This new segment had been in existence since 7 July 1997 on an experimental basis, and started full scale operations on 1 September 1997,

reportedly with the aim of wooing institutional investors back to the BSE. This attempt has yet to prove successful and the turnover in this segment remains very marginal.

In this segment, trades settle on a daily rolling basis on the fifth working day from their trade day (the trade day is counted as T+0). This settlement cycle is conventionally termed as T+5. For example, a transaction made on Monday pays in and pays out for funds and securities on the next Monday. The BSE plans to reduce the settlement cycle to T+3 in the future.

This facility is currently limited to trades of shares that are registered in the name of financial institutions, mutual funds, FIIs registered with SEBI, and scheduled commercial banks. The sellers have to be institutional investors, but this excludes non-banking finance companies (NBFCs) for the purpose of the Sunshine segment. The buyers can be either institutions or individuals.

Unlike in the ordinary settlement segment, there is no auction for short delivery of shares in this segment. Shortages are directly closed out either at the highest price for the shares on the day of auction or 20% above the closing price on the day of auction. Objections of transfer arising from fake or forged shares traded in this segment are compulsorily auctioned off or closed out once the clearing house declares these as bad delivery. The clearing house does not wait for the selling broker to rectify or replace objected shares in another 21 days before auctioning off or closing out the objected shares⁹. The close-out rate of objected shares is 20% above the closing price on the day of auction.

There is a separate window on the BOLT system for trading in the Sunshine Segment. All trades in the segment settle through the clearing house and have to result in delivery. Therefore, neither *badla* trading nor hand-delivery is permitted in the segment.

The payments of funds for trades in this segment are made by debiting or crediting to members' current accounts with the Stock Exchange Branch of the Bank of India. Members who trade in the segment are, therefore, required to always maintain a necessary balance in their bank accounts. If the balance falls short of a required payment amount on a settlement day, the member will be deemed as being in default¹⁰.

⁹ "BSE gets nod for mandatory auction of fake shares", *The Financial Express*, August 1, 1997.

¹⁰ "BSE to shift to T+5 rolling settlement for institutional trades", *The Financial Express*, July 2, 1997.

Negotiated Trade Segment

In this segment, BSE members can execute off-the-market transactions where execution prices are negotiated off the market, and still settle them through the BSE's clearing house. SEBI reportedly suggested that a single transaction should be more than 10,000 shares or Rs. 2,500,000 in order to be executed in this fashion¹¹.

7.2.4 NSE-listed Stocks**Cleared Deals and Non-Cleared Deals**

The NSE conforms to a 7-day trading period. Securities listed or permitted to trade on the NSE can be settled either through the clearing house of the NSE, the National Securities Clearing Corporation Limited (NSCCL) (see Section 7.4.6), or through a delivery versus payment route without involving the NSCCL. The former are known as 'cleared deals', and the latter as 'non-cleared deals'.

There are two main markets on the NSE:

- (1) the wholesale debt market for trading of pure debt instruments; and
- (2) the capital market for trading in equities, convertible debentures, etc.

Our discussion here will be limited to the clearing and settlement of trades on the capital market which can be divided into a few segments:

- (i) the normal market segment, in which the NSE provides the special settlement facilities for institutional investors,
- (ii) the book entry segment,
- (iii) the institutional lot segment, and
- (iv) the trade-for-trade segment¹².

Normal Market Segment

This market segment is the most popular and accounts for more than 90% of trade volumes on the NSE. All trades executed in this segment settle through the NSE's clearing house, namely, the NSCCL.

¹¹ "SEBI plans guidelines for negotiated deals", *The Financial Express*, April 29, 1997.

¹² The description in this section is based on "Clearing and Settlement System, Capital Market" by National Stock Exchange of India Limited, and clarifications from various market participants.

Let's walk through the settlement of a trade executed on the normal market segment of the NSE step by step, as shown in Table 7.3.

Table 7.3
NSE's Settlement Cycle: Normal Market Segment

<i>Day</i>	<i>Activities</i>
1 - 7	Wednesday- Tuesday Trading period starts. Trading period ends.
8	Wednesday Brokers or custodians report trades which they will not settle to the clearing house.
13	Monday Pay-in of securities and delivery of documents by the selling broker or custodian to the clearing house.
14	Tuesday Pay-in of funds by the buying broker or custodian to the clearing house through a clearing bank. The clearing house identifies short deliveries.
15	Wednesday Pay-out day for securities and funds. Auction for short deliveries
17	Friday Pay-in of securities and funds auctioned for short deliveries. The buying broker or custodian reports bad deliveries (if any) to the clearing house, and the clearing house in turn intimates it to the delivering member.
18	Saturday Pay-out of securities and funds auctioned for short deliveries. The selling broker or custodian picks up the bad deliveries for rectification.
20	Monday The selling broker or custodian rectifies or replaces the bad deliveries.
22	Wednesday Auction for bad deliveries not rectified/replaced
24	Friday Pay-in of securities auctioned for bad deliveries
25	Saturday Pay-out of securities auctioned for bad deliveries

On the NSE, a trading period (known as a 'settlement period' on the BSE) starts on Wednesday (Day 1) and ends on Tuesday (Day 7) of the

following week. All trades executed during this particular trading period are then settled during the subsequent week.

At the end of the trading period, the NSE multilaterally nets members' delivery obligations and generates delivery statements (settlement statements) for its members. On Monday (Day 13) following the trading period, the selling brokers or custodians, who are clearing members of the clearing house, pay in securities to the clearing house. On Tuesday (Day 14), the buying brokers or custodians pay in funds to the clearing house through a clearing bank. The clearing house pays out both funds and securities to the selling brokers or custodians and the buying brokers or custodians, respectively, on Wednesday (Day 15). Thus, settlement is completed in eight days from the end of the last day of the trading period.

The NSCCL has appointed Canara Bank¹³ and HDFC Bank as clearing banks for settlement of funds. All clearing members are required to open accounts with a designated branch of any one of the clearing banks exclusively for settlement purposes. The bank's branch is electronically connected to the NSCCL and electronic funds transfers are effected for pay-in and pay-out on the instructions of the NSCCL.

On the pay-in Monday (Day 13), the selling broker or custodian notifies the NSCCL which securities it will or will not be able to deliver. The clearing house identifies short deliveries on Tuesday (Day 14) and then auctions them off on Wednesday (Day 15) through the NSE's on-line trading system. Pay-in for the auction takes place on Thursday (Day 14) and pay-out on Friday (Day 17).

In the event of a buy-in auction, the value of undelivered shares at the closing price on Friday (Day 10) is debited to the selling brokers or custodians who fail to deliver securities. If the auction price is higher than the debited price, the selling brokers or custodians are required to pay the difference. Any short-delivered shares that are still left unmatched after the auction are closed out at the highest price between the first day of the trading period or Wednesday (Day 1) and the day of the closing out or Wednesday (Day 15), or 20% over the closing price on the auction day or Wednesday (Day 15), whichever is higher.

Likewise, a buying broker or custodian is required to report bad deliveries (deliveries which are *prima facie* defective, e.g. those which

¹³ The second largest commercial bank in India and the 529th in the world with the Tier I capital of US\$ 494 million equivalent and total assets of US\$ 9,065 equivalent. The bank is headquartered in Bangalore. (*The Bankers*, July 1997).

do not contain a broker's stamp) to the clearing house by Friday (Day 17). The selling broker or custodian has to rectify these within two days, *i.e.* by Monday (Day 20); otherwise the clearing house auctions them off on Wednesday (Day 22). Shares auctioned for bad delivery are paid-in on Friday (Day 24). Finally, shares auctioned for bad delivery are paid-out on Saturday (Day 25). The cost of the auction and the closing out in respect of bad deliveries is paid by the NSCCL and is then charged to the selling member in the same manner as that of short deliveries with a time lag of one week.

Thus far, the NSCCL guarantees timely settlement of all trades by committing its own fund to close out an unmatched position caused by a short or bad delivery. Until July 1997, the NSCCL also guaranteed the settlement even when a selling broker failed to rectify an objection of transfer. This latter part of the settlement guarantee was withdrawn and no longer exists (see Section 7.4.6).

Book Entry Segment

The settlement in the book entry sub-segment of the NSE is much simpler than that in the normal market segment, because no bad delivery is expected in the book entry sub-segment. As such, the settlement in the book entry sub-segment is different from that in the normal market segment in two aspects:

- (i) the settlement for funds and securities takes place on the fifth working day from the trade day on a daily rolling basis (the daily rolling settlement); and
- (ii) there are no procedures to rectify bad deliveries or objections of transfer.

Every trade in this segment settles on the fifth working day (T+5). For arriving at the settlement day, all intervening holidays as announced by the clearing house including bank holidays, NSE holidays, Saturdays and Sundays are excluded. For example, a trade carried out on Monday typically settles on the following Monday. The settlement cycle in the book entry sub-segment is shown in Table 7.4.

In the book entry segment of the NSE, every short delivery is first debited or credited to the clearing members of the clearing house directly at the closing price of the short-delivered shares on the previous trading

Table 7.4
NSE's Settlement Cycle: Book Entry Subsegment

Day	Activities
1	T+0 Trade day. Every day the exchange is open for trading is a trading period.
	T+1 Investors confirm their trades with their custodians.
	T+2 Custodians confirm trades with their client investors.
7	T+5 at or before 13:30 Pay-in of securities; delivery of documents by the delivering members of the Clearing House.
	at or before 15:50 Pay-in of funds by members through the Clearing Bank
	at or after 17:30 Pay-out of securities through the Depository and funds through the Clearing Banks.
	T+6 Auction for short delivery
	T+8 Auction pay-in and pay-out day for securities and funds

day to the settlement day¹⁴. Then, it is auctioned off on the next trading day and settled on a T+2 basis. Finally, short deliveries that are left unmatched are closed out at the highest price prevailing on the NSE from the trade day till the day of closing out, or 20% above the official closing price on the auction day, whichever is higher.

Special Settlement Facilities for Institutional Investors

The NSE provides institutional investors with special facilities for their settlements. These special settlement facilities substantially reduce settlement risks for institutional investors by minimizing paper movements.

The exchange treats trades done on behalf of institutions who are settling through custodians (custodial trades) separately. When the exchange generates the delivery statements for members, it uses an allocation process which tries to minimize paper movements.

Deliveries are allocated against receipts on the following principles:

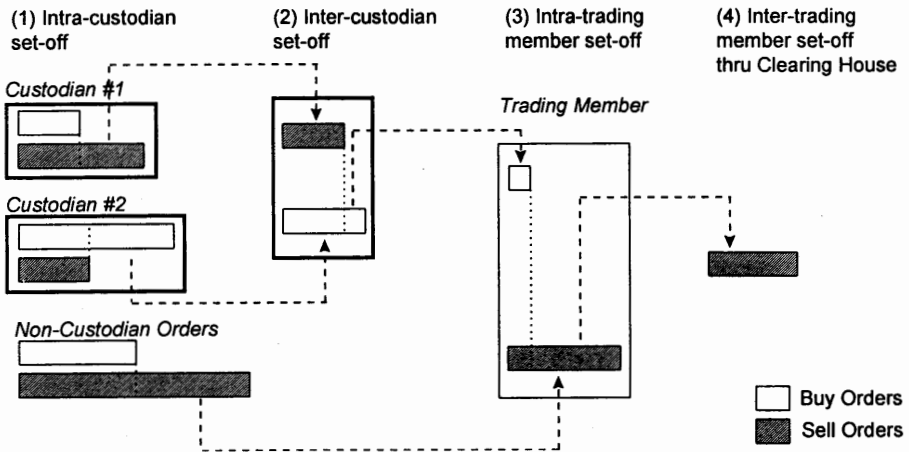
1. for each custodian, intra-custodial deliveries and receipts are set off (intra custodian);
2. excess custodial deliveries are matched against excess custodial receipts (inter custodian);

¹⁴ Deutsche Bank Mumbai Branch's news letter, dated July 3, 1997.

3. remaining custodial deliveries and/or receipts are matched against the trading member receipts and deliveries; and,
4. finally, the trading member's deliveries are matched against other trading members' receipts through the clearing house.

The advantage of these special facilities for institutions is that, to the extent of intra-custodian and inter-custodian deliveries, trades are assured of settlement (see Figure 7.2).

Figure 7.2
Special Settlement Facilities for Institutional Investors



The clients of all custodians who are clearing members have been assigned codes by the exchange. In order to identify custodial trades, the trading system requires trading members to enter the custodial client code along with the order entry. The identity of the client is not known to the market. The data is used by the clearing system to identify a trade as a custodial trade. It is possible for a client to use more than one custodian in which event the codes will be distinct and separate. Custodians are connected to the exchange. At the end of each day, they receive a report of all trades done on behalf of their clients, which they are required to confirm. The last date for confirmation of trades is one day after the close of the trading period *i.e.* Wednesday. Any trades which are not confirmed by the custodians are reverted back to the trading member.

The confirmation of trades is an important part of the settlement process. Custodial clients are required to indicate to the trading members

the appropriate code so that the trading member can enter it during order entry.

Custodians had to develop software and modify their procedures to meet the exchange schedules. Almost all the leading custodians have now joined as clearing members and the process of confirmation and custodial settlement is already in place. This is of benefit both to institutions and trading members.

Institutional Lot Segment

The NSE has 'temporarily' suspended trading in this segment since 11 September 1996. The stock exchange is not expected to resume it now that the depository system has been in operation since December 1996.

The institutional lot segment was set up to activate an institutional market where large volume trades would take place in institutional board lots. (Trades executed for financial institutions, SEBI-registered FII's, banks and SEBI-registered mutual funds are considered as institutional trades.) An institutional board lot was also commonly known as a 'jumbo lot'. According to market participants in India, however, this was not well accepted in the market as discussed earlier in Section 4.7.2.

Trades in the institutional lot segment were allowed in multiples of 1,000 shares irrespective of the face value of the securities. Such share certificates were commonly referred to as 'jumbo certificates'. As with the normal market settlement (as discussed earlier in this Section), the trading period on the institutional lot segment was from Wednesday to Tuesday. A trading member could enter and monitor any security in this market segment just as in the normal market. The NSE generated delivery statements, as in the normal market, by multilaterally netting positions.

The settlement was different, however. Pay-in and pay-out of funds and securities were effected on the same day, the subsequent Tuesday, at the clearing house premises. All parties to the settlement of trades in this segment (institutions, custodians etc.) were required to come to the clearing house and exchange securities among themselves. Funds were paid into the NSE clearing account with the clearing bank (Canara Bank or HDFC Bank) on settlement day and paid out by the clearing bank on the same day.

There were two important conditions to be observed in the settlement of securities in this segment:

- securities could be delivered in market lots or in institutional board lots and the receiving member had to accept such delivery as good delivery.

- securities delivered had to be registered in the name of the delivering member and blank transfer forms were not allowed to be delivered.

Custodians were required to notify the clearing house of the successful exchange of funds and securities.

DVP-settled Trades

The NSE, unlike the BSE, does not have a separate “Negotiated Trade Segment”. However, transactions satisfying the following conditions are permitted to be settled on a DVP basis without going through the NSE Clearing House:

- transactions approved by the NSE;
- transactions the contract amount is more than Rs.5 million; and,
- transactions for spot or hand-delivery only.

A transaction executed in this segment is settled on a date determined by the parties to the transaction between themselves. The members report the settlement details to the NSE within 24 hours of the settlement.

There is a facility on the NSE’s trading system for entering a negotiated trade. The parties to the trade must enter an order for a negotiated trade on the system along with the counter-party identity. Once such an order is put in by both parties to the trade, the Market Watch Section of the NSE checks if the trade in question satisfies all the three conditions mentioned above, and, if it does, the section gives its approval and this results in a trade.

Trade-for-Trade Segment

Trades in this segment are kinds of negotiated trades designed for institutional investors and are settled trade-for-trade on a rolling basis. They are confirmed by T+3, and are settled on T+10 (10 working days) directly between institutions and/or their custodians without any involvement of the NSCCL, the NSE’s clearing house. However, settlement details have to be reported to the NSCCL within 24 hours of the settlement.

There is no concept of market lots in this segment and so delivery of shares of any lot size is required to be accepted by the receiving member. In other words, the delivering clearing member (the selling broker or

custodian) can make the delivery of shares in settling a trade in the segment in any one of the following lots at his or her choice:

- marketable lots;
- certificates of denominations of 1,000 shares; or
- certificates of the denomination of the traded quantity (only regular market deals).

7.2.5 Negotiated Trades

What Indian market participants mean by 'negotiated trades' or 'negotiated deals' in a broad sense is not only off-the-market transactions whose execution prices are negotiated off the market, but also ordinarily-priced transactions whose delivery terms are negotiated by the counterparties (DVP-based transactions). Therefore, it is better to assume that negotiated trades in the Indian context include all the following:

- hand-delivery trades among BSE members;
- trades in the Negotiated Trade Segment of the BSE;
- DVP-settled trades on the NSE; and
- trades in the trade-for-trade segment of the NSE.

Negotiated deals are very popular in Indian markets, and are closely associated with settlements on a delivery versus payment basis. This is because the majority of FIIs who generally deal in huge lots prefer to trade and settle on a DVP basis rather than through the clearing house, though settlements through the clearing houses have been rapidly increasing. Brokers also favor negotiated deals to avoid settlement troubles including objections of transfer.

7.2.6 Reports

Execution Confirmation

The local broker who executes orders normally reports all executed transactions to the FIIs by fax immediately after trading hours. Some brokers are willing to confirm them via faxing a transaction upon the execution of orders.

Contract Notes

Original contract notes for FIIs have to be forwarded to their custodians usually after the closing of the market, with copies being sent directly to

the FIIs by the local brokers who executed the transactions on their behalf.

Settlement Confirmation

The custodian sends a settlement confirmation to his or her FII client and his or her broker via SWIFT¹⁵, fax or telex.

Account Statement

The broker and the custodian both mail or courier an account statement to their FII client on a fortnightly or a monthly basis as per the FII's requirements.

7.3 Delivery versus Payment

7.3.1 DVP and Clearing House

The term 'delivery versus payment' (DVP) is also commonly used but loosely defined in India. What is called a DVP settlement can refer to a settlement in one of the four following cases:

- (1) The selling custodian or broker settles a trade directly with the buying custodian by delivering securities against a payment.
- (2) The selling custodian or broker settles a trade directly with the buying broker by delivering securities against a payment.
- (3) The selling custodian settles a trade with the selling broker by delivering securities against a payment.
- (4) The buying broker settles a trade with the buying custodian by delivering securities against a payment.

Cases (1) and (2) are relevant to negotiated trades. Cases (3) and (4) can take place as part of the settlement process through the clearing house.

¹⁵ A consortium of U.S. and European banks joined forces in 1973 to establish a set of data processing and computing standards for communications among banks. Today, the Society for Worldwide Interbank Financial Telecommunication, called S.W.I.F.T., operates the largest, cross-border system in the world for exchanging banking-specific electronic messages. S.W.I.F.T. currently operates in 130 countries. Every day it processes an estimated \$2.5 trillion in payment instructions among nearly 5,000 banks and other institutions that are co-owners of S.W.I.F.T.

In a DVP-based transaction, the buying custodian pays only within 48 hours after he or she has confirmed that the delivery is a good delivery in all aspects; the selling custodian does not release the sold securities until the cheque that he or she receives has been honored. Additionally, many FIIs are encouraged or bound by their trust deeds, internal or other rules not to part with the funds unless securities have been received. Given the current settlement system in India, with exceptions of Sunshine Segment on the BSE and the book entry segment on the NSE, it is impossible to meet such requirements by settling trades through the clearing house.

The fact that a trade is settled on a DVP basis does not always mean that there is no settlement through the clearing house; actually, a trade may be settled *via* DVP between the selling custodian and the selling broker and between the buying broker and the buying custodian, and through the clearing house between the selling and buying brokers (Cases (3) and (4) above; See Figure 7.3 and Table 7.5).

For a DVP settlement in Case (4), the buying broker delivers shares at the counter of the buyer's custodian bank by prior appointment. The custodian bank checks the physical delivery of share certificates and their filled-in transfer deeds and verifies them for good delivery. This procedure involves the actual counting of share certificates and scrutiny of transfer deeds, ensuring receipt of dividend on non *pari-passu* shares and securing the client's interests in corporate actions. This is accomplished by ensuring that shares can be processed and sent for registration prior to the book closure and record dates. Payments are usually made to brokers by 11:00 a.m. on the day after the receipt of shares and after the custodian banks are satisfied that the shares are in good deliverable form.

Figure 7.3
When a Trade Settles via DVP...

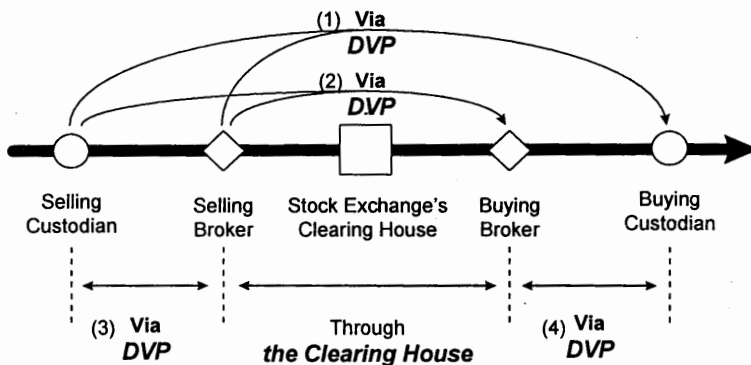


Table 7.5

Settlement Procedures via DVP & Clearing House (Cases (3) & (4))

Assumptions:

- FII(S) has sold securities safe-kept with Custodian(S) through Broker(S).
- Investor(B) has bought the securities to be safe-kept with Custodian(B), through Broker(B).

	Step 1.	Broker(S) pays funds to Custodian(S).
	Step 2.	Custodian(S) delivers securities and filled-in transfer deeds to Broker(S) in the premises of Custodian(S).
	Step 3.	Broker(S) checks the securities and the filled-in transfer deeds received.
	Step 4.	Broker(S) accepts the securities and the filled-in transfer deeds.
Pay-in Day	Step 5.	Broker(S) delivers the securities and the filled-in transfer deeds to the Clearing House.
	Step 6.	The Clearing House counts the securities received. (Short delivery is immediately returned to Broker(S) for rectification.)
	Step 7.	Broker(B) pays funds to the Clearing House.
Pay-out Day	Step 8.	The Clearing House pays funds to Broker(S).
	Step 9.	The Clearing House delivers the securities and the filled-in transfer deeds to Broker(B).
	Step 10.	Broker(B) checks the securities and the filled-in transfer deeds received. (Bad delivery is immediately returned to the Clearing House for rectification.)
	Step 11.	Broker(B) accepts the securities and the filled-in transfer deeds.
	Step 12.	Custodian(B) receives the securities and the filled-in transfer deeds from Broker(B) on the premises of Custodian (B).
	Step 13.	Custodian(B) checks the securities and the filled-in transfer deeds received.
	Step 14.	Custodian(B) accepts the securities and the filled-in transfer deeds.
	Step 15.	Custodian(B) pays funds to Broker(B) within 48 hours.
	Step 16.	Custodian(B) sends the securities and the filled-in transfer deeds to the transfer agent.
	Step 17.	The transfer agent checks the securities and the filled-in transfer deeds.
	Step 18.	The transfer agent accepts the securities and the filled-in transfer deeds, and registers the securities.
	Step 19.	Custodian(B) receives the registered securities from the transfer agent.

Institutional investors used to prefer trades on a DVP basis to those through the clearing house as the former gave them more protection from settlement troubles than the latter. This held true especially in the case of trades on the BSE because the BSE's clearing house, unlike the one of the NSE, neither facilitated nor ensured timely rectification of settlement

problems in the past. FIIs preferred DVP settlement even if they had to pay a premier brokerage for it (see Section 7.3.2). Now that SEBI has imposed a water-tight rectification procedures of settlement problems on all stock exchanges and the BSE's clearing house has also instituted a trade guarantee system, institutional investors' preference has been shifting to settlements through the clearing house of a stock exchange from DVP settlements.

One disadvantage of DVP settlements is that the clearing house of a stock exchange does not directly help to guarantee or ensure that trades settle properly. For trades settling via DVP, parties concerned, such as brokers and custodians, have to fix short and bad deliveries by themselves. For trades settling through the clearing house, however, the NSE's clearing house provides a counter-party guarantee (see Section 7.4.6). The BSE's clearing house intermediates when rectification of short and bad deliveries is needed (see Sections 7.4.2 and 7.4.3), and guarantees a counter-party risk as its proposed trade guarantee fund has become operational.

7.3.2 Funding by Brokers

Premium Brokerage for DVP

For DVP trades, Indian brokers charge a premium brokerage of 0.75-1.00%, as compared to 0.25-0.75% for trades with settlement through the clearing house. This is because brokers have to fund such trades for facilitating DVP settlement with investors (or their custodians), currently at 24-36% *per annum*. In Table 7.5, Broker(S), the selling broker, has to fund the transaction from Step 1 to Step 8, and Broker(B), a buying broker, has to fund the transaction from Step 7 to Step 15.

Custodians versus Brokers

There are two more aspects in the settlement process that may affect the brokers' financial position. First, Broker(S), a selling broker, pays funds by cheque in Step 1. Custodian(S), the seller's custodian, makes sure that the cheque is honored before he or she releases the securities to Broker(S). If Broker(S) pays by a bank cheque, the securities are released immediately. Broker(S)'s funds float in a no-interest bearing account for a few days.

The second aspect is how soon Custodian(B), the buyer's custodian, pays to Broker(B) in Step 15 after the custodian has checked and accepted the securities along with the filled-in transfer deeds. An article appearing

in the Economic Times on 15 August 1996 said "It will be mandatory for all custodians to make payments within 48 hours for shares delivered. Currently, some custodians take up to 72 hours to release payments". Accordingly, there is some room for the custodians to enjoy the float for one or two days at the expense of the brokers (and ultimately at the expense of the investors through a higher commission rate, at least in theory).

7.3.3 Partial Delivery

A short delivery gives rise to a partial delivery in the case of trades that settle on a DVP basis. A partial delivery is not an issue for trades that settle through the clearing house, because any short delivery is auctioned or closed out in the prescribed time-frame.

FII's usually do not accept a partial delivery. If an investor agrees to such a delivery, a custodian may entertain it subject to prior confirmation from his or her FII client. As part of the SEBI-announced uniform practice, partial settlements of trades are permitted¹⁶ on the condition that the first delivery be of a minimum of 50% of the entire trade, and that the balance be delivered in one lot within 15 days of the first delivery.

7.3.4 Delayed Settlement

A delayed settlement may occur in the case of a DVP settlement between the broker and the custodian or the investor. The broker is supposed to settle trades with the custodian or investor on a settlement date right after the pay-out. The broker sets the settlement date in consultation with his or her client. A custodian's experience indicates that brokers normally fix the delivery date within 2 to 3 days of the pay-out day, allowing for the rectification of any bad and/or short delivery of securities that they receive from the clearing house.

To avoid delayed settlements, the custodian follows up with the broker over the phone and/or other means prior to a settlement date. If the trade fails, the custodian and the broker set up another settlement date. The investor and/or the custodian keep a note of the broker's track-record and monitor his or her performance for future reference.

¹⁶ "SEBI prescribes uniform rules for DVP trades", *The Financial Express*, October 4, 1996.

7.4 Settlement Troubles

7.4.1 Battles against Settlement Troubles

Settlement troubles that often occur in the Indian stock market can generally be categorized as follows:

- short deliveries;
- bad deliveries; and
- objections to transfer.

Short and bad deliveries will be discussed extensively in the following sections, and objections to transfer separately in Section 7.5.3.

The chance of settlement troubles in the Indian stock market used to be notoriously high. A war against such troubles has been fought on two fronts: prevention of troubles before they occur, and rectification of troubles once they occur. Various measures have been taken with success.

Settlement troubles in the Indian stock markets come about as a result of a combination of many factors, which include paper-based transactions, under-developed infrastructure, widely scattered corporate headquarters across the huge country, poor discipline and internal control of some market participants, etc. In spite of transactions being based on physical certificates, safe-keeping of certificates with brokers would lessen the need for their physical hauling around. However, this system is not popular in India. Asked why, a custodian answered that Indian investors did not trust their brokers to safe-keep their shares for them. One Indian broker points to the high level of speculation on the markets as the main cause of such settlement troubles, especially short deliveries. As mentioned in Section 4.5.5, the Indian stock markets are highly speculative. When a speculator fails to square up his or her positions within the settlement, it more often than not results in a short delivery.

7.4.2 Short Delivery

A short delivery takes place when a broker, a custodian or the clearing house delivers fewer securities than what were contracted for either to another broker, a custodian or the clearing house.

Let's assume that a broker sells 1,000 XYZ shares of Rs.10 face value on the market and delivers them to the clearing house. The broker is supposed to deliver 20 lots of 50 XYZ shares or 10 lots of 100 XYZ shares with a duly filled-in share transfer form (transfer deed) for each

lot. On the pay-in day the selling (delivering) broker normally makes a voluntary disclosure of his or her short deliveries (if any) to the clearing house on a covering sheet which is attached to the deliveries,. The clearing house staff also physically count the XYZ shares delivered to ascertain the number of shares is what was contracted for. If, for instance, there are only 950 share certificates, the delivery is short by 50 shares. It must be noted that the clearing house does not check the securities for bad delivery but just counts the shares (Step 6 in Table 7.5).

Short deliveries between the clearing house and the broker are taken care of by the 'Buy-in' procedures that will be discussed later in Section 7.4.4.

Short deliveries between the custodian and the broker, or between brokers, have no specific time limit within which these must be rectified. An FII's custodian usually does not accept a partial delivery without the FII client's consent, and, consequently, does not pay the funds (see Section 7.3.3) in a DVP-based transaction. If the securities are to be delivered to the clearing house, a delay in rectification may result in an automatic auction by the clearing house.

7.4.3 Bad Delivery

Definition of Bad Delivery versus Objection of Transfer

A bad delivery is a delivery of share certificates and their accompanying transfer deed that have an obvious defect, such as the absence of a broker's stamp from the transfer deed, which would apparently disqualify the ownership of the share certificates from being transferred to the buyer of the share (an objection of transfer) (see Section 7.5.3) if these are submitted to the company's transfer agent for registration of the transfer.

It is easy to get confused about the term "bad delivery" because it is used in two senses:

- (i) a *prima facie* defective delivery, and
- (ii) an objection of transfer.

The former generally takes place when the buying broker or custodian rejects share certificates, while the latter occurs when the company rejects the share certificates submitted to it for registration. Documents published by the NSE tend to distinguish "bad delivery" from "objection of transfer" clearly, but those from SEBI or the press do not. Though confusing, the usage of "bad delivery" for a objection of transfer is not necessarily incorrect. As long as an objection is justifiable, such as when

the shares are fake, forged or stolen, the original delivery is a bad delivery. It is in this sense that the term is used in the phrase "Bad Delivery Cell" (see Section 7.5.3).

Naturally, there will neither be bad deliveries nor objections of transfer in a segment where only shares in a book entry form are dealt with; namely, the Book Entry Segment of the NSE.

Curb on Irrational Claims of Bad Delivery

An objection of transfer usually results in a painstaking and time-consuming rectification process (Section 7.5.3). If defective share certificates or transfer deeds look likely to lead to an objection of transfer, the delivered share certificate is usually rejected on the grounds of bad delivery as a precautionary measure. This now happens so often that people have become suspicious of each other's delivery and this suspicion tends to mess up the whole system¹⁷. To overcome this problem, SEBI introduced on 16 July 1996 an elaborate uniform code of good and bad deliveries, "SEBI Approved Good/Bad Delivery Norms", in order to curb irrational claims of bad delivery and avoid unnecessary confusion in the Indian capital markets. Previously, individual exchanges laid down their own norms, which led to many delivery disputes. There are 109 norms, some of which are shown in Table 7.6.

Rectification of Bad Delivery

The buying broker member collects deliveries of securities along with the filled-in transfer deeds from the clearing house on the pay-out day, which is Monday for trades executed on either BSE or NSE.

For trades on BSE, the buying broker or custodian immediately checks the securities and the accompanying transfer deeds, and has to report a bad delivery (if any) to the BSE's clearing house by the end of the following Tuesday. The selling broker collects the bad delivery for rectification on the following Wednesday. The selling broker rectifies the delivery or gives a non-rectification notice to the BSE's clearing house by

¹⁷ Indian people used to obsessively turn down damaged Rupee notes in their daily transactions. They carefully checked the notes that they were receiving and the discovery of insignificant, inconsiderable damage on the Rupee notes prompted the receiver to reject them. A 5-millimeter rip on the edge of a note or a 10-millimeter diameter taint at the corner would frighten humble shoppers, taxi drivers, rikshawalas, shop clerks and even tellers of banks. Such slightly damaged notes tended to end up in the hands of innocent foreign tourists.

Table 7.6
Extract from SEBI APPROVED GOOD/BAD DELIVERY NORMS

No.	Description	Good/Bad
2	<p>Mutilated Transfer Deed with the signatures of the transferor, witness, directors and officer of the Company / distinctive numbers / any material portion badly torn overwritten, or defaced.</p> <p>Typical Cases:</p> <p>A) Material portion defined here only pertains to the material portion at the time of delivery and not prospective one. For a buyer Consideration column, Specimen signature column, Name, Address, Occupation will also be the material portion. Material portion includes of transferor's name and signature, company name, folio no., certificate no., distinctive nos., number of shares, name and signature of the transferee, specimen signature of transferee.</p> <p>B) Transfer Deed torn in the prospective material portion</p> <ul style="list-style-type: none"> • Torn and pasted with self-adhesive tape on which the required details can be filled in without any difficulty. • Transfer Deed torn in non-material portion and held together by a transparent tape • Transfer Deed torn end-to-end at any angle 	<p>BAD</p> <p>GOOD</p> <p>GOOD</p> <p>BAD</p>
19	Shares sold by FIIs and transfer deed signed by a Custodian on behalf of the FII. (Copy of RBI approval is not required to be attached with each market lot).	GOOD
74	<p>Share certificates defaced or mutilated in portion: The following will be considered as material portion in the case of share certificate:</p> <p>(i) Share certificates torn end-to-end and pasted with transparent self-adhesive tape</p> <p>(ii) Where shares have been transferred to a new holder and if torn at the original holders name portion</p> <p>(iii) Folio number and name overwritten in one or two characters and not authenticated by the authorized signatory</p> <p>(iv) If the share certificate is torn at the company name portion but is decipherable</p>	<p>BAD</p> <p>BAD</p> <p>GOOD</p> <p>GOOD</p> <p>GOOD</p>
91	Share Certificate and Transfer Deed not attached together.	BAD

the following Thursday. The buying broker or custodian collects the rectified delivery from the clearing house on the following Friday. If the selling broker fails to rectify the bad delivery, the securities are auctioned off (see Table 7.2 and Step 10 in Table 7.5).

The NSE member checks the securities and the accompanying transfer deeds and has to report a bad delivery to the NSE' clearing house by Friday noon. The selling broker is given back the bad delivery on Saturday and is required to rectify it by Monday (in practice by Tuesday noon at the latest). If the selling broker fails to do so, the securities are auctioned on Wednesday.

NSE imposes a penal interest on a bad delivery until rectification, and also charges the defaulting member a penal point that results in fines and even suspension. Bad deliveries that remain unrectified and become due for auction account for less than 0.5% of all trades on this exchange¹⁸.

7.4.4 Buy-in

Buy-in by the BSE's Clearing House

In order to efficiently dispose of short and bad deliveries or objections of transfer that have taken place, the clearing houses of the stock exchanges have buy-in procedures in place. The buy-in process generally starts with an auction for the shares that have not been delivered, rectified or replaced, and is followed by a closing-out (squaring-off) of the transaction if the auction is unsuccessful. Earlier BSE used to be clearly behind NSE in this area, but that is no longer the case.

The buy-in process for shares traded in the ordinary settlement segment of BSE has been discussed in Section 7.2.3, namely "Settlement through the Clearing House".

The rolling settlement segment (Sunshine Segment) has a slightly different procedure. No auction for short delivery is conducted in this segment; instead, short deliveries are directly closed out at the close-out rate.

Table 7.7 gives the close-out rates applicable to short deliveries, bad deliveries and objections of transfer in the ordinary settlement and "Sunshine" segments of BSE.

¹⁸ "Clearing and Settlement System, Credit Market" by National Stock Exchange of India Limited.

Table 7.7
Close-out Rates on BSE

	<i>Ordinary settlement segment</i>	<i>Sunshine segment</i>
Short delivery	The highest price for the shares from the trade day till the day of auction or 20% above the closing price on the day of auction, whichever is higher	The highest price for the shares from the trade day till the day of auction or 20% above the closing price on the day of auction, whichever is higher
<i>Prima facie</i> bad delivery	The highest price for the shares from the trade day till the day of auction or 20% above the closing price on the day of auction, whichever is higher	
Objection of transfer	20% above the closing price on the day of auction	20% above the closing price on the day of auction

Source: BSE.

Buy-in by the NSE's Clearing House

The buy-in process for shares traded in the NSE's normal market segment was explained in Section 7.2.4, "Normal Market Segment"

NSE imposes a penal interest applicable until the shortage is either made up through auction or the deal is squared off. The exchange also charges the broker some penalty points under the penalty point system which will result in fines and even suspension. According to NSE, only 1% of all trades on the exchange normally result in auctions¹⁹.

The book entry segment of NSE also has a buy-in procedure that is slightly different from that in the normal market segment. This is because all trades in the book entry segment are settled through account transfer, and also on a daily rolling basis. All short deliveries on the settlement day are auctioned on the next trading day and settled on a T+2 basis. Then, short deliveries that are left unmatched are closed out. Neither bad deliveries nor objections of transfer are expected.

Table 7.8 shows the close-out rates applicable to short deliveries, bad deliveries and objections of transfer in the normal market and book entry segments of NSE.

¹⁹ *Ibid.*

Table 7.8
Close-out Rates on the NSE

	<i>Normal market segment</i>	<i>Book entry subsegment</i>
Short delivery	The highest price for the shares from the trade day till the auction day or 20% above the closing price on the auction day, whichever is higher	The highest price for the shares from the trade day till the auction day or 20% above the closing price on the auction day, whichever is higher
<i>Prima facie</i> bad delivery	The highest price for the shares from the trade day till the auction day or 20% above the closing price on the auction day, whichever is higher	Not applicable
Objections of transfer	20% above the closing price of the auction day (after the rectification period of 21 days)	Not applicable

Source: NSE.

Buy-in for DVP

There exist no formal buy-in procedures for DVP trades. As discussed in Section 7.3.1, DVPs occur between the brokers for all hand-delivery trades, and may occur between a broker and a custodian even for trades settling through the clearing house when investors elect DVPs.

Since nothing prohibits a contractual arrangement for a buy-in between the parties concerned, some brokers and custodians make such arrangement before they start business with each other.

7.4.5 Precautionary Measures

Careful brokers and custodians take some precautionary measures in order to reduce the probability of settlement troubles. Such measures include:

- Dealing only with well-known and reputed brokers;
- Avoiding deals where many brokers are involved;
- Settling trades through the clearing house to ensure the guarantee of trades done;
- entertaining orders only from investors with good references;

- Collecting funds or securities from the broker or the custodian (or the investor) before the pay-in day; and
- Following up with the brokers prior to the settlement so as to confirm their actual ability to deliver.

7.4.6 Counter-party Guarantee

Settlement Guarantee Fund

The counter-party of a broker or an investor may make a short or bad delivery, or may fail to pay for the shares purchased, and may further fail to rectify these in a timely manner. In such a case, the counter-party is in default. However, a broker or an investor trading on NSE is substantially indemnified from any loss arising from such a default, thanks to the Settlement Guarantee Fund. This fund was set up by the National Securities Clearing Corporation Limited (NSCCL) in June 1996 in order to financially underpin the guarantee against settlement risks. It is the first one of its kind in India²⁰.

NSE set up NSCCL as its clearing house for trades executed on the exchange. The clearing house guarantees timely settlement of all trades in the normal market segment. All NSE member brokers and custodians have been required to participate in the clearing house system since October 1996 as either a clearing member or a custodial participant, and to settle their trades through the clearing house. Custodial participants are typically banks, financial institutions, mutual funds or large corporations. A custodian registered as a clearing member is responsible for settling funds and securities of a custodial participant that has a custodial account with it²¹.

It is the Settlement Guarantee Fund that the NSCCL taps to instantaneously finance a pay-out of funds or securities till the clearing house collects monies that a defaulting member owes it. NSCCL thus assumes the role of a buyer to all sellers and a seller to all buyers. It takes over the defaulting member's obligation to pay funds or deliver securities, and completes the pay-in process in a prescribed manner. If a defaulting position is successfully auctioned, the buying member assured of the timely delivery of securities that he or she bought; or the selling member

²⁰ NSE web site: <http://www.nseindia.com/htdocs/nscccl/object.htm>.

²¹ NSE's memo *Clearing and Settlement Procedure*, with no date, obtained in April 1997.

assured of timely payment for the securities that he or she sold. In case the auction is unsuccessful and the position is then squared off, the clearing house will promptly return to the buying member the money that the buying member paid in; or it will immediately return to the selling member the securities that the selling member delivered and will pay the difference (if any) between the sale price and the close-out price of the securities²² (see Section 7.2.4). Thus, there is neither any significant opportunity loss nor financial loss to the buyer or the seller due to a default of his or her counter-party.

There are three cases in the whole settlement process where an auction and close-out (squaring-off) may be necessitated and, consequently, the counter-party may default. These events are:

- Short delivery;
- Bad delivery; and
- Objection of transfer.

The fund was initially designed to cover counter-party defaults arising from any of the three events. However, the clearing house surprised the market by withdrawing the coverage against an objection of transfer in July 1997²³. This part of the settlement guarantee thus no longer exists (see “Rectification of Objected Certificates” in Section 7.5.3).

A part of the cash and security deposit that a new NSE trading member places with the exchange (see Section 4.4.2) is set aside as an initial contribution to the settlement guarantee fund. The present size of the fund is approximately Rs. 3 billion (US\$ 84 million). As the trading volume on the exchange rises, the members will be required to make additional contributions²⁴.

A defaulting member is levied a penal charge at the rate of 2% per month for the first two days and 3% per month thereafter on the amount outstanding from the day the money is due till all obligations are discharged²⁵.

The NSE also has a separate fund known as the investor’s compensation fund, into which a certain amount is mandatorily contributed by the members.

²² NSE web site, *op. cit.*

²³ The NSE press release “NSE Restricts Settlement Guarantee Only Upto Pay-Out”, dated July 22, 1997.

²⁴ NSE web site, *op. cit.*

²⁵ NSE web site, *op. cit.*

Trade Guarantee Fund

BSE has finally put in place an effective counter-party guarantee mechanism. The BSE's clearing house, unlike the one of the NSE, did not and does not guarantee trades against either bad or short delivery caused by the counter-party. Therefore, SEBI made the expansion of the BOLT²⁶ outside Mumbai subject to the condition of setting-up of a trade guarantee fund that would ensure the timely settlement of all trades executed on BSE. In May 1997, the trade guarantee fund was approved by SEBI and came into operation after the minimum fund requirement of Rs. 600 million (approx. US\$ 17 million) was contributed by BSE. Under this scheme, the exchange, instead of its clearing house, offers guarantee to trade through the fund.

The trade guarantee fund was designed to have an "initial" capital of Rs. 1,725 million²⁷ (approx. US\$ 48 million) comprising:

- (i) the exchange's initial contribution,
- (ii) members' initial contribution,
- (iii) members' continuous contribution based on each member's turnover (at 0.00075% of trade value²⁸), and
- (iv) income from investment of the capital.

However, of the four components of the "initial" capital, only the exchange's initial contribution was fully funded at the beginning. As in August 1997, only about one-third of all BSE members had submitted bank guarantees for members' initial contribution.

The Defaulters' Committee, consisting of BSE members' representatives and outsiders in the ratio of 40:60, has complete control over the management and administration of the fund. When a BSE member fails to pay any amount due to the clearing house, the governing board or the president of the exchange will declare the member a defaulter within 24 hours of such failure, and the committee will then authorise the fund to pay the due amount directly to the clearing house. The committee will recover the amount, with interest at 2.5% per month²⁹ from the defaulter member.

²⁶ Bombay Stock Exchange On-Line Trading system.

²⁷ "BSE's trade fund to come into force from May 12", *The Economic Times*, May 11, 1997.

²⁸ "Damani in Delhi to push BOLT expansion plan", *The Financial Express*, May 9, 1997.

²⁹ A note "Trade Guarantee Fund", the BSE, May 1997.

BSE's clearing house has expressed its intention to join the NSE's depository system as a depository participant. However, the working of the fund appears to throw an obstacle to the clearing house's participation in the depository system. A review and decision on each default case by the Defaulters' Committee, however, makes it difficult to fully assure that securities and funds get transferred in twenty-four hours³⁰, the time stipulated under the NSE's depository system; and, the pay-in and pay-out days in the book-entry segment of the NSE fall on the same day.

7.5 Registration of Ownership

7.5.1 Registration for Transfer

Once a trade duly settles, delivered shares can either be sold again in another transaction and delivered to the next buying broker or custodian as long as their transfer deed is valid (see Section 7.2.2), or sent to the registrar or the transfer agent of the issuer for registration.

Title to a share certificate passes by delivery. However, only those who are registered with the company as shareholders on the record date are entitled to various rights, including the right to share in profits of the company by way of dividends, the right to share in its assets upon dissolution, the right to vote, and the remedial rights. Registration of ownership of shares entitles shareholders to various corporate actions.

Shareholders who wish to register as shareholders have to deliver share certificates together with transfer deeds (see Section 7.2.2) to the company or its transfer agent for a transfer of shares in or debentures of the company.

Securities purchased by an FII shall be registered:

- (i) in the FII's name where the FII may be acting for itself or the funds managed by it, or
- (ii) in its name for the account(s) of its sub-accounts if it is a power-of-attorney holder or fund manager provided it has disclosed the names of the sub-accounts for whom it is holding the power of attorney.

³⁰ "BSE entry into depository hinges on counter-party risk", *The Financial Express*, June 17, 1997.

7.5.2 Time for Registration

Section 113 of the Companies Act provides that securities be transferred within two months; the listing requirements of the stock exchanges lay down a transfer period of one month. In practice, most companies take 30 to 45 days to complete the transfer process. There are, however, many cases where the process actually take 60 days, and sometimes even longer.

Such delays obviously cause problems to investors. During the transfer period, the shareholder is not able to sell his or her shares for an unreasonably long period since the share certificates are not in his or her possession. If the delivery is a bad one and there is objection to the transfer, the unnecessary passage of time may make the rectification of the objection more troublesome.

Some custodians address such delays by closely monitoring the process for their clients. In addition, guidelines were set among Indian registrars in August 1996 that:

- the registrars would intimate the custodians the status of deliveries within seven days of the submission of share certificates;
- in the case of objections (see Section 7.5.3), the registrars would be required to return the shares within seven days; and
- good deliveries would be transferred and sent back to transferees within 30 days”.

A long transfer period exposes a shareholder to market risks that cannot be hedged under the current circumstances of the Indian capital market. The price of the shares can decline substantially during the transfer period even as the shareholder cannot sell off his or her holdings in the market during that period. The practice of lending and borrowing of securities lending which would facilitate short sales is not yet available in the Indian market though there are plans to establish such a system in an effort to provide more stability and liquidity in the market in accordance with the G30 recommendations (see Section 5.4). The *badla* system on BSE, however, does to some extent fill in this gap for domestic investors other than the mutual funds (see Section 4.3.8). Of course, the FII Guidelines explicitly prohibit FIIs from any short sale of shares (see Section 2.3.6).

7.5.3 Objection to Transfer

Reasons for Objections

An objection of transfer is also referred to as an objection of registration, a company objection or, simply, an objection. It is also, wrongly, called a bad delivery (see Section 7.4.3).

It is not uncommon for the transfer agent to object to the registration of the transferee as a new shareholder of the company on the grounds that the transferee has failed to establish his or her ownership of the share certificates. The transfer agent often assumes that the share certificates submitted for transfer are stolen, forged or have been illegally sold. Then, the transfer agent returns the share certificates to the buying FII's custodian. The technical reasons for such objections are bad deliveries that have been overlooked by either the broker or the custodian and some other defects of the share certificates that only the transfer agent is able to notice. These defects include:

- Mismatching of any of the distinctive number Range ("DNR"), the certificate number or the registered folio number with those on the company's register.
- Signature difference.
- Stolen certificates.

Problematic Objections

Market participants observe that on average 8-12% of shares submitted for transfer are denied registration and returned. A custodian bank claims that its objection rate is 2%, thanks to its careful check of certificates and documents. It is said that the objection rate is on the increase; more and more stolen share certificates have been slipping into the system as the recent economic reform has made Indian criminals realize the pecuniary value of share certificates. As is the case with bad deliveries, people get caught in a vicious cycle of suspicion. Transfer agents are inclined to return share certificates under objection for questionable reasons. Unfortunately, there are also some companies in India that are known for unreasonable objections.

Rectification of Objected Certificates & Bad Delivery Cell

Objections of transfer used to be settled between the selling and buying brokers and/or custodians. There was no time limit for rectification of objected certificates and these typically took many months to rectify. This was

one of the notorious features that kept away foreign investors from the Indian stock market. The rectification process was more problematic in the case of trades involving brokers from different exchanges. However, the Indian capital market has seen a remarkable improvement in this area.

In order to ease the problem of the cumbersome rectification of objections, SEBI has mandated the creation of a bad delivery Cell (BDC) at each stock exchange. This cell is intended to play the role of a centralized bad delivery rectification agency, and is presumably modeled after the NSE's objection rectification procedure which has already been in place and functioning well. The BDC intermediates the rectification process of objections between the buying and the selling brokers whether belonging to the same exchange or different stock exchanges.

BSE set up its BDC in December 1997. The buying broker submits objected share certificates to the BDC every Tuesday. Remember that *prima facie* bad deliveries are also reported on Tuesday (see Section 7.2.3. and Table 7.2). If the selling broker fails to rectify these within 21 days of receipt of the objected share certificates, or the rectified share certificates come under objection for the second time, the BDC auctions off such shares. The transaction that has not been matched through the auction is squared off at 20% above the closing price on the day of auction³¹. The whole process will be completed within a maximum of 45 days. It should be noted that only trades settling through the clearing house enjoy the benefit of the BDC; objections resulting from trades settled on a DVP basis have to be rectified in the same manner as before – between the selling and buying brokers.

NSE has laid down a tight schedule for the rectification of objected certificates. Such cases are required to be reported to the NSE clearing house. According to NSE's schedule, the selling broker is given 21 days to rectify the objected shares. If the buying broker fails to do so, the shares will be auctioned off in the auction session that follows immediately after, according to the exchange's routine auction schedule. (An auction of an unrectified objection fits into the exchange's routine auction schedule.)

³¹ *cf.* "the highest price of the shares in the last six months or highest of ex-date price, whichever is later, or 20% over the closing price on the last rectification day" (Section 1.5 of Procedure for Handling Intra-Exchange and Inter-Exchange Company Objections through Bad Delivery Cell (BDC), SDM/Policy/4296/96, dated October 4, 1996).

On NSE, auctions are held every Wednesday (Day 22 in Table 7.3). Those objected share certificates whose rectification period of 21 days expired during a week period from the preceding Tuesday (Day 14) to the preceding Monday (Day 20) are auctioned off on that Wednesday (Day 22), and are paid-out on the following Friday (Day 24). In case the rectification period of 21 days expires on Tuesday, the objected share certificates are auctioned off or the unsettled transaction is closed out by the 30th day (= 21 + 9) from the date on which the selling broker acknowledged the objection. The close-out rate is 20% above the closing price of the auction day³². If the 21st day falls on Monday, the problem is solved by the 25th day.

An increasing number of faked, forged or stolen share certificates have been entering into the Indian clearing system. These have resulted in objections of transfer, and have caused the clearing house considerable losses when the brokers who introduced such certificates failed to rectify them. The total amount of faked shares that NSE and its clearing house had detected since its inception reached Rs. 250 million as in June 1997. In 1996-97, the clearing house could not recover Rs. 50 million and wrote it off as a loss³³. In order to restrain unscrupulous members from introducing defective share certificates, NSE demanded personal indemnity bonds in favour of the clearing house against losses arising from the introduction of such share certificates into the clearing system from the dominant shareholders and/or partners of its trading members. The majority of the trading members stoutly opposed NSE's demand. After repeated postponements of the deadline for submission of the personal indemnity bond, NSE finally dropped the demand on 22 July 1997 but simultaneously withdrew the coverage of the settlement guarantee fund from losses arising from objections of transfer.

7.5.4 Registration Cost

The basic cost involved in registering share certificates is the stamp duty at 0.50% of the contract value or the market value at the previous day's

³² "SEBI revises norms for unrectified bad deliveries", *The Financial Express*, December 17, 1997 (On some occasions in this article like the headline, the term "bad delivery" is used for the meaning of objection.)

³³ "NSE lifts June 15 deadline for indemnity bonds", *The Financial Express*, June 13, 1997, and "Brokers need not fear NSE indemnity bond", *The Financial Express*, June 14, 1997.

closing price, whichever is higher. Some custodians frank the transfer deeds, and others charge additional costs of dispatching the share certificates by courier to the registrar.

It must be noted that the registration of a physical certificate of shares is subject to stamp duty, but the transfer of registered ownership of shares through a depository is not liable for any stamp duty³⁴. On the other hand, when a beneficiary owner of shares opts out of a depository and asks the issuing company to issue a new share certificate, stamp duty is payable on such a new share certificate and a fee is payable to the company or its transfer agent³⁵.

Stamp duty is payable at the time of registration of the shares. In practice, the registered owner of shares, when he or she sells the shares, affixes share transfer stamps of an appropriate rupee amount on the front of a share transfer form (transfer deed). A stamped transfer deed is valid for registration of ownership until the first book closure date or within 12 months after the transfer deed was stamped, whichever is later³⁶. In the event of the transfer deed becoming outdated for one reason or another, the shares will have to be sent for registration in the buyer's name and stamp duty will be paid by the buyer. Subsequently, the share will come back transferred in the buyer's name.

Stamp duty will be discussed again in Section 10.5.

7.5.5 Transfer Agents

There are numerous transfer agents in India, and many of the large ones are affiliated to the larger Indian business houses, like Tata and Reliance. The major eligibility criteria for transfer agents is :

- minimum paid-up capital of Rs. 1,000,000; and
- registration with SEBI.

Consequently, the transfer agent business is one with low entry barriers and many companies have an in-house department that takes charge of the transfer processes.

³⁴ Section 8A of the Indian Stamp Act, 1899. (Part I of the Schedule to the Depository Act, 1996).

³⁵ Section 8A (b) of the Indian Stamp Act, 1899. (Part I of the Schedule to the Depository Act, 1996).

³⁶ Section 108 (1A) (b) (i) of the Companies Act, 1956. This provision applies to listed shares. For unlisted shares, a transfer deed is valid for 12 months after it is stamped. (Section 108 (1A) (b) (ii), *Ibid.*).

The general problem investors face with transfer agents is the time taken by many of them to return shares after the transfer (see Section 7.5.2). In India, stock markets have yet to become paperless and investors are, by and large, reluctant to have their shares safe-kept by their brokers. After 1991, when economic liberalization began in India, many transfer agents were overwhelmed by a sudden increase in the number of shareholders and transactions. However, it is said that this problem has since been alleviated as the number of transfer agents has gone up in response.

Another problem with transfer agents is that they often return shares under objection for inappropriate reasons. Transfer agents also have the power to demand inspection of any documents that they may require to satisfy themselves regarding the good faith of the transferees. This can, at times, pose a problem, especially if the documents are not locally available and when FIIs are reluctant to part with certain documents which they feel are of a sensitive nature.

7.6 Depositories

7.6.1 The National Securities Depository Ltd.

The First Depository in India

The National Securities Depository Ltd. (NSDL) is the first depository in India. It was promoted by the Unit Trust of India, Industrial Development Bank of India and NSE, and was registered with SEBI in June 1996. The trading of securities held in the depository started with Reliance Industries shares in December 1996.

The NSDL had appointed 29 depository participants as in June 1997.

All the NSE trading members are supposed to have access to NSDL. Prior to the commencement of the dematerialized securities trading, NSE directed its members to compulsorily open an account with a depository participant of NSDL on the grounds that it would act as a back-up against any accidental entry of quotes by members in the book-entry sub-segment where dematerialized stocks are traded³⁷. BSE is also

³⁷ "NSE: has directed its members to compulsorily open account with a Depository Participant", *Express Investment Week*, December 10, 1996.

expected to gain access to NSDL by registering as a depository participant once its trade guarantee fund is in place³⁸.

Dematerialization

Investors are encouraged to surrender their holdings of securities in a physical form to get them canceled and create securities in an electronically registered form, i.e. credit balances for the securities in their favour. This process is called "dematerialization". Credit of securities into NSDL is also made upon the fresh issue of securities in a dematerialized form³⁹.

The dematerialization process is outlined below:

An investor makes a dematerialization request, along with his or her physical certificates of securities, to the issuer or its registrar through a depository participant (see Section 3.2.6). After prescribed verification and confirmation, the registrar destroys the certificates and electronically notifies NSDL. The registrar substitutes in its records NSDL as a registered owner in respect of the securities and informs NSDL accordingly. NSDL then enters the name of the investor as the beneficial owner of the securities, credits the investor's account, and informs the investor's depository participant accordingly⁴⁰. The whole process takes 15 days.

The reverse process is call "rematerialization". A beneficiary owner of a dematerialized security is entitled to withdraw his or her security balance with NSDL at any time, and to cause a physical certificate issued by the issuer through the prescribed procedures. The issuer has to issue the certificate within 30 days of receipt of the rematerialization request⁴¹.

Despite initial skepticism among some market participants, dematerialization is gaining some momentum. The U.S. SEC amended the relevant rule of the Investment Company Act of 1940 of the United States in May 1997 so that U.S. funds may maintain their assets with

³⁸ "Optimistic NSDL chief says 'take-off' stage not far off", *The Financial Express*, May 29, 1997.

³⁹ Corporation Bank is reportedly considering adopting on-line allotment for its Rs. 2,500 million public issue. ("Corporation Bank may use online allotment for issue", *The Financial Express*, June 17, 1997).

⁴⁰ Section 9.2 of the Bye Laws of National Securities Depository Limited.

⁴¹ *Ibid.*, Section 9.4; The SEBI is considering reducing the rematerialization period to 10 days from 30 days. ("SEBI to set up committee to iron out glitches before dematerialisation", *The Financial Express*, October 21, 1997).

NSDL⁴². The Unit Trust of India (UTI) decided in May 1997 to dematerialize 50% of its holdings in every scrip that is currently admitted for dematerialization at NSDL. The Industrial Development Bank of India (IDBI) has also dematerialized 50% of its own eligible investments. These moves are expected to prompt FIIs to follow suite⁴³. About 50 FIIs

⁴² The majority of FIIs are from the United States. Rule 17f-5 of the Investment Company Act of 1940 of the United States allows funds in the United States to place their assets in the custody of an “eligible foreign custodian”. The issue is whether or not the NSDL falls under the definition of an eligible foreign custodian. The rule was amended in May 1997 and became effective in June 1997. The only defined category of an eligible foreign custodian in the rule before the amendment that was applicable to the NSDL was a foreign securities depository that operates *the only system* for the central system for the handling of securities in a country (Rule 17f-5(c)(2)(iii)). That in the amended rule is a securities depository or clearing agency that acts a system for the central system for the handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority as defined under section 2(a)(50) of the Act (the amended Rule 17f-5(a)(1)(ii)). The “only system requirement” has been eliminated in the amended rule. The SEC’s no-action letter in response to the SEBI’s inquiry was issued on April 17, 1997, before the effective date of the amendment. The SEC’s letter was based on the SEBI’s representation that the NSDL was the only depository for handling securities or equivalent book-entries in India. Some U.S. FIIs felt uncomfortable with the SEC’s letter, because the basis for the SEC’s judgment, that is, the SEBI’s representation, did not necessarily hold true. What if the BSE sets up its own depository? In fact, the BSE has been preparing for it. However, the US SEC reportedly confirmed to the NSDL that “(the amended) rule 17f-5 is self-operative and does not require any foreign institution that satisfied the definition of ‘eligible foreign custodian’ to obtain prior approval of the SEC before serving as a foreign custodian for the US-registered investment companies.” (“National Securities Depository Ltd. meets foreign custodian eligibility, says UD regulator Securities and Exchange Commission; major fillip to attract US-based funds in India to depository system”, *Business Standard*, August 28, 1997; “Amendment in SEC rules to help FII trading via depositories”, *The Financial Express*, August 4, 1997).

⁴³ “UTI to demat 50% of its holdings”, *The Financial Express*, May 30, 1997, and “Optimistic NSDL chief says ‘take-off’ stage not far off”, *The Financial Express*, May 29, 1997.

are said to have commenced a due diligence exercise to dematerialize their holdings⁴⁴.

Table 7.9 lists the top 20 companies whose shares have been dematerialized and their dematerialization ratios. The Industrial Credit and Investment Corporation (ICIC) tops the list. Incidentally this list also contains many favourite stocks of the Indian institutional investors.

Furthermore, NSE is preparing to make it mandatory for thinly traded stocks to be traded only in a dematerialized form by the end of 1997⁴⁵.

Table 7.9
Top 20 Dematerialization List

Stock	Demat. Ratio	Stock	Demat. Ratio
ICICI	14.16%	BSES	7.36%
Gujarat State Fertilizers Co.	12.02%	Indian Rayon	7.31%
Reliance Industries	10.93%	Hindustan Organic	7.19%
Synthetics & Chemicals	10.45%	Housing Development Finance Corp	6.74%
Hindalco Industries	10.08%	Essar Oil	6.47%
Associated Cement Co.	9.42%	Crisil	5.76%
Larsen & Tubro	8.52%	Bharat Petroleum Corp.	5.66%
Indo Gulf Fertilizer & Chemical	8.35%	Jindal Iron & Steel	5.25%
ITC	8.28%	Siemens	4.72%
Grasim Industries	8.17%	Indian Petrochemical Corp.	4.60%

Source: NCDL/ *Financial Times*, Sep. 11, 1997.

Account Transfer

Trades of dematerialized securities held in the custody of NSDL, no matter whether the trades are effected on NSE or off market, settle through account transfers on the register of the NSDL.

The account transfer has made possible what has been logistically impractical or costly for securities in a physical form. This includes:

- (i) the abolition of market lots,
- (ii) pay-in and pay-out on the same day,

⁴⁴ Deutsche Bank, *India: Market Watch*, Issue No: Vb May 16-31, 1997, Mumbai, p. 3.

⁴⁵ "Scripless trading for small-cap stocks to be made mandatory", *The Financial Express*, June 14, 1997.

- (iii) reduced funding cost to brokers,
- (iv) no stamp duty on transfer, and
- (v) daily rolling settlements.

NSE dispensed with market lots in dematerialized stocks in May 1997. There is no physical difficulty and resulting cost for odd lots of dematerialized stocks. This enhances the liquidity as well as the market value of odd lots⁴⁶.

In the book entry sub-segment of NSE, the settlement for funds and securities take place on a single day, that is, Tuesday following the end of the trading period and delivery versus payment is ensured. Pay-in day is Tuesday, instead of Monday (see Table 7.4 in Section 7.2.4).

Indian brokers charge a premium brokerage of 0.75-1.00% for DVP trades because brokers have to fund such trades for facilitating DVP settlement with investors (or their custodians), currently at 24-36% *per annum* (see Section 7.3.2). Account transfers do away with the one day difference between pay-in and pay-out days, and the verification and counting of delivered certificates. As a result, the period of brokers' funding is shortened to one day from nearly a week⁴⁷, and brokers save 0.40-0.60%.

Transfer of registered ownership of shares through a depository involves no physical certificate and, therefore, is not liable for any stamp duty⁴⁸. However, this exemption might not apply to bonds⁴⁹.

In July 1997, NSE introduced a T+5 daily rolling settlement system in its book entry segment ahead of its initial schedule⁵⁰. Due to unexpectedly low liquidity in this segment, however, NSE has decided to re-introduce the weekly settlement system (the batch settlement system) effective 1 October 1997 in addition to the existing rolling settlement system⁵¹.

⁴⁶ "Trading in demat ICICI scrips surge on NSE, Reliance in tow", *The Financial Express*, May 11, 1997.

⁴⁷ "Depository can solve brokers' liquidity: Bhave", *The Financial Express*, May 23, 1997.

⁴⁸ Section 8A of the Indian Stamp Act, 1899. (Part I of the Schedule to the Depository Act, 1996).

⁴⁹ "How to me the depository more investor-friendly", *The Financial Express*, June 16, 1997.

⁵⁰ "NSE slashes trading charges for demat segment", *The Financial Express*, May 30, 1997.

⁵¹ NSE Circular No. NSE/CMT/00370, dated September 29, 1997.

Improvements of Market Efficiency

Account transfers pave the way for further improvements in market efficiency. Examples are:

- (i) stock lending,
- (ii) arbitrage trading between cash and futures markets, and
- (iii) shortening of the allotment period of new issues.

In addition to the fact that there is absolutely no possibility of bad delivery, the fungibility of dematerialized securities⁵² will no doubt give thrust to stock lending. Once futures and option contracts of the NSE-50 get the go-ahead, there lies a green field of arbitrage opportunities between cash and futures markets. A trouble-free settlement system will make the green field greener. There would be no need to mail fresh certificates of new issues if all allotments were only made in a book-entry form. That would be translated into a much shorter allotment time and much less exposure to the market risk on the part of successful subscribers. The first to contribute to the market efficiency may be daily rolling settlements.

Low Liquidity

All rosy pictures about the depository system and dematerialization that have so far been discussed is subject to the single most important element in the capital market — liquidity. Without liquidity of dematerialized shares, the benefits from the depository and book entry systems would end up being a pie-in-the-sky.

The reality has been so far disappointing. The book entry segment of NSE lacks liquidity. Let's take an example. For a week period from 22 to 30 July 1997, 6,076 shares of Industrial Credit and Investment Corporation of India Ltd. (ICICI) were traded in the book entry segment⁵³. This was less than two percent of the volume of shares traded in the physical form segment of NSE. It is very difficult for brokers to match their orders in the book entry segment. Investors would miss out on chances to make profits or cut loses, and stockbrokers would miss brokerages. In fact, a shareholder of ICICI had 52,000 share of the company rematerialized in July 1997. This was the first case of illiquidity

⁵² Section 9 of the Depository Act, 1996.

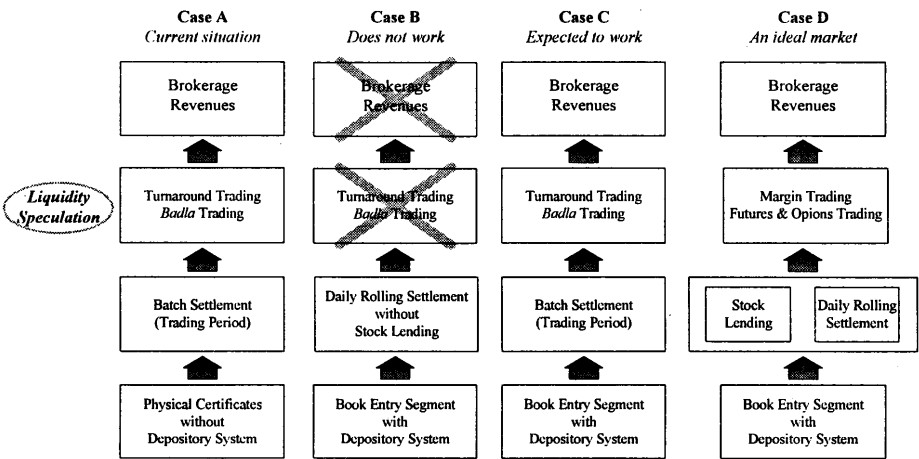
⁵³ "Plagued by illiquidity, Jet Age opts for rematerialisation", *The Financial Express*, August 1, 1997.

in the book entry segment leading to a rematerialization request by a shareholder⁵⁴.

A Pitfall and a Solution

Why does the book entry system with daily rolling settlements have low liquidity? This is because it has left little room for speculation. Figure 7.4 analyzes (i) how a physical certificate segment such as the normal market segment on the NSE is working, (ii) how the book entry system with daily rolling settlements does not work, (iii) how the book entry system with weekly settlements (batch settlements) is expected to work, and (iv) how an ideal market should work.

Figure 7.4
Book Entry Segment, Speculation & Liquidity



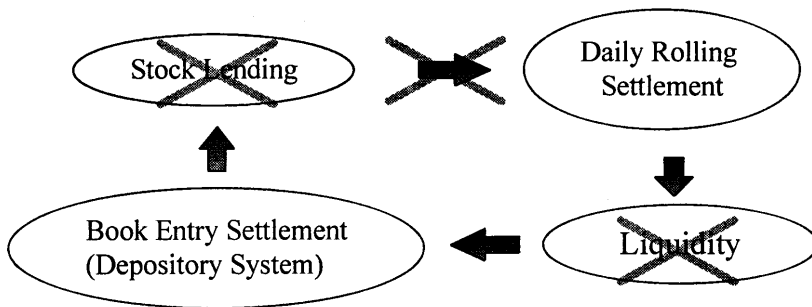
Given the physical delivery system that currently prevails in the Indian stock market, the batch settlement system facilitates investors' speculation through turnaround trading and *badla* trading, which in turn provide the market with liquidity and market intermediaries with revenues (Case A). The NSE has introduced the book entry segment which was based on the first depository in the country. This made the daily rolling settlement possible. However, the new system lacks a stock lending system. The daily rolling settlement system without a stock lending system stifles turnaround trading and adversely affects revenues

⁵⁴ *Ibid.*

to market intermediaries (Case B). It is no wonder that the NSE's book entry segment has had little liquidity.

A combination of the book entry system and the daily rolling settlement has failed to produce an initially expected chain of favourable effects in the market. Figure 7.5 illustrates how the expected chain was supposed to work and has broken down.

Figure 7.5
Breakdown of Chain Effects Hoped For



The Stock Holding Corporation of India and other institutions will begin stock lending soon (see Section 5.4), though it is unlikely to take off until the book entry system substantially frees the market from fake, forged and stolen shares. Without appropriate remedies to generate liquidity in the book entry segment, the depository system would become a white elephant. In order to cope with this problem, the NSE recently announced that it would replace the daily rolling settlement system with the weekly settlement system⁵⁵. This measure would facilitate speculation and subsequently induce liquidity (Case C). Sufficient liquidity in the book entry segment would lead to dematerialization of more shares, which would in turn prepare the field for stock lending. Then, the full-fledged stock lending would facilitate margin trading and arbitrage activities using stock index futures and options. With margin trading and stock index futures and options in place, the daily rolling settlement would finally fit into the Indian stock market (Case D).

⁵⁵ "NSE to weekly fix depositories from October 1", *The Economic Times*, September 19, 1997.

Compulsory Dematerialization

In order to break through the chicken and egg situation of the depository system and dematerialization, SEBI took the bold decision in October 1997 of imposing the book entry settlement on institutional investors. It would be compulsory for institutional investors to settle their trades through a depository effective 15 January 1998.

This new rule will be applicable to specific groups of institutional investors and securities. Institutions whose trading of specific securities will have to be settled through a depository will be domestic financial institutions, FIIs, mutual funds, and banks which have a minimum securities portfolio of Rs. 1 billion (approximately US\$ 28 million).

The SEBI, in consultation with the NSDL, designates such securities on the basis of three broad parameters: (i) substantial institutional holding, (ii) significant liquidity, and (iii) reasonable distribution of dematerialization workload among registrars⁵⁶. The list of such securities will be expanded in a phased manner⁵⁷.

Though only the NSE's clearing house is currently linked to the NSDL, the BSE's clearing house is also expected to join the depository system of the NSDL by 15 January 1997 (see Section 7.6.2). Therefore, the institutional investors designated for the compulsory dematerialized trading will be able to trade the compulsorily materialized securities on either of the NSE and the BSE.

Some market participants have expressed concern that the compulsory dematerialization may give rise to segmentation of the Indian stock market: dematerialized markets for institutional investors, and physical markets⁵⁸. Retail investors are generally more speculative than institutional ones. Speculation is essential for liquidity of a market (see Section 4.5.3). If the concern comes true, therefore, the new measure will likely face a setback due to low liquidity and high volatility of the dematerialized markets. The NSE's recent replacement of the daily rolling settlement system with the weekly settlement system in its book entry segment will presumably help alleviate the possible problem.

⁵⁶ "NSDL frames parameters for selection of stocks for compulsory demat", *The Financial Express*, October 17, 1997.

⁵⁷ SEBI Press Release Ref: PR No. 115/97, dated October 15, 1997.

⁵⁸ "SEBI to form working group to thrash out problems on demat; allays fears of market segmentation through this system", *Business Standard*, October 21, 1997.

7.6.2 BSE Depository

BSE, in conjunction with BoI Shareholding Ltd., is also trying to set up a depository. The oldest exchange in India has a plan to offer its members depository service at an aggressively low cost. The BSE's depository is proposed to cover all BSE-listed stocks, which is much a broader universe than that of the NSE-traded securities.

Meanwhile, BSE intends to have its clearing house (BoI Shareholding Ltd.) join NSDL as a depository participant, and the clearing house has, in fact, applied to NSDL for this purpose. This arrangement would enable shares dematerialized at NSDL to also trade on BSE. This makes sense, given the fact that shares in a physical form can be freely traded on both the stock exchanges.

This plan has hit a snag. A depository system works only if the clearing house guarantees timely settlement of trades. The problem is twofold:

- (i) BSE's trade guarantee fund that guarantees settlement of trades on the exchange is owned and managed by the exchange but not its clearing house; and
- (ii) A mechanism built in the BSE's trade guarantee fund, that is a review and decision on each default case by the Defaulters' Committee, will likely prevent full assurance that securities and funds get transferred in 24 hours⁵⁹ (Remember that the pay-in and pay-out days in the book-entry segment of the NSE fall on the same day).

NSDL, BSE and BoI Shareholding Ltd. are likely to resolve the problems by working out a tripartite agreement which will legally oblige BSE to guarantee settlement of trades cleared through the clearing house⁶⁰.

⁵⁹ "BSE entry into depository hinges on counter-party risk", *The Financial Express*, June 17, 1997.

⁶⁰ "BOI Shareholding to rework application to join NSDL", *The Financial Express*, August 25, 1997.

Investment in New Issue

8.1 Public Issues

8.1.1 Unspecific and Many Investors

What has been discussed in this book up to this point essentially pertains to the secondary market of Indian securities. FIIs are permitted to invest in the Indian primary market, too. The primary market is a market of securities being issued by the issuer to investors, while secondary market is a market of existing securities being transacted among investors.

Shares are first issued to promoters (founders) of a company. Subsequently, the company's securities, including shares, may be privately issued to promoters' relatives, friends, business associates, including directors and employees of the company, the company's vendors and customers, banks and other financial institutions, mutual, pension or investment funds, and so on. Such investors are specific and limited in number. As a company grows further, it may need to publicly

Table 8.1
Primary Issues in India

(in Rs. bil.)

Year	Public Issues		Rights Issues		Total	
	No	Amount	No	Amount	No	Amount
1991-92	206	24	257	39	463	62
1992-93	546	76	488	109	1,034	185
1993-94	773	154	370	89	1,143	244
1994-95	1,342	210	324	66	1,666	276
1995-96	1,426	142	267	65	1,693	208
1996-97	753	116	131	27	884	143

- 1994-95 data does not include 26 rights issues for Rs. 114.3 million.
- 1995-96 data does not include 32 rights issues for Rs. 143.5 million.

Source: SEBI Annual Reports 1995-96 & 1996-97.

raise additional capital from investors beyond the original specific and limited number of investors. A public issue or an issue to the public, is an issue of new securities to unspecific and many investors, or the public. It is followed by listing of the company's shares on a stock exchange for secondary trading. The first issue to the public by an unlisted company is specifically called an initial public offering (IPO).

8.1.2 Protection of Investors' Interests

A new issue to the public has naturally no history of trading on a stock exchange. Investments in the primary market therefore involve higher risks than those in the secondary market. Accordingly, additional protection of the interests of investors is needed. The Indian capital market has been improving in these aspects.

An issuer knows much more about itself and the investment instrument that it offers than an investor. The issuer thus is no doubt in an advantageous position over the investors in a new issue transaction. Therefore, the issuing company of a public issue is required to make true, fair and adequate disclosure on the issue, the company and other relevant matters through a prospectus and an abridged prospectus, or through a letter of offer in the case of a rights issue, in order to protect the interests of the investor. Disclosure in respect of new issues is one of the areas that the Government of India, through SEBI, has made the greatest efforts to improve since the economic reforms were launched in 1991. This has been discussed in details in Chapter 6.

Listing of a public issue is important in at least two aspects for protection of investor interests:

- (i) the transferability of securities is practically substantiated by listing on a stock exchange; and
- (ii) price movements of securities on a stock exchange themselves are also a comprehensive indicator of all relevant information available to the public.

Prior to an amendment to the Companies Act, 1956 in 1988, however, a public issue of securities in India did not necessarily require listing of the securities. Listing was not compulsory, unless the prospectus provided that the newly issued securities would be listed. Today, listing is mandatory and an application for listing has to be made before an issue is offered to the public. If a stock exchange to which a listing application

was made rejects the securities for listing, any allotment of the securities will be void¹.

Though investments in new securities in India are often very profitable due to quick price appreciation of the newly-issued securities, they involve a significant level of market risk or price fluctuation risk. This is because investors subscribing to new securities commit themselves to the issue price during the offering period but are able to sell the new securities only after the subscribed securities have been allotted to the investors and the allotted securities admitted to a stock exchange for trading. Meanwhile, the price of the securities is continuously affected by developments and events inside and outside the issuing company. The longer the period between the subscription and the commencement of trading on an exchange, the greater is the market risk of the new securities. Therefore, it is important to reduce the period between the subscription and the commencement of trading on an exchange, especially in the case of IPOs.

In India, the period officially used to be 70 to 85 days, as compared to none in the United States, 5 days in the UK and 14 days in Japan. This has now been reduced to between 30 and 35 days since May 1996². SEBI is considering a move to further shorten the time period for allotment of securities after a public or rights issue to 15 days from 30 days³. Unfortunately, despite the official time limit there are cases where the listing is heavily delayed and trading does not start on time.

Moreover, hedging tools are being introduced in the Indian capital market. This can be considered a proactive means to protect investors' interests. The capital markets in developed countries have hedging tools such as a stock lending system and various kinds of futures and options in place. Such hedging tools enable investors in new issues to hedge against price movements during the non-trading period. Investors in India's new securities are thus exposed to a market risk that they would otherwise be able to substantially reduce by properly using the hedging tools. The *badla* trading system is a sort of hedging tool, but FIIs are prohibited from using it. To overcome this limitation of the Indian capital market, the Government of India has issued a new interpretation to the capital

¹ Section 73 of the Companies Act, 1956, as amended by the Companies (Amendment) Act, 1988.

² SEBI Press Release No. SMD/RCG/JJ/1819/96, dated May 15, 1996.

³ "Allotment period may be cut to a fortnight", *The Financial Express*, May 15, 1997.

gains tax to pave the way for the introduction of a stock lending system (see Section 5.4). It has also amended the Securities Contracts (Regulation) Act, 1956 to accommodate the introduction of futures and options contracts of the NSE-50, a National Stock Exchange index (see Section 4.4.8).

8.1.3 Allotment

Usually, the allotment of securities offered to the public is made within 30 days of the closure of the public issue. In the case of any delay beyond 30 days of the closure of the issue, the company has to pay penal interest to the investors, currently at 15% per annum⁴. This time period for allotment of securities may be reduced to 15 days in the near future⁵.

Securities issued and allotted in an Indian public issue are divided into three groups according to the mode of allotment:

- (1) net offer to the public;
- (2) firm allotments; and
- (3) reservations.

Net offer to the public: Net offer to the public is the portion of a public issue that is offered to the public for subscription at the offer price. This has to be at least 25%⁶ of the total number of securities offered in the issue to qualify for listing.

In an issue of Rs. 1 billion or more, however, an issuer is allowed to place up to 100% of the issue through book building without reserving at least 25% for net offer to the public⁷.

An important objective of a public issue is the widening of the shareholder or bondholder base of the issuer by attracting a range of new

⁴ SEBI Press Release No. SMD/RCG/JJ/1819/96, dated May 15, 1996. Listing agreements of stock exchanges have been amended accordingly.

⁵ "Allotment period may be cut to a fortnight", *The Financial Express*, May 15, 1997.

⁶ Section 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957, as amended by the Notification F. No. 1/33/SE/92, dated September 20, 1993, issued by the Ministry of Finance; Section 3 of SEBI Clarification VIII, dated October 11, 1993; Section B-4 of SEBI Clarification XIII, dated October 12, 1996. In addition, the public shareholdings should not be reduced to less than 20% of the voting capital of the company in order to maintain the listing. (Section 40B (9) of the BSE Listing Agreement Form).

⁷ Section 3 of SEBI Press Release No. PR/100/97, dated September 5, 1997.

shareholders or bondholders. Therefore, a minimum of 50% of net offer to the public out of the public issue amount has to be reserved for individual investors applying for securities not exceeding 1,000 securities in each case⁸.

Firm allotments: Firm allotments are the portion of a public issue that is reserved for, and placed with, selected investors, including major clients of the merchant bank, at the issue price on a firm basis. Such firm allotments have to be disclosed in the offer document.

A firm allotment to permanent/regular employees of the issuer is subject to a ceiling of 10% of the issue amount.

Previously, there were individual ceilings to firm allotments that could be made to (i) Indian and multilateral development financial institutions, (ii) Indian mutual funds, (iii) FIIs, including Non-Resident Indians and Overseas Corporate Bodies (NRIs/OCBs). These ceilings have been removed. As a result, the first two categories of investors may be freely allotted securities up to 75% of the issue amount. However, an allotment to the category of FIIs and NRIs/OCBs is still constrained by the 24% or 30% ceiling for the aggregate foreign ownership by FIIs and NRIs/OCBs under the RBI regulation⁹.

Reservations: Reservations are the portion of a public issue that is reserved for and allotted to investors of selected categories at the issue price on a competitive basis. If securities reserved for a certain category are oversubscribed, all of them are allotted to subscribers (investors) of that category in proportion to the number of securities applied for. If securities reserved for a certain category are undersubscribed, each subscriber (investor) of that category is allotted as many securities as he or she applied for; the balance is added first to any other reserved category or categories, and then to the net offer to the public. Reservations are also required to be disclosed in the offer document.

There is also the 10% individual ceiling of reservations for:

- (i) permanent employees (including working directors) of the company (or the permanent employees of the promoting companies in the case of a new company), and
- (ii) shareholders of the promoting companies in the case of a new company (or shareholders of group companies in the case of an existing company).

⁸ SEBI Clarification No. XI, dated May 29, 1995.

⁹ Section 3 of SEBI Clarification No. XII, dated September 29, 1995.

As noted above, other categories no longer have the maximum limits of reservations, except for FIIs including Non-Resident Indians and Overseas Corporate Bodies (NRIs/OCBs) being subject to the 24% or 30% limit under the RBI regulation, as the case may be¹⁰.

There is some confusion in the Indian terminology of firm allotments and reservations. There are cases where firm allotments are described as “reservations on a firm basis”, and reservations as “reservations on a preferential basis”¹¹. More confusingly, a preferential allotment is another concept of allotment of securities¹², and will be discussed in Section 8.4.

Securities may be issued to the promoters or his or her group by way of a firm allotment, a reservation or a preferential allotment (in the true sense). These shares allotted to the promoters or his or her group have a lock-in (lock-up) period of three years¹³. However, the shares allotted to FIIs and other certain categories of persons¹⁴ through reservations or firm allotments in public issues are not subject to a lock-in period¹⁵.

8.1.4 Underwriting and Minimum Subscription Requirement

Whether or not an issuer can raise a proposed amount of capital through a public or rights issue affects the issuer’s future operations and performance, and consequently the investors’ decision on investment in the new issue. Investors’ interests should be protected in this respect, too.

Public or rights issues may or may not be underwritten. Whether or not an IPO is underwritten is at the option of the issuer¹⁶. If the book-building

¹⁰ *Ibid.*

¹¹ This confusion is found in Section 3 of SEBI Clarification No. XII, dated September 29, 1995. Section H of the SEBI Guidelines has the similar flaw. The term of “preferential allotment” in Section H (d) of the SEBI Guidelines is presumably meant to be reservations for shareholders.

¹² The term of “preferential allotment” in Section H (d) of the SEBI Guidelines is presumably meant to be reservations for shareholders.

¹³ Section 9, Additional Guidelines - Preferential Allotments of Shares, SEBI Press Release, dated 4-8-94, as amended by Press Release, dated 8-8-94, and “Meeting of Advisory Committee on Primary Market held on Thursday, February 06, 1997”, SEBI Press Release Ref. No. PR 33/97, March 6, 1997.

¹⁴ Indian and multilateral development financial institutions, Indian mutual funds, permanent/regular employees of the issuer company.

¹⁵ Section 3, SEBI Clarifications No. VIII.

¹⁶ Section (iii) of Additional Guidelines - Withdrawal of Lock-in Period Provisions, SEBI Press Release, October 10, 1994.

process is employed to price an issue, however, underwriting is mandatory as far as the net offer to the public (but not firm allotment and reservations) is concerned¹⁷.

Furthermore, each public or rights issue is conditional to its receiving the stipulated minimum subscription. However, the minimum subscription requirement for a public offer differs from that for a rights issue in the number of days in which it has to be satisfied.

A public issue is effected only if the total of:

- (i) the amount subscribed by the public,
- (ii) the amount devolved on and accepted by underwriters (if any), and
- (iii) the amount procured from other sources such as the promoters of the company (if any),

exceeds 90% of the issue amount within 60 days from the date of closure of the issue. If the subscription to an issue falls short of 90% of the issue amount, the shortfall devolves on underwriters who are obligated to accept it under the underwriting agreement in an underwritten issue. Alternately, the promoters of the company themselves make up the shortfall or procure it from somewhere else in the case of a non-underwritten issue, provided that such an intention has been adequately disclosed in the offer document. Otherwise, the issuing company is required to refund the amount of subscription to the subscribers¹⁸.

A rights issue is effected only if the minimum subscription, which is 90% of the issue amount, within 42 days from the date of closure of the issue. Otherwise, the issuing company is required to refund the amount of subscription to the subscribers. If refund of the subscription amount is delayed by more than 8 days after the issuer becomes liable to repay the subscription amount (*i.e.* 42 plus 8 days after the date of closure of the

¹⁷ Section B.v. of SEBI Clarification No. XIII, dated October 12, 1995.

¹⁸ SEBI Clarifications No. 19 (RMB (DIP Series) Circular No. 5 (96-97)), dated May 14, 1997; Section D (a), SEBI Guidelines, (PMD Circular 4545/92, dated June 11, 1992); Section D (a)-(b), SEBI Guidelines, dated November 4, 1992; Section C.5 of RMB (GI Series) Circular No. 1; Section 5 of RMB (GI Series) Circular No. 7 (93-94), dated January 20, 1994; and Clause 14 (2) of Model Underwriting Agreement between Underwriter and Issuer-Company, circulated in RUW Circular No. 1 (93-94), dated November 19, 1993. (RUW = Registered Underwriters)

issue), the issuer is required to pay interest for the delayed period at 15% per annum^{19/20}.

It is worth noting, however, that this requirement of 90% minimum subscription does not apply to offer for sale²¹.

8.1.5 Initial Public Offering

Characteristics of Indian IPOs

The first public offering of equity shares or convertible securities by a company, which is followed by the listing of a company's shares on a stock exchange is known as an initial public offering (IPO). FIIs have been permitted to invest in unlisted securities since October 1996²². Therefore, IPOs are now very crucial for FIIs in recovering their investments in unlisted Indian securities.

Only companies that satisfy certain conditions are permitted to issue their shares to the public. The criteria for IPOs in India have the following characteristics:

- they are generally easy to meet;
- the IPO criteria for project companies are far easier on the condition that a public finance institution or scheduled commercial bank has appraised the company's project and has participated in the project financing; and,
- meticulous conditions are imposed on attributes of IPOs.

Earlier, the criteria used to be far more moderate. For instance, a new-born or existing company without a profitable track record was allowed to issue new shares or existing shares at par, that is, at a face value of Rs. 10 per share, though such an IPO was subject to promoters' contribution and lock-in period (or lock-up period) requirements. Listed companies mushroomed after 1991-92 (see Figure 4.2). Many of these were poor performers and their shares had little liquidity (see "Too Many Small Companies Listed" — Section 4.3.4). This problem was addressed by the

¹⁹ Section 73 (2) and (2A) of the Companies Act, 1956.

²⁰ Section X of Annexure-I to SEBI Guidelines for Rights Issue (RMB (DIP Series) Circular No. 1 (95-96)), dated May 23, 1995.

²¹ Part D of SEBI Clarification No. XVI, dated July 17, 1996.

²² SEBI (FIIs) Amendment Regulations, 1996, by SEBI Notification dated October 9, 1996, F. No. SEBI/LE/10/0130/96.

Malegam Committee Report in September 1995²³. Thereafter, in April 1996, SEBI limited IPOs in principle to those companies which have a track record of dividend payment for at least three years out of the immediate preceding five years²⁴. Later, in August 1997, SEBI further tightened this requirement by stipulating a track record of dividend payment for “the immediately preceding three years”²⁵.

The relatively easy criteria probably reflect the Government of India’s policy to make the most of the capital market to finance the country’s badly needed industrial development.

The criteria for an IPO in India can be analyzed in two aspects:

- (1) the eligibility for an IPO, and
- (2) on which stock exchange the securities can be listed.

Eligibility for Initial Public Offering

An Indian company, excluding certain banks, is currently permitted to make an IPO if:

1. the company has a track record of dividend payment for the immediate preceding three years²⁶; or
2. a public financial institution or scheduled commercial bank has appraised the project to be financed through the proposed offer to the public, and the appraising agency participates in financing the project by way of loan or equity to the extent of at least 10% of the project cost²⁷.

Apart from the eligibility for an IPO, the listing criteria of Indian stock exchanges also place some restrictions on an IPO, since IPOs must be followed by listing of initially offered shares²⁸. First of all, listing of

²³ Section 22.3 of the Malegam Committee Report on Disclosure Requirements in Offer Documents.

²⁴ Part A of the SEBI Clarification Nos. XV, RMB (DIP Series) Circular No. 1 (96-97), dated April 17, 1996.

²⁵ SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997.

²⁶ The guideline was modified to “the immediately preceding three years” from “at least three years out of the immediately preceding five years”. (SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997).

²⁷ Part A of the SEBI Clarification Nos. XV and Part A of the SEBI Clarification Nos. XVI of the SEBI Guidelines.

²⁸ Section 73 of the Companies Act, 1956, as amended by the Companies (Amendment) Act, 1988.

publicly offered securities is compulsory, and a minimum of 25% of each class of securities issued by the company must be offered to the public for subscription in order for the security to be eligible for listing on a recognized stock exchange²⁹. An Indian unlisted company which has been in commercial operations for less than two years and makes an IPO faces restrictions as to which stock exchange its shares can be listed, depending on its post-issue capital³⁰. The relationship between the post-issue capital and the relevant stock exchange on which the publicly offered securities are listed is shown in Table 8.2.

Table 8.2
IPO Listing & Post-issue Capital

<i>Post-issue Paid-up Capital (C)</i>	<i>Relevant Stock Exchange</i>
$C < \text{Rs. } 30 \text{ mil.}$	The OTC Exchange of India
$\text{Rs. } 30 \text{ mil.} \leq C < \text{Rs. } 50 \text{ mil.}$	The OTC Exchange of India, or any other stock exchange with (a) electronic trading facility and (b) market maker(s) for the securities ³¹
$\text{Rs. } 50 \text{ mil.} \leq C$	Any stock exchange

Compiled from Clarification No. XII of the SEBI Guidelines.

The listing is additionally subject to listing requirements of the stock exchange on which the company desires to list the securities. For example, an issuing company must have a post-issue capital of at least Rs. 100 million for listing on BSE, or Rs. 200 million for listing on NSE. The BSE and NSE listing requirements have been earlier detailed in Sections 4.3.5 and 4.4.5, respectively.

If a company has a paid-up capital of more than Rs. 50 million, it has to list its securities on more than one stock exchange³².

²⁹ Rule 19 (2) (b) of SC (Regulation) Rules, 1957, as amended in September 1993. Section B of the SEBI Guidelines dated June 11, 1992 provides that an existing private or closely-held company has to offer not less than 20% of the equity to make an IPO.

³⁰ Clarification No. XII of the SEBI Guidelines, dated September 29, 1995, and Section B. iv. of SEBI Clarification No. XIII, dated October 12, 1996.

³¹ The market making requirements are set forth in detail. The clarification provides for a public issue of securities by an unlisted company, and does not explicitly limit its application to equity shares or equity-linked securities. Finance companies have different but easier criteria.

Besides eligibility conditions for going public and listing, an IPO is further subject to other conditions both in terms of promoters' minimum contribution and a lock-in period for promoters' contribution. These conditions are rather complicated, though they have been gradually simplified.

A listed company making a public offer may freely price its equity shares or convertible securities, provided that the company has a three-year³³ track record of consistent profitability³⁴ and makes a disclosure of the relevant information on the offer document³⁵. Earlier, there used to be detailed pricing norms imposed on an IPO, depending on whether the issue was priced at par, at a premium or otherwise. Such pricing norms no longer exist.

Promoters' Minimum Contribution

The promoter group³⁶ of an issuing company, including its promoters, directors, friends, relatives, associates, etc., is required to make at least a certain amount of contribution, known as "Promoters' Contribution", to company's IPO³⁷ (Table 8.3). The promoter and/or his or her followers are required to invest their money as a kind of commitment. If there are no identifiable promoters or promoter group among the shareholders of a company, however, the promoters' contribution is not required³⁸. The requirements of the promoters' contributions are outlined in this section.

The rate of contribution is generally 20% of the total issued capital in the case of an unlisted company with a three-year track record of consistent profitability³⁹. Please note that the criterion for this requirement is similar to, but less restrictive than, the first eligibility criterion for an IPO, which is "a track record of dividend payment for immediately preceding three years". Some profitable companies which qualify for an IPO under the

³² Ministry of Finance F. No. 14 (2)/SE/85, dated September 23, 1985.

³³ 2 years in the case of public sector banks. (Part B of SEBI Clarification No. XVI, dated July 17, 1996).

³⁴ Section B (i) of SEBI Guidelines, dated June 11, 1992.

³⁵ SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997.

³⁶ Explanation II in Section A of SEBI Clarification No. XIII, dated October 12, 1995.

³⁷ Section L of SEBI Clarification No. I, dated June 17, 1992.

³⁸ Section III.3 of Part A of SEBI Clarification No. XIV, dated March 1, 1996.

³⁹ SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997.

Table 8.3
Promoters' Minimum Contribution in IPOs

<i>Class of Companies</i>	<i>Promoters' Minimum Contribution</i>
(1) An unlisted company with a three-year track record of consistent profitability	20% ⁴⁰ of the post-issue capital
(2) An unlisted company which does not have a three-year track record of consistent profitability but has been set up by existing company(ies) with a five-year track record of consistent profitability.	50% of the post-issue capital if the issue size is Rs. 1 billion or less <hr/> The slab rates* of the post-issue capital, as described below, if the issue size exceeds Rs. 1 billion
(3) An unlisted company of which shares are offered for sale	The promoters' shareholding after offer for sale shall not be less than 20% of the post-issue capital.

* Slab rates: Promoters' minimum contribution of an unlisted company which does not have a three-year track record of consistent profitability but has been set up by existing company(ies) with a five-year track record of consistent profitability, is computed by applying the slab rates mentioned in Table 8.4 below. However, the aggregate contribution will in no case be less than 20% of the expanded capital⁴¹.

Source: SEBI Guidelines & Clarifications.

second eligibility criterion may choose not to pay dividends to their shareholders and retain their earnings for one reason or another.

Stricter requirements are applicable to an unlisted company which does not have a three-year track record of consistent profitability but has been set up by an existing company or companies with a five-year track record of consistent profitability⁴². In such a case, the existing company is the promoter. Obviously, such an unlisted company is eligible for an IPO only under the second eligibility criterion. If the size of an IPO is Rs. 1 billion or less, the rate of contribution is 50% of the post-issue capital; otherwise, slab rates ranging from 15% to 50% (see Table 8.4) are applicable when computing the promoters' minimum contribution⁴³.

Finally, a condition similar to the promoters' contribution is applicable to an unlisted company whose existing shares are offered for sale to the

⁴⁰ Part B of SEBI Clarification No. XIX, RMB (DIP Series) Circular No. 5 (96-97), May 14, 1997.

⁴¹ Section 2.1-2.3 of SEBI Clarification No. VII, August 10, 1993; Part B of SEBI Clarifications No. XIX, RMB (DIP Series) Circular No. 5 (96-97), May 14, 1997.

⁴² Section 2.1 of SEBI Clarification No. VII, August 10, 1993.

⁴³ *Ibid.*, Sections 2.2- 2.3.

public by its promoter(s). In such a case, the promoters are required to maintain their shareholding at 20% or more of the company's capital⁴⁴.

Table 8.4
Slab Rates for Promoters' Minimum Contribution

Size of Capital Issue (including Premium) (C)	Percentage of Contribution
On first Rs. 1 billion (C ≤ Rs. 1 bil.)	50%
Next Rs. 2 billion (Rs. 1 bil. < C ≤ Rs. 3 bil.)	40%
Next Rs. 3 billion (Rs. 3 bil. < C ≤ Rs. 6 bil.)	30%
Balance of issue amount (Rs. 6 bil. < C)	15%

Source: Section 2.3, SEBI Clarification No. VII.

Certain equity shares do not qualify for promoters' contribution, including shares of a company that the promoters acquired during the preceding three accounting years as a result of:

- (i) a revaluation of assets or capitalization of intangible assets or
- (ii) a revaluation of reserves without the infusion of cash⁴⁵.

In addition, shares of an unlisted company which were issued to the promoters during the preceding one accounting year at the expense of the public do not qualify for promoters' contribution to an IPO⁴⁶, either.

In an IPO through convertible securities, the promoters have an option to contribute to the issue by way of subscription to equity shares or to convertible securities offered in the issue, subject to a disclosure of the relevant information in the offer document⁴⁷.

The promoters' minimum contributions to an IPO that have been discussed so far in terms of percentage are also subject to minimum rupee amounts: Rs. 25,000 from each individual, and Rs. 100,000 from a firm or company⁴⁸.

⁴⁴ Section B (d) of SEBI Clarification No. II, dated July 16, 1992; SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997.

⁴⁵ Sections M (a)-(b) of SEBI Guidelines, dated June 11, 1992; Sections M (iii)-(iv) of SEBI Press Release, dated April 13, 1994 (Additional Guidelines-Bonus Issue, RMB (DIP Series) Circular No. 2 (94-95), dated April 15, 1994).

⁴⁶ Section L of SEBI Clarification No. V, dated November 4, 1992; SEBI Press Release, dated August 25, 1995.

⁴⁷ Section A (a) of SEBI Clarification No. II, dated July 16, 1992; Section 2.5 (b) of SEBI Clarification No. VII, August 10, 1993.

⁴⁸ *Ibid.*, Section 2.7. Reduced to Rs. 25,000 from Rs. 50,000.

Table 8.3 summarizes the promoters' contribution requirements for IPOs.

Lock-in Period

In an IPO, the promoters' minimum contributions will be locked in for a period of three years⁴⁹ from the date of allotment in the issue or the date of commencement of commercial production, whichever is later. During this period, all members of the promoter group are prohibited from disposing of shares acquired as a result of the promoters' contribution. In addition, if the promoters' contribution in an IPO exceeds the promoters' minimum contribution, the excess will also be locked in for a period of three years⁵⁰.

Listing Delay or Rejection

As has been discussed in Section 8.1.2, quick listing is important to reduce the period between the subscription and the commencement of trading on an exchange, especially in the case of IPOs. Investors in Indian IPOs should be aware of a possible delay in, or rejection of, listing and the resultant market risk, and should carefully select IPO issues to invest in.

The probability of listing delay or rejection is not low. A survey based on public issues made in the calendar year 1996⁵¹ revealed that 7.2% of companies that proposed to list on the BSE had not been listed by June 12, 1997. This shameful track record can be clearly seen in Table 8.5.

Table 8.5
BSE Listing Delay & Rejection in 1996

	# of Issues	
Proposed to list on the BSE	602	
Canceled issues	21	
Issues actually made	581	100.0%
Listed by June 12, 1997	538	92.6%
Rejected to list	2	0.3%
Not listed by June 12	40	6.9%

Source: *The Financial Express*.

⁴⁹ Part B of SEBI Clarification No. XIX, RMB (DIP Series) Circular No. 5 (96-97), May 14, 1997; Reduced to 3 years from 5 years across the board.

⁵⁰ SEBI Press Release, dated October 26, 1994.

⁵¹ "40 firms fail to list on BSE", *The Financial Express*, June 16, 1997.

Even a reputable financial institution like Gujarat State Financial Corporation took as long as 111 days. Its Rs. 4.7 million issue was closed on February 21, 1997 and began to trade on the BSE only on 12 June 1997. The issue was lead-managed by reputable merchant bankers: ICICI Securities, Lloyds Finance, Gujarat Industries Investment Corporation and BoI Finance⁵².

8.1.6 Public Issues by Listed Companies

Eligibility for Public Issue

Naturally, an issue of equity shares or convertible securities to the public by a listed company seeking to raise fresh capital faces typically fewer restriction than an IPO. Only if a listed company which intends to issue new securities to the public such that its post-issue net worth would grow to more than five times its pre-issue net worth, does the company have to satisfy the eligibility criteria for an IPO before it makes the proposed issue (see “Eligibility for Initial Public Offering” of Section 8.1.5)⁵³.

There are no pricing norms for an issue to the public by a listed company⁵⁴.

Promoters’ Minimum Contribution

In a public issue by a listed company, the promoters are either required to contribute at least 20% of the proposed issue, or to ensure that their shareholding be kept at 20% or more of the company’s expanded capital⁵⁵. However, there are exemptions to this rule.

Firstly, a public issue by a company which has been listed on a stock exchange for at least three years and has a track record of dividend payment for at least three immediate preceding years does not require the promoters’ contribution, subject to a disclosure of the relevant information in the offer document⁵⁶. Secondly, if there are no identifiable

⁵² “GSFC oversteps SEBI guideline, listing after 111 days”, *The Financial Express*, June 23, 1997.

⁵³ The guideline was modified to “will have a post-issue net worth of more than five times its pre-issue network” from “has been listed for less than 3 years or does not have a three-year track record of dividend payment out of the preceding five years”. (SEBI Press Release Ref. No. PR 91/97, dated August-12, 1997).

⁵⁴ Section C (a) of SEBI Guideline, dated June 11, 1992.

⁵⁵ Section L (a) of SEBI Clarification No. II, dated July 16, 1992.

⁵⁶ Section III.3 of Part A of SEBI Clarification No. XIV, dated March 1, 1996.

promoters or promoter group among the shareholders of a company, the company's public issue, like an IPO, does not require the promoters' contribution⁵⁷.

In a composite issue of equity shares and rights by a listed company, the promoters are required to either contribute at least 20% of the proposed issue, or to ensure that their shareholding be kept at 20% or more of the company's expanded capital. The expanded capital does not include proceeds from the rights issue⁵⁸.

As in the case of an IPO, certain equity shares in a public issue by a listed company do not qualify as the promoters' contribution, including shares of a company that the promoters acquired during the preceding three accounting years as a result of:

- (i) a revaluation of assets or capitalization of intangible assets, or
- (ii) a revaluation of reserves without infusion of cash⁵⁹.

In a public issue of convertible securities, the promoters have the option to contribute to the issue by way of subscription either to equity shares or to convertible securities offered in the issue, subject to a disclosure of the relevant information in the offer document⁶⁰.

The promoters' minimum contributions to a public issue are also subject to minimum rupee amounts: Rs. 25,000 from each individual, and Rs. 100,000 from a firm or company⁶¹.

Lock-in Period

The lock-in period, like the promoters' minimum contribution, is also applicable to a public issue. As in the case of an IPO, the promoters' minimum contribution to a public issue (if any) will be locked in for a period of three years⁶² from the date of allotment in the issue or the date

⁵⁷ Section III.3 of Part A of SEBI Clarification No. XIV, dated March 1, 1996.

⁵⁸ Section 3 (C) of SEBI Clarification No. VIII, dated October 11, 1993.

⁵⁹ Sections M (a)-(b) of SEBI Guidelines, dated June 11, 1992; Sections M (iii)-(iv) of SEBI Press Release, dated April 13, 1994 (Additional Guidelines-Bonus Issue, RMB (DIP Series) Circular No. 2 (94-95), dated April 15, 1994).

⁶⁰ Section A (a) of SEBI Clarification No. II, dated July 16, 1992; Section 2.5 (b) of SEBI Clarification No. VII, August 10, 1993.

⁶¹ Section 2.7 of SEBI Clarification No. VII, August 10, 1993; Reduced to Rs. 25,000 from Rs. 50,000.

⁶² The lock-in period in respect of public issues has been reduced to 3 years from 5 years across the board. Part B of SEBI Clarifications No. XIX, RMB (DIP Series) Circular No. 5 (96-97), May 14, 1997.

of commencement of commercial production, whichever is later. In addition, if the promoters' contribution in a public issue exceeds the stipulated minimum promoters' contribution, the excess contribution will also be locked in for a period of three years.

Table 8.6. summarizes the promoters' contribution requirements and their lock-in periods for public issues by listed companies.

Table 8.6
**Minimum Promoters' Contribution & Lock-in Period
in Public Issues by Listed Companies**

<i>Class of Companies</i>	<i>Minimum Promoters' Contribution</i>	<i>Lock-in Period</i>	
		<i>For Minimum Promoters' Contribution</i>	<i>For Excess of Contribution</i>
(1) A company which has been listed on a stock exchange for at least 3 years and has a track record of dividend payment for at least 3 immediate preceding years	Not required	Not applicable	Not applicable
(2) A listed company which does not satisfy the conditions in (1) above.	The contribution to be at least 20% of the proposed issue or the shareholding to be at least 20% of the expanded capital.	3 years	3 years

Source: SEBI Guidelines & Clarifications.

8.2 Rights Issues

8.2.1 Rights Issue *versus* Public Issue

In India, where companies laws are influenced by the UK, issues of new shares for cash have to be made by way of rights unless (i) a special resolution in favor of a public issue by the company is passed in a general meeting or (ii) the votes cast in favor of the proposal exceed those cast against the proposal and a special approval is granted by the Central

Government⁶³. However, new capital raised by public issues far exceeds that raised by rights issues. In 1995-96, for instance public issues accounted for 83% of the total number of issues, and 68% of the total amount raised, while rights issues accounted for 17% of the total number of issues, but 32% of the amount raised⁶⁴.

Investors are advised to refer to the letter of offer when they wish to invest in a rights issue. The letter of offer is a disclosure document for a rights issue whose disclosure contents are simpler than those of a prospectus.

Rights issues by listed companies are no longer subject to a promoters' contribution requirement, and consequently there is no lock-in period applicable to promoters' contributions⁶⁵. A listed company may freely price its equity shares or convertible securities offered through a rights issue. It is mandatory to appoint a registrar to an issue for rights issues⁶⁶.

8.2.2 Renounced Rights

All rights offered by listed companies can be renounced. An exchange's listing agreement for shares usually requires an applicant company to commit itself to granting the right of renunciation to shareholders and to forwarding a supply of the renunciation forms promptly to the stock exchange.

Non-renounceable rights issues may arise in the following situations:

- where a preferential share issue results in a right to subscribe to shares of associate companies; and,
- where such an issue is offered by unlisted companies.

8.3 RBI Approval

FIIIs are not totally free to invest in an IPO issue or any other new issue. Their investments in Indian new issues are subject to prior approval from both RBI and SEBI.

⁶³ Section 81 (1)-(1A) of the Companies Act, 1956.

⁶⁴ SEBI Annual Report 1996.

⁶⁵ Part B of the SEBI Clarification No. XIX, RMB (DIP Series) Circular No. 5 (96-97), dated May 14, 1997.

⁶⁶ SEBI Press Release Ref. No. PR 91/97, dated August 12, 1997.

FII's are allowed to subscribe to only those new issues that have quotas specially reserved for FII's, NRIs and OCBs (see Section 2.2). An issuing company which wishes to allocate part of its new shares to foreigners, has first to obtain in-principle permission from RBI to reserve such a quota in its new issue. The company, then files a registration statement of the new issue with SEBI and the Registrar of Companies, along with RBI's in-principle permission.

The maximum amount of new shares or equity-linked securities that a company can reserve for foreigners is 24% or 30% of the company's share capital, since the aggregate foreign ownership is subject to an overall ceiling of 24% or 30%, as the case may be (see Section 2.3.5).

An FII applies for subscription to the newly-issued securities through its custodian. The custodian, upon receipt of the necessary instructions and funds, applies for the subscription. An individual FII's subscription is also subject to RBI's approval. The issuing company can issue certificates only after it has received the approval from RBI. It is said that there have been some cases where certificates were ready with the issuing company for several months but the company was unable to release them formally to FII's because it could not receive an approval letter from RBI.

8.4 Private Placement

A private placement is also known as a placing. Existing shareholders are not normally given the chance to participate in a private placement. Instead, securities are sold directly to third parties. Private placements are often made with a limited number of sophisticated investors such as FII's, venture capital funds, pension funds, financial institutions, vendors, etc. before a listing is obtained. This helps the company broaden its shareholder base to qualify for a listing. A private placement may be also made in conjunction with a public issue or after the company has gone public.

There is no clear-cut distinction between a preferential allotment and a private placement in the Indian context. A preferential allotment is also a private placement to the extent that it is neither a public offer nor a rights issue (see Section 8.5). No offer or invitation is treated as made to the

public if the offer or invitation can properly be regarded, in all the circumstances:

- as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation; or
- otherwise as being a domestic concern of the persons making and receiving the offer or invitation⁶⁷.

Therefore, neither does a prospectus nor an abridged prospectus need to be delivered to investors in a private placement. The SEBI Guidelines for Disclosure and Investor Protection do not apply to a private placement, either⁶⁸.

Shares or debentures that were privately placed are not subject to any lock-in period as the lock-in period for securities issued by way of a preferential allotment to investors other than the promoters or his or her group was removed in March 1996⁶⁹.

SEBI is expected to regulate private placement in the near future since private placement of debt securities by Indian corporations has been growing because issuers have realized the simplicity of private placement procedures⁷⁰. Indian securities that are privately issued without sufficient disclosure may find their way to unsophisticated investors, who are prone to fraudulent issues of securities or may be misled into unsuitable investments. In developed countries, therefore, private placement is generally subject to very strict restrictions.

8.5 Preferential Allotment

8.5.1 Definition of Preferential Allotment

An issue of securities to selected persons, at a price which may or may not be related to the prevailing market price of the securities, is

⁶⁷ Section 67 (3) of the Companies Act, 1956.

⁶⁸ Proviso of Section 56 (3) of the Companies Act, 1956 and SEBI Press Release, dated January 28, 1993.

⁶⁹ Part B of SEBI Clarification No. XIV, dated March 1, 1996.

⁷⁰ "Capital market watchdog should frame effective norms for private placement, feel experts", *Business Standard*, October 13, 1997; "Norms to regulate private placement market in offing", *The Financial Express*, October 17, 1997.

conventionally called preferential allotment in the Indian capital market. The selected persons need not be existing shareholders of the company. A preferential allotment is not linked to a public issue and should not be mixed up with reservations on a preferential basis in a public issue (see Section 8.1.3). This method of a new issue is increasingly used in India due to the growing threat of takeovers.

The common shareholders are the owners of a company. Therefore, they have a general preemptive right to anything of value that the company may wish to distribute, including the potentially valuable opportunity to buy new issues of securities. Hence, a preferential allotment is subject to a special resolution in favor of a public issue by the company which is passed in a general meeting or a special approval which is granted by the Central Government under Section 81 (1A) of the Companies Act, 1956. It is different from a public issue in that securities are not issued to the public (unspecific and many investors) but to selected persons.

8.5.2 Pricing Rules and Lock-in Period

A preferential allotment earlier had some undesirable features. Firstly, allotments tended to be made to the promoters or existing management. Secondly, the issue prices of securities tended to be unrelated to the prevailing market price or the rationally calculated economic value of the securities in favor of the allottees⁷¹. The minority shareholders' interests were thus likely to be compromised, especially in the context of takeover rivalries. To alleviate this problem, SEBI introduced pricing rules and a lock-in period in August 1994.

A preferential allotment of shares can now only be made at a price not less than the higher of the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date, or that on a stock exchange⁷² during the two weeks preceding the relevant date. The relevant date here

⁷¹ Additional Guidelines - Preferential Allotments of Shares, SEBI Press Release, dated August 4, 1994, as amended by SEBI Press Release, dated August 8, 1994. SEBI RMB (DIP Series) Circular No. 3 (94-94), dated August 5, 1994.

⁷² It is not clear what "a stock exchange" means. To be precise, the text defines "stock exchange" as stated in the sentence after the following above, but not "the stock exchange". Therefore, the definition of "stock exchange" may apply to "a stock exchange". If so, "a stock exchange" should read "the stock exchange".

means the date thirty days prior to the date on which the general shareholders meeting is convened under Section 81 (1A) of the Companies Act, 1956 to consider the proposed preferential allotment. The stock exchange means any of the stock exchanges in which the shares are listed and in which the highest trading volume in respect of the shares of the company has been recorded during the preceding six months prior to the relevant date⁷³. The pricing formula for a preferential allotment to FIIs or non-residents is slightly different from the above and will be discussed later in this section.

Pricing of shares to be issued upon the exercise of warrants or conversion of convertible bonds that are issued by way of a preferential allotment is also regulated so that the allottees may not be unreasonably favored at the expense of the minority shareholders.

Securities issued to the promoters or his or her group by way of a preferential allotment have a lock-in (lock-up) period of 3 years⁷⁴, and are not transferable for that period. The lock-in period for securities issued to other categories of investors by way of a preferential allotment was removed in March 1996⁷⁵.

8.5.3 Preferential Allotment to FIIs

A preferential allotment to FIIs is permitted up to 15% of the equity of the company, subject to the individual foreign ownership limit of 10% and the aggregate foreign ownership limit of 24% or 30%, as the case may be⁷⁶.

The price at which a preferential allotment can be made to FIIs can not be less than the highest price during the previous 26 weeks on all the stock exchanges where the securities of the company are listed⁷⁷. The 26 weeks are counted from the date of the resolution by the general

⁷³ Additional Guidelines - Preferential Allotments of Shares, SEBI Press Release, dated August 4, 1994, as amended by SEBI Press Release, dated August 8, 1994. SEBI RMB (DIP Series) Circular No. 3 (94-94), dated August 5, 1994.

⁷⁴ *Ibid.*, and "Meeting of Advisory Committee on Primary Market held on Thursday, February 06, 1997", SEBI Press Release Ref. No. PR 33/97, March 6, 1997

⁷⁵ Part B of SEBI Clarification No. XIV, dated March 1, 1996

⁷⁶ SEBI Press Release (IIMARP Department), dated May 13, 1994

⁷⁷ SEBI Press Release (IIMARP Department), dated January 11, 1994

shareholders meeting under Section 81 (1A) of the Companies Act, 1956⁷⁸.

Securities issued to FIIs by way of a preferential allotment are not subject to any lock-in period.

8.5.4 Preferential Allotment to Non-Residents

Central to the Government of India's economic reforms is the raising of foreign capital for the expansion of Indian companies. The raising of foreign capital by Indian companies is often coupled with strategic alliances with foreign companies which are not FIIs. In this situation, a preferential allotment may be used not only to raise capital but also to reinforce the strategic alliance with the foreign shareholder for technology transfer, overseas marketing network, and so on.

Investments in Indian companies by foreign investors who are not registered FIIs are governed separately from portfolio investments by registered FIIs, and are beyond the scope of this book. Therefore, the discussion here is limited to the pricing rules and lock-in period of shares issued to non-residents by way of a preferential allotment.

The Reserve Bank of India (RBI) laid down the pricing rules for preferential allotments to non-residents in respect of:

- (i) listed companies, and
- (ii) unlisted companies or companies whose shares are listed but not regularly traded⁷⁹, separately.

For listed companies, the pricing rules are the same as those of SEBI which have been described in Section 8.5.2. However, for unlisted companies or companies whose shares are listed but not regularly traded, the pricing of shares has to be based on the net asset value (NAV) and profit earning capacity value (PECV) per share according to the valuation guidelines

⁷⁸ SEBI Press Release (IIMARP Department), dated May 13, 1994.

⁷⁹ "Regularly traded" is not defined in the relevant circular of the RBI. However, it is reasonable to infer from other RBI circulars No. AD/MA20/1996, No. RBI AD (M.A. Series) Circular No. 20, dated October 28, 1996, and RBI Press Release No. 1996-97/155, dated September 18, 1996 that a share is considered as regularly traded if the annualized trading turnover in that share during the preceding six calendar months prior to the month in which the application for an approval is submitted to the RBI, is 2% or more (by number of shares) of the listed stock.

notified by the former Controller of Capital Issues (CCI) of the Government of India in December 1990⁸⁰.

The shares issued to non-residents by way of a preferential allotment are not transferable for a period of five years from the date of their allotment⁸¹.

8.6 Refund of Subscription Money

8.6.1 Undersubscription

The issuing company is entitled to retain and use the proceeds from a public issue only if the total of:

- (i) the amount subscribed by the public,
- (ii) the amount devolved on and accepted by underwriters (if any), and
- (iii) the amount procured from other sources such as the promoters of the company (if any),

has exceeded 90% of the issue amount within 60 days from the date of closure of the issue. If the total falls short of 90% of the issue amount, the issuing company is required to cancel the new issue and refund the entire subscription amount to the subscribers⁸² (see Section 8.1.4).

Furthermore, SEBI has asked the stock exchanges to incorporate more stringent clauses into their listing agreement in respect of the time frame for the allotment of securities in a public issue. Under such clauses, the issuing company is required to make the allotment of securities offered to the public within 30 days of the closure of the public issue as far as

⁸⁰ RBI AD (M.A. Series) Circular No. 12, dated July 8, 1994 and June 16, 1995.

⁸¹ RBI AD (M.A. Series) Circular No. 12, dated June 16, 1995. The SEBI removed a lock-in period for preferential allotments to investors other than the promoters or his/her group in March 1996 (Part B of SEBI Clarification No. XIV, dated March 1, 1996). It is not clear that the same removal is applicable to the RBI rule.

⁸² SEBI Clarifications No. 19, RMB (DIP Series) Circular No. 5 (96-97) May 14, 1997; Section D (a), SEBI Guidelines, (PMD Circular 4545/92, dated June 11, 1992); Section D (a)-(b), SEBI Guidelines, dated November 4, 1992; Section C.5 of RMB (GI Series) Circular No. 1; Section 5 of RMB (GI Series) Circular No. 7 (93-94), dated January 20, 1994; and Clause 14 (2) of Model Underwriting Agreement between Underwriter and Issuer-Company, circulated in RUW Circular No. 1 (93-94), dated November 19, 1993. (RUW = Registered Underwriters)

possible, and to pay interest at 15% per annum if the allotment is not made and/or the refund orders not dispatched to the investors within 30 days from the closure of the public issue⁸³ (see Sections 8.1.3 & 8.1.4).

How are the 60- and 30-day periods related to each other? A public or rights issue falls through if it is undersubscribed and 90% or more of the issue amount is not procured within the 60-day period, and consequently the subscribed monies need to be refunded. In the case of a public issue, the issuing company is obligated to pay interest at 15% per annum unless it completes the allotment or refunds the subscribed monies within the 30-day period. If the issuing company pays interest after the end of the 30-day period, therefore, the public issue can survive the undersubscription for another 30 days by paying interest on the subscribed monies.

As for a right issue, the minimum subscription requirement and the penal interest payment is straightforward. The period in which the minimum subscription is to be made is 42 days from the date of closure of the issue, 8 days after which the obligation to pay the 15% penal interest for the delayed refund is triggered (see Section 8.1.4).

8.6.2 Oversubscription

In the case of oversubscription of a public issue, the issuing company generally makes the allotment up to the issue amount plus the “green shoe” amount (if any), and refunds the amount of the unallotted securities within 30 days of the closure of the issue. This is because the company is required to pay interest at 15% per annum on the amount to subscribers after the 30-day deadline⁸⁴.

⁸³ SEBI Press Release SMD/RCG/JJ/1819/96, dated May 15, 1996, and “Amendments to the Listing Agreement – Clause 44 & Clause 45”, BSE Press Release, dated May 28, 1996; in the case where a 100% book-building method is employed (see Section 8.1.3), the allotment period is 15 days. (SEBI Clarification No. XXI, Ref. No. 125/97, dated October 23, 1997)

⁸⁴ *Ibid.*

Debt Market

9.1 Characteristics of the Indian Debt Market

9.1.1 Market Size

The total market size of the Indian debt market is currently estimated to be in the range of US\$92 billion¹ and US\$ 100 billion. The exact market size is not clear. The total outstanding balance of debt securities listed on the NSE's wholesale debt market segment was Rs. 3,184.73 (approximately US\$ 89 billion) as at the end of June 1997. There is a significant amount interested in bonds that were issued privately and not listed on NSE. Table 9.1 indicates that India has the third largest debt market in East, Southeast and South Asia.

Table 9.1
Size of Asian Fixed Income Markets (1996)

	(in US\$ bil)
South Korea	231.1
India	96.8
Taiwan	75.6
Singapore	58.0
China	51.8
Malaysia	47.1
Hong Kong	39.9
Philippines	38.3
Indonesia	30.4
Thailand	17.3
Total	686.3
Japan	4,095.6*

* Outstanding balance of government and corporate bonds as at the end of September 1996.

Source: Peregrine, Asia Fixed Income Market Handbook, March 1997.

¹ "Corporate bond issues likely to double in 5 years: Patil", *The Financial Express*, July 16, 1997.

India's debt market has a substantial growth potential. If it is converted into per capita size, the market is not necessarily large at present, accounting for approximately 30% of her GDP. Given the expected growth of India's GDP, the current ratio of India's debt market size to the country's GDP and other factors, however, the debt market is expected to grow at an annual rate of approximately 15% in nominal rupee terms.

The breakdown of the Indian debt market in Table 9.2 shows that the public sector's financing in the debt securities market accounts for nearly 90% of the total. If debt financing by development financial corporations like the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India is excluded, the private sector's financing in the debt market amounts to only US\$ 7 billion equivalent, or 7% of the total. The government deficit has evidently crowded out the private sector borrowing from the debt market. However, the declining trend in the fiscal deficit is expected to give more room for debt financing by corporations.

Table 9.2
Estimated Size of India's Debt Market

	<i>(in US\$ bil.)</i>
Government sector	
Bonds	71
Treasury bills	5
Public sector undertakings	12
Development financial institutions	5
Certificate of deposits	4
Corporate issues	3
Total	100

Source: Peregrine.

9.1.2 Liquidity

Indian debt securities are traded in the wholesale debt market segment of NSE (see Section 4.4.6) and over the counter. The ratio of the trade volumes on NSE and over the counter is roughly estimated by the exchange to be 60:40 in respect of government securities including T-bills, and 25:75 in respect of other debt securities. However, it is said that

even trades recorded in the wholesale debt market segment of the NSE are mostly negotiated over the phone and then registered with the exchange for reporting purposes; and that very little order matching actually goes on in the exchange.

This phenomenon is neither strange nor peculiar to India, and exists everywhere in other parts of the world. Bond trading is, in a sense, much more complicated than stock trading. It involves some negotiations before a trade is done. The stock investor wants to buy or sell a specific stock or stocks. There are very few alternatives to his or her choice. There is usually little room for negotiation other than the information that one sees on the trading screen. In picking up a particular issue of bonds, the bond investor or trader essentially looks at the yield, maturity, liquidity and credit risk of a bond, and often has flexibility in some of these parameters. In a typical case, the investor or trader has no strong reason to stick to a specific issue so long as his or her investment parameters are satisfied. There can be at least a few alternatives to his or her choice, and the investor or trader usually negotiates the terms of a trade before he or she trades.

The liquidity of the Indian debt market is generally not high, though it is increasing. Since statistics of the whole debt market in India were not available, the trading data in the wholesale debt market segment of the NSE during the period from January to June 1997 were analyzed in order to sketch out the liquidity pattern of the Indian debt market. The analyses are given in Table 9.3 and Table 9.4. The salient features in respect of the trading liquidity are:

- Trading of government securities, namely, dated government securities and T-bills, is dominant, and highly liquid. Dated government securities were traded every day and T-bills were traded in 90.1-92.3% of the period.
- Corporate bonds were as liquid as government securities, though their outstanding amount was very small.
- State government securities and PSU bonds were very illiquid. The annualized turnover ratios of state government securities and PSU bonds were only 8% and 7%, respectively.

Table 9.3
Security-wise Breakdown of Trades on NSE

	Jan-Jun 1997				Apr-Jun 1997			
	Amount (Rs. bil)	Share	Days traded	% Days traded	Amount (Rs. bil)	Share	Days traded	% Days traded
T-bills	87.74	20.9%	132	92.3%	45.51	18.1%	64	90.1%
Other Govt sec.	287.01	68.4%	143	100.0%	178.58	71.1%	71	100.0%
State govt sec.	5.25	1.3%	83	58.0%	4.06	1.6%	30	42.3%
PSU bonds	14.51	3.5%	94	65.7%	6.64	2.6%	46	64.8%
Institutions/Banks	13.44	3.2%	70	49.0%	9.11	3.6%	42	59.2%
Corporate bonds	11.53	2.7%	55	38.5%	7.36	2.9%	33	46.5%
Mutual funds	0.01	0.0%	1	0.7%	0.00	0.0%	0	0.0%
Others (securitized debt)	0.03	0.0%	1	0.7%	0.03	0.0%	1	1.4%
Total	419.52	100.0%	143	100.0%	251.29	100.0%	71	100.0%

Compiled from NSE data.

Table 9.4
Estimated Annual Turnover of Debt Securities on NSE

	Outstanding Amount (in Rs. bil.)			Traded amount (Apr-Jun '97) (in Rs. bil.)	Estimated annual turnover
	30 Jun '97	31 Mar '97	Estimated average (Apr-Jun '97)		
Gol Sec.	2,087.92	2,215.26	2,151.59	224.09	42%
State govt sec.	213.88	206.56	210.22	4.06	8%
PSU bonds	385.74	379.36	382.55	6.64	7%
Corporate bonds	71.18	60.70	65.94	7.36	45%

Compiled from NSE data.

9.1.3 Statutory Liquidity Ratio

The Statutory Liquidity Ratio (SLR) significantly affects the holding pattern of Indian debt instruments. Under the Banking Regulation Act, 1949, commercial banks² are required to maintain a stipulated portion of their demand and time liabilities in India as liquid assets in the form of cash, gold or unencumbered approved securities. This reserve requirement is known as the SLR which is currently set at 25% of the net

² To be precise, commercial banks referred to are scheduled commercial banks.

demand and time liabilities on a daily basis³. The approved securities eligible for meeting this requirement include central government securities, treasury bills, state government securities, and government-guaranteed bonds. Consequently, commercial banks are traditionally dominant investors in those securities.

Government-related financial institutions like the Life Insurance Corporation, General Insurance Corporation, and provident funds are also subject to similar requirements when investing a minimum amount of their funds in government securities.

RBI gradually raised the SLR in the 1970s, and the ratio went up as high as 35% in the 1980s. The increase in the ratio was not intended to enhance banks' liquidity but was needed to support the rapidly growing size of government borrowing at that time. To minimize their debt servicing cost, the central and state governments fixed the yield on government securities at an artificially low level. The SLR became instrumental in financing the budget deficits at the expense of the normal mechanism of the financial market. Commercial banks would have had little rationale for investing in such low-yielding bonds if the statutory requirements did not compel them to hold a certain amount of government securities⁴.

In April 1993, the Indian Government revised its bond pricing policy to reflect the prevailing market-driven yield. This new policy highlights the Indian Government's determination not to abuse the SLR any longer.

All scheduled banks are required to submit to the RBI their compliance reports on each alternate Friday, which is referred to as a "reporting Friday". The report contains the holdings of SLR-eligible securities and their evaluation for SLR requirement purposes.

9.1.4 Investment by FIIs

FIIs are allowed to invest up to 30% of their funds in Indian debt securities. Subject to a special approval from SEBI, however, FIIs are permitted to set up funds to invest 100% in Indian debt securities. In either of the two cases, FIIs are not allowed to invest in treasury bills of

3 RBI, Section 17 (d) of "Monetary and Credit Policy for the Second Half of 1997-98", Ref. No CPC.BC.165/07.01.279/97-98, dated October 21, 1997.

4 Corporate Investment Research and Consultancy Bureau, *Structure and Management of The Gilt-edged Securities Market in India*, New Delhi, 1983, p. 33.

the Indian Government. More details of regulations regarding FIIs' debt investment are given in Section 2.3.7.

Though FIIs have obtained special approvals from SEBI for investments in Indian debt securities which total US\$ 1.778 billion, their actual investment stood at US\$ 105.2 million as of August 11, 1997⁵.

9.2 Types of Debt Instruments⁶

9.2.1 Central Government Securities

Characteristics

Central Government Securities (GoISecs) are medium- to long-term rupee-denominated obligations issued by RBI on behalf of the Government of India to finance the central government's fiscal deficit. The maturity period of GoISecs ranges from 2 years to 10 years. It used to be 5 to 31 years in the 1980s. There are various types of central government securities such as fixed-rate bonds, flaring rate bonds, zero coupon bonds (first issued in January 1994). Coupon payments on fixed-rate and flaring rate bonds are made semi-annually. Interest is calculated on the basis of a 360-day year, consisting of 12 months of 30 days each (day count of 30/360). Government securities are not rated.

There is currently no withholding tax on coupon payments of government securities. Withholding tax on government securities was abolished on June 1, 1997. Earlier, coupon payments of central government securities were subject to withholding tax which varied according to the investor's tax category. Provident funds were exempt from withholding tax.

No matter whether they are in a book entry or physical form, central as well as state government securities are exempt from stamp duty on the registration of ownership.

Primary Market

Earlier, RBI underwrote all issue amounts of government securities at a sub-market yield. The Indian Government changed the pricing policy for

⁵ SEBI Press Release Ref. No. PR 91/97, August 12, 1997.

⁶ Descriptions in this sections were considerably based on World Bank, June 1995, *The Emerging Asian Bond Market, India*; Peregrine, *Asia Fixed Income Market Handbook*, Mar. 1997; and an NSE note, *NSE - Wholesale Debt (WDM) Segment*.

government to market-determined levels from artificially low sub-market levels in April 1993; the pricing of government bonds at market levels has increased the demand for such bonds.

The primary dealer system was introduced in March 1995 (see Section 3.2.5). Under the new system, primary dealers registered with RBI can bid for government securities that are issued through a treasury style (French) auction by RBI. There is no fixed frequency or calendar for issuance. RBI announces the details of an auction through a press release two business days before the scheduled auction. All resident Indian entities and FIIs are eligible to bid for the issue in an auction through one of the registered primary dealers. Successful bids normally settle two business days later.

A typical issue size is Rs. 30-50 billion (approx. US\$ 840-1,400 million).

Secondary Market

With a view to making the secondary market of Central Government Securities active, the Securities Trading Finance Corporation of India Ltd. (STCI) and Discount and Finance House of India Ltd. (DFHI) were established in November 1995 and started their primary dealer operations in March 1996. These were the first two primary dealers in India. Four more primary dealers were appointed in June 1996 and 17 satellite dealers were appointed from all over the country in April 1997 (see Section 3.2.5). These are expected to be market makers in government securities, T-bills and commercial papers. To the same end, the wholesale debt market segment was instituted at the National Stock Exchange (see Section 4.4.6) in June 1994.

Banks had been allowed to retail government securities, subject to the stipulation that the banks shall not buy the security from the person to whom it is sold within a period of 30 days. In order to promote the retail market segment and provide greater liquidity to retail investors, RBI allowed banks in October 1997 to freely buy and sell government securities on an outright basis at prevailing market prices, without any restriction on the period between sale and purchase⁷.

Government securities are reasonably liquid. Primary dealers provide two-way quotes for these securities. Daily trading volumes on NSE averaged Rs. 2.5 billion during the period between April and June 1997

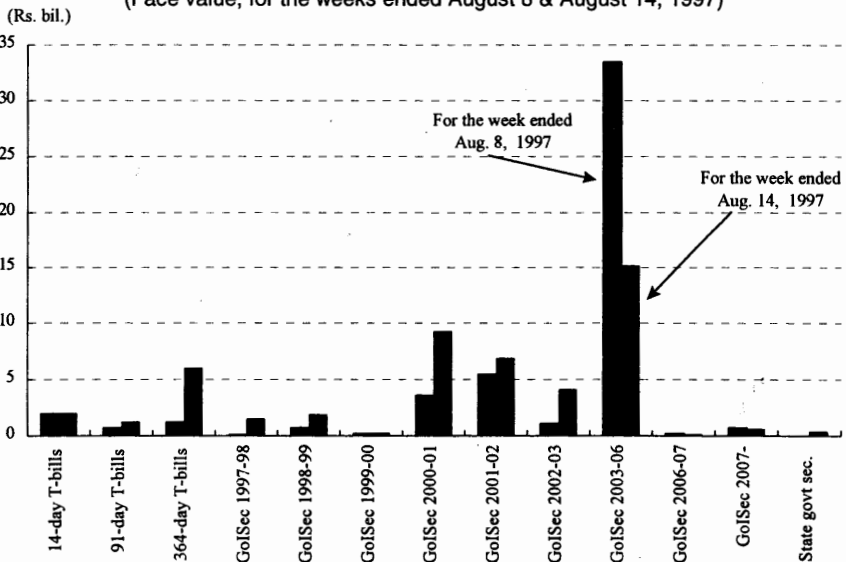
⁷ RBI, Section 17 (m) (vi) of "Monetary and Credit Policy for the Second Half of 1997-98", Ref. No CPC.BC.165/07.01.279/97-98, dated October 21, 1997

with transaction sizes ranging from Rs. 50 to 100 million. Trading takes place either over the phone between the primary dealers or through the NSE trading members on the NSE. The main reasons for the high liquidity of government securities are:

- (i) that their issue sizes are large;
- (ii) that they are “risk-free”;
- (iii) that they have shorter maturities; and
- (iv) that they are eligible for inter-bank repo transactions.

Figure 9.1 shows the secondary market transactions in government securities for the weeks ended 8 August and 14 August 1997. Debt securities of what maturity period are actively traded significantly depends on the interest rate expectation prevailing in the market. Yet, it is reasonable to say that government securities of 6-9 years maturity periods in general have the highest liquidity in the Indian debt market, followed by those of 3-4 years, 4-5 years and 5-6 years or 364-days T-bills.

Figure 9.1
Secondary Market Transactions in Government Securities*
(Face value, for the weeks ended August 8 & August 14, 1997)



* As reported in SGL accounts at the RBI, Mumbai, which accounts for nearly 98% of total transaction in the country.

Source: The RBI.

Brokerage for government securities is normally 1 basis point (0.01%) but is negotiable. It can be collected from the buyer or the seller, or from the both.

Investors

Commercial banks are dominant investors in government securities due to the RBI's requirement of SLR (see Section 9.1.3). As stated above, the demand for government securities has increased since the Indian Government's change in the pricing policy in April 1993, and the investor base has widened to include securities insurance companies, non-banking financial institutions, provident funds, pension funds, and cash-rich corporations. RBI also purchases government securities and uses them for its open market operations.

Clearing and Settlement

RBI is responsible for the administration of the public debt of the central government as well as state governments. Accordingly, RBI functions as the registrar and the depository for central and state government securities. Holders of these securities register their ownership with the Public Debt Office of the RBI. To own and transact government securities, commercial banks and financial institutions open and maintain the subsidiary general ledger (SGL) and current accounts with the central bank. Other holders of government securities open and maintain sub-accounts with one of the SGL account holders.

Government securities are in a book entry form. Their trades settle on a delivery versus payment (DVP) basis on the trade date through SGL accounts or their sub-accounts. The seller issues an SGL transfer form to the buyer, and the buyer in turn submits it to the Public Debt Office of the RBI for transfer of ownership. This DVP system for government securities was introduced in July 1995.

Physical certificates of government securities are also available on request. At the time of primary issue, an investor can get physicals by applying to the Public Debt Office of the RBI. He or she will receive them in about 10-15 days. In the case of a secondary market transaction, the buyer who wishes to have physicals requires the seller to make a request to the office in favor of the buyer. In such a case, it takes 20-30 days.

9.2.2 Treasury Bills

Characteristics

Treasury Bills (T-bills) are short-term rupee denominated obligations issued by RBI on behalf of the Government of India, and are in the form of a discounted government promissory note or by credit to the Securities General Ledger account. The RBI is currently slated to issue T-bills of four maturity periods: 14, 91, 182 and 364 days. However, it presently issues only 14-, 28-, 91- and 364-day T-bills. T-bills can be broadly grouped into three categories:

- (i) ad hoc,
- (ii) on-tap, and
- (iii) auctioned T-bills.

Interest is calculated on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365).

No withholding tax is applicable to T-bills. No stamp duty is payable on the transfer of T-bills, either.

Primary Market

Ad hoc T-bills are issued by the Indian Government only to RBI when required. There is no pattern of issuance. On-tap T-bills are issued by RBI to investors on every working day. The auction for 91-day T-bills is held every Friday for an amount notified in advance by the RBI. The RBI can participate in 91-day T-bill auctions. 364-day T-bills are auctioned on a bi-weekly basis on the Wednesday preceding the reporting Friday (see Section 9.1.3). The RBI does not subscribe to 364-day T-bills.

T-bills are issued through a competitive treasury-style (French) auction. An investor can submit multiple tenders at different prices, on separate forms subject to the auction size limit. All T-bill auctions have a notified amount which is filled by bids up to a cut-off price. Non-competitive bids are outside the notified amount, and fully or partially accepted from pension funds and state governments at the RBI's discretion⁸. They are filled at the weighted average price of the successful bids. Successful bids settle one business day later for 91-day T-bills and two business days later for 364-day T-bills.

⁸ RBI, Section 17 (m) (iv) of "Monetary and Credit Policy for the Second Half of 1997-98", Ref. No CPC.BC.165/07.01.279/97-98, dated October 21, 1997.

A typical auction size of 91-day T-bills and 364-day T-bills ranges from Rs. 5 billion (approx. US\$ 140 million) and Rs. 3-10 billion (approx. US\$ 84-280 million), respectively. RBI used to purchase roughly 95-100% of T-bills issued; after the introduction of auctions in April 1993, which reflects the demand and supply relationship in the market place, however, the RBI's participation radically declined and other investors now purchase over 25% of T-bills on the average.

Secondary Market

T-bills are also reasonably liquid. Primary dealers act as market makers and provide two-way quotes on a daily basis. Daily trading volumes on the NSE averaged Rs. 641 million during the period between April and June 1997 with an average transaction size of Rs. 50 million. Trading of T-bills, just like that of government securities, takes place either over the phone between the primary dealers or through the NSE trading members on the NSE. The main reasons for the high liquidity of T-bills are the same as those for government securities in general:

- (i) that their issue sizes are large;
- (ii) that they are "risk-free";
- (iii) they have shorter maturities; and
- (iv) that they are eligible for inter-bank repo transactions.

Investors

Only RBI can hold add hoc T-bills. Table 9.5 below shows that the predominant investors in on-tap and auctioned T-bills are commercial banks, followed by state governments. RBI participates in the residual

Table 9.5
Investors of T-bill
(Face value, August 14, 1997)

	14-day (auction)	14-day (inter- mediate)	91- day	364-day	Total (Rs. bil)	%
RBI	0.00	0.00	0.00	0.00	0.00	0.0%
Banks	58.79	0.00	17.24	110.96	186.99	57.6%
State government	0.00	68.44	27.91	0.00	96.35	29.7%
Others	2.35	6.43	3.35	29.25	41.38	12.8%
Total	61.14	74.87	48.50	140.21	324.72	100.0%*

* Rounding error.

Source: The RBI.

portion of auctioned 91-day T-bill issues. After the adoption of market-determined pricing, the investors in T-bills widened to include finance companies, cash-rich corporations, public sector undertakings, and mutual funds.

FIIIs are currently not permitted to invest in T-bills.

Settlement and Clearing

T-bills are in a book entry form, but their physical certificates are also available on request. Trades of T-bills, like those of central government securities and state government securities, settle through SGL accounts with the RBI. At the time of primary issue, the investor can get physicals by applying to the Public Accounts Department of the RBI. He or she will receive them in about 10-15 days. In the case of a secondary market transaction, the seller is required to make a request for physicals to the department in favor of the buyer. In this case, physicals will be available to the buyer in 15-30 days.

9.2.3 State Government Securities

State government securities pay fixed-rate coupon on a semi-annual basis. All the state government securities offered during a particular financial year carry identical coupon rates and maturity. Coupon rates on state government securities are usually higher than those on central government securities to make up for lower liquidity and credit quality. Interest is calculated on the basis of a 360-day year, consisting of 12 months of 30 days each (day count of 30/360).

Interest payments on state government securities, like those on central government securities, are not subject to withholding tax; and state government securities are exempt from stamp duty for the registration of ownership.

During a fiscal year, RBI pools together and offers bonds of all the state governments pooled together for subscription, in one or two tranches, since individual fund requirements are too small to warrant separate issuance. New issues settle within 2-3 days. State government securities are not rated. However, the secondary market differentiates between securities issued by large, industrial and financially-sound states and other states.

The secondary market of state government securities is illiquid. Daily trading volumes on NSE averaged Rs. 57 million during the period

between April and June 1997. The typical transaction size was Rs. 5-10 million.

The investor profile for state government securities is almost the same as that for central government securities.

As has been discussed earlier in Section 9.2.1, state government securities settle through the RBI.

9.2.4 Government-guaranteed Bonds

Government-guaranteed bonds are medium- to long-term debt securities issued by government agencies and public sector undertakings (PSUs) and guaranteed by the central government or a state government in respect of principal and interest payments. Typical issuers of government-guaranteed bonds include infrastructure-related PSUs, state-owned utility, transport and housing finance companies. Their issue sizes range from Rs. 50 million to Rs. 4 billion, and their maturity period is 5-10 years, though it used to be much longer. They have bullet redemption and fixed semi-annual coupon payments.

In reference to the day count for interest calculation, there are two types of government-guaranteed bonds: those which qualify for the SLR (see Section 9.1.3) and those which do not. Interest for the former is calculated on the basis of a 360-day year, consisting of 12 months of 30 days each (day count of 30/360), and the latter on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365). Currently, the latter type are issued.

Interest payments are subject to 20% withholding tax, and stamp duty is payable on a transfer deed of government-guaranteed bonds.

Since the Indian Government delinked PSU finances from the central government budget in 1992/93, these bonds have been gradually phased out except for issuers in a few selected sectors such as telecommunications, power and irrigation.

Government-guaranteed bonds have rather low liquidity in the secondary market.

Trades of government-guaranteed bonds settle on a DVP basis. Most of the bonds are available in a registered form. Therefore, the ownership has to be registered with the issuer for a bondholder to receive interest and principal payments.

9.2.5 Public Sector Undertaking Bonds

Characteristics

Public Sector Undertaking Bonds (PSU bonds) are medium-term obligations issued by public sector companies such as ones in which the central or a state government has more than a 51% stake. The market for PSU bonds has grown substantially over the past decade. Some issues of PSU bonds in the past were tax-exempt. All PSU bonds have a bullet redemption, and some of them are embedded with put or call options. Many of these were issued by infrastructure-related companies like railways and power companies and their issue sizes vary widely from Rs. 0.1-10 billion.

Their coupon rates and maturity periods used to be determined by the government. Taxable PSU bonds were allowed to be issued only with a 13% coupon rate (except for initial issues with a 14% coupon rate in 1985) and a 7-year maturity until 1992. The current guidelines for the issuance of PSU bonds are as follows:

- minimum maturities of taxable and tax-free PSU bonds are 5 years and 7 years respectively;
- PSUs are allowed to green-shoe oversubscriptions up to 25%;
- PSUs are allowed to issue floating rate bonds and deep discount bonds; and,
- all new issues have to be listed on a stock exchange.

Interest is calculated on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365). Interest payments on PSU bonds are subject to 20% withholding tax, and stamp duty is payable on a transfer deed.

Primary Market

The majority of PSU bonds are privately placed with banks or large investors. Public issues are mandatorily rated by one or more of the three rating agencies in India. Historically, default rates of PSU bonds are negligible and PSUs are perceived as quasi-sovereign risks. New issues of PSU bonds settle at the convenience of the issuer and investors.

Secondary Market

The liquidity of PSU bonds is very low though higher than that of government-guaranteed bonds or state government securities. Trading normally takes place in multiples of Rs. 50 million for state-run pension

funds, banks and other financial institutions, and in multiples of Rs. 100,000 for small trusts and retail investors. Most trades are done through brokers. Daily trading volumes on NSE averaged Rs. 93 million during the period between April and June 1997.

Investors

Investors in PSU bonds include banks, insurance companies, non-banking finance companies, provident funds, mutual funds, financial institutions and individuals.

Clearing and Settlement

Though most PSU bond issues used to be in a bearer form in the past, they are now in a registered form. PSU bonds require no transfer deed for registration of new ownership and, therefore, are exempt from stamp duty. However, contact notes for transactions of PSU bonds require stamp duty at 0.01%.

9.2.6 Corporate Debentures

Corporate debentures are short- to medium-term obligations issued by private and public sector corporations. The term “debenture” is somewhat confusing. A debenture in the United States signifies unsecured long-term debt; in the United Kingdom, it usually refers to secured debt. In India, it is statutorily used as a synonym of the term “bond”⁹.

Interest is calculated on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365). Interest payments of more than Rs. 10,000 on corporate debentures are subject to 20% withholding tax with some exceptions, and stamp duty is payable on a transfer deed.

Corporate bonds can be privately or publicly issued. Public issues of debentures with a maturity of 18 months or longer are mandatorily rated by at least one of the three rating agencies in India. A typical maturity of publicly-issued plain vanilla corporate debentures is between 3 and 12 years. A typical issue size of such debentures ranges from Rs. 300 million to Rs. 2 billion. However, the majority of corporate debentures have a maturity period of less than 18 months and are placed privately.

⁹ Section 2 (12) of the Companies Act, 1956, defines “debenture” as “debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets or the company or not”.

Earlier, debt instruments of a corporation could be listed only after its equity had been listed on any recognized stock exchange. This restriction has been removed. The removal will particularly ease the listing of debt instruments for infrastructure projects¹⁰.

Floating rate debentures have been increasingly issued since 1994/95.

Corporate bonds are issued in a registered form, and their trades settle by physical delivery of bond forms together with a duly-executed transfer deed.

9.2.7 Commercial Paper (CP)

Commercial papers (CPs) are short-term, rupee denominated, unsecured negotiable usance promissory notes issued by Indian public and private sector manufacturing companies. The first issue of CPs was made in 1991. Their maturity varies from 91 days to one year. 91-day CPs are more popular. Interest is calculated on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365).

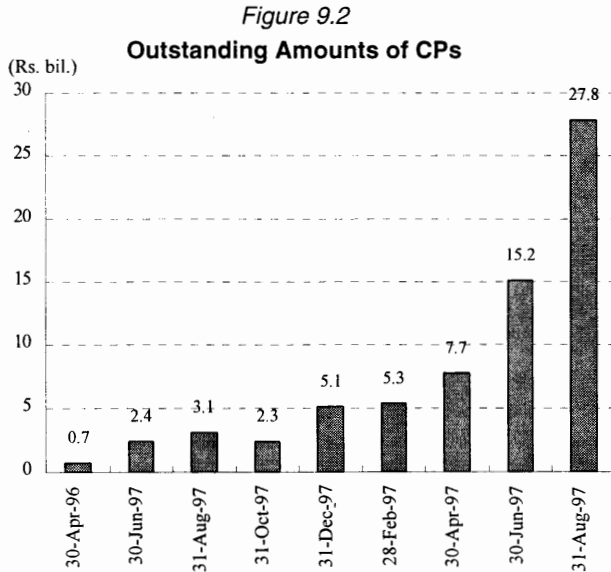
CPs are not subject to withholding tax. They do not attract stamp duty on their transfer deeds, either. This is because CPs are promissory notes and promissory notes, under Indian tax laws, are not subject to stamp duty.

Though the outstanding amount of CPs has been on the increase, as shown Figure 9.2, it had only reached Rs. 27.83 (approximately US\$ 0.77 million) as of August 31, 1997. The eligibility criteria for issuance of CPs are rather restrictive. For instance, an issuer of CPs has to have a minimum working capital of Rs. 40 million. Hence, CPs' role in the Indian capital market remains limited, relative to other financial instruments.

In addition to financial criteria, the issuers of CPs are required to obtain one of the top two short-term debt ratings from at least one of the four recognized rating agencies (see Sections 9.3.1 and 9.3.2). The rating has to be current and should not be more than two months old.

Primary dealers offer two-way quotes for CPs. Brokerage ranges from 5 to 20 basis points (0.05-0.20%).

¹⁰ Para. 44 of Capital and Money Markets, *Economic Survey '97*, Ministry of Finance.



Source: The RBI

Primary placements of CPs are subject to stamp duty at 0.05% for bank investors and at 0.25% for all other investors. Secondary transactions of CPs do not attract any stamp duty as mentioned above. Because of these differential rates of stamp duty, CPs are often placed first with banks and then sold to end-investors.

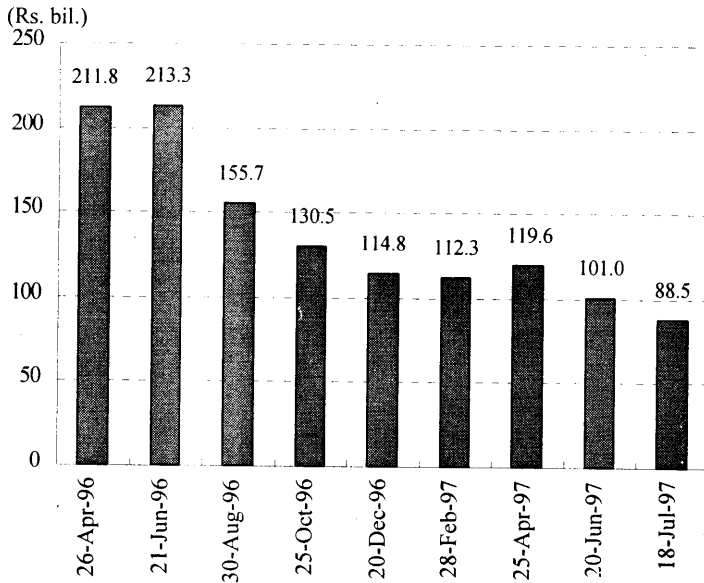
9.2.8 Certificates of Deposit (CD)

Certificates of Deposit (CDs) are rupee denominated, unsecured negotiable promissory notes made with commercial banks and development finance institutions. CDs issued by banks are always at a discount to the face value, while those by development finance institutions may bear coupons. They are transferable by endorsement and delivery. Interest is calculated on the basis of a 365-day year, consisting of 12 months of the actual number of days each (day count of actual/365).

An issue amount of CDs is a minimum of Rs. 0.5 million and in multiples of Rs. 0.1 million¹¹. As shown in Figure 9.3, the outstanding

¹¹ RBI, Section 17 (l) (ii) of "Monetary and Credit Policy for the Second Half of 1997-98", Ref. No CPC.BC.165/07.01.279/97-98, dated October 21, 1997.

Figure 9.3
Outstanding Amounts of CDs



Source: The RBI

amount of CDs has been declining sharply, and stood at Rs. 88.50 (approximately US\$ 2.45 billion) as of July 18, 1997. CDs are supplementary to deposits as a source of funds to banks, and pay higher interest than deposits. As a marginal demand for loans declines in a slower economy, the banks first reduce the balance of CDs. This is why the outstanding amount of CDs has been decreasing recently.

Primary dealers make a market for CDs by offering two-way quotes for them. CDs may be transferred only after 30 days after the issuance. Brokerage for CDs is in the range of 5-10 basis points (0.05-0.10%). CDs are subject to stamp duty whose rate varies according to maturity periods: 0.125% for 90 days, 0.250% for 91-180 days, 0.375% for 181-364 days, and 0.500% for one year.

Table 9.6 gives a summary of the debt instruments in the Indian debt market.

Table 9.6
Types of Indian Debt Instruments

<i>Issuer</i>	<i>Instrument</i>	<i>Maturity</i>	<i>Settlement</i>	<i>Day Count</i>
Central Government	Government of India Securities	2 to 10 years	Book entry at RBI	30/360
Central Government	T-Bills	91 or 364 days	Book entry at RBI	Actual/365
State Government	State Government Securities	5 to 10 years	Book entry at RBI	30/360
Government Agencies & Public Sector Undertakings	Government-guaranteed bonds	5 to 10 years	DVP	30/360
Public Sector Undertakings	PSU Bonds	5 to 10 years	DVP	Actual/365
Private Sector Corporates	Corporate Debentures	1 to 12 years	DVP	Actual/365
Private & Private Sector Corporates	Commercial Paper	3 months	DVP	Actual/365
Banks & Financial Institutions	Certificate of Deposit	3 months (banks), 1-3 yr (FIs)	DVP	Actual/365

Compiled from World Bank, June 1995, *The Emerging Asian Bond Market*, India, and Peregrine, *Asia Fixed Income Market Handbook*, Mar. 1997.

9.3 Credit Rating

9.3.1 What Is Credit Rating?

Credit rating is a systematic and relative evaluation of a security's credit worthiness. Ratings are assigned to a particular issue, not the issuer, and are usually expressed in alphabetic, numeric or plus/minus-sign symbols, or their combinations. A lending institution may rate its loans for internal use only. A rating agency rates privately or publicly issued debt instruments for its client's private use or the public's use.

The Indian rating agencies, like those in other development countries, have been instrumental in the development of capital markets. They generally play the following roles:

- assisting individual and institutional investors in making investment decisions in fixed income securities;
- enabling companies and other institutions to mobilize funds from a wider investor base, in larger amounts, and at a fair cost;
- enabling intermediaries to place debt instruments with investors by providing them with an effective marketing tool; and
- providing regulators with a market-driven system for bringing about discipline and healthy growth of the capital market¹².

The first credit rating in India was set up in 1987. There are currently four rating agencies in the country:

- (i) Credit Rating Information Services of India Limited (CRISIL),
- (ii) ICRA Limited¹³ (ICRA),
- (iii) Credit Analysis & Research Limited (CARE), and
- (iv) Duff & Phelps Credit Rating India Private Limited which is the Indian subsidiary of Duff & Phelps, Inc. (D&P).

Table 9.7

Promoters/Major Shareholders of Indian Rating Agencies

Agency	Founded in	Promoters/Major Shareholders
CRISIL	1987	Industrial Credit and Investment Corporation of India, Unit Trust of India, Housing Development Finance Corporation Limited, Asian Development Bank
ICRA	1991	The Industrial Finance Corporation of India, State Bank of India, Life Insurance Corporation of India
CARE	1993	Industrial Development Bank of India, Canara Bank, Unit Trust of India

Source: CRISIL, ICRA & CARE.

The first three agencies were founded as a national policy. This is clear from the facts that their promoters were state-controlled public finance institutions as shown in Table 9.7; and that each of them was founded by 15-26 major Indian and foreign financial institutions operating in India who were generally users of rating services as fixed income investors. It is interesting to note that the Asian Development Bank, an enthusiastic promoter of capital markets in developing countries, took a 15% stake in

¹² *CRISIL Corporate Profile*, Mumbai, 1997, p. 1

¹³ Formerly "Investment Information and Credit Rating Agency of India Limited"

CRISIL. The supranational's share¹⁴ was acquired by Standard & Poor's Rating Service, USA in May 1997.

9.3.2 Compulsory & Optional Rating

Under the RBI or SEBI regulations, credit rating is compulsory for the following issues:

- a public issue of debentures or bonds with a conversion or redemption period of more than 18 months¹⁵;
- an issue of commercial paper (the RBI permits only those CPs that have one of the top two short-term debt ratings by a recognized rating agency, to be issued.); and
- a fixed deposit program of a non-banking financial company which has net worth funds of more than Rs. 5 million (approx. U.S.\$ 0.14 million).

However, credit rating is optional for:

- PSU bonds; and,
- privately-placed non-convertible debentures up to Rs. 50 million.

Indian rating agencies undertake ratings only at the request of the issuers and publish only those ratings that the issuers have accepted, while U.S. counterpart rate securities and publish ratings on their own initiative. The rating agencies' ratings and other products are published not only through the agencies' own publications but also various information vendors such as Bloomberg, Reuters, Knight Ridder and Datastream.

9.3.3 Rating Symbols

Indian rating symbols are alphabetic, numeric or plus/minus signs or their combinations: AAA, AA, A, BBB, BB, B, C and D for long- or medium-term debt and 1, 2, 3, 4 and 5 for short-term debt, as shown in Table 9.8. They are common to all the three Indian agencies, and, therefore, convenient to users of the ratings; on the other hand, the usage

¹⁴ The ADB's stake was diluted to 9.6% from 15% through CRISIL's initial public offering in 1993.

¹⁵ Sections F (b) and (f) of the SEBI Guidelines, Press release dated June 11, 1992.

of alphabets and numbers as rating symbols varies from agency to agency in the United States.

From the foreign investor's point of view, the Indian ratings are obviously not compatible with those in their home countries or those of U.S. rating agencies. Though India has never issued sovereign bonds offshore, her credit ratings are split between an investment grade Baa3 from Moody's and a sub-investment grade BB+ from Standard & Poor's. The strength of a chain is that of its weakest link. Thus, when a foreign investor invests in a domestic issue of Indian bonds with a credit rating of AAA from an Indian rating agency, the effective credit worthiness of his or her investment will be a rating of Baa3/BB+ or lower.

Table 9.8
Rating Symbols

Description of grades (Actual expressions slightly vary from agency to agency.)	CRISIL		ICRA		CARE
	Debentures	Fixed Deposit	Long-term	Medium-term	Long-term & Medium-term
			Debentures, bonds, preference shares	Certificate of Deposit, fixed deposit	Debentures, bonds, fixed deposit, certificate of deposit, structures obligation
High investment grade	AAA	FAAA	LAAA	MAAA	CARE AAA
	AA	FAA	LAA	MAA	CARE AA
Investment grade	A	FA	LA	MA	CARE A
	BBB		LBBB	MBBB	CARE BBB
Speculative grade	BB	FB	LBB	MBB	CARE BB
	B	FC	LB	MB	CARE B
(Poor grade)	Substantial risk	C	LC	MC	CARE C
	Default	D	LD	MD	CARE D
Short-term (up to 1 yr.)					
Highest safety	P-1		A-1		PR-1
High safety	P-2		A-2		PR-2
Adequate safety	P-3		A-3		PR-3
Risk prone	P-4		A-4		PR-4
Default	P-5		A-5		PR-5

Source: CRISIL, ICRA and CARE.

Taxation

10.1 Tax Consultant

An FII may appoint his or her own public accountant as a tax consultant who, on his or her behalf, files the necessary tax clearance.

Before sales proceeds are credited to an FII's foreign currency account with the custodian bank, the FII has to obtain a certificate providing the computation of tax payable from a chartered accountant. Thereafter, the custodian bank deducts the withholding tax on capital gains, credits the net sales proceeds to the foreign currency account and, if so instructed, repatriates them to the FII.

International audit firms, including the following have offices in India and provide FIIs with professional services necessary for their tax clearances:

- Arthur Andersen;
- KPMG Peat Marwick;
- Price Waterhouse; and
- Ernst & Young.

The scope of work that those tax consultants generally provide FIIs can be summarized as follows:

- computation of capital gains tax liability on a periodic basis on the basis of the information provided by local custodians;
- advising an FII about its advance tax liability to be paid on the due dates as defined under the Income-tax Act, 1961;
- applying to the Income-tax Authorities for lower withholding tax in order for the FII to benefit from tax treaties;
- assisting in the preparation and filing of the Return of Income;
- assisting in preparation and submission of an application to the Authority for Advance Ruling;
- representing before the tax authorities during assessment and appellate proceedings;

- advising the FII on specific tax issues which may arise during the course of the engagement; and,
- advising on international tax implications with particular reference to tax treaties.

10.2 Income Taxes

In order to induce foreign portfolio investments in Indian securities India offers concessional taxation of income of FIIs from securities or capital gains arising from their transfer. Accordingly, FIIs benefit from a concessional tax rate of 20% on interest income (other than income on units of the Unit Trust of India) and a tax rate of 10% on long-term capital gains. Such taxes are withheld by the FII's custodian at the time of repatriation. Table 10.1¹ shows income tax rates applicable to FIIs, Indian individuals and Indian corporates.

Table 10.1
**Income Tax Rates applicable to FIIs, Indian Individuals
& Indian Corporates**

	<i>FIIs</i>	<i>Indian Individuals</i>	<i>Indian Corporates</i>
Long-term Capital Gains	10%	20%	30%
Short-term Capital Gains	30%	30%* or less	35%
Interest	20%	30%* or less	35%

* The maximum marginal rate of income tax applicable to Indian individuals.

To qualify as a long-term capital asset, securities (other than units) listed on a recognized stock exchange have to be held for more than 12 months, and other securities for more than 36 months. Long-term gains, in contrast with short-term gains qualify for a lower tax rate than short-term gains².

¹ Modified Guidelines for Foreign Institutional Investors (Taxation Aspect), No. F.5(13)/SC/91-FIU, dated March 24, 1994, issued by the Ministry of Finance, Department of Economic Affairs, Investment Division.

² *Ibid.*

With effect from 1 June 1997, dividends distributed by a company are tax free in the hands of the recipient. However, the company has to pay a 10% tax on dividends distributed to shareholders.

FII's interest income is withheld at source by the issuing company. However, no deduction of tax is made from any income by way of capital gains. Instead, each FII, while applying for initial registration with SEBI, appoints a tax agent. FII's custodial bank is usually designated as a tax agent for the FII³. The agent is obliged to withhold tax on the FII client's realized capital gains. He or she issues a certificate to the Income Tax Authorities in India which states that the FII client has paid tax on the capital gains, with one copy being furnished to the FII client.

The various tax rates above are reduced or nullified under various double taxation avoidance treaties (tax conventions or tax treaties) with different countries. There is no exemption/concession with regard to withholding tax except under various tax treaties, as will be discussed in the following section.

10.3 Tax Treaties

10.3.1 Avoidance of Double Taxation

An FII's income from Indian securities, or capital gains arising from their transfer, may be taxed in India as well as the FII's home country. India's tax treaties with various countries are designed to avoid such double taxation. They nullify or reduce Indian taxes imposed on income earned by FIIs through portfolio investments in India and paid to them in those countries, and generally entitle FIIs to tax credits in those countries in respect of taxes withheld in India. Applicable withholding tax rates by the domicile of the beneficiary owner (the FII) are tabulated in Table 10.2.

It is important to notice that capital gains that a resident of Indonesia, South Korea or Mauritius earns from portfolio investments in Indian securities are only taxable in the country in which the beneficiary owner is a resident.

India, like many other countries, does not have any tax treaty with Hong Kong; therefore, the default rates shown in Table 10.1 apply.

³ *Ibid.*

Table 10.2
Withholding Tax Rates under Tax Treaties

Domicile of Beneficiary Owner	Interest	Capital Gains	
		Short-term	Long-term
Hong Kong	20%	30%	10%
Indonesia	10%	*	*
Japan	10-15%	30%	10%
Korea	10-15%	*	*
Malaysia	20%	30%	10%
Mauritius	20%	*	*
Singapore	15%	30%	10%
UK	15%	30%	10%
USA	15%	30%	10%
India	20	30	10

* Taxable only in the country in which the beneficiary owner is a resident.

10.3.2 India-Mauritius Treaty

Treaty Benefits

The most tax-efficient tax treaties are those with Mauritius and the UAE. Of the two the India-Mauritius Treaty⁴ is more popular because capital gains derived by a resident of Mauritius are not taxable in India but taxable only in Mauritius.

Major tax benefits under the treaty are summarized as follows:

- capital gains from the sale of shares in an Indian company arising to a Mauritian resident is only taxable in Mauritius according to Mauritius tax law⁵; and
- business profit of a Mauritian enterprise⁶ is taxable only in Mauritius unless the Mauritian resident carries on that business through a permanent establishment in India⁷.

⁴ The official name of the treaty is "The Convention between the Government of the Republic of India and the Government of Mauritius for Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect of Taxes on Income and Capital Gains and for Encouragement of Mutual Trade and Investment", and will be called "The India-Mauritius Treaty" hereinafter.

⁵ *Ibid.*, Article 13 (4).

Furthermore, Mauritius does not levy any tax on capital gains earned by an offshore company, and Mauritian tax rates except for the tax rate on interests, if levied, are lower than India's concessional tax rates for FIIs.

To take advantage of this treaty, generally an offshore company or a fund is set up in Mauritius and registered with SEBI, either as an FII or a sub-account of an FII. To qualify for the benefits of the treaty, it may be necessary to demonstrate that the transaction is not designed merely to obtain treaty benefits but has a primary business purpose attached to it. Reportedly more than 2,000 investments into India, including those by a number of portfolio investments of international funds, have been made through Mauritius to avoid income tax on capital-gains.

Under the treaty, the term "Resident of Mauritius" means any person⁸ who, under the laws of Mauritius, is liable to taxation therein by reason of his or her domicile, residence, place of management or any other criterion of a similar nature⁹.

For investments in Indian securities from Mauritius, foreign investors usually set up investment funds or subsidiaries in that island country in the Indian Ocean from which ultimate investments are made into Indian companies. These are illustrated in Figure 10.1.

These days, however, the double taxation avoidance convention between India and Mauritius is not necessarily a "wild card" for foreign investors who intend to enjoy the treaty benefits. There have been three significant cases since early 1996 where the Indian tax authorities' rulings have had substantial impacts on the structuring of investment schemes:

- (i) NatWest Bank case in January 1996;
- (ii) AIG case in May 1997; and
- (iii) Foreign & Colonial case in January 1997.

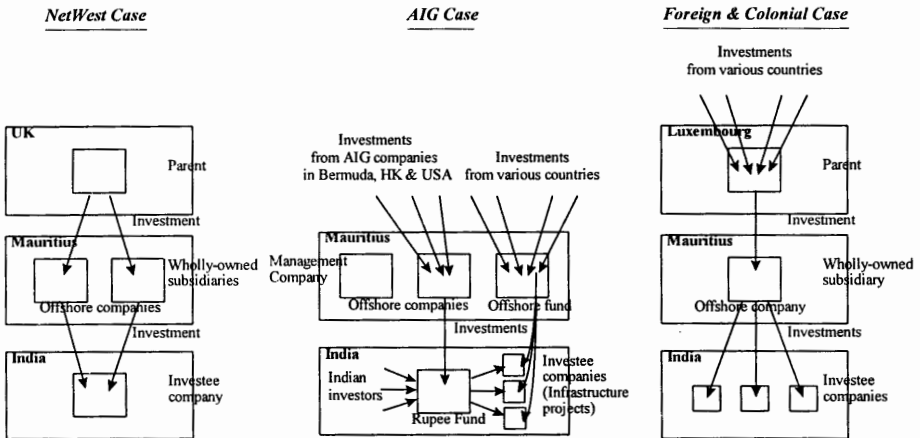
⁶ The term "enterprise" of Mauritius means an industrial, mining, commercial, plantation or agricultural enterprise or similar undertaking carried on by a resident of Mauritius. (*Ibid.*, Article 3 (1) (g)).

⁷ *Ibid.*, Article 7 (1).

⁸ The term "person" includes an individual, a company and any other entity, corporate or non-corporate, which is treated as a taxable unit under the taxation laws in force in Mauritius. (*Ibid.*, Article 3 (1) (e)).

⁹ *Ibid.*, Article 4 (1).

Figure 10.1
Investment Structures through Mauritius



These diagrams were drawn, based on descriptive information of the cases from various sources. They may have ignored or overly simplified some aspects of the cases and thus may not reflect the cases accurately.

NatWest Bank Case¹⁰

In this particular case, the applicability of the tax benefits under the treaty was denied by the Authority for Advance Ruling (AAR) in India in January 1996. The AAR rejected the benefit of a lower tax rate, *i.e.* 5% on dividend income earned on investments made in India through offshore companies in Mauritius by reason of the avoidance of tax, while it ruled that the Mauritian companies as Mauritian residents were entitled to the capital gains tax exemption.

NatWest Bank, a British bank, set up two wholly-owned subsidiaries in Mauritius in November 1994 after the revised tax treaty between India and the UK was notified in early 1994. The Mauritian subsidiaries invested in shares of HDFC Bank in India in early 1995. A claim of the Mauritian subsidiaries was put up before the AAR soon after.

The AAR ruled that the purpose of the investment in the shares of HDFC Bank in the name of the Mauritian subsidiaries was the avoidance

¹⁰ KPMG's Memorandum "Analysis of Recent Ruling by Authority for Advance Ruling (AAR) - Mauritius Tax Treaty", Linklaters & Paines' *Investment Funds Newsfile*, May 1996, and "Legal Personality And The "Nat West" Ruling - Valmet Mauritius Limited", *Business Monitor*, July 22, 1996, website <http://businessmonitor.co.uk/docs/proc/177/4legal.html>.

of the Indian income tax that would have fallen on the UK parent had it directly invested in the Indian shares. The Indian authority further concluded that the real owner of the dividends from the Indian company was not the Mauritian subsidiaries but the UK parent. The India-Mauritius tax treaty does not have an anti “treaty shopping” clause, *i.e.* one which prohibits treaty benefits where the treaty is simply being used for the purposes of getting those benefits. Nevertheless, the Indian authority denied those benefits. Coupled with the authority’s somewhat contradictory stance towards taxes on capital gains and dividends, this ruling confused the investment community.

AIG Case¹¹

In this case, the AAR upheld the availability of the India-Mauritius tax treaty in the context of an investment fund in August 1996, primarily on the grounds that there were sufficient commercial reasons for the fund being based in Mauritius.

An Indian rupee trust was created to raise capital from external investors as well as a fund company located in Mauritius, and to invest in Indian companies in conjunction with the Mauritian fund company. This was a single-tier fund structure. The fund was managed by a Mauritius-based management company. The fund company and the management company in Mauritius claimed the treaty benefits. It was argued for the applicant companies that:

- the expectation was that there would be a wide range of international investors investing through the fund, and a central offshore location was desirable;
- Indian exchange control made it difficult for many international investors to invest directly in India individually, and that, therefore, the Mauritian fund company was chosen as a single channel for such foreign investments into the Indian trust; and,
- Mauritius was chosen for locating the fund company, because it had recently emerged as a low-cost offshore financial center and is

¹¹ KPMG’s Memorandum “Analysis of Ruling by Authority for Advance Ruling (AAR) - Mauritius Tax Treaty”, “India: Positive Tax Ruling on Mauritian Treaty”, Linklaters & Paines’ *Investment Funds Newsfiles*, September & November 1996, and “Legal Personality And The “Nat West” Ruling - The “AIG” Sequel - Valmet Mauritius Limited”, *Business Monitor*, September 30, 1996, website <http://businessmonitor.co.uk/docs/proc/192/8aig.html>.

preferred by offshore investors in view of its well-developed financial sector.

The AAR held that the fund and the manager were residents in Mauritius and the treaty benefits were available to both the companies, and confirmed that the reduced withholding rate on dividends (15%) would apply to the fund and that the fund's capital gains would be exempt from Indian income tax. The authority acknowledged that the availability of the tax concessions was clearly influential in the decision to select Mauritius, but that was not the predominant motive and there were sufficient commercial reasons on the facts for this structure.

Foreign and Colonial Case¹²

In this latest case, the Indian Tax Inspectorate cleared the application of the India-Mauritius tax treaty to a Luxembourg-listed company investing in Indian securities through a wholly-owned Mauritian subsidiary in January 1997. This was a two-tier fund structure.

As was the case with NatWest and AIG, the determination of the residence of a Mauritian company is critical to the availability of the treaty benefits. In determining the residence of the Mauritian subsidiary in this particular case, too, the Indian tax authority seemed to have given much weight to the role of the board of the subsidiary in the overall conduct of the fund's business. Accordingly, the favorable decision appeared to have been prompted by the active involvement of the directors of the subsidiary in the management of the fund.

Outlook for the Tax Treaty

Our discussion here is in no way intended to advise international investors on any tax-effective scheme for investments in Indian securities. Each investor is strongly advised to consult his or her own tax consultant on a particular case under precise circumstances. However, it may be worth pointing out some tendencies of the Indian tax authorities that can be observed in their rulings on the three cases.

First of all, a one- or two-tier fund structure using a Mauritian subsidiary will be eligible for tax benefits under the India-Mauritius tax treaty in appropriate circumstances. In either case, the Indian tax authorities seem to consider the corporate substance of a Mauritian

¹² The case was discussed on a no-name basis in "India: Further Positive Tax Ruling on Mauritian Treaty", Linklaters & Paines' *Investment Funds Newsfile*, March 1997.

company to be critical in determining the residence of the company for tax purposes. Currently essential are the active involvement of the Mauritian board of directors, its independence and its participation in the execution of the fund's investment policy and in ensuring compliance with that policy¹³.

What are the prospects for the tax treaty? These can be analyzed in two aspects:

- (i) the Indian Government's concern over the abuse by investors, including those in India, of the treaty benefits and the Mauritian Government's concern over the economic viability of the country without routing foreign investments into India; and
- (ii) India's needs for foreign capital.

In order to alleviate India's concern, for instance, the Mauritian Government has brought the offshore business in line with onshore to avoid the country being tagged as a tax haven by setting out a uniform 15% tax treatment for offshore companies registered after June 30, 1998 and local incentive companies under the new Income Tax Act 1995¹⁴. In turn, the Mauritian Government successfully secured the assurance of the Indian Government, during the Indian Prime Minister's visit to Mauritius in early February 1997, that it would not adopt any unilateral measure which would adversely affect the tax treaty and the Mauritian Offshore Financial Sector.

After having shocked the investment community with its ruling on the NatWest case, the Indian tax authorities have again been getting friendly with foreign investors. Apart from international taxation theories, what stance the Indian tax authorities would take towards tax-effective investment schemes designed for foreign investors is basically a policy issue of the Indian Government to attract foreign investments under international competition. India has indeed been competing with other developing countries for foreign capital that is badly needed for her economic development. India presumably cannot afford to ignore this reality by offering foreign investors uncompetitive investment frameworks.

Sometimes, the reality of international finance is pretty different from a government official's perception. The NatWest case may remind you of

¹³ *Ibid.*

¹⁴ Mauritius International Business & Finance Centre (MOBAA), Website <http://www.internet.mu/mobaa/regime.html>.

the uproar after the U.S. Treasury Department announced its proposal in August 1987 to repeal the exemption of withholding tax on interest payments to Cayman subsidiaries of U.S. corporations which issued Eurobonds through the subsidiaries in the Caribbean tax haven. The uproar made the U.S. Treasury Department officials realize the irreversible reality, and the proposal was withdrawn after a month or so.

10.4 Computation of Capital Gains

The capital gains tax is computed on the rupee denominated gains on a transaction. As mentioned earlier in Section 10.1, the computation of capital gains has to be done and certified by an FII's tax consultant who is a chartered accountant. In this process, the custodian provides the tax consultant with the relevant details of FII's status and transactions.

The Indian Income Tax Act allows for long-term capital gains to benefit in two ways:

- (1) a lower tax rate is applicable; and
- (2) the cost of purchase can be enhanced by way of a "Cost of Inflation" factor.

However, the benefit for long-term capital gains, arising out of the "Cost of Inflation" factor is not applicable to FIIs. FIIs are not eligible for exchange rate or indexation (inflation) rate benefits.

10.5 Stamp Duty

Stamp duty is payable on financial transactions or instruments including bills of exchange, share transfers, bills of lading etc. Rates vary significantly from state to state. It is payable for trading of securities as well as registration of ownership of such securities. For registration of ownership of shares, it must be noted that the registration of a physical certificate of shares is subject to stamp duty, but transfer of registered ownership of shares through a depository is not liable for any stamp duty¹⁵.

¹⁵ Section 8A (c) of the Indian Stamp Act, 1899. (Part I of the Schedule to the Depository Act, 1996).

In the primary market, stamp duty is paid by the issuer. The investor is exempt from stamp duty payment. Stamp duties on shares and on debentures are determined by reference to the prescribed rates in force in the state in which the issuing company's registered office is located. In the State of Maharashtra, the stamp duty rates on newly-issued shares and unsecured debentures are 0.10% and 0.75% of the face value, respectively. Stamp duty on secured bonds in Maharashtra is levied on the value of the security pledged for the bonds. In other states, stamp duty is payable at a fixed rupee amount per certificate.

In the secondary market, stamp duty on share transactions in the State of Maharashtra, where the BSE and the NSE are located, is payable by the broker at the rate of 0.01% of the transaction amount for trading. It is also payable by the transferee (buyer) at the rate of 0.50% for the registration of share certificates, calculated on the contract value or the market value at the previous day's closing price, whichever is higher.

Stamp duty on debentures is payable at the rate of 0.01% for trading in Maharashtra. It varies between 0.50% and 2.00% for the registration of ownership, depending on the rate prevailing in the state in which the issuing company's registered office is located (and not where the transaction takes place).

However, there has been a serious dispute between brokers and the Stamp Duty Office of the Maharashtra Government on how to compute the amount of stamp duty payable by brokers for trading. BOI Shareholding Ltd., the clearing house of the BSE, collects stamp duty from BSE members in a contract value or a market value calculated on the delivery volumes, while the Stamp Duty Office asserts that the amount of stamp duty payable be calculated on the actual trading turnover pursuant to the relevant clause of the Bombay Stamp Duty Act, 1956. Since delivery volumes are in the range of 10-20 per cent of actual traded volumes, brokers would be required to pay 5 to 10 times as much as they are customarily paying. On the other hand, NSE brokers has not paid stamp duty for trading at all, since the stock exchange had left the payment to individual brokers on the grounds that its member brokers are scattered across the country. The recent computerization of securities transactions on the stock exchanges has suddenly enabled the Stamp Duty

Office to trace down the accurate volume of trade for the calculation of stamp duty amount payable¹⁶.

In the case of a depository, the transfer of registered ownership of shares through a depository is not liable for any stamp duty as stated above, but rematerialization of share ownership is subject to stamp duty¹⁷. It is not crystal-clear whether the transfer of registered ownership of bonds through a depository is also not liable for any stamp duty¹⁸. A beneficiary owner of shares may opt out of a depository and have the issuing company issue a new share certificate, on which stamp duty is payable.

10.6 Service Tax

A service tax is levied on brokerage commissions earned by a broker at the rate of 5.00 %. The brokers may pass on this tax to their clients.

¹⁶ “Brokers must pay stamp duty on turnover”, *The Financial Express*, November 7 1996 and “BSE, NSE brokers face Rs 60-cr stamp duty burden”, *The Financial Express*, March 11, 1997.

¹⁷ Section 8A (b) of the Indian Stamp Act, 1899. (Part I of the Schedule to the Depository Act, 1996).

¹⁸ “How to make the depository more investor-friendly”, *The Financial Express*, June 16, 1997.

Custodial Services

11.1 Safe Custody of Shares

11.1.1 Safekeeping Methods

Custodians usually place shares in pouches and store them in fire-proof cabinets within vaults. Bar codes are then affixed to individual certificates which can be scanned for identification.

Custodians are insured against risks arising from theft. Actual insurance policies vary from custodian to custodian. Some custodian banks have a better coverage than others. If there is any damage or mutilation of the scrips, the scrips are replaceable. The risk of the loss or damage of scrips, whilst in the safe custody of the custodian, has to be borne by the custodian concerned.

11.1.2 Inspection of Records

With regard to physical verification and reconciliation of records, SEBI and RBI conduct external audits on an annual basis.

As for the internal checks, the periodicity of verification and reconciliation of records is custodian-specific and procedures adopted vary among custodians.

Clients can usually arrange with their custodians to audit files and shares pertaining to their holdings at the custodians' premises.

11.1.3 Protection of Clients' Assets

SEBI requires custodians to segregate their clients' assets and cash from the custodian's own assets and cash. In addition, custodians are required to maintain separate cash and securities accounts for each of their clients.

11.2 Corporate Actions

11.2.1 Sources of Corporate Action Information

The listing guidelines provide that every company listed on the exchange has to notify the exchange of its corporate actions well in advance. The company informs the stock exchange where its shares are listed, and the exchange, in turn, informs the investors and members through various sources. The BSE circulates daily notices, while the NSE transmits it online. The exchange, from time to time, also sends circulars on listed companies' corporate actions to its members. Some brokers maintain a database on corporate actions and provide such information on a regular basis to their clients.

Financial or business magazines and local newspapers are a reasonable source of such information. Some of them are:

Newspapers	<i>The Business Standard</i>
	<i>The Financial Express</i>
	<i>The Economic Times</i>
Magazines	<i>Capital Market</i>
	<i>Dalal Street Journal</i>
	<i>Business Today</i>

11.2.2 Date for Determining Corporate Entitlements

The book closure date or the record date is used to determine all corporate entitlements.

Different stock exchanges have different settlement cycles and the ex-dates are announced by the exchanges themselves. However, the responsibility of fixing the record date or book closure date rests with the company concerned. This situation invariably results in the occurrence of the possibility of having an ex-date fixed after the official record date or book closure date. When this arises, both trades done cum benefit and trades settled after the official book closure date would still be entitled to the announced corporate action benefit.

11.2.3 Notification to Foreign Investors

Upon a corporate benefit being declared, the custodian will inform his or her FII clients of the same via SWIFT¹, telex or fax. Thereafter, the

¹ See Footnote 14 on page 159.

custodian monitors his or her clients' feedback in order to ensure that proper instructions are obtained for the custodian's follow-up.

In case some shares are kept in street name instead of being registered, the FII must make sure that his or her custodian has such a system so as to ensure that all stocks, whether registered or in street name, are monitored at the same time.

11.2.4 Proxy Service to Foreign Investors

A proxy service to foreign investors like FIIs is a gray area. Despite formal inquiries, neither SEBI nor RBI has announced its official position in this matter. It is a general understanding in the market that the custodians do not provide proxy services to their foreign clients. However, some custodians have been offering such services in respect of those companies whose registered offices are located in metropolitan areas.

11.3 Custodial Charge

Custodial charges generally consist of the transaction fee and the safe custody fee (the portfolio fee). The former is charged for each transaction that the investor settles through the custodian. The fee amount may be a certain percentage of a transaction value or a dollar amount per transaction. The latter is charged for the custodial services to the investor's portfolio in safe custody. The fee is usually quoted at a certain percentage of the value of the portfolio on an annual basis, but the portfolio is valued on a monthly or quarterly basis and the fee is payable accordingly. The economy of the custodial fees is significantly affected by each investor's trading pattern.

The custodial fees in India are expensive relative to those in many other countries. This is mainly because the clearing and settlement in the country involves a great deal of labor, as has been discussed earlier.

Some custodians operating in India have their custodial service networks outside the country on a regional or global basis, too. If the investor uses a particular custodial bank's service anywhere else, he or she may have an additional bargaining edge in order to lower the fees.

Table 11.1 gives a typical range of custodial charges for FIIs.

Table 11.1
Custodial Charge

	Case A	Case B
Transaction fee	0.25%	US\$ 250 per transaction
Safe custody fee	0.25 to 0.35%	0.20 to 0.25%

11.4 Dividend & Sales Proceeds

11.4.1 Dividend Payment

In India, dividends are paid only in cash and there is no concept of a stock dividend or stock split.

The dividend amount to be declared is proposed to, and approved by, the company's board of directors. A dividend payment is declared by the company at its Annual General Meeting. The notice of the dividend amount proposed to be declared is given to the stock exchange at least 42 days before the record date. Thereafter, the annual general meeting of shareholders approves and declares the dividend payment. Dividends are paid within 42 days of the Annual General Meeting. The working draft of the Companies Bill, 1997 has proposed reducing the period to 30 days from 42 days².

Dividends are usually paid annually. However, some companies pay an interim dividend which requires the approval of its board of directors during the financial year but not the approval of the shareholders. Though not legally required, interim dividends are usually expected to be paid within 42 days of the date of approval by the board of directors.

Dividends are subject to withholding tax at source (see Section 10.2). Refunds can be claimed in the tax returns.

11.4.2 Repatriation

Sales proceeds

After the sale of securities, an FII has to first obtain from a chartered accountant a certificate providing the computation of tax payable on capital gains (if any). The FII's custodian withholds the tax and then can

² "Payout period cut to 42 days", *The Financial Express*, May 7, 1997.

credit the net Rupee sales proceeds to the FII's non-resident foreign currency account and repatriate them to the FII's account outside India.

It takes approximately three weeks from the date of the sale of securities, assuming a normal settlement period, to repatriate the net sales proceeds. As the parties involved in this operation get used to paper work relevant to the particular FII, the period may be reduced to 15 days from the date of sale of securities.

Dividends

All dividend cheques are issued in the form of demand drafts, usually drawn on banks located in the big towns. Payee banks designated in these demand drafts are obliged to pay the dividend cheque proceeds to the named payees within 48 hours upon the presentation of these demand drafts. A high value cheque (a cheque of more than Rs.100,000) may be cleared on the same day; cheques of a smaller amount take two days for clearance. The dividend proceeds are credited to the FII's Special Non-Resident Rupee Account.

If an FII intends to repatriate the cleared dividend proceeds, the custodian bank is responsible for ascertaining and withholding the proportion of the tax amount payable, if any, before converting the funds into a foreign currency and crediting the foreign currency denominated funds to the FII's foreign currency account. Thereafter, the repatriation of funds is allowed. Such a process should be completed within 48 hours.

11.4.3 Foreign Exchange Control

Dividend income repatriation by FIIs does not require exchange control clearances.

Until August 1997, the RBI banned FIIs from entering into foreign exchange forward contracts for any purposes. However, the central bank removed the ban in respect of FIIs' investments in debt instruments³. FIIs can thus cover their Indian rupee-denominated positions in Indian fixed income securities and determine yields on their investments in terms of a foreign currency like the US dollar. In connection with the repatriation of dividends or sales proceeds from FIIs' equity investments, RBI does not allow FIIs to enter into forward foreign exchange contracts with any locally registered foreign exchange dealer.

³ RBI Press Release No. 1997-98/121, August 11, 1997.

Information about India

12.1 Internet Sites Related to India

As India is still far from the center of the world's economy and politics, information on India that appears in foreign mass media is limited. Nevertheless, the internet today provides those interested in Indian affairs with instant access to first-hand information on Indian politics, economy, society, regulations and so on, thanks partly to the world-level computer application technology among Indians.

Yahoo's search engine is an efficient means of locating a Web site of a specific company if you know the name of the company. Otherwise, a selection of Web sites listed below will be useful for following the Indian securities market and its background.

Regulators

1. Ministry of Finance
<http://www.nic.in/finmin/>
Maintained by the Ministry of Finance, the Government of India. Contains Finance Minister's speeches, press releases, capital market, economic indicators, budget, economic survey. Full texts of the Union Budget and the Economic Survey are available on this site.
2. Securities Exchange Board of India
<http://www.sebi.com/main.html>
Maintained by the Securities Exchange Board of India. Provides extensive information through pages: about SEBI, annual report, acts, rules & regulations, guidelines, investor related information, press releases, frequently asked questions. The Indian version of the U.S. SEC's home page. The pages may be a little better maintained, given their importance to the investment community.
3. Reserve Bank of India
<http://www.reservebank.com/>

Maintained by the Reserve Bank of India, the central bank of India. Provides official information on India's financial situation including weekly statistical supplement, RBI bulletin, annual report, press releases, NRI investments, publications, and speeches by RBI senior executives. Its press releases section (<http://www.reservebank.com/pressrel/>) presents the monitoring of FIIs' investments in Indian companies against the overall ceiling (see Section 2.3.5).

4. National Stock Exchange of India

<http://www.nseindia.com/>

Maintained by the National Stock Exchange of India. Well-maintained. Serves as an extensive source of information on the NSE, including descriptive and quantitative information about the NSE, stock prices, the markets, the members, the news, NSCCL, CM, WDM, F&O, depository and technology.

5. Bombay Stock Exchange

<http://www.bseindia.com/>

Maintained by the Bombay Stock Exchange of India. Presents basic information about the BSE including stock prices, index, daily press releases, news, members, history, developments and future plan, objectives and functions, governing board, FAQs.

Media

1. *The Financial Express*

The Indian Express

<http://www.expressindia.com/>

Provides full-length articles from *The Financial Express* and *The Indian Express*, Indian Express publications. Contains sections on economy, corporate, markets, politics, leisure and sports. Covers the capital market very well. Updated daily and searchable. The search function is remarkably convenient for following specific subjects. Past issues are archived.

2. *The Economic Times*

<http://www.economictimes.com/>

Online edition of India's most widely circulated financial and business owned by Bennett, Coleman & Co. Ltd. Covers corporate India, Indian economy, world, stocks & shares, Indian politics. Updated daily. Past issues are archived but not searchable.

3. *The Times of India*

<http://www.timesofindia.com/>

Online edition of India's most widely circulated English daily owned by Bennett, Coleman & Co. Ltd. Updated daily. The past issues are archived but not searchable.

4. *Business Standard*

<http://www.business-standard.com/>

Online edition of a New Delhi-based national business newspaper owned by Business Standard Ltd. Provides information about markets, corporate, stocks, economy, finance, politics, macro indicators and editorials. Updated daily. Past issues are archived but not searchable.

5. *The Hindu*

<http://www.webpage.com/hindu/index.html>

Online edition of a Madras-based national newspaper. Provides national, international, regional, business, sport news. Updated daily and searchable. Past issues are archived.

6. *Business Line*

<http://www.indiaserver.com/bline/>

Online edition of a financial daily from *The Hindu* group of publications. Updated daily and searchable. The past issues are archived.

7. *The Hindustan Times*

<http://www.hindustantimes.com/>

Offers an on-line version of a New Delhi-based daily newspaper. Contains politics in the capital and the various states, economy, markets, and sports. Updated daily and searchable. Back issues are archived.

8. Washington Post stories about India

Via WashingtonPost.com: World Reference -- India

<http://www.washingtonpost.com/wp-srv/inatl/longterm/worldref/country/india.htm>

9. The Associated Press stories about India

Via WashingtonPost.com: World Reference -- India

<http://www.washingtonpost.com/wp-srv/inatl/longterm/worldref/country/india.htm>

10. Capital Market India Section

<http://www.capitalmarket.co.in/>

Covers corporate scoreboard, fixed deposits, annual reports, news briefs, market today, broker research, capital market P/E ratios, Indian GDRs & ECBs for FEE.

Rating Agencies

1. Credit Rating Information Services of India Limited (CRISIL)
<http://www.indozone.com/crisil>
2. ICRA Limited (ICRA)
<http://www.icraindia.com>
3. Credit Analysis & Research Limited (CARE):
<http://www.accessindia.com/care>

Link

1. Yahoo's India Directory
<http://www.yahoo.com/Regional/Countries/India>
Links to information on India. Well-organized. Covers arts, business, computers and internet, education, entertainment, government, health, libraries, news and media, organizations, politics, real estate, recreation and sports, science, society and culture, and usenet.
2. Bhaarat Ek Khoj: Discovery of India
<http://www.mahesh.com/india>
Links to India related sites by Mahesh. Well-organized and extensive. Covers budget, business, companies/corporations in India, conferences and trade shows, consulates, corruption, currency exchange information, defense, economy, Government of India and State Governments, history, investment/stocks, law/legal, media, NRI, tax/ customs/exercise duty, and many cultural and social subjects. Its media link is excellent.
3. Indian Newspapers, Magazines and News Servers
<http://www.mahesh.com/india/media.html>
A part of Bhaarat Ek Khoj: Discovery of India. Offers an extensive list of newspapers, magazines, news web sites that are related to India, and published in and outside India. Includes not only English publications but local language ones.
4. INDIAWORLD
<http://www.indiaworld.co.in/index.html>
India's daily internet magazine. Links to sites on various topics.
5. IndiaWorld Headlines -- Late News delivered via email
<http://www.indiaworld.co.in/open/news/latenews.html>
A part of IndiaWorld. Provides headlines of important articles and their brief descriptions from major daily newspapers like *The Times of India*, *The Economic Times*, *The Indian Express*, *The*

Financial Express, The Business Standard. The contents of this page are also available via email. This is a FREE service, and is broadcast once a day. If you would like to subscribe, send an email message to listserv@indiaworld.co.in, with the phrase "subscribe headlines" (without the quotes) in the body of the message. The Late News page is updated by 8:30 a.m. (in the morning) and by 10:30 p.m. (at night) India Time.

6. Business Samachar

<http://www.dhan.com/paper/>

A part of Indiaworld. Provides major business headlines from Financial Express, Business Standard, Economic Times, Business Line under the categories of front page, economy, and corporate. Links to individual articles from the headlines. Updated every 30 minutes.

7. India Related Links

<http://www.physik3.gwdg.de/~sarma/indial.html>

Maintained by Sada Siva Sarma A. Contains a huge list of links related to India and its culture, including recipes, religion, music, politics and sports.

8. The IndiaPages WWW Index

<http://www.webpage.com/indiapages/catalog/index.html>

9. Anveshan-Search India Links

<http://ugweb.cs.ualberta.ca/~srinivas/anveshan.html>

10. Prasad Naik's India Links

<http://www.ee.ualberta.ca:80/~naik/india.html>

General

1. U. S. State Department Notes

Via WashingtonPost.com: World Reference -- India

<http://www.washingtonpost.com/wpsrv/inatl/longterm/worldref/country/india.htm>

The U.S. State Department's gopher document describing the history, government, politics and economy of India.

2. www.commercenetdia.com

<http://www.commercenetindia.com/>

Serves as complete reference Website on Indian Trade and Commerce. Contains India The Country, Indian Constitution, Indian Legal System, Indian Banking & Finance, Indian Economy, Doing Business with India, Maharashtra The Corporate State, Maharashtra Key Data 1997-98, Indian Publication on the Internet,

Indian Organization on Internet, Indian Budget 1997-98, Budget speeches, Budget reactions, Budget Analysis, Indian Copyrights & Patents, Indian Agriculture, Indian Taxation, Indian Infrastructure, India & It's neighbors, India Overview, etc.

12.2 Lakhs and Crores

There are lots of big numbers involved in the discussion of the Indian securities market. Indians usually use Indian units for a hundred thousand and ten million, even when they are using English. Such Indian units for numbers are as follows:

- *Lâkh* = Lakh = 1,00,000 = 100,000 = A hundred thousand
- *Karôr* = Crore = 1,00,00,000 = 10,000,000 = Ten million

They say ten lakh rupees instead of a million rupees. *Lâkh* and *Karôr* are conventionally spelled as “lakh” or “lac” and “crore”. They both derive from Sanskrit words. Interestingly, they do not use other local units such as *Hazâr* for a thousand, *Arab* for a billion, and *Kharb* for a hundred billions when using English. This usage of Indian numbers of units is also found in Pakistan, Bangladesh, Sri Lanka and Myanmar.

12.3 Acronyms

Every community has its own set of jargon. Indian is no exception. What is conspicuous in India is the use of a host of acronyms in conversation and writings. Some of these are unique to India and hard for average non-Indians to figure out what they stand for. Shown in Table 12.1 are acronyms (except a few) that are often used in political, economic and financial literature in India.

Table 12.1
Acronyms in Indian Capital Market

AAR	Authority for Advance Ruling	AMFI	Association of Mutual Funds of India
ACC	Associated Cement Co. Ltd.	AP	Andhra Pradesh
AI	Air India	BDC	Bad Delivery Cell
AMBI	Association of Merchant Bankers of India	BHEL	Bharat Heavy Electricals Ltd.
AMC	Asset Management Company	BJP	Bharatiya Janata Party

BOLT	BSE on-line trading system	ECS	Electronic Clearing Service
BSE	Bombay Stock Exchange	EGM	Extraordinary General Meeting
CAC	Capital Account Convertibility	EPF	Employee Provident Fund
CAGR	Compound Annual Growth Rate	F&O	Futures and Options
CARE	Credit Analysis and Research Ltd.	FB	Foreign Broker
CBDT	Central Board of Direct Taxes	FCCB	Foreign Currency Convertible Bond
CBI	Central Bureau of Investigation	FCD	Fully Convertible Debenture
CCI	Controller of Capital Issue	FCNR (B)	Foreign Currency Non-Resident Accounts (Banks)
CCPS	Cumulative Convertible Preference Share	FDI	Foreign Direct Investment
CEA	Central Electricity Authority	FERA	Foreign Exchange Regulation Act
CEPS	Cash Earning per Share	FI	Financial Institution
CERC	Central Electricity Regulatory Commission	FICCI	Federation of Indian Chambers of Commerce and Industry
CII	Confederation of Indian Industries	FII	Foreign Institution Investor
CLB	Company Law Board	FIPB	Foreign Investment Promotion Board
CMIE	Centre for Monitoring Indian Economy	FIRE	Financial Institutions Reform and Expansion Project
CP	Commercial Paper	FISE	Federation of Indian Stock Exchanges
CPI	Communist Party of Indian	FRB	Floating Rate Bond
CPI-M	Communist Party of Indian (Marxist)	GAIL	Gas Authority of India Ltd.
CRISIL	Credit Rating Information and Services of India Ltd.	GDP	Gross Domestic Product
CRR	Cash Reserve Ratio	GDR	Global Depository Receipt
CRR	Cash Reserve Requirement	GFD	Gross Fiscal Deficit
CSE	Calcutta Stock Exchange	GIC	General Insurance Corporation
DFHI	Discount & Finance House of India	GoI	Government of India
DFI	Development Financial Institution	GoISec	Government of India Security
DNR	Distinctive Number Range	HC	High Court
DoT	Department of Telecommunications	HDFC	Housing Development Finance Corporation
DRR	Debenture Redemption Reserve	IA	Indian Air Lines
DVP	Delivery versus payment	IAS	Indian Administrative Service
ECB	Euro-Convertible Bond	ICICI	Industrial Credit and Investment Corporation of India
ECB	External Commercial Borrowing	ICOR	Incremental Capital Output Ratio
ECGC	Export Credit Guarantee Corporation of India Ltd.	ICR	Initial Counter Receipt

IDBI	Industrial Development Bank of India	M RTP	Monopolies & Restrictive Trade Practices
IECG	Inter-Exchange Coordination Group	MTNL	Mahanagar Telephone Nigam Ltd
IFC(W)	International Finance Corporation (Washington)	N/w	Network
IFCI	Industrial Finance Corporation of India	NABARD	National Bank for Agricultural and Rural Development
IFDC	Infrastructure Finance Development Corporation	Natex	NSE-50 Index
IIMARP Dept.	Institutional Investors, Mergers & Acquisitions, Research & Publication Department (of the SEBI)	NBFC	Non-banking Finance Company
IICRA	Investment Information & Credit Rating Agency	NCD	Non Convertible Debenture
ILFS	Infrastructural Leasing & Financial Services	NDTL	Net Demand and Time Liabilities
INC	Indian National Congress	NEAT	National Exchange for Automated Trading
IOC	Indian Oil Corporation Limited	NEP	New Economic Policy
IPCL	Indian Petrochemical Corp. Ltd.	NHAI	National Highways Authority of India
IR	Indian Railway	NHPC	National Hydro Power Corp.
ITDC	Indian Tourism Development Corp.	Nifty	NSE-50 Index
ITI	Indian Telephone Industries	NPA	Non-performing Assets
JD	Janata Dal Party	NPC	National Planning Committee
JPC	Joint Parliamentary Committee	NPM	Net Profit Margin
L&T	Larsen & Toubro Ltd.	NR(E)RA/NR(E)	Non-Resident (External) Rupee Account
LIC	Life Insurance Corporation	NRI	Non Resident Indian
LS	Lok Sabha (Lower House)	NRNR/NR(NR)RD	Non-Resident (Non-Repatriable) Rupee Deposit
M/s	Messrs.	NSCCL	National Securities Clearing Corporation Ltd.
MAT	Minimum Alternative Tax	NSDL	National Securities Depository Limited
MF	Mutual Fund	NSE	National Stock Exchange
MMMF	Money Market Mutual Fund	NTPC	National Thermal Power Corp.
MNC	Multinational Corporation	O&M	Operation & Maintenance
MTNL	Mahanagar Telecom Nigam Ltd.	OCB	Overseas Corporate Body
MoF	Ministry of Finance	OFCD	Optionally Fully convertible Debentures
MoST	Ministry of Surface Transport	OMO	Open Market Operations
MOU	Memorandum of Understanding	ONGC	Oil and Natural Gas Corporation
MP	Madhya Pradesh	OPM	Operating Profit Margin
MPBF	Maximum Permissible Bank Finance	OTC	Over The Counter
		OTCEI	Over-The-Counter Exchange of India

PAN	Permanent Account Number	Sensex	BSE Sensitive Index (BSE-30 Index)
PCD	Partly Convertible Debenture	SFC	State Finance Corporation
PCR	Permanent Counter Receipt	SGL	Subsidiary General Ledger
PCS	Purchase Confirmation Slip	SHCIL	Stock Holding Corporation of India Ltd.
PD	Primary Dealer	SIDBI	Small Industries Development Bank of India
PDO	Public Debt	SIDC	State Industrial Development Corporation
PECVPS	Profit Earning Capacity Value per Share	SLR	Statutory Liquidity Reserve
PF	Provident Fund	Smt.	Shrimati (= Mrs.) <i>cf.</i> Shri = Mr.
PFC	Power Finance Corporation	SPN	Secured Premium Note
PFI	Public Financial Institution	SPV	Special Purpose Vehicle
PMS	Portfolio Management Scheme	SRA	Special Reserve Account
PSE	Public Sector Enterprise	SRO	Self-regulatory Organization
RAIN	Registrars' Association of India	STA	Share Transfer Agent
PSU	Public Sector Undertaking	STCI	Securities Trading Corporation of India Ltd.
RBI	Reserve Bank of India	TD	Transfer Deed
RCTC	Risk Capital and Technology Finance Corporation of India	TDICI	Technology Development and Information Company of India
RIL	Reliance Industries Ltd.	TDS	Tax Deduction at Source
RMB	Registered Merchant Banker	TELCO	Tata Engineering and Locomotive Co. Ltd.
ROC	Registrar of Companies	TFCI	Tourism Finance Corporation of India
RRB	Regional Rural Bank	TISCO	Tata Iron and Steel Co. Ltd.
RS	Rajya Sabha (Upper House)	TM	Trading Member
RTI	Registrar to an Issuer	TRAI	Telecom Regulatory Authority of India
RUW	Registered Underwriter	ULB	Urban Local Body
SAIL	Steel Authority of India Ltd.	ULCRA	Urban Land Ceiling and Regulation Act
SBI	State Bank of India	UP	Uttar Pradesh
SC	Share Certificate	UTI	Unit Trust of India
SCICI	Shipping Credit and Investment Corporation of India	VSAT	Very Small Aperture Terminal
SCRA	Securities Contracts (Regulation) Act, 1956	WDM	Wholesale Debt Market
SCS	Sale Confirmation Slip	WOS	Wholly-owned Subsidiary
SEB	State Electricity Board	ZCB	Zero Coupon Bond
SEBI	Securities & Exchange Board of India		

Appendix I

Aggregate Foreign Ownership Status of Indian Companies

<i>Restrictive Status</i>	<i>Companies</i>
Foreign ownership has reached the 30% overall limit, and no further purchase is allowed:	<ul style="list-style-type: none">• Housing Development Finance Corporation• Mastek Limited
Foreign ownership has reached the 26% threshold, and the RBI clearance is required for further purchase:	<ul style="list-style-type: none">• Infosys Ltd.
Foreign ownership has reached the 24% overall limit, and no further purchase is allowed:	<ul style="list-style-type: none">• Zee Telefilmss, Satyam Computers Ltd.• Satyam Computers Services Ltd.• Nagarjuna Constructions Ltd.• Patheja Forgings Auto Parts Manufacturing Ltd.• NIIT Ltd.• Max India Ltd.• Shivalik Projects Ltd• Polyplex Corporation Ltd.• Carrier Aircon Ltd.• Digital Equipment (India) Ltd.• Wartsila Diesel India Ltd.• Elgi Equipments Ltd.• Gujarat Ambuja Cements Ltd.
Foreign ownership has reached the 20% threshold, and the RBI clearance is required for further purchase:	<ul style="list-style-type: none">• Essel Packaging Ltd.• BFL, Software Ltd.• Paper Products Ltd.• Punjab Tractors Ltd.• TVS Suzuki Motor Cycles Ltd.• Fiat Products Ltd.• Mahavir Spinning Mills Ltd.• Oweal Spinning and Weaving Mills Ltd.• Ramco Industries Ltd.
Foreign ownership has reached the 20% overall limit, and no further purchase is allowed (public sector banks):	<ul style="list-style-type: none">• State Bank of India (SBI).

Source: RBI (Press releases dated 4 October 1997).

Appendix II

Typical Settlement Cycle on BSE*

<i>Week</i>	<i>Day</i>	<i>Activities</i>
1	Monday	The Settlement Period starts.
	Friday	The Settlement Period ends.
2	Monday	<ul style="list-style-type: none"> • The BSE issues settlement reports to its members.
	Thursday	Pay-in day <ul style="list-style-type: none"> • The selling brokers or custodians deliver shares to the clearing house. • The buying brokers or custodians deliver cheques to the clearing house.
	Friday	<ul style="list-style-type: none"> • Buying brokers' bank accounts are debited and the cheques are encashed by 10:30 a.m.
	Saturday	Pay-out day <ul style="list-style-type: none"> • The clearing house credits bank accounts of the selling brokers or custodians, and release the cheques to the selling brokers or custodians. • The clearing house releases securities to the buying brokers or custodians.
3	Monday	<ul style="list-style-type: none"> • The clearing house, on behalf of the selling brokers or custodians who have not delivered in full, puts up the short delivery for auction. Short delivery is auctioned or closed out. • The buying brokers or custodians examine delivered securities, and report bad delivery (if any) to the clearing house by 7:00 p.m.
	Tuesday	<ul style="list-style-type: none"> • The selling brokers or custodians collect the rectified delivery from the clearing house.
	Wednesday	<ul style="list-style-type: none"> • The selling brokers or custodians rectify the delivery or give non-rectification notices to the clearing house. • The selling and buying brokers sign confirmation letters for rectification and submit them to the clearing house. • The selling brokers or custodians deliver the rectified securities to the clearing house.
	Thursday	<ul style="list-style-type: none"> • The buying brokers or custodians collect the rectified delivery from the clearing house.
4	Monday	<ul style="list-style-type: none"> • If the selling brokers or custodians fail to rectify the bad delivery, the securities will be auctioned.

*This settlement cycle will take effect in January 1998. Please see Footnote 8 at Page 179.

Source: BSE.

THE INDIAN SECURITIES MARKET

A GUIDE FOR FOREIGN AND DOMESTIC INVESTORS

This is the first book to present a comprehensive overview of the operations, regulations and important developments in the Indian capital markets which both foreign and domestic investors will find immensely useful — as will the various market players and participants.

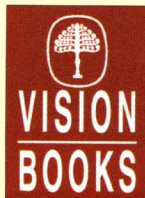
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- Indian stock exchanges: organization, membership, trading mechanism and stock indices
- Trading rules and practices for stocks and debt instruments
- Custody, settlement and clearing issues — procedures and problems
- Investing in new issues — disclosure and accounting practices of Indian companies
- Characteristics of the Indian debt market, types of debt instruments, rating agencies
- Market participants and how they operate
- Emerging developments such as electronic trading, dematerialization of stocks, depositories, stock lending and share buy-back.

Highlights for foreign investors:

- Foreign investors eligible to invest in India; investment routes and options
- Portfolio investment by foreign investors: rules, regulations and procedures
- Taxation rates and bilateral tax treaties
- Significant differences in norms and practices between India, US and UK — for instance GAAP and disclosure requirements.



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