Reforms in Indian Capital Market

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Abstract

A well-developed financial system is the backbone of any developed as well as fast developing economies. Capital market provides the financial backbone for business entities. Indian capital market has undergone tremendous changes after the establishment of Securities and Exchange Board of India (SEBI) in 1992. A number of measures are taken by SEBI, Ministry of Finance, RBI and other regulators to make Indian stock market a dependable platform for Foreign Institutional Investors (FIIs), Domestic Institutional Investors (DIs), High Net worth Individuals (HNIs) and Retail Investors. Introduction of new products also helped in inviting potential investors (foreign as well as domestic) to Indian Capital Market.

Key Words: Capital Market, SEBI, FII, Retail Investor

Introduction

Indian Capital Market is exposed to tremendous reforms in the last decade. The reforms are triggered by changes in policy by Union Government and the same is accepted and stimulated by introduction of new financial products by stock exchanges, better legal frame work by the regulator and active participation by depository participants, share brokers, domestic as well as foreign investors.

Literature Review

Senbet, Lemma, Journal of Financial & Quantitative Analysis, Sep79, Vol. 14 Issue 3 This article discusses the development of finance and investment policies for international business enterprises with a focus on international capital market equilibrium. The author argues that current valuation models do not account for realistic treatment of foreign exchange rate fluctuations, differential international interest rates, or differential international taxes. The article presents the multinational firm valuation based in the international equilibrium pricing model, discusses the impact of firm valuation and the irrelevance of financing and taxes, examines the capital structure policies of a corporation doing business in two countries, including the tradeoffs, and explores multinational capital budgeting.

Nishiotis, George P, Journal of Financial & Quantitative Analysis, Sep2004, Vol. 39 Issue 3

Using a sample of emerging market closed-end funds, the author found evidence that indirect investment barriers exert powerful effects on asset pricing differences across countries. As per the author not only do indirect investment barriers contribute to international capital market segmentation, but also they can lead to segmentation even in the absence of strong capital inflow restrictions. This result is consistent with Bekaert and Harvey's (1995) conclusion that "other markets appear segmented even though foreigners have relatively free access to their capital market". The empirical results of this paper provide a rational market segmentation explanation of both premiums and discounts in emerging market closed-end funds, and they are consistent with the deterrent effect of indirect barriers on equity flows to emerging markets found in the capital flow literature.

Wonglimpiyarat, Jarunee, European Journal of Operational Research, Jan2009, Vol. 192 Issue 1

This paper is concerned with the influence of capital market laws and initial public offering (IPO) process on venture capital. It discusses the impact of US federal state laws and Securities and Exchange Commission (SEC) regulations to the capital markets, arguing if the rules and regulations are burdensome to entrepreneurs and new-growth businesses. The impact of Sarbanes-Oxley Act and the future Investment Act on venture capital funds and entrepreneurial companies going public are also discussed. The paper proposes the model of venture capital financing describing the process from fund raising to investment exits, the linkages of the venture capital market to the financial/capital markets and the related capital market laws.

Indian Financial System

Financial system is a complex set up for any county, which includes financial institutions like banks, NBFCs (Non Banking Financial Companies), regulators, products etc. Broadly the Indian Financial System can be classified in to two heads, viz, the institutions and regulators in the filed of banking and allied services and the institution and regulators in the filed of financial market. Banking sector institutions include Reserve Bank of India, Pubic Sector Banks, Private Sector Banks, Co-operative Banks, and Foreign Banks. NBFCs and organizations like LIC, GIC etc also play a major role in the financial system. There are many national level organizations like ICICI, IDBI, IFCI etc and state level organizations like State Financial Corporations (SFCc) provide long term finance to the requirements of industry. Specialized organizations like NABARD, EXIM Bank etc also join in providing long term as well short term finance to specific sector of industry.

Financial Market constitutes the next major component of the financial system. Financial market can be classified in to money market and capital market. Money market is the market for financial instruments having a life of less than one year. Money market includes Treasury Bills, Commercial Paper, Certificate of Deposit and Call Money. Primary Market and Secondary Market constitutes the secondary market. Primary market, which is also called IPO market is the market for raising owner's equity and fresh shares are issued in the primary market. The issued shares are traded in the secondary market or stock exchange. NSE (National Stock Exchange) and BSE (Bombay Stock Exchange) are the two major stock exchanges in India for trading in financial instruments. Screen based trading and competition killed majority of old exchanges in India and now major share of trading volume is contributed by NSE and BSE.

Primary Market

IPO is the major source of raising finance for a corporate. Investor sentiment towards the corporate as well as the share price plays a major role in the success of IPOs. SEBI played a mojor role in the development of IPOs. Indian IPO market witnessed maximum growth and success from 2000 to 2007. The growth in major indices in India, viz, SENSEX and NIFTY and positive sentiment towards Indian stock market supported by domestic as well as foreign institutional investors are the main reason for the IPO boom between 2000 and 2007. This boom continued till the sub prime crises in 2008 and the investor sentiment became negative after that. The following table gives the details of IPO market in India in the last few years:

Year	No. of IPOs	Amount Raised (Rs.in Crores)	Issue Succeeded	Issue Failed
2007	108	33,946.22	104	4
2008	39	18,339.92	36	3
2009	22	19,306.58	21	1
2010	66	36,362.18	64	2
2011	40	6,043.57	37	3
2012	27	6,865.94	25	2
2013	39	1,645.87	37	2
2014	40	1,103.10	39	1

Source; SEBI Report

Secondary Market

BSE is the oldest stock exchange in India which is stared in the year 1875. SENSEX is the index of BSE (created based on the average price movement of 50 stocks) is the representative of stock performance of the shares listed at BSE as well as considered the representative of price movement of the Indian stock market. The introduction of derivatives changed the scenario and now NSE is leading in the Indian market. MCXSX (stock trading wing of Multi Commodities Exchange which is now called Metropolitan Stock Exchange of India Ltd) also started its operation last year and it's yet to capture the market. NIFTY (which shows the average price movement of 50 stocks) and SX-40 (price movement of 40 stocks) are the indices of NSE and MCXSX respectively.

The reforms in the area of capital market can be broadly classified in to 3 heads, viz;

1. Capital Market Reforms from the angle of Regulator's
2. Capital Market Reforms from the angle of Products', and
3. Other Initiatives

All the 3 sectors contributed positively for the growth of capital market segment in India as well positively contributed to the interest of market's stakeholders.

Capital Market Reforms from the angle of Regulators

Ministry of Finance, SEBI and RBI are the major three regulators in the area of capital market. Since foreign funds play a major role in the capital market, its inflow and outflow comes under the preview of RBI.

Role of SEBI

SEBI acts as the prime regulator in the area of capital market. It's established in the year 1992 to protect the interest of investors as well as to ensure fair practice to prevail in the area of capital market. SEBI is the final word to all issue linked with capital market. SEBI monitors and controls all the actions of all market participants like stock exchanges, brokers, listed companies, FIIs, investors, financiers etc.

Securities Contracts (Regulation) Amendment Act, 2007

The Securities Contracts Regulation Act, 1956 has been amended to include securitization instruments under the definition of "securities" and provide for disclosure based regulation for issue of the securitized instruments and the procedure thereof. This has been done keeping in view that there is considerable potential in the securities market for the certificates or instruments under securitization transactions. The development of the securitized debt market is critical for meeting the humungous requirements of the infrastructure sector, particularly housing sector, in the country. Replication of the securities markets framework for these instruments would facilitate trading on stock exchanges and in turn help development of the market in terms of depth and liquidity.

Permanent Account Number (PAN)

PAN is made compulsory for dealing in stock market. It has become the unique proof of identity as well as proof of signature. This helped a lot in avoiding lots of frauds liked with IPO as well as in proper accounting of income and wealth.

IPO Grading

SEBI has made it compulsory for companies coming out with IPOs of equity shares to get their IPOs graded by at least one credit rating agency registered with SEBI from May 1, 2007. This measure is intended to provide the investor with an informed and objective opinion expressed by a professional rating agency after analyzing factors like business and financial prospects, management quality and corporate governance practices etc.

Investor Protection and Education Fund (IPEF)

SEBI has set up the Investor Protection and Education Fund (IPEF) with the purpose of investor education and related activities. SEBI has contributed a sum of Rs.10 crore toward the initial corpus of the IPEF from the SEBI General Fund. In addition following amounts will also be credited to the IPEF namely:

i. Grants and donations given to IPEF by the Central Government, State Governments or any institution approved by SEBI for the purpose of the IPEF;

ii. Interest or other income received out of the investments made from the IPEF; and

iii. Such other amount that SEBI may specify in the interests of the investors.

American Depository Receipt (ADR) & Global Depository Receipt (GDR)

Government had set up an Expert Committee under the Chairmanship of Mr. Saumitra Choudhury, Member Economic Advisory Council to Prime Minister to review the extant ADR / GDR. The committee has recently submitted its report to the Government. The recommendations of the Committee are under consideration.

Migration of Mutual Funds from Commission Based System to Fee Based System

SEBI has stipulated that since August 2009 no entry load shall be there for any mutual fund scheme and the upfront commission to distributors will be paid by the investor directly based on his assessment of various factors including the service rendered by the distributor. In order to have parity among all classes of unit holders, SEBI has mandated that no distinction among unit holders should be made based on the amount of subscription while charging exit loads. Of the exit load charged to the investor, a maximum of one percent of the redemption proceeds shall be maintained in a separate account which can be used by the Asset Management Company to pay commissions to the distributor and to take care of other marketing and selling expenses. Any balance needs to be credited to the scheme immediately. These measures are meant to protect the interests of the investor.

Strengthening of Credit Rating Agencies

In order to have a greater enforceability of the regulatory framework relating to issue of capital by companies and to streamline the disclosures while also taking into account changes in market design, the erstwhile SEBI (Disclosure and Investor Protection) guidelines (DIP Guidelines) governing public offerings were replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR). There were certain changes made in the ICDR regulations vis-a-vis the provision contained in DIP Guidelines, on account of:

(a) Removal of redundant provisions contained in DIP Guidelines,

(b) Modifications on account of change in market design, and

(c) Bringing more clarity in the existing provisions of the DIP Guidelines.

Financial Task Force (FATF)

India became the 34th country to join the Financial Action Task Force (FATF) as its full-fledged member. Action Task Force (FATF) is an inter-governmental body, responsible for setting global standards on anti-money laundering (AML) and combating the financing of terrorism (CFT). India became Observer at FATF in the year 2006. Since then, India has been working towards full-fledged Membership of FATF.

Capital Market Reforms in the angle of Products'

Products always play an important role in any market. Indian capital market has seen a positive growth in the variety of financial products introduced successfully.

Stocks – Delivery Based Trading

Delivery based stock trading is the primitive product in capital market segment. This base product is also in growth face in the last 10 years. The following table shows the movement of SENSEX in the last 5 years which is also a reason for the increase in delivery volume:

Source: www.bseindia.com

Buy Today Sell Tomorrow (BTST)

BTST is a facility provided by the stock broker with the permission of exchange. T+2 is the settlement cycle followed in India, ie, if you buy a stock today then the stock will be credited to your demat account after 2 day. For example; if you buy a stock on Monday then the stock will be credited to your account by Wednesday (provided Monday, Tuesday and Wednesday are not trading holidays). BTST provides the option to sell the stock before the stock is credited to the investors account. If any default happens in crediting the stock then the broker buys the stock through auction which makes the product riskier.

Margin Trading

Margin is day trading without actual possession of stock. The trader can make a buy/sell order in the morning and square off the transaction in the evening before the end of the trading day. The traded will gain/ loose based on the price fluctuations of that particular stock on that trading day. The trader needs to block only 20-25% of the value of the stock for availing this facility.

Mutual Funds

Mutual Funds are one of the oldest products traded in the market. Mutual Funds eliminate the basic two limitations of Indian investors, viz; lack of big money and lack of knowledge regarding the price movements. The following table shows the growth in Assets under Management (AUM) of a few major Asset Management Companies (AMCs) in India in the last few years:

Asset Under Management (Rs. In Crores)				
AMC	June - 03	Sep - 14	Change	% Change
HDFC Mutual Fund	11961	141581	129520	1082.85
ICICI Prudential Mutual Fund	12637	127664	115027	910.24
Reliance Mutual Fund	3713	122068	118355	3187.59
Birla Sunlife Mutual Fund	7307	102616	95309	1304.35
UTI Mutual Fund	16015	83250	67235	419.82
SBI Mutual Fund	3951	72850	68899	1743.83

Source: www.valueresearchonline.com

Exchange Traded Funds (ETFs)

An exchange-traded fund which is based on a basket of securities listed on various exchanges in India. ETFs in Indian stock market aim to capture the major sectors of the Indian economy by owning a diversified mix of major companies that represent the majority of the total market capitalization of the Indian economy. Currently Index ETFs, Gold ETFs and Sector-wise ETFs are traded in the Indian capital market.

Stock Derivatives

Stock Derivatives are introduced in the year 2000. This paved the way for the entry of FIIs and Domestic Institutional players in Indian Market. Both Futures and Option Contracts are traded in the Indian market. The following table shows the growth of stock based derivative trading in the Indian capital market:

Year	Turnover (Rs. in Crores)	Average Daily Turnover (Rs. in Crores)
2000 - 01	2365	11
2001 - 02	101926	410
2002 - 03	439862	1752
2003 - 04	2130610	8388
2004 - 05	2546982	10107
2005 - 06	4824174	19220
2006 - 07	7356242	29543
2007 - 08	13090477.75	52153.3
2008 - 09	11010482.2	45310.63
2009 - 10	17663664.57	72392.07
2010 - 11	29248221.09	115150.48
2011 - 12	31349731.74	125902.54
2012 - 13	31533003.96	126638.57
2013 - 14	38211408.05	152236.69
2014 - 15	27823994.39	204588.19

Source: SEBI Report

Currency Derivatives

Currency Futures is a transferable futures contract that specifies the price at which a currency can be bought or sold at a future date. Currency future contracts allow investors to hedge against foreign exchange risk. It is introduced in India in 2008. The following table shows the growth of currency future market in India:

Year	Annual Turnover (Rs. in Crores)	Average Daily Turnover (Rs. in Crores)
2008 - 2009	1,62,272.43	1,167.43
2009 - 2010	17,82,608.04	7,427.53
2010 - 2011	34,49,787.72	13,854.57
2011 - 2012	46,74,989.91	19,479.12
2012 - 2013	52,74,464.65	21,705.62
2013 - 2014	40,12,513.45	16,444.73
2014 – 2015	15,48,706.93	11,644.41

Source: SEBI Report

Commodity Derivatives

Commodity Futures provides hedging opportunity for an exporter or importer as well speculation opportunity for a trader. National Commodities and Derivatives Exchange (NSDEX) and Metropolitan Stock Exchange of India Ltd (mSXI) earlier called Multi Commodities Exchange (MCX) provides the trading platform for Commodity Future Contracts.

Interest Rate Futures

Interest Rate Futures are also introduced in the Indian Capital Market to exploit the opportunities of interest rate fluctuations.

Wholesale Debt Market (WDM)

The recession and sub-prime crises of 2008 gave a good momentum to the debt market. Since the indices were not supporting for IPO, many corporates having potential profitable projects raised debt capital from the market in the form of Debentures and Public Deposits. Debt Mutual Funds also gained importance during that period.

Capital Market Reforms – Other Initiatives

In addition to the reforms from the products and regulators angle, a few other initiatives also helped in the development of capital market. The market is made electronic which made the transactions simple and sophisticated. Majority of physical shares were converted to electronic form and screen based trading became the norm of the day.

Reforms in insurance sector also contributed positively to the growth of capital market. The norms for insurance companies regarding their investment in securities market are liberalized. SEBI has set up regional offices in metros including Chennai, which increased the confidence and reach of investors and traders. The regional offices provided a good platform for addressing grievances. SEBI also started promoting educational session for customers and appointed SEBI approved trainers for educating investors. NSE and BSE have to spend a specific percentage of their turnover as part of

Corporate Social Responsibility and they are conducting customer awareness sessions at Tier 2 and Tier 3 cities also.

Transparency has increased a lot from the investor's angle. Now all investors will be getting a mobile intimation from NSDL after every buying and selling. This helps in avoiding frauds which was earlier committed by brokers.

Future Reforms

The future of Indian capital market is expected to have a steady and long term growth potential. A few reforms are also in the pipeline under the consideration of the new government. The rules regarding External Commercial Borrowings (ECBs) are expected to be liberalized. Now there is confusion regarding the taxation rules on the income earned abroad by an Indian MNC and industry is expecting a clear favorable policy decision regarding this and outward remittance limit is also expected to be increased.

Mobile trading and internet based trading is expected to increase in the coming years. The low transaction cost and technology is expected to play a major role in the coming years.

Conclusion

Indian Capital Market is already in the growth face. A clear policy decision from government, vigilant eye from the regulators, transparency from the stock exchanges and prudent action by the brokers and financiers is the requirement of the day to maintain the growth rate on the Securities Market. A strong capital market provides the foundation for a developed economy

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